Association for Financial Markets in Europe

Prudential review of Investment Firms

AFME Comments on amendments tabled by MEPs

September 2018

The following paper provides commentary on the amendments to the Commission's IFR/IFD proposals proposed by ECON MEPs. A number of these amendments represent significant changes in comparison to the Commission's original proposals. They have not yet been subject to impact assessment and would benefit from further consideration as to their functioning in practice and potential consequences on the EU's capital markets, some of which highlight below.

Any changes to the existing approach for the direct cross-border provision of certain investment services under the present equivalence regime should also consider the implications of the authorisation regimes which will ultimately prevail. The issue of appropriate access to the EU27 for 3rd country providers and EU27 firms' ability to trade with 3rd country firms need to be considered side by side, while also ensuring that the EU prudential framework effectively addresses the underlying risks of the wide variety of EU27 firms engaged in investment services in a proportionate manner.

While we appreciate the need for the co-legislators to progress rapidly on the IFR file, we invite MEPs to reflect on these matters further before proceeding to a vote in the ECON Committee.

Treatment of Class 1 investment firms

IFR Compromise J

Art 60 IFR – classification of "class 1" investment firms

AFME is supportive of the EC's proposal that systemic, bank-like investment firms carrying out MiFID activities 3 and 6 be classified as credit institutions[1]. This enables such firms (which are likely to be part of international banking groups subject to Basel standards) to remain under the CRD/R regime. It also enables SSM supervision for their Banking Union activities. Beyond this, we also think it is important for smaller investment firms belonging to a banking group and carrying out MiFID activities 3 and 6 to have the ability *to opt-in to CRD/R framework,* subject to competent authority approval. This is described in more detail in our position paper on the EC's original proposals and for which we provided suggested drafting (attached).

In terms of the classification threshold for so-called class 1 firms, it is our understanding that the Commission's intention was to apply the €30 billion asset test to *aggregated assets within the EU*. However, the ECON draft compromise J suggests that this test should be carried out at the *highest level of consolidation,* which could imply *including all group assets on a global basis*. This change is likely however to have the effect of bringing a greater number of firms than originally envisaged by the EC under the CRD/R as credit institutions, effectively

[1] Classification as a credit institution should not give rise to automatic deposit taking permission – this may require clarification of certain Member States authorisation processes – and we recommend a change be made to Art8a of the CRD to require this. See further in this paper and in attachment for more information

extending the EC's proposal beyond those firms that may be systemic to the EU or that carry out bank-like activities. The implications of this change should be analysed further before decisions are made by the ECON.

Any fixed numerical threshold in a level 1 text may, by its very nature, not always be able to capture the "most appropriate" population of firms that should be classified as systemic, bank-like firms. In its recent opinion[2] commenting on the IFR proposals the ECB suggested other criteria in addition to balance sheet size, such as revenues or measures of interconnectedness to address this concern. This is also likely to be something that will evolve over time. Supervisory discretion, such as that already provided for in the EC's proposal in CRR Art 4(1)b(iii) (new), is therefore indeed necessary to address potential circumvention or Union financial stability risks and alleviates the disadvantages of a fixed total assets threshold, as is our suggestion that firms themselves be allowed to ask for classification as a credit institution and remain on the CRD/R with the agreement of their CA. We comment on cases where further, framed supervisory discretion may also be relevant below.

New Art 4a IFD: CA discretion to subject certain investment firms to the CRD/R

As noted above, we are supportive of giving CAs the discretion to opt in to the CRR smaller investment firms carrying out MiFID activities 3 & 6, where such investment firms formally request an opt-in or where the consolidating supervisor considers this to be necessary under CRR Art 4(1)b(iii) (new). We also note however that the amendment to Art4a of the IFD in compromise J gives CAs the possibility to opt *any* investment firm in to the CRR, including those which are not systemic or do not conduct bank-like activities (i.e. MiFID activities 3 & 6). As drafted, this amendment is therefore very broad and could convey extensive powers to the CAs, potentially going beyond the original objectives of the EC's proposal. Without more context or framing around this discretion (and the accompanying proposed EBA mandate), we would think this may create issues for the level playing field between smaller, non-systemic and non—bank like entities.

We wonder if the source of ECON concerns underlying this amendment may relate to future hypothetical situations occurring where firms operating in the EU could potentially become systemic and bank-like without necessarily meeting the criteria in the IFR amended CRR Art 4(1)(b)). If this is the case, the ECON should better describe the discretionary power by giving examples of the types of situations where it might be more appropriate for a CA to subject a firm to the CRD/R rather than the IFR (while at the same time <u>not</u> subjecting it to ECB supervision for Banking Union activities). We also refer the reader to our comments on draft IFD compromise D below.

Furthermore, we wish to point out that, as currently drafted, the approach in new IFD Art 4a delegating the criteria for the basis of the CA decision to the EBA in technical standards (in conjunction with ESMA) is unlikely to work from a timing perspective as there is in practice not enough time for the EBA to finalise and the EC to adopt such an RTS and then for CAs to require or assent to the CRR before the entry into force of the IFR as currently proposed.

[2] Opinion of the ECB dated 22 August 2018

Technical issue: it is not clear if this amendment would have the desired effect of bringing such firms under CRD/R in practice as all references to investment firms in the CRD/R may have to remain in place to cater for this CA discretion.

IFR 12a – amending CRR Article 119 para 5: clarifying that the IFR is a prudential regime comparable to the CRR

We fully support this amendment which ensures that capital requirements under the CRR for exposures to IFR investment firms will remain unaffected by the present changes. This is line with the Basel agreement of December 2017.

IFD Art 8a CRD: suggested additional clarification

To avoid any national authorisation procedures potentially requiring investment firms who will, going forward, be licensed as credit institutions to take deposits (or other repayable funds from the public), we recommend a clarification to Art 8a of the CRD. We provide wording to this effect (attached) whereby it is specified that where deposit taking would be incompatible with a mandatory structural separation requirement, this should not be required in the context of credit institution authorisation.

AM 195 Directive (Rapporteur)

Re-authorisation process

We support the proposed simplification of the authorisation process for investment firms which will be classified as credit institutions (streamlined process taking existing information into account).

Other supervisory issues

IFD Compromise D

Art 35 IFD – supervisory measures (extending SSM supervision to all investment firms belonging to a 3rd country G-SIB)

As already noted, under the EC's original proposal, there is the possibility for supervisors to designate undertakings carrying out MiFID activities 3 and 6 as credit institutions even if they are below the 30 billion asset threshold at individual entity level (CRR Art 4(1)b(iii)), resulting in the criteria for direct ECB supervision being applicable to these newly designated credit institutions. The ECB supervision criteria for significant banks are sufficiently broad that they cover any circumstances where a credit institution may be of systemic relevance to the Eurozone or a domestic economy within the Eurozone. Moreover, the ECB has the ability to classify a credit institution as significant at any time to ensure that supervisory standards are applied consist[3]. It therefore does not seem necessary to change Art 35 of the IFD to enable ECB supervision of firms belong to G-SIBs if they directly carrying out activities 3 and 6 given Art 4(1)(b)(iii).

However, as it goes beyond MiFID activities (3) and (6), the amendment to Art 35 would also result, for instance, in small investment firms carrying out portfolio management (MiFID activity (4)) *always* being subject to SSM supervision, only because they belong to a G-SIB. They would however be carrying out a business very different to 'banking' and would not naturally fit under the supervisory remit of a banking supervisor of systemic/significant banks. A non-GSIB owned investment firm with a balance sheet close to, but under, 30 billion carrying out the same activity would however be subject to the supervision of the relevant national competent authority.

It is also unclear whether the amendment would actually have the effect the ECON intends - changes to the SSM's mandate in the SSM Regulation are still likely to be required to convey such supervisory powers to the ECB (cf the EC's original proposal to reclassify certain investment firms as credit institutions as per the proposed changes to CRR Art 4(1) to achieve this).

Finally, if the purpose of the amendment is to provide the ECB with the possibility to supervise subsidiaries of 3rd country G-SIBs in cases where they do not carry out MiFID activities 3 or 6 but where they may ultimately be a justified reason to include them under (the CRD/R and) the ECB's supervisory remit, we suggest this be done via a well-defined extension to the originally proposed changes to CRR Art 4(1). This extension could provide some additional but framed discretion to the ECB to designate investment firms as credit institutions subject to their supervision even if they do not conduct MiFID 3 and 6 but where they could nevertheless be considered to be systemic and bank-like entities. For instance, there may be cases where a subsidiary of a third country firm engages in the reception and transmission of orders (MiFID activity (1)) with its parent which will then carry out the client activity (which may be bank-like). This may be a cause of concern if the parent is located in a 3rd country jurisdiction which is not subject to a high-quality regulatory regime, potentially creating financial stability and/and or circumvention risks. To avoid the disadvantages already discussed, the discretion needs to be framed in such a way it is clear that other types of investment firms such as those engaged in portfolio management would not fall under the scope of this discretion.

We therefore query whether this amendment is fully necessary or proportionate as proposed and there may be other means to address concerns regarding financial stability or circumvention risks.

Level of application of the requirements for investment firms belonging to banking groups

AMs 66, 67, 69, 70 Regulation (Various MEPs)

Waivers for Class 2 firms

[3] It is also AFME's recommendation that smaller investment firms be allowed to opt to remain on the CRD/R and obtain credit institution classification.

We support these amendments which extend the waiver from solo level requirements for class 3 firms to other investment firms belonging to banking groups. For instance, his will allow class 2 investment firms, such as asset managers, which belong to banking groups to continue to benefit from waivers for individual requirements as is presently the case under the CRD/R. These firms will still be included in the consolidated requirements applying to the group under the CRD/R

Links between IFR classification and the CRD5 IPU provision

Given the IFR proposal to classify class one investment firms as credit institutions, there are interlinkages between the IFR and CRD5 IPU requirement which need to be examined together to ensure the appropriate scope is put in place and that there is operational consistency of the IPU.

Third country equivalence regime

AM 28 Regulation (Rapporteur)

Exclusion of MiFID activities 3 and 6 (underwriting/dealing on own account) from the cross-border provision of MiFID services by third country firms

Provided that equivalence decisions are based on a robust assessment of regulations, AFME does not support AM 28, which would mean that a third country firm from a jurisdiction that has been granted an equivalence decision would not be able to deal on its own account or underwrite financial instruments and/or place financial instruments on a firm commitment basis without establishing a branch in the EU. We have explained our concerns with this AM in an AFME position paper available here.

This would severely limit the ability of EU-based banks, broker-dealers, asset managers, corporates and other financial market participants to deal with non-EU counterparties, to participate in deals placed by non-EU banks or to have their own issuances underwritten by non-EU providers, e.g. in order to access non-EU capital markets.

The various national regimes which today regulate the relationships between EU and non-EU market participants enable such activities and services for crucial circumstances. Especially Member States housing significant global financial market activity needed to ensure this. But these national regimes would discontinue three years after a Commission equivalence decision has been made with respect to a particular third country (Art. 46 (4), subpara. 5, 54 (1) MiFIR). They would be replaced by an EU regime which, if AM 28 is implemented, would be much more restrictive.

Limiting the ties between EU and non-EU market participants would be a severe retrograde step for EU capital markets and their connection to the world. This would disadvantage EU banks, broker-dealers and asset managers who e.g. wish to manage global funds, access global markets to finance large transactions, hedge risks including in the global markets or more generally participate in global capital markets as centres of liquidity. It would also disadvantage EU corporates who wish to operate their treasury and foreign exchange operation in a competitive way. Furthermore, it would weaken global capital flows whose strength is of importance for the systemic stability of financial markets.

DRAFT COMPROMISE L & AMs 28-36 and 296-333 (Various MEPs)

MiFIR Third Country Regime & changes to Articles 46 and 47

A number of AMs tabled by MEPs, partly reflected in draft Compromise L, seek to fundamentally redefine the scope and nature of the MiFIR third country equivalence regime. The effect of the proposed changes would be to introduce a narrower equivalence regime covering fewer investment services/activities (to be precisely defined in the legislation), with the implication that other investment services/activities are removed from the current scope of the equivalence regime. Third country firms would be required to comply with the full MiFID2/R requirements in certain areas (e.g. reporting and transparency requirements) which would no longer be subject to the equivalence assessment. The justification for some of the proposed AMs is that the EU should not defer certain aspects to the third-country rules and supervision.

AFME shares the objective to maintain a level playing field between EU firms and third country firms. We believe that an effective, stable and proportionate equivalence regime can bring benefits including increased competition, increased capital flow and increased choice for investors in Europe while preserving fairness of treatment between EU firms and third country firms.

The proposed AMs raise concerns in our view. They would potentially:

- Weaken the relevance of the EU equivalence regime by narrowing the scope of equivalence and removing key investment services/activities from equivalence assessments;
- Give rise to questions about extraterritoriality, legal certainty and duplicative regulatory and supervisory regimes;

As expressed in our position paper, AFME is of the view that it is necessary to undertake a "detailed and granular" assessment of equivalence where the investment services provided and the activities performed by third country firms are likely to be of systemic importance for the EU, as proposed by the Commission, without requiring the Commission to rely on strict line-by-line comparability in its assessments as equivalence frameworks have a track record of being effective with the use of outcomes-based approaches. We support an approach to equivalence focusing on the regulatory objectives pursued and the outcomes delivered by the third country framework in question to ensure that the financial stability, market integrity and investor protection in the EU are not put at risk.

AM 29 Regulation (Rapporteur), AM 323 & 326 (Delvaux, Fernández), AM 327 (Torvalds, Nagtegaal, Cornillet), AM 328-330 (Cornillet, Berès, Lamassoure, Sander)

Overall equivalence process & role of the EP

AFME is very supportive of the role played by the European Parliament in financial services legislation and the scrutiny of key decisions and processes. However, we believe that the ultimate decision on third country equivalence status should remain with the Commission, with an improvement in the role of the ESAs in the equivalence framework. Changing the process for the determination of third country equivalence to give the European Parliament or Council a veto right would introduce increased uncertainty and institutional complexity. We have explained our views in AFME's submission to the recent report by Brian Hayes MEP on EU relationships with third countries available here.

AMs 331-332 Regulation & 198-99 Directive (Lamassoure, Sander, Cornillet)

Reverse solicitation

The EU reverse solicitation regime is specified in the MiFID2/MiFIR framework through operative parts and supporting recitals. It is also supported by Level 3 Q&As prepared by ESMA: the investor protection Q&As under MiFID2/MiFIR (updates of 25 May 2018 and 12 July 2018) give further detail on how the regime should be applied with particular reference to the meaning of "initiates at its own exclusive initiative the provision of an investment service or activity by a third-country firm" and the delineation of new categories of investment product (which goes to the boundary between products provided before and after the entry into force of the new regime).

AFME supports the objective of preserving EU market integrity. We note that the application of ESMA Q&As is rigorously scrutinized by ESMA and national competent authorities given their practical significance to achieve a level-playing field[4]. If legislators consider it necessary to reinforce the operative (i.e. legally binding) provisions, then a possible solution would be to move any normative recital language (in this case MiFID 2 Recital 111[5] and MiFIR Recital 43[6]) into new operative provisions, without any change. This would preserve the regime as recently negotiated by the European legislators while delivering the desired increased certainty. We do not believe that it is necessary to develop an RTS or a new secondary legislation.

As a general principle, we stress the importance of consultation with market participants and the preparation of impact assessments prior to the introduction of changes to EU frameworks, particularly those as complex as MiFID2/MiFIR. We therefore strongly caution against the proposed MEP amendments and changes to the reverse solicitation framework without proper consultation and analysis of their impact on EU markets.

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[4] [1] https://www.esma.europa.eu/questions-and-answers

[5] ***MiFID Recital 111***

The provision of this Directive regulating the provision of investment services or activities by third-country firms in the Union should not affect the possibility for persons established in the Union to receive investment services by a third country firm at their own exclusive initiative. Where a third-country firm provides services at the own exclusive initiative of a person established in the Union, the services should not be deemed as provided in the territory of the Union. Where a third-country firm solicits clients or potential clients in the Union or promotes or advertises investment services or activities together with ancillary services in the Union, it should not be deemed as a service provided at the own exclusive initiative of the client.

[6] ***MiFIR Recital 43***

The provisions of this Regulation regulating the provision of services or undertaking of activities by third-country firms should not affect the possibility for persons established in the Union to receive investment services by a third-country firm at their own exclusive initiative or for Union investment firms or credit institutions to receive investment services or activities from a third-country firm at their own exclusive initiative or for a client to receive investment services from a third-country firm at their own exclusive initiative through the mediation of such a credit institution or investment firm. Where a third-country firm provides services at the own exclusive initiative of a person established in the Union, the services should not be deemed as provided in the territory of the Union. Where a third-country firm solicits clients or potential clients in the Union or promotes or advertises investment services or activities together with ancillary services in the Union, it should not be deemed as a service provided at the own exclusive initiative of the client.

Interdealer trading is an example of an important activity for the functioning of EU markets that could be negatively impacted were undue restrictions to be introduced on reverse solicitation.

AMs 333-334 Regulation (Lamassoure, Sander, Cornillet) & 196 Directive (Berès) and 197 Directive (Cornillet)

Requirements on MTFs and OTFs

We do not support these AMs, which would impose physical presence requirements on MTFs and OTFs. As noted above, we support a strengthened equivalence process instead of the introduction of new requirements on financial market infrastructures. We note that these AMs could have the effect of limiting the access of EU firms to certain markets if infrastructure providers are not willing to set up branches/subsidiaries in the EU – this would put EU firms at a disadvantage if they are not able to access infrastructures or liquidity pools in a similar capacity as global competitors.

Tick size regime for systematic internalisers

Draft Compromise K & AMs 27, 57-58, 291-293, and 335-337 Regulation (Various MEPs)

Changes to the MiFIR tick size regime for systematic internalisers

We do not support these AMs. AFME's view is that trades executed on systematic internalisers or trading venues that are above Large in Scale or that are non-price forming should not be subject to the tick size regime. We have explained our thinking in a recent paper available here.

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