# FESE Position Paper on IFR/D Level II

Brussels, 2nd December 2019

In the context of the review of the EU prudential regime for investment firms, FESE fully supports the objective of policymakers to ensure robust and transparent financial markets, and well-capitalised investment firms. We also agree with the principle that the prudential rules for investment firms should be appropriate, proportionate and sensitive to the specific risks of each investment firm. Indeed, for large and systemically important investment firms, particularly credit institutions, the current Level I texts appear to achieve this. However, for smaller and local investment firms, like principal trading firms, the regime would need to be proportionally calibrated in order not to hinder their market making function.

In this paper, we provide an overview of the priorities for Exchanges in the context of the prudential requirements and classifications set in the Investment Firms Regulation and Directive (IFR/IFD) for the purposes of EBA's Level II work. We base our assessment on observations regarding market making's crucial role in financial markets and the safeguards already provided by the MiFID II/R and EMIR frameworks.

FESE's main priorities reflect the importance for market making of having both a well-tailored classification regime for investment firms, especially proprietary trading firms, and capital requirements rules technically consistent across instruments, especially ETDs**.** They focus on:

- K-DTF;
- K-CMG;
- Classification; and
- Consolidation.

## 1. K-DTF

K-DTF attempts to draw a link between operational risk capital and the amount of trading an investment firm undertakes. The calculation is based on the absolute sum of buying and selling in notional terms. Market making firms play a specific role within capital markets, and generally find themselves trading frequently throughout a day in order to facilitate end-user interest. This function creates sufficient liquidity for other investment firms to transfer risk in order to achieve their financial objectives. MiFID II Art. 17 and 48 mandate the binding presence for market making firms in the most liquid futures contracts. This acknowledges just how vital firms like this are in ensuring that financial markets are liquid in all market conditions. It is therefore likely that market making firms will experience relatively high capital requirements in relation to K-DTF compared with other types of investment firms. In line of this, it is essential to safeguard well-calibrated prudential requirements to ensure that these firms will not be harmed by a possible disproportionately high capital burden.

**Coefficient adjustments for stressed markets**

K-DTF can fluctuate significantly, especially during stressed markets. Despite IFR Art. 33 mandating 9-month averaging, volume spikes can still result in volatile and disproportionate capital requirements. Market makers could be forced to stop providing liquidity at times where their liquidity provision is most needed by end-investors. Accordingly, IFR Art. 15 mandates EBA, in consultation with ESMA, to develop draft RTS to specify adjustments to the K-DTF coefficients for cash and derivatives trades in the event that, in situations of market stress, the K-DTF requirements seem overly restrictive and detrimental to financial stability. We would suggest expanding the 9-month reference period when calculating K-DTF as this would result in a better-calibrated metric. However, the Level II delegation is very narrow as per IFR Art. 15 and changing the K-DTF calculation method itself (IFR Art. 32) in such a manner is not possible at Level II.

An alternative would be to apply an adjusted scalar over the 9-month period under certain circumstances, without removing any observations. This would entail a comparison of "regular" and "exceptional" volumes to specify a certain ratio. This alternative classification should refer to the MiFID II/MiFIR RTS 8 market making concept of "exceptional circumstances" as such occurrences are rare and they involve a bilateral calibration per product day-by-day.

**Usage of an options premium**

There is a strong ecosystem of principal trading firms who specialise in performing the role of a market making. This group are fundamental to the functioning of liquid options markets. Investment managers that employ the use of options can generate higher returns, particularly when the markets are in times of stress. The mere existence of this form of derivative acts as the backbone of many other forms of investment product, allowing consumers greater choice and varied ways to manage their investments.

Consistency and proportionality are critical objectives in the context of implementing a framework that avoids unintended harm to a particular market. The provision to adjust K-DTF for interest rate products accounts for duration risk and acknowledges that not all financial products are created equal from a risk perspective.

Option products are mechanically different from their underlying futures, stock or swap instruments. An option on a futures contract or stock gives the buyer the right, but not the obligation to buy or sell the underlying asset. Therefore, to measure operational risk, meaning to change the position in an option, the holder would need to sell an option if the position is long and buy an option if the position is short. Hence, the option holder would operate rather with an option fee or a premium than with the notional of an underlying.

Thus, the maximum loss of an option, in case of holder taking an incorrect position and not being able to correct it, would be equal to the premium amount. The seller has the obligation to buy or sell the underlying asset if the buyer exercises the agreement. An option can be thought of as a contingent claim where the payout is depended on the realisation of some uncertain outcome. This is conceptually similar to the mechanics of an insurance policy.

A common use case for such a product would be an investor who owns a portfolio of shares who wishes to neutralise downside price risk. At the same time, the investor may want to continue to enjoy any future upside of the portfolio. A put option would allow this investor to protect the value of the investment portfolio for a fee. The fee is the premium of the option which is paid to the seller. If the underlying shares drop below a given threshold (the strike price), the buyer can exercise the agreement to sell the underlying, thus protecting the value of the portfolio. Whether the underlying asset is a particular stock, future or a swap instrument, the process is the same.

Hence, we believe the risk associated with options is not adequately captured in the current Level I text, and additional clarification is needed to ensure an adequate calibration. We consider that, although it would be more detrimental for options than the delta-adjustments approach, the same RTS on coefficients could also address the risk overestimation for options contracts via an options premium.

**Policy Recommendations:**

RTS should specify an operable methodology for realistic K-DTF coefficient adjustment in situations of high volatility.

RTS should specify how K-DTF needs to be calculated for exchange traded option contracts, in a realistic manner that reflects as much as possible the actual risk profile of such contracts.

## 2. K-CMG

IFR Art. 23 allows investment firms to calculate Risk-to-Market based on the margin requirements imposed by the general clearing member that is responsible for settling or clearing a trade for all positions subject to clearing, or on a portfolio basis (where the whole portfolio is subject to clearing or margining).

In order for K-CMG to be implemented successfully, the definition of portfolio is important, while the RTS should reflect operational practices by clearing firms.

**Policy Recommendations:**

The RTS should recognise the variety in models used by different general clearing members.

K-CMG should be possible to be used for trading strategies between EU and third country markets.

## 3. Classification

Proprietary trading firms, especially in their role as liquidity providers and market makers, are non-bank like entities, which follow a business model that poses a limited risk to the market. In the course of their trading activity, proprietary trading firms accumulate extensive, yet balanced and effectively hedged portfolios. It is important to point out that


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some market makers, especially in the options markets, do not close out all their individual positions, but use various options, futures and stocks to hedge exposures across their entire book. Thereby, these entities are significantly different from other investment firms. These types of proprietary trading firms as a collective group provide substantial services to the stability and liquidity of financial markets, while posing a limited risk to the markets, and thus form a crucial component of the Capital Markets Union.

Given the sensitivity of proprietary trading firms' viability to prudential requirements which are introduced with the IFR framework, we clearly welcome legislators' efforts to further strengthen the principle of proportionality when it comes to the actual calibration of capital requirements. Should capital requirements be set at disproportionate levels for proprietary trading firms, such firms will encounter difficulties in being able to continue to provide liquidity under MiFID II/R, thereby reducing the ability of EU markets to thrive in a global setting.

Consequently, we consider that, to establish a level playing field in terms of capital treatment between firms that take deposits and run complex banking operations versus principal trading firms who risk only their own capital and who compete in specific markets, principal trading firms should not be in scope of CRR2 (Class-1 Minus) as they are non-systemic firms.

**Policy recommendations:**

EBA should provide clear guidelines to NCAs on the classifications of IFs as systemic.

RTS should be based on existing EBA OS-II Guidelines and recognise the non-systemic nature of principal trading firms (and other Class-2 investment firm business models). Appropriate Investment Firms-specific ancillary indicators may be added if deemed necessary.

RTS should recognise legal netting for purpose of calculating the IFR/IFD Classification asset thresholds (EUR 15/5bn).

## 4. Consolidation

The provisions set in IFR Art. 7 seem to extend their application at a consolidated basis, globally. At the same time, unlike for banking supervision, which is all rooted in the Basel Framework, no third country has similar, stringent, extraterritorial requirements for investment firm groups.

The IFR consolidation regime at RTS level must be scoped cautiously and proportionately to investment firms' risk profiles as the non-targeted application of the framework may render European investment firms uncompetitive by:

- Over-assessing risk and overcapitalising the firms;
- Introducing incompatibilities with prudential requirements in other jurisdictions; and
- Requiring the use of metrics that are unfit for third country market structures as they are calibrated to Europe.

**Policy recommendations:**

IFR Art. 8 Group Capital Test (i.e. granting a waiver from the IFR Art. 7 requirement to consolidate and capitalise under IFR for all group wide activities globally) should be widely available as originally designed.

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| Consolidation under IFR Art. 7 should be sensible and not include locally unregulated/uncapitalised entities or activities, and disapply the K-factor calculation for American and Asian-Pacific market structures for which the K-factors are not suitable (e.g. K-DTF). |

About FESE

The Federation of European Securities Exchanges (FESE) represents 36 exchanges in equities, bonds, derivatives and commodities through 19 Full Members from 30 countries, as well as 1 Affiliate Member and 1 Observer Member.

At the end of September 2019, FESE members had 8,853 companies listed on their markets, of which 14% 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; 1,340 companies were listed in these specialised markets/segments in equity, increasing choice for investors and issuers. Through their RM and MTF operations, FESE members are keen to support the European Commission's objective of creating a Capital Markets Union.

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