London Stock Exchange response to
Designing a new prudential regime for investment firms EBA/DP/2016/02

Introduction

This paper reflects the views of UK and Italian multilateral trading facilities (MTFs) operated by London Stock Exchange Group (LSEG or the Group), including Turquoise Global Holdings Limited, MTS SpA, MTS France S.a.S. and EuroMTS Ltd, and EuroTLX SIM S.p.A. These entities are classified as investment firms under the Markets in Financial Instruments Directive 2004/39/EC (MiFID) and subject to prudential and other requirements under the Capital Requirements Regulation EU 575/2013 (CRR).

LSEG strongly welcomes the EBA's work to review the prudential regime applicable to categories of investment firms (IFs), in particular prudential requirements that apply to investment firms that operate MTFs. Indeed the current regime is designed for credit institutions and requires unnecessary effort/calculations for these types of investment firms.

At this stage, it's hard to say if it is better to include IFs that operate only MTFs in Class 2 or in Class 3 of the proposed new regime, though LSEG does not believe they should be precluded from a possible Class 3. The classification may not be significant if the new regime for MTFs is appropriately tailored for this kind of business, leading to a correct (i.e. enough to deal with the risks, but not excessive) definition of capital requirement.

Regulators and the industry need to analyse worked scenarios to evaluate the impact of the EBA's proposed categorisation and their potential benefits and disadvantages, including calibration of the proposed factors. Any revised prudential requirements should distinguish between investment firms operating MTFs and investment firms operating OTFs (e.g. paragraph 17) to reflect the risk and business model distinctions between the two types of trading venues. Under certain circumstances, an OTF will be able to hold positions to facilitate trading but this will never be the case of IFs that operate only MTFs.

We also would be grateful if the recognition under CRR/CRD for various types of investment firms is extended to other banking regulation, i.e. the BRRD, which impose high regulatory overheads.

Finally, this review of "pillar 1" minimum capital requirements will need to go hand-in-hand with a review of "pillar 2" (i.e. additional requirements on an individual firm basis), otherwise it will not have much if any impact. No point changing pillar 1, if this will just be again uplifted by a pillar 2 adjustment to prior levels.

About LSEG

London Stock Exchange Group is an international markets infrastructure business. Its diversified global business focuses on capital formation, intellectual property and risk and balance sheet management. LSEG operates an open access model, offering choice and partnership to customers across all of its businesses. The Group can trace its history back to 1698.

The Group operates a broad range of international equity, ETF, bond and derivatives markets, including London Stock Exchange; Borsa Italiana; MTS (Europe's leading fixed income market); and Turquoise (a pan-European equities MTF). Through its platforms, LSEG offers market participants, including retail investors, institutions and SMEs unrivalled access to Europe's capital markets. The Group also plays a vital economic and social role, enabling companies to access funds for growth and development.

Further information about London Stock Exchange Group can be found at www.lseg.com

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4.2 General principles governing the categorisation of investment firms

Question 1
What are your views on the application of the same criteria, as provided for G-SIIs and O-SIIs, for the identification of 'systemic and bank-like' investment firms? What are your views on both qualitative and quantitative indicators or thresholds for 'bank-like' activities, being underwriting on a firm commitment basis and proprietary trading at a very large scale? What aspects in the identification of 'systemic and bank-like' investment firms could be improved?
No comment.

Question 2
What are your views on the principles for the proposed prudential regime for investment firms?

> *The principles seem sensible and recognise that the current regime focuses too much on banks and involves a great deal of unnecessary calculation. We believe that simplicity is key, particularly in terms of monitoring and reporting. It is difficult for us to comment on the approach without performance of the calibration exercise (i.e. not knowing what the K-factor scalars will be).*
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> *However, having reviewed the approach, whilst the proposed solution seems much more appropriate for the majority of investment firms than the current regime, it still does not seem highly applicable to investment firms that operate only MTFs and for which do not hold client positions. In particular, only one or two of the K-factors seem applicable the nature of MTF operators.*
>
> *In general though, the new regime would seem an improvement on the present regime.*

Question 3
What are your views on the identification and prudential treatment of very small and non-interconnected investment firms ('Class 3')? If, for example, such class was subject to fixed overheads requirements only, what advantages and drawbacks would have introducing such a Class 3? Conversely, what advantages and drawbacks could merging Class 3 with other investment firms under one single prudential regime with 'built-in' proportionality have?

> *As an alternative, we recommend that it may be more simple to merge Class 3 with Class 2, and have a regime with built-in proportionality (i.e. "higher of…" type dynamics). This could avoid "cliff-edge" classifications of firms, where regulatory*

classifications drive business decisions (which is a problem with the current CRR, i.e. for firms holding client money).

Question 4
What are your views on the criteria discussed above for identifying 'Class 3' investment firms?

Given the nature of the customers of MTFs, and the risks to which their operators are subject, we see no reason why operators of MTFs should be precluded from classification as 'Class 3' investment firms, if such a classification regime is implemented. However, given the other criteria discussed (i.e. quantitative thresholds), it seems unlikely that many MTF operators would fall into this category.

We question if "being a member of a wider group" (letter H of Q4) is a criterial for automatically classifying an IF as Class 2. In particular, paragraph 18 discusses whether IFs that are part of a wider group (especially where it is a non banking group) should be considered interconnected. This approach would be a barrier to a more simple capital treatment for IFs belonging to a corporate group. If would penalise them from IFs that operate the same business on a stand alone basis but perform the same business and present the same risks.

4.3 Prudential regime for investment firms

Question 5
Do you have any comments on the approach focusing on risk to customers (RtC), risk to markets (RtM) and risk to firm (RtF)?

We believe that the approach is fundamentally sensible – however we have some doubts around the RtF. Given the principles of the proposed approach are designed to protect "customers" and "markets", the risk to the firm shouldn't matter for its own sake. We understand the rules are driving at the potential increased risk of conduct issues but we question the presence of a "solution" to this via prudential regulation. For MTFs, conduct controls exist through our systems and controls framework and governance structures and are actively supervised by member state supervisors.

We believe that the leverage ratio may also be too complex in its calculation for these purposes, without some kind of simplification.

Question 6
What are your views on the initial K-factors identified? For example, should there be separate K-factors for client money and financial instruments belonging to clients? And should there be an RtM for securitisation risk-retentions? Do you have any suggestions for additional K-factors that can be both easily observable and risk sensitive?

The K-factors do not seem appropriate to operators of MTFs, who are unlikely to also have assets under management / advice / safekeeping, or liabilities to customers / client money held. The only RtC that seems potentially applicable is the "customer orders handled", but even that seems to have been written with brokers in mind. The paper mentions this under paragraph 40 (talking also about the "Proprietary Trading Activity" RtM).

We particularly question the fact that both K-factors are based around number of orders/trades, as opposed to value. This metric does not acknowledge that fact that, for example, the average size on an equity MTF may be less than €10,000, whilst for a fixed income MTF could be hundreds of thousands or millions of Euro. Also, counting "orders" is very subjective, given that MTFs do not have visibility of underlying client orders, only those sent by members (who are likely to be operating multi-venue strategies and hence splitting client orders from "parents" into multiple "child" orders). Additionally, many MTF members do not use the "amend" functionality on orders, instead they are more likely to cancel and replace with new orders to change size or price. Such trading practices may "distort" order volumes and therefore it would not a reliable factor upon which to base capital requirements.

We believe that a useful approach may be to have a K-factor (or sub K-factor) specific to MTF (and potentially OTF) operators. Perhaps, since an issue that the EBA identify is around "market access", a proxy for substitutability of the MTF services may be used. However any such factor should be structured in a way that does not penalise an MTF for success.

*On the other hand, since the focus is on having enough capital to wind down (non-systemic firm would still be subject to CRR), we shouldn't worry that these factors will be n/a (i.e. 0) and be left with the FOR (as a proxy for a wind down). On that note (**and relating to "Question 9"**), we believe that FOR should remain part of the capital regime.*

Question 7
Is the proposed risk to firm 'up-lift' measure an appropriate way to address the indirect impact of the exposure risk a firm poses to customers and markets? If not, what alternative approach to addressing risk to firm (RtF) would you suggest?
No comment.

Question 8
What are your views on the 'built-in' approach to delivering simpler, proportionate capital requirements for Class 3 investment firms, (compared to having a separate regime for such firms)?
No comment.

Question 9
Should a fixed overhead requirement (FOR) remain part of the capital regime? If so, how could it be improved?
No comment.

Question 10
What are your views on the appropriate capital requirements required for larger firms that trade financial instruments (including derivatives)?
No comment.

Question 11
Do you think the K-factor approach is appropriate for any investment firms that may be systemic but are not 'bank-like'?
No comment.

Question 12

Does the definition of capital in the CRR appropriately cater for all the cases of investment firms that are not joint stock companies (such as partnerships, LLPs and sole-traders)?
No comment.

Question 13
Are there cases described above a real concern for the investment firms? How can those aspects be addressed while properly safeguarding applicable objectives of the permanence principle?
No comment.

Question 14
What are your views on whether or not simplification in the range of items that qualify as regulatory capital and how the different 'tiers' of capital operate for investment firms would be appropriate? If so, how could this be achieved?
No comment.

Question 15
In the context of deductions and prudential filters, in which areas is it possible to simplify the current CRR approach, whilst maintaining the same level of quality in the capital definition?
No comment.

Question 16
What are your views overall on the options for the best way forward for the definition and quality of capital for investment firms?
No comment.

Question 17
What are your views on the definition of initial capital and the potential for simplification? To what extent should the definition of initial capital be aligned with that of regulatory capital used for meeting capital requirements?
No comment.

Question 18
What aspects should be taken into account when requiring different levels of initial capital for different firms? Is there any undesirable consequence or incentive that should be considered?
No comment.

Question 19
What are your views on whether there is a need to have a separate concept of eligible capital, or whether there is potential for simplification through aligning this concept with the definition of regulatory capital used for meeting capital requirements?

> *For the purposes of simplification, we don't see the need to have a separate concept of eligible capital for initial capital / own funds etc. These should be consolidated.*

Question 20
Do you see any common stress scenario for liquidity as necessary for investment firms? If so, how could that stress be defined?
No comment.

Question 21

What is your view on whether holding an amount of liquid assets set by reference to a percentage of the amount of obligations reflected in regulatory capital requirements such as the FOR would provide an appropriate basis and floor for liquidity requirements for 'non-systemic' investment firms? More specifically, could you provide any evidence or counter-examples where holding an amount of liquid assets equivalent to a percentage of the FOR may not provide an appropriate basis for a liquidity regime for very small and 'non-interconnected' investment firms?

We note that for the first time for most investment firms, liquidity requirements may be introduced. We would be keen to understand the potential liquidity measures and do not believe that these should be unduly burdensome (i.e. LCR/NSFR). If LCR is to be used, then it should not be implemented in the same manner as for credit institutions, where interbank receivables, i.e. cash at bank, is excluded, given that investment firms are not likely to have access to central bank liquidity. This is touched upon in the discussion paper.

This, the third of the three posited scenarios on liquidity risk, seems to be most sensible, as it ties back liquidity requirements to capital requirements (i.e. K-factors and FOR), which a firm will already be calculating (and so adds the least burden). This seems the most aligned with the fundamental objective – i.e. ensuring an orderly wind down. Would like further clarity around what would count as a "liquid asset" however (i.e. is this as per HQLA rules, per BIPRU etc.).

Finally, this review of "pillar 1" minimum capital requirements will need to go hand-in-hand with a review of "pillar 2" (i.e. additional requirements on an individual firm basis), otherwise it will not have much if any impact. No point changing pillar 1, if this will just be again uplifted by a pillar 2 adjustment to prior levels.

Question 22
What types of items do you think should count as liquid assets to meet any regulatory liquidity requirements, and why? (Please refer to Annex 4 for some considerations in determining what may be a liquid asset).
No comment.

Question 23
Could you provide your views on the need to support a minimum liquidity standard for investment firms with the ability for competent authorities to apply "supplementary" qualitative requirements to individual firms, where justified by the risk of the firm's business?
No comment.

Question 24
Do you have any comment on the need for additional operational requirements for liquidity risk management, which would be applied according to the individual nature, scale and complexity of the investment firm's business?
No comment.

4.4 Other prudential considerations

Question 25
What are your views on the relevance of large exposures risk to investment firms? Do you consider that a basic reporting scheme for identifying concentration risk would be appropriate for some investment firms, including Class 3 firms?

No comment.

Question 26
What are your views on the proposed approach to addressing group risk within investment firm-only groups? Do you have any other suggested treatments that could be applied, and if so, why?
No comment.

Question 27
In the case of an investment firm which is a subsidiary of a banking consolidation group, do you see any difficulty in the implementation of the proposed capital requirements on an individual firm basis? If so, do you have any suggestion on how to address any such difficulties?
No comment.

Question 28
What other aspects should the competent authorities take into account when addressing the additional prudential measures on an individual firm basis under the prudential regime for investment firms?
No comment.

Question 29
What examples do you have of any excessive burden for investment firms arising from the current regulatory reporting regime?
No comment.

Question 30
What are your views on the need for any other prudential tools as part of the new prudential regime for investment firms? And if required, how could they be made more appropriate? In particular, is there a need for requirements on public disclosure of prudential information? And what about recovery and resolution?
No comment.

4.5 Governance and remuneration

Question 31
What are your views on the relevance of CRD governance requirements to investment firms, and what evidence do you have to support this?
No comment.

Question 32
As regards ‘systemic and bank-like’ investment firms, do you envisage any challenges arising from the full application of the CRD/CRR remuneration requirements, and if so, what evidence do you have to support this? For all other investment firms, what are your views on the type of remuneration requirements that should be applied to them, given their risk profiles, business models and pay structures?

> *The UK Financial Conduct Authority (and national competent authorities in other member states) have implemented remuneration tiering system that take into account the risk profile of MTFs (which are designed to be risk neutral) by putting them at the lowest level of application of the remuneration rules. We believe that the same principle*

should be applied to other entities which do not seek to take market or credit risks, and that CRD IV should be amended to explicitly reflect this.

We believe that more useful proposal would be to omit investment firms that do not take credit risk from the scope of the remuneration “bonus cap” rules. Such rules do not serve the aim of acting a break on risk taking, in this context they only encourage increased fixed pay and cause the costs of such firms to become more inflexible (as well as increasing fixed overheads and hence capital requirements). An exemption would allow MTF operators to better manage their businesses to meet market conditions.

Question 33
What is your view on a prudential remuneration framework for other than ‘systemic and bank-like’ investment firms that should mainly aim to counteract against conduct related operational risks and would aim at the protection of consumers?
No comment.

4.6 Alternative approach to a new regime

Question 34
What are your views on having a separate prudential regime for investment firms? Alternatively, should the CRR be amended instead to take into account a higher degree of proportionality? Which type of investment firms, if any, apart from systemic and bank-like investment firms, would be better suited under a simplified CRR regime?
No comment.

Question 35
What are the main problems from an investment firm perspective with the current regime? Please list the main problems with the current regime.
No comment.