**ICE response to the EBA consultation on the implementation of IFR/IFD**

Draft Regulatory Technical Standards related to implementation of a new prudential regime for investment firms on:

* The reclassification of investment firms as credit institutions under Article 8a (6) of Directive 2013/36/EU.
* The prudential requirements for investment firms under Articles 7(5), 9(4), 13(4), point (a) to (c) of Article 15(5) and Article 23(3) of Regulation (EU) 2019/2033.
* The prudential requirements for investment firms under Article 5(6) of Directive (EU) 2019/2034.

Overview of questions for consultation

1. **Is the proposed articulation of the K-factors calculation methods, in particular between AUM and CMH and ASA, exhaustive or should any other element be considered?**

ICE Futures Europe and ICE Endex (‘the Exchanges’) welcome the opportunity to respond to the EBA consultation on Draft Regulatory Technical Standards (‘RTS’) related to implementation of a new prudential regime for investment firms. The Exchanges fully support the approach taken in the draft RTS specifying the methods for measuring the K-factors[[1]](#footnote-1) (‘Draft RTS 7’), whereby for the purpose of the calculation of K-DTF the premium of exchange traded options is used. The basis for this adaptation recognises that not all derivatives are equal in risk terms. The Exchanges firmly believe that options exposure is not equivalent to that of the underlying futures and this should therefore be accounted for. The Exchanges would like to make the following two recommendations to further improve the drafting of the relevant RTS and the functioning of K-DTF.

Firstly, Articles 8(1) and 10(1), Draft RTS 7 set out the instruments that an investment firms must include as cash trades when calculating client orders handled ("COH") and daily trade flows ("DTF") pursuant to Article 33, IFR. Articles 9 and 11, Draft RTS 7 set out methods of measuring derivatives for the purpose of COH and DTF respectively. The wording used in Articles 8 & 10 and in Articles 9 & 11 of Draft RTS 7 are broadly similar.[[2]](#footnote-2) Our understanding of the EBA intentions is that all exchange traded options (including options on futures) be subject to the charges for cash trades described in Article 8(2), RTS 7. However, if that is indeed the case, further amendments may be required to result in such a state of affairs.

The term "derivatives", is defined in the Level 1 text, Article 4(1)(10), IFR, which in turn refers to Article 2(1)(29) of the Markets in Financial Instruments Regulation ("MiFIR"),[[3]](#footnote-3) which in turn refers to Article 4(1)(44)(c) and Annex I, Section C (4) to (10) of the Markets in Financial Instruments Directive.[[4]](#footnote-4) This includes a broad range of options, including on futures, commodities and securities.

Articles 9 and 11, RTS 7 make provision for the COH and DTF charges respectively for all derivatives, which in principle will therefore include all options. However, "exchange-traded options" have also been included within "cash trades" pursuant to Article 8(1)(d) and 8(2) and 10(1)(d) and 10(2) of RTS 7.

It seems tolerably clear that the relevant COH and DTF charges for over-the-counter options would be governed by Articles 9 and 11 of the RTS. However, the current drafting is potentially problematic as regards (i) exchange traded options in general, because it is unclear whether these are always included as cash trades, derivatives or both; or (ii) exchange traded options on securities versus other kinds of exchange traded options, which even less naturally fall under the definition of "cash trades". The treatment of any exchange traded options as both derivatives and cash trades would doubtless be an unintended interpretation of RTS 7, since it could lead to a double counting, yet as it stands, this is the more natural interpretation of the words currently proposed.

There would be two conceptual ways of resolving the potential unclarities in the drafting: (a) introduce a provision allowing the options premium approach to be applied for options that are derivatives, reflecting the approach available for those options which are included in the "cash trades" sections, or (b) exclude exchange-traded options from the scope of derivative transactions for the purposes of calculating COH and DTF, by inserting a cross reference for the provision relating to cash trades (with the available options premium). We understand that the latter is the intended approach, since the higher charge for cash trades in general is supposedly intended to apply to exchange-traded options, as well as the usage of options premium. [[5]](#footnote-5)

It should be noted that introducing a distinction between sub-categories of derivatives might give rise to a perception that the adjustment for the time to maturity available under Article 33(2)(b), IFR would apply only to "true" derivative transaction (i.e. excluding exchange traded options, which are counted as cash transactions). Wording should be introduced to clarify that this is not intended.

The following amendment is suggested to Articles 8-11:[[6]](#footnote-6)

*Article 8*

*Methods for measuring cash trades for the purpose of COH*

1. *For the purposes of measuring COH under Article 20 of Regulation (EU) 2019/2033 regarding cash trades, an investment firm shall include as cash trade any transaction where a counterparty undertakes to receive or deliver any of the following:* 
   1. *transferable securities;*
   2. *money-market instruments;*
   3. *units in collective investment undertakings;*
   4. *exchange traded options whose underlying is any of the items in (a) to (c).*
2. *Where the transferable security is an exchange traded option as referred to in paragraph 1(d), the investment firm shall use the option premium used for the execution of that exchange traded option.*

*Article 9*

*Methods for measuring derivatives for the purpose of COH*

1. *For the purposes of measuring COH under Article 20 of Regulation (EU) 2019/2033 regarding derivatives, the notional amount of a derivative contract shall be determined according to the provisions of Article 29(3) of that Regulation.*
2. *Where the derivative is an exchange traded option other than one referred to in paragraph 1(d) of Article 8, the investment firm shall measure the COH for such a derivative in the same way as for a cash trade which is an exchange traded option, in accordance with paragraphs 1 and 2 of that Article, with no additional charge under this Article 9. Nothing in this paragraph shall restrict the application of the adjustment for the time to maturity available under paragraph 2(b) of Article 33 of Regulation (EU) 2019/2033 for all derivatives, including exchange traded options.*

*Article 10*

*Methods for measuring cash trades for the purpose of DTF*

1. *For the purposes of measuring DTF under Article 33 of Regulation (EU) 2019/2033 regarding cash trades, an investment firm shall include as cash trade any transaction where a counterparty undertakes to receive or deliver any of the following:* 
   1. *transferable securities;*
   2. *money-market instruments;*
   3. *units in collective investment undertakings;*
   4. *exchange traded options whose underlying is any of the items in (a) to (c).*
2. *Where the transferable security is an exchange traded option as referred to in paragraph 1~~(a)~~(d), the investment firm shall use the option premium used for the execution of that exchange traded option.*

*Article 11*

*Methods for measuring derivatives for the purpose of DTF*

1. *For the purposes of measuring DTF under Article 33 of Regulation (EU) 2019/2033 regarding derivatives, the notional amount of a derivative contract shall be determined according to the provisions of Article 29(3) of that Regulation.*
2. *Where the derivative is an exchange traded option other than one referred to in paragraph 1(d) of Article 10, the investment firm shall measure the DTF for such a derivative in the same way as for a cash trade which is an exchange traded option, in accordance with paragraphs 1 and 2 of that Article, with no additional charge under this Article 11. Nothing in this paragraph shall restrict the application of the adjustment for the time to maturity available under paragraph 2(b) of Article 33 of Regulation (EU) 2019/2033 for all derivatives, including exchange traded options.*

# Secondly, on the treatment of Exchange Traded Options under K-DTF and COH Articles 8-11, RTS 7 provides that where the transferable security to be measured for the purposes for COH or DTF is an exchange traded option, the investment firm must use the option premium used for the execution of that exchange traded option. We make some suggestions to clarify these provisions.

### The reason to include exchange traded options, with premium paid for such options, is that the buyer is buying the option (financial instrument) and settles the market value of that option, which is the premium of the option. However, it is unclear how these provisions relate to portfolios. As currently drafted, it is arguable that the option premium to be used should be calculated on a leg-by-leg basis, rather than based on the spread of the options taken as a portfolio, which is more reflective of the way the market operates in practice.

### The following amendment is suggested:

### *Where the transferable security is an exchange traded option as referred to in paragraph 1(d), the investment firm shall use the option premium used for the execution of that exchange traded option or, where the option forms part of a portfolio, the aggregate net option premium of that portfolio*.

1. **Are the requirements for notion of segregated accounts sufficient? Are there issues on segregated accounts which need to be elaborated further?**

N/A

1. **Is there any example of situations of market stress which would not been taken into account applying the proposed approach but would be relevant for the measurement of the K-DTF?**

### Article 1, RTS 9[[7]](#footnote-7) sets out the mechanism by which adjustments to the K-DTF coefficient referred to in Table 1 of paragraph 2 of Article 15, ITR shall be made. Such adjustments are to be made in "stressed market condition" as referred to in Commission Delegated Regulation (EU) 2017/578, on the basis that the standard K-DTF requirements seem overly restrictive and detrimental to financial stability.

### There appear to be two main unclarities in the drafting of the relevant provisions:[[8]](#footnote-8)

### "Trade that occured" vs "cash trade that occurs" vs "trading that occured" vs "trading cash trade that occurs": Each of the definitions of DTFexcl and DTFincl (one for the purposes of K-DTF cash trades, one for the purposes of K-DTF derivatives) uses a different formulation for the trades that are to be either excluded or included. At least one of these ("trading cash trade that occurs") appears to be manifestly wrong. If differences are meant by the differences in usage, it is not clear what these are.

### "Extreme volatility" vs "exceptional circumstances": The two definitions of "DTFexcl" refer to "extreme volatility" whereas the two definitions of "DTFincl" refer to "exceptional circumstances". Both cross-refer to Article 2.

#### This gives rise to various issues. Under Article 2, the start and end times of "period of extreme volatility" shall "reflect precisely the times when the trading venue made public the occurrence of such an exceptional circumstance" under Article 3(a) of the relevant MiFID II delegated Regulation.[[9]](#footnote-9) Article 3(a) of the relevant Regulation defines "exceptional circumstances" (for these purposes) as "a situation of extreme volatility…" Given that these time periods are therefore co-extensive, it is unclear what is intended by the different usages. The wording in Article 2 itself is intended to, but does not quite, map exactly onto Article 3(a).

#### The following amendments are suggested:

#### *For the purposes of Article 1, a period~~s~~ of extreme volatility shall be a ~~those~~ situation~~s~~ referred to in of point (a) Article 3 of Commission Delegated Regulation (EU) 2017/578. The~~ir~~ start and end times of each period of volatility shall reflect precisely the times when the trading venue made public the occurrence of ~~such~~ an exceptional circumstance under point (a) of Article 3 of Commission Delegated Regulation (EU) 2017/578 and the resumption of normal trading in accordance with Article 4 of that Regulation respectively.*

### It might be considered appropriate to include within the definition of "extreme volatility" those situations referred to in Article 3(b) and (c) of the relevant Regulation, namely:

### *(b) war, industrial action, civil unrest or cyber sabotage;*

### *(c) disorderly trading conditions where the maintenance of fair, orderly and transparent execution of trades is compromised, and evidence of any of the following is provided: (i) the performance of the trading venue's system being significantly affected by delays and interruptions; (ii) multiple erroneous orders or transactions; (iii) the capacity of a trading venue to provide services becoming insufficient.*

### Recently, Central Bank emergency rate cuts outside of the normal decision making cycle and national government responses to the Covid-19 pandemic impacted market volatility perhaps as much as the actual virus ; there may be regulatory appetite to apply a broader definition of volatility in light of the economic problems caused by over-margining and risk-based capital requirements in the midst of the Covid-19 crisis.

### The use of the situation where a trading venue makes public the occurrence of such an exceptional circumstance under MiFID as the determinant of extreme volatility, improperly conflates these concepts and "stressed markets" for adjustment of the K-DTF coefficient. It also gives rise to issues as to how non-MiFID exchanges, as well as non-equity markets, are to address the situation. It is of particular practical concern that a regulated market in making a determination under Article 3 of Commission Delegated Regulation 2017/578 will likely do so first of all with a view to legal certainty and enforceability of its own decision, and not with regard to the effects on K-DTF coefficients. Articles 3(b) and 3(c) involve harder factual tests, of which a Board may more easily be satisfied. The existence of a war, industrial action, civil unrest or cyber sabotage is a factual matter, as are a system being affected by delays or interruptions. However, a determination of "extreme volatility" is harder to make, since the adjective used in the definition calls for very unusual events, whose threshold is undefined. In light of the concerns arising from market movements in the recent Covid-19 downturn, and the subjectivity of Article 3(a), we consider it very important that at least 3(b) and better still 3(c) also be added as triggers.

In addition, the Exchanges suggest broadening the scope of occasions when adjustments to the K-DTF coefficients should be made to include stressed market conditions. The Exchanges are not aware of recent events where “situations of extreme volatility” have been triggered, not even during extreme volatile peaks of the Covid-19 outbreak. The usage of the stressed markets condition triggered by exchanges does give rise to practical implementation issues that would need to be resolved. As a simpler alternative to the adjustment linked to MIFID-market-making-definitions for stressed markets, a more generic statistical method reducing deviations could be defined by EBA, in order to avoid market makers from the need to identify stressed markets, which may vary across products and exchanges. Measuring against the historical median of a time period to identify stressed markets might be one approach to consider. This would also remove the subjective nature of exchanges declaring stressed markets or extreme volatility in, or near to, real time as events are unfolding.

1. **What would be appropriate thresholds or events that should trigger the comparison between the calculation under the K-CMG compared to the one under the K-NPR?**

N/A.

1. **Which other conditions should be considered to avoid double counting or to prevent regulatory arbitrage in the use of the K-CMG approach?**

### Under Article 2, RTS 10,[[10]](#footnote-10) the amount of the total margin referred to in Article 23(2), IFR shall be the required amount of collateral in the collateral account comprising the initial margin, variation margins and other financial collateral, as required by the clearing member's margin model from the investment firm.

### As drafted, this would include variation margin that has been subject to the settlement to market treatment under Article 274(2)(c), Capital Requirements Regulation ("**CRR**").[[11]](#footnote-11) The settlement to market treatment under the CRR provides that a CCP will determines the current (end of trading day) value of a derivative for the purposes of its own risk management. The CCP then uses this determination to crystallise the contingent profit accruing to the relevant party (resulting from the change in the market value of the derivative since the previous determination), which then becomes due and payable as between the parties, by way of outright transfer of the accrued profit, in accordance with the CCP's procedures. The result is that the exposure of the relevant contracts has been re-set to zero (until the next determination period).

### The effect of the settlement to market treatment is that the relevant settlement payment provided to the CCP should not be considered "variation margin" because it is not an asset of the clearing member investment firm recorded on the books and records of the CCP, and so there is no exposure to the CCP with respect to such payments.[[12]](#footnote-12) The payment is an outright cash payment which extinguishes the exposure.[[13]](#footnote-13)

### The following amendment is suggested:

### *4. Any amounts due or paid under contracts in order to settle the outstanding exposure to market, where the terms are reset so that the market value of the contract is re-set to zero as referenced in point (c) of Article 274(2), Regulation (EU) No 575/2013, shall be excluded from the scope of variation margin for the purposes of paragraph 1.*

1. **Do you have any comment on the elements included in this Consultation Paper for the application of the aggregation method?**

N/A.

1. **Do you currently use the method of proportional consolidation for the consolidation of subsidiaries in accordance with Article 18(4) of Regulation (EU) No 575/2013? If proportional consolidation is used, please explain if the conditions included in this Consultation Paper are met.**

N/A.

1. **Do you have any comments on the conditions established in this Consultation Paper to apply proportional consolidation to investment firms groups under Regulation (EU) No 2019/2033?**

N/A.

1. **The methods for calculating the K-factors in a consolidated situation may allow for further specifications. Is there any K-factor for which the calculation in the context of the consolidated basis would require further specifications? What aspects should be considered?**

N/A.

1. Draft RTS to specify the methods for measuring the K-factors, EBA Consultation Paper, pp. 49 *et seq.* [↑](#footnote-ref-1)
2. Subject to a typographical error, namely the use of "(a)" when "(d)" is presumably intended in Article 10(2). [↑](#footnote-ref-2)
3. Regulation (EU) No 600/2014. [↑](#footnote-ref-3)
4. Directive 2014/65/EU. [↑](#footnote-ref-4)
5. We note, however, that as cash trades, they are subject to a coefficient of 0.1%, rather than the coefficient for derivatives of 0.01% under Article 15, IFR. [↑](#footnote-ref-5)
6. Note that further amendments to Article 8(2) and 10(2) are proposed below. [↑](#footnote-ref-6)
7. Draft RTS to specify adjustments to the K-DTF coefficients, EBA Consultation Paper, pp. 61 *et seq.* [↑](#footnote-ref-7)
8. Disregarding the typo in the word "occurred" on each occasion. The word "referred" in Article 10(1) is also unfortunately spelt with four "r"s. [↑](#footnote-ref-8)
9. Commission Delegated Regulation (EU) 2017/578. [↑](#footnote-ref-9)
10. Draft RTS to specify the calculation of the amount of the total margin for the calculation of K-CMG, EBA Consultation Paper, pp. 66 *et seq.* [↑](#footnote-ref-10)
11. Regulation (EU) No 575/2013. [↑](#footnote-ref-11)
12. Where variation margin is due and payable to the clearing member investment firm by the relevant CCP but such amounts have not actually been transferred, such amounts are still reflected in the books and records of the CCP, and so ought to be included. [↑](#footnote-ref-12)
13. This is to be contrasted with the mark-to-market treatment, whereby the party out of the money is obliged to provide assets with an equal value to the exposure, without resetting/extinguishing the exposure. The assets used to collateralise the value of the contract are properly included within the scope of "variation margin". [↑](#footnote-ref-13)