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On behalf of the Public Affairs Executive of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

Position Paper

Prudential supervision and requirements of investment firms

May 2018

Introduction

The private equity industry appreciates the Commission's intention to develop a more appropriate and coherent regime for all entities holding a MiFID licence. We note however that MiFID covers a wide and diverse range of investment firms and the proposed Directive and Regulation will therefore apply to entities that vary (potentially significantly) in their business model and, as a result, in the potential risks that they generate.

While private equity fund managers are typically regulated under the AIFM Directive, some private equity businesses or sub-businesses might also operate under a MiFID licence and will therefore fall under the new proposed framework. Private equity firms holding a MiFID licence, in the vast majority of cases, provide only a few limited investment services, such as the reception and transmission of orders and investment advice. They cannot hold client money or securities, they do not generally need to deal or take portfolio management decisions and their clients' investments are not likely to be affected by short term market movements. These firms include:

i. adviser/arranger MiFID firms outside of the scope of CRD IV
ii. MiFID firms with limited authorisations to provide investment services
iii. a limited number of MiFID firms holding a "placing without a firm commitment" permission.

Under the current CRD/CRR framework, these types of investment firms are typically subject to a fixed initial capital requirement. We believe that there were good reasons for originally imposing a simple, flat rate regulatory capital requirement on such firms, requiring them to continue to be solvent but also, unlike other private undertakings, to maintain a small margin of capital above that, but without expecting them to maintain further capital which would be disproportionate in light of their substitutability.

The prudential regime now being proposed will lead to a significant increase in capital requirements for this type of investment firm, which will not be proportionate to the risk they pose.

In this position paper we express our key concerns regarding the Commission proposal and suggest a few potential solutions to ensure that MiFID investment firms which are only providing a limited number of services are subject to requirements that are appropriately tailored to their specific characteristics and to the risk they pose.

I. <u>Transitional period, scope and review clause for capital and liquidity requirements</u>

We regret that despite the Commission's general ambition to create a more tailored and proportionate prudential framework, some investment firms, as explained in the paper above, will now be subject to significantly higher capital requirements than under the existing regime.

It is worth noting that a large number of very small firms, which will be impacted the most by the new capital requirements, did not have the bandwidth to engage in the data collection exercises which were undertaken by the EBA to determine the impact of the proposed changes[1]. We therefore fear that the level of capital such firms will have to hold under the new regime may not have been properly assessed in the EBA analyses and in the Commission Impact Assessment. While the Commission's Impact Assessment indicates that the increase of capital requirements will be up to 3 times, we found that some investment firms will see their capital requirements increase by 13 to 300 times.

In any case, in our view an increase in capital requirements does not appear to be justified given the lack of any evidence that the type of firms referred to in the introduction generated any prudential concerns, even during the financial crisis. Such a significant increase in capital is also likely to create unnecessary barriers for them to operate in the Capital Markets Union, inhibiting competition and limiting the establishment of new firms in the future. Taking this into account, we appreciate the Commission's suggestion to cap the increase in capital requirements on any particular firm for five years to provide investment firms with additional time to adapt to the new situation.

However, we believe that a transitional relief which automatically expires after 5 years is not an adequate solution for all firms given the severe impact of the proposal on some firms that provide only certain low risk MiFID investment services - for example, firms which do not hold client money or assets and which are only providing the following services: (a) investment advice; (b) reception and transmission of orders; and (c) placing without a firm commitment.

In our view, the proposal should therefore provide the opportunity for the Commission to **extend the transitional period to this specific group of firms**, if it concludes, based on the results of a bespoke analysis, that the new capital requirements have the potential to seriously impact market competition and the establishment of new firms in the market. This should be done well before the current 5-year transitional period expires but after a relevant period of time that would allow the Commission and the EBA – and ultimately ESMA (see section VI) - to collect sufficient data on these type of firms and on the impact of the new rules in order to determine if they should be subject to additional capital requirements.

Given the nature of the business model of the firms described above, this transition period should apply <u>irrespective of their income or amount of assets under management or advice.</u> Without the possibility of such an extension, there is a significant risk that these will automatically be subject to extremely high capital requirements which are not proportionate to the risk they pose.

Finally, Article 57 of the Regulation, as currently drafted, provides transition relief to firms that were either: a) not in existence on or before the date of application of the Regulation; or b) previously subject to capital

[1] Following the Call for advice of the European Commission on the future regime for investment firms, the EBA launched two calls for evidence in July 2016 and July 2017 to MiFID investment firms to gather evidence on the impact of the proposed changes.

requirements under CRD IV/CRR. However, a number of investment firms, particularly those operating as advisers/arrangers, are still currently subject to CRD III capital requirements in accordance with a derogation set in Article 95 (2)) of the CRR. Therefore, we believe that a clarification should be added, for example to recital 30, to ensure that these firms also benefit from the transitional relief.

<u>Proposed amendments</u>

We suggest adding the following paragraph 4 to Article 59:

By [3 years from the date of entry into force of this Regulation], the Commission shall, based on the data collected under Article 49, prepare a report on the impact of requirements set out in Article 11 of this Regulation on investment firms that are only authorised to provide investment services and activities listed in points (1), (5) and (7) of Section A of Annex I to Directive 2014/65/EU.

Depending on the results of the report, the Commission shall adopt a delegated act in accordance with Article 54 to extend the five-year period referred to in paragraph 1 of Article 57 by another five years if it concludes that the new capital requirements have the potential to seriously impacted market competition and the establishment of new firms in the market.

We would also suggest making the following changes to Recital 30:

(30) In order to facilitate a smooth transition […]

Equally, investment firms which were only subject to a requirement for initial capital under Regulation (EU) No 575/2013/Directive 2013/36/EU and for which capital requirements under this Regulation would more than double compared to their situation under Regulation (EU) No 575/2013/Directive 2013/36/EU should be able to limit their capital requirement under this Regulation to twice their initial capital requirement under Regulation (EU) No 575/2013/Directive 2013/36/EU ***(including, where applicable, that set by competent authorities in accordance with the derogation granted to them under Article 95(2) of Regulation (EU) No 575/2013)*** *for a period of five years from the date of application of this Regulation.* ***Given a significant number of firms did not have the bandwidth to engage in the EBA data collection exercises, the Commission shall consider the possibility that the capital requirements of some of these firms will increase significantly as a result of this new Regulation. The Commission should therefore closely examine, before the end of the transitional period, what would be the impact of the regime on those firms and take the appropriate measures to ensure it does not impact on market competition and the establishment of new firms in the market.***

II. <u>K-factors</u>

a. <u>K-AUM</u>

One of the main elements of the Commission proposal is the introduction of "K-factors", linking the firms' capital requirements more closely to its different activities. Among these factors, the K-AUM one has been introduced as a proxy for customer risk and, according to recital 23 of the proposed Regulation, is designed to "*capture the risk of harm to client from an incorrect discretionary management […] and provides reassurance and customer benefits in terms of the continuity of service*".

While we generally disagree with the view that the purpose of a prudential regime for investment firms (in contrast to a regime applying to the banking sector) is to ensure a continuity of service, particularly for firms providing services to closed ended funds, we also believe the proposed K-AUM factor does not in all cases effectively capture the risk posed to the client.

There are several reasons why the size of a firm's business, measured in assets under management, is not a good proxy for the risk it poses to its customers:

- a larger, better-resourced firm may indeed have more extensive systems and controls to prevent failings or breaches, and so it may present a lower customer risk than a firm with fewer customers but a much less-detailed control environment;
- solely looking at the firm's size does not take into account measures the firm has taken to cover its liability towards third parties, such as maintenance of professional indemnity insurance, which could as a result address the risk the customer is facing from poor execution;
- the nature of the advice being provided and the number and type of clients the services are being provided to are also relevant factors: a MiFID investment firm providing investment advice to a few professional clients which are aware of the risks they are taking cannot really be compared to another firm providing discretionary management services to very large numbers of retail investors.

Further to this, it should be noted that, in some cases, the failure of the firm will not affect the continuity of the provision of services. For private equity advisers/arrangers, the termination of its appointment does not prevent the client (in this case, the private equity fund manager) from continuing to run its business without receiving advice, without waiting for or being dependent on any steps in the winding up of the previous adviser. The failure of firms such as advisers/arrangers, which operate under MiFID licences, would have no impact on investors or the wider financial market.

Given that AuM (including assets under advice) is not an appropriate proxy for risk, and in order to avoid a situation where a large firm has to hold capital for the sole purpose of the size of its assets under management, we would therefore suggest at the very least introducing a provision similar to the one proposed under Article 9 paragraph 3 of AIFMD, capping the maximum amount of own funds arising from the K-AuM factor at EUR 10 million. This would ensure that the largest of the firms which can easily be wound down and pose little or no systemic risk would not have to hold tens of millions of euros in capital requirements.

Comparison between the AIFMD and Investment Firms Regulation regimes

Legislation	**Initial capital**	**Fixed Overheads Requirements**	**Capital based on AuM**
AIFMD	125.000€	¼ of fixed overheads	0.02% above € 250 million AuM, **capped at € 10 million**
Investment Firms Regulation	From 75.000 to 750.000€	¼ of fixed overheads	0.02%

Proposed amendments

We suggest adding a new paragraph 2a to Article 15 of the Regulation to align the maximum amount of capital requirements related to the size of a firm to the AIFMD:

2a. The value of the capital requirement resulting from the application of the co-efficient for the K-AuM factor in paragraph 2 shall never be higher than EUR 10 million.

b. K-CMH

In addition to our comments expressed above, we also are also concerned about the proposed definition of client money held. According to the definitions of the proposed Regulation (Article 4 paragraph 1), client money held for the purpose of the K-factors is “the amount of client money that an investment firm holds or controls, regardless of any legal arrangements in relation to asset segregation and irrespective of the national accounting regime applicable to client money held by the investment firm”.

In the private equity industry, it is typical for cash belonging to an investment fund (the client) to be held in a bank account established in the name of the fund (not in the name of its manager or its adviser). Typically, a fund manager (and potentially a private equity MiFID firm) will have a mandate over the account (i.e. authority to direct the bank to transfer cash, for example to pay for the purchase of shares).

This activity is widely understood to amount to “controlling” as opposed to “holding” client money. In the event of insolvency of the firm, controlled cash would not be at risk and there would be no complication or delay in returning cash to the investment fund because the entitlement of the fund will be evident to the bank. This is to be distinguished from a situation in which a bank account is established in the name of an investment firm but designated as a client account. In those circumstances, the firm (only) will record the entitlements of each of its clients to share in the account, and the insolvency of the firm would give rise to greater prudential policy concerns. The proposal as currently drafted would result in a firm holding client money having the same capital requirement as one which merely controlled it but was otherwise equivalent. This would ultimately fail to reflect the difference in the risk posed by the two firms.

We acknowledge that, in a case in which a firm controls but does not hold client money, there may be a risk of fraud by means of the mandate but we submit that such risk is adequately addressed through the threshold conditions for authorisation of the firm – relating to the suitability of its staff and its controllers and the application of appropriate internal systems and controls.

An analogous proposal to K-CMH including client money controlled as well as held would be one whereby K-ASA applied to client assets controlled as well as those safeguarded or administered; no such proposal is made presumably because it would be a clear mismatch between the method of measuring risk and the actual activity undertaken.

Consequently, the definition of “client money held” (Article 4, paragraph 1 section 26 of the proposed Regulation) should be clarified so that where a firm only controls - but without holding - client money, this should not count towards the K-CMH factor either for the purposes of the boundary between firms that are small and not interconnected and those that are not, or for the purposes of calculating capital requirements.

If this is not done, K-CMH is potentially substantially duplicative of K-AUM and produces a perverse incentive to be invested always in assets as opposed to cash. For example, a firm managing portfolios totalling EUR 4 billion with 5% held in cash would have additional capital requirements resulting from K-AUM (co-efficient 0.02%) and K-CMH (co-efficient 0.45%) totalling EUR 1.700.000, while if the firm held 0.5% in cash then the additional capital requirements from k-AUM and K-CMH would be EUR 890.000, a reduction of approximately 48%. If it may be desirable for a firm to convert certain investments in a client's portfolio to cash for a period (e.g. during market volatility), K-CMH effectively disincentivises a firm from doing so because by controlling the resulting cash the firm's capital requirement will be increased.

Proposed amendments

We suggest making the following change to Article 4, paragraph 1 of the Regulation:

(26) 'K-CMH' or 'K-factor in relation to client money held (CMH)' means the capital requirement relative to the amount of client money that an investment firm holds~~ or controls~~, regardless of any legal arrangements in relation to asset segregation and irrespective of the national accounting regime applicable to client money held by the investment firm;

We also suggest amending Recital 23 of the Regulation:

(23) [...] K-CMH captures the risk of potential for harm where an investment firm holds the money of its customers, regardless of whether they are on its own balance sheet or segregated in other accounts. ***Therefore calculations involving K-CMH should not include money with a credit institution held directly by a client but over which the firm has a mandate.*** *K-COH captures [...]*

c. **K-COH**

We are concerned about the proposed description of client orders handled (COH). Paragraph 2 of Article 20 of the proposed Regulation states that "COH shall include transactions executed by investment firms providing portfolio management services on behalf of investment funds." The execution of orders on behalf of clients is an integral part of the business of firms providing portfolio management services. Any risks associated with portfolio management services are, as a result, already captured by K-AUM. To include transactions executed as part of portfolio management in K-COH is therefore another (see above) form of double counting.

Proposed amendment

We suggest making the following change to Article 20, paragraph 2 of the Regulation:

[...] COH shall ~~in~~exclude transaction executed by investment firms providing portfolio management services on behalf of investment funds. [...]

III. **Public disclosure on remuneration**

Article 51 of the proposed Regulation states that investments firms have to disclose several elements of their remuneration policy to the public. While we are not opposed to provisions that would allow national competent authorities to benefit from relevant information on the remuneration model of the investment firm, it is not clear to us why such an information is additionally required to be made available to the public.

While credit institutions are currently subject to public disclosure requirements, we believe this might be justified by their status of "public interest entities" (PIE)[2]. Unlike investment firms, credit institutions are indeed recognised under EU law to perform a public service, as they take deposits and carry out extensive lending activities for individuals.

[2] The most recent definition of "PIEs", included in the Accounting and Audit Directives (2013/34/EC and 2014/56/EC respectively), specifically covers credit institutions but not investment firms.

Investment firms we represent, such as private equity advisers/arrangers, only offer their services to clients who typically are sophisticated professional investors. This is especially true for firms which only offer certain types of services, such as investment advice or reception and transmission of orders. Given the difference in nature between credit institutions and these types of investment firms, we believe that it would not be logical and proportionate to apply the same disclosure remuneration requirements to the two types of entities.

Furthermore, there are a number of investment firms which, despite being considered as small and not interconnected, will only have a handful of employees whose professional activities have a material impact on their firms' risk profile. As these firms are typically smaller than banks, there is an increased risk that the information they will make at the disposal of the public could not be aggregated in a manner that would ensure sufficient confidentiality for the relevant individuals.

Proposed amendment

We suggest removing Article 51 of the Regulation. If that is not acceptable, we suggest at least amending Article 23, paragraph 2 of the Directive:

This Section shall not apply where:

a) *on the basis of the assessment referred to in paragraph 1, an investment firm determines that it meets all of the conditions set out in Article 12(1) of [Regulation (EU) ---/----[IFR]*
b) ***investment firms are only authorised to provide the investment services and activities listed in points (1), (5) and (7) of Section A of Annex I to Directive 2014/65/EU***

IV. Liquidity

Under Article 42 of the Regulation, firms are required to hold liquid assets equivalent to at least one third of their fixed overheads requirement. While small and non-interconnected investment firms can include trade receivables to meet one third of this requirement, these are subject to a substantial 50% haircut. This option is not available to the remainder of firms that will be subject to the proposal. Other than cash the other types of assets that can be used to meet liquidity requirements will not generally be held by private equity firms.

It is, however, expensive and inefficient to require firms to maintain large cash amounts on their balance sheets. This reduces the ability of firms (especially smaller firms and start-ups) to invest in their businesses and staff. In our view, small and non-interconnected investment firms and firms which do not deal on own account (and therefore do not have trading counterparty risk) should be able to meet liquidity requirements entirely from trade receivables.

Proposed amendment

We suggest amending Article 42, paragraph 2 of the Regulation:

*For the purposes of paragraph 1, an investment firm **which does not carry out the activities referred to in points (3) or (6) of Section A of Annex I of Directive 2014/65/EU** ~~that meets the conditions set out in Article 12(1)~~ may also include receivables from trade debtors and fees or commissions receivable within 30 days in their liquid assets, where those receivables ~~comply with the following conditions:~~*

~~(a) they account for up to one third of the minimum liquidity requirements as referred to in paragraph 1;~~

~~(b) they~~ are not to be counted towards any additional liquidity requirements required by the competent authority for firm-specific risks in accordance with Article 36(2)(k) of Directive (EU) ----/--[IFD]~~;~~

~~(c) they are subject to a haircut of 50%~~.

V. Treatment of AIFMD top-ups

Under Article 6 paragraph 4 of the AIFM Directive, external AIFMs are allowed to provide some non-core ancillary MiFID services, such as investment advice, safe-keeping of fund shares or units, or reception and transmission of orders, provided they are also engaged in regular collective portfolio management activities. While these firms remain regulated under the AIFMD, they have to apply MiFID organisational requirements and conduct of business rules and make sure they have sufficient initial capital for their MiFID activities. They have been widely referred by the industry as AIFMs with MiFID "top-up" permissions.

Our experience is that EU Member States currently take different approaches regarding the prudential treatment of these firms. While in some countries MiFID capital requirements only apply (as defined in Article 9 of the Directive) to the MiFID "top-up" activities (and AIFMD capital requirements to the core AIFMD-regulated business), in others the appropriate capital requirement for the whole firm is the higher of the one set in AIFMD and the one that apply to its MiFID ancillary activities. We believe that the former approach is correct and that it should be clarified in the Directive that the capital requirements set in this legislation should only apply to the MiFID "top-up" activities and not to the whole firm.

VI. Role of the ESAs

The current prudential regime applicable to investment firms has been primarily designed to ensure the stability of the banking sector. Given that banks have a fundamentally different risk profile to most investment firms, our experience suggests that the CRD/CRR framework it is not well suited to address the specific risks that are inherent to their typical activities. Given that the European Commission's objective is to better tailor the existing regime to the specificity of investment firms, we believe that ESMA, rather than the EBA, should be in charge of any level two measures referred to in the proposed Directive and Regulation as they have relevant experience of investment firms' business model.

While there is no doubt that ESMA would benefit from the EBA expertise in setting capital requirements for the banking industry, the expertise of securities regulators and their understanding of very specific characteristics of MiFID firms would ultimately ensure that the new regime and any level 2 measures are appropriately tailored to their business model. This would limit the number of situations where investment firms operating on an agency basis have to comply with requirements that are not suited to their business model.

VII. Timing

Finally, in light of the ongoing debate of the CRD/CRR package it is important to ensure that investment firms remain subject to the existing regime until this new Directive and Regulation enter into force. It would be particularly problematic if these firms had to apply the new CRD/CRR requirements for only a few years and then become subject to the new prudential regime.

Contact

Thank you in advance for taking our comments into account as part of the negotiation process. We would be more than happy to further discuss any of the comments made in this paper.

For further information, please contact Christophe Verboomen (christophe.verboomen@investeurope.eu) at Invest Europe.

About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About Invest Europe

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