V/F/I Verband der Finanzdienstleistungsinstitute e.V.

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Position Paper to EBA Discussion Paper on a new prudential regime

EBA/DP/2016/02

Dear Sirs,

the Verband für Finanzdienstleistungsinstitute e.V. (Association for Financial Services Institutions) is a German professional association representing small and intermediate sized investment firms. Their activities are predominantly services in the categeories

Nr. 1 Reception and transmission of orders in relation to one or more financial instruments.

Nr. 4 Portfolio management.

Nr. 5 Investment advice.

of Annex I Section A of MIFID (DIRECTIVE 2004/39/EC).

Most of our members are investment firms which are generally excluded form the scope of Regulation (EU) 575/2013 according to the restrictive definition of „investment firms“ under Art. 4 Nr.1 (2) (c) of this Regulation, i.e. they are not authorized to provide the ancillary service referred to in point (1) of Section B of Annex I to Directive 2004/39/EC, which provide only one or more of the investment services and activities listed in points 1, 2, 4 and 5 of Section A of Annex I to that Directive, and which are not permitted to hold money or securities belonging to their clients and which for that reason may not at any time place themselves in debt with those clients.

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Therefore 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.

As to Question 3:

The proposed new “Class 3” firm category was developed in the EBA report of 2015 (EBA/Op/2015/20) as listing and including several MIFID- Services (Categories 2 through 6 of the report). A major reason to create a separate class 3 category for prudential purposes is the fact that the categories of MIFID and MIFID II (as under its forerunner ISD) were and are in parts interpreted differently in different member states.
Instead of creating a new class or category for prudential purposes, the investment firms as any citizen in the Common Market should and could expect that the European legislator create a coherent system of legislation and iron out such “interpretation differences” of member states of Directive legislation which has not only an impact on the prudential regime, but also in other areas. The Directive 2014/65/EU in Art. 4 par. 2 gives the Commission the power exactly to do that through a delegated Act. It would be preferable to have such a solution and to attach the capital requirements to such clarified categories of services with their variations. Considering the maze of the European bureaucracy and legislation trying to merge 28 resp. 27 member states’ interests, this might, however, be wishful thinking transferring the task of proper interpretation of the Directive text to the European Court.

Having stated this, we strongly favour to change the present system only where absolutely necessary and to revamp the prudential regime of investment firms in line with an overhaul of MIFID II in the future defining and categorizing the service categories and their prudential regime in a separate besides regulation under MIFID revisited. As far as our members are concerned, especially the line between reception and transmission of orders and execution of orders is blurred.

Nonetheless, we will comment on the Questions posed by EBA and relevant to our members.

<u>Fixed Overhead requirement:</u>

The report of 2015 (page 85) recommended:
“In the last tier, small and non-interconnected firms warrant a very simple regime to wind them down in an orderly manner. Such a regime could be based mainly on fixed overheads requirements (FORs) that fulfil the objective of setting aside sufficient capital for ensuring safe and sound management of their risks. These firms could also be subject to simplified obligations with regards to reporting obligations.”

We disagree with this recommendation.

When firms not holding client funds and/or instruments voluntarily wind down their investment service business (non-failed), the liquidation and transfer of the service is usually done before the licence is returned and/or formal liquidation takes place.

Investment firms going into involuntary liquidation (usually insolvency) rarely do have the funds anymore to fulfil the FO requirement.

Furthermore, the FOR discussion neglects an important private law element. The contracts between investment service firm and their clients usually provide that, with the return or the withdrawal of the licence or in the case of insolvency, the service contracts and accompanying managing powers terminate for cause. The investment firm does not transfer anything. Post contractual transitional (emergency) duties do not extend even to the present three months term. It is the client who must find another service provider with or without recommendation of the investment firm. The solution lies on the side of the larger clients who use the intermediary or management firm. They are (UCITS, AIFMs or pension funds or schemes) or should be under the duty to manage their risk in such a stress scenario and have an alternative available.

The prudential requirement for the going concern of the investment firm should be satisfied by the initial capital.

This rationale applies also to portfolio management and placement firms without firm commitment.

In our view, the “built-in proportionality” solution has one major draw-back. We assume that the proportionality factor under this premise would be set at a level which does not create any unreasonable and additional financial burden to the class 3 investment firm. The drawback lies in the administrative burden to monitor and report the base on which the proportionality factor is applied. If the calculation, reporting and eventual adjustment of the capital based on proportionality would be restricted to an annual exercise combined with the preparation of the annual financial statements, the small firms could probably live with such a solution. To prepare, however, additional monthly and quarterly reports, in addition to other existing reporting duties, would discourage small firms even more as they are already discouraged under the present system.

There is a further argument against all sorts of variable capital requirements. Any capital requirement will not cover the crucial problem of small firms concerning clients with a sum in issue or with serial claims. No reasonable capital requirement will cover those risks. Such risks can be adequately addressed only by an insurance or compensation scheme solution, whereby the risk is distributed onto a larger community. This is the typical model for other than financial service activities, especially of liberal professions, with malpractice potential. Prudential capital requirements for class 3 entities are inadequate.

As to Question 4:

The category “Class 3” firms should include only those firms which do not pose any direct risk to client funds and instruments and to markets, but whose activities bear only an operational risk (malpractice).

Hence, from this category firms with the following specifics are excluded.

Holding client assets

These firms pose an enhanced risk to clients which should be mitigated by greater capital requirements compared to those firms who cannot hold client assets. This risk becomes visible especially in the case of winding down or liquidating such a firm. The transfer of such assets (funds and instruments) require a time which may go beyond the three months FOR. Furthermore, the firm's obligations should be covered by own capital to a greater extent before spreading this risk over the financial community via the compensation scheme. This distinguishes these firms essentially from firms not holding client assets.

The same rationale applies to firms providing the **services of safeguarding and administration**. Such firms should not be included in the class 3 category.

Firms dealing on own account

Firms dealing on account, be it as a service to clients, be it as proprietary trading do not belong into class 3. They pose a market and country party risk which should adequately covered by own capital. It should be made clear, however, that this does not apply to firms having holdings and/or positions for purposes of investing their own funds not being part of the trading book. In this activity the firm functions more as a client in the financial markets.

Firms underwriting or placing with a firm commitment

Firms underwriting or placing instruments with a firm commitment do not belong into the class 3. They pose a market or counterparty risk. Firms underwriting without firm commitment do not belong into class 3 either because they hold client-issuer's instruments albeit provisionally. They belong into the category of firms holding client assets. Firms placing without firm commitment act as issuer's proxy in receiving and accepting subscriptions and do not hold the issue in their account. As long as they do not cash in the subscription amount, they should be included in class 3. The present treatment is not reasonable.

Granting of credits and loans

Firms granting credits and loans in connection with their investment services do not belong into class 3. This ancillary service is in character banking with corresponding counterparts risks and should be treated as such.

Operating a MTF or OTF

These firms operate markets which are subject to different considerations. We do not have members operating such trading facilities. Therefore, we are not in a position to evaluate the capital needs of such a firm. We think, markets should have their own capital requirement class and their operators do not belong into class 3.

Being a member of a wider group

The question is whether the services of these firms are interconnected and integrated into a structured concept of several financial services. In this case, such a firm should be seen and treated as part of a group and not as a class 3 firm. The risks of this firms are connected with the risk exposure of the group. When the firm is only formally part of a wider group, but its services stand alone and are not interconnected, such an intermediary firm should be treated as standing alone and, if otherwise qualifying, should be included into the class 3 category.

Using the MIFID passport

The use of the passport should not play any role in defining the class 3 category. Such a distinction would contradict the idea of an internal market. The risks posed by such a firm do not differ according to different jurisdictions. Their intermediary activities are the same regardless of where their clients are located.

Using tied agents

This should not influence the definition of the class 3 category. The use of tied agents is a special kind of outsourcing intermediary activities which otherwise would be performed through dependant employees. The latter structure does not raise any additional questions. The issue concerns rather the FOR where part of their commissions are included in the fixed overheads. The reasons for this inclusion are not clear. In the situation of winding down a firm, the payment of salaries might be a problem and should be covered by capital. As a rule tied agents' contracts terminate forthwith when and if a firm is liquidated. The commission is based on successful intermediation which by definition does not take place anymore. In many cases, the tied agent controls the goodwill of his customer base and switches his/ her clients to a new firm taking from then on regulatory responsibility. There are no funds required by the old firm to effect this change because customer contracts of the firm if existing on an on-going basis are terminated as well. To take firms with tied agents out of class 3 is not warranted. The problems are the ones of outsourcing in general and not of covering risks through capitalization.

As to Question 5:

In principle, the approach to capture risk to markets and risk to clients is a reasonable approach which would apply in any capitalization system. For class 3 firms, however, risk to markets and risk to client as a base for setting the capital requirement should be restricted to direct risks and not extend to such indirect risk like problems in transferring or finding new services and similar

soft factors. The hard factors are risk to markets which do not exist when firms are not themselves become a party to transactions. In the case of investing own funds (not in the trading book), such firms are usually insignificant for the markets. The main risk is operational risk to clients causing damage to the client by any sort of malpractice. If one wants to cover this risk (in many cases inadequately), on could extrapolate this risk from the past practice of the firm. If the firm has caused harm to the client resulting in damage payments to the client (voluntary or involuntary) the average amount in the past for instance for the last five years could be the base for applying a k- factor.

We oppose the idea to capture the risk to firm (RtF) of class 3 firms for the following reason: The firms are small. Their operational viability is already founded in the initial minimum capital as a floor. Regulation should not be a tutelage for the firms to protect them from their own behaviour. If a firm fails and has to be liquidated, it should be liquidated and leave the market for financial services. Since the firms are small, there is not any major impact on the clients and/or markets.

As to question 7:

RtF might play a role in large service institutions insofar as their failure is more likely to be perceived in the market as problem signal with corresponding rational or irrational reactions of other participants in the market. In addition, the mere size of such firms carries the risk that not all of their clients will necessarily, easily and quickly find other firms providing the same service at the same cost. These large firms are in nature class 3 firms except that they might not be considered small. The issue is where the line should be drawn between a small and a large firm. The above reasoning leads to the conclusion that large firms are those which must be considered systemic in the financial service landscape. Thus, the line should be drawn using a triad of income (commission), number of clients and assets under management. For each element should a size be determined. When the firm meets two of these elements, it should be considered "large" and not benefit of the class 3 treatment.

The lines could be:

Annual Commission income: € 20 million
Assets under Management: € 10 billion
Active Clients: 5.000

To take number or size of orders mediated or size of assets under advice as criteria is not appropriate in our opinion. Such criteria would make sense in order environment for permanent clients. It does not make any sense for clients with one time transactions who do not use the services of the firm on a continuing basis. In addition, the criterion “asset under advice” is inadequate because the advisor does very often not know whether and to which extent the client follows the advice. Hence, this criterion would not reflect the reality.

As to Question 35:

The main problem for small investment firms under Regulation 575/2013 is that they have to implement and acquire an oversized and expensive electronic systems to comply for the reporting requirements (ITS on Reporting - COREP).The minimum annual costs are 7.500,00 EUR. This is for small firms a substantial cost factor.

Whatever the final recommendation of EBA to the Commission will be, our petitum to EBA is to keep it as simple and manageable for the so called class 3 firms. These firms whose “forte” in the market is the usually close personal relation of service provider and client should not be driven out of the market by increasing the financial and administrative burden. Only widespread existing problems among firms in this category should be corrected and not any anecdotal cases or theoretically perceived dangers which have not materialized in the past.

Kind regards,

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