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Consultation Paper (EBA/CP/2020/06) of 4 June 2020

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

Dear Sir, dear Madam,

the Bundesverband der Wertpapierfirmen e.V.(bwf) is a trade association representing the common professional interests of securities trading firms and market specialists (market makers) at the securities exchanges throughout Germany.[1] In this capacity, we expressly welcome the possibility to comment on EBA's Consultation Paper (EBA/CP/2020/06) of 4 June 2020 on Draft Regulatory Technical Standards related to implementation of a new prudential regime for investment firms.

General remarks

The new prudential regime for investment firms is a well-intentioned piece of legislation whose final outcome unfortunately can only partly convince from a methodological point of view. The sheer number of "Level II" mandates alone demonstrates that the original aim not only to avoid undue capital requirements but to establish an overall more proportionate, less complex regime which also

[1] bwf is listed on the EU register of interest representatives under the ID 258694016925-01.

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avoids any unnecessary administrative burden and undue compliance costs,[2] has not be achieved.

In the contrary, the politically motivated "reintroduction" of CRR-based capital calculations, adopted from the banking-regulation-toolbox, was not only clearly antagonistic to the original concept[3] but completely wiped out any effort to reduce the administrative burden for market-makers or any other investment firm maintaining a trading book. Even more, since the CRR based calculation of K-NPR is only a small part of the overall K-factor regime, it can be argued that the complexity of the regulatory framework – at least for sell side firms – was rather increased than reduced.

The gospel of "specific risks posed by investment firms"

With the reintroduction of CRR capital requirement in form of K-NPR, the often stated gospel that the new regime would more adequately reflect the *"specific risks posed by investment firms"* was not convincing anymore.[4] In an overall assessment, one could even argue that the K-factor regime openly violates the general call for simplicity and comparability, demanded by the Basel Committee for any new piece of regulation.[5] In other words, where is the justification that an investment firm has to hold regulatory capital, e.g. in relation to its assets under management or customer orders handled, while a universal bank offering the same investment services – and therefore is directly competing with the investment firm in this respect – has not.

Furthermore, the classification rules fail to recognize that from a regulatory point of view, dealing on own ac-count on a bank's balance-sheet funded by deposits should be treated differently from dealing on own account by firms funded solely by own capital or by investors anticipating the risks involved in the business in which they invest. A fundamen-

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[2] Cf. European Commission Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the prudential requirements of investment firms and amending Regulations (EU) No 575/2013, (EU) No 600/2014 and (EU) No 1093/2010, COM(2017) 790 final, 2017/0359 (COD), Brussels, 20.12.2017, p. 6

[3] Cf. *„This proposal therefore creates a new regime for the majority of investment firms by carving them entirely out of the CRR/CRD IV framework and leaving only systemic investment firms within the scope of the latter."*, Explanatory Memorandum, European Commission Proposal of 20.12.2017, COM(2017) 790 final.

[4] Cf. EBA/CP/2020/06, p. 92, para. 138.

[5] Cf. Basel Committee on Banking Supervision, Discussion paper, the regulatory framework: balancing risk sensitivity, simplicity and comparability, July 2013 (BCBS258). – Even though the analysis of the BCBS has no immediate legal relevance for EU legislation, it unveils some fundamental conceptual weaknesses of the IFR-regime from a risk management as well as from a level playing field and better regulation perspective.

tally misconception which is reflected in particular by the clearly disproportionate decision that from the first Euro traded, an investment firm is not regarded to be *"small and non-interconnected"* anymore.[6] And as we know, there are more "zero"-thresholds which effectively exclude firms, from the moment they start their business, from the application of more proportionate "class 3" rules.[7]

Even though, the points raised above refer to "Level I" decisions, we thing it is important to keep these misconceptions in mind when discussing the proposed "Level II" drafts. Even more since the "Level I" text is essentially based on EBA's proposals.

Impact of CoVid19 on the implementation timeline

Furthermore, the implementation deadline of June 2021 has become a matter of great concern. As a result of the CoVid19-pandemic and the strong growth in trading volumes observed this year, IT-resources in investment firms were under severe stress for the last months which inevitably delayed the implementation efforts for the new IFR-regime. This affects in particular the required IT-system changes like new data bases and interfaces to retrieve the data sets required to comply with the new K-factor regime and the associated reporting requirements. Furthermore EBA openly admits in its very ambitious *"roadmap on investment firms"* the risk of delays of certain highly complex "Level II measures.[8]

It therefore appears objectively uncertain whether the implementation deadline can be met and we would like to urge EBA to propose to the Commission a six month "phase-in" period, which would allow firms to adopt the new rules as soon as they are ready (either on time on 26 June 2021 or with a slight delay), while giving the IT- and compliance departments a little bit more "breath" in these very demanding times. Such an adjustment would correspond with other shifts of implementation deadlines resulting from the CoVid19-pandemic which could be recently observed, e.g. the proposed delay the entry into force of the CSDR

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[6] The „zero"-threshold for DTF also contradicts EBA's original assessment *"although trading for own account carries high risks when conducted within a banking group (due to contagion risk), the situation should be assessed differently for standalone firms. The insolvency of a firm without external clients generally affects only the owners of the firm (and, to some extent, the firm's counterparties and creditors)"*, EBA/ESMA, Report on Investment Firms, (EBA/Op/2015/20), December 2015, p. 19. And within the same report *"A 'bank-like' own funds requirement may not be appropriate when addressing the risks of investment firms that only deal on own account and have no external clients"* (Ibid, p. 92).

[7] However, we would agree, that investment firms holding client money or assets should always be categorized at least as "class 2" firms.

[8] Cf. EBA ROADMAP ON INVESTMENT FIRMS EBA MANDATES ARISING FROM IFR/IFD, June 2020, p. 12

settlement discipline regime as requested by the European Commission.[9] Furthermore, such a "phase-in" approach should not give raise to any regulatory concern, since investment firms are already appropriately regulated and many CRR investment firms currently have to apply the same rules as credit institutions.

This said, we would like to comment on the Consultation Paper – to the extent that the questions raised are relevant with respect to the business models of bwf member firms – as follows:

Comments on the draft RTS to specify the calculation of the fixed overheads requirement and to define the notion of a material change (Article 13 (4) of the IFR)[10]

While EBA's explanatory remarks could give the impression that the fixed overhead requirement (FOR) is based on a concept which was developed for investment firms with limited authorisation and only now is extended to other investment firms,[11] it is worth mentioning that the concept was first introduced with the first capital adequacy directive from 1993 where it was applied to all investment firms which had to cope with the provisions of the directive.[12]

This mentioned, we are generally supportive of the way in which EBA has handled its mandate resulting from article 13 para. 4 IFR[13] in particular with respect to the development of additional deductible items und the *"subtractive approach"*.[14] We are in particular reassuring with respect to the deductibility of *"losses from trading on own account in financial instruments"*[15] and *"payments related to contract-based profit and loss transfer agreements"*[16]

Variable transaction fees are not "fixed overhead" costs

However, we do not agree with the proposal to limit the deductibility of *"fees, brokerage and other charges"* to situations *"where they are passed*

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[9] Cf. ESMA is preparing a new RTS to further postpone CSDR settlement discipline, URL: https://www.esma.europa.eu/press-news/esma-news/esma-preparing-new-rts-further-postpone-csdr-settlement-discipline

[10] Cf. EBA/CP/2020/06, p. 12 et seq. and p. 22 et seq.

[11] CF. Ibid., p. 13, para. 32

[12] Cf. Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions, Annex IV

[13] Regulation (EU) 2019/2033 of the European Parliament and of the Council of 27 November 2019 on the prudential requirements of investment firms and amending Regulations (EU) No 1093/2010, (EU) No 575/2013, (EU) No 600/2014 and (EU) No 806/2014, article 13, para. 4

[14] Cf. EBA/CP/2020/06, p. 47, draft RTS 6, article 1 para. 6

[15] Ibid. (d)

[16] Ibid. (e)

on and charged to customers." [17] Here it should be remembered that the FOR-concept is based on the underlying idea that an investment firm should have sufficient own funds to cover costs which would still occur under a *"gone concern"* assumption for a period of three months in order to allow for an orderly wind-down. Since an investment firm, after the decision to shut down its business is made, would immediately cease trading, all fees which are truly variable and transaction-based (in the contrast e.g. to membership fees, which usually occur on an annual basis) should be deductibility for the purpose of FOR calculation, since they clearly are not fixed overheads but variable costs.[18]

Provisons and reserves

Furthermore, we would like to propose an additional deductible item in form of allocations to provisions and reserves,[19] because no further allocations to reserve funds would be made after a shut-down decision is made (and the release of existing reserves could help to unwind an investment firm in an orderly manner).

„Material change"

Finally, with respect to the question what constitutes a *"material change"* for the purpose of the purposes of article 13 (2) of Regulation (EU) 2019/2033, we are sceptical regarding the appropriateness of the proposed absolute threshold of a change of 2 million Euros or more in projected fixed overheads for the current year. Generally, we are of the opinion that, the definition of anything "material" cannot be made in a meaningful way without taking at least the size of the business into account. Therefore, thresholds in this context should principally be defined in relative terms. The only exemption to be considered here would be the establishment of a *de minimis* threshold up to which a change in expected fixed overheads should never be considered to constitute a *"material change"*.

[17] Ibid. (a)

[18] In this context it should be noted that the three month time horizon is an extremely conservative assumption from the perspective of sell-side firms, whose activities which require regulatory attention (unwinding existing positions and fulfillment of payment or delivery obligations from unsettled trades) can usually be carried out within a few "T+2" Settlement cycles.

[19] E.g. for general banking risks a stipulated by §340f and §340g of the German Commercial Code (HGB).

Question 3
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?

While EBA is asking for further examples of situations of market stress, we would like to point out, that EBA's proposal might be based to some extend on a misunderstanding of MiFID II and of Delegated Regulation (EU) 2017/578.

Limited scope of Delegated Regulation (EU) No. 2017/578

EBA states: "The MiFID allows an IF that wishes to operate as market makers on regulated markets and other trading venues (MTF and OTF) to benefit from certain incentives, in exchange for which the IF has to agree to a market making agreement. The Delegated Regulation (EU) No. 2017/578 sets out the detailed obligation for IFs to enter into such a market making agreement and its content as well as obligations upon trading venues for having market making schemes in place."[20]

However, this not fully correct. Delegated Regulation (EU) No. 2017/578 does not stipulate a general incentive framework for market makers, in fact it is not even addressed at market makers as such as defined in MiFID II, Article 4 para. 1 (7)[21] or in other parts of EU legislation, e.g. in the Short Selling Regulation.[22] Delegated Regulation (EU) No. 2017/578 rather specifies requirements for an investment firm *"that engages in algorithmic trading to pursue a market making strategy"* in accordance with and within the narrow scope of Article 17 para. 3 MiFID II. Here, the legislative intent was to implement regulatory minimum standards for *"de facto"* market makers,[23] whose trading strategy was not subject to any regulatory requirements before MiFID II.[24]

Furthermore, market making agreements and –schemes in the sense of Delegated Regulation (EU) No. 2017/578 are not only restricted to algorithmic trading but also exclusively apply to the market model of *"con-*

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[20] EBA/CP/2020/06, p. 22, para. 84.

[21] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

[22] Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps

[23] Sometimes also referred to as "shadow market makers".

[24] Recital 60 of MiFID II clarifies *„Investment firms that engage in algorithmic trading pursuing a market making strategy should have in place appropriate systems and controls for that activity. Such an activity should be understood in a way specific to its context and purpose. The definition of such an activity is therefore independent from definitions such as that of 'market making activities' in Regulation (EU) No 236/2012 of the European Parliament and of the Council."*

tinuous auction order book trading".[25] Consequently, the provisions of Delegated Regulation (EU) No. 2017/578 are not directly relevant for any other market model as defined in MiFID II, RTS 1, Annex 1 and MiFID II, RTS 2, Annex 1.

Since there can be no doubt that the adjustment of the coefficient for K-DTF in the case of stressed market conditions shall be applicable independently from the market model and the trading technology applied, it is more than unfortunate that article 15 (5) of Regulation (EU) 2019/2033 expressly refers to Delegated Regulation (EU) No. 2017/578 and it is paramount to clarify that the definition of *"stressed market conditions"* as referred to in article 6 of Delegated Regulation (EU) No. 2017/578 in an IFR context should be understood in a generalized way and in particular should not be limited to continuous auction order book trading systems. Accordingly *"parameters to identify stressed market conditions in terms of significant short- term changes of price and volume"*[26] should be regarded to be independent of the market model and the trading venue.

"Stressed market conditions" vs "exceptional circumstances" and "extreme volatility"

While the question of applicable scope of *"stressed market conditions"* result from a reference in the "Level I" text, we think EBA might also have faced a problem of comprehension when drafting the RTS.

EBA points out: *"Article 3 of Delegated Regulation (EU) No. 2017/578 describes 'exceptional circumstances' where the obligation for investment firms to provide liquidity on a regular and predictable basis set out in the MIFID shall not apply. In particular, point (a) of Article 3 covers definition of extreme volatility: 'a situation of extreme volatility triggering volatility mechanisms for the majority of financial instruments or underlyings of financial instruments traded on a trading segment within the trading venue in relation to which the obligation to sign a market making agreement applies.' Point (a) of Article 3 therefore seems to regard such an extreme volatility situation the circumstances that might potentially be of more relevance to the calculation of the K-DTF."*[27]

Based on this assessment, EBA suggests: *"For the purposes of assessing whether any adjustment to the calculation of K-DTF is required, it seems that only point (a), i.e. a situation of extreme volatility (that triggers vola-*

[25] Delegated Regulation (EU) No. 2017/578, article 1 para. 1

[26] Delegated Regulation (EU) No. 2017/578, article 6 para. 2

[27] EBA/CP/2020/06, p. 22, para. 85

tility mechanisms for the majority of financial instruments on a trading segment within the trading venue) is of relevance."[28]

We think that there is a fundamental misunderstanding here since there is a substantial difference between *"stressed market conditions"* as stipulated by article 6 (2) of Delegated Regulation (EU) No. 2017/578 (which can apply to a single financial instrument) and *"exceptional circumstances"* in form of *"extreme volatility triggering volatility mechanisms for the majority of financial instruments or underlyings of financial instruments traded on a trading segment within the trading venue"* as stipulated by article 3 (a) 2 of Delegated Regulation (EU) No. 2017/578. According to article 15 (5) of Regulation (EU) 2019/2033, a situation of *"stressed market condition"* should be sufficient to trigger an adjustment of the K-DTF coefficients. However, apart from the general problem described above that the scope of Delegated Regulation (EU) No. 2017/578 is too narrow, EBA's mandate is limited to find a solution for the adjustment of the coefficients for K-DTF based on the definition of article 6 (2) of Delegated Regulation (EU) No. 2017/578 alone.

Finally and just for the sake of clarity, the application of article 3 (a) of Delegated Regulation (EU) No. 2017/578 would require a situation where more than fifty percent of all financial instruments traded on a specific trading venue or segment of a trading venue would have triggered a volatility mechanism. Actually, we are not aware of a single case where this happened within the Union since Delegated Regulation (EU) No. 2017/578 entered into force. This empirical evidence makes it clear that a situation of *"extreme volatility"* as described in article 3 (a) 2 of Delegated Regulation (EU) No. 2017/578 was never intended to be the trigger event for an adjustment for the coefficients for K-DTF. It also would be a pretty useless exercise to use this very specific and narrow definition of *"extreme volatility"* as a trigger event in the K-DTF context since it can be reasonably assumed that any temporary incentives with respect to capital requirements would not stimulate additional liquidity provision in a meaningful way under – fortunately rather theoretical – conditions when quoting obligations are waived and more than fifty percent of all financial instruments traded have already triggered a volatility mechanism.

Guidance on "DTFexcl" and "DTFincl" calculation

To conclude our comments to this question, we think it would be helpful to offer additional explanatory guidance for the definition of *"DTFexcl"* and *"DTFincl"* as proposed in draft RTS 9 article 1 (1)[29] since the

[28] Ibid para 86

[29] EBA/CP/2020/06, p. 63 & 64

concept behind the formulas which include derivatives traded in the case of calculating K-DTF for cash trades and cash trades in the case of calculating K-DTF for derivatives trades might not be immediately clear to everyone.

Question 4
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?

While K-NPR and K-CMG are alternative methods of regulatory capital calculation within the IFR-framework, their original purpose is completely different

Comparing K-NPR and K-CMG proverbial means comparing *"apples and pears"*. Aside from the fact that the outcome of the calculations are monetary values which can be comparably higher or lower in a given situation, there is no meaningful criterion – regardless of which value is higher – to decide about which approach is more adequate from a regulatory point of view. K-NPR and K-CMG are simply measuring completely different things.

In this context, it must be remembered that to the extent that K-NPR is considered to be a *"risk to market"* K-factor, it is simply a fatal methodological misconception. K-NPR, which applies calculations based on CRR methodology, captures *"market risk"* which is something fundamentally different. From the perspective of the K-factor categorisation, K-NPR is falsely regarded to be *"risk to market"*, while in fact it is *"risk to firm"*, arising from assets held whose valuations are subject to fluctuations in market prices. Accordingly, K-NPR measures risks of a firm caused by the markets and not vice versa.

Conversely, K-CMG addresses *"risk to market"* to the extent that it mitigates settlement risk and that the clearer who requires the collateral is a market participant himself. However, it also should be remembered that it is a core functionality of the clearer to absorb the settlement risk of its clients and to guarantee the fulfilment of the settlement to the client's market counterpart, no matter whether the client who undertook the trade fails or not.

It is also worth noticing, that while the calculation of K-NPR is based on end of day positions, K-CMG depends on a firm's trading volume. Accordingly, both values might develop differently over time. In regard of the strong growth in trading activity during the recent month, our observation is that margin requirements have multiplied and grown much faster than NPR/CRR capital requirements.

Accordingly, we are of the opinion that the thresholds which would trigger a comparison of K-CMG to K-NPR proposed in article 4 para. 2 (b) of draft RTS 10 (20% change in K-CMG capital requirements resulting from a change in business strategy of a trading desk and 10 % change in K-CMG capital requirements resulting from a change in the clearing members margin model) are calibrated much too low.

Furthermore, there is no convincing argument that a mandatory comparison between K-CMG and K-NPR should be triggered in cases where K-CMR capital requirements *increase*. Therefore, we are strongly of the opinion that only *decreasing* K-CMR capital requirements resulting from changes in business strategy (and not from general market activity) or changes in the clearing member's margin model should be regarded as trigger events for a mandatory comparison of K-CMG and K-NPR.

Avoiding unnecessary administrative burden

It should be further noted that licencing fees for software which automatically calculates K-NPR/CRR capital requirements and other IT-resources employed for this purpose are a significant cost block in particular for small and mid-sized investment firms. Therefore, it would be clearly disproportionate and in contradiction with the intended avoidance of unnecessary compliance costs and administrative burden by the new framework,[30] if firms would be obliged to employ the resources required to be able to calculate K-NPR and K-CMG parallel at all times. Accordingly if a comparable K-NPR calculation should be triggered for an investment firm which currently uses the K-CMG approach, such a calculation should be allowed to be done in the form of a rough calculation (by using a standard spread-sheet application) first and only if the results would raise regulatory concern, a detailed calculation would be required.

Question 5
Which other conditions should be considered to avoid double counting or to prevent regulatory arbitrage in the use of the K-CMG approach?

Avoiding undue disadvantages for investment firms using multiple clearers

EBA proposes in Article 3 of draft RTS 10 that investment firms which make use of more than one clearing member *"shall calculate the K-CMG*

[30] Cf. European Commission Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the prudential requirements of investment firms and amending Regulations (EU) No 575/2013, (EU) No 600/2014 and (EU) No 1093/2010, COM(2017) 790 final, 2017/0359 (COD), Brussels, 20.12.2017, p. 6

by first determining the third highest amount of total margins required on a daily basis by each clearing member separately over the preceding three months, then adding those amounts and multiplying the outcome by 1.3." [31]

The proposed calculation, which sums up the three highest amounts of each clearing member, instead of determining the total margins required across all clearing members an investment firm makes use of first, would put firms with multiple clearing members at an unjustified systematic disadvantage. While it is often not feasible, especially for smaller and mid-size investment firms to use multiple clearers (in particular because this inevitably leads to a fragmentation of collateral), using multiple clearers would reduce the concentration of counterparty risk which the clearer represents from an investment firm's perspective. Accordingly, it should be desirable from a regulatory point of view (even though it is not feasible for many firms), if an investment firm is able to make use of more than one clearer and it should be rather incentivized than penalized by comparably disadvantageous capital requirement calculations.

Incommensurability of K-NPR and K-CMG

Since K-NPR and K-CMG – as demonstrated in our answer to question 4 – are simply *"two different pairs of shoes"*, to require an investment firm to *"adequately justify the difference between these capital requirements"*[32], as proposed by EBA, is a meaningless and objectively unachievable task. Furthermore, while it is appropriate and comprehensible to require consistency of application of K-CMG with respect to all positions of a trading desk[33] as well as across trading desks which are *"similar in terms of business strategy and trading book positions"*[34], it is again an impossible task to require that *"K-CMG would be appropriately reflecting the risks of an investment firm's trading book positions, including expected holding periods"*[35] simply because K-CMG does not measure position risk, let alone expected holding periods in any way. Therefore, article 4 (1) (c) in draft RTS 10 should be deleted, in order to avoid another fundamental methodological misconception within the IFR-framework.

[31] EBA/CP/2020/06, p. 69

[32] Ibid, p. 68, draft RTS 10, recital 5

[33] Cf. EBA/CP/2020/06, p. 68, draft RTS 10, article 4 para. 1 (a)

[34] CF. Ibid, (b)

[35] Ibid (c)

Switching from K-CMG to K-NPR can never raise concerns of regulatory arbitrage

Article 4 (2) (a) of draft RTS 10 suggests that unless business strategy or operations of a group of dealers has changed, an investment firm should be bound to the use of the K-CMG approach for a period of at least 24 months.[36] We think that this restriction – in its generalisation – lacks a convincing rationale.

In this context, it is worthwhile remembering that – as already mentioned in our answer to question 4 – despite of the CRR based K-NPR is a methodological misconception in so far as it does not capture *"risk to market"*, it needs to be recognized that it calculates capital requirements for trading book activities in a way which is deemed sufficient and appropriate for systemically important "Class 1" firms and credit institutions which fund their trading book activities at least in part by deposits.[37] Therefore, if a firm voluntarily wishes to switch from K-CMG to K-NPR, it can hardly be regarded as regulatory arbitrage, even if the change should result in a decrease of capital requirements. Accordingly, investment firms should be enabled to switch from K-CMG to K-NPR at any time. However, we understand that it is not desirable from a regulatory point of view, if firms change the way of calculating their capital requirements too often. We therefore suggest, that the proposed 24 months period[38] should be applied only if a firm who has switched from K-CMG to K-NPR before wishes to re-implement the K-CMG approach.

Question 6
Do you have any comment on the elements included in this Consultation Paper for the application of the aggregation method?

With regard to the draft RTS 5 on prudential consolidation of investment firm groups (Article 7(5) of the IFR) we share the same opinion with our colleagues of BVI Bundesverband Investment und Asset Management, whose comments we adopt:

"In general, we strongly disagree with the approach taken by the EBA in defining a completely new scope of group constellations in Articles 2 to 5 of the Draft RTS. Such an extension of the scope is not covered by the mandate given in Article 7(5) IFR which states that the EBA shall develop draft RTS to specify 'the details of the scope and methods for prudential consolidation of an investment firm group, in particular for the purpose of calculating the fixed overheads requirement, the permanent minimum capital requirement, the K-factor requirement on the basis

[36] Cf. EBA/CP/2020/06, p. 70

[37] Even though it does not require investment firms to adopt recent and future changes to CRR.

[38] Under the conditions laid down in draft RTS 10, article 4 para. 2 (a), EBA/CP/2020/06, p.70

of the consolidated situation of the investment firm group, and the method and necessary details to properly implement paragraph 2' of Article 7 IFR. That mandate limits the EBA to develop details on the scope for prudential consolidation within the given definitions and requirements in the IFR and not to develop completely new principles of the scope.

Moreover, the new proposals in Articles 2 to 5 of the Draft RTS are in considerable contradiction to the approach taken by the IFR definition of an investment firm group with reference to Article 22 of Directive 2013/34/EU. In particular, the cases defined in Article 22 of that Directive would be undermined by the proposed Articles 2 to 5 of the Draft RTS. In addition, Articles 2 to 5 of the Draft RTS considerably deviate from the current regulations on own funds on a consolidated basis for groups consisting of investment firms only (i.e. without any credit institutions) according to Article 98 CRR II. This is not in line with the purpose described in Recital 12 of the IFR to mirror the existing treatment of such investment firm groups under the CRR and CRD. The EBA itself states the need to ensure such a consistency in Recitals 3 and 4 of the Draft RTS. In this context, it is not appropriate to copy a draft RTS established under the CRR in 2017 with divergent legal basis that did not enter into force - also due to the justified criticism of the banking industry.

Furthermore, according to Article 7(2) and Recital 12 of the IFR, the parent undertaking of an investment firm group should be required to comply with the requirements of the IFR based on the consolidated situation of the group. We therefore strongly disagree with defining new responsibilities such as that an investment firm being a subsidiary in an investment firm group (for instance as part of a holding structure) should ensure that other entities within the group that are not subject of the IFR implement arrangements, processes and mechanisms to ensure proper consolidation. That would lead to the situation that such an (as the case may be, very small-sized) investment firm needs to be capitalised to fulfil the capital requirements in the group on a consolidated basis.

Hence, we have expected that the Draft RTS will deal with principles regarding consolidation methods considering the special features of management companies licenced under the AIFMD or UCITS Directive, investment funds such as UCITS or AIF or securitisation special purpose entities being part of a group. Statements on this are completely missing in the draft RTS.

More specifically, we suggest the following amendments to the Draft RTS:

1. Article 2(1) of the Draft RTS: Group of undertakings which meet the conditions set out in Article 22 of Directive 2013/34/EU

We urge the EBA to delete Article 2(1) of the Draft RTS which refers to group constellations of paragraph 7 of Article 22 of Directive 2013/34/EU. Such an approach would be not in line with the definition set out in Article 4(1)(25) IFR. According to that definition, a group of undertakings which meets all the conditions set out in

Article 22 of Directive 2013/34/EU (and not limited to those of paragraph 7) should be qualified as an investment firm group. That involves cases where Member States are required to draw up consolidated financial statements and a consolidated management report if a parent undertaking fulfils certain conditions such as it has a majority of the shareholders' or members' voting rights in a subsidiary undertaking.

Moreover, and much more importantly, the approach proposed by the EBA in Article 2 of the Draft RTS would ignore that the conditions in paragraph 7 depend on the implementation by the Member state in its national law because according to Article 22(7) of Directive 2013/34/EU, a Member State may require any undertaking governed by its national law to draw up consolidated financial statements and a consolidated management report if certain conditions are fulfilled (such as non-related undertakings are managed on a unified basis in accordance with a contract). Therefore, the EBA approach set out in Article 2 of the Draft RTS would lead to the situation that these undertakings would be qualified as an investment firm group which are required to comply with certain rules of the IFD and IFR on a consolidated basis in any case. That is much stricter as required under the IFR and should be considered.

2. Articles 3 to 5 of the Draft RTS: Extending the definition of an investment firm group

We urge the EBA to delete Articles 3 to 5 of the Draft RTS. We strongly disagree with the proposed substantial extension of the scope by adding further group constellations such as undertakings with significant influence without participation or capital ties (Article 3 of the Draft RTS), single management other than pursuant to a contract, clauses in memoranda or articles of association (Article 4 of the Draft RTS) or participations or capital ties (Article 5 of the Draft RTS).

We are aware that in its hearing on 30 June 2020, the EBA referred to its consultation on technical standards specifying the methods of prudential consolidation under Article 18 of Regulation (EU) No 575/2013 (Capital Requirements Regulation - CRR), 9 November 2017.[39] However, this ignores the fact that the legal bases regarding the scope are fundamentally different in the IFR on the one hand and in the CRR on the other and do not justify such an extension. In detail:

- Legal definition of an 'investment firm group': Article 4(1)(25) IFR defines for the first time the term of an 'investment firm group' with the following group constellation of which at least one is an investment firm and which does not include a credit institution:

[39] Available under the following link: https://eba.europa.eu/sites/default/documents/files/documents/10180/2019694/3b8e5188-f7e3-4d11-b9ae-256e47d61e4b/Consultation%20Paper%20on%20RTS%20on%20methods%20of%20prudential%20consolidation%20%28EBA-CP-2017-20%29.pdf

- a group of undertakings which consists of a parent undertaking and its subsidiaries or a group of undertakings which meet the conditions set out in Article 22 of Directive 2013/34/EU of the European Parliament and of the Council.

According to this clear definition, there is no room for extending the scope of the definition of an investment firm group to further cases as proposed by the EBA in Articles 3 to 5 of the Draft RTS. This is a major difference compared to the existing rules on prudential consolidation under the CRR because the CRR does not even define the term of an 'investment firm group'. Any such extension would require respective Level 1 amendments of IFR and cannot be effected by means of RTS.

- The IFR does not contain a provision which is similar with Article 18(6) CRR: According to Article 18(6) CRR, competent authorities shall determine whether consolidation is required in case of significant influence without a participation or other capital ties and single management other than pursuant a contract, memorandum or articles of association. There is neither a comparable regulation in the IFR nor a mandate to specify such cases in a Draft RTS under the IFR. The reference to a similar approach of the EBA public consultation on technical standards specifying the methods of prudential consolidation under Article 18 CRR is therefore in no way appropriate. This applies even more as the RTS on methods of prudential consolidation under Article 18 CRR is under development and has not even entered into force yet.[40]

- Articles 3 to 5 of the Draft RTS are much more stringent as the approach of Article 18(6) CRR: We understand the proposed Articles 3 to 5 in conjunction with Articles 6 to 7 of the Draft RTS in such a way that competent authorities should only have a right to choose the consolidation method (such as full or proportional consolidation, aggregation method), but no longer whether consolidation is required or not. Irrespective of the lack of a legal basis for such an approach, this would be much more stringent as it is currently required under the CRR: according to Article 18(6) CRR, competent authorities shall determine whether consolidation is required in additional cases such as of significant influence or single management.

3. Contractual arrangements: delegation of functions in the asset management sector

Irrespective of the legal basis and the substantial extension of the scope of the prudential consolidation of an investment firm group, the cases proposed by the EBA in Articles 2 and 3 of the Draft RTS would lead to inappropriate group constel-

[40] Cf. the reference made by the EBA itself on its website: https://eba.europa.eu/regulation-and-policy/accounting-and-auditing/rts-on-methods-of-prudential-consolidation

lations in the asset management sector. Because asset management companies qualify as financial institutions in the meaning of the definition in Article 4(1)(14) IFR, they could be related with an investment firm on a contractual basis and would fulfil the proposed group approach proposed by the EBA.

The following example will demonstrate this:

- According to the UCITS Directive and the AIFMD, management companies can delegate portfolio management services of the investment funds such as UCITS or AIF to third parties (such as investment firms with a licence to provide asset management) on a contractual basis. That case is fully covered by the prudential requirements of the AIFMD or UCITS Directive. However, Articles 2 and 3 of the Draft RTS on prudential consolidation of investment firm groups could be understood in such a way that such a contract would qualify as a significant influence without participation or capital ties. This would lead to the situation that the investment firm and the management company would be qualified as an investment firm group with the effect that the investment firm must carry out consolidation of the management company although this case is already comprehensively covered by the UCITS Directive or the AIFMD.

In the further alternative, if EBA maintains its approach, we urge to clarify that cases where an AIF or UCITS management company delegates functions such as the portfolio management to an investment firm on a contractual basis are out of scope of prudential consolidation."

We have no objection to the publication of our opinion, including the personal data contained in it or on the letterhead. Please do not hesitate to contact us if you have any questions regarding our comments or require further coordination.

Yours sincirely,

Michael H. Sterzenbach
Secretary General