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FESE views on the Review of the Prudential Framework for Investment Firms

1. Introduction

The Federation of European Securities Exchanges (FESE) represents 33 exchanges in equities, bonds, derivatives and commodities through 18 Full Members from 27 countries, as well as 1 Affiliate Member and 1 Observer Member.

At the end of 2017, FESE members had 8,456 companies listed on their markets, of which 12% are foreign companies contributing towards the European integration and providing broad and liquid access to Europe’s capital markets. Many of our members also organise specialised markets that allow small and medium sized companies across Europe to access the capital markets; 1,107 companies were listed in these specialised markets/segments in equity, increasing choice for investors and issuers.

FESE is a keen defender of the Internal Market and many of its members have become multi-jurisdictional exchanges, providing market access across multiple investor communities. FESE represents public Regulated Markets. Regulated Markets provide both institutional and retail investors with transparent and neutral price-formation. Securities admitted to trading on our markets have to comply with stringent initial and ongoing disclosure requirements and accounting and auditing standards imposed by EU laws.

FESE is registered in the European Union Transparency Register with number 71488206456-23.

2. FESE has serious concerns regarding the impact of the proposals on market makers

FESE fully supports the aim of policy makers that financial markets should be robust, transparent and open, and that firms are well capitalised. We also welcome the underlying objective followed by the European Banking Authority (EBA) in their Opinion as well as the Commission’s legislative proposals, based on this Opinion, on designing a new prudential regime for investment firms, i.e. to categorise investment firms into three classes based on the risks they pose and to attach different capital and prudential requirements to the respective classes.

We consider that this class-based approach provides a reasonable starting point to harmonize prudential requirements within and between single classes. Based on this categorisation scheme, it is important that capital requirements are calibrated in a way which pays particular attention to the principles of prudence and proportionality in order to avoid any disruptive effects during the transitional phase from the old to the new regime and beyond.

We have concerns regarding the potential impact of the proposals on market makers and liquidity providers, as they do not appropriately accommodate risks associated with investment firms’ business activities; in particular, they do not fully recognise that investment firms may positively contribute to market liquidity and transparency. In effect, this may result in wrongly calibrated capital requirements which may – by the very design and calibration of the calculation method – disincentivise respective investment firms from providing liquidity. Furthermore, it should be kept in mind that the proposals are clearly linked to other regulatory dossiers and political projects, such as the Capital Markets Union (CMU) project, MiFID II and EMIR.

In addition, we ask the co-legislators to apply proportionality when assessing the potential implications of a lack of international consistency with other major jurisdictions. The new prudential regime for

Investment Firms should not disincentivise market makers from third countries to reduce or even cease their liquidity provision activities on European exchanges nor discriminate EU firms in global competition.

We, therefore, urge the Commission and the co-legislators to consider amendments that should appropriately reflect the limited risk market makers pose to the market, and the benefits they provide, especially in cleared derivatives markets. They should also be consistent with provisions and obligations established under other EU legislation (in particular MiFID II and EMIR), and with the objectives of the CMU project. Finally, we see some value in analysing in more depth (and beyond the sheer consideration of liquidity in itself) what effect the proposals may have on the diversity and heterogeneity of liquidity providing investment firms. We consider it essential for the effective transfer of risks among interconnected markets that there are investment firms with diverging investment horizons, trading strategies, portfolio management or risk appetite – to name just a few factors which critically and directly are subject to prudential requirements.

3. Market makers pose limited risk and play a positive role in financial markets and the CMU

In addition to large investment firms, some of which are engaged in client business with activities that may indeed be considered 'bank-like', there are also proprietary trading firms that are non-systemic and play an important role in Europe's financial markets. Proprietary traders are generally of medium or small size and are non-bank like entities, which follow a business model that poses a limited risk to the market. European capital markets form an undeniably strong part of the European and global economy by providing access to capital for hundreds of thousands of companies, be it large caps or SMEs. Capital is provided by a great variety of European and international investors, ranging from local retail investors, to international pension funds, investment firms and proprietary traders. In respect of the latter, the following important points regarding their role in capital markets are worth noting in the context of the discussions on capital requirements:

- Although proprietary traders are not necessarily focused on providing long term investments, they do play a pivotal part in the **long-term resilience** (fair, orderly, safe and sound markets) and overall attractiveness of the European capital markets.

- Proprietary traders provide **liquidity to capital markets**, liquidity that is much needed in order to support a price formation process for the shares of all issuers, from SMEs through to large caps. This liquidity provides a safeguard to the markets that not only supports a stable flow, but also provides an assurance to investors that – should they need to withdraw or increase their investments – there will always be a counterpart willing to take on or provide the flow. This assurance installs confidence in investors to make choices, choices which support the growth of companies and local economies in Europe.

- In the course of their trading activity, **market makers accumulate extensive, yet balanced and effectively hedged portfolios**. Any market risk is managed by margin posted to the general clearing member, and ultimately to a CCP, as all transactions are **centrally cleared**. Moreover, these firms do not hold clients' assets or engage in deposits taking. Therefore, these entities are significantly different from other investment firms and, indeed, from credit institutions.

- Furthermore, as envisaged by the European legislator upon implementation of **MiFID II/MiFIR**, proprietary traders that are acting as market makers are under the obligation to provide liquidity on a regular and predictable basis. Even in times where other actors withdraw their investments from the market, proprietary traders are expected to be there to provide the necessary counterbalance in the market.

- This presence and the flow it underpins matters to the market as the assurance of liquidity supports a **transparent and fair price formation process** which provides end investors with the best possible price for their investments.

- In addition, **transparent liquidity in share trading** (especially where it concerns SMEs) increases the visibility of listed companies. Moreover, in cases where stock markets are supported by exchange-traded derivatives markets (ETD), launching individual equity options on shares can lead to both an augmentation in liquidity and the ready availability of hedging tools, which positively impact the visibility of the underlying company and the investor's risk management capabilities.

- Given the post MiFID II environment where it has become challenging for smaller companies to obtain coverage from **independent analysts**, visibility has become even more essential to future growth and access to capital.

- As proprietary traders are **very much global players**, there is no guarantee of continued flow to the European markets, unless there is a commercial incentive. There is a real risk that the requisite commercial incentive will be significantly reduced should the Commission Proposals on Prudential Requirements for investment firms be implemented in their current form.

While we fully support the need for **proper safeguards to ensure that trading in the market is supported by actual funds from a prudential perspective**, we feel it is important to recognize the specific role these traders play, the risks they pose to the market, and the role that central clearing has in these markets.

4. The proposals have serious shortcomings and are inconsistent with MiFID II and EMIR

The proposed Capital Requirements framework establishes a set of risks against which investment firms are required to hold own funds.

In respect of proprietary trading firms, the regime limits these risks to those the firms pose to the **market (RtM[1])** and the **firms (RtF[2])** themselves. They are not required to hold own funds to cover client risks given the nature of their activity.

While FESE welcomes this approach from a **conceptual standpoint**, we share the concerns of the proprietary trading community that the detailed methodology underpinning the approach risks delivering a disproportionate capital treatment to the detriment of efficient functioning capital markets in the EU. This is because the proposals do not measure risk - and consequently capital requirements - appropriately since they ignore the specifics of market makers' trading behaviours and do not account for market makers' business models or other regulatory obligations.

Moreover, the regime applies a **classification approach** to investment firms in order to distinguish three different categories and apply appropriate level of own funds requirements. While this is welcome, proprietary trading firms are ***de facto excluded*** from the lowest level of requirements under Class 3 simply as a result of their activities as 'dealing on own account' being defined as a Class 2 activity.

In the context of **CMU and the focus on strengthening public markets**, such an approach may – if it increases barriers to entry of new (small) proprietary trading firms – be detrimental to the overall goal.

[1] Risks to Market
[2] Risks to Firm

➢ Risks to Firm (RtF)

The retained criterion based on **'daily trading flow' (K_{DTF})** is not a suitable proxy for determining market makers' operational risk as it is likely to double or triple count transactions and risk for the purposes of own funds requirements.

FESE is of the view that this approach is at odds with **Article 17(3) MiFID II** that puts an obligation on market makers to provide liquidity on a regular and predictable basis, except in exceptional circumstances, and to enter into a binding written agreement with trading venues. These measures were introduced in MiFID II to ensure predictability and orderly and efficient functioning of markets, to reduce the risk of overreaction which can exacerbate market volatility, and to incentivise investment firms during stressed market conditions to provide liquidity. In addition to the market making schemes mandated by MiFID II, there are also additional liquidity provisions via exchanges' commercial incentives programmes. These liquidity providers provide valuable liquidity, particularly in less liquid instruments where they in fact may be the only source of liquidity, and are thus an integral part of European markets.

Recommendation: FESE believes that market making and liquidity provision activities should be properly reflected in the methodology for the classification of investment firms, as well as in the K-Factor approach to risk calculation.

➢ Risks to Market (RtM)

The framework establishes two methodologies for the calculation of own funds in respect of Risks to Market, one based on **K_{NPR} ('net position risk)** and the other on **K_{CMG} ('clearing member guaranteed')**.

The approach based on **clearing member guaranteed** is underpinned by the EMIR framework and has proven to be very resilient. Importantly, the calculation under **K_{CMG}** is more acute and accurate and therefore inherently lower. This is because the model is based on all the client's positions (globally) and delivers a single collateral requirement.

As a general point, it should also be noted that clearing firms are generally large credit institutions or investment firms which are subject inter alia to CRD IV and CRR in their own right, and that CCPs are also subject to stringent prudential requirements under EMIR.

However, the **proposed framework effectively excludes K_{CMG}** as it mandates that the methodology delivering the highest level of own funds requirements must be retained. The result will be a de facto use of **the 'net position risk' approach - K_{NPR}** as it will deliver the highest level of own funds requirements.

However, under the **K_{NPR}** approach, while CRR provides for three different methodological approaches, the most likely one that will be used will be based on the **Fundamental Review of the Trading Book (FRTB)** pursuant to the revised legislation.

The feedback FESE Members have from their proprietary trading community and General Clearing Members is that the **FRTB approach suffers from limitations in respect of the approach to netting and the absorption of shocks**. This is likely to result in increased capital needs for firms, particularly in the ETD and fixed income space. Moreover, it is unclear **whether the FRTB under K_{NPR} can fit with the philosophy** of a more tailored and proportionate capital regime, taking a broad diversity of trading landscapes into account.

FESE therefore believes that the K_{CMG} is the more suitable proxy to determine the risk posed by market makers, and should thus not be subordinated to the K_{NPR}.

In addition, the Commission proposal explicitly limits use of the K_{CMG} approach to circumstances in which the clearing member concerned is a credit institution. This is not justified on prudential grounds, given that non-bank clearing members are investment firms which are subject to CRD IV and CRR in their own right. It would lead to a concentration of clearing services in a smaller number of clearing members, which is of concern from a financial risk perspective and would reduce competition. The use of the K_{CMG} approach should also be re-calibrated so that it is based, more logically, on the initial margin requirements established by the relevant CCP (not by the internal model of the clearing member, as is currently stated in the Commission proposal).

Finally, it needs to be made clear that non-EU entities are not included in the calculations for initial capital under Article 8 of the draft Regulation as this would be incompatible with non-EU capital requirements and would unnecessarily and disproportionally complicate and increase group capital requirements.

We would also like to stress that under any new capital regime for non-bank like and systemic investment firms, a beneficial treatment of centrally cleared business should be implemented, with lower risk weight for such business as outlined in Articles 300 to 311 CRR.

Recommendation: FESE suggests that, given the diversity of the market risks resulting from different types of business models for market makers and liquidity providers trading with proprietary capital, it would be **preferable to introduce true optionality** for firms and NCAs to determine the most suitable approach to market risk capital calculations.

5. The proposals would have adverse impact on EU financial markets and should be amended

Should the legislation be adopted in the current form, it would result in a large overstatement of risks and disproportionate capital requirements for market makers. As a result, market quality and resilience will be adversely affected by possibly forcing a large group of market makers to retreat from the markets. This would disturb the price discovery process and result in decreased and less diverse liquidity and transparency, increased volatility, reduced competition in the market, and eventually increased systemic risk as trading will be concentrated only in a small number of large firms. Consequently, other market participants may face funding and hedging difficulties resulting in a further aggravation of a stressed market situation, which may spread to the wider economy very swiftly.

This sharply contradicts the intentions of the MiFID II market making ambitions to encourage more liquidity providers to offer their services, including in stressed markets. Furthermore, the reduced liquidity in capital markets will also decrease the access to public capital for SMEs and further reinforce reliance on bank funding, which is at odds with the objectives of the CMU and with the priorities set out in the Communication from the Commission on the mid-term review of the Capital Markets Union action plan to promote more diverse funding channels.

In addition, the lack of international consistency with other major jurisdictions could further aggravate these consequences, as market makers from third countries may also stop their liquidity provision activities on European exchanges, which would contribute to the further destabilisation of the European financial system as a whole.

In short, the proposed approach would thus have adverse implications on the stability, resilience, security and effective functioning of EU financial markets. Consequently, we urge the Commission and the co-legislators to amend the current proposals. The amendments should fully take into account the limited risk market makers pose to the market, and the benefits they provide, especially in cleared derivatives markets, and should also be consistent with provisions and obligations established under other EU legislation (in particular MiFID II and EMIR), and with the objectives of the CMU project.