Regulatory Counsel
Financial services

CALL FOR ADVICE ON THE INVESTMENT FIRMS PRUDENTIAL FRAMEWORK – RESPONSE ON THE DISCUSSION PAPER

RegCounsel Financial Services B.V.

Dear Sir(s), Madam(s),

RegCounsel Financial Services B.V. ("**Recofise**") would like to take the opportunity to respond to the EBA-ESMA Discussion Paper on the Commission Call for Advice on the investment firms prudential framework (the "**Discussion Paper**").

By way of background, Recofise is a Dutch boutique law firm specializing in Dutch and EU financial regulatory law, particularly prudential regulation. Our clients include financial institutions (including investment firms) that are active on the Dutch and international financial markets. We have extensive experience advising clients on complex legal issues regarding capital requirements, risk management and regulatory reporting (e.g., IFREP, COREP and FINREP).

In light of this, Recofise closely follows developments relating to the prudential framework applicable to investment firms, particularly concerning the upcoming report by the Commission to the Council and to the Parliament regarding multiple aspects of the IFD and IFR, which may include a legislative proposal to amend the prudential framework.

Recofise has assessed the considerations and questions in the Discussion Paper in view of its impact on the investment firms' market, drawing on our extensive experience advising clients on their compliance with the current prudential framework.

We are available to provide further explanations of our response. Our contact details are as follows:

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Sincerely,

RegCounsel Financial Services B.V.

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Table of contents

General introductory comments

The European Union ("**EU**") developed a specific prudential framework for investment firms to establish a more proportional, risk-sensitive, and appropriate regime for these businesses. This need arose because the banking prudential regime, which had since the adoption of the Capital Requirements Regulation ("**CRR**") been applied to investment firms in the EU, did not adequately address the risks they face.[1] The banking regime, shaped by the Basel framework and codified in the CRR and the Capital Requirements Directive ("**CRD IV**"), is primarily designed to secure deposit-taking functions of banks, and the impact the lending business has on the position of the banks' financiers.[2]

As early as 2015, the European Banking Authority ("**EBA**") published an initial report on the application of the prudential framework and the potential for revising it into a regime tailored to investment firms. After several reports, opinions and papers, the EU adopted the Investment Firm Regulation ("**IFR**") and the Investment Firm Directive ("**IFD**") in 2019, which became applicable in June 2021. Now, three years after the IFR and IFD became applicable, the review process has begun with a joint discussion paper from the European Securities and Markets Authority ("**ESMA**") and EBA (the "**Discussion Paper**") issued to follow up in the Call for Advice from the European Commission (EBA/DP/2024/01 3 June 2024). The Discussion Paper poses several direct questions regarding potential amendments to the IFR and IFD, while also raising other issues related to the investment firm framework to initiate broader discussion.

To provide background to our response, we briefly revisit the fundamental principles behind the IFR and IFD, recalling the key considerations that shaped this new prudential regime for investment firms.[3]

Firstly, the CRR/CRD IV regime was considered too complex and disproportionate for investment firms. Banks and investment firms, while sharing some overlapping services, are fundamentally different businesses with distinct business models. Despite this, investment firms were subject to extensive prudential rules designed primarily for banks. This led to a complex differentiation into 11 categories of investment firms under CRR/CRD IV, with some firms facing substantial capital requirements while others had minimal obligations. A significant issue was the tendency of competent authorities to "correct" capital requirements though substantial Pillar 2 add-ons.[4] Moreover, the banking prudential framework is designed to prevent bank failures in almost all foreseeable scenarios, based on the assumption that the public interest is best served by avoiding bank failures, i.e., a "going concern" approach. However, investment firms are generally smaller, less interconnected, and more easily replaced than banks. Therefore, the initial IFR/IFD framework did not seek to prevent investment failures at all costs but instead focus on facilitating an orderly wind-down without triggering market contagion, i.e., a "gone concern" approach.[5] The need for extra resources to keep an investment firm afloat in the public interest should be the exception. Consequently, the capital and liquidity requirements designed for banks resulted in a disproportionate and overly complex framework for investment firms, which the IFR/IFD sought to simplify.

Secondly, the banking prudential framework was not sufficiently risk-sensitive to specific risks faced by investment firms. Under CRR/CRD IV, firms were categorized into 11 different groups based on their activities and services. These categorizations and the associated capital requirements were based on perceived risk levels and assumptions that did not fully address the actual risks related to such activities. As a result, the banking regime imposed capital requirements on the basis of the investment services and activities undertaken by those firms, according partially to the main types of business models of the respective firms,

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1 Commission Staff Working Document, *Review of the prudential framework for investment firms: Accompanying the proposals for IFR and IFD,* (2017), p. 8; (hereinafter: "**Commission Staff Working Document**").

2 Idem.

3 See: EBA, Discussion Paper: Designing a new prudential framework for investment firms, (2016), par. 1:'*This [IFR/IFD] new framework aims to simplify the existing categorisation of investment firms and propose a single, more coherent approach to their prudential requirements. The proposed framework aims to be more proportionate and reduce the complexity compared to the existing framework [CRR/CRD IV] while at the same time increasing the risk sensitivity*.' (hereinafter: "**EBA Discussion Paper 2016**").

4 See: E.P.M. Joosen and M.L. Louisse, *Een nieuw prudentieel regime voor beleggingsondernemingen (I)*, (2018).

5 It must be noted however that with the adoption of the Final report on Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) under the Investment Firms Directive of 19 June 2023 (EBA/GL/2022/09 ESMA35-36-2621) this conceptual design became blurred as the Guidelines purported to introduce some of the elements of the bank recovery and resolution framework to apply to the sector of investment firms too.

however not fully addressing the actual risks related to such activities. After all, the requirements were still calibrated for banks, not investment firms. Moreover, this categorization focused more on the range of activities than on the scale of those activities, leading to a lack of sensitivity to the size of the businesses involved. In contrast, the IFR introduces K-factors that quantify the risks associated with each activity and its scale. As a result, under the previous regime, many competent authorities resorted to imposing significant Pillar 2 add-ons.[6]

Thirdly, the inconsistent application of the banking prudential framework to investment firms across Member States led to issues with respect to the level-playing field in Europe, the potential for regulatory arbitrage, and legal uncertainty. The most glaring example of this inconsistency was the wide variation in Pillar 2 add-ons imposed by different authorities, with some imposing more than 100% of the Pillar 1 requirement through Pillar 2.[7] This practice became so prevalent that the European Commission noted that the fallback Pillar 2 add-on was at the risk of becoming the primary method of capitalizing firms.[8]

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6 E.P.M. Joosen and M.L. Louisse, *Een nieuw prudentieel regime voor beleggingsondernemingen (I)*, (2018).

7 Commission Staff Working Document, (2017), p. 13.

8 Idem.

PART I – REVIEW OF THE INVESTMENT FIRM REGULATION

1 Categorisation of investment firms

General response

Three sub-groups of Class 1 firms

The Discussion Paper passes over the issue of categorisation of Class 1 firms, though briefly mentions this topic.[9] The 'pure' Class 1 firms with a balance sheet exceeding EUR 30 billion must obtain a licence as a credit institution under art. 4(1)(b) CRR. The rationale for this requirement is that: '*[t]he largest and most interconnected investment firms have business models and risk profiles that are similar to those of significant credit institutions. They provide 'bank-like' services and underwrite risks on a significant scale. Furthermore, systemic investment firms are large enough to, and have business models and risk profiles which, represent a threat for the stable and orderly functioning of financial markets on a par with large credit institutions.*'[10] In essence, the EU regulator has determined that the largest of firms must be directly authorised as banks and, due to their size, be supervised by the ECB[11] to manage their systemic risks. However, one can wonder to what extent such firms truly engage in bank-like activities and pose a financial stability risk, particularly as the IFR and other European sources do not provide concrete substantiation for this viewpoint.[12]

Nevertheless, the IFR Proposal includes some explanatory text, stating: '*[…] these firms typically incur and underwrite risks on a significant scale throughout the single market. Their activities expose them to credit risk, which is mainly in the form of counterparty credit risk as well as market risk for positions they take on own account, whether for their clients or themselves. They therefore constitute a greater risk to financial stability given their size and interconnectedness.*'[13] This consideration indicates the influence of a teleological element. It is evident that the IFR was drafted around the time of Brexit with, presumably, the Commission having a specific group of large UK-based firms in mind.[14] These eight firms, which together held about 80% of the total assets held by all 6000+ investment firms in the EU, engaged in all activities typically for investment banks except for deposit attraction.[15] Thus, the Class 1 category seems less about the specific characteristics of firms exceeding the EUR 30 billion threshold and more about codifying the characteristics of the firms targeted by the Commission.[16]

The new prudential regime for investment firms introduced further rules for Class 1A and Class 1B investment firms. The Class 1A firms uphold a balance sheet over EUR 15 billion. These firms must be authorized as investment firms but apply the banking prudential framework under art. 1(2) IFR. The Class 1B firms uphold a balance sheet over EUR 5 billion. These firms may be subjected to the banking prudential framework by their competent authority applying the discretion based on art. 5 IFD. The legal justification for these sub-groups has been debated, with some authors questioning its adequacy.[17]

Background of Class 1 firms

This subdivision of Class 1 firms was introduced in the presidency compromise version of the IFR. Consequently, the categorisations of Class 1A and Class 1B firms have not been extensively discussed compared to the general categorisation under IFR. However, there are some indications of the rationale behind this differentiation. For example, Recital (42) of the IFR states: '*[…] it is possible that large investment firms which are not of systemic importance but which deal on own account, underwrite financial instruments*

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9 Discussion Paper, (2024), par. 23-24

10 Recital (9) IFR.

11 IFR Proposal Explanatory Note, (2017), p. 14;

12 B.J. Nieuwenhuijzen, *IFR/IFD – een nieuw prudentieel regime voor beleggingsondernemingen*, in: Beleggingsondernemingen. Een nieuw regime na IFR/IFD (ed. I.P. Palm-Steyerberg, (2022), p. 35.

13 IFR Proposal Explanatory Note, (2017), p. 3.

14 Commission Staff Working Document, (2017), p. 4, 14-15 and fn 8; EBA, *Report on Investment Firms*, (2015), p. 90-95.

15 EBA, *Report on Investment Firms*, (2015), p. 27.

16 As also evidenced by the following passage from the IFR Proposal Explanatory Note: '*At present, these [Class 1] firms are largely concentrated in the UK but are in the process of considering plans to relocate parts of their operations to the EU-27, notably to Member States participating in the Banking Union. While this covers only a small number of firms, they nevertheless represent a sizeable share of the total assets and business volume of all investment firms in the EU.*'

17 B.J. Nieuwenhuijzen, (2021), par 383-392.

or place financial instruments on a firm commitment basis have business models and risk profiles that are similar to those of other systemic institutions. Given their size and activities, it is possible that such investment firms present some risks to financial stability and, although their conversion into credit institutions is not deemed to be appropriate in light of their nature and complexity, they should remain subject to the same prudential treatment as credit institutions.' This suggests a financial stability concern, though it remains unclear why Class 1A firms are considered systemically important or why Class 1A firms with business models similar to systemic institutions should be subjected to the banking framework. Preparatory documents leading up to the IFR and IFD do not clearly determine the systemic risks of Class 1A firms. The reasoning that dealing on own account and underwriting or placing financial instruments is bank-like seems tenuous and likely reflects the original eight UK-based firms for which Class 1 was designed even though other firms with systemic or bank-like activities may currently exist, or could emerge in the future.

Recommendations Class 1A regime

We agree with the Discussion Paper´s conclusion that further investigation is needed to analyse the Class 1A regime. Like other authors, we believe that the IFR's intent to provide a proportional and risk-sensitive regime is misaligned with the mechanic consequences of Class 1A firm qualification and the imposition of the full banking requirements. We specifically are concerned about the automatic EUR 15 billion quantitative limit in art. 1(2) IFR and advocate for a qualitative assessment under art. 5 IFD.

The EUR 15 billion threshold requires certain firms to apply the CRR/CRD IV framework solely based on balance sheet size. While the IFR acknowledges that *some* large firms *could* pose some risk to financial stability, this is not certain. The current quantitative threshold in art. 1(2) IFR is problematic, as it does not necessarily correlate fully with systemic risk, as other qualitative criteria for such assessment (e.g., interconnectedness, substitutability, cross-border footprint, etc.) are not taken into account by art. 1(2) IFR. Firms both above and below this threshold may or may not pose systemic risks. In our view, the objective can therefore be better achieved by means of a qualitative threshold. In this regard, we recall the original strong language of the EBA, i.e., that Class 1 firms are those that '*would comprise any 'bank-like' investment firms that are systemic or would otherwise present a <u>clear</u> risk to financial stability in normal conditions.'*[18]

The mechanic application of the banking framework to firms with balance sheets over EUR 15 billion may revert to an originally considered misaligned framework that does not fully address the risks posed by such firms. Firms covered by the EUR 15 billion threshold, i.e., those dealing on own account or placing instruments on a firm commitment basis, stand to gain relatively little from CRR/CRD IV application if their activities do not extend beyond these activities. Both the IFR and CRR currently use the same market risk framework, while the IFR's operational risk framework might even lead to higher capital requirements than CRR/CRD IV. Consequently, a Class 1B firm may end up with the old situation pre-IFR/IFD due to the EUR 15 billion threshold, for reasons that may be founded but that are not founded *per se*. To that end, the EBA already considered in 2015 that *'[…] due to the heterogeneity of the population, <u>criteria only based on balance sheet size may not be sufficient and could provide incorrect insights</u> when dealing with the risks an investment firm may pose to the financial system, since it does not capture, for example, intraday exposures, concentration risk, or specific business model activities.'*[19]

Therefore, we recommend removing art. 1(2) IFR as the mere transgression of the EUR 15 billion threshold does not effectively capture systemic risk or bank-like activities.

Instead, art. 5 IFD offers a more fitting approach for a significance assessment. This discretionary assessment, guided by quantitative indicators, requires competent authorities to assess a firm's systemic relevance before applying the CRR framework. Expanding on this assessment, Recital (7) of the IFD states that: '*It is possible that investment firms which deal on own account, which underwrite financial instruments or place financial instruments on a firm commitment basis on a significant scale, or which are clearing members in central counterparties, have business models and risk profiles that are similar to those of credit institutions. Given their size and activities, it is possible that such investment firms present comparable risks to financial stability as credit institutions. Competent authorities should have the option of requiring them to remain subject to the*

[18] EBA, *Report on Investment Firms*,(2015), p. 24.
[19] EBA, *Report on Investment Firms*,(2015), p. 26.

same prudential treatment as credit institutions that fall within the scope of [CRR] and to compliance with prudential supervision under [CRD IV].' A Delegated Regulation further developed these requirements,[20] containing further indicators mirroring the O-SII considerations under CRR/CRD IV. As such, art. 5 IFD allows for a discretionary assessment that adequately evaluates the bank-like characteristics of the firm's activities and their potential systemic impact.

While we recognise that discretionary assessments can create differences between Member States and therefore potentially an unlevel playing field, we believe that such assessments must be conducted objectively. To address this, firms meeting certain quantitative indicators of the art. 5 IFD regime could undergo mandatory assessments by their competent authority, with outcomes subject to EBA scrutiny. These assessments could be periodic or triggered by further breaches of indicators. This approach would ensure assessments are made and harmonised through EBA control, aligning with the IFR´s presumption that firms are not systemically important and that CRR/CRD IV requirements may not be appropriate for their business.

Q1: What would be the operational constraints of potentially removing the (EUR 5 Bn) threshold?

We believe this question is best answered by firms themselves, as they are directly impacted by such regulatory thresholds and are best positioned to provide detailed insights into the operational constraints they might face.

Q2: Would you suggest any further element to be considered regarding the thresholds used for the categorisation of Class 3 investment firms?

We do not suggest adding any further elements to the list of conditions for qualifying as a Class 3 firm. However, from a methodological perspective, we propose considering the elimination of conditions (h) and potentially reducing the quantitative thresholds in conditions (a) and/or (b).

Due to the cumulative nature of art. 12 IFR, conditions (h) and (i) only practically serve to classify certain firms as Class 2 instead of Class 3. Specifically, these are firms whose:

(a) ASA, CMH, DTF, NPR/CMG and TCD are zero;
(b) AUM is less than EUR 1.2 billion;
(c) COH is less than EUR 100 million/day for cash trades and EUR 1 billion/day for derivatives,

but whose:

(d) balance-sheet total is more than EUR 100 million and/or total annual gross revenues from investment services and activities are more than EUR 30 million.

In all other scenarios where an investment firm qualifies as Class 2 instead of Class 3 due to conditions (h) and/or (i), it does so because it also triggers other conditions under (a) to (g) of art. 12 IFR.

Consequently, in the unique scenario described above, these "large" firms only concern firms providing limited (i) portfolio management, (ii) investment advice, (iii) reception and transmission of client orders, and/or (iv) execution of order services, since their only non-zero elements could be:

- AUM, **but less than** EUR 1.2 billion; and/or
- COH, **but less than** EUR 100 million/day for cash trades and EUR 1 billion/day for derivatives.

If such a firm poses a risk warranting Class 2 classification (i.e., meaning it should consider the K-factor requirements for the calculation of its own funds requirements), we believe it would be methodologically more sound to eliminate conditions (h) and (i) and potentially reduce the quantitative thresholds under conditions (a) and/or (b) to a level that warrants Class 2 firm qualification if the conditions are not met. However, we do not see any direct reason for reducing the latter thresholds.

The IFR stipulates that firms should be considered to be Class 3 firms for the purposes of the specific prudential requirements for investment firms where they do not conduct investment services which carry a

[20] Commission Delegated Regulation (EU) 2021/2153 of 6 August 2021 supplementing Directive (EU) 2019/2034 of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria for subjecting certain investment firms to the requirements of Regulation (EU) No 575/2013.

high risk for clients, markets or themselves and where their size means they are less likely to cause widespread negative impacts for clients and markets if risks inherent in their business materialise or if they fail.[21]

However, in our view, the decisive factor to warrant Class 2 classification should be the nature of the investment services provided by the firm – such as the level of AUM and COH activities - which directly impact client risks and the firm's operational risk profile. An increased balance sheet size alone does not necessarily reflect the risk posed to clients or the market. These risks are already addressed by the FOR applicable to Class 3 firms, whose prudential purpose is to serve as a capital cushion to ensure an orderly wind-down of a firm. Therefore, firms should be classified as Class 2 based on their increased provision of investment services and corresponding risks, rather than solely due to a larger size, which would inadvertently inflate regulatory burdens without addressing the underlying risk factors.

This approach would also align the conditions for Class 3 classification (i.e., staying below the AUM and COH thresholds) with the consequences of failing to meet these conditions (i.e., facing higher own funds requirements resulting from the switch to the K-factor regime and having a high K-AUM and/or K-COH calculation). After all, a mere increase in balance size does not warrant calculation of K-factors (nor does it even necessarily increase K-factors), nor adds to prudency, if they remain zero or within the preset limits.

Therefore, we propose eliminating conditions (h) and (i) completely and decreasing the quantitative elements in conditions (a) and (b) to a level that warrants Class 2 firm qualification if the conditions are not met.

Q3: Do you have any views on the possible ways forward discussed above regarding the transition of investment firms between Class 2 and Class 3 should be introduced?

We believe that frequent reclassification of investment firms within the same financial year or over a 12-months period is undesirable as it causes uncertainty for such firms. Accordingly, we propose that, once a firm no longer meets the conditions to qualify as a Class 3 firm, it shall be a Class 2 firm for a period of at least 12 months.

To address these issues, we suggest amending art. 12(3) IFR as follows:

"3. Where an investment firm no longer meets all the conditions set out in paragraph 1, it shall cease to be a small and non-interconnected investment firm **for a period of 12 months with immediate effect**.

By way of derogation from the first subparagraph, where an investment firm no longer meets the conditions set out in points (a), (b), (h) or (i) of paragraph 1 but continues to meet the conditions set out in points (c) to (g) of that paragraph, it shall cease to be considered to be a small and non-interconnected investment firm after a **period of three months and for a period of at least 12 months**, calculated from the date on which the threshold was exceeded. The investment firm shall notify the competent authority without undue delay of any breach of a threshold."

[21] Recital (17) IFR.

2 Fixed Overheads Requirement (FOR)

Q4: Should the minimum level of the own funds requirements be different depending on the activities performed by investment firms or on firms' business model? If yes, which elements should be considered in setting such minimum?

While we acknowledge that there may be a case for varying the fixed overheads requirement ("**FOR**") based on the activities performed by investment firms or their business models, we ultimately recommend against introducing a more complex FOR resulting in higher upfront Pillar 1 capital requirements.

In favour of an activities-based FOR, we argue the following. If the FOR were to depend on the activities performed or the business model of an investment firm, those that conduct more activities (i.e., generally those with a more challenging wind-down process) would be required to hold more months of fixed overheads as own funds compared to firms with a simpler business model (i.e., those with a generally simpler wind-down process). This could make the FOR a more accurate proxy for facilitating an orderly wind-down. For instance, firms servicing many clients may face more difficulties in ceasing operations compared to those with no clients. However, for the latter firms (i.e., that deal on own account), the FOR no longer primarily addresses operational risks as it did under CRR, but rather acts as a *de facto* capital floor if the K-Factor requirement is lower, ensuring sufficient capital for an orderly wind-down.[22] Thus, a pure activities-based FOR would have to account purely for the wind-down scenario. In our experience, the size of an investment firm can also be a crucial factor in determining wind-down complexity. A large Class 2 (almost Class 1) firm would *generally* be harder to wind down than a small Class 3 firm, as it can be expected that it will have generally more, and generally more complex, relations. However, equally so, size does not necessarily express complexity in wind-down, as large firms may be equally easy to wind down when they have a simple business model. For instance, large trading firms that only deal in cleared trades through a clearing member and CCP should theoretically be fairly easily (orderly) wound down regardless of their trading book size. Conversely, a small firm with many client contracts and service agreements with other financial institutions might be fairly hard to wind down due to varying termination periods and rights. Though, these are specific cases that are a deviation of the possible general rule that larger firms are more difficult to wind down than smaller firms. Against this background, we believe there could be scope to argue in favour of calibrating the FOR based on (a) the size of the firm and (b) the investment services or activities conducted.

However, against such an activity- and size-based FOR, we argue that the approach outlined above essentially mirrors a stratified and less granular Pillar 2 assessment of a firm´s wind-down capacity. We note that the SREP Guidelines already address the adequacy of wind-down capital. In our view, such a firm-specific assessment under Pillar 2 is more suitable than any non-granular regime under Pillar 1. For example, the nuance in the size criterion is best addressed on a case-by-case analysis rather than by general rules. The K-factor regime is already designed to cover firm-specific risks related to the services and activities conducted. Introducing an activity-based variation in the FOR might duplicate the K-factor regime and hollow out the Pillar 2 assessment.

Therefore, we suggest not developing a more complicated or higher FOR on an activity based argumentation or on a general extension of the relevant period, without any fundamental argumentation (e.g., if a quantitative survey by EBA and ESMA were to indicate that the average wind-down period for investment firms exceeds three (3) months[23]) as to why such period would need to be longer.

It should be noted however that a higher generic Pillar 1 FOR requirement prevents the tailor made solutions and assessments that are purported to be made in the current regime in the context of the SREP, based on the criteria of Article 1 Delegated Regulation (EU) 2023/1668. A careful alignment of the Level 1 text and Level 2 rules should be conducted to prevent overlap or inconsistencies in approaches.

Q5: Is it necessary to differentiate the deductibles by activity or by business model for the purpose of calculating the FOR? If yes, which items should then be considered and for what reasons?

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[22] Discussion Paper, (2024), par. 47, 49-50; EBA Final Report, *On Investment Firms*, (2015), p. 60.

[23] In line with the original reasoning behind the FOR in the IFR, see: EBA Final Report, *On Investment Firms*, (2015), p. 61.

We believe that, for the same reasons mentioned in our response to Q4, it is not necessary to differentiate the deductibles by activity or business model for calculating the FOR. Introducing such differentiation would complicate the FOR unnecessarily, moving it towards a more complex model akin to the SREP assessment. Including specific business activities as deductible items would shift the FOR from its basic subtractive approach towards a more complicated (almost) additive approach, which is undesirable in our view. We recall that the subtractive approach was chosen over the additive approach as the latter was deemed impractical and less prudent than the former.[24] Therefore, we oppose including further specific deduction grounds in the RTS specifying certain aspects of the FOR ("**FOR RTS**")[25] or art. 13(4) IFR.

However, we see merit in introducing a residual general deduction ground in art. 13(4) IFR, which includes certain deduction grounds, with further specifications in the FOR RTS. These current deduction grounds are non-exhaustive, as indicated by EBA during the drafting of the FOR RTS.[26] However, in our experience, competent authorities tend to apply these grounds strictly, generally refusing deductions outside the specified list in art. 13(4) IFR or the FOR RTS. This rigidity is further exacerbated by the IFREP report, which does not clearly allow for a residual category of deduction grounds, forcing firms to appoint residual incidental costs to inappropriate entries, creating data quality issues.

To address this issue, we propose including a residual deduction ground in art. 13(4) IFR. This would allow firms to deduct variable costs not covered by the current deduction grounds. Permissions for deductions on this residual ground could be subject to supervisory approval and guided by specific EBA guidelines. This would prevent regulatory arbitrage and ensure a level playing field across Member States, though it would not stratify as much as direct inclusion in the RTS. Hence, it would provide legal certainty for firms and allow the EBA the flexibility to identify business activities deserving of specific deduction through guidelines, which if deemed necessary could then be implemented in the FOR RTS.

We concretely propose to amend art. 13(4) IFR as follows:

'*4. EBA, in consultation with ESMA, shall develop draft regulatory technical standards to supplement the calculation of the requirement referred to in paragraph 1 which includes at least the following items for deduction:*

(a) staff bonuses and other remuneration, to the extent that they depend on the net profit of the investment firm in the respective year;

(b) employees', directors' and partners' shares in profits;

(c) other appropriations of profits and other variable remuneration, to the extent that they are fully discretionary;

(d) shared commission and fees payable which are directly related to commission and fees receivable, which are included within total revenue, and where the payment of the commission and fees payable is contingent on the actual receipt of the commission and fees receivable;

(e) fees to tied agents;

(f) non-recurring expenses from non-ordinary activities;

(g) other incidental variable costs.

Competent authorities shall allow an investment firm to deduct other incidental variable costs included in sub-paragraph (g), provided that the investment firm has demonstrated to the competent authority that the item submitted for deduction cannot reasonably be identified as a fixed cost and cannot be allocated to any of the other deduction grounds included in sub-paragraphs (a) to (f) of this paragraph.

[24] EBA, *Final Report on own funds requirements for investment firms based on fixed overheads under Article 97(4) of Regulation (EU) No 575/2013 (Capital Requirements Regulation – CRR)*, (2014), p. 3-4.

[25] Commission Delegated Regulation (EU) 2022/1455 of 11 April 2022 supplementing Regulation (EU) 2019/2033 of the European Parliament and of the Council with regard to regulatory technical standards for own funds requirement for investment firms based on fixed overheads.

[26] EBA Final Report, *On the draft RTS on the implementation of the IFR/IFD*, (2020), p. 8.

EBA shall also specify for the purposes of this Article the notion of a material change.

EBA shall submit those draft regulatory technical standards to the Commission by 26 December 2020. Power is delegated to the Commission to supplement this Regulation by adopting the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1093/2010.

(5) For the purposes of sub-paragraph (g) of paragraph 4, EBA, in consultation with ESMA, shall issue guidelines specifying further the costs that competent authorities may recognise as eligible for deduction as other incidental variable costs in the calculation of the requirement referred to in paragraph 1.'

Q6: Are expenses related to tied agents material for the calculation of the FOR to the extent to require a dedicated treatment for their calculation? If yes, are the considerations provided above sufficient to cover all the relevant aspects?

We understand that the rationale behind including third-party costs incurred on behalf of the firm, including those related to tied agents, in the fixed expenses of that firm is to prevent firms from outsourcing activities to artificially lower their fixed expenses base.[27] In principle, we agree with this rationale since these costs would still be owed to third parties in a gone concern scenario. As mentioned in the Discussion Paper, the FOR serves as a gone concern capital floor, facilitating an orderly wind-down.

We recall that the prudential purpose of the FOR is to provide a "capital cushion" for an orderly wind-down of a firm. It was estimated that such a wind-down should not take significantly longer than three (3) months, hence the FOR was set at one-fourth (25%) of the fixed overheads over the past financial year. During the initial drafting of the IFR regime, the calibration of the FOR under CRR was deemed appropriate. In cases where a firm might need more than three (3) months, a Pillar 2 add-on was considered more suitable to cover wind-down capital shortcomings than further adjusting the FOR.

The capital retained under the FOR requirements is primarily meant to be used in a wind-down scenario, i.e., the capital serves to pay creditors and prevent insolvency procedures before the firm's commercial activities can be properly wound down. Therefore, including third-party fixed costs incurred on behalf of the firm should be clearly anchored in a legally enforceable obligation (e.g., an agreement). Without such an obligation, there is no reason to assume that a firm should continue to pay the third party during an orderly wind-down.

If including such costs aims to prevent regulatory arbitrage by firms that might outsource costs without remuneration, we believe the same reasoning applies. A firm that shifts fixed costs to another party without paying fair compensation (e.g., group entities making non-arms length arrangements) would naturally have lower costs. The same reasoning applies to tied agents under art. 29 MiFID II. Firms are not under a regulatory obligation to pay tied agents a fixed amount; the remuneration for services rendered by the tied agents should be clearly detailed in an agreement.[28]

We therefore propose a strict legalistic approach for including third-party costs. If there is no legally enforceable claim, these costs should not be included in the FOR. However, we do not believe that third-party costs should be included when such costs are already covered within the total expenses in the annual financial statements referred to in paragraph 1 as an expense of the investment firm for the payment of a fair compensation for the activities performed by the third party that incurred the fixed expenses.

We therefore recommend amending art. 1(5) FOR RTS as follows:

'*5. Where third parties, including tied agents, incurred fixed expenses, on behalf of the investment firms**, under a legally enforceable agreement between the investment firm and the third party,** ~~and therefore have not already been included within the total expenses in the annual financial statements referred to in paragraph 1~~, those fixed expenses shall be added to the total expenses of the investment firm**, unless those fixed expenses are already covered within the total expenses in the annual financial statements referred to in***

27 EBA Discussion Paper, (2016), p. 31.

28 ESMA, *Supervisory Briefing: On supervisory expectation in relation to firms using tied agents in the MiFID II framework,* (2022), p. 8.

paragraph 1 as an expense of the investment firm for the payment of a fair compensation for the activities performed by the third party that incurred the fixed expenses*. Where a breakdown of the third party's expenses is available, an investment firm shall add to the figure representing the total expenses only the share of those fixed expenses applicable to the investment firm. Where such a breakdown is not available, an investment firm shall add to the figure representing the total expenses only its share of the third party's expenses as it results from the business plan of the investment firm.*'

Q7: Should the FOR be calculated distinguishing the costs related to non-MiFID activities, which criteria should be considered? What kind of advantages or disadvantages would this have in practice?

In our view, the FOR should not be linked to the type of activities conducted by the firm. We reiterate that the FOR primarily serves as a capital floor to ensure an orderly wind-down of the firm, functioning as gone concern capital. As gone concern capital, it is irrelevant to differentiate between types of activities being wound down, as the entire legal entity must be wound down in such a scenario. The FOR is designed not to address significant sums of going concern capital but rather to ensure sufficient gone concern capital, based on the fundamental principle that investment firms are generally not systemically important and should be allowed to fail.

In instances where the FOR capital is used to absorb costs in an orderly wind down scenario, the process must culminate in the cessation of all commercial activities of the relevant legal entity of the firm.[29] Therefore, differentiating between activities for the purposes of FOR seems rather theoretical, as this would hinder the orderly wind-down of MiFID activities. Ultimately, creditors related to MiFID activities generally rank *pari passu* with creditors related to other services in insolvency scenarios. Hence, MiFID activity-related creditors do not have a greater entitlement to receive payments from the FOR capital than non-MiFID activity-related creditors, except where specifically provided for such subordination.

Linking the FOR to specific activities could in our view complicate the FOR-calculation process without providing substantial benefits. It could create unnecessary administrative burdens for firms and lead to inconsistencies in how firms prepare for potential wind-downs. Additionally, differentiating activities might not effectively address the practical realities of insolvency proceedings where all creditors, regardless of the type of activity, must be treated equally.

Therefore, we recommend maintaining a unified approach to calculating the FOR, without distinguishing between costs related to MiFID and non-MiFID activities. This approach ensures simplicity, clarity, and fairness in managing the capital requirements for the orderly wind-down of investment firms.

Q8: Should expenses related to fluctuation of exchange rates be included in the list of deductions for the calculation of the FOR? If yes, which criteria should be considered in addition to the ones suggested above?

We do not have any comments on this question.

[29] Which also seems to be in line with the original thinking of the IFR, see EBA Discussion Paper, (2016), p. 51.

3 Review of existing K-factors

3.1 Client Orders Handled (COH)

3.1.1 Specify the scope of K-COH and K-DTF in respect of placement services

The Discussion Paper raises the issue of ambiguity concerning the scope of K-COH, especially regarding the service of "placing of financial instruments without firm commitment".[30] The Discussion Paper argues that the IFR should clarify that the service is covered by either K-COH or, if the process is carried out on the book of the investment firm, K-DTF.[31] We believe that strictly including placement (and underwriting) services under K-COH or K-DTF could be contrary to the original design of the IFR. In this context, we recall that the EBA considered that: '*As regards the question how to treat underwriting or placement services, it has to be taken into account that the issuing sell-side probably does not need much prudential protection, if the term 'customer' applies at all. Therefore, the activities should be captured only if the firm provides services to investors by selling financial instruments to them.*'[32]

It is in our view essential to clarify that all client orders executed by a firm in its own name should be included in K-DTF. However, "placing of financial instruments without a firm commitment" should not automatically fall under K-COH, as the firm does not necessarily pose a risk to the client in such scenario.

We propose to clarify that all client orders executed by a firm <u>in its own name, i.e., as principal,</u> are included in K-DTF.

We also propose to amend the IFR to explicitly state that the "placing of financial instruments without a firm commitment" does not automatically trigger K-COH. Instead, such activities should be assessed based on their impact and whether they present risks to clients.

3.1.2 Specifically exclude name give-up transactions

In our experience, *name give-up transactions* are common in, e.g., the fixed income markets. In our view, the IFR should clarify how to treat these transactions, rather than leaving it with the current EBA Q&A:[33] '*The question of the inclusion of orders related to a 'name give up' activity in the measurement of COH therefore depends on whether this type of activity falls under one of the above-mentioned provisions. As this depends on how the transaction is carried out, the COH calculation should be performed as follows:*

- *(i) Where the investment firm receives, transmits or executes orders in relation to the transaction on behalf of the counterparties, that transaction has to be included in the COH calculation (art. 4(1)(30) of the IFR).*
- *(ii) If the investment firm takes on an arranging role in a transaction between two or more counterparties, bringing their interests together, but without any reception, transmission or execution of orders in relation to the transaction on behalf of the counterparties, that activity should not be included in the COH calculation.*
- *(iii) If a transaction is executed by the investment firm in its own name, that transaction should be excluded from the COH calculation in accordance with Article 20(2), sixth subparagraph of the IFR.'*

We note that the traditional form of a *name give-up transaction* generally falls under point (ii) and thus does not attract a risk charge for the brokering firm. The Discussion Paper suggests including a clarification of the treatment of such transactions in the IFR or, alternatively, in the Delegated Regulation with regards to RTS specifying the methods for measuring the K-factors ("**K-Factors RTS**").[34]

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30 Point (7), Section A, Annex I to MiFID II.
31 Discussion Paper, p. 32.
32 Annex to EBA Opinion (OP-2017-11), (2017), par. 135, (hereinafter: "**Annex to the Opinion**").
33 EBA Q&A 2021_6316.
34 Commission Delegated Regulation (EU) 2022/25 of 22 September 2021 supplementing Regulation (EU) 2019/2033 of the European Parliament and of the Council with regard to regulatory technical standards specifying the methods for measuring the K-factors referred to in Article 15 of that Regulation.

In our view, this aligns with the original purpose of K-COH, as, with a *name give-up transaction,* "clients" are reasonably not exposed to any significant risks due to operational failures of the firm, other than missed opportunity costs perhaps. The reason therefore is that the arranging firm is not involved in the actual conclusion of the transactions it arranges. The arranging firm merely connects parties, which if done incorrectly, at most leads to no conclusion of a transaction and a lost commission for the firm.

We propose including a clear carve-out for name give-up transactions in art. 7(2) K-Factors RTS:

"2. An investment firm shall not include orders received and transmitted in the measurement of COH where:

(a) it takes on an arranging role in a transaction between two or more counterparties, bringing their interests together, but without any reception, transmission or execution of orders in relation to the transaction on behalf of the counterparties; or

(b) it brings together two or more investors to bring about a transaction between those investors, such as in the case of corporate finance or private equity transactions."

3.1.3 Include liquidity contract activities under K-DTF

The Discussion Paper considers whether market-making activities, particularly under liquidity contracts, should be included under K-COH or K-DTF. Specifically, liquidity contracts involve arrangements where a market maker agrees with an issuer to transact in a financial instrument on its own account exclusively on behalf of the issuer during a certain period of time, with the sole purpose of enhancing the liquidity of the instrument.[35] The market maker typically receives a flat fee, and all trading gains and losses are attributed to the issuer. Such liquidity contracts cannot be regarded as *traditional* market making contracts as required under Delegated Regulation (EU) 2017/578 ("**RTS 8**").[36]

In practice, liquidity contract activities are undertaken by investment firms licensed to deal on own account that specialise in leveraging strategies (e.g., high frequency algorithmic trading strategies) for liquidity provision (i.e., market makers). The issuer provides funds (and securities) to the market maker, which performs buying and selling activities in the relevant financial instrument of the issuer within certain parameters (e.g., until the maximum amount of funds provided). The profits and losses are generally attributed to the issuer, not the market maker; however, the market maker does not act in the capacity of agent. Since the liquidity contract does not create a MiFID-client relationship or involve the firm acting as an investment firm dealing intermediary for the issuer, the activities conducted under the liquidity contract solely qualify as dealing on own account.[37] As the result of the liquidity provision exercise is attributed to the issuer after the transactions are performed, these are not trading gains or losses on behalf of the issuer but rather the costs of the liquidity provision service.

Given that the activities under a liquidity contract involve dealing on own account and not handling client orders, they should in our view be subject to market risk charges. Therefore, these activities should for operational risk purposes be included in K-DTF rather than K-COH.

We propose to amend the IFR to clarify that transactions completed under liquidity contracts are to be included in K-DTF. Specifically, we recommend including in art. 33(3) IFR or art. 10 K-Factors RTS that transactions completed under liquidity contracts are to be included in K-DTF.

3.2 Assets Under Management (AUM)

35 See for example: CESR, *Accepted Market Practice – Spain: Liquidity Contracts*, (2008).

36 Commission Delegated Regulation (EU) 2017/578 of 13 June 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards specifying the requirements on market making agreements and schemes.

37 This is supported by the fact that the liquidity contract does not constitute a relation under which the issuer engages the investment firm as an intermediary in its investment dealings. The issuer merely contracts a service related to the liquidity of its financial instrument, whereby the service is not catered towards the acquisition or disposal of the financial instrument itself. In the extension thereof, the issuer is also not entitled nor covered by any duty of care incumbent on the firm as the service in question is not an investment service as covered by MiFID II. Though the result of the liquidity provision exercise is attributed to the issuer after the transactions are performed, these are not trading gains or losses on behalf of the issuer but rather the costs of the liquidity provision service.

Q9: Should the concept of 'ongoing advice' be further specified for the purpose of calculating the K-AUM? If yes, which elements should be taken into account in distinguishing a recurring provision of investment advice from a one-off or non-recurring one?

The Discussion Paper raises the question whether the concept of "ongoing advice" needs further specification for the purpose of calculating K-AUM, and if so, what elements should be considered in distinguishing between recurring and non-recurring advice. In this context, we note that a recent Q&A of the EBA clarified when monitoring activities qualify as ongoing advice (and thus should be included in AUM), as certain technical services currently offered to investors are not straightforwardly identified as such.[38] The Q&A stipulates that:

(i) assets related to monitoring activities that involve the mere reception and aggregation of statements on the value of assets under management by other undertakings should not be included in the AUM calculation;

(ii) assets related to monitoring activities that entail advice on the portfolios, such as the analysis of the performance of an investment portfolio (e.g., comparison with benchmarks and alternative scenarios analysis), asset allocation or concierge services, should be included in the AUM calculation.

Despite this, the demarcation of "monitoring services" remains somewhat unclear in our view. For instance, it is uncertain whether (assets related to) every monitoring service that goes beyond mere reception and aggregation of statements should automatically be included in AUM or if there needs to be an explicit element of advice.

To address these uncertainties, we propose a more precise and qualitative definition of "ongoing advice" that includes the requirement for a recurring, continuous, or non-incidental obligation to provide recommendations under a contract. This definition should also explicitly go beyond mere data aggregation and require an element of implicit or explicit suggestions on portfolio or investment decisions. This aligns with MiFID II's distinction between providing mere information and providing recommendations, ensuring that only those assets covered by some sort of advisory relationship with a continuous element are included in AUM.[39]

Moreover, the Q&A suggests that if one firm provides monitoring activities and another provides advisory services, both firms should include the relevant assets in AUM. It is unclear to us whether the EBA, when referring to "monitoring activities" in this context refers to the monitoring activities under (i) above (i.e., those that involve the mere reception and aggregation of statements on the value of assets under managements) or under (ii) (i.e., those that entail advice on the portfolios). From the Q&A it appears to be the first, as the EBA refers to the potential risk of a misrepresentation or an inaccurate aggregation of the portfolios when referring to the risk of monitoring client's portfolios. This would contradict the Q&A which stipulates that assets related to such monitoring activities should not be included in the AUM calculation.

That being said, the Q&A seems to suggest double capitalisation for the same assets, which appears inconsistent with the original intent of AUM, which was determined as: '*[…] for the firm that holds the responsibility to the customer to hold the adequate level of capital related to this activity under either AIFMD/UCITS or the new prudential regime.*'

We propose the following:

(i) If a firm performs monitoring activities that involve the mere reception and aggregation of statements on the value of assets under management, those assets should not be included in the AUM calculation, regardless of whether another firm provides advisory services in respect of the same assets.

38 EBA Q&A 2022_6418.

39 ESMA, *Supervisory briefing on understanding the definition of advice under MiFID II*, (2022), p. 10.

(ii) Only the firm providing "ongoing advice" – which is directly responsible for managing the client's investment decisions – should include the assets in AUM. This is based on the premise that the advising firm bears the primary responsibility for the client's investment outcomes.

Thus, to reflect the original objective of K-AUM and the risk to the client it aims to cover, we recommend that, where ongoing investment advice and monitoring activities are performed by different firms for the same assets of a single client, only the firm providing the ongoing investment advice should include those assets in the AUM.

3.3 Daily Trading Flow (DTF)

Q10: Does the K-DTF provide a proper level of capital requirements for the provision of the services Trading on own account and execution of order on behalf of clients on account of the investment firm? If not, what elements of the calculation of the K-DTF present most challenges?

(A) Remain the current formula

Although we recognise the issues with the current K-DTF, we also believe that it is "the best of the rest". The current K-DTF is a simple and proportional mechanism that provides for a capital buffer broadly related to the risks it targets. As such, we do not oppose retaining the current K-DTF.

(B) Change the notional amount to the market value

The current K-DTF framework includes the notional amount of derivative transactions, but this measure may not accurately reflect the operational risk associated with these trades.[40] The notional amount primarily seems to serve as a supervisory tool to gauge the scale of derivative contracts cleared by firms, particularly those that frequently net out or close their positions within a trading day. However, it does in our view not effectively capture the actual financial exposure or the operational risks involved in these transactions. Thus, if the current K-DTF calculation methodology were to be maintained, we recommend using a market value-based metric.

We propose amending art. 33(2)(b) IFR to replace the "notional value" of derivative contracts with the "market value" or the "amount paid or received" for each trade.

We also suggest merging the separate coefficients for cash trades and derivative trades into a single (tiered) coefficient. This simplification will streamline the calculation and ensure consistency across different types of trades.

(C) Amend the scope of cash trades

To ensure that the K-DTF framework provides a consistent and accurate measure of operational risk, we propose clarifying the scope of transactions included under K-DTF. Currently, the K-Factors RTS specify that for cash trades, DTF should encompass transactions where a counterparty "undertakes to trade" certain instruments.[41] This wording has, in our experience, led to varying interpretations among firms, creating inconsistencies in how transactions are considered from a prudential perspective. Some firms include both settled and unsettled transactions, while others only include settled transactions. This lack of uniformity creates an unlevel playing field and introduces discrepancies in the application of capital requirements.

We propose clarifying which transactions are to be covered by the phrase "undertakes to trade" from art. 10(1) K-Factors RTS.

Q11: Would you have any examples where the calculation of the K-DTF based on comparable activities or portfolios results in very different or counterintuitive outcomes? If yes, how could the calculation of the K-DTF be improved?

We consider the industry to be best situated to provide a clear example from practice.

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40 As calculated pursuant to art. 29(3) IFR.

41 Art. 10(1)K-factors RTS.

3.4 Concentration risk in the trading book (CON)

3.4.1 Introduction

To lead up to our feedback on K-CON, we deem it necessary to include some background on this K-Factor.

K-CON addresses concentration risk related to individual or highly connected private sector counterparties when exposures to such counterparties exceed 25% of the firm's own funds.[42] This risk is addressed by means of a capital add-on, in line with the large exposures framework of the CRR.[43] K-CON should be distinguished from K-TCD, which is based on the counterparty credit risk framework of CRR[44], and primarily pertains to positions/exposures included in the trading book of investment firms dealing on own account.[45]

We recall that the K-CON framework was first formally introduced during the preparation of IFR/IFD in the Opinion of the EBA. As concentration risk was viewed through the lens of the CRR large exposure regime, K-CON lacks the detailed calibration discussion that many other K-Factors have undergone. Although K-CON intends to be a more proportional and simplified application of the CRR large exposure framework, in our view, firms face uncertainties critical to the application of the K-CON regime.[46]

3.4.2 Issue of the definition of client for the purposes of K-CON

A central issue with K-CON in our view is its scope of application. Although art. 35 *et seq.* IFR pertain to exposures towards clients, art. 4(1) IFR defines clients for purposes of Part Four (K-CON) to include <u>any</u> counterparties of the firm, i.e., a broad definition that could encompass most, if not all, transactions of the firm. Additionally, art. 36(1) and 24 IFR limit the K-CON framework to transactions in the trading book, hence to firms dealing on own account.[47] Exposures outside the trading book are excluded from both the K-CON and K-TCD frameworks.

We note that Recital (22) of the IFR considers that K-CON covers "*concentration risk in an investment firm's large exposures to specific counterparties based on the provisions of the CRR that apply to large exposures in the trading book*", clarifying that (a) K-CON stems from the CRR large exposure regime, (b) K-CON's applicability is limited to positions in the trading book, and (c) K-CON's applicability is limited to specific counterparties of the firm. As set out above, however, art. 4(1)(4) IFR changes the scope to *any* counterparty of the firm, implying an assessment of all transactions with counterparties included in the trading book. The Discussion Paper suggests this interpretation could even include cash credit or margins held at clearing members, which we believe is incorrect.

The reason therefore is that the EU legislator did not intend for all counterparties to fall under the K-CON framework, primarily evidenced by the exclusions in art. 41 IFR and the limitation to the trading book. Specifically, art. 36(1) IFR states that only transactions covered by K-NPR or K-TCD fall within K-CON.[48] Thus, both (a) positions capitalised under K-NPR and issued by any counterparty, and (b) exposure values of contracts capitalised under K-TCD, produce relevant figures for calculating K-CON. Moreover, in respect of (b), we note that cleared and exchange-traded derivatives are excluded from K-TCD, meaning most derivative positions held at clearing members are not within K-CON's scope.

By way of background, we note that there has been significant discussion on including firms' actual exposures to clearing members for deposited margins, assets, and other instruments under K-CON. E.g., this was discussed during the preparation of the IFR, with the first EBA Report in 2015 explicitly stipulating that '*the CRR large exposures regime includes <u>an exemption from the threshold limit for trade exposures and default</u>*

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42 Or specific thresholds for credit institutions or other investment firms.

43 Recital (7) and (26) IFR.

44 Recital (23) IFR.

45 Art. 24 IFR.

46 E.P.M. Joosen and M.L. Louisse, *Een nieuw prudentieel regime voor beleggingsondernemingen (II)*, (2018), p. 177; E.P.M. Joosen, *Kapitaal- en Liquiditeitseisen*, in: Beleggingsondernemingen. Een nieuw regime na IFR/IFD (ed. I.P. Palm-Steyerberg, (2022), p. 143-147.

47 Art. 24 IFR: '*K-TCD and K-CON shall be based on the transactions recorded in the trading book of an investment firm dealing on own account, whether for itself or on behalf of a client.*'

48 Annex to the Opinion, (2017), par. 269: '*For the avoidance of doubt, any item that is excluded within the methodologies prescribed for the calculation of capital requirements (i.e. for K-NPR and K-TCD) is not an exposure for the purposes of the concentration risk limit regime.*'

fund contributions to CCPs […].'[49] These exemptions, implemented in art. 400(1)(j) CRR, reflect the limited diversification options against CCPs (i.e., concentrations are inherent to the clearing business) and the generally bankruptcy-remote nature of assets held at clearing members.[50]

Under CRR, such trade exposures to clearing members are exempt from counterparty credit risk requirements (art. 305 and 306 CRR) and subsequently from the large exposure's framework (art. 400 CRR). A 2016 EBA Discussion Paper again mentioned including an exemption for clearing members exposures, though that Paper did no longer delineate between the two types of trade exposures.[51] Ultimately, the Annex to the Opinion in 2017 explicitly excluded all exposures to private sector entities with specific roles, being trade exposures arising from centrally cleared financial instruments.[52]

Although the IFR does not explicitly include such exemption, it is in our view implicitly incorporated within the K-CON framework. K-CON covers only trading book positions, and trade exposures are not the same as trading book positions. The financial instruments held by firms in bankruptcy-remote accounts at clearing members are not trade exposures, instead they form the trading book positions of the firm. Trade exposures on the other hand are, according to art. 4(1)(91) CRR, current exposures, including variation margin due to clearing members but not yet posted, and any potential future exposure of a clearing member or a client, to a CCP arising from derivatives, as well as initial margin. Under IFR, cleared derivatives are excluded from the K-TCD framework and thus from K-CON.

More specifically, whereas the Annex to the Opinion suggested a separate K-TCD charge for trade exposures *vis-à-vis* clearing members, the final IFR text does not contain this mechanism. Instead, the final text changed the proposal of the EBA to an exemption for OTC derivatives that are cleared directly or indirectly through CCPs and completely removed any reference to trade exposures from the IFR. In this sense, the K-CON framework would in our view also align with the large exposures framework of the CRR where trade exposures *vis-à-vis* clearing members are explicitly excluded.[53]

Summarising, we perceive this removal (i.e., the removal of any reference to trade exposures from the IFR) to be driven by the perception that trade exposures as such are not addressed in the IFR whatsoever, distancing the K-TCD framework from the counterparty credit risk framework of CRR. Consequently, trade exposures are in our view not captured by K-CON as these are not included in the trading book and thus not captured by K-NPR nor K-TCD. That being said, in view of the uncertainty in the market, we suggest to explicitly clarify that any trade exposures of the firm *vis-à-vis* their clearing member(s) are excluded from the scope of the K-CON and K-TCD frameworks.

3.4.3 Clarification of the concept of client

We believe that the current definition of "client" in respect of K-CON is problematic, as it is not fully clear which parties are in scope, nor which parties the legislature intended to capture, primarily due to the addition of the sentence: *'[for the purposes of K-CON], 'client' means any counterparty of the investment firm*.'[54] Based on the understanding that K-CON does not aim to capture concentration risks of firms *vis-à-vis* its clearing members, and also to connect to (i) the intention of the K-CON framework and (ii) the CRR large exposures regime, in our view, the core principle should be that, for purposes of Part Four of the IFR, a "client" means any party to whose risk of default the firm is exposed to through instruments issues by such party as included in the trading book or contracts directly concluded with such party as included in the trading book. E.g., if the firm holds shares or bonds issued by party A then it should consider such party A as a "client" for K-CON purposes, even though this party A is not a "counterparty" of the firm under the current definition of "client". The rationale behind this would be that, as a concentration of instruments issued by party A included in the trading book of the investment firm would expose the firm to the default of party A even where it would not have a direct relationship with such firm. This is in our view the core of specific market risk.

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49 EBA, *Report on Investment Firms*, (2015), p. 53.
50 EBA, *Report on Investment Firms*, (2015), p. 55.
51 EBA Discussion Paper, (2016), par. 143.
52 Annex to the Opinion, (2017), par. 272.
53 Compare EBA Q&A 2013_474.
54 E.P.M. Joosen, *Kapitaal- en Liquiditeitseisen*, in: Beleggingsondernemingen. Een nieuw regime na IFR/IFD (ed. I.P. Palm-Steyerberg, (2022), p. 143-147.

Against this background, we concretely propose to:

-- amend the definition of "client" in art. 4(1)(4) IFR as follows: *''client' means a client as defined in point (9) of Article 4(1) of Directive 2014/65/EU except that, for the purposes of Part Four of this Regulation, 'client' means any party* ***to whose risk of default the investment firm is exposed to through:***

(a) instruments issued by such party as included in the trading book; or

(b) contracts directly concluded with such party as included in the trading book*';*

-- clarify that any trade exposures of the firm *vis-à-vis* their clearing member(s) are excluded from the scope of the K-CON and K-TCD frameworks.

3.4.4 Not including non-trading book exposures

The Discussion Paper suggests a hard limit on concentrated exposures, similar to the large exposures regime in art. 395 CRR. Art. 37(3) IFR currently includes hard limits for positions in the trading book. Expanding the K-CON regime to non-trading book business would not align with the IFR's original objective, which was to provide a more proportional regime better suited to investment firms' typical activities. Including non-trading book exposures in the concentration risk module seems therefore inappropriate to us.

Introducing a hard limit for non-trading book positions could be burdensome for smaller firms (Class 2 and 3 investment firms) with limited counterparty access, imposing significant operational constraints as a 25%-limit would be quickly reached. We believe the Pillar 2 framework adequately covers non-trading book exposures through art. 29 and 36 IFD, including concentrated aspects of such exposures.[55]

Particularly, this problem would arise in respect of deposits of funds and/or instruments held by investment firms in segregated accounts. Originally it was decided that it was not optimal to include such accounts in the scope of the concentration risk framework as these generally do not represent risk-taking by investment firms but result from operational constraints (such as the one mentioned above).

The Discussion Paper seems to suggest that, in the event that a hard limit would be introduced for non-trading book exposures, in any case exposures in the form of segregated accounts should be excluded from K-CON. We support this notion if it were decided to include non-trading book exposures to the concentration risk framework, especially where this limit would cover (bankruptcy remote) margins and financial instruments held at clearing members.

3.5 Clearing Member Guarantee (CMG)

3.5.1 Background

Before the introduction of the CRR firms trading on own account could already be capitalized based on the margin requirements of their clearing members. The 2006 Capital Adequacy Directive ("**CAD**")[56] allowed institutions to calculate position risk using the margin required by the exchange or clearing member if the competent authority deemed it an accurate risk measure.[57] This framework was, after disappearing under CRR, introduced under the IFR as the "clearing margin given" K-factor ("**K-CMG**"), an alternative to K-NPR for market risk calculation.

Though K-CMG is not directly accessible, a very limited number of firms clearing most positions through a clearing member prefer it for easing capital calculations and potentially offering more favourable capital requirements.

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55 As also specifically covered by the provisions of Commission Delegated Regulation (EU) 2023/1668 of 25 May 2023 supplementing Directive (EU) 2019/2034 of the European Parliament and of the Council with regard to regulatory technical standards specifying the measurement of risks or elements of risks not covered or not sufficiently covered by the own funds requirements set out in Parts Three and Four of Regulation (EU) 2019/2033 of the European Parliament and of the Council and the indicative qualitative metrics for the amounts of additional own funds.

56 Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions.

57 Annex to the Opinion, (2017), par. 169.

3.5.2 General feedback

The Discussion Paper suggests a quantitative survey to confirm potential regulatory arbitrage risks by firms applying K-CMG to parts of their trading portfolios. It also calls for reintroducing the “higher of” methodology between K-NPR and K-CMG, which was previously removed from the IFR proposal.

We reiterate the Commission’s conclusion during the IFR introduction that such a construction would make K-CMG obsolete. No investment firm would apply for K-CMG if it only applies when higher than K-NPR, however, in many instances K-CMG does produce the lower capital requirements, certainly in the event a firm is not able to apply the new FRTB model approaches (which is rarely the case in view of the operational complexities). Additionally, the operational burden of calculating K-NPR, even when using K-CMG, undermines the potential prudential benefits of K-CMG. The more accurate and risk-sensitive models of clearing banks, which K-CMG allows firms to leverage, particularly benefit less sophisticated investment firms by providing better risk detection and potential capital relief.

These advanced models provide better risk detection and allow capital relief where possible. The margin required by clearing members, though encompassing more types and variations of risk, is usually lower than the capital requirement under the simplified standardised approach to market risk under the CRR. This difference arises from the internal model of the clearing member being more risk-sensitive, more granular capitalisation and a larger netting set that can be used by the clearing member. Contrarily, the standardised approach usually compensates for its lack of risk sensitivity through more conservative capital requirements. Arguably, the provisions surrounding regulatory arbitrage in art. 23 IFR and the K-CMG RTS could be tightened to prevent cherry-picking by firms permitted to apply K-CMG. However, there is no direct indication that the current provisions of art. 23 IFR and art. 2 K-CMG RTS are not sufficiently stringent.

3.5.3 Feedback on the K-CMG coefficient

The Discussion Paper mentions the possibility of recalibrating the coefficient applied to the third-highest margin requirement over the reference period, i.e., 1.3. The Annex to the Opinion did not include a coefficient and only saw a flat application of K-CMG as the capital requirement, if higher than K-NPR. The coefficient is an additional regulatory buffer of 30% on top of the margin required by clearing members serving as an additional prudential safeguard. It can be questioned to what extent the 30% additional risk charge is fair and logical. As identified above, the clearing member requiring the margin from the firm already requires a certain additional margin for conservative purposes, covering generally more risks than the mere market risk. Thus, the margin required should theoretically cover more risk than a dry K-NPR charge. Nonetheless, K-NPR can be higher than K-CMG due to the decreased risk sensitivity in the prudential model applied, e.g., the simplified standardised approach, and smaller netting sets of firms as compared to the clearing members, which need to have an internal model. This internal model must cover at least 99% of the exposures' movements over an appropriate time horizon with at least two-business days holding period and must comply with the model requirements applicable to CCPs per art. 41 EMIR.

We propose reconsidering the 30% additional capital requirement on top of K-CMG. This significant additional requirement does not seem to directly cover any risks not already incorporated in the margin requirement. Any risk not sufficiently covered by K-CMG in Pillar 1 needs to be addressed by the firm through Pillar 2 capital add-ons, which should adequately cover any residual risks. Since we cannot directly identify any other reason for the 30% additional requirement, we propose lowering or entirely removing this additional capital charge as it does not align with the original goal of expressing the firm's risk to the market.

If a firm fails, the clearing member's margin requirement principally covers the loss, and the market is safeguarded through the clearing member's guarantee, which is fully capitalised per CRR. The additional capital requirement therefore does not further protect the market against the firm's failure. Even without an additional K-CMG coefficient, applying the third-highest requirement over the reference period, the ‘high-water mark,’ already provides an additional level of prudence through the delayed correction of the capital requirement. In the event where the margin requirement decreases compared to the high-water mark, the K-CMG requirement will only decrease after the high-water mark that is currently applicable is more than three months old. Conversely, if the margin requirement increases, the clearing member will demand immediate fulfilment thereof with (usually) the firm's own funds, effectively immediately increasing the K-CMG requirement, which will also increase through an immediate adjustment of the high-water mark.

We do not directly object to the high-water mark itself, as it provides for a flooring of the capital requirement over at least a three-month period, which is generally not a time frame wherein the amount of regulatory own funds retained by firms is adjusted upwards (or downwards). We do, however, propose to implement a specific provision in respect of the high-water mark for market makers during high market volatility. Akin to the regime limiting K-DTF in times of high-volatility, a limit on the (persistent) increase of K-CMG during times of high volatility should be introduced to not disincentivise trading in such periods.[58] During periods of high trading volatility, market makers are generally required to expand their market making activities to facilitate trading. Due to the high-water mark, following periods of market volatility, market makers will be left with a artificially high K-CMG requirement, due to the three-month latency period in the K-CMG calculation. As market makers may not be interested in such persistent high capital requirement, market makers may restrict their liquidity provision in times of market stress, leading to a risk of reduced market liquidity, with potential detriments to financial stability. For this reason, Commission Delegated Regulation (EU) 2022/76 ("**K-DTF RTS**")[59] provides for a lowering of the K-DTF coefficients during periods of market stress, which are normalised when volatility returns to normal levels.

We propose to copy this regime to a certain extent, but instead of lowering K-CMG during market stress, we suggest excluding the K-CMG requirements from the high-water mark calculation during such period. First, this safeguards the adequate capitalisation of the market maker during the market stress as the market risk charges are relevant regardless of the reason they incur and should be financed to satisfy the clearing member. Second, it does not unduly penalise the market maker for liquidity provision for a duration of up to three months after the stress event. What constitutes a "period of market stress" can be aligned with art. 2 of the K-DTF RTS, as based on art. 6(2) of Commission Delegated Regulation (EU) 2017/578, i.e., those periods identified as stressed market conditions by the trading venues.[60]

Concretely, we propose to introduce a new RTS or to expand the K-DTF RTS with the following article:

Article [⧫]

Adjustment of K-CMG calculation

'***1. In the event that stressed market condition as referred to in paragraph 2 occur as a result of which the K-CMG calculation pursuant to Article 23(2) of Regulation (EU) 2019/2033 would be increased by the total margin required during such stressed market period, the total margin requirements of the respective day(s) in those stressed market conditions shall be excluded from the K-CMG calculation after the stressed market conditions have ended in accordance with paragraph 2.***

2. For the purposes of paragraph 1, an event of stressed market condition means a situation where the parameters referred to in Article 6(2) of Delegated Regulation (EU) 2017/578 are met and where those stressed market conditions lead to increased trading volumes. The start and end time of an event of stressed market condition shall be the time which the trading venue has identified in accordance with Article 6(2) of Delegated Regulation (EU) 2017/578.'

3.5.4 Feedback on the interplay of K-NPR and K-CMG

We propose evaluating the interplay of K-NPR and K-CMG once a firm applies for supervisory approval to apply K-CMG. According to art. 2(1)(d) K-CMG RTS, firms wishing to apply K-CMG need systems to compare K-NPR with K-CMG in the following cases:

(i) When a change in the business strategy of a trading desk results in a change of 20% or more in the capital requirements for that trading desk based on the K-CMG approach.

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58 See Recital (1) K-DTF RTS.

59 Commission Delegated Regulation (EU) 2022/76 of 22 September 2021 supplementing Regulation (EU) 2019/2033 of the European Parliament and of the Council with regard to regulatory technical standards specifying adjustments to the K-factor 'daily trading flow' (K-DTF) coefficients.

60 Commission Delegated Regulation (EU) 2017/578 of 13 June 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments with regard to regulatory technical standards specifying the requirements on market making agreements and schemes.

(ii) When a change in the clearing member's margin model results in a change in the margins required of 10% or more for the same portfolio of underlying positions for a trading desk.

These cases seek to balance preventing regulatory arbitrage and proportionality.[61] The EBA deemed the 20% and 10% changes significant and appropriate as measuring points. However, the differentiation between the two percentages is inadequately motivated. Material changes to the margin model of a clearing member are, under both EMIR and CRR, subject to supervisory approval and various model governance rules. For example, per art. 363(3) CRR, a clearing member must obtain separate supervisory approval for a material adjustment of its internal model, which could already be met at a 5% change in the risk figures per art. 7a et seq. Commission Delegated Regulation (EU) No 529/2014.[62] A CCP must observe strict model validation governance for implementing significant changes to its margin models, including validation by the relevant competent authorities[63]. Thus, the lower threshold of 10% for changes to the margin required by clearing members does not seem warranted against the robust background such changes would have undergone before affecting the firm.

Hence, we propose either deleting this (second) case or heightening the threshold to a 20% adjustment in the margin required. Moreover, we recommend clarifying that the change in the margin required should be due to the market risk of the trading portfolio of the firm cleared through the clearing member, as firm-specific increases do not reflect relevant changes that would be reflected in K-NPR and hence ought to warrant a comparison between K-NPR and K-CMG.

Therefore, the case where a change in the margin required by the clearing member triggers a comparison moment, i.e., art. 2(1)(d)(ii) K-CMG RTS, seems superfluous. The comparison to K-NPR will already have been made by the clearing members and the CCPs, whereby a comparison with K-NPR by the firm, often applying the simplified standardised approach, would not add much to prudency. Alternatively, we recommend raising the 10% threshold to 20% to make the comparison more proportionate. Moreover, in the first case, based on a change in the business strategy of the trading desk, we recommend clarifying that the trading desk in question should be subject to K-CMG, as under the current phrasing, the change in strategy of a trading desk subject to K-NPR could theoretically trigger the comparison moment. Additionally, a change in business strategy should not be perceived to have occurred where the firm merely decided to expand or contract its trading activities numerically. We recommend altering the comparison cases in the following manner:

(i) where a change in the business strategy of a trading desk **subject to K-CMG** results in a change of 20 % or more in the capital requirements for that trading desk based on the K-CMG approach, **where a change in the business strategy shall be more than a mere increase or decrease in traded volume**;

(ii) where a change in the clearing member's margin model results in a change in the margins required **by the clearing member of the firm** of **20** % or more for the **market risk of the** same portfolio of underlying positions for a trading desk.

If such thresholds are triggered, a firm will still have to explain the deviation between K-NPR and K-CMG based on (a) the relevant trading strategies, (b) the firm's own risk management framework, (c) the level of the investment firm's overall own funds requirements calculated per art. 11 IFR, and (d) the results of the SREP if available. Point (b) ties into the requirement of art. 2(1)(e) K-CMG RTS, whereby the firm has to use the K-CMG calculation for its own risk management and regularly compare its risk assessment results with the margins required by the clearing member. This is a somewhat cryptic requirement, implying that the firm should regularly calculate its market risk by means of K-NPR against the K-CMG outcomes. We propose clarifying that the firm should use the K-CMG outcome in its risk management framework and regularly

61 EBA Final Report [], par. 90.

62 Commission Delegated Regulation (EU) No 529/2014 of 12 March 2014 supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for assessing the materiality of extensions and changes of the Internal Ratings Based Approach and the Advanced Measurement Approach.

63 Art. 41 and 49(1a) EMIR and art. 47 et seq. Commission Delegated Regulation (EU) No 153/2013.

compare the margins required to its internal market risk assessment.[64] Art.2(1)(e) K-CMG RTS should be amended as follows:

(e) the investment firm makes use of the outcome of the K-CMG calculation in its risk management framework and regularly compares the results of its own **internal market** risk assessment with the margins required by clearing members;

3.5.5 Feedback on interaction with the implementation of the FRTB: Use of K-CMG

The Discussion Paper does not clarify whether K-CMG remains a viable alternative to the market risk calculation methodologies of the CRR after the implementation of CRR3, specifically the FRTB.[65] We refer to paragraph 5 for a broader discussion of the FRTB implementation. Here, we note that K-CMG should remain an alternative methodology for calculating the RtM capital requirement in certain circumstances.

The Discussion Paper suggests that when a firm applies the FRTB, K-CMG should no longer be available. In other words, if a firm applies (i) the alternative standardised approach of art. 325c *et seq*. CRR or (ii) the alternative internal models approach of art. 325az *et seq*. CRR, K-CMG could no longer be applied to any part of the portfolio. We do not see a direct reason for excluding the K-CMG approach if a firm applies the FRTB approach. Under the FRTB approach, institutions can apply the alternative internal model approach to one part of their trading book and the alternative standardised approach to another.[66] As we have set out above, the (alternative) internal model approach is reflected in the K-CMG approach through the internal model of the clearing member. Clearing members, after the implementation of CRR3, will be required to apply the alternative internal model approach as art. 1(194) CRR3 removes the regular internal model approach, relocating clearing members for eligibility under art. 23 IFR to the alternative internal model approach. Hence, it aligns with the FRTB reasoning to apply both the K-CMG and alternative standardised approach. However, it would not be appropriate to permit the simultaneous application of the simplified standardised approach and FRTB methodologies on an individual basis. Though we recognise that this may be difficult to supervise for competent authorities, leading to possible risks of regulatory arbitrage.

3.5.6 Feedback on interaction with the implementation of the FRTB: Threshold

Another point is the threshold from which firms must apply the FRTB approach. The CRR requires institutions to apply the FRTB approach when they surpass either an alternative or a relative threshold. Since the relative threshold is inapplicable to firms, the absolute threshold set in art. 325a(1)(b) CRR of EUR 500 million would be the limit from which firms must apply the FRTB, if art. 325a CRR applies to firms pursuant to art. 22 IFR. As the Discussion Paper indicates, the FRTB methodologies, including the alternative standardised approach, bring a material increase in complexity of the regulatory framework, with increased risk sensitivity. However, as the IFR aims to be a proportional regime for firms, a flat application of the EUR 500 million trading book size threshold would effectively subject firms surpassing that limit to the complex FRTB/CRR rules. <u>Hence, as the Discussion Paper also mentions, firms should be able to opt-in to the FRTB methodologies, subject to supervisory approval.</u>[67]

If an absolute threshold is set, the distinction between Class 2 and Class 1 firms would diminish, as firms not deemed systemically relevant would be subject to rules designed for systemically relevant institutions with significant trading books. For such institutions, proportionality requires a lower limit than the EUR 15 billion threshold for Class 1b firms, as their combined trading activities and deposit-taking create more volatility and impact.[68] Firms dealing on own account, however, pose a significantly lower risk to consumers, hence they should not be subjected to an absolute threshold for the FRTB rules application. Additionally, the manner in

[64] Clarifying that margins only need to be compared to market risk so as to avoid a double consideration under K-CMG of other risks for the firm, that may be included in the margin required, in addition to the consideration of the other risks to the firm in pillar 1 and 2.

[65] Though it touched upon in paragraph 145 of the Discussion Paper.

[66] See art. 325(1)(b), (4)and 325az(1) CRR3.

[67] See also Nieuwenhuizen, par. 421.

[68] See Recital (42) CRR3 and Recital (42) of Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012 (CRR2).

which the trading book size is calculated according to art. 325a(2) CRR, particularly sub-paragraph (f), would quickly lead firms to surpass the EUR 500 million threshold, despite adjustments introduced to that sub-paragraph (f) by art. 1(157)(c)(ii) and (iii) CRR3.

More concretely, we propose not to amend art. 23 IFR in this regard and to include a new art. 22(2) and (3) IFR that determine the following:

'(2) Prior to applying the approaches referenced in paragraph 1 point (b) or point (c) investment firms shall seek the approval of the competent authority.

(3) EBA, in consultation with ESMA, shall develop draft regulatory technical standards to specify the conditions which an investment firm must fulfil in order to be able to obtain the approval from the competent authority as referred to in paragraph 2.

EBA shall submit those draft regulatory technical standards to the Commission by 26 December 2020.

Power is delegated to the Commission to supplement this Regulation by adopting the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulation (EU) No 1093/2010.'

We would furthermore suggest extending the consideration of art. 325(4) CRR3 to the IFR, so as to permit the application of FRTB methodologies and the simplified standardised approach not on an individual, but on a consolidated basis.

3.6 Assets under safekeeping and administration (ASA)

The K-Factor for client assets safeguarded and administered ("**K-ASA**") is designed to cover the risks associated with failures in the safeguarding process.[69] K-ASA ensures that firms hold capital proportional to the balances of client assets they hold, regardless of whether these assets are on the firm's own balance sheet or in third-party accounts.[70] ASA refers to the value of assets that an investment firm safeguards and administers for clients, regardless of whether these assets appear on the firm's own balance sheet or are in third-party accounts.[71]

However, this definition, along with art. 19(2) IFR, has created a problematic situation. Art. 19(2) IFR states: '*Where an investment firm has formally delegated the tasks of safeguarding and administration of assets to another financial entity, or where another financial entity has formally delegated such tasks to the investment firm, those assets shall be included in the total amount of ASA which is measured in accordance with paragraph 1.*'

Firstly, the terms "financial entity" and "formally delegated" are not defined in art. 4 IFR, leading to a certain degree of legal uncertainty regarding the scope of K-ASA.[72] Moreover, the scoping, where clear, seems to encompass circumstances that may not directly give rise to the risks K-ASA intends to cover. However, this cannot be directly deduced from the IFR itself, as the specific risks targeted remain rather vague. On the one hand, operational risks surrounding the safeguarding of client assets seems to be relevant, while on the other, liability risks arising from failures in safeguarding client assets also seem to play a role.

During the preparation of the IFR, the EBA explicitly referred to the organisational requirements of MiFID II related to safeguarding as the risks to be addressed by a prudential buffer through K-ASA.[73] Currently, the IFR does not differentiate between various types of safeguarding, such as structural or statutory segregation, nor the associated different levels of operational risk. Instead, the IFR treats assets safeguarded at a custodian bank the same as those retained on the firm's own balance sheet, without considering the different operational tasks required in these scenarios.

69 Art. 14 IFR; EBA Discussion Paper, (2016), par. 37(c).
70 Recital (24) IFR.
71 Art. 4(1)(29) IFR.
72 B.J. Nieuwenhuijzen, (2021), par. 414.
73 Annex to the Opinion, (2017), par. 141.

As a result, in situations where MiFID II organisational requirements are met in a way that removes most safeguarding risks from the firm, K-ASA still imposes a capital requirement. This could be considered as a duplication of capital requirements, as in the case mentioned above, the custodian bank will have already capitalized the deposits according to the applicable prudential framework.

Therefore, it appears that K-ASA, in its current form, oversimplifies the organisational governance applied to safeguarding by firms in safeguarding assets, resulting in a severely risk-insensitive capital requirement. Additionally, when applied strictly, K-ASA might pose problems for small firms wishing to qualify as a Class 3 firm, as they will quickly have a non-zero K-ASA.[74]

Q12: What are the elements of the current methodology for the calculation of the K-ASA that raise most concerns? Taking into account the need to avoid complexifying excessively the methodology, how could the calculation of the K-ASA be improved to assess those elements?

In view of the above, we recommend differentiating between structural and statutory separation. Structural separation involves using a separate legal entity for safeguarding customer funds, whereas statutory separation involves a legal structure to legally separate client assets from the firm's own assets. The latter scenario poses a higher risk of comingling client assets than the former, as structural separation requires strict administrative segregation (and not also separate legal segregation since the assets are already legally separated by the mere fact that they are held by a separate legal entity). Additionally, the separate legal entity is often a bank or another entity not under the firm's control, which generally applies its own 'additional' separation procedures, which decreases the likelihood of operational risks materializing.[75]

In contrast, statutory separation requires both rigorous administrative segregation and legal segregation, imposing an additional operational burden on the investment firm with potentially significant consequences if not implemented correctly. Hence, different coefficients should be introduced in art. 15(2) IFR, as has been done for client funds through the different K-CMH coefficient for funds held in separated accounts and non-separated accounts.

Q13: Clients' asset protection may be implemented differently in different Member States. Should this aspect be considered in the calculation of the K-ASA? If so, how should that be taken into account in the calculation?

We refer to our differentiation between the statutory and the structural methods of asset segregation above. In our view, the workings of a national statutory separation mechanism could best be addressed through a Pillar 2 assessment. The national regimes are too diverse to be fully incorporated into the Level 1 text, so we propose using the two general terms of asset safeguarding.

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74 B.J. Nieuwenhuijzen, (2021), par. 413.

75 However, where the firm uses a dependent legal entity, such double application of administration requirements does not really provide any additional protection for the customer, as it will be the firm itself that is responsible for the separation at the dependent legal entity; see B.J. Nieuwenhuijzen, (2021), par. 167-171.

4 Risks not covered by K-Factors

The Discussion Paper addresses risks currently outside the K-factor regime, questioning whether these should be included in Pillar 1 or addressed under Pillar 2. Initially, the IFR framework deliberately excluded certain risks from Pillar 1, relocating them to Pillar 2 where relevant.[76] This was done to create a proportional framework that reflects the risks investment firms face, ensuring their stability or facilitating orderly wind-downs.[77]

4.1 Non-trading book positions

Including non-trading book positions in Pillar 1 does in our view does not align with the IFR's goal of a more proportional prudential regime. The Discussion Paper suggests that significant non-trading book positions might merit a regime similar to the standardised approach to credit risk.[78]

Investment firms typically do not lend money to clients, avoiding the scope of credit institutions defined in art. 4(1)(1)(a) CRR.[79] Firms generally do not have significant non-trading book activities other than those essential for business operations, not including off-balance sheet items. This was one of the main reasons for the legislature to create the IFR/IFD framework; the CRR with its primary focus on credit risk was deemed ill-fitting.[80] To that end, the IFR mainly incorporates credit risk through the K-TCD framework, being the proportional application of the counterparty credit risk framework of the CRR. Other instances of credit risk were consciously left out of the Pillar 1 framework, though credit risk was incorporated in the Pillar 2 framework, particularly by means of art. 29 and 36 IFD.

The Commission Delegated Regulation (EU) 2023/1668 ("**Pillar 2 Add-on RTS**")[81] mandates firms to consider interest and credit risk arising from non-trading book activities under Pillar 2. Competent authorities apply these add-ons based on the SREP procedure, the EBA and ESMA SREP Guidelines ("**SREP Guidelines**")[82] and art. 40 IFD. The Pillar 2 Add-on RTS lacks specific quantitative metrics for credit risk, but the SREP Guidelines, provide considerations for assessing credit risks uncovered under Pillar 1:[83]

(i) Nature of credit risk considering the types of counterparties and exposures;
(ii) Off-balance sheet exposures, particularly guarantees; and
(iii) Impairment risk.

Examples of credit risks not covered under Pillar 1 include (i) bonds held to maturity, (ii) financial guarantees issued to clients or group entities, (iii) margin loans and (iv) certain exposures to banks. Whilst these risks should be covered, they should in our view not be addressed as if they were included in a banking book of the firm. Instead, the risks they produce should be covered to such an extent that the likelihood of firm failure is reduced and the risk of a disorderly wind-down remains limited.[84] This inward-out perspective of capitalisation is different from the outward-in perspective of the credit risk framework of the CRR that seeks to express the credit risk incurred by the institution and, hence, the potential losses it may suffer as a result thereof. Applying a CRR-like standardised approach to credit risk for firms therefore in our view generally does not align with the purpose of the IFR/IFD framework, even though there may be firms for whom it may be appropriate.

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76 See, amongst others, EBA Discussion Paper, (2016), p. 16-17 and 23.
77 Annex to the Opinion, (2017), par. 86-91.
78 Discussion Paper, par. 121.
79 Commission Staff Working Document, (2017), p. 3.
80 E.g. EBA, Report on Investment Firms, (2015), p. 36-37; EBA Discussion Paper (2016), par. 183-184; Commission Staff Working Paper, p. 10: 'Credit risk, the component which accounts for most of the resulting capital required from banks, is largely irrelevant for most investment firms which do not lend.'
81 Commission Delegated Regulation (EU) 2023/1668 of 25 May 2023 supplementing Directive (EU) 2019/2034 of the European Parliament and of the Council with regard to regulatory technical standards specifying the measurement of risks or elements of risks not covered or not sufficiently covered by the own funds requirements set out in Parts Three and Four of Regulation (EU) 2019/2033 of the European Parliament and of the Council and the indicative qualitative metrics for the amounts of additional own funds.
82 Joint EBA and ESMA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) under Directive (EU) 2019/2034.
83 SREP Guidelines, (2022), par. 231-234.
84 Recital (3) Pillar 2 Add-on RTS.

While we propose not implementing a CRR-like credit risk regime, for firms with significant non-trading book activities incurring uncovered credit risks, we see merit in the Pillar 2 Add-on RTS containing a treatment similar to CRR's standardised approach for such firms. A relative and absolute threshold, similar to the FRTB rules under CRR, could be established, triggering Basel rules on credit risk for firms exceeding thresholds. We note that if such thresholds were to be introduced, these should be set at representative levels, with the relative threshold probably not being lower than 25% of non-trading book activities compared to trading book activities. Like art. 325a(2) CRR, a list of positions generating insufficiently treated credit risk, like margin loans, could be created. Level 2 regulation could specify that firms in principle must apply the standardised approach to credit risk when breaching the thresholds, e.g., for margin loans to corporate clients the risk weight treatment for rated or unrated corporates, or any other sufficiently prudent approach subject to supervisory approval.[85]

This proposal retains Pillar 2's flexibility, allowing to account for unique credit risk exposures. Implementing this in the Pillar 2 Add-on RTS ensures direct applicability, unlike inclusion in the IFD, which requires national transposition.

As some form of scaler should be applied as the CRR, unlike the IFR, uses risk weighted assets, we suggest a 4% capital charge to the RWA, calculated under the proposed Pillar 2 credit risk framework. We also suggest including that competent authorities have the discretion to waive the credit risk requirement if necessary.

When setting the threshold suggested above, the legislator should consider the distinctive functions of Class 1 and Class 2 firms.

4.2 Non-trading book positions in crypto assets

Q14: Should crypto-assets be included into K-factor calculation, either as a new K-factor or as part of K-NPR?

No incorporation of crypto-asset exposures into the K-factor calculation

We believe that incorporating crypto-asset exposures into the K-factor calculation, such as K-NPR, would be challenging. Currently, the market generally understands that proprietary trading in crypto-assets does not require authorization under the Markets in Crypto-Assets Regulation ("**MiCAR**").[86] Moreover, MiCAR does not contain any specific prudential capitalisation requirements for the (proprietary) trading of crypto-assets, even if it were to be subject to an authorisation requirement.[87]

The Basel standard on Crypto-Assets[88], as provisionally included in art. 501d CRR3, does not appear to apply to firms, as this article is not included in a part of the CRR applicable to firms dealing on own account through art. 21 IFR. Consequently, K-NPR should only cover crypto-asset exposures that qualify as financial instruments through the market risk framework of CRR. For instance, derivatives with crypto-assets as underlying do qualify as financial instruments, which prompts the question as to how crypto-assets should be dealt with in this frame. Arguably, the most appropriate treatment currently available, within the constraints of the market risk framework, would be to mark crypto assets as commodities, expressing their volatile nature. Nevertheless, the uncertainty remains a significant issue for firms wishing to deal in crypto assets, with no supervisory guidance available.

Services related to crypto assets should be prudentially regulated under the MiCAR framework. Including crypto-assets in the K-factor calculation could create level playing field issues. Crypto-asset service providers ("**CASPs**") authorized under MiCAR are not subject to an equivalent K-factor regime and must only meet the higher of PMC or FOR. Apparently, the EU legislator did not consider it necessary to create a K-factor-like

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85 Where we note that the average counterparty of firms in bilateral relations such as margin loans will not be rated and thus attract the comparatively heavy risk weight of the new art. 122(2) CRR3, i.e. 100%.

86 Regulation (EU) 2023/1114 of the European Parliament and of the Council of 31 May 2023 on markets in crypto assets.

87 See J.J.F. van der Meer and S.W. van de Ven, *De implicaties van MiCAR op handelaren voor eigen rekening in cryptoactiva*, (2024); and A. Pantaleo and A. Vianelli, *Digital Asset Market Making and MiCAR: In or Out?* (2024); though it appears that ESMA has not definitively made up its mind on this point at the time of writing.

88 BCBS, *Prudential treatment of cryptoasset exposures*, (2022), (the "Cryptoasset Standard"); and as amended by BCBS, *Cryptoasset standard amendments*, (2024).

framework under MiCAR. Therefore, introducing a new K-factor for crypto-asset services is primarily not advisable on dogmatic grounds. f at all, a K-factor requirement for crypto-assets should be implemented into MiCAR.

Including a K-factor regime for trading in crypto assets under MiCAR

If crypto-assets were to be included into a K-factor calculation, we would recommend doing so within the MiCAR framework rather than the IFR/IFD framework. From a methodological standpoint, we oppose introducing additional K-factor requirements for crypto-asset under the IFR/IFD, as this framework is designed for investment services and activities related to financial instruments. The RtM K-factors seek to protect the traditional financial market, not the crypto-asset market. It is therefore in our view not appropriate to apply K-factors to other activities than investment services and activities, e.g., including crypto-asset services.

Should it be decided to include crypto-assets in the K-factor calculation, we propose (i) introducing a new K-factor for crypto-assets in the MiCAR framework, and (ii) including a provision in the IFR stipulating that such K-factor applies to firms having crypto-assets in their trading book. In our view, this should be the most methodological sound approach towards the prudential treatment of crypto assets for investment firms.

Regardless, as a last resort to combat the legal uncertainty that is currently rife, as well as to close the prudential gap that is faced by crypto asset exposures on firms' balance sheet, a new K-factor could be included in IFR.

Including a K-factor regime for trading in crypto assets in IFR

Crypto-assets on firms' balance sheets can carry significant market risk. Therefore, it may be imprudent to leave the trading of crypto-assets entirely uncapitalised, especially when conducted by non-bank entities.

Whereas the European legislator may not have deemed it necessary to subject CASPs engaged in proprietary trading to any additional capital requirements, this does not mean that firms should be exempt from such requirements. If one were to rank CASPs, firms and banks by their importance to financial stability, CASPs would rank lowest and banks highest, with firms falling somewhere in between. Consequently, it is conceivable that firms should be required to capitalise their crypto-asset exposures but CASPs should not. Similarly, banks should be held to the most conservative and prudent standards according to the Basel standard on crypto-asset exposures, while firms could be subject to a prudent, but slightly less strict capital requirement.

Therefore, a specific regime for crypto-assets could be included in IFR. As the Discussion Paper suggests, this could either be done in a new K-factor or K-NPR. We do not consider the latter appropriate because K-NPR refers to CRR, which already contains the Basel standard on crypto-assets. Integrating crypto-assets into K-NPR would require importing the entire market risk framework into IFR, potentially creating a parallel regime with minor differences. This could lead to interpretation challenges and significantly complicate the IFR.

Thus, creating a new K-factor for crypto-assets, e.g. 'K-CRY', seems the preferred course of action. This K-CRY could be based on the structure of the CRR market risk framework, for instance on that applied to commodities under the (simplified) standardised approach. Such framework would allow for the netting and hedging of crypto-asset exposures, though the exact calibration of the coefficients applied in course of the K-CRY regime would be challenging. These coefficients should adequately reflect the volatile and risky nature of crypto-assets, however, they should not be inhibitive for the proprietary trading of crypto-assets. The level of these coefficients should be set by means of a quantitative survey, taking into account the different risk-profile of firms and banks and the characteristics of the crypto-asset markets.

If K-CRY is introduced, to maintain a level playing field with proprietary traders in crypto-assets (which is, arguably, currently unregulated, and, thus, not a capitalized activity), an inevitable consequence of applying this K-factor to MiFID proprietary traders is that dealing on own account in crypto-assets should be regulated under MiCAR and possibly subject to the same K-CRY requirements. Whether this is a desired consequence is beyond the scope of this response.

4.3 Operational risk for firms calculating the K-DTF

The Discussion Paper raises whether there should be a dedicated K-factor to cover operational risks for firms dealing on own account. Currently, these firms are required to capitalise operational risks under K-DTF. Below, we discuss the coverage of operational risk in the CRR and IFR for firms dealing on own account before answering the questions posed.

Background

The K-factors were developed as proxies for the risks investment firms face.[89] One significant risk inadequately captured under CRR was operational risk.[90] The RtC K-factors are mostly operational risk proxies, reflecting the fundamental thought behind the IFR that clients bear most losses due to firms' operational failures. Firms dealing on own account, however, do not retain capital under these K-factors. Instead, the RtF K-factors, specifically K-DTF, capturing '*the operational risks to an investment firm in large volumes of trades concluded […] in one day which could result from inadequate or failed internal processes, people and systems or from external events, […].*'[91] These risks are deemed particularly relevant, as firms dealing on own account might be held liable by their counterparties which, *in lieu* of capital requirements, could trigger a bankruptcy.[92]

Upon creation of K-DTF, the EBA already considered K-DTF '*a rough proxy for the amount of operational risk stemming from [dealing on own account].*'[93] However, as set out in paragraph 3.3, we consider K-DTF a proxy with certain limitations, for the main reason that the operational risk of dealing on own account does, in practice, not scale linearly with the (notional) volume of trades nor is it related to the total volume of trades. Rather, the proportional relevance of operational risk generally links to the number of trades, as the risks referred to in Recital (26) IFR could repeat themselves with each trade though the likelihood of risks materialising might decline.

Operational risks are in our view best addressed through organizational measures and proper risk management, rather than through capital requirements. Although capitalizing operational risks may incentivize mitigation, the goal should be to prevent them. Any operational risk measure should scale linearly and recognize and reward risk mitigation.

Q15: In the context of addressing operational risk for investment firm trading on own account, is there any further element to be considered to ensure that the requirements are proportionate to their trading activities?

We refer to our answer under Question 10.

Q16: The discussion paper envisages the possibility to rely on alternative methodologies with respect to the K-DTF. If the respondents suggest an alternative approach, how would this refer to the two activities addressed under the K-DTF (trading on own account and execution on own account on behalf of the clients)?

To calculate the operational risk requirement, the Discussion Paper suggests (i) reverting to the Basic Indicator Approach ("**BIA**"), (ii) the Standardised Approach ("**OP-SA**") of the CRR, or (iii) an option where firms add their FOR to the K-factor requirement as a capital charge for operational risk.

First, we note that the operational risk framework of the CRR will be fully revised with the implementation of CRR3, where the current approach for calculating operational risk will be replaced with the Business Indicator Component ("**BIC**"). Second, the current operational risk calculation methodologies, as the Discussion Paper identifies, cover too broad a scope to properly reflect the operational risks related to the specific activity of dealing on own account. Therefore, we consider remaining the K-DTF requirement discussed above, in combination with a firm specific Pillar 2 add-on, insofar necessary, more appropriate than (a simplification of) the CRR3 operational risk framework.

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89 Annex to the Opinion, (2017), par. 22 and 218.
90 EBA Discussion Paper, (2016), par. 29.
91 Recital (26) IFR; Annex to the Opinion, (2017), par. 178: 'Moreover, RtF should also address the operational risks that stem from the activity of dealing on one's own account or trading in one's own name when executing clients' orders.';
92 B.J. Nieuwenhuizen, par. 495-497.
93 Annex to the opinion, (2017), par. 208.

4.4 Investment firms operating trading venues

The Discussion Paper addresses the current situation where Multilateral Trading Facilities ("**MTFs**") and Organised Trading Facilities ("**OTFs**") are not required to hold additional capital to conduct their respective MiFID activities. It states that this lack of capital requirements was not an oversight of the original IFR but a conscious policy choice to keep the framework simple. However, it posits that excluding capital requirements for the operation of an OTF or MTF leaves certain risks unaddressed. While we agree this deserves attention, the Discussion Paper does not clarify or seek direct input on what these risks might be. It appears to propose capital requirements for the sake of having them. Below we will briefly discuss the background of OTF and MTF's prudential treatment, potential risks, and whether current capitalisation is adequate.

Originally, the EBA recommended that OTF or MTF operators not include transactions processed on their trading venues in K-COH or K-DTF.[94] Furthermore, given the business model of MTF or OTF operators, it is not guaranteed that they will qualify as Class 2 firms and thus be required to calculate K-factors. This was specifically mentioned by the EBA, allowing MTF or OTF operators to possibly remain Class 3 firms.[95] If an MTF or OTF operator qualifies as a Class 2 firm, it should calculate the relevant K-factors for its MiFID activities, provided the metrics do not reflect the actual operations of the MTF or OTF.[96] The EBA initially recommended excluding MTF and OTF operators from Class 3 but revised this stance in July 2017.[97] Respondents to the 2016 Discussion Paper felt that operating an MTF/OTF should not preclude firms from being classified as Class 3, considering the limited risk of such operations.[98] Consequently, the final decision allowed OTF or MTF operators to qualify as Class 3 firms, subjecting them to the permanent minimum capital requirement ("**PMC**") of EUR 750k for OTF operators and EUR 150k for MTF operators, or FOR.[99]

From a prudential perspective, the primary risk of a trading platform is the loss of continuity of trading services.[100] If an MTF or OTF operator ceases operations, it would disrupt market participants' trading activities and could impact financial stability. Nevertheless, the prudential risks directly influencing an MTF operator are limited, as these firms are almost exclusively concerned with operating the trading venue and not other investment services.[101] However, the risks these firms pose to the financial system can be significant if their platforms become essential liquidity pools for certain instruments.[102] In such cases, the firm might exhibit systemic qualities, making it difficult to replace and warranting additional prudential safeguards.[103] For OTF operators, the same reasoning applies, with the added complexity that they are allowed and expected to engage in matched principal trading, dealing on own account, or other investment activities.[104] Moreover, an OTF is a discretionary trading venue, unlike an MTF, which is non-discretionary. This means an OTF may intervene in transactions on its platform, creating further operational risk, whereas an MTF may not, limiting its operational risk.

We cannot conceive a good metric to include in Pillar 1 as a proxy for the risks MTF and OTF operators represent. Due to the specificities of their business models and varying market importance, any metric linked to trade volumes, as envisaged by the EBA, would in our view poorly express the present risk. The new K-factor envisaged by the EBA would use the calculation methodology of K-COH with the amount of *sold* interest in financial instruments as a base value.[105] This new K-factor would repeal art. 7(4) K-factors RTS, which currently excludes MTF or OTF arranged trades from the K-COH requirement and would modify the K-COH regime to fit MTF and OTF investment activities.[106] Especially for derivatives trading platforms, this could yield

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94 See Annex to the Opinion, (2017), p. 68.
95 Annex to the Opinion, (2017), p.17.
96 Annex to the Opinion, (2017), p. 45; Notwithstanding the limited (no) regulatory room for MTF operators to engage in dealing on own account, see art. 19(5) MiFID II.
97 EBA Presentation, State of play of the EBA Advice on the design of a new prudential framework for MiFID investment firms, (2017), p. 7.
98 Annex to the Opinion, (2017), p. 14.
99 Art. 13 IFR and art. 9(4) and (3) IFD respectively.
100 B.J. Nieuwenhuijzen, (2022), p. 45.
101 Idem; Art. 19(5) MiFID II.
102 B.J. Nieuwenhuijzen, (2022), p. 46.
103 B.J. Nieuwenhuijzen, (2022), p. 153-154.
104 Art. 20(2) and (3) MiFID II.
105 See EBA, 2024 EBA Data Collection for CFA on IFR/IFD, (2024), p. 16.
106 Annex to the Opinion, (2017), par. 138.

vast sums of nominal sold interest, raising questions about the appropriate calibration of the K-COH coefficients of art. 15(2) IFR. Both sides of transactions on an MTF or OTF are already capitalised under K-DTF or K-COH, covering the same risks. If the exchange were required to calculate a capital requirement for the same risk as both parties to the transaction, the total required capital per firm should presumably be lowered.

Further critique lies in the legal position of the MTF or OTF operator in the transaction chain. K-DTF covers operational risks of firms acting as principals, while K-COH covers operational risks as agents. MTF or OTF operators, when acting purely in their operator capacity, are neither principals nor agents. Their obligations to exchange members are generally efforts-based or largely excluded from liability. Therefore, in the event of an operational failure, MTF or OTF operators may not be held liable by exchange members, limiting the risks covered by K-COH. Similarly, OTF or MTF operators would not incur direct losses in trade failures, limiting the risks covered by K-DTF. A new K-factor could be based on the income generated from operating an MTF or OTF, as repeated trading failures would dampen the income of firms operating a faulty platform. This was considered in 2016 during the IFR preparation but dismissed for unclear reasons.[107] Any metric based on income would be susceptible to arbitrage, e.g., through transfer pricing structures. Nevertheless, not all trading venues are authorised in the same manner in all Member States, i.e., not all MTF and OTF operators are required to apply for the same licences under MiFID II. This as certain interpretative differences exist between competent authorities as to what the business of operating a trading venue truly comprises and therefore which investment services are being provided. Therefore, operating a trading venue can in certain instances also involve the provision of certain investment services covered by K-COH, though making a differentiation between these activities and services is essential from a prudential perspective.[108]

Pillar 2 seems better suited for the capitalisation of MTF and OTF operators (for their MTF/OTF-related activities). In the course of the SREP, a competent authority can assess the (systemic) importance of an operator and capitalise it to permit an orderly wind-down or withstand certain shocks if it has a systemic liquidity pool. Thus, firms operating an OTF or MTF should be required to undergo the SREP, amending art. 25 *et seq.* IFD and particularly art. 36(2) IFD. A more suitable amendment (than the inclusion of a new K-factor) to the framework applicable to MTFs and OTFs might be a resolution regime for systemic trading venues, in line with developments on outage plans.[109] Non-systemically important venues can be wound down in an orderly fashion, enshrined in a FOR-based capital buffer, and thus not subjected to this regime. MTFs or OTFs whose interruption would significantly impact the markets need to be wound down without disrupting their critical service. Whether this fits best within IFR or IFD or is more appropriate for implementation in MiFID II or BRRD, is beyond the scope of this paper.

4.5 Investment firms providing other prudentially regulated or non-regulated services

Q17: When addressing other activities an investment firm may perform, which elements, on top of the discussed ones, should be also taken in consideration?

We oppose the introduction of a new K-Factor to address other activities an investment firm may perform (e.g., crowdfunding service) and recommend that the risk of such activities is capitalized through the firm-specific assessment under Pillar 2, insofar the risks are not already capitalized through Pillar 1.

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107 EBA Discussion Paper, (2016), par. 40.

108 Recital 8 K-factors RTS.

109 B.J. Nieuwenhuijzen, (2022), p. 153-154; ESMA, *Final Report and Opinion on Market Outage*, (2023); IOSCO, *Final Report on Market Outages*, (2024).

5 Adoption of FRTB for investment firms

Above, we already discussed the implementation of the FRTB into the IFR framework and its interplay with existing requirements such as K-CMG. Here, we address a specific aspect of the FRTB mentioned in the Discussion Paper: (i) amendment of the relevant provisions in the IFR to introduce the simplified standardised approach, and (ii) the multipliers applied to the (simplified) standardized approach capital requirements under art. 325(2) CRR3. These multipliers will significantly impact the amount of capital required by firms for their position risk, warranting a thorough discussion on their appropriateness.

First, we suggest clarifying in the IFR that art. 325(2) CRR applies to firms, but do not suggest applying art. 325a(1) CRR to firms. The reason therefore is that most firms dealing on own account have simple trading books and generally do not trade in complex products. These firms should therefore in our view always be permitted to use the simplified standardized approach.

Second, provided that art. 325(2) CRR applies to firms, we note the following in respect of the multipliers set out in that article. The scalars under art. 325(2) CRR stem from the BCBS' conclusion that the (simplified) standardized approach lacks sufficient risk sensitivity and thus requires a multiplier for a conservative calibration of the requirement.[110] The BCBS noted that the standardized approach, next to the more altered model-based approach, lacked risk sensitivity, offered limited recognition of hedging and diversification benefits, and failed to adequately capture risks associated with more complex instruments.[111] However, the BCBS also acknowledged that "supervisors faced challenges in requiring banks to switch to the use of the standardized approach in a short time frame, as the risk-insensitive design of the standardized approach could lead to a large increase in capital requirements for banks with significant trading activities", indicating an already conservative calibration of the (simplified) standardized approach. Although this commentary may imply problems with the sensitivity of the model and the ability to deal with complex products, it does not necessarily indicate that the capital requirements for regular instruments in the trading book is too low.

The BCBS identified that most trading losses during the 2007-2009 financial crisis occurred in structured credit/securitization exposures, prompting a thorough revision of the market risk treatment for securitization positions.[112] Consequently, the BCBS substantially overhauled the standardized approach, resulting in the new (alternative) standardized approach as will now be (further) implemented as part of CRR3.

The current standardized approach under CRR, based on the Basel II standards from 2006 (and 1996), will be retained as the simplified standardized approach. In 2017, the BCBS proposed retaining this approach to facilitate the adoption of the market risk standard for non-internationally active banks. The BCBS set the following indicators to qualify as a non-internationally active bank:[113]

(i) The bank should not be a G-SIB;
(ii) The bank should not use the internal models approach for any of its trading desks; and
(iii) The bank should not hold any correlation trading positions.

These requirements have been implemented as art. 325a(1) CRR3. However, they no longer effectively distinguish small banks with simpler trading books; CRR3 now refers to "banks with a medium-sized trading book" as eligible for the simplified standardized approach.[114] As set out above, firms generally have simpler trading books compared to large investment banks, despite the complex activities of some of the larger trading firms. Additionally, firms dealing on own account have no depositors affected by trading book losses, and their capitalization is not set to prevent failure per se, according to the fundamental premise of the IFR. In this context, a proportional application of the scaling factors of art. 325(2) CRR3 might be more appropriate for these firms. A quantitative assessment of the risks currently not covered by the standardized approach could calibrate these factors, considering the IFR's gone concern approach.

110 BCBS, Explanatory note on the minimum capital requirements for market risk, (2019), p. 11.
111 BCBS, Consultative Document: Fundamental Review of the Trading Book, (2012), p. 9.
112 BCBS, *Consultative Document: Fundamental Review of the Trading Book,* (2012), p. 58; See figure 2 in Table 6 on the indicated pager, where losses are split out between the various business lines.
113 BCBS, Consultative Document: Revisions to the minimum capital requirements for market risk, (2018), p. 39.
114 Recital (42) CRR3.

In our view, the proposed scalars are significant enough to justify a specific quantitative assessment for firms. The BCBS calculated that the share of market risk-weighted assets as a percentage of total risk-weighted assets would increase from 4.4% to 5.3% on average after implementing the FRTB, leading to a 0.9% increase in RWA for the average bank. This translates to a (roughly) 0.9% higher total capital requirement for banks due to a 22% higher market capital requirement.[115] Firms dealing on own account predominantly have their capital requirement determined by RtM. As such, these firms will experience a significant increase in RtM capital requirements, especially proprietary trading firms that are almost exclusively subject to RtM capital requirements (notwithstanding RtF requirements). Given the level of the scalars,[116] the expected increase in required capital is likely to be more in the regions of 50% to 100% than 1%, which must be fully funded through equity, bonds, or loans, unlike the relatively inexpensive deposits accessible to banks.

115 BCBS, Explanatory note on the minimum capital requirements for market risk, (2019), p. 13-14.

116 I.e. an increase of: (i) 30% for general and specific risk of debt instruments; (ii) 250% for general and specific risk on equity instruments; (iii) 20% for FX-risk; and (iv) 90% for commodity risk.

6 CVA adjustments for investment firms

CRR3 transposes the amended Basel III standard on credit valuation adjustment ("**CVA**") risk[117], being – according to CRR3 – the risk of losses arising from changes in the value of CVA, calculated for the portfolio of transactions with a counterparty as set out in the first paragraph, due to movements in counterparty credit spread risk factors and in other risk factors embedded in the portfolio of transactions.[118] Currently, CVA risk is included in art. 32 IFR, where it is set as a multiplier of either 1 or 1.5, depending on the type of underlying transaction. However, CVA risk is not a standalone K-factor; it feeds into the K-TCD calculation of art. 26 IFR, unlike in the CRR where CVA risk is a separate risk charge. Nonetheless, under the CRR, the CVA risk charge applies to the same transactions as the counterparty credit risk framework, roughly corresponding to the K-TCD requirement. Therefore, art. 25(5) IFR mandates that firms applying the counterparty credit risk framework of the CRR must also apply the CVA factor of art. 32 IFR (i.e., 1 or 1.5), or they must directly apply the CVA risk charge according to the CRR.

The Discussion Paper considers whether it might be appropriate to introduce the revised CVA rules of Basel III, as transposed in CRR3, into the IFR. This would involve importing the revised methodologies under CRR3 for CVA risk:

(i) The simplified approach;[119]
(ii) The basic approach, with[120] or without hedges;[121] and
(iii) The standardised approach.[122]

Without delving into these methodologies in detail, we want to comment on their appropriateness for firms. First, these methodologies are ranked by increasing complexity, with the standardized approach being materially complex even for sophisticated banks. Second, these methodologies will significantly increase CVA risk requirements if applied to firms. It is reasonable to expect that firms will generally only apply the simplified approach, which would double the required capital for CVA risk. Art. 385 CRR3 sets the CVA risk multiplier at 100% of the counterparty credit risk requirements, which, if applied to the IFR, would mean a CVA factor of 2 instead of 1.5. The conditions for apply the simplified approach are that the market value of the firm's derivative positions must be below:

(a) 5% of the firm's total assets;
(b) EUR 100 million.

This means that only larger firms with significant OTC derivative books would exceed these thresholds.

We propose to leave the CVA regime of art. 32 IFR relatively unchanged, possibly raising the CVA multiplier from 1.5 to 2. It could be argued that the shortcomings in the CVA framework identified by the BCBS do not extend to firms. Furthermore, the opt-out of art. 25(5) IFR could be retained for firms wishing to switch to more sophisticated, risk-sensitive methodologies such as the basic approach or standardized approach, with the latter subject to supervisory approval. This aligns with the original idea of providing a proportional and simplified methodology for firms compared to the CRR regime, especially considering that neither the EBA nor the Commission originally recommended a capital requirement for CVA risks at all.[123]

6.1 Some comments on K-TCD in general

We would like to make some general comments on the K-TCD factor, that otherwise is not discussed in the Discussion Paper. We recall that K-TCD fundamentally captures the risk that the counterparty of a firm to a

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117 BCBS, Targeted revisions to the credit valuation adjustment risk framework, (2020).

118 Art. 381 CRR3; Compare the definition of art. 32 IFR: 'For the purposes of this Section, CVA means an adjustment to the mid-market valuation of the portfolio of transactions with a counterparty which reflects the [current market value] of the credit risk of the counterparty to the investment firm but does not reflect the CMV of the credit risk of the investment firm to the counterparty.'

119 Art. 385 CRR3.

120 Art. 384(1)(a) CRR3.

121 Art. 384(1)(b) CRR3.

122 Art. 383 *et seq.* CRR3.

123 Annex to the Opinion, (2017), par. 184-185; and EBA Advice, *On the new prudential framework on investment firms*, (2017), recommendation 31; Art. 26 of the IFR Proposal.

transaction could default before the next and/or final settlement of the transaction's cash flows. This concept of counterparty credit risk ("**CCR**") is however not fully reflected in the art. 4(1)(35) IFR definition of trading counterparty default risk, which is defined as: '*the* exposures *in the trading book of an investment firm […] giving rise to the risk of trading counterparty default.*' This contrary to the definition of counterparty credit risk in art. 272(1) CRR, which corresponds generally to the fundamental concept given above. The deviation in the IFR definition from the CRR definition is difficult to explain as the drafting history and Recital (22) of IFR clearly indicate that K-TCD is a simplified version of the CRR counterparty credit risk framework. The deviation is somewhat problematic as the definition of K-TCD is (a) circular, i.e. trading counterparty default is the risk of a trading counterparty defaulting, and (b) less precise, i.e. the CRR definition clarifies the settlement aspect of CCR. Additionally, the definition of K-TCD could be amended to reflect certain transactions that carry no CCR for the firm. These include back-to-back transactions where the fulfilment of the firm's obligations *vis-à-vis* one counterparty are fully contingent on the performance of another counterparty *vis-à-vis* the firm.[124] Under IFRS, such transactions are derecognized in the accounts of the firm, fully removing these from the trading book.[125]

Therefore, we propose introducing a new definition in art. 4(1)(35) IFR for *trading counterparty default*:

'**means the exposures in the trading book of an investment firm in instruments and transactions referred to in Article 25 insofar giving rise to the risk that the counterparty to a transaction could default before the next and/or final settlement of the transaction's cash flows.**'

Moreover, we propose to reintroduce a simplified Maturity Factor ("**MF**") in art. 29(8) IFR.[126] The MF is a parameter that takes account of the time period over which the Potential Future Exposure ("**PFE**") of a derivative contract is calculated. More precisely, within PFE, MF reflects the time horizon appropriate for the type of transaction and is calculated at the trade level. Under the CCR framework of CRR, specifically art. 279c CRR, the calculation of the MF varies depending on whether the netting set is margined or unmargined. Originally, the EBA proposed a simplified MF in the Annex to the Opinion, which was subsequently included by the Commission into the IFR proposal. However, the MF was removed in the final IFR, without a clear motivation as to why the MF was removed. Instead, art. 29(8) IFR currently contains fixed MF multipliers of 0.42 for (roughly) margined netting sets and 1 for unmargined netting sets. As a result, the remaining maturity of derivative contracts is arguably insufficiently reflected in the PFE, with contract maturing the next day attracting a similar treatment of contracts maturing in ten years.

Furthermore, due to the absence of an MF factor, the K-TCD framework is largely insensitive to new market developments such as the concept of Settle-to-Market ("**STM**"). Currently, art. 29(5) fourth subparagraph IFR contains an indirect reference to STM, though only in reference to interest rate and credit derivatives, which are subject to the duration adjustment of art. 29(4) IFR. By partially taking over the wording of the CRR and adding it to the EBA's and Commission's original proposal, a dynamic though proportional MF is created that also allots for STM for other asset classes. Though, we support the retainment of the current 'preconfigured' MF on a netting set level, whereby the MF formula would be an alternative to the current art. 29(8) IFR.

Therefore, we propose inserting a new art. 29(9) IFR:

'**9. As an alternative to the multipliers of paragraph 8 firms may, subject to the prior approval of the competent authority, calculate a maturity factor (MF) for each transaction that shall be determined by the following formula:**

MF = (min (M;1 year) / 1 year)^0.5

For unmargined trades, maturity (M) shall be the shorter of one year and remaining maturity of the derivative contract, as determined in the second subparagraph of paragraph 5, but no less than ten business days.

124 See the so-called 'pass-through regime' of IFRS, par. 9.3.2.5. IFRS.

125 Idem.

126 Annex to the Opinion, (2017), par. 202; IFR Proposal, (2017), art. 29(8).

For margined trades, maturity (M) shall be the margin period of risk. The minimum margin period of risk (MPOR) shall be at least ten business days for non-centrally cleared derivative transactions subject to daily margin agreements and five business days for centrally cleared derivative transactions subject to daily margin agreements.

Where a transaction is structured to settle outstanding exposure following specified payment dates and where the terms are reset so that the market value of the transaction is zero on those specified dates, the remaining maturity (M) of the transaction shall be equal to the time until the next reset date.'

7 Definition of "Trading Book"

The current definition of the trading book is outlined in two provisions of the IFR: art. 4(1)(54) and (55). Together, these paragraphs define the trading book as financial instruments and commodities held with (hedges of) trading intent, being those proprietary instruments intended to be resold in the short term, generally with the goal to benefit from short term price movements. This definition aligns broadly with the trading book concept for banks as defined in art. 4(1)(86) CRR.[127] However, this definition in the CRR is set to undergo a significant revision as part of the CRR3 implementation. The Discussion Paper explores whether this revised definition should also be incorporated into the IFR.

This consideration is crucial for regulatory consistency and because it impacts the capitalization of positions. Under the IFR, positions in the trading book are generally subject to Pillar 1 requirements, with some exceptions. Additionally, whether a position is included in the trading book can affect MiFID II licensing requirements, such as for dealing on own account. Therefore, the revised trading book definition should prevent regulatory arbitrage, similar to the reform for banks. However, the regulatory arbitrage prevented by the CRR's revised definition may not directly apply to investment firms. The revised CRR3 approach aims to clearly delineate between the banking and trading books to prevent institutions from switching treatments between these books.

The revised approach in art. 104 CRR3 introduces presumption lists to objectify the classification of positions.[128] Briefly, the new regime mandates that if a position is listed in art. 104(2) or (3) CRR3, it is assigned to the (non-)trading book unless a derogation applies, subject to supervisory approval. For investment firms, this rationale of preventing regulatory arbitrage is less relevant. Typically, firms have only trading book positions subject to Pillar 1 requirements, while non-trading book positions might be capitalized through specific K-factors or Pillar 2 requirements. Significant regulatory arbitrage by moving positions between the trading and banking books would be difficult or highly unlikely. Additionally, many positions listed in art. 104(3) CRR3 as excluded from the trading book are not typically held significantly by investment firms. Thus, implementing the CRR3 trading book delineation in the IFR in our view creates an unnecessarily complex framework. Consideration could be given to including a discretionary power for the competent authority to assign assets to the trading book if there are substantial indications of regulatory arbitrage. This would allow both firms and supervisors the flexibility to manage balance sheets effectively.

Alternatively, as suggested in the Discussion Paper, a list of assets that should not be included in the trading book could be established for firms not authorized to deal on own account.[129] These positions could include assets held to meet liquidity requirements under art. 43 IFR. Instead of listing the specific liquid assets in art. 43(1)(a)-(c) IFR, we suggest referencing to the assets held to meet liquidity requirements. Validating that assets are held for liquidity purposes should not impose a significant operational burden or complicate supervision, as firms already report these assets.

Moreover, it could be argued that firms not authorized to deal on own account should be allowed to keep the amount of own funds required by art. 9 IFR without including them in the trading book. We oppose including own funds in the trading book since they can be invested in any asset and are not subject to use restrictions. Allowing investment of own funds into liquid assets would not align with regulatory purposes and could lead to unintended consequences.

We propose an exemption for all assets held to meet liquidity requirements, with a transitional regime. The transition regime should account for the appreciation of these assets, such as when positions representing 100% of the liquidity requirement appreciate to 120%. As long as these designated assets are not sold, they should remain excluded from the trading book. Additionally, a small buffer, such as 25% of liquid assets, could be permitted to be excluded from the trading book. Excess liquid assets above 125% would then fall within the trading book scope and, thus, licensing requirements. This approach should be operationally manageable, as firms generally retain the liquidity requirement fully in cash. We do not want to introduce a regime that

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127 Art. 4(1)(86) CRR: "trading book' means all positions in financial instruments and commodities held by an institution either with trading intent or to hedge positions held with trading intent in accordance with Article 104 [CRR].'; Annex to the Opinion, (2017), par. 151.

128 Recital (38) CRR3;

129 Discussion Paper, (2024), par. 160-161.

incentivises selling liquid assets when they appreciate in value over the 25% buffer, as this would limit the availability of liquidity in need and create an unnecessary amount of transactions. Moreover, due to the calibration of the liquidity requirement, firms generally retain the requirement fully in cash anyways.

Concretely, a potential provision could read like this:

'***1. The liquid assets held by firms that are not authorised to deal on own account pursuant to point (6) of Article 4(1) of Directive 2014/65/EU for purposes of meeting the liquidity requirement of Article 43 should not be assigned to the trading book.***

2. The liquid assets held by the investment firms referenced in paragraph 1 shall not be assigned to the trading book up to 125% of the requirement of Article 43(1). Liquid assets as referred to in Article 43(1) points (a), (b) and (c) held by the investment firm in excess of 125% of the requirement referred to in Article 43(1) shall be assigned to the trading book where they meet the requirements of Article 4(1) points (54) and (55).

3. If the liquid assets held by the investment firm are not assigned to the trading book as referred to in paragraph 1 and 2 and appreciate to represent more than 125% of the requirement of Article 43(1), they shall remain unassigned to the trading book for as long as they are not sold by the investment firm.

4. Where the investment firm is required to hold additional liquid assets by the competent authority pursuant to Article 39(2) point (a) or (k) or Article 42 of Directive (EU) 2019/2034, these shall be treated in accordance with paragraph 1,2 and 3.

5. Where an investment firm has assigned to the non-trading book a position in an instrument meeting the requirements of Article 4(1) points (54) and (55), the investment firm's competent authority may ask the investment firm to provide evidence to justify such assignment. Where the investment firm fails to provide suitable evidence, the competent authority may require the investment firm to reassign that position to the trading book.'

8 Liquidity Requirements

Currently, liquidity requirements for firms are specified in art. 43 IFR, which mandates that firms retain one-third of their FOR in liquid assets. Liquid assets are defined in art. 43(1)(a)-(d) IFR and generally align with HQLA under the CRR framework, along with unencumbered short-term deposits.[130] Additionally, firms may face further liquidity requirements under Pillar 2 to address their specific liquidity risk, as detailed in Commission Delegated Regulation (EU) 2023/1651 ("**Liquidity RTS**").[131]

Overall, the liquidity requirement framework under IFR is considerably simpler compared to the Liquidity Capital Requirement ("**LCR**") banks must follow, both in qualitative and quantitative terms. The primary liquidity need for the average firm is expected to be for regular operational expenses.[132] Unlike banks, firms typically do not face severe liquidity outflows during stress events, such as bank runs.

To address the lower liquidity requirement, the same haircuts applicable to banks are applied to liquid assets under the IFR, providing a level of inherent prudence. Despite its simplicity and comparatively lower requirement, the liquidity framework appears appropriate for most firms. Unlike, the LCR[133], which is a stress-based metric, the IFR liquidity requirement focuses on the fundamental principle that investment firms are non-systemic and can be orderly wound down if necessary.[134]

The Discussion Paper explores several aspects of calibrating the IFR liquidity requirement, generally advocating for increased liquidity and additional qualitative clarifications.

Q18: Investment firms performing MiFID activities 3 and 6 (trading on own account and underwriting on a firm commitment basis) are more exposed to unexpected liquidity needs because of market volatility. What would be the best way to measure and include liquidity needs arising from these activities as a liquidity requirement?

In drafting the IFR, specific attention was given to the liquidity needs of firms dealing on own account and underwriting on a firm commitment basis. Historically, under the CRR, these firms were the only investment firms subject to liquidity requirements.[135] Their liquidity is particularly sensitive to market risk, as sudden price movements may necessitate additional margin deposits.[136] The EBA determined that a differentiated liquidity regime for firms dealing on own account should be addressed through Pillar 2, while applying a uniform Pillar 1 liquidity requirement to all firms.[137]

The most (conservative) expression of the liquidity requirement for most firms dealing on own account is the minimum net liquidity they must retain at their clearing members. This amount typically includes a safety margin beyond the market risk charge determined by the clearing member and should cover most trading-related liquidity needs. For operational expenses, firms should maintain cash reserves at their bank, ideally with the same institution.

The margin retained at the clearing member serves as a stress-based buffer, reflecting the firm's specific liquidity needs. Conversely, cash held in a cash account covers operational expenses and is less likely to fluctuate significantly under stress.

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130 Whereas banks may not use commercial bank deposits as liquid assets and are restricted to certain central bank deposits, investment firms are permitted to use such liquidity to meet their requirements. This as for investment firms there is not a similar contagion risk or interconnectedness problematic as cross holdings under banks pose; see Annex to the Opinion, (2017), par. 252-253; EBA Discussion Paper, (2016), par. 117.

131 Commission Delegated Regulation (EU) 2023/1651 of 17 May 2023 supplementing Directive (EU) 2019/2034 of the European Parliament and of the Council with regard to regulatory technical standards for the specific liquidity measurement of investment firms under Article 42(6) of that Directive.

132 Annex to the Opinion, (2017), par. 231.

133 Which was one of the crucial points being considered in the drafting of the IFR; See EBA, *Report on Investment Firms*, (2015), p. 48; EBA Discussion Paper, (2016), par. 127-129; Annex to the Opinion, (2017), par. 236-141.

134 Commission Staff Working Document, (2017), p.9: 'As a result of the low systemic relevance of most investment firms, the underlying CRR/CRDIV premise of ensuring sufficient buffers of capital and liquidity to withstand significant losses may be misplaced and represent disproportionate costs for them.'; Recital (28) IFR; and Discussion Paper, (2024), par. 177.

135 EBA, Report on Investment Firms, (2015), p. 44.

136 EBA, *Report on Investment Firms*, (2015), p. 46; Annex to the Opinion, (2017), p. 72.

137 Notwithstanding the possible derogation for class 3 firms under art. 43(3) IFR.

Trading capital is often funded by equity, so depositing this capital as cash at the clearing member effectively creates a liquidity buffer. In that sense, firms already ring-fence a part of their capital through depositing it at the clearing bank. However, clearing and cash accounts should not be part of the same netting set to avoid encumbrance issues. This separation ensures that liquidity used for operational expenses remains unaffected by margin calls. This could be construed as an encumbrance of the deposit, as clearing banks generally may use such deposits to remediate any capital shortages in the clearing account. In other words, when the firm would need the liquidity to cover an operational expense, but the clearing member requires additional margin, generally speaking the clearing member may debit the cash account held to the required amount. Therefore, the liquidity requirement as currently applicable should be kept on a completely separate bank account, or if held in liquid assets, in a separate securities account. As such, the liquidity held to adhere to the liquidity requirement is 'dead' capital for a trading firm, it cannot add to the liquidity available for trading.

Maintaining one month of operational expenses as a liquidity buffer is standard and essential for business continuity. However, requiring several months' worth of liquidity could be economically burdensome and impractical, as it would need to be funded through equity, bonds or loans. Moreover, firms are generally prohibited from using the liquidity to meet the requirement, unless exceptional circumstances occur and supervisory approval has been obtained.[138] This immobile nature of the liquidity required was one of the reasons in the preparation of the IFR to moderate the quantity of liquidity required, so as to not crowd well-managed firms out of the market through regulatory reasons.[139]

A tailored regime for firms dealing on own account could be based on their trading activities and liquidity profile, potentially using a volatility percentage with a buffer over a one year period in respect of the RtM K-factor requirement. However, this approach might better reflect market risk than liquidity risk and would be a poor substitute for the clearing member's margin model. In the end, the volatility in margin calls may be a better metric but this is highly unpredictable and firm-specific, and firms do not (necessarily) report margin calls to competent authorities, complicating this approach. The EMIR Review may improve transparency on margin calls under stressed conditions, providing insight into appropriate liquidity buffers. If a *margin based* buffer were implemented, it could result in a double requirement, as liquid assets should not be part of the clearing account's netting set. Moreover, such margin based requirement would not acknowledge the liquidity providing character of most if not all clearing relationships, with the clearing bank generally providing for a liquidity facility for the trading firm.

Given the complexities and firm-specific nature of margin-based metrics, it is preferable to rely on the SREP for liquidity adequacy assessments. The SREP can tailor liquidity requirements based on the firm's trading strategy, a more flexible and precise approach than a fixed Pillar 1 requirement.[140] Admittedly, this reasoning is severely focused on cleared trading; however, OTC trading lends itself even less to a predetermined Pillar 1 regime and is less predictable than cleared markets.

Raising the liquidity requirement to several months of fixed costs, instead of one, would further immobilize capital that could be deposited as margin, due to the prohibitive function of art. 44(1) IFR. This would strain firm funding and is an inappropriate proxy for the liquidity needs due to trading stress. Thus, we agree with the EBA's conclusions in 2017 and find developing a specific liquidity regime for firms dealing on own account to be impractical and undesirable.

Q19: Investment firms performing the activities of providing loans and credit to clients as an ancillary service in a non-negligeable scale would be more exposed to liquidity risks. What would be the best way to measure such risk in order to take them into account for the purposes of the liquidity requirements?

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138 Art. 44 IFR; the Annex to the Opinion, (2017), par. 251 considered it best not to subject the use of the liquidity buffer in exceptional circumstances to prior supervisory approval, however, the IFR does seem to have implemented such a prior approval regime. This makes it even harder for a firm to use the liquidity and in the event of a sudden margin call, which is discussed here, the firm will have to obtain supervisory approval before the final margin deposit time – generally no later than end of day. This makes art. 44(1) IFR particularly troublesome in the event of liquidity stress.

139 EBA Discussion Paper, (2016), par. 128.

140 EBA Discussion Paper, (2016), par. 129; See also art. 2(2) of Commission Delegated Regulation (EU) 2023/1651.

Providing loans and credit to clients is not a common activity for most firms and generally does not occur on a large scale.[141] However, some firms may engage in this activity more significantly, though they represent a small subset of the total investment firm population. As mentioned earlier regarding the Pillar 1 capital charge for these activities, introducing a Pillar 1 liquidity requirement would complicate the IFR to the extent that it would undermine the proportionality principle that underpins it.

We would advise against the introduction of a flow or stock-based measure, as this would effectively create a quasi-LCR, shifting the Pillar 1 regime closer to the banking regime – something that has been deemed inappropriate and disproportionate. Introducing a provision similar to art. 45 IFR, which addresses client guarantees, would be challenging. Client loans are on-balance-sheet items and imposing a provision akin to art. 45 IFR would essentially introduce a credit risk weight for these client exposures in the form of liquidity rather than capital. Moreover, this approach would disrupt the IFR framework by requiring specific liquidity requirements for certain on-balance-sheet items while not doing so for others.

Therefore, we believe it to be the most appropriate to continue handling the treatment of client loans under the SREP, given the highly idiosyncratic nature of such lending. Additionally, under the qualitative requirements of art. 29(1)(d) IFD, there is a sufficiently prudent risk management framework in place to manage the liquidity risks that an investment firm may face.

Q20: Investment firms, providing any of the MiFID services, but exposed to substantial exchange foreign exchange risk may be exposed to liquidity risks. What would be the best way to measure such risk in order to take them into account for the purposes of the liquidity requirements?

We believe that the best way to measure the foreign exchange risk ("**FX risk**") to which firms are exposed would be (a proportional version of) the method as used by art. 351 *et seq.* CRR.

Technically, art. 21(4) IFR already requires the inclusion of positions, beyond those in the trading book, which give rise to FX or commodity risk in their own funds requirements through the RtM K-factor requirement. However, it is unclear to us whether firms that do not deal on own account are required to capitalize their FX risk under this provision. Applying this requirement to all firms could also be disproportionate and unfamiliar for many firms that do not deal on own account, as this means that all firms would need to adhere to the FX risk framework outlined in art. 351 *et seq.* CRR. These firms, however, would be the primary targets for an FX risk liquidity charge, as those dealing on own account already quantify and capitalize their FX risk through their operational funding, utilizing clearing accounts and margin requirements.

One potential solution is to implement a proportional liquidity requirement version of the FX risk capital requirement from the CRR into the IFR. The detailed and complex rules of the LCR, including those on currency mismatches, are too intricate to apply effectively to all firms. Therefore, adapting the capital requirement under art. 351 CRR into a proportional liquidity measure could be beneficial, as this methodology is relatively straightforward. It is important to note that qualitative requirements regarding FX liquidity risk, such as those found in art. 29(1)(d) and, to some extent, art. 42 IFD, are essential complements to any Pillar 1 requirement.

To address this, a new article could be included:

'Article 43a

Foreign exchange liquidity requirement

1. If the sum of an investment firm's overall net foreign-exchange position, calculated in accordance with paragraph 3, exceeds 10% of its total own funds, the investment firm shall calculate, in addition to the requirement of Article 43(1), a liquidity requirement for foreign exchange risk. The liquidity requirement for foreign exchange risk shall be the sum of its overall net foreign-exchange position in the reporting currency, calculated in accordance with paragraph 3, multiplied by 4%.

2. The net foreign exchange position in each currency <u>other than the reporting currency</u> shall be calculated as the sum (positive or negative) of asset items (positive) and liability items (negative).

141 Commission Staff Working Document, (2017), p. 16.

3. The net position in foreign exchange per currency other than the reporting currency, calculated in accordance with paragraph 1, shall be converted at spot rates into the reporting currency. They shall then be summed separately to form the total of the net short positions and the total of the net long positions respectively. The higher of these two totals shall be the investment firm's overall net foreign-exchange position.

4. The requirement calculated in accordance with paragraph 1 shall be held in liquid assets as set out in points (a) to (d) of Article 43(1).

5. By way of derogation from paragraph 1, competent authorities may exempt investment firms that meet the conditions for qualifying as small and non-interconnected investment firms set out in Article 12(1) from the application of paragraph 1 and shall duly inform EBA thereof.'

Q21: Are there scenarios where the dependency on service providers, especially in third countries, if disrupted, may lead to unexpected liquidity needs? What type of services such providers perform?

We do not have any comments on this question.

Q22: Are there scenarios where the dependency on liquidity providers, especially in third countries, would lead to unexpected liquidity needs? Could you provide some examples?

We do not have any comments on this question.

Q23: What other elements should be considered in removing the possibility of the exemption in Article 43 of the IFR?

For the reasons outlined above and mentioned in the Discussion Paper, we support removing the exemption for small and non-interconnected firms currently included in art. 43(1), second sub-paragraph, IFR. Small firms, like larger ones, need to cover their monthly operational expenses and should be capable of being wound down in an orderly manner. Therefore, whether one adopts a going concern or gone concern approach to liquidity requirements, there does not appear to be a compelling reason to exempt small and non-interconnected firms. However, these firms should still be allowed to use the assets listed in art. 43(3) IFR, considering the specific nature of their business models.[142]

We would also like to address art. 44(1) IFR. This provision deviates from the original proposals by the EBA and the Commission.[143] Initially, the provision was intended to impose a general prohibition on using the liquidity buffer except in exceptional circumstances. If a firm invoked this provision, it was required to notify the competent authority immediately and restore the full requirement within 30 days.[144] However, in the final and current IFR, the notification requirement was changed to a prior approval right. Reflecting on the EBA's rationale, this design choice seems illogical to us: "*Investment firms should be allowed to use the liquidity buffer only in exceptional and unexpected circumstances. As liquidity may be required in a very short term, the use of the liquidity resources may be allowed prior to supervisory approval; however, this should always be immediately accompanied by notification to the competent authority.*"[145]

This change appears to have been made after the European Parliament's report and was likely agreed upon during trilogue negotiations, as it is included in the final text.[146] We recommend removing this amendment, as the liquidity buffer should be accessible to firms when needed. Particularly in the case of unexpected liquidity shocks, which are typically what drive the need for a buffer, firms may need to act within a single day, such as for margin calls. Waiting for supervisory approval in such cases seems to create an unnecessary obstacle without adding significant prudential value.

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142 Annex to the Opinion, (2017), par. 255-256.

143 See art. 43(1) IFR Proposal; and Commission Staff Working Document, (2017), p. 22.

144 Art. 44(2) IFR.

145 Annex to the Opinion, (2017), par. 250.

146 Art. 43(1) of European Parliament, Provisional Agreement Resulting from Interinstitutional Negotiations: Proposal for a regulation of the European Parliament and of the Council on the prudential requirements of investment firms and amending Regulations (EU) No 575/2013, (EU) No 600/2014 and (EU) No 1093/2010 (COM(2017)0790 – C8-0453/2017 – 2017/0359(COD)), (2019).

Therefore, we propose redrafting art. 44(1) IFR as follows:

'*1. Investment firms may, in exceptional circumstances****, reduce the amount of liquid assets held. Where such reduction occurs, the investment firm shall notify the competent authority without delay.***'

9 Prudential consolidation

The topic of prudential consolidation for investment firm groups has recently been addressed with the new Commission Delegated Regulation (EU) 2024/1771 on prudential consolidation of investment firms ("**Consolidation RTS**")[147]. This regulation further develops the provisions of art. 7 IFR and the EBA Guidelines on the Group Capital Test ("**EBA GCT Guidelines**")[148], which expand on the application of the Group Capital Test ("**GCT**") under art. 8 IFR. The Discussion Paper also touches on other important aspects of the prudential consolidation regime, which we will discuss below.

9.1 Background

Consolidated supervision is intended to complement the supervision of individual authorised entities by providing a broader view of the risks that a firm may face due to its membership of a group. It effectively treats the group's entities as if they were a single firm.[149] The same types of risks that can occur in consolidated banking groups, such as leverage buildup, multiple gearing of regulatory capital, and the spread of risks across group entities, can also arise in investment firm groups. However, unlike banking groups, investment firm groups are not subject to a resolution scheme and are not wound down as a whole.[150] Consequently, consolidated supervision for investment firms does not need to ensure that losses are up-streamed or that capital is mobile to facilitate a resolution strategy, such as a *single point of entry* strategy.

Originally, the EBA recommended the GCT as the default method of consolidation, with full consolidation under art. 7 IFR as an alternative.

9.2 Inclusion of Exempted Firms in the Consolidated Situation

Another issue raised in the Discussion Paper is whether firms exempt from MiFID authorization, in line with art. 3(1) MiFID II, should be included in the consolidation scope. Including such exempted firms and allowing them to be at the head of an investment firm group, is problematic. Currently, art. 7(1) and 4(1)(11) IFR provide an exhaustive list of entities within the scope of consolidation, which does not include exempted firms. Including them in the IFR consolidation would effectively impose many prudential requirements on them, counteracting their exemption from the MiFID regime. This would essentially indirectly reintroduce these requirements.

Moreover, including exempted entities seems inconsistent with applying requirements on a *consolidated basis*, i.e., as if the group were a single investment firm, which primarily aims to capture all prudentially regulated firms within the group (or those indirectly subject to it, such as tied agents and ancillary service undertakings).[151] It is important to note the limited scope of consolidation under the IFR compared to the CRR, which can include many subsidiaries under art. 18 CRR. The IFR follows a strict consolidation principle, as reiterated in the EBA Final Report on the Consolidation RTS,[152] whereby the purpose of consolidation is also different from that of banking groups, as noted above.

We do not consider it necessary to include exempted institutions within the consolidation scope. The risk to clients or the market from firms exempted under art. 3(1) MiFID II is negligible, which is why they were exempted from MiFID II in the first place. Including them in them in the investment firm group does in our view does not align with the purpose of the IFR or the consolidation paradigm.

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147 Commission Delegated Regulation (EU) 2024/1771 of 13 March 2024 on supplementing Regulation (EU) 2019/2033 of the European Parliament and of the Council with regard to regulatory technical standards specifying the details of the scope and methods for prudential consolidation of an investment firm group.

148 EBA, *Final report Guidelines on the application of the group capital test for investment firm groups in accordance with Article 8 of Regulation (EU) 2033/2019*, (2024).

149 EBA, *Report on Investment Firms*, (2015), p. 68.

150 EBA Discussion Paper, (2016), par. 150.

151 See also: EBA Discussion Paper, (2016), par. 149: *'[…] it should be noted that each prudentially regulated entity in the group should already have its own on-going regulatory capital requirements at an individual level, appropriate to the particular nature of its own business, and it would not seem proportionate to try to extend 'proxy' capital requirements to cover every type of unregulated entity that could exist within a group, particularly if there are no customers of a regulated service or activity.'*

152 EBA, *Final Report Draft Regulatory Technical Standards on the scope and methods of consolidation of an investment firm group under Article 7(5) of Regulation (EU) 2019/2033*, (2023).

Therefore, we recommend not including exempted MiFID II firms within the consolidated scope of investment firm groups.

9.3 Intermediary Holding Companies

Another issue addressed in the Discussion Paper concerns the situation where an investment firm group exists within a banking group. This can happen because the definition of an investment holding company ("**IHC**") in art. 4(1)(23) IFR only looks "downward", focusing on the IHC's subsidiaries. Art. 4(1)(57) IFR, which defines a union parent investment holding company ("**Union Parent IHC**"), only looks "upward" to ensure it is not a subsidiary of another investment firm or IHC. As a result, when an IHC is a direct subsidiary of a credit institution, it qualifies as the Union Parent IHC and is thus required to consolidate under art. 7(1) IFR, even though it will itself be consolidated by the credit institution or its parent undertaking.

The Discussion Paper argues that this structure is intentional, with the EBA suggesting that the IFR was deliberately designed to allow for this combined situation to consolidate investment firm activities under a specialized parent undertaking. Additionally, the Discussion Paper expresses concern that groups could easily restructure to move entities outside IHC consolidation perimeter and into the CRR perimeter to avoid apply IFR requirements on a consolidated basis at the IHC level.

We see several issues with this reasoning. First, during the drafting of the IFR, there was no mention of a desire to create a *specialized* holding company to consolidate investment firm groups. The choice of a separate consolidation regime seems to have been driven primarily by proportionality considerations, given that the intra-group risks being covered were considered less extensive than those under the CRR (e.g., no need for resolution strategies or depositor protection).[153] The consolidated application of the IFR was a last-minute change from the originally proposed GCT regime, which was intended to be the default. Full consolidation was not generally deemed necessary on proportionality grounds, which further undermines the argument that a specialized consolidating entity was purposefully created.

Second, the regulatory arbitrage mentioned in the Discussion Paper, where subsidiaries are moved from the IFR consolidation to the CRR consolidation, aligns with the purpose of consolidation. The CRR consolidation regime has a different regulatory objective than the IFR consolidation regime. When non-investment firms are consolidated under the IFR, they may need to apply K-factors for their intra-group risks. Under the CRR, non-investment firms would follow the CRR consolidation regime, which still addresses intra-group risks, but from a banking perspective. The individual investment firms themselves are not relieved from calculating K-factors specific to their investment services and activities, in addition to the CRR regime that they will be subjected to.[154] Thus, moving entities from the IFR consolidation to the CRR consolidation does not reduce prudential oversight. As noted by the EBA in 2016: *'[w]here an investment firm is part of a banking group, the credit institution in the group will already be required to apply consolidated supervision under the CRR, which should include a MiFID investment firm if within the scope of the relevant consolidation group; only where group risk is not /already addressed in this way would the above approach for investment firms need to be applied.'*[155]

Third, CRR consolidation under art. 18 CRR has a broader scope than IFR consolidation. This could result in situations where an IHC within a banking group does not include an entity for consolidation, while the CRR parent undertaking does, leading to confusion.

Therefore, applying both consolidation regimes within one group creates confusion and imposes double requirements. Including an IHC within a banking group does not contribute to the regulatory goal of consolidated supervision within a banking group. In fact, IHC groups may be subject to triple requirements: individual firm requirements, consolidated IFR requirements, and consolidated CRR requirements. It is

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153 See also: Annex to the Opinion, (2017), par. 66-67; When considering what the appropriate treatment of firms within banking groups should be, the EBA noted in respect of an option where firms would be required to apply IFR on an individual level and CRR on a consolidated level, that such option: '*[…] would result in a duplication of rules, which goes against the objective of simplicity […].*' Seen against that light, the current framework as supported by the EBA presents a triple application of capital requirements.

154 Annex to the Opinion, (2016), par. 73.

155 EBA Discussion Paper, (2016), par. 158.

evident from the preparation of the IFR that there was no intention to apply both IFR and CRR simultaneously. This aligns with the intent that investment firm-only groups are the ones captured under art. 7 IFR.

9.4 Definition of Union Parent Investment Firm

Regarding the refinement of the definition of Union Parent Investment Firm ("**UPIF**") in art. 4(1)(56) IFR, we are concise. The current definition results in a situation where a firm without any investment firms or financial institutions as subsidiaries as subsidiaries is not required to consolidate. For instance, an investment firm with only ancillary service undertakings or tied agents would not qualify as a UPIF and, therefore, would not be subject to consolidation under art. 7 IFR.

The key question is whether such an investment firm should be required to consolidate and, if so, whether this would address any relevant risks not covered at the individual level. It can be argued that any risks associated with such a firm are already addressed by individual requirements, and any residual risks are not significant enough to necessitate consolidated supervision. Ancillary service undertakings and tied agents are not subject to prudential requirements individually. The risks posed by tied agents are managed directly by the firm, while ancillary service undertakings generally do not generate risks that are capitalized under Pillar 1, thus avoiding double gearing. Since the investment firm is the parent entity, leverage risks are not a concern.

Therefore, there appears to be no compelling regulatory reason to modify the definition of UPIF.

We recommend leaving the definition of UPIF unchanged.

9.5 Regulatory Arbitrage through Ancillary Service Undertakings

Ancillary service undertakings are included within the consolidated situation pursuant to art. 4(1)(11) IFR. However, they are not considered financial institutions under art. 4(1)(14) IFR, as they are not listed in that article and their principle activities consists of owning or managing property, managing data-processing services, or a similar activity which is ancillary to the principal activity of one or more investment firms. Accordingly, their principle activity does, by definition, not involve acquiring holdings or pursuing one or more of the activities listed in points (2) to (12) and point (15) of Annex I to CRDIV (which is required to qualify as a "financial institution"). The interpretation of what constitutes "principle activity" is discussed below. Since ancillary service undertakings are not financial institutions, they cannot be classified as IHCs. Consequently, if a parent undertaking has both an investment firm and an ancillary service undertaking as subsidiaries, where the latter is the main activity, the parent would not qualify as a financial institution or an IHC.

Under CRR3, the definition of financial institution will be revised to include ancillary service undertakings under art. 4(1)(26) CRR3. The revised definition in art. 4(1)(18) CRR3 reads:

'*"ancillary services undertaking" means an undertaking the principal activity of which, whether provided to undertakings inside the group or to clients outside the group, consists of any of the following:*

- *(a) a direct extension of banking;*
- *(b) operational leasing, the ownership or management of property, the provision of data processing services or any other activity insofar as those activities are ancillary to banking;*
- *(c) any other activity considered similar by EBA to those referred to in points (a) and (b).*'

The definition of ancillary service undertaking in art. 4(1)(1) IFR is:

''*ancillary services undertaking' means an undertaking, the principal activity of which consists of owning or managing property, managing data-processing services, or a similar activity which is ancillary to the principal activity of one or more investment firms.*'

Thus, the IFR's definition of ancillary service undertaking is similar but not identical to the definition under art. 4(1)(26(b) CRR3. The inclusion of ancillary service undertakings as financial institutions under CRR3 for consolidation purposes does not align well with the more proportional framework of the IFR. The IFR aims to be less intrusive, not focusing on resolution or extensive resilience, allowing firms to fail if necessary. The inclusion of ancillary service undertakings as financial institutions under CRR3 seems inconsistent with this regulatory approach. The CRR consolidation seeks to ensure the stability of banking groups and banks to a greater extent and includes more significant ancillary service undertakings, such as those under art.

4(1)(26)(a) CRR3. In contrast, the less significant ancillary service undertakings under the IFR do not seem to warrant consolidation by themselves.

Aligning the IFR with CRR3 by designating ancillary service undertakings as financial institutions is not proportional in our view and could impose consolidation requirements on many firms without capturing significant additional risks.

Principal vs. Main Activity of Financial Institutions and IHCs

The concern arises when an ancillary service undertaking is placed at the head of the group to avoid consolidation requirements, as it would not qualify as an IHC. Currently, ancillary service undertakings are by definition not included in the list of financial institutions under art. 4(1)(14) IFR.

The term "principal activity" is debatable but seems to refer to business strategy rather than a size criterion. Under the CRR and the forthcoming CRR3, the definition of an investment firm does not use a specific size criterion to determine “principal activity”. Conversely, the definition of a financial holding company does use a size criterion, where a financial institution is considered a financial holding company if over 50% of its equity, consolidated assets, revenues, or other relevant indicators are associated with subsidiaries that are financial institutions.

Given this, "principal" appears to be different from "main" as it lacks a size criterion, which is included in the definition of a financial holding company. Thus, an investment firm group could potentially avoid consolidation requirements by placing an ancillary service undertaking at the head of the group, since it would not qualify as an IHC.

To address this issue, the definition of IHC in the IFR should be revised to include clear criteria for when a financial institution primarily holds investment firms or financial institutions as subsidiaries. Additionally, the definition could be amended to ensure that ancillary service undertakings whose subsidiaries are exclusively or predominantly investment firms or financial institutions are also classified as IHCs.

9.6 Group Capital Test

Background on the GCT and IFR

The Discussion Paper proposes incorporating further details on the application of the GCT directly into art. 8 IFR, along with a related RTS.[156] These changes should be viewed in light of the recently finalised EBA Guidelines on the application of the GCT (“**GCT Guidelines**”).[157] During the drafting process, the EBA aimed to structure the fragmented European application of the GCT to investment firm groups, focusing on defining what constitutes a *sufficiently simple group that does not pose a significant risk to the clients or market*.[158] Specifically, the EBA suggests introducing strict limits on the number of legal entities within an investment group and the total size of the assets to qualify for the GCT. If these parameters are met, the competent authority can assess, using the methodology of the new RTS, whether it is appropriate to grant permission to apply the GCT. Additionally, the EBA prefers to clarify the calculation of own funds requirements when the GCT is applied in the new (proposed) RTS, formalising the methodology currently outlined in the GCT Guidelines.

Before commenting on this proposal, we will briefly explain the background of the GCT. The GCT originally derived from the CAD and was incorporated into art. 15 CRR. Art. 15 CRR listed requirements that an investment firm group had to meet to be eligible for derogation from the regular consolidation framework, including the requirement of being an investment firm-only group. These conditions were designed to ensure that investment firms are not unduly exposed to risk from other parts of the group, even without consolidated supervision.[159] If the group met these requirements, it could apply the GCT, and the firms in the group would only be subject to own funds requirements on an individual basis. This did not imply that group risks were

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156 Discussion Paper, (2024), par. 200.

157 EBA, *Final report Guidelines on the application of the group capital test for investment firm groups in accordance with Article 8 of Regulation (EU) 2033/2019*, (2024).

158 Art. 8(1) IFR.

159 EBA, *Report on Investment Firms*, (2015), p. 68.

irrelevant for firms meeting the requirements, but rather that such risks could also be managed in a more proportional manner than full prudential consolidation.[160]

Application and Impact of the GCT

The GCT addresses group risks by requiring that parent undertakings in the group retain sufficient own funds to cover the full book value of all of their holdings, subordinated claims and, certain other assets, in investment firms, financial institutions, ancillary services undertakings, and tied agents in the investment firm group, as well as the total amount of contingent liabilities in favour of those entities, the so-called *solo-plus* methodology.[161] Entities located in third countries that would qualify as any of the aforementioned entities are also included. This approach prevents *double gearing* of capital and captures intra-group exposures. In effect, the GCT requires the group to maintain an amount of externally raised capital (i.e., not from group entities) sufficient to cover internally raised eligible capital instruments.[162] Consequently, the GCT does not require the calculation of K-Factor requirements on a consolidated level, simplifying the consolidated capital requirement.

Another significant effect of applying GCT is the disapplication of certain governance rules on a consolidated basis, particularly those in art. 25 *et seq.* IFD, which include remuneration rules. These rules can be particularly problematic for internationally operating firms with a European parent entity, as the strict IFD remuneration rules are generally not applied to firms in third countries. Moreover, since there is no international standard on capital requirements for investment firms akin to Basel for banks, most third-country investment firms are not subject to capital requirements comparable to those under the IFR. The GCT, therefore, prevents these third-country firms from having to calculate K-Factor requirements, or from requiring the parent undertaking to calculate K-Factor requirements on their behalf. Instead, the parent undertaking 'only' needs to calculate the book value of its holdings, providing a simpler methodology, though not necessarily capital relief. However, due to the GCT Guidelines' requirements, parent undertakings end up calculating the K-Factor requirement of the third-country subsidiary regardless.[163]

Evolution of GCT in the IFR

Crucially, the original IFR proposal and its preparatory documentation used the GCT as the default mode of consolidation for investment firm groups. Full consolidation under art. 7 IFR was originally a discretionary alternative to the GCT, to be applied by competent authorities when investment firm groups were either (i) structured to exploit regulatory arbitrage, or (ii) posed significant risks that warranted comprehensive treatment in a manner different from the GCT, for instance when the investment firm would be substantially interconnected.[164] This reasoning supported the GCT as the default, and underpinned the entire IFR, due to the relatively limited risk profile of firms compared to the banks and them being "allowed to fail". The similarity between a disapplication ground aimed at preventing Class 2 firms from structuring themselves to avoid classification as a Class 1 firm and a disapplication ground based on significant (systemic) risks is apparent. The application of full consolidation seemed necessary only for systemically relevant groups, with the more proportional GCT being applied to 'regular' Class 2 firm groups.[165] It was therefore surprising to the market and legal scholars[166] alike when the final IFR reversed this proposed regime, resulting in the derogation GCT now included in art. 8 IFR. The reasoning behind this switch remains unclear, with no explanation provided in the final version of the IFR, apart from Recital 12 IFR:

'*In order to mirror the existing treatment of investment firm groups under [CRR] and [CRD IV], for groups consisting only of investment firms, or where consolidation under [CRR] does not apply, the parent*

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160 EBA, *Report on Investment Firms*, (2015), p. 70.

161 Art. 8(3)(a) and (b) IFR; formerly art. 15(1)(d) CRR; see also E.P.M. Joosen and M.L. Louisse, *Een nieuw prudentieel regime voor beleggingsondernemingen (II)*, (20218), p. 175.

162 Annex to the Opinion, (2017), par. 59.

163 This as a ratio of required capital between the GCT and regular full prudential consolidation has to be calculated. For the third-country firms that are not capitalised under an equivalent regime to the IFR, the capital requirement applied is the *nominal amount of own funds*, which has been equated with the requirements under the K-Factors of IFR; see GCT Guidelines, par. 29-30.

164 Commission Staff Working Paper, (2017), p. 23.

165 E.P.M. Joosen and M.L. Louisse, *Een nieuw prudentieel regime voor beleggingsondernemingen (II)*, (2018), p. 175-176.

166 B.J. Nieuwenhuijzen, (2021), p. 199-203.

undertaking in such groups should be required to comply with the requirements of this Regulation based on the consolidated situation of the group. Alternatively, instead of prudential consolidation, where such investment firm groups reflect simpler structures and risk profiles, competent authorities may allow the parent undertaking in the group to have sufficient capital to support the book value of its holdings in the subsidiaries.'

Concerns with Hard Limits

We now address the proposals put forward by the Discussion Paper, as they are fundamentally connected to this complex regulatory background. The underlined passage above has been interpreted by EBA as requiring substantial framing of the parameters within which investment firm groups can apply for the GCT. The GCT Guidelines set indicative quantitative limits on the number of entities and ownership layers in a group. If a group falls within these limits, it is presumed to be simple and not risky. The Discussion Paper proposes including these soft limits as hard limits within the IFR. If a group meets these limits, it would be eligible to apply the GCT, provided permission is granted using a methodology set out in a forthcoming RTS. This RTS will likely follow the GCT Guidelines. However, if an investment firm group does not meet the proposed hard limits, it would not be eligible to apply the GCT, regardless of the RTS methodology. Here, the Discussion Paper fundamentally errs in considering the rationale of the GCT.

The entire developmental history of the GCT in the IFR suggests a subjective requirement that aims to be proportional to the size and scope of investment firm groups. As a result, the criteria for applying the GCT in art. 8 IFR are highly subjective. The EBA has adopted Guidelines detailing when a group of firms is *sufficiently simple and does not pose material risk to clients or the market*. However, the history of the GCT in the IFR shows that the presumption was that investment firm groups principally *are* eligible for the GCT. Only when a group poses systemic risk should full consolidation be applied. Although the IFR ultimately changed the starting point to full consolidation, the suitability of the GCT for most investment firm groups was not necessarily altered. Implementing hard quantitative limits in the IFR would stratify a regime originally considered prudent for most groups.[167] Excluding groups based on mere numerical grounds feels disproportionate and risk-insensitive and lacks proper justification. Moreover, introducing such limits would likely lead to harmonisation of group structures along a regulatory model, yielding little concrete benefit. The resulting GCT would assess group risks less on their merits and more on the 'complexity' of the group structure.

Recommendations

We therefore strongly oppose the implementation of hard limits in the IFR. We also argue that the GCT Guidelines should be reviewed, as their requirements are not directly connected to the original foundation of the CGT. One particularly problematic aspect of the GCT Guidelines is the requirement for the parent undertaking to calculate the ratio between the GCT and full consolidation capital requirements.[168] For regular groups without third-country subsidiaries, this requirement renders the GCT ineffective. Not only does the investment firm not gain capital efficiencies, since the GCT capital requirement is usually higher than that of full consolidation, but the operational gains of not having to calculate K-Factors on a consolidated level are also lost. Removing this requirement appears particularly pressing. The competent authority could use such a measure internally, but this should not extend in any way to the applicant investment firm group. Therefore, we argue that the exemption in paragraph 17 of the GCT Guidelines should be applied by default in all but the most exceptional cases.[169]

167 Annex to the Opinion, (2017), par. 71.

168 GCT Guidelines, (2024), par. 12(g) and 15(a).

169 GCT Guidelines, (2024), par. 17: '*For the purposes of [calculating the ratio of the GCT capital requirement against the art. 7 requirement], competent authorities may exempt the [consolidating entity] from the obligation to calculate the own funds requirements of the investment firm group according to Article 7 [IFR] if they deem that the effort required to perform such a calculation would be disproportionate. If competent authorities grant this exemption, the own funds requirements of the investment firm group according to Article 7 of that regulation should be replaced with the sum of the individual own funds requirements of all undertakings of the group that are Union parent investment firms, Union parent investment holding companies, Union parent mixed financial holding companies and any other parent undertakings that are investment firms, financial institutions, ancillary services undertakings or tied agents. If an undertaking is not an investment firm, the individual own funds requirements are those applicable under the relevant prudential framework. If an undertaking is a subsidiary*

Furthermore, we believe the GCT should generally be more accessible to the majority of investment firm groups. While art. 7 IFR can remain the starting point, it is our view that if a group does not pose a systemic risk, as assessed along the lines of art. 1 IFR, it should be eligible to apply the GCT. The GCT, in turn, should limit the number of required calculations to preserve the proportional nature of the regime and encourage its use in the sector. If too many administrative hurdles are imposed, the GCT's application will remain sporadic and limited to the largest groups, whereas small and medium-sized groups should benefit from the GCT's proportional nature.

Therefore, we propose that the RTS setting out the methodology to assess GCT eligibility should adopt a positive approach, i.e., a bound discretion, stating that competent authorities will permit the application of the GCT where the following factors do not indicate that the group is complex or poses a material risk to clients and the market:

(i) The number of ownership layers between the consolidating entity and the firm(s);[170]
(ii) The number of entities in the group;[171]
(iii) The presence of multiple clearing members in the group;[172]
(iv) The transfer of trading positions or client assets/funds within the group; and[173]
(v) The clarity and transparency of ownership rights within the group.[174]

These requirements should not be strictly defined by concrete numbers, as they inherently require a case-by-case assessment. Similar to the current approach in the GCT Guidelines, these indicators could be developed through Guidelines. However, it remains crucial that a positive and flexible framework of the GCT is preserved.

We fully support the Discussion Paper's notion that the application of the GCT should be distinct from the extraterritorial effect of the IFR and IFD requirements, as should full consolidation under art. 7 IFR. The imposition of IFR/IFD requirements on third-country entities, which generally exceed local requirements by a substantial margin, creates a distortion in the market. Therefore, the extraterritorial effect of the IFR/IFD regime should be eliminated. However, as a means to manage risk from third-country entities, the approach under art. 8(4) IFR could be retained (partially), requiring groups to maintain the own funds of the third-country entity at EU parent undertaking level. Whether this should be the *notional* own funds as interpreted by the GCT Guidelines is open to debate.[175] It is arguable that simply requiring the retention of the book value of the holdings in third-country undertakings provides a solid starting point, which could then be adjusted to the level of own funds required locally, provided they ensure a satisfactory level of prudence. If the local jurisdiction does not impose own funds requirements that ensure a satisfactory level of prudence, the notional own funds required under the IFR could be applied.

Concretely, we propose to amend the following articles in the following manners:

Art. 4(1)(11) IFR:

'*'consolidated situation' means the situation that results from applying the requirements of this Regulation in accordance with Article 7 to a Union parent investment firm, Union parent investment holding company or Union parent mixed financial holding company as if that undertaking formed, together with all the investment firms, financial institutions, ancillary services undertakings and tied agents in the investment firm group, a single investment firm; ~~for the purpose of this definition, the terms 'investment firm', 'financial institution', 'ancillary services undertaking' and 'tied agent' shall also apply to undertakings established in third countries, which, were they established in the Union, would fulfil the definitions of those terms.'~~*

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undertaking located in a third country, the individual own funds requirements should be calculated in accordance with paragraph 20.'

170 Corresponding to GCT Guidelines, par. 12(a) and 14(c) and (d).
171 Corresponding to GCT Guidelines, par. 12(a) and 14(a) and (b).
172 Corresponding to GCT Guidelines, par. 15(c).
173 Corresponding to GCT Guidelines, par. 14(e) to (h) and 15(d).
174 Corresponding to GCT Guidelines, par. 12(d) to (f) and 14(i) to (k).
175 I.e. the own funds under IFR; see GCT Guidelines, (2024), par. 20.

Art. 8(4) IFR:

'Competent authorities may allow a Union parent investment holding company or a Union parent mixed financial holding company and any other parent undertaking that is an investment firm, a financial institution, an ancillary services undertaking or a tied agent in the investment firm group, to hold a lower amount of own funds than the amount calculated under paragraph 3, provided that this amount is no lower than the sum of the own funds requirements imposed on an individual basis on its subsidiary investment firms, financial institutions, ancillary services undertakings and tied agents, and the total amount of any contingent liabilities in favour of those entities.

~~For the purposes of this paragraph, the own funds requirements for subsidiary undertakings as referred to in the first subparagraph which are located in third countries shall be notional own funds requirements that ensure a satisfactory level of prudence to cover for the risks arising from those subsidiary undertakings, as approved by the relevant competent authorities.~~'

We propose to insert a new art. 8a IFR:

Article 8a

Subsidiary undertakings in third-countries

'1. For the purposes of Article 7 and Article 8, the own funds requirements for third-country subsidiary undertakings that would fulfil the definition the terms of 'investment firm', 'financial institution', 'ancillary services undertaking' and 'tied agent' in Article 4 were they established in the Union, shall be notional own funds requirements that ensure a satisfactory level of prudence to cover for the risks arising from those subsidiary undertakings, as approved by the relevant competent authorities.

2. For a satisfactory level of prudence to be ensured, Union parent investment firms, Union parent investment holding companies, Union parent mixed financial holding companies and any other parent undertakings that are investment firms, financial institutions, ancillary services undertakings or tied agents in the investment firm group shall hold at least enough own funds instruments to cover the sum of the following:

(a) the sum of the full book value of all of their holdings, subordinated claims and instruments referred to in point (i) of Article 36(1), point (d) of Article 56, and point (d) of Article 66 of Regulation (EU) No 575/2013 in the third-country subsidiaries; and

(b) the total amount of all of their contingent liabilities in favour of the third-country subsidiaries.

3. By way of derogation from paragraph 2, competent authorities may allow a Union parent investment holding company or a Union parent mixed financial holding company and any other parent undertaking that is an investment firm, a financial institution, an ancillary services undertaking or a tied agent in the investment firm group, to hold a lower amount of own funds than the amount calculated under paragraph 2, provided that this amount is no lower than the sum of own funds requirements imposed under applicable local law on an individual basis on their third-country subsidiaries, and the total amount of any contingent liabilities in favour of those entities under applicable local law.

4. Where competent authorities apply the derogation of paragraph 3 and no local own funds requirements apply, a Union parent investment holding company or a Union parent mixed financial holding company and any other parent undertaking that is an investment firm, a financial institution, an ancillary services undertaking or a tied agent in the investment firm group should, to ensure a satisfactory level of prudence, retain own funds requirements for third-country undertakings equal to at least the own funds requirements calculated in accordance with Parts Three and Four.

5. For the purposes of this article 8a, the Commission may adopt, by way of implementing acts, a decision as to whether a third country applies own funds requirements that ensure a satisfactory level of prudence.

Article 25(4) IFD is amended to:

'4. Member States shall require investment firms to apply the provisions laid down in Article 32 to remuneration awarded for services provided or performance in the financial year following the financial year in which the assessment referred to in paragraph 3 took place.

Where this Section applies and Article 8 of Regulation (EU) 2019/2033 is applied, Member States shall ensure that this Section is applied to investment firms on an individual basis.

Where this Section applies and prudential consolidation as referred to in Article 7 of Regulation (EU) 2019/2033 is applied, Member States shall ensure that this Section is applied to investment firms on an individual and consolidated basis.

By way of derogation from the third subparagraph, this Section shall not apply to subsidiary undertakings included in a consolidated situation that are established in third countries. ~~*, where the parent undertaking in the Union can demonstrate to the competent authorities that the application of this Section is unlawful under the laws of the third country where those subsidiary undertakings are established.*~~*'*

10 Interactions of IFD and IFR with other regulations

10.1 Interaction with UCITS Directive and AIFMD

Q24: Do you have any views on the possible ways forward discussed above concerning the provision of MiFID ancillary services by UCITS management companies and AIFMs?

Background

The Discussion Paper states that it is essential to identify regulatory loopholes that allow entities to conduct investment firm activities or provide investment firm services without being covered by the IFR/IFD. In this context, it refers to art. 6(3) of Directive 2009/65/EC ("**UCITS Directive**") and art. 6(4) of Directive 2011/61/EU ("**AIFMD**"), pursuant to which a UCITS management company or AIFM ("**Fund Manager**") may provide the following MiFID services:

(a) Individual portfolio management;
(b) Non-core services comprising:
   a. Investment advice;
   b. Safe-keeping and administration in relation to shares or units of collective investment undertakings.

Additionally, AIFMs may also provide reception and transmission of orders in relation to financial instruments (together, with the services under (a) and (b): "**MiFID Top-Up Services**"). When a Fund Manager is authorized to provide MiFID Top-Up Services, it must comply with the relevant MiFID II conduct rules that apply to such services. However, under MiFID II and the IFR, no capital requirements arise in relation to the provision of these additional services.[176] As a result, Fund Managers can be authorised, on top of their UCITS/AIFMD-specific services, to carry out MiFID services, without their own funds requirements under the UCITS Directive and AIFMD necessarily taking due account of the risks associated with these services. As also noticed by the Discussion Paper, this may result, in certain cases, in an asymmetric prudential treatment of these services compared to investment firms providing the same services, e.g., by having to set aside regulatory capital under relevant K-factors.

Recommendations

To ensure a symmetric and adequate level-playing field, we recommend that Fund Managers authorized to provide MiFID Top-Up Services should comply with the same prudential rules as investment firms that provide the same services. The reason therefore is that providing investment services involves certain prudential risks, regardless of whether the entity providing the services is authorized under a MiFID licence, an AIFMD licence or a UCITS licence. It is therefore evident that the approach to addressing these risks is independent of the specific licence under which the services are provided. Aligning prudential rules applicable to Fund Managers for the provision of investment services with the prudential rules applicable to investment firms, ensures that Fund Managers providing investment services maintain sufficient capital for the risks associated with the provision of these services ("same risks, same rules"). Additionally, this prevents regulatory arbitrage: entities cannot influence the prudential rules applicable to the investment services they provide by selecting a specific licence.

More concretely, we recommend a prudential twofold approach[177], whereby Fund Managers authorized to provide MiFID Top-Up Services are subject to the highest of the capital requirements (i) as calculated under the AIFMD/UCITS-regime, and (ii) as calculated under the IFR-regime. This approach prevents overlap and double counting between the prudential requirements of the AIFMD or UCITS Directive and the IFR, where the same risks might be mitigated by two capital requirements. In practice, this increases the regulatory burden for Fund Managers providing MiFID Top-Up Services. However, since only the highest capital requirement would apply, it is crucial that (i) capital requirements under the IFR and the AIFMD or UCITS Directive are fully calculated by the Fund Managers, and (ii) determining the capital requirement under the

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176 Except for local law differences. For example, under Dutch law, Fund Managers are subject to IFR capital requirements in relation to the provision of MiFID services.

177 Similar to the twofold approach currently applicable to Fund Managers under Dutch law.

IFR is done independently from the determination under the AIFMD or UCITS Directive and vice versa. Potential overlap between IFR capital requirements and those under the AIFMD or UCITS Directive is also avoided by applying only the highest capital requirement.

Practical implications

In practice, under the AIFMD/UCITS-regime, a Fund Manager authorized to provide MiFID Top-Up Services should maintain at least the highest of the following capital requirements:

(a) a minimum capital requirement for Fund Managers of EUR 125,000[178];
(b) a FOR of 25% of the fixed costs over the past financial year[179];
(c) an AUM requirement of EUR 125,000 plus 0.02% times the AUM above EUR 250 million[180].

Under the IFR-regime, Fund Managers should then maintain at least the highest of the following capital requirements:

(a) the permanent minimum capital requirement for a firm (i.e., Fund Manager) that performs MiFID Top-Up Services of EUR 75,000[181];
(b) a FOR of 25% of the fixed costs over the past financial year[182];
(c) the K-factor requirement, being the applicable requirement as an exponent of the relevant K-Factors of the Fund Manager[183].

Consequently, the higher of the AIFMD/UCITS-regime and the IFR-regime would be the leading quantitative capital requirement for the Fund Managers providing investment services. This method is in our view also intuitive from a methodological point of view, in the sense that a Fund Manager that provides relatively limited MiFID Top-Up Services (compared to its AIFMD/UCITS business) will have relatively low K-factors and therefore more likely fall under the AIFMD-regime. However, a Fund Manager that provides a more significant amount of MiFID Top-Up Services (compared to its AIFMD/UCITS business) will have relatively high K-factors and therefore more likely fall under the IFR-regime.

Class 3 Fund Managers

In view the rationale behind Class 3 firms, we believe that for Fund Managers that qualify as Class 3 firms under art. 12 IFR, the IFR-regime capital requirement should be the highest of the FOR and the permanent capital requirement. As a result, a Fund Manager that meets the requirements under art. 12 IFR should not need to calculate the K-factor requirement.

K-factors

The K-factor requirement would be the main difference between the AIFMD/UCITS regime and the IFR regime. Fund Managers should in our view only calculate K-factors for services attributable to the investment services they provide. In view of the investment services that Fund Managers may provide under the AIFMD and the UCITS Directive, the RtM and RtF K-factors do not apply to Fund Managers. Consequently, the only relevant K-factors are K-AUM, K-COH, K-CMH and K-ASA.

K-AUM

For Fund Managers that provide MiFID Top-Up Services, K-AUM likely is the most relevant K-Factor. As set out under paragraph 3.2,-AUM pertains to the value of assets that a firm manages for its clients under both discretionary and non-discretionary portfolio management arrangements constituting investment advice of an ongoing nature. Discretionary investment management refers to managing portfolios in accordance with mandates given by clients on a discretionary basis as defined in art. 4(1)(8) MiFID II, which means managing

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178 Art. 9(2) AIFMD / art. 7(1) UCITS Directive.
179 Art. 9(5) AIFMD / art. 7(1)(a)(iii) UCITS Directive.
180 Art. 9(3) AIFMD / art. 7(1)(a) UCITS Directive.
181 Art. 14 IFR jo. 9(2) IFD.
182 Art. 13 IFR.
183 Part Three IFR.

portfolios based on client instructions containing one or more financial instruments. Therefore, "collective" portfolio management (as in scope of the AIFMD and UCITS Directive) does not fall under discretionary portfolio management (as in scope of the MiFID/IFR-regime).

Under the AIFMD and UCITS Directive, a Fund Manager must maintain own funds of EUR 125,000 plus 0.02% of the amount exceeding EUR 250 million, up to a maximum of 10 million. We can imagine that AUM-related capital requirements under the IFR and those under the AIFMD and the UCITS Directive overlap, particularly if Fund Managers invest "individually" managed (i.e., AUM) in the "collective" funds they manage. It is therefore essential that the capital requirements under the IFR and the AIFMD or UCITS Directive are fully calculated and that no netting occurs with the capital requirement for collectively managed portfolios under the AIFMD or UCITS Directive when calculating the K-AUM requirement.

K-COH

As referred to in paragraph 3.1, COH concerns the value of orders handled for clients, through the reception and transmission of client orders and through the execution of orders on behalf of clients. Since a Fund Manager cannot provide the investment service of execution of orders on behalf of clients, the calculation of K-COH only applies to the reception and transmission of client orders. For Fund Managers, K-COH should in our view only pertain to orders from individual clients, meaning that orders handled by a Fund Manager in the context of managing a client's investment portfolio should not be covered by K-COH if the Fund Manager has already calculated K-AUM for that client's investments. K-COH should include transactions arising from investment advice, insofar the investment firm did not calculate K-AUM in respect of those transactions. Consequently, orders received and transmitted in connection with ongoing investment advice, for which the manager calculates K-AUM, should not be included in K-COH.

K-CMH

The K-factor K-CMH applies when a Fund Manager holds client money. If the Fund Manager is not authorized to conduct the MiFID ancillary service of safekeeping, we believe that no capital should be required based on K-CMH. However, if the Fund Manager has such authorization, e.g., for purposes of asset segregation requirements, the Fund Manager should calculate K-CMH.

K-ASA

The K-factor K-ASA applies when a Fund Manager safeguards and administers assets for clients from individual investment mandates. If the Fund Manager is not authorized for the MiFID ancillary service of safekeeping, we believe that no capital should be required based on K-ASA. However, if the Fund Manager has such authorization, e.g., for purposes of asset segregation requirements, the Fund Manager should calculate K-ASA.

10.2 Interaction with MiCAR

Q25: Are differences in the regulatory regimes between MiCAR and IFR/IFD a concern to market participants regarding a level playing field between CASPs and Investment firms providing crypto-asset related services? In particular, are there concerns on the capital and liquidity requirement regimes?

The Discussion Paper addresses the interaction between the MiCAR and the IFR/IFD framework.[184] It examines how MiCAR interacts with the capital and liquidity requirements under IFR/IFD for firms providing crypto-asset services.[185] The Discussion Paper notes that firms may be exempt from most (if not all) prudential requirements for CASPs if they follow the notification regime under art. 60 MiCAR. As the Discussion Paper indicates, this exemption arises because the IFR/IFD regime is generally considered more conservative than MiCAR. The situation is in that sense comparable to banks providing investment services, which are not subject to IFR/IFD requirements because CRR/CRD IV requirements are generally more stringent.

184 Discussion Paper, (2024), par. 214-225.

185 Discussion Paper, (2024), par. 217-222; See art. 3(1)(16) MiCAR for a definition of crypto-asset services. Roughly, most of the crypto-asset services coincide with the non-token-based investment services and activities included in MiFID II, see art. 60(3) MiCAR.

The question then is how IFR/IFD prudential requirements apply when a firm acts as a CASP. Specifically, should crypto-asset services be included in the K-Factors, the FOR and/or the liquidity requirement?

We believe that, in principle, no additional Pillar 1 requirements should be applied to crypto-asset services under the IFR/IFD. First, the IFR/IFD framework is designed for investment services and activities. As previously mentioned, we do not consider it appropriate to use Pillar 1 to target other activities than investment services and activities. Therefore, crypto-asset services should be addressed within the MiCAR framework. Second, including CASP activities in Pillar 1, such as in the K-factors, could create level playing field issues. Pure CASPs are not subject to a K-factor equivalent regime and must only hold the higher of PMC or FOR.[186] Introducing a new K-factor for crypto-asset services is therefore not advisable; if at all, such requirement should be handled under MiCAR. That being said, if it is decided to introduce a K-factor for crypto-asset exposures, we propose to do so in the manner set out in our answer to Question 14.

Third, the FOR is based on a firm's total expenditure. Excluding crypto-asset services from the FOR would require a new deduction ground. However, in line with our previous comments, the FOR should cover the orderly wind-down of the entire firm, not just its investment services and activities of the firm. Thus, excluding crypto-asset services from the FOR calculation under art. 13 IFR is not appropriate in our view. Fourth, we recommend a restrictive approach for the capitalisation of crypto-asset services within the Pillar 2 framework, where they would pose a risk that ought to be caught in the IFD based SREP assessment.[187] Class 1 and Class 1a firms must follow the transitional regime due to CRR/CRD IV requirements.

Competent authorities may identify risks related to crypto-asset services that need to be capitalised. However, MiCAR does not have a similar Pillar 2 regime for CASPs, leading to an uneven playing field if firms face a Pillar 2 add-on for their crypto-asset services. Moreover, MiCAR made a conscious legal choice not to impose additional capital requirements beyond the FOR or PMC. Nevertheless, the prudential requirements under art. 67 MiCAR aim to ensure consumer protection, similar to the RtC-induced capital requirements under the IFR.[188] Evidently, the EU legislator did not find it necessary to impose higher capital requirements for adequate consumer protection. The IFR, with its RtC K-Factor requirements specifically aimed at capitalising risks to clients, does necessitate specific capital for client protection. This discrepancy means that a *MiCAR customer* and an *IFR/MiFID II client* do not receive equal protection. Fundamentally, capitalising risks to clients for firms also providing crypto-asset services through Pillar 2 would differentiate in the protection offered to a service-recipient depending on whether they approach a CASP or a firm, creating an unlevel playing field. However, dogmatically, it would be difficult to permit firms to award a lower protection to clients when they receive crypto-asset services than when they receive investment services.

Despite these issues, we believe that Pillar 2 should not be used to capitalise all risks to clients from crypto-asset service provision. Although this creates the problems described above, the legislator seems to have opted for lower protection for crypto-asset service recipients. Pillar 2 add-ons should in our view only be applied if risks to customers adversely affect MiFID II clients, the traditional financial markets or the firm's stability to the point of preventing an orderly wind-down.

Q26: Sections 5.2, 5.4 as well as this Section 9.1 all touch upon how crypto-assets (exposures and services) may influence the IFD and the IFR. Is there any other related element that should be considered in the review of the investment firms' prudential framework?

We do not have any comments on this question.

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186 Art. 67(1) MiCAR.
187 See Discussion Paper, (2024), par. 224.
188 Recital (80) MiCAR.

PART II – REVIEW OF THE INVESTMENT FIRM DIRECTIVE

11 Remuneration and its governance

Q27: Is the different scope of application of remuneration requirements a concern for firms regarding the level playing field between different investment firms (class 1 minus and class 2), UCITS management companies and AIFMs, e.g., in terms of the application of the remuneration provisions, the ability to recruit and retain talent or with regard to the costs for the application of the requirements?

We do not have any comments on this question.

Q28: Are the different provisions on remuneration policies, related to governance requirements and the different approach to identify the staff to whom they apply a concern for firms regarding the level playing field between different investment firms (class 1 minus under CRD or class 2 under IFD), UCITS management companies and AIFMs, e.g. in terms of the application of the remuneration provisions, the ability to recruit and retain talent or with regard to the costs for the application of the requirements?

We do not have any comments on this question.

Q29: Are the different provisions, criteria and thresholds regarding the application of derogations to the provisions on variable remuneration, and that they apply to all investment firms equally without consideration of their specific business model, a concern to firms regarding the level playing field between different investment firms (class 1 minus under CRD and class 2 under IFD), UCITS management companies and AIFMs, e.g., in terms of the application of the remuneration provisions, the ability to recruit and retain talent or with regard to the costs for applying the deferral and pay out in instruments requirements? Please provide a reasoning for your position and if possible, quantify the impact on costs and numbers of identified staff to whom remuneration provisions regarding deferral and pay out in instruments need to be applied.

We do not have any comments on this question.

Q30: Are the different provisions regarding the oversight on remuneration policies, disclosure and transparency a concern for firms regarding the level playing field between different investment firm, UCITS management companies and AIFMs, e.g., with regard to the costs for the application of the requirements or the need to align these underlying provisions? Please provide a reasoning for your position.

We do not have any comments on this question.

12 Other Elements

Q31: What would be costs or benefits of extending existing reporting requirement to financial information? Which other elements should be considered before introducing such requirement?

We do not have any comments on this question.

Q32: Should there be the need to introduce prudential requirement for firms active in commodity markets and that are not currently subject to prudential requirements? How could the existing framework for investment firms be adapted for those cases? If a different prudential framework needs to be developed, what are the main elements that should be considered?

We do not have any comments on this question.

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