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Donnerstag, 3. September 2020

Comments on the Consultation Paper on Draft Regulatory Technical Standards related to implementation of a new prudential regime for investment firms

Dear Sirs,

The association represents mostly the interests of so-called Class 3 firms with a limited licence (not holding client funds or instruments) and not trading on own account. Our members are not interconnected. Therefore, this paper will focus on the regulation of these mostly small investment firms.

On behalf of our members, we would like to make the following comments on the draft RTS

1. Comment on

6 - Draft RTS to specify the calculation of the fixed overheads requirement and to define the notion of a material change (Art. 13 (4) of the IFR).

Art. 13 par. 4 lit e of REGULATION (EU) 2019/2033 provides that fees to tied agents shall be deducted from the overheads when calculating the fixed overheads capital requirement.

The draft RTS Art. 1 par. 5, EBA includes the fixed expenses (overheads?) of third parties, in particular of tied agents, into the fixed overheads of the investment firm.

> “Where fixed expenses have been incurred on behalf of the investment firms by third parties, including tied agents, and these fixed expenses are not already included within the

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> total expenses included in the annual financial statement referred to in paragraph 1, these shall be added to the total expenses of the investment firm. Where a break-down 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 break-down 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."

The corresponding recital is rather short and does not shed any light on the rationale of the EBA draft provision:

> (4) Investment firms should include fixed costs (expenses, overheads?) of third parties in the calculation of their total expenses. However, where these costs are not fully incurred on behalf of the investment firms, these should be included up to the amount attributable to the investment firm.

The discussion in the Consultation paper does not deal with this issue.

We do not think that the inclusion of tied agents' fixed overheads into the fixed overheads of the investment firm is an appropriate element of determining the FOR for the investment firm.

We base our opinion on two grounds: the legislative reason of the FOR and practical considerations.

Legislative reason:

The rationale of FOR is to cover the expected expenses of the investment firm during the period of winding down the firm

(cf. Consultation paper Txtnr. 173: "Given that the FOR is designed to ensure that the investment firm has enough money to run the business during the wind down period")

Agreements between the Investment firm and its tied agents usually provide for payments of commissions to the tied agents for the investment firms business generated by the tied agent through his/her investment advice and/or order reception and transmission activities.

These agreements do not create any responsibility for the investment firm to cover any fixed overheads of its tied agents. If this were the case against the rule, these obligations would enter into the fixed overheads of the investment firm directly.

Furthermore, a firm winding-down may reduce or stop its activity entirely.
(cf. CP Textnr. 170)

Should this be the case, the activities of the tied agent for the investment firm would come to a stop as well. Whether the tied agent will look for another investment firm to continue operations or will cease as well business, is not a matter to be decided by the investment firm winding down.

> The tied agent's fixed expenses do not play any role in the financial position of the investment firm during the winding down process.

One can only guess the reasons which prompted EBA to include the fixed assets of third parties into the FOR of the investment firm. If this measure should prevent negative effects on the third parties and on the market in general, this effect would not be achieved because the capital of the investment firm would not benefit the financial situation of the third party.

The EBA draft treats these third parties, in particular the tied agents, like branch offices of the investment firm. This is, however, not the case. Only in the case of provision of services in another member state through tied agents established there, Art. 35 Directive 2014/65/EU (MIFID II) prescribes rules which essentially treat those tied agents similar to branch offices of the investment firm. No similar rules exist in the basic legislative texts on which the EBA RTS-draft elaborates.

Regarding other third parties which include most likely firms to which the investment firm have outsourced part of their activities, the EBA draft provides that their fixed expenses shall be included in the fixed overheads of the outsourcing investment firm unless those fixed expenses of the third firm are already included in the investment firm's fixed overheads. This text is misleading. The fixed expenses of the insourcing firm are usually not included in the fixed overheads of the outsourcing investment firm, but rather the consideration paid to the insourcing firm by the outsourcing investment firm are included in the latter's overheads. This is by definition income of the insourcer and not part of the insourcer's fixed expenses. This consideration (except the variable commissions for tied agents) is part of the fixed overheads of the outsourcing investment firm.

There is no rule of law which obliges the third party to inform the investment firm on the overheads incurred by the third party.

Conclusion: The entire paragraph 5 (Art. 1) in the EBA draft should be deleted.

Practical difficulties to EBA's concept including the fixed overheads of tied agents into the Fixed overheads of the investment firm:

The FOR is based on the fixed overheads of the preceding year. Investment firms are required to prepare their financial statements within a relative short time after the end of the accounting year. (e.g. Germany 31st of March - § 26 KWG; France 31st of May - Article R533-1 Code monétaire et financier – the other EU member states have probably similar deadlines) Tied agents are not subject to these deadlines, but rather prepare their annual statements according to general accounting and tax regulation which might range from 6 months to one year or when the financial statement is prepared for purposes of taxation event longer (e.g. firms in Germany using tax-accountants for the preparation of their statements very often have a deadline at the end of February of the year after the next). The investment firm will never receive in time the information on the FOs of their tied agents to include them in their own FO calculations. The information received will likely be one or two years two years old.

EBA takes into account the case of third parties resp. tied agents operating in other business areas. Tied agents are generally small firms not having a cost centre accounting. According to the EBA draft, an investment firm, therefore, 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."

We have not found any rule according to which an investment firm should include third party expenses in its business plan.

COMMISSION DELEGATED REGULATION (EU) 2017/1943 requires under Art. 1 lit a), Art. 6 lit a) and e) the following information of an applicant investment firm to be included in the business plan (programme of operations):

(ii) for domestic tied agents: details on its intention to use tied agents;

(a) a programme of initial operations for the following three years, including information on planned regulated and unregulated activities detailed information on the geographical distribution and activities to be carried out by the investment firm. Relevant information in the programme of operations shall include: (i) the domicile of prospective customers and targeted investors; (ii) the marketing and promotional activity and arrangements, including languages of the offering and promotional documents; identification of the Member States where advertisements are most visible and frequent; type of promotional documents (in order to assess where effective marketing will be mostly developed); (iii) the identity of direct marketers, financial investment advisers and distributors, geographical localisation of their activity;

(e) a list of the outsourced functions, services or activities (or those intended to be outsourced) and a list of the contracts concluded or foreseen with external providers and resources (in particular, human and technical, and the internal control system) allocated to the control of the outsourced functions, services or activities;

From this we conclude that only the consideration owed or paid to third parties are for purposes of the programme of operations relevant expenses of the investment firm and not any "share of the fixed expenses" of the third party.

The basis of estimated allocation of third party expenses assumed by EBA's draft does not exist.

These reasons also lead us to the conclusion that the provision Art. 1 par. 5 of the draft should be deleted.

If the purpose of the inclusion of third party FO into the FO of the investment firm were to prevent an abusive shifting of FO of the investment firm, in order to minimise its own FO, to a third party, in particular to tied agents, the draft text does not reflect this, but goes far beyond this purpose treating "all" third party FO as FO of the investment firm.

The splitting and allocation of third party FO to the investment firm of those FO which are applicable to the investment firm in Sentence 2 and 3 of draft Art. 13 (5) covers a different situation, namely when and if the third party (tied agent) carries on activities which are not considered financial services rendered on behalf of the investment firm.

To achieve the purpose of preventing an abusive shifting, the draft ought to specify which type of expenses are genuine FO of the investment firm which it may not shift to a tied agent and which type of expenses are genuine FO of the tied agent. Only the former would have to be included in the investment firm's FO and the latter not. This should be properly reflected in the RTS text.

2. Comment on

7 - Draft RTS to specify the methods for measuring the K-factors (Article 15(5), point a) of the IFR)

Draft text:

> Article 3
>
> Methods for measuring the AUM in case of discretionary portfolio management
>
> …………………………..
>
> (c) the calculation shall include cash except any amounts covered under CMH in accordance with Article 4.

Comment:

This item is not clear and should be revisited to avoid misunderstandings in the future application of this provision.

The K Factor AUM shall cover with the investment firms' capital those risks which are connected with the assets which are subject to the management power of the investment firm.

Cash as "asset under management" must be distinguished from "Client money held" (CMH).

Recital 24 of the IFR clarifies that K-CMH excludes client money that is deposited on a (custodian) bank account in the name of the client itself, where the investment firm has access to the client money via a third-party mandate.

But cash which is deposited in an account in the client's name at the bank executing the trades initiated by the portfolio manager is not necessarily an "asset under management". It can be treated as an "asset under management" only when and if the management power (proxy) of the portfolio manager includes the authority to make dispositions in the client's name in this cash account. The practice of portfolio managers, at least in Germany, is to restrict the management authority to buying and selling financial instruments only. Dispositions in the client's cash account are expressly excluded. The movements in the cash account are triggered by the executing or custodian bank as a necessary consequence of the trades initiated by the portfolio manager. The portfolio manager cannot transfer any funds out of the account. The execution of transactions not covered by the cash in the account may be refused. The portfolio manager "has no access to the client money via a third party mandate." Therefore, in this management structure, the risk connected with the management extends exclusively to the financial instruments under management and not to the cash in the client's cash account.

It should be clarified that this type of cash being excluded from the management authority of the portfolio manager should as well be excluded from the calculation of AUM.

Art. 3 lit. c) should read:

> "the calculation shall include cash *to which the investment firm has access via a third party mandate except* any amounts covered under CMH in accordance with Article 4."

3. Point to note for future review of IFR Art. 60

IFR Art. 54 provides:

> 1. Investment firms shall report on a quarterly basis to the competent authorities all of the following information:
>
> (a) level and composition of own funds;
> (b) own funds requirements;
> (c) own funds requirement calculations;
> (d) the level of activity in respect of the conditions set out in Article 12(1), including the balance sheet and revenue breakdown by investment service and applicable K-factor;
> (e) concentration risk;
> (f) liquidity requirements.

Comment:

For investment firms which maintain a multiple of own funds compared to the own funds requirements, it is an undue burden to make quarterly reports, in particular calculating K-factors which have no information or other value for the supervising authority.

Example: An investment firm's own funds requirements are constantly determined by FOR which at all times exceeds the funds required according to the K-factor calculation. The own funds amount to 500% of the own fund requirement.

We suggest that in the next review to be undertaken according to Art. 60, the quarterly reporting of K-factor calculations be suspended and replaced by annual reporting for those investment firms whose own funds amount at least to 200% of the own fund requirement.

Kind regards,

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