Statement relating to the Investment Firms Review

By way of introduction, the International Regulatory Strategy Group (IRSG) is a practitioner-led body comprising leading UK-based figures from the financial and professional services industry. It aims to be one of the leading cross-sectoral groups in Europe for the financial and related professional services industries to discuss and act upon regulatory developments. The IRSG is a body comprised of Members with international reach; including EU27 as well as third country headquartered firms with significant operations in the EU27. The IRSG seeks to promote an international framework that will facilitate open and competitive capital markets globally. Its role includes identifying strategic level issues where a cross-sectoral position can add value to existing industry views.

In this vein, the EU Regulation Standing Committee convenes a cross-sectoral group of members to monitor and prioritise IRSG engagement with new EU policy and legislation that would have an impact on the UK and on global capital markets in which the UK will continue to participate prominently post-Brexit.

We wish to provide some comments regarding the Investment Firms Directive and Investment Firms Regulations (collectively, the "Investment Firms Review" or "IFR"), now that the trilogue phase is underway. In providing these comments, we do not wish to duplicate the work of other industry associations, such as the joint industry association letter of 8 November 2018. Nor do we wish to suggest detailed amendments to the already advanced technical work that has taken place. We instead wish to highlight some of the IRSG's concerns at a macro level; where there could be adverse impact for both EU firms and consumers as well as those in third countries. We also wish to bring to your attention a number of sector specific concerns that have arisen for our members.

We focus our comments from the perspective of the UK market's desire to contribute positively to the EU's Capital Markets Union (CMU) project, and the importance of keeping the CMU open to funding and liquidity flows from around the world (including the UK, regardless of Brexit outcomes).

Firstly, we recognise and welcome the significant progress that has been made on the IFR file – both in the European Parliament's ECON Committee, and in the Council of the European Union. We welcome the co-legislators' push to finalise trilogues before the end of this Parliamentary mandate. Completing the IFR and other outstanding CMU-related files will ensure the EU is a step closer to completing the EU financial union (i.e. Banking Union and CMU).

Significant progress has been made on CMU during the term of the current European Commission, particularly in terms of planning and conceptualising the elements needed to build the CMU. However, in terms of tangible progress regarding legislative change for CMU, there has been slower progress than hoped for. So far, only the Prospectus Regulation, Securitisation Regulation (and associated capital requirements amendments) have entered into force, and the EuVECA and EuSEF regulations have been amended in line with CMU objectives. Other than this, there is no other substantive CMU-related legislation that has completed the legislative process.

In our view, the IFR (or as commonly called, the "New Prudential Regime for Investment Firms") is an important *prudential* building block that would enable investment firms to further contribute to the development of the EU's capital markets. We support the development of an appropriately tailored prudential regime for investment firms, rather than relying on a set of rules originally designed to apply to banks. We believe that this reviewed framework – if calibrated well – will be paramount to make the Capital Markets Union project a success.

If the co-legislators are able to successfully conclude the IFR file, then the EU institutions – including the Commission, Parliament and Council – will be able to say that although there is still more work to do on CMU, the conclusion of IFR means that the CMU project is on track, and CMU can be even more ambitious under the next Commission.

The stumbling blocks to completing IFR are primarily non-prudential points. We would therefore encourage policymakers to view completion of IFR as a prudential priority, with both prudential and CMU objectives. Accordingly, we would also encourage policymakers not to allow other issues, such as MiFID third country equivalence, to become a roadblock to completion of the file. It would be very unfortunate for a file that has made so much progress to fall at the last hurdle.

Reaching a balanced result on this file is essential to enhance the prospects of larger capital markets in the financing of the European economy, particularly after Brexit. To achieve this balance outcome, we have a few specific suggestions in the ongoing trilogues.

- To take an open-minded approach on which prudential regime (CRR or IFR) that an investment firm belonging to a banking group joins. We fully understand that Class 1 investment firms must remain subject to the CRR regime. However, non-Class 1 investment firms in banking groups should have the choice of which regime to adopt – bearing in mind that in some cases, it will be more efficient for a banking group to apply one regime (CRR) throughout its group. We advocate for an opt-in for non-Class 1 investment firms to remain on CRR, regardless of whether the investment firm and its parent undertaking are located in the same Member State or not.
- A narrow approach to MiFIR third country equivalence (for example by removing certain key MiFID activities from scope) will reduce capital and liquidity flows into the EU from third countries, thus hindering the development of the CMU and increasing costs. EU capital markets should be open and accessible – and EU financial market participants need to be able to trade with financial market participants around the world to diversify risk, access liquidity and for investment opportunities. Separating the EU from other markets would be a significant step backwards for the development of EU capital markets, and negative for EU-based companies who regularly depend on such access. Global financial firms have always relied on sourcing cross-border liquidity in OTC fixed income markets and this liquidity has not shifted to the EU as part of Brexit preparations. Notice should be taken that any impact on back-to-back trading, such as from removing dealing on own account, will lead to fragmentation of liquidity and increase the costs of funding for financial firms (including the costs of obtaining a MiFID license in the EU e.g. capital, legal entity overheads, etc.). This will hamper the development of EU trading platforms in the wake of Brexit in terms of liquidity, volume and scale in a way that is not compatible with the Capital Markets Union.
- In regard to remuneration, we would advise against an overwhelmingly strict regime in IFR, noting that EU investment firms will need to compete in a global market with investment firms from other jurisdictions. We urge policymakers to avoid unnecessary difficulties for non-systemic firms by eliminating national discretion to apply a fixed-to-variable remuneration ratio.
- Regarding the definition of 'Group' and non-EU assets, assets of EU firms held outside the EU through subsidiaries and branches should not be included in the calculation of assets for the purpose of classification. Including non-EU activities outside the EU would render European firms uncompetitive in markets outside the EU. Only EU based subsidiaries and branches should be included in the calculation of assets as proposed in the Council text.
- To consider carefully the legislation's impact on K-factors.
    - In particular, an enhanced "smoothing mechanism" will avoid circumstances whereby an investment firm risks being in breach of regulatory capital requirements due to artificial and temporary spikes in the K-factor measurements.

- We welcome recognising CMG as an alternative to NPR that should apply to all centrally cleared transactions by a CCP. We are not in favour of the multiplier (x1,5) in the Council text as it includes discretion for national supervisors and can only lead to market fragmentation across the EU single market. We moreover believe that the other built-in safeguards in the CMG provide sufficient comfort to regulators.
- Regarding K-DTF, we fully support recognising the duration as a correction on the notional amount of Interest Rate Swaps (IRS). Eliminating the duration would disproportionality penalise asset classes traded in large notional amount, while the DTF seeks to address operational risk and not market risk where the size of a position matters.
- Further, as put forward by Council amendment, legislators should consider defining client money controlled within the K-CMH definition as money deposited on a custodian bank account in the name of the client itself to which the firm has no direct access. This would reduce risk by ensuring such funds are out of the reach of the firm and of creditors; such risks can be reflected in a recalibration of the K-CMH.
- Finally, take notice that it is essential that there should be no exclusion of one-off or infrequent advice and unused regulatory permissions for advising on investments within the K-AUM definition. Else this would lead to a situation in which investment firms are required to hold capital against K-AUM where they have a regulatory permission for advising on investments, however they do not have any advisory mandates with their clients.

- The final European Parliament text introduced a new article (Article 51a IFR) which calls for a specific disclosure framework covering large asset managers' engagement with companies in which they invest. This amendment runs counter to well- established corporate governance requiring all holders in a company regardless of sector to disclosure their holdings in a company as set out in the Transparency Directive. This proposal will lead to inconsistent disclosure and reporting practices in Europe which the Commission has sought to minimise or eliminate – these disclosures are already covered in the Shareholder Rights Directive (SRD) (proxy voting matters); the Transparency Directive (shareholding reporting) and the Market Abuse Regulation (company meetings). The SRD is only due to be fully implemented later this year and we need to have a better understanding of the effectiveness of the SRD before making further changes.

The IRSG would be pleased to engage further on the matters raised above and stands ready to meet with policymakers in Brussels or to engage with officials in a more detailed way via our EU Regulation Standing Committee.

Yours sincerely

Mark Hoban
IRSG Chair