



State of play of the EBA Advice on the design of a new prudential framework for MiFID investment firms

London, 3 July 2017

Disclaimer

The purpose of this presentation is to inform on the **state of play** of the EBA Advice on the design of a new prudential framework for MiFID investment firms , which the EBA is invited to produce for the Commission as per Call for Advice of June 2016. The expected time for delivery of this Advice is September 2016.

The findings and conclusions that are presented in these slides are only preliminary policy recommendations.

- Previous steps:

- ✓ **1st EBA Report on MiFID investment firms** December 2015
- ✓ **Received CfA from the EU Commission** June 2016
- ✓ Data collection MifiD and UCITS/AIFMD November 2016
- ✓ Technical roundtables with industry stakeholders June and Dec 2016

- ✓ **EBA Opinion on the first part of the CfA** October 2016
- ✓ Data collection commodity derivatives firms July 2016
- ✓ **EBA Discussion Paper MiFID investment firms** November 2016
- ✓ Public hearing with industry stakeholders July 2017

- Next steps:

- Additional data collection July 2017
- **EBA Advice in response to EU Commission's CfA** September 2017
- **Publication EBA Final Report** September 2017

Elements in the scope of the Call for Advice

1. Categorisation
2. Consolidated supervision
3. Capital composition
4. Capital requirements
5. Liquidity requirements
6. Concentration risk
7. Additional requirements on an individual firm basis - Pillar 2
8. Reporting
9. Commodity derivative firms
10. Remuneration and governance
11. Impact assessment, calibration and data collection

Annex: List of recommendations

Categorisation (1/2)

- New categorisation of MiFID investment firms distinguishing between:
 - **Class 1:** Large or systemic investment firms to which the full CRD/CRR requirements should be applied; categorisation based on guidelines or level 2 regulation
 - **Class 2:** Other non-systemic investment firms should apply a more tailored prudential regime: categorisation based on specific thresholds for the various activities and services
 - **Class 3:** Small and non-interconnected investment firms extending some limited and non-combined services to which a very simple regime should be applied.

Categorisation

K-factor relevant for categorisation

Risk type	K-factors	Description
Risk to Customer (RtC)	K-AUM	Assets under management - under both discretionary portfolio management and non-discretionary (advisory) arrangements
	K-CMH	Client money held
	K-ASA	Assets safeguarded and administered
	K-COE	Customer orders executed - execution-only in name of client
Risk to Market (RtM)	K-NPR	Net position risk – based on the market risk requirements (position risk, FX, commodities) of CRR and/or BCBS FRTB and made appropriate for investment firms
	K-DTF	Daily trading flow – value of transactions

Categorisation (2/2)

- Thresholds determine the exclusion from Class 3
- Thresholds are not based on MiFID services but on K-factors
- Threshold levels:
 - **AUM** (including assets under management for assets under advice) combined is higher than **EUR 1.2 bn**
 - **COE** (client orders executed) is higher than **500 order a day** over a year
 - **ASA** (for assets safeguarded and administered) is higher than **zero**
 - **CMH** (for client money held) is higher than **zero**
 - **NPR, DTF** (net position risk and daily trading flow) are higher than **zero**
 - Balance sheet total is higher than **EUR 100 million**
 - Total gross revenues is higher than **EUR 30 million**
- The following conditions for exclusion from Class 3 are not anymore recommended: holding MIFID passport, using tied agents, operating MTF or OTF, being part of a wider group

Consolidated supervision (1/2): investment firms part of banking groups

All investment firms part of a group containing a credit institution and/or systemic (Class 1) investment firm should be subject to:

- the new prudential regime for investment firms on a **solo basis** unless waived in accordance with a provision equivalent to Article 7 of the CRR and where such a waiver is only applicable to Class 3 firms;
- all the **CRR** requirements on a **consolidated basis**, as part of any obligations for consolidated supervision that fall upon institutions subject to the CRR.

Consolidated supervision (2/2): Investment firm-only groups

- The group should not include any credit institutions or systemic investment firms (Class 1).
- The composition of entities that should be included within the scope of such a group should include **all prudentially regulated entities**.
- The parent company should be subject to a **group capital test** that addresses situations of excessive leveraging risks and multiple gearing of capital. Such test can be developed based on the conditions required under Article 15 and 17 of the CRR.
- **Concentration limits** should apply at solo level.
- Each investment firm in the group should have in place systems to monitor and control the sources of **capital and funding** of all regulated entities within the group; this should include the compliance with the **liquidity requirements**.
- **Liquidity requirements** should be applicable at **consolidated or sub-consolidated level** subject to supervisory approval and the existence of centralised liquidity management functions.

Capital definition and composition

- One single composition of regulatory capital for all types of investment firms.
- The **definition** of the regulatory capital in the new prudential framework should be aligned to the one in the CRR for credit institutions, while the **composition** should be adapted to the new framework.
- The following instruments should be eligible for meeting the regulatory capital requirements:
 - **CET1, Additional Tier 1 and Tier 2** instruments in the CRR;
 - Additional Tier 1 is eligible up to **one third of CET1** capital.
 - Tier 2 capital is eligible up to **one third of T1** capital.
- Investment firms should always be required to **deduct** the items referred to in Articles 37 to 47 of the CRR, in particular intangible assets and deferred tax assets. Such deductions should always be **applied in full** and should not be subject to any of the thresholds currently applied in the CRR.

Capital requirements: Initial capital and FOR

- It is recommended setting the levels of **Initial Capital (IC)** for the authorization of an investment firm to:
 - **EUR 750 000** for firms that are authorised to provide the investment services and activities listed in points (3), (6), (8) and (9) of Section A of Annex I to Directive 2014/65/EU; [**Dealing on own account, Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis, Operation of an MTF; Operation of an OTF**].
 - **EUR 75 000** for firms that are **not** permitted to **hold money or securities belonging to their clients** and which for that reason may not at any time place themselves in debt with those clients and are not authorised to provide the investment services and activities listed in points (3), (6), (8) and (9) of Section A of Annex I to Directive 2014/65/EU;
 - **EUR 150 000** all the other investment firms.
- The **FOR** requirements should be set to at least **one quarter of the fixed overheads** of the previous year, calculated using the methodology in the Delegated Regulation 488/2015. The consistency of the current methodology for the calculation of FOR should be reviewed in light of the new prudential regime.

Capital requirements: Class 3 investment firms

- **Class 3** investment firms should be subject to a minimum **capital requirement** equal to the **higher of**:
 - Initial capital / Permanent Minimum Capital (PMC) requirement;
 - the Fixed Overheads Requirement (FOR).

Capital requirements: Class 2 investment firms

- Investment firms in Class 2 should be subject to a minimum Pillar 1 capital requirement equal to the **higher of**:
 - Initial capital / Permanent Minimum Capital (PMC) requirement;
 - Fixed Overheads requirement (FOR);
 - capital requirements determined by the **K-factors formula**.

- Capital requirement from applying **K-factors formula** is the sum of the following:

$$\text{Capital requirement} = R_tC + R_tM + R_tF =$$

$$= a*K\text{-AUM} + b*K\text{-CMH} + c*K\text{-ASA} + d*K\text{-GIA} + e*K\text{-COE} + \\ + \max(K\text{-NPR}, f*K\text{-DTF}) + K\text{-TCD} + K\text{-CON}$$

- where a, ..., f are coefficients currently being analysed and calibrated starting with data collected, and where the amount of a k-factor is simply zero if a firm does not undertake the relevant activity.

Capital requirements: Class 2 investment firms

The K-factor formula including all the components is then based on the following factors:

Risk type	K-factors	Description
Risk to Customer (RtC)	K-AUM	Assets under management - under both discretionary portfolio management and non-discretionary (advisory) arrangements
	K-CMH	Client money held
	K-ASA	Assets safeguarded and administered
	K-GIA	Income from giving investment advice
	K-COE	Customer orders executed - execution-only in name of client
Risk to Market (RtM)	K-NPR	Net position risk – based on the market risk requirements (position risk, FX, commodities) of CRR and/or BCBS FRTB and made appropriate for investment firms
	K-DTF	Daily trading flow – value of transactions
Risk to Firm (RtF)	K-TCD	Trading counterparty default – based on CRR counterparty credit risk framework simplified for investment firms;
	K-CON	Concentration risk – in line with the CRR large exposures regime for trading book

Capital requirements: Class 2 investment firms trading on own name

- K-factors K-NPR, K-DTF, K-TCD apply to **trading book positions** only, relevant only for firms that trade on own name
- **K-NPR:** Net position risk, based on the market risk requirements (position risk, FX, commodities) of CRR 2. Specific characteristics of the IFs may justify the introduction of some adjustment in the calculation of K-NPR, such as removing the relative thresholds for using the Simplified Standardized Approach.
- **K-DTF:** daily trading flow (**value** of transactions where the firm is dealing in their own name) requirement in order to capture those IFs whose dealing activity creates a big footprint in the market, but does not lead to material market risk requirements;
- **K-TCD:** Trading counterparty default - **counterparty credit risk** framework based on MtM approach simplified for investment firms
- **K-CON:** Concentration risk, in line with the CRR large exposures regime for trading book (i.e. add-ons apply to the capital requirements for excessive concentration risk in trading book)
- **Uplift factor is not supported anymore** and it is replaced by **K-TCD**.

Proposed calibration of the coefficients

K-Factor	Coefficient
K-AUM	0.02%
K-CMH	0.45%
K-ASA	0.04%
K-GIA	16.34%
K-COE/K-DTF cash trades	1.50%
K-COE/K-DTF derivative trades	0.06%

- **K-NPR:** No coefficient, calculation based on CRR2 methodology for market risk
- **K-TCD:** No coefficient, calculation based on a (simplified) methodology for counterparty credit risk based on the MtM method
- **K-CON:** No coefficient, calculation based on large exposures methodology for the trading book of CRR (Art. 397)
- **K-COE/K-DTF:** (Calibrated based on data collection, covering both cash trades and derivative trades) Coefficient to be estimated with additional data collection

Liquidity requirements (1/2)

- The application of liquidity requirements of the Delegated Act EU 2015/61 on **LCR** should be extended to all **Class 1** investment firms
- This recommendation **does not extend to applying to the NSFR**, as the design of the NSFR requirements is still under development.
- **Class 2 and Class 3** investment firms should have internal rules and procedures that allow them to monitor, measure and manage exposures and liquidity needs to ensure the adequacy of liquidity resources.
- Furthermore, Class 2 firms should be subject to additional liquidity **reporting** requirements.

Liquidity requirements (2/2)

- Class 2 and Class 3 investment firms should be required to hold an amount of liquid assets for an amount **equal to one third of the FOR requirements** (i.e. equal to funding 1 month worth of Fixed Overheads).
- The liquid assets **eligible** to meet the liquidity requirements should be
 - aligned with the list of high quality liquid assets (HQLA) the Delegated Act on **LCR**,
 - supplemented with **unencumbered own cash** of the firm (which cannot include any client money).
- During **exceptional and unexpected circumstances**, investment firms may monetarise their liquid assets to cover liquidity needs, even if such a use of liquid assets may result in the amount of liquid assets held falling **below the minimum** liquidity requirements. Firms should have a plan how to rebuild their buffer.
- In such cases, investment firms should **notify** their competent authority immediately.

Additional requirements on an individual firm basis

Pillar 2

- Class 2 and Class 3 investment firms responsible for **assessing the adequacy** of the new minimum requirements to their own risk situation
- For **competent authorities** to undertake individual firm-specific assessments.
- Recommendation to provide CAs with appropriate supervisory powers and possibility to take actions, notably possibility to:
 - increase **capital** requirements
 - increase **liquidity** requirements
 - limit **concentration** risk.

Reporting (1/2)

- The new prudential framework for investment firms should include a **simplified reporting framework** for Class 2 and Class 3 investment firms.
- Class 1 investment firms should be subject to the requirements of the CRD/CRR.
- The reporting requirements should be proportional to size and complexity of the firm; this should include all the key attributes on:
 - Solvency;
 - Capital composition;
 - Capital requirement calculations;
 - Liquidity requirements;
 - Concentration risk;
 - Additional requirements for specific business models.
- Class 2 firms should be required to report more granular information than Class 3 firms

Reporting (2/2)

- It is recommended that Class 2 investment firms report to competent authorities on **concentration risk**, and in particular (where applicable) on:
 - concentration risk associated with the default of counterparties for trading exposures, both on an individual counterparty and aggregate basis;
 - where client money is held;
 - where client securities are deposited;
 - the firm's own cash at bank; and
 - concentration risk from earnings.

- Class 3 firms should **not** be subject to reporting requirements on concentration risk.

- Pillar III
 - Class 3 firms should have no disclosure requirements;
 - Class 2 firms should have disclosure requirements limited to the level of capital requirements and the solvency ratio.

Commodity derivative firms

- **All commodity derivative firms** in the scope of MiFID 2 should be in the scope of the new prudential framework.
- The new prudential regime should include criteria that would allow the exemption from the prudential requirements of positions that are objectively measurable as reducing risks directly related to **commercial activities**.
- The new prudential regime may be tailored to the specificities of commodity derivative firms trading in specific markets or to specific aspects of their accounting practices.
- A **phase-in period** for the introduction of the new prudential regime should be envisaged considering that the scope of the commodities derivative firms.

- Proposed calibration is not final and might be subject to further tuning
- **Complementary data** required
- Major focus on investment firms trading on own account, in particular to calibrate the K-factor daily trading flow
- Data collection **open to all investment firms** (including those who did not participate to the previous quantitative exercise)
- **Templates and instructions** available on EBA website ([link](#))
 - Submission to CAs
 - Submission directly to EBA only for firms currently not prudentially regulated
 - Deadline: one month from publication

Remuneration and governance

- For Class 1 investment firms, it is proposed to apply the governance requirements set out in CRD in full
- For Class 2 and Class 3 investment firms, some simplifications are proposed, keeping in mind that the MiFID II governance requirements will remain applicable for all investment firms

Remuneration and governance

Summary table – recommended application of governance provisions

CRD/CRR Requirements	Description	Class 1 firms	Class 2 firms	Class 3 firms
Article 76 CRD	Requirements on the treatment of risks, the involvement of management bodies and establishment of a risk committee for significant institutions	Remains under CRD	YES (partly)	NO
Article 77-82 CRD	Specific requirements for the management of risks (credit and counterparty risks, residual risk concentration risk, securitisation risk)	Remains under CRD	NO	NO
Article 83 CRD	Specific requirements for the management of market risk	Remains under CRD	YES (when dealing on own account and holding client assets)	NO
Article 84 CRD	Specific requirements for the management of interest risk arising from non-trading book activities	Remains under CRD	NO	NO
Article 85 CRD	Specific requirements for the management of operational risk	Remains under CRD	YES	NO

○ Detailed recommendations are provided in annex to this presentation

Remuneration and governance

Summary table – recommended application of governance provisions

CRD/CRR Requirements	Description	Class 1 firms	Class 2 firms	Class 3 firms
Article 86-87 CRD	Specific requirements for the management of liquidity risk and risk of excessive leverage	Remains under CRD	NO	NO
Article 88 CRD	Requirements on governance arrangements	Remains under CRD	YES (article 9 MIFID II)	YES (article 9 MIFID II)
Article 89 CRD	Requirements on country-by-country reporting	Remains under CRD	YES	NO
Article 90 CRD	Requirements on public disclosure of return on assets	Remains under CRD	NO	NO
Article 91 CRD	Requirements on the suitability and composition of management body	Remains under CRD	YES (article 9 MIFID II)	YES (article 9 MIFID II)
Article 96 CRD	Requirements for institutions maintaining a website on corporate governance and remuneration	Remains under CRD	NO	NO

○ Detailed recommendations are provided in annex to this presentation

Remuneration and governance

Summary table – recommendations in the area of remuneration

Requirements existing in CRD/CRR	Description	Category 1 firms	Category 2 firms	Category 3 firms
Article 92 CRD	Remuneration policies	Remains under CRD	YES (MiFID applies)	NO (MiFID applies)
Article 94 CRD	Variable elements of remuneration	Remains under CRD	Partly	NO
Article 95 CRD	Remuneration Committee	Remains under CRD	NO	NO
Article 450 CRR	Remuneration policy	Remains under CRR	NO	NO

- Detailed recommendations are provided in annex to this presentation

Recommendations

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Recommendation 1. This regime is appropriate for all MiFID investment firms.

Recommendation 2. Recommendation for a new categorisation of MiFID investment firms distinguishing between:

- a) large and systemic investment firms to which the full CRD/CRR requirements should be applied (Class 1);
- b) other non-systemic investment firms, which activities and services combine but are not limited to asset management, advisory, trading on own account, executing orders on behalf of clients, transmission and reception of orders, holding client money and administrating and safeguarding client financial instruments, and above specific thresholds for the various activities and services should apply a more tailored prudential regime based on the activities/services risks – K-factor approach(Class 2); and
- c) small and non-interconnected investment firms extending some limited and non-combined services to which a very simple regime should be applied (Class 3).

Recommendation 3. In line with the EBA Opinion on the identification of Class 1 firms¹ of 19 October 2016 dedicated Level 2 regulation should be developed for the identification of

systemic investment firms (Class 1) taking the specificities of IFs into account.

Recommendation 4. It is recommended to develop a consolidated single rulebook, separate from the one applied to credit institutions, for all MiFID investment firms not falling in Class 1 based on the recommendations given in this Advice.

Recommendation 5. All the investment firms that fulfil one or more of the following conditions should be excluded from Class 3:

- a) AUM (for assets under management) + AUA (for assets under advice) combined is higher than EUR 1.2 bn;
- b) NPR, DTF, TCD are higher than zero;
- c) ASA (for assets safeguarded and administered) is higher than zero;
- d) COE (client orders executed) is higher than 500 order a day over a year;
- e) CMH (for client money held) is higher than zero;
- f) Balance sheet total is higher than EUR 100 million;
- g) Total gross revenues are higher than EUR 30 million.
- h) The thresholds under (a), (d), (f) and (g) should be applied on a combined basis for all investment firms that are part of the same group. The threshold under (b), (c) and (e) should be applied on a solo basis.
- i) The conditions above should be reviewed after 3 years after the implementation.

¹ [Opinion of the European Banking Authority on the First Part of the Call for Advice on Investment Firms](#), EBA-Op-2016-16, Recommendation 2, p. 3.

Recommendation 6. All the investment firms that are not included in Class 1 or Class 3 should be considered Class 2 investment firms.

Recommendation 7. All the investment firms should meet the prudential requirements on an ongoing basis. Investment firms should be reclassified to Class 2 immediately if one of the categorisation thresholds is exceeded; however, a Class 2 firm should meet the criteria for being in Class 3 for at least 6 months before being re-categorised in that class.

Recommendation 8. For the consolidated supervision of investment firm-only groups the following should be considered:

- a) The group should not include any credit institutions or systemic investment firms (Class 1).
- b) The composition of entities that should be included within the scope of such a group should include all the prudentially regulated entities and should include tied agents where they are owned by the investment firm.
- c) The parent company should be subject to a group capital test that addresses situations of excessive leveraging risks and multiple gearing of capital. Such test can be developed based on the conditions required under Article 15 and 17 of the CRR for derogation from consolidated supervision and adjusted for the specificities of investment firms.

- d) Each investment firm in the group should have in place systems to monitor and control the sources of capital and funding of all regulated entities within the group; this should include the compliance with the liquidity requirements.

Recommendation 9. All investment firms part of a group containing a credit institution and/or systemic (Class 1) investment firm should be subject to:

- a) the new prudential regime for investment firms on a solo basis unless waived in accordance with a provision equivalent to Article 7 of the CRR and where such a waiver is only applicable to Class 3 firms; and
- b) all the CRR requirements on a consolidated basis, as part of any obligations for consolidated supervision that fall upon institutions subject to the CRR.

Recommendation 10. An investment firm group subject to consolidated supervision should apply the capital requirements at consolidated level. However, liquidity requirements should be applicable at consolidated or sub-consolidated level subject to supervisory approval and the existence of centralised liquidity management functions. Concentration limits should apply at solo level.

Recommendation 11. The new prudential regime should identify only one single composition of regulatory capital for all types of investment firms. The definition of the regulatory capital in the new prudential framework should be aligned to the one in

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the CRR for credit institutions, while the composition should be adapted to the new framework.

Recommendation 12. The following instruments should be eligible for meeting the regulatory capital requirements:

- a) CET1, Additional Tier 1 and Tier 2 instruments as defined in Articles 25 to 71 of the CRR;
- b) Additional Tier 1 is eligible up to one third (1/3) of CET1 capital.
- c) Tier 2 capital is eligible up to one third (1/3) of T1 capital.

Recommendation 13. The use of prudential filters should be aligned to the treatment suggested in the EBA Opinion EBA/Op/2014/05 where it is recommended not deviating from the prudential treatment which is currently applied at the international level under CRR rules (i.e., full deduction of own credit risk).

Recommendation 14. Investment firms should always be required to deduct the items referred to in Articles 37 to 47 of the CRR, in particular intangible assets and deferred tax assets. Such deductions should always be applied in full and should not be subject to any of the thresholds currently applied in the CRR.

Recommendation 15. Taking into account that the legal form of MiFID investment firms is not prescribed under Union law, the new prudential regime may include a mechanism to recognise alternative legal forms of investment firms, such as limited liability partnerships (LLPs), partnerships, and sole-traders. It is also recommended introducing a mechanism similar to the one

included in the CRR for the approval of CET1 capital. This mechanism should be designed to ensure that the forms of capital available to such non-joint stock companies provide equivalence to the general principles of permanence and loss absorbency required for capital instruments for joint stock companies.

Recommendation 16. It is recommended that the definition of capital used for the purposes of meeting the minimum levels required as a condition for initial authorization of an IF under MiFID should be aligned with the definition of own funds for the purposes of meeting the on-going capital adequacy requirements of IFs (i.e., Permanent Minimum Capital, fixed overheads requirements and, where applicable, capital requirements under the K-factor formula).

Recommendation 17. The new prudential regime for Class 2 and Class 3 investments firms should include provisions for the application of an Initial Capital Requirements (IC) for the authorisation phase, which could either include Level 2 legislation or rely on MIFID services. It should also require meeting the Permanent Minimum Capital (PMC) requirements and minimum levels of Fixed Overheads Requirement (FOR) on an ongoing basis. Both the PMC and the FOR should be set as a minimum to the capital requirements for all IFs.

Recommendation 18. It is recommended setting the levels of Initial Capital (IC) for the authorization of an investment firm to:

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- a) EUR 750 000 for firms that are authorised to provide the investment services and activities listed in points (3), (6), (8) and (9) of Section A of Annex I to Directive 2014/65/EU;
- b) EUR 75 000 for firms that are not permitted to hold money or securities belonging to their clients and which for that reason may not at any time place themselves in debt with those clients and are not authorised to provide the investment services and activities listed in points (3), (6), (8) and (9) of Section A of Annex I to Directive 2014/65/EU;
- c) EUR 150 000 all the other investment firms.

Recommendation 19. It is recommended setting the levels of Permanent Minimum Capital (PMC) differentiating between classes:

- a) EUR 5 million for investment firms that meet the conditions for being subject to full CRR requirements (Class 1 firms);
- b) Equals to the initial capital for all other firms.

Recommendation 20. A transitional period should be envisaged to allow IFs that are currently subject to IC to afford the new level of Permanent Minimum Capital or of FOR requirements. Those investment firms should be required to comply with the requirements of Permanent Minimum Capital only after a transitional period of five years, increasing of a fixed amount each year.

Recommendation 21. The FOR requirement should be set to at least one quarter of the fixed overheads of the previous year, calculated using the methodology in the Delegated Regulation 488/2015. The consistency of the current methodology for the calculation of FOR should be reviewed in light of the new prudential regime.

Recommendation 22. Investment firms in Class 2 should be subject to a minimum Pillar 1 capital requirement equal to the higher of:

- a) the Permanent Minimum Capital (PMC) requirement;
- b) the Fixed Overheads requirement (FOR);
- c) the capital requirements determined by the K-factor formula, as set out below.

Recommendation 23. Class 3 investment firms should be subject to a minimum Pillar 1 capital requirement equal to the higher of:

- a) the Permanent Minimum Capital (PMC) requirement;
- b) the Fixed Overheads Requirement (FOR).

Recommendation 24. The total capital requirements for Class 2 investment firms should be based on the following elements:

- a) They should consider the potential risk that individual investment firms can pose to their customers (RtC);
- b) They should consider the potential impact an investment firm can have on the markets in which it operates, should the firm fail or otherwise need to exit that market, in particular where a failure or exit leads to a sudden and/or a temporary dislocation in market access

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or market liquidity or a loss of market confidence or market integrity (RtM).

- c) Any risk to the firm itself (RtF) shall be measured by the K-factor based on the simplified approach described in Section Error! Reference source not found..

Recommendation 25. The new prudential regime should include all the following elements:

- a) Specific capital requirements for the Risk to Customers (RtC), Risk to Market (RtM) and Risk to Firm (RtF), based on appropriate proxies (K-factors);
- b) The formula for the calculation of the capital requirements that takes into consideration all those elements.
- c) The following formula is recommended:
K-factors Capital Requirements = RtC + RtM + RtF

Recommendation 26. For the calculation of RtC, the new prudential regime should specify all the relevant factors and their calculation:

- a) The factors that are relevant to capture the risk to customers (K-factors for RtC) and their respective metrics are the following:
 - i) K-AUM: amount of assets under management;
 - ii) K-CMH: amount of client money held;
 - iii) K-ASA: amount of assets safeguarded and administered;

- iv) K-GIA: income from giving investment advice other than on assets covered by management agreement;
- v) K-COE: number of customer orders executed (value of transactions of execution-only in name of client). For cash trades value means the absolute gross settlement and for derivatives value means notional amount of trades executed.

Recommendation 27. It is recommended calculating the capital requirement corresponding to RtC using the following formula:

$$RtC = \sum a_i * K_i$$

where K_i are the K-factors above and the coefficients a_i are specified within the ranges provided in the following table:

K-Factor	Coefficient
K-AUM	0.02%
K-CMH	0.45%
K-ASA	0.04%
K-GIA	16.34%
K-COE/K-DTF cash trades	1.50%
K-COE/K-DTF derivative trades	0.06%

Recommendation 28. For K-CMH (client money held) it is recommended that a harmonised definition is given making unequivocally clear that the K-CMH factor applies to investment firms that have control of money belonging to clients, regardless of the legal arrangements on asset

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segregation and irrespective of the accountancy treatment under national law of client money held by an IF.

Recommendation 29. For advisory firms, it is recommended that the K-AUA factor for assets under advice not covered by management agreements is replaced by the K-GIA factor for giving investment advice. The calculation of K-GIA should be based on the income generated from giving investment advice (MiFID II service A5), i.e. disregarding other advisory services that are not regulated by MiFID II, such that K-GIA will only apply to very large advisory firms, that are allocated to Class 2.

Recommendation 30. For the calculation of the capital requirements for RtM, the new prudential regime should specify all the relevant factors and their calculation. It is recommended to calculate the RtM as the higher of:

- a) K-NPR: an RtM requirement for net position risk for investment firms, calculated on (net open) positions end-of-day, measured on the basis of the FRTB methodology and;
- b) K-DTF: a daily trading flow (value of transactions where the firm is dealing in their own name) requirement in order to capture those IFs whose dealing activity creates a big footprint in the market, but does not lead to material market risk requirements, measured on the basis of the same methodology and calibration used for the RtC of K-COE.

- c) For cash trades 'value' means the absolute gross settlement and for derivatives 'value' means notional amount of trades either averaged or the highest reached over a period of time.

Recommendation 31. Specific characteristics of the investment firms may justify the introduction of some adjustment in the calculation of K-NPR, such as removing the relative thresholds for using the Simplified Standardized Approach.

Recommendation 32. Conditional to supervisory approval and subject to a number of strict conditions, RtM can (alternatively to Rec 30) be set as $\max(K-NPR, K-CMG)$ (for clearing member guaranteed). The metric for K-CMG would be the highest total intra-day haircut or margin posted at the clearing member in a previous period (covering at least the preceding 12 months). At least the following conditions should apply:

- a) The trading firm exclusively deals on own account (MiFID II activity A3) and has no external customers;
- b) All execution and settlement transactions take place under the responsibility of a (general) clearing member and are either guaranteed by that clearing member or settled on a delivery-versus-payment basis;
- c) The capital requirements for position risk are calculated as the highest total intra-day margin ('haircut') posted at the clearing member in a previous period (e.g. the past year);

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- d) The trading firm is outside the scope of prudential consolidation of a banking group (i.e. the IF is not part of a banking group);
- e) The calculation of the intra-day haircut or margin is based on an internal model that is assessed and approved by a competent authority;
- f) The (general) clearing member that guarantees the execution and settlement transactions is subject to full CRD and CRR. (or – if relevant – supervisory and regulatory arrangements of a third country that are at least equivalent).

Recommendation 33. The application of liquidity requirements of the Delegated Act EU 2015/61 on LCR should be extended to all Class 1 investment firms; however the scope could be subject to adjustments in outflow rates. This recommendation should not be intended applying to the NSFR as well, because the design of the NSFR requirements is still under development and, at this juncture, it is not possible to conclude whether it is suitable for Class 1 investment firms or not.

Recommendation 34. Class 2 and Class 3 investment firms should have internal rules and procedures that allow them to monitor, measure and manage exposures and liquidity needs to ensure the adequacy of liquidity resources. Furthermore, Class 2 firms should be subject to additional liquidity reporting requirements.

Recommendation 35. Class 2 and Class 3 investment firms should be required to hold an amount of liquid assets for an amount equal to one third of the FOR requirements (i.e. equal to funding 1 month worth of Fixed Overheads).

Recommendation 36. The liquid assets eligible to meet the liquidity requirements under the new prudential regime for investment firms should be aligned with the list of high quality liquid assets (HQLA) of Level 1, 2A and 2B assets as set out in the Delegated Act on LCR,² supplemented with unencumbered own cash of the firm (which cannot include any client money). There should be no limit to the type of liquid assets to be held to meet the minimum liquidity requirements.

Recommendation 37. Haircuts should be applied to the market value of assets held by the investment firms for the purposes of meeting the minimum liquidity requirements. The level of haircuts should be aligned with the one prescribed in the Delegated Act on LCR. Unencumbered own cash of the firm should receive a 0% haircut.

Recommendation 38. The level of liquidity requirements should be adjusted by deducting from the amount of liquid assets held, the 1.6 percent of the total amount of guarantees provided to customers.

² EU Delegated Act on LCR, Articles 10 to 16, available here: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0061&from=EN>.

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Recommendation 39. For Class 3 firms, trade debtors and fees or commissions receivable within 30 days should be allowed to meet the minimum liquidity requirements, conditional to the following conditions:

- a) They may account to up to a one third of the minimum liquidity requirements;
- b) They should not be allowed to meet any of the liquidity requirements above the level set at 1 month of FOR, such as additional liquidity requirements requested on a firm-specific basis (Pillar 2);
- c) They should be subject to a haircut of 50%.

Recommendation 40. During exceptional and unexpected circumstances, investment firms may monetarise their liquid assets to cover liquidity needs, even if such a use of liquid assets may result in the amount of liquid assets held falling below the minimum liquidity requirements. In such cases, investment firms should notify their competent authority immediately.

Recommendation 41. The new prudential framework for investment firms should require all investment firms to monitor, identify and manage any concentration risk, including in respect of RtC.

Recommendation 42. It is recommended that Class 2 investment firms report to competent authorities on concentration risk, and in particular (where applicable) on:

- a) concentration risk associated with the default of counterparties for trading exposures, both on an individual counterparty and aggregate basis;
- b) where client money is held;
- c) where client securities are deposited;
- d) the firm's own cash at bank; and
- e) concentration risk from earnings.

Recommendation 43. Class 3 firms should not be subject to reporting requirements on concentration risk.

Recommendation 44. Class 2 firms with positive K-NPR, K-DTF should be subject to the following requirements:

- a) Maximum exposure should be set to a limit equals to 10 percent of the regulatory capital;
- b) The measurement of the exposure values should be the value used by the IF for the purposes of calculating market and counterparty credit risk.
- c) Concentration risk multipliers of the capital requirements for an individual exposure that should be set in line with what is prescribed for banks for the treatment of Large Exposures in the trading book.

Recommendation 45. Where applicable, the exemptions from concentration limits should be aligned with the exemptions of the CRR large exposures regime.

Recommendation 46. A harmonised process for the individual assessment of concentration risk of investment firms within

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the framework of the supervisory review and evaluation process (Pillar 2) should be ensured via Level 2 regulation.

Recommendation 47. Recommendation for a requirement for investment firms to also be responsible for assessing the adequacy of the new minimum requirements to their own risk situation and for CAs to undertake individual firm-specific assessments (i.e. a proportionate Pillar 2 tool for investment firms). Recommendation to provide CAs with appropriate supervisory powers and possibility to take actions, notably the possibility to increase capital and liquidity requirements and limit concentration risk.

Recommendation 48. Recommendation to pursue harmonization via Level 2 instruments addressed to CAs for the individual assessment of investment firms, which are sufficiently flexible and proportionate (and potentially for Class 2 investment firms only, but with CAs having the option to apply to some or all Class 3 investment firms as deemed appropriate).

Recommendation 49. The new prudential framework for investment firms should include a simplified reporting framework for Class 2 and Class 3 investment firms. Class 1 investment firms should be subject to the requirements of the CRD/CRR.

Recommendation 50. The new reporting framework for Class 2 and Class 3 investment firms should be based on the following elements:

- a) It should be addressed to all the investment firms without any exemption for any type of firm or business model;
- b) All investment firms should report the key attributes highlighted in this Advice, e.g. solvency and K-factors, and on all the parameters needed for the firm's categorisation;
- c) The reporting requirements should be proportional to size and complexity of the firm;
- d) Class 2 firms should be required to report more granular information than Class 3 firms, including:
 - i) Solvency;
 - ii) Capital composition;
 - iii) Capital requirement calculations;
 - iv) Liquidity requirements;
 - v) Concentration risk;
 - vi) Additional requirements for specific business models.

Recommendation 51. It is recommended to reduce the disclosure requirements (Pillar III) to the strict minimum. In particular:

- a) Class 3 firms should have no disclosure requirements;
- b) Class 2 firms should have disclosure requirements limited to the level of capital requirements and the solvency ratio.

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Recommendation 52. Commodity derivative firms in the scope of MiFID 2 should be in the scope of the new prudential framework.

Recommendation 53. The new prudential regime should be tailored to the specificities of commodity derivative firms trading in specific markets or to specific aspects of their accounting practices.

Recommendation 54. A transitional regime or phase-in period for the introduction of the new prudential regime should be envisaged considering that the scope of the commodities firms may be unclear for a while and that the prudential regime is new for a number of firms.

Recommendation 55. The new prudential regime should include criteria that would allow the exemption from the prudential requirements of positions that are objectively measurable as reducing risks directly related to commercial activities (positions for hedging purposes).

Recommendation 56. In the context of governance the following recommendation should be considered:

- a) No changes to the provisions within Article 109 CRD are recommended in the context of this review, independent of the category of investment firms involved.
- b) The governance requirements set out in CRD should fully apply to Class 1 firms, while a lighter governance framework should be applied to Class 2 and Class 3 firms.

- c) It is not considered necessary to apply Art 74 CRD to Class 2 and Class 3 investment firms, as MiFID's governance requirements are deemed to sufficient to ensure robust governance arrangements.
- d) Additional risk management requirements as developed in Article 76 (1) CRD and the requirement to commit sufficient time for risk management within Article 76 (2) CRD should be applied to Class 2 firms that are authorised to hold clients assets.
- e) The investment firms that deal on own account and are at the same time allowed to hold client assets should be subject to the provisions within Article 83 on market risks.
- f) Article 85 CRD should be applied to Class 2 firms and competent authorities supervising them.
- g) The application of Article 89 CRD (country by country reporting) is recommended for Class 2 firms only.

Recommendation 57. In the context of remuneration the following elements should be considered:

- a) Class 1 investment firms should fully remain under the remuneration framework set out within CRD.
- b) The new remuneration framework should differentiate between Class 2 and Class 3 firms and not between different business activities.
- c) Class 3 firms should only be subject to the remuneration provisions of MiFID, no additional requirements are deemed necessary.

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- d) **The remuneration requirements for Class 2 firms should be similar to Articles 92 and 94 CRD and apply to the staff that has a material impact on the firms risk profile. Class 2 firms should still be subject to MiFID remuneration provisions for sales staff. The pay out in instruments requirement in Article 94 (1)(l) CRD should only be applied to Class 2 firms that are regularly involved in the issuing of instruments and to listed companies.**
- e) **The European Commission should carefully consider the advantages and disadvantages of a restriction of the variable remuneration encoded in Article 94 (1)(g)(i) and (ii), when proposing a legal framework for Class 2 firms.**

Recommendation 58. It is recommended that a legislative proposal for a new prudential framework for Class 2 and Class 3 investment firms contains a review clause, e.g. three years after the date of application of this new regime, based on a monitoring report.

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