Frankfurt am Main,
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BVI[1] position paper on a new prudential framework for MiFID investment firms

The Commission launched a review of the prudential requirements of investment firms in the EU with the following objective[2]:

> *"The objective of the review is to comprehensively evaluate and, where necessary, revise the way in which capital, liquidity and other key prudential requirements apply to investment firms in the EU. It is included in the Commission's Work Programme as a REFIT-exercise mandated by Articles 493(2), 498(2), 508(2), and 508(3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation, CRR) in recognition of the fact that the current framework, which is largely focused on credit institutions, is not fully suited to all investment firms. It covers all investment firms including those identified as global or other systemically important institutions in accordance with Article 131 of Directive 2013/36/EU (Capital Requirements Directive, CRD). The review is carried out in consultation with the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA). More broadly, it forms part of the initiatives of the Commission to ensure a strong and fair Single Market with a well-functioning financial system to boost growth and jobs."*

We welcome the initiative to evaluate the appropriateness of existing prudential requirements applicable to investment firms under the CRR and CRD IV. The extraordinary number of regulatory reforms in the banking sector in the aftermath of the 2008 financial crisis has resulted in a complex legal system that is largely focused on credit institutions and that therefore requires a range of specific exemptions for non-bank entities like investment firms. **We therefore support the Commission's proposal to introduce a separate new framework in the form of a directly applicable Regulation for investment firms outside the banking requirements.** This could lead to better regulation which simplifies the application and implementation of the prudential requirements for investment firms. Separate prudential requirements, moreover, would allow a targeted supervisory process focused on the risks arising from the activities of investment firms.

In detail, however, we would like to share the following observations:

I. Scope of a new prudential regime of MiFID investment firms

A new Regulation should apply to all investment firms in the meaning of the CRR and firms defined in Article 4(1) No (2) (b) and (c) CRR (all together, hereinafter "MiFID investment firms"). This approach would create a clearer distinction between the prudential requirements of credit institutions and MiFID investment firms.

Our understanding is that the new prudential regime for investment firms shall not apply for UCITS management companies or AIF managers authorised to conduct certain MiFID services or activities. The prudential requirements of UCITS or AIF management companies are conclusively regulated by

[1] BVI represents the interests of the German fund industry at national and international level. The association promotes sensible regulation of the fund business as well as fair competition vis-à-vis policy makers and regulators. Fund companies act as trustees in the sole interest of the investor and are subject to strict regulation. Funds match funding investors and the capital demands of companies and governments, thus fulfilling an important macro-economic function. BVI's over 100 members manage assets of nearly 3 trillion euros for private investors, insurance companies, pension and retirement schemes, banks, churches and foundations. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de/en.
[2] Cf. Inception Impact Assessment of the Commission, Ref. Ares(2017)1546878 - 22/03/2017.

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Directive 2009/65/EC ("UCITS Directive") and Directive 2011/61/EC ("AIFMD"). These requirements reflect the specific risks of their special business models irrespective of whether or not they also provide MiFID services.

Moreover, we have noted that any persons for whom the MiFID does not apply (irrespective of whether there are of reasons of legal exemptions in the meaning of Article 2 of the MiFID or optional exemptions in the meaning of Article 3 of the MiFID) are also out of scope of new prudential requirements for MiFID investment firms.

II. Categorisation of MiFID investment firms

In general, one of the more specific challenges would be the question to what extent a new Regulation should apply to MiFID investment firms. MiFID investment firms have different business models and risk profiles based on differing client bases, risk appetites and risk horizons. The current prudential requirements of the CRR distinguish between eleven categories of MiFID investment firms, classified by the provided investment services and authorisation. The new proposal of the EBA with only three categories of MiFID investment firms could lead indeed to a simpler prudential regime. On the other hand, such an across-the-board approach could not be appropriate to consider the special business models and risks arising from the activities provided by the MiFID investment firms.

Germany, in particular, represents about 700 MiFID investment firms, accounting for nearly one quarter of all firms affected by the new initiative. 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. According to the EBA's analyses of the population of MiFID investment firms by category there are a total of about 870 MiFID investment firms in the EU with such a limited license. Germany, therefore, is the biggest market in this field. It is of the utmost importance to carefully analyse whether the current regime applicable to MiFID investment firms with such a limited license under the CRR and CRD is workable and effective.

In our view, there is no need for introducing stricter prudential requirements under a new Regulation in order to reflect the business models of such firms and to capture the risks faced and posed by them. Bearing in mind that the vast majority of these limited-licensed firms are relatively small sized firms and effective supervisory practices are already in place, it is questionable whether a modified regime should be enforced without practical need at this stage. **Therefore, we would like to request the Commission to clarify that limited-licensed firms are generally qualify as Class 3 investment firms for which only initial capital requirements and minimum levels of fixed overheads requirements (FOR) apply.** Because they are already subject to specific obligations relating to conduct, organisation and reporting under the MiFID and EMIR, there is no need to overrule additional governance requirements established under the CRD for these firms. **As an alternative, this could also call for an approach that the national regulators or national authorities should have the power to decide if some rules of the new system should apply to limited-licensed MiFID investment firms or not, taking into account the specific business models in each Member State.**

However, with regard to the recommendations presented by the EBA in its Opinion[3], we would like to make the following remarks:

- **Class 1 MiFID investment firms:** EBA recommends that systemic investment firms which are exposed to the same types of risk as credit institutions should be categorised as Class 1 investment firms for which the full CRD/CRR requirements should be applied. EBA also recommends that dedicated Level 2 Regulatory Technical Standards should be developed for the identification of systemic investment firms (Class 1) taking their specificities into account. In this we believe the proposed Level 1 text should be explicit.

  In this context, we do not share the EBA's concerns that large investment firms that grow into systemically important firms would have to switch regimes[4] or that can potentially have an impact on others, irrespective of their business modes or risk profile[5]. We also strongly disagree with the blanket assertion insinuated in the impact assessment of the European Commission that the current framework is not fully sensitive to risks as MiFID investment firms grow, e.g. if firms' liabilities to clients increase in terms of the amount of their assets which they hold.

  The size of a MiFID investment firm or the amount of the assets it manages is no suitable criterion to evaluate systemic risks and, as a consequence, it is not appropriate to stipulate which prudential requirements should apply. This applies all the more for asset managers. They manage the assets of their clients as trustees and as such do not enter into financial market transactions on their own books. The amount of assets managed by an asset manager, therefore, does not give an indication on whether potential systemic risks could materialise. We would like to highlight that the FSB strongly supports this view in its policy recommendations to address structural vulnerabilities from asset management activities published in January 2017.[6] While the proposed FSB recommendations for operational risk (published in 2016) focused on asset managers that are large, complex and/or provide critical services, the FSB changed its view fundamentally: The final recommendation on operational risks only calls for comprehensive and robust risk management frameworks and practices to all asset managers commensurate with the level of risks their activities may pose to the financial system. The size and the services provided by asset managers are no longer an issue.

  The criteria used for the purpose of identifying Global Systemically Important Institutions (G-SIIs) and Other Systemically Important Institutions (O-SIIs)[7], in this context, seem to be not designed to address the special business models and risks of asset managers' activities. We therefore propose to clarify that MiFID investment firms which provide investment services such as portfolio management, investment advice, the reception or transmission of orders in relation to one or more financial instruments 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 generally not classify as Class 1 investment firms. This is of utmost importance because the EBA also proposed that class 1 investment firms should be supervised by the ECB[8].

[3] https://www.eba.europa.eu/-/eba-issues-opinion-on-the-design-of-a-new-prudential-framework-for-investment-firms.
[4] Cf. paragraph 179 of the EBA's Discussion Paper, Designing a new prudential regime for investment firms (https://www.eba.europa.eu/documents/10180/1647446/Discussion+Paper+on+a+new+prudential+regime+for+Investment+Firms+(EBA-DP-2016-02).pdf).
[5] Cf. paragraph 39 of the EBA's Annex to the EBA Opinion (https://www.eba.europa.eu/documents/10180/1976637/Annex+to+the+EBA+Opinion+EBA-Op-2017-11.pdf).
[6] http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf.
[7] http://www.eba.europa.eu/documents/10180/930752/EBA-GL-2014-10+%28Guidelines+on+O-SIIs+Assessment%29.pdf/964fa8c7-6f7c-431a-8c34-82d42d112d91.
[8] https://www.eba.europa.eu/documents/10180/1756362/EBA+Opinion+on+Brexit+Issues+%28EBA-Op-2017-12%29.pdf).

- **Class 2 and 3 MiFID investment firms**: EBA recommends that other non-systemic investment firms should be classified as Class 2 or Class 3 investment firms. In this context, we very welcome the clarification (paragraph 130 of the Annex to the EBA Opinion) that the K-factor based approach excludes AuM that another firm has formally delegated and also excludes advice to support the performance of the portfolio management service. The assessment of K-factors for reasons of categorisation should be feasible for our members.

III. Group context

The CRD/CRR and the Solvency II Directive already state comprehensive prudential requirements on group level including a respective consolidated supervision by the lead group regulator. Such prudential consolidation sufficiently addresses the potential group risks stemming from the operations and/or wind-down of individual MiFID investment firm subsidiaries. Therefore, we request the Commission to clarify the following issues:

- **Recommendation 10:** It should be clarified respectively by including also specific references to insurance groups required under the Solvency II Directive. An additional regulation of investment firm-"only" (sub-) groups within banking or insurance groups would cause disproportionate administrative burden and could even lead to conflicting requirements and supervision. This is explicitly acknowledged for banking groups but not for insurance groups under Recommendation 10 of the EBA's recommendations.

- **Recommendation 8 d)** and the **first sentence of Recommendation 10** should not only generically refer to investment firms, but to EU investment firms (see the last sentence of Art. 15(1) CRR).

IV. Capital Definition

There is no obvious reason why deductions from regulatory capital should always be applied in full and should not be subject to any of the thresholds currently applied in the CRR (cf. Recommendation 15 that excludes the application of Article 48 CRR). This would constitute an unfair disadvantage in particular to investment firms with financial sector subsidiaries compared to CRR regulated entities. Therefore at least holding related thresholds should be adequately applicable. Moreover, we are unable to assess at the current stage the impact of Recommendation 13 that proposes a new composition of capital requirements. As long as the same capital definition applies for banks and investment management companies licensed under the UCITS-D and AIFMD (that references to the capital definition of the CRD/CRR), the same approach should also apply for a new regime for MiFID investment firms.

V. Capital requirements

The discussion 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 (in particular for small-sized investment firms).

Moreover, it should be considered whether or not and to what extent risks have materialised in the past. In this context, the approach stated in Article 14(4) of the Delegated Regulation (EU) No 231/2013 could be appropriate. According to this approach, the competent authority may authorise the company to provide lower 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. With regard to the German asset management sector, we have a good overview because many of our members provide us on a voluntary basis with data on losses deriving from operational risk occurrences. According to our experience 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.

VI. Other prudential requirements

All other requirements of the CRD and CRR with regard to liquidity, leverage, large exposure and corporate governance currently do not apply to MiFID investment firms with a limited license. Limited-licensed MiFID investment firms do not take investment risks (including liquidity risks) onto their balance sheets. Operational risk management standards with regard to the management of the clients' portfolios are already in place. The MiFID (and the future MiFID II) requirements already address the governance requirements in an appropriate manner. We therefore would like to point out the following issues:

1. Liquidity requirements

Recommendation 40: 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 the Commission would prefer a list of pre-defined liquid assets, the list should include bank deposits and units of open-ended investment funds too, as these are liquid or readily convertible to cash on short notice. This would also reflect the current situation of MiFID investment firms. The alignment with the proposed HQLA list defined under the Delegated Act on LCR would lead to disproportional burden and organisational expenditure as eligible criteria are extensively referring to CRR regulations being not relevant in other respects (e.g. credit ratings). A more general approach without a pre-defined list of liquid assets would give more flexibility and would better reflect the different business models and activities of MiFID investment firms. 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.[9]

In any case liquidity needs must not trigger additional license requirements. In Germany, for example, the purchase and sale of financial instruments for own account which does not constitute trading on

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

own accounts in the meaning of the MiFID investment service is also deemed to be a financial service requiring approval (proprietary business).[10]

2. Concentration risks

Large exposure risks associated with the activities of investment firms cannot be totally ruled out and should hence be subject to supervisory monitoring. However, it should be borne in mind that – unlike credit institutions – the typical activities of portfolio managers do not incur significant credit risks. Hence, the relevance of a large exposure regime (including a large exposure reporting scheme) for investment firms requires an in-depth discussion, particularly in light of the principle of proportionality. The typical activities of these firms do not incur significant credit risk. Therefore, in this business area concentration risks (including reporting) have much less importance.

3. Remuneration

We disagree with **Recommendation 59** and the suggested indistinctive application of Articles 92 and 94 CRD to risk-takers of all Class 2 investment firms. The risk profiles of MiFID investment firms differ significantly depending on their activities. In particular for limited-licensed MiFID investment firms, the full application of the banking remuneration requirements is disproportionate to the risk profile of such firms. As the EBA states itself in its discussion paper, for many investment services the remuneration depends to a larger extent on fees paid. As regards the management of client assets, the specific risk appetite and framework is laid down in the investment management agreement with the client and determined by the client. Moreover, it must be noted that that all investment firms already comply with MiFID remuneration requirements and, as such, have remuneration policies in place that are appropriately considering the protection of consumers. Therefore limited-licensed firms should be treated like Class 3 firms (Recommendation 59 c) or at least the different risk profiles of investment firms should be recognised by a clarification that remuneration requirements should apply on a proportionate basis. Consequently, it should be clarified that the suggestion to consider a bonus cap should not apply to limited-licensed investment firms. For example, the German legislator requires MiFID investment firms with a limited license to fulfil the general remuneration requirements of the CRD (without identification of risk takers, without applying all pay-out rules). A bonus cap, moreover, does not apply. The current German approach, in our view, could be also appropriate at the European level.

VII. Transitional period

In case of extending the prudential requirements of limited-licensed MiFID investment firms, it is sufficient to implement a general transition period for the implementation (not limited to capital requirements).

VIII. Competent Authority

A completely new regime for MiFID investment firms outside the banking requirements should be clearly required under guidance of securities regulators and authorities, especially ESMA.

[10] Cf. Article 1(1a) Sentence 3 of the German Banking Act.