Frankfurt am Main,
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BVI's[1] response to the European Commission's Inception Impact Assessment on the Review of the appropriate prudential treatment for investment firms

BVI takes the opportunity to present its views on the Commission's understanding of the problem and possible solutions regarding a review of the appropriate prudential treatment of investment firms.

We welcome the initiative to evaluate the appropriateness of existing prudential requirements applicable to MiFID investment firms under the CRR and CRD IV in terms of capital, liquidity, leverage, large exposure, corporate governance etc. The extraordinary number of regulatory reforms in the banking sector in the aftermath of the 2008 financial crises has resulted in a complex legal system that is largely focused on credit institutions and that particularly requires lots of exemptions for MiFID investment firms.

We therefore support the Commission's proposal to introduce a separate new framework in the form of a directly applicable Regulation for MiFID investment firms outside the banking requirements. This could lead to better regulation which simplifies the application and implementation of the prudential requirements for MiFID investment firms. Separate prudential requirements, moreover, would allow a targeted supervisory process focused on the risks arising from the activities of investment firms.

Given that the Commission is referring to EBA's previous work[2], we would like to stress the following point: We strongly disagree with the EBA's view that the new framework 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 Directive 2011/61/EC ("AIFMD"), taking into account MiFID services.

However, we consider the following issues as a challenge for developing such a new framework:

I. For which kind of MiFID investment firms should a new Regulation apply?

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.

We understand that it could be necessary to apply special rules required by other European legislation also to certain investment firms. This can be achieved through references from the new Regulation to the relevant requirements of other Directives or Regulations. In particular, it will be necessary to determine whether and to what extent the CRR/CRD requirements should apply to certain MiFID investment

[1] BVI represents the interests of the German investment fund and asset management industry. Its 97 members manage assets of EUR 2.8 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.
[2] Cf. Inception Impact Assessment, Section D, "Consultation Strategy".

firms (please also see below under Section II). In this context, we do not share the EBA's concerns[3] that large investment firms that grow into systemically important firms would have to switch regimes. We also strongly disagree with the blanket assertion insinuated in the impact assessment 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.[4] 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)[5], 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 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 out of the scope of this framework.

Moreover, the scope of a new prudential regime should not include UCITS management companies or AIF managers which conduct certain MiFID services or activities. The prudential requirements of UCITS or AIF management companies are conclusively regulated by 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.

II. To what extent should a new Regulation apply?

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 investor bases, risk appetites and risk horizons. This could call for an approach

[3] 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).

[4] http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf.

[5] http://www.eba.europa.eu/documents/10180/930752/EBA-GL-2014-10+%28Guidelines+on+O-SIIs+Assessment%29.pdf/964fa8c7-6f7c-431a-8c34-82d42d112d91.

that the national regulators or national authorities should have the power to decide if some rules of the new system should apply to smaller sized MiFID investment firms or not, taking into account the specific business models in each Member State.

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 is a total of about 870 MiFID investment firms in the EU with such a limited licence. Germany, therefore, is the biggest market in this field. We would like to limit the following remarks only to these firms.

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 their business models and to capture the risks faced and posed by this kind of firms. Bearing in mind that the vast majority of these 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 specific need at this stage. We therefore propose to consider the following issues:

Capital requirements: MiFID investment firms with a limited license are only required to fulfill the capital requirements of Article 95(2) of the CRR. All of our members affected (and as far as we know also all other German firms with such a limited authorisation), in fact, currently apply the capital calculation method based on the fixed overheads required in Article 95(2)(b) CRR. An initiative for expanding the capital requirements of these firms can only be based on compelling reasons. We are not aware of such reasons.

The EBA’s discussion paper[6] addresses in principle operational risks which should be covered by new capital requirements. We request the Commission to assess which and in which amount operational risks could occur in the specific business models of MiFID investment firms with a limited license. The following analysis could be helpful:

- The German supervisory authority (BaFin) has established a simple calculation and reporting sheet for these firms.[7] It could be helpful to evaluate BaFin’s data base whether or not the current CRR capital requirements fulfilled by MiFID investment firms with a limited license in the past.

- It should be considered whether or not and to what extent risks have materialised in the past. The German investor compensation scheme, for instance, compensated only 22 cases of a MiFID investment firm being unable to meet its obligations to its investor clients since 1999 until the end of 2016. Only a very limited number of these compensation cases with a very low amount of compensation were MiFID investment firms with a limited license.

[6] https://www.eba.europa.eu/documents/10180/1647446/Discussion+Paper+on+a+new+prudential+regime+for+Investment+Firms+(EBA-DP-2016-02).pdf.
[7] https://www.bafin.de/SharedDocs/Downloads/DE/Formular/BA/dl_140414_meldebogen_ek_anlage_ba.pdf?__blob=publicationFile&v=1.

- 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.

Only in the case that there is a need to extend the current capital requirements to an approach based on **K-factors** to MiFID investment firms with a limited license, the forthcoming discussion should clearly distinguish 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. 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 and the AIFMD. The investment management companies are obliged to cover operational risks (such as professional liability risks) through additional own funds.[8] 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. **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 for a UCITS or AIF 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.**

We therefore appreciate that under the EBA's template for management companies authorised under the AIFMD or UCITS Directive conducting MiFID services, financial information about client money or financial instruments should be broken down by individual (services provided for a single client) and collective (services provided for collective investment undertakings such as UCITS or AIF via delegation agreements including pension funds). The data sheet for MiFID investment firms, however, does not differentiate in the same manner. We kindly ask the Commission to bear in mind that the data delivered by MiFID investment firms licensed as portfolio managers could create the impression that it covers discretionary 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 requirements on behalf of the external manager (the MiFID 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).

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. We therefore would like to point out the following issues:

[8] Cf. Article 14 of the Delegated Regulation (EU) No 231/2013 of 19 December 2012, BaFin Circular 1/2017 on the mini-mum requirements of risk management for investment management companies.

- Asset managers do not take investment risks (including liquidity risks) onto their balance sheets. In the asset management area, operational liquidity risk management standards with regard to the management of the client's portfolios are already in place.

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

- The MiFID (and the further MiFID II) requirements already address the governance requirements in an appropriate manner.

- 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 the pay-out rules). A bonus cap, moreover, does not apply. If there is a need (of which we are not aware at this stage) to extend the current CRD remuneration requirements to these firms at the European level, the proportionality principle should apply because MiFID investment firms commonly have different risk profiles, based on differing investor bases, risk appetites and risk horizons. The current German approach, in our view, could be also appropriate at the European level.

III. How burdensome would be the implementation of a new regime?

The burden of implementation of a new framework depends on the content of the new regime. There are the following issues which should be considered for MiFID investment firms with a limited license:

As long as the prudential requirements remain unchanged, the implementation burden would be reduced to a minimum. The German legislator would be obliged to amend or (in view of a directly applicable Regulation) delete the current legal requirements for MiFID investment firms. The MiFID investment firms would then be required to review and amend their internal guidelines and documentation published to clients or in marketing materials with regard to any changes in view of references to new legal requirements. Amending the documentation could lead to an administrative and cost burden, and even more so when small sized MiFID investment firms need advice from external consultants. It therefore could be helpful to implement a transition period for the implementation.

In case of extending the capital requirements to an approach based on K-factors, in general, it is not possible to calculate the impact as long as the formula is incomplete. For the time being, our members are therefore 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, the implementation effort of such a K-factor approach would probably be manageable since the factors needed for this calculation are known. The monitoring burden, however, would increase because the MiFID investment firm would be obliged to calculate the fixed overheads and the K-factor based capital requirements. Size-based-factors such as assets under management, however, could be very volatile. This could lead to the situation that the MiFID investment firm is obliged to retain extra capital in avoiding additional capital commitments by their owners on a regular basis.

Because asset managers with a limited license are not required to fulfil most of the CRR reporting requirements, we are not aware of any excessive burden for such firms arising from the current regulatory reporting regime.

IV. 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.