David Howson
President
Cboe Europe

July 16, 2021

Mr. Jóse Manuel Campa
Chairperson
European Banking Authority

Re: Consultation Paper on Proposed Regulatory Technical Standards Relating to the Reclassification of Investment Firms as Credit Institutions

Dear Chair Campa:

Cboe Europe greatly appreciates the opportunity to respond to the European Banking Authority's ("EBA's") second consultation paper on proposed Regulatory Technical Standards relating to the reclassification of investment firms ("IFs") as credit institutions. Cboe Europe is one of the largest pan-European equities exchanges in Europe and in the coming months will launch a pan-European exchange-traded options and futures platform. Given our background and practical experience developing and maintaining financial markets we believe we are uniquely positioned to offer our feedback on the proposed RTS.

The proposed RTS sets forth the calculation methodology related to the EUR 30 billion group threshold for an IF to be required to apply for credit institution authorisation. As proposed, the RTS requires IFs when calculating assets to: 1) include the assets of affiliated non-EU entities conducting relevant MiFID II activities (i.e., "dealing on own account" or "underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis")[1] and 2) calculate these assets in accordance with International Financial Reporting Standards ("IFRS") or EU local GAAP accounting standards.

As stated in our response to the initial consultation paper on draft RTS prudential requirements for IFs,[2] we understand the importance of well-calibrated prudential regimes and the negative consequences that can arise when prudential requirements are not adequately risk-sensitive or fit for purpose.[3] It is

[1] Points (3) and (6) of Section A of Annex 1 to Directive 2014/65/EU.

[2] *See* Cboe's letter in response to the European Banking Authority draft RTS prudential requirements for investment firms, (September 4, 2020), *available at*, https://cdn.cboe.com/resources/government_relations/EBA-Response.pdf.

[3] *See e.g.,* Cboe's letter to the FSB, BCBS, CPMI, and IOSCO in response to the consultation on incentives to centrally clear over-the-counter (OTC) derivatives (September 7, 2018), *available at*, http://www.cboe.com/aboutcboe/government-relations/pdf/fsb-comment.pdf and Cboe's response to The Board of Governors of the Federal Reserve System proposed rulemaking to adopt the standardized approach for counterparty credit risk (SA-CCR) (March 19, 2019), *available at*, http://www.cboe.com/aboutcboe/government-relations/pdf/sa-ccr-comment.pdf (supporting the replacement of the current exposure method (CEM) with SA-

our belief that requiring EU IFs to account for global assets of non-EU entities when calculating the EUR 30 billion group threshold will subject certain IFs to credit institution authorisation that do not merit such a designation based on their risk profile when compared to credit institutions. Ultimately, we believe this may discourage IFs from providing services to EU markets; hinder the ability of EU IFs to compete globally; and incentivise IFs to limit liquidity provision when approaching the EUR 30 billion threshold. In short, we believe this creates a real risk that European markets become more insular, less liquid and less attractive for global investment – all to the detriment of EU investors.

To limit these negative outcomes and ensure proprietary market-making firms, in particular, are able to continue providing meaningful liquidity to European markets and to compete globally, we recommend:

1) The draft RTS be amended to allow IFs to calculate the classification threshold on the basis of the value of EU assets of EU entities.
2) To the extent the prescribed accounting methodology (IFRS or other) does not allow for the possibility of netting economically offsetting positions (long options vs. short options or options hedged via related underlying, etc.), we recommend the EBA provide additional guidance that the classification methodology allows such offsetting when calculating assets.
3) To the extent global assets remain in scope, we recommend:
    a. allowing EU IFs when calculating non-EU assets to apply the accounting standard applicable to the jurisdiction in which the non-EU entities are incorporated; and
    b. delaying the implementation of the RTS until such time as a more fulsome impact assessment has been conducted consistent with the EBA supported principle of a non-disruptive transition.

In support of these recommendations we note the following:

<u>Proprietary market-making firms are not credit institutions</u>: It is well known that the intent of IFR/IFD is to separate prudential requirements for IFs and credit institutions in recognition of the inherently different risks posed by IFs compared to credit institutions. Whereas credit institutions have clients, deposits, and large OTC portfolios, proprietary market-making firms supporting centrally-cleared exchange-traded derivatives markets have neither clients nor deposits and generally have limited OTC portfolios. Moreover, these firms are experts at managing risk, and often hold large portfolios of trading positions (resulting from providing liquidity to investor orders across hundreds or thousands of option series) that have limited risk at the end of the day as a result of hedging and offsetting positions. Credit institutions are fundamentally different entities with fundamentally different risk profiles than proprietary market-making firms. Of course we recognise that IFR/IFD was intended to treat certain IFs as credit institutions. Our concern is that the overly expansive group test will in fact lead to more IFs being caught whose activities and risk profile do not justify treatment as a credit institution.

<u>Proprietary market-making firms provide critical liquidity to listed options markets</u>: Centrally-cleared options are versatile risk management tools that can be employed by institutional and retail investors

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CCR as CEM's insensitivity to risk reduced liquidity, increased costs to investors, and a heightened possibility of market dislocation during volatile environments). We are seeking to avoid similar outcomes in the application of the new IFR/IFD regime.

to protect and enhance portfolios. While our goal is to foster a reliable and vibrant market ecosystem where diverse trading interest can compete and interact to the benefit of all investors, the contribution to public markets of proprietary market-making firms cannot be overstated. Proprietary market-making firms and the liquidity they provide are a critical component of the exchange-traded ecosystem. Listed options markets, in particular, require the support of professional liquidity providers to promote the functioning of the marketplace. This is due, in part, to the significant number of options series (i.e. contracts on the same underlying with different strike prices and expiration dates). This means, at the most basic level, professional liquidity providers help ensure that investors have a competitive bid/ask market to trade against. This is an incredibly important role when considering the fundamental purpose of derivatives markets, which is to provide a mechanism by which investors can hedge risk. Without vibrant participation by professional liquidity providers this risk transfer mechanism would be severely impaired. The draft RTS, as proposed, creates a friction that may prevent fulsome liquidity provision and, in effect, hinder the proper functioning of the risk management system.

Capital Markets Union: The draft RTS may lead to IFs that neither provide bank-like services nor have risk profiles similar to banks having to be authorised as credit institutions. There is no question that the regulatory burden of being a credit institution may cause IFs to reconsider their EU activities. This appears to be at odds with the broader political goal of developing attractive and competitive capital markets in the EU and at odds with the European Commission action plan that states that "[o]nly well-functioning, deep and integrated capital markets" can support the objectives of the CMU.[4] As noted by the European Commission's High Level Forum on the CMU, prudential requirements impact the ability of institutions to make markets.[5] The HLF recommended that market making by IFs should be supported through appropriately calibrated level II guidance under the Investment Firm Regulation/Directive. Professional liquidity providers are central to the well-functioning of capital markets, and adopting an RTS that allows IFs to fully provide liquidity to European markets is good for the development of capital markets.

Ensure netting is allowed under prescribed accounting standards: To the extent the prescribed accounting standard (IFRS or other) prevents meaningful netting of economically offsetting positions, we strongly recommend the EBA provide clear guidance that will allow IFs to apply an additional overlay to the accounting standard that will allow IFs to perform such netting when calculating assets for purposes of the threshold. The purpose of the EUR 30 billion threshold is to capture IFs that may pose a greater systemic risk by virtue of their size. Setting aside the fact that professional liquidity providers – regardless of the size of the balance sheet – do not pose risks similar to credit intuitions, if the prescribed accounting standard does not allow for appropriate and adequate netting the connection between risk and the EUR 30 billion threshold will be even more remote. Options market-making firms, for example, maintain large portfolios of positions that are significantly hedged. In order to ensure IFs aren't penalized for hedging and to ensure the threshold has an appropriate connection

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4 COM(2020)590 final.

5 *See* A New Vision for Europe's Capital Markets, Final Report of the High Level Forum on the Capital Markets Union, pg 49, (June 2020), *available at*, https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf.

to risk, we strongly believe the value of assets should be calculated on the basis of netting economically offsetting positions (e.g., long options vs. short options or options hedged via related underlying, etc.).

To the extent global assets remain in scope:

Inclusion of global assets creates unnecessary extraterritorial considerations: While the RTS technically applies to EU entities, it is undeniable that requiring an EU IF to consider global assets of affiliated non-EU entities brings forth extraterritorial considerations, such as determining which non-EU entities "carry out any of the relevant activities" (i.e., dealing on own account or underwriting), as well as applying IFRS or EU local GAAP standards to entities and assets for which an alternative accounting standard applies. To avoid additional extraterritorial complexities we recommend that if global assets remain in scope the draft RTS be amended to allow IFs when calculating non-EU assets to utilise the accounting method applicable in the jurisdiction in which the non-EU entities are incorporated.

Delay the implementation of the RTS on Classification: To the extent global assets remain in scope we strongly believe the principle of a non-disruptive transition supports a further delay of the implementation of the RTS on classification. While the Investment Firm Regulation was proposed in 2015 and passed in 2019, it's clear that for many IFs the first indication that they may need to be treated as credit institutions was when this draft RTS was published in June 2021. Given this, we do not believe it is reasonable or consistent with a non-disruptive transition to require IFs to become authorised credit institutions in the near-term. We support the EBA's recent Opinion advising supervisors not to prioritise any supervisory or enforcement action until six months after the final methodology is in place;[6] however, we also believe an additional delay beyond that period is appropriate given the potential impact on firms now in scope. Indeed, the Capital Requirements Regulation was adopted in 2013 and applied in January 2014, but wasn't fully implemented until five years later, in 2019. It is reasonable to give IFs that could be required to become credit institutions pursuant to this revised RTS significantly more time to analyse and adapt their operations as necessary.

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Cboe Europe greatly appreciates the opportunity to provide comments on the draft RTS prudential requirements for investment firms. We believe Cboe's recommendations, if adopted, will strengthen the prudential regime and help ensure European markets and European investment firms remain globally competitive. Please do not hesitate to contact us if you have questions or wish to discuss these comments further.

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[6] *See* EBA Opinion on appropriate supervisory and enforcement practices for the process of authorising investment firms as credit, *available at*, https://www.eba.europa.eu/eba-provides-clarification-implementation-new-prudential-regime-investment-firms.