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**President**  
**Cboe Europe**

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Mr. José Manuel Campa  
Chairperson  
European Banking Authority

**Re: Consultation Paper on draft RTS prudential requirements for investment firms**

Dear Chair Campa:

Cboe Europe greatly appreciates the opportunity to respond to the European Banking Authority's ("EBA's") consultation paper on draft RTS prudential requirements for investment firms ("IFs"). Cboe Europe itself is one of the largest pan-European equities exchanges in Europe with operations in the UK and Netherlands. Cboe Europe and its affiliates, together, represent a global provider of market infrastructure and a leader in centrally cleared exchange-traded equities, options, and futures. Given our background and practical experience nurturing markets we believe we are uniquely positioned to offer recommendations that will strengthen the prudential regime for IFs.

Moreover, we understand the importance of well-calibrated prudential regimes and the negative consequences that can arise when prudential requirements are not adequately risk-sensitive or fit for purpose.<sup>1</sup> The Investment Firm Regulation ("IFR") and Investment Firm Directive ("IFD") represent a tremendous opportunity to implement a prudential framework that is not only more risk-sensitive but adapted to the specific risks posed by IFs. Thus, we fully support the intent of this new prudential regime to separate the prudential treatment of IFs and credit institutions and applaud policymaker's efforts in this regard.

We recognize, however, that if the RTS are not well-calibrated the ability of IFs to provide liquidity to European markets will be negatively impacted.<sup>2</sup> More broadly, mis-calibration brings a real risk that this landmark prudential regime will unintentionally create a more insular, less liquid, less competitive

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<sup>1</sup> See e.g., Cboe's letter in response to The Board of Governors of the Federal Reserve System proposed rulemaking to adopt the standardized approach for counterparty credit risk (SA-CCR) (March 19, 2019), *available at*, <http://www.cboe.com/aboutcboe/government-relations/pdf/sa-ccr-comment.pdf> (supporting the replacement of the current exposure method (CEM) with SA-CCR as CEM's insensitivity to risk reduced liquidity, increased costs to investors, and a heightened possibility of market dislocation during volatile environments). We are seeking to avoid similar outcomes in the application of the new IFR/IFD regime.

<sup>2</sup> As noted by the European Commission's High Level Forum on the Capital Markets Union prudential requirements impact the ability of institutions to make markets. The HLF recommended that market making by investment firms should be supported through appropriately calibrated level II guidance under the Investment Firm Regulation/Directive. See *A New Vision for Europe's Capital Markets, Final Report of the High Level Forum on the Capital Markets Union*, pg 49, (June 2020), *available at*, [https://ec.europa.eu/info/sites/info/files/business\\_economy\\_euro/growth\\_and\\_investment/documents/200610-cmu-high-level-forum-final-report\\_en.pdf](https://ec.europa.eu/info/sites/info/files/business_economy_euro/growth_and_investment/documents/200610-cmu-high-level-forum-final-report_en.pdf)

Europe to the detriment of EU investors. To help ensure this is not the result, set forth below are a number of substantive recommendations that will enable IFs – proprietary market-making firms in particular – to continue to provide meaningful liquidity to European markets and to compete globally. Beyond the below recommendations we strongly encourage the EBA to consider the comments and recommendations from the investment firm community whose insights will be invaluable.

### **Recommendations**

Our goal as a provider of market infrastructure is to foster a reliable and vibrant market ecosystem where diverse trading interest can compete and interact to the benefit of all investors. From banks and funds to CCPs and retail investors, this broad ecosystem relies on the contributions of many different groups to carry out this goal. The contributions of proprietary market-making firms, in particular, cannot be overstated, especially in exchange-traded options markets.<sup>3</sup> In short, proprietary market-making firms and the liquidity they provide are a critical component of the exchange-traded ecosystem. The below recommendations are intended to support the ability of these firms to continue to provide meaningful liquidity to European markets.

### **Investment Firm Classification**

As previously noted, the intent of IFR/IFD is to separate prudential requirements for IFs and credit institutions in recognition of the inherently different risks posed by IFs compared to credit institutions. Whereas credit institutions have clients, deposits, and large OTC portfolios, proprietary market-making firms have neither clients nor deposits and primarily provide liquidity in centrally-cleared, exchange-traded markets. Moreover, these firms are experts at managing risk, and often hold large portfolios of trading positions that have limited risk at the end of the day as a result of hedging and offsetting positions. Credit institutions are fundamentally different entities with fundamentally different risk profiles than proprietary market-making firms. It should therefore be a very high bar under the IFR/IFD regime to require IFs to be authorized as credit institutions or apply the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD).

#### *Reclassification of IFs as Credit Institutions*

IFR amended the definition of ‘credit institution’ in Art. 4(1) of CRR in an attempt to create a threshold above which an IF must seek authorisation as a credit institution. Pursuant to this amendment an IF is deemed a credit institution if performing a relevant activity (i.e., dealing on own account or underwriting or placing on a firm commitment basis)<sup>4</sup> and the total value of the consolidated assets of

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<sup>3</sup> In exchange-traded options markets there are often hundreds of options (representing different strike prices and expiration dates) per underlying equity or index. This means professional liquidity providers are relied upon to provide two-sided quotes (willing to buy and sell) as investor orders are less likely to interact with each other. This is an important service market-makers provide to the industry.

<sup>4</sup> Activities referred to in points (3) and (6) of Section A of Annex I to Directive 2014/65/EU (MiFID).

the undertaking, either individually (“solo test”)<sup>5</sup> or as part of a group (“group test”),<sup>6</sup> exceeds EUR 30 billion.

The solo test and group test are further illuminated by IFD amendments adding Art. 8a to CRD, which provides that member states shall require undertakings to apply for authorisation as credit institutions when either:

- under the solo test – the average of monthly total assets, calculated over a period of 12 consecutive months, is equal to or exceeds EUR 30 billion or
- under the group test – the average of monthly total assets calculated over a period of 12 consecutive months is less than EUR 30 billion but the undertaking is part of a group in which the total value of the consolidated assets of all undertakings in the group carrying out relevant activities is equal to or exceeds EUR 30 billion.

Art. 8a seeks to provide further clarity by instructing the EBA to draft RTS on reclassification setting forth the methodology for calculating the above thresholds. Art. 7 of the draft RTS on classification proscribes the calculation methodology relevant for the solo test, and Arts. 8 and 9 proscribe the methodology for calculating the group test.

As a general matter we agree that it may be reasonable to subject certain IFs to credit institution authorisation; however, if the balance sheet analysis envisioned under the EUR 30 billion threshold does not take into account economically offsetting positions, the threshold will not be risk-sensitive. Identifying IFs that are sufficiently bank-like in scale and scope as to justify credit institution authorization may prove difficult. For purposes of calculating “total value of the assets” in accordance with this threshold the draft RTS on reclassification provides that the assets shall be determined on the basis of either: prudential individual reporting in accordance with applicable law; International Financial Reporting Standards, or national accounting laws.<sup>7</sup> To the extent calculating the total value of assets in accordance with these proposed standards would not allow for the possibility of netting economically offsetting positions we recommend the EBA provide additional guidance that will allow such netting to be taken into account. Options market-making firms, in particular, maintain large portfolios of positions that are significantly hedged. Determining the value of assets on the basis of netting will help ensure these market-making firms, which are not bank-like, are not treated as banks by the new prudential regime. This will also incentivize other IFs to hedge portfolios as hedging will decrease the likelihood of credit institution reclassification. Incentivizing hedging will have the added benefit of reducing risks to firms and risks to the market.

In addition, to the extent the draft RTS on reclassification includes non-EU entities and non-EU assets in the calculation of total assets, we are concerned that the standard may subject certain IFs to credit authorisation that do not merit such a designation. This will place EU firms at a competitive disadvantage vis-à-vis non-EU firms; discourage firms from organizing in the Union; and incentivize firms in the Union to limit their liquidity provision when approaching the EUR 30 billion threshold. To

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<sup>5</sup> See Art. 4(1)(1)(b)(i) CRR and Art. 8a(1)(a) CRD as amended by IFR/IFD.

<sup>6</sup> See Art. 4(1)(1)(b)(ii) and (iii) CRR and Art. 8a(1)(b) CRD as amended by IFR/IFD.

<sup>7</sup> See Art. 3. of supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards for the calculation of the threshold referred to in Art. 8a(6)(b) of CRD.

limit these negative outcomes we recommend the draft RTS be amended to make it clear that the solo and group tests are determined on the basis of the value of EU assets of EU entities (including EU branches of non-EU groups in the case of the group test).<sup>8</sup>

*Subjecting Certain IFs to CRR*

Art. 5(1) IFD provides that if the total value of consolidated assets of an IF is equal to or greater than EUR 5 billion, NCAs may subject the IF to the requirements of CRR, instead of the new prudential regime, provided one of paragraphs (a)-(c) of Art.5(1) is satisfied:

- (a) the IF's activities are "on such a scale that the failure or the distress of the IF could lead to systemic risk;"
- (b) the IF is a clearing member; or
- (c) the competent authority considers it to be justified in light of the size, nature, scale and complexity of the activities of the investment firm concerned, taking into account the principle of proportionality and having regard for: (i) the importance of the investment firm for the economy of the Union or of the relevant Member State; (ii) the significance of the investment firm's cross-border activities; (iii) the interconnectedness of the investment firm with the financial system.

The draft RTS on CRR treatment specifies that for purposes of Art. 5(1)(a) a firm's activities could lead to systemic risk only so far as the activities exceed certain thresholds involving: non-centrally cleared OTC derivatives; underwriting or placing of financial instruments; granting credits/loans to investors; or debt securities (i.e., bank-like activities). We support the draft RTS on this point as it clearly and appropriately identifies bank-like activities that could lead to the application of banking regulations.

We also believe it would be appropriate for the EBA to provide further guidance as it relates to determining whether competent authorities are "justified" in subjecting IFs to CRR pursuant to paragraph (c) of Art. 5(1). We strongly encourage the EBA to support the view that such action would generally not be required by emphasizing that the factors to be considered in paragraph (c) would be unlikely to apply to the majority of firms that might otherwise be in scope. Moreover, we are of the view that applying prudential requirements designed for banks (CRR) can only be "justified" when the IF is carrying out bank-like activities, such as the ones identified in Art. 5(1) (a) (i.e., activities related to non-centrally cleared OTC derivatives, underwriting, credits/loans, and debt securities). In our view, it would not be proportionate to apply CRR to IFs that primarily transact in centrally cleared exchange-traded products, and it would also directly undermine the intent of IFR/IFD, which is to create a separate prudential regime for IFs that is fit for purpose and captures the specific risks posed by such firms.

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<sup>8</sup> Art. 4(1)(b) provides that for the purpose of the group test where the undertaking is part of a third-country group, the total assets of each branch of the third-country group authorised in the Union shall be included in the combined total value of the assets of all undertakings in the group.

### Consolidation

As previously noted, it is critically important to European markets that the implementation of IFR/IFD does not limit the ability of European IFs to provide meaningful liquidity and compete globally. Art. 8 of IFR provides one such mechanism that will help ensure European firms are not unnecessarily burdened by group consolidation requirements that do not adequately capture the risk associated with such firms. Specifically, Art. 8 of IFR provides that rather than applying the prudential requirements on a consolidated basis according to Art. 7, competent authorities may allow IFs to apply the group capital test in accordance Art. 8 when: group structures are sufficiently simple and there is no significant risk to clients or market.

We strongly encourage the EBA to support the wide availability of the group capital test, especially for IFs that are not providing bank-like services but rather are primarily engaged in the trading of centrally-cleared exchange-traded instruments. We believe the group capital test will not only help ensure IFs can compete globally and provide value to European markets, but is also more likely to result in proportionate outcomes as it relates to IF prudential requirements.

For IFs to which the group capital test will not apply, Art. 7 of IFR provides that relevant requirements must be satisfied on the basis of their consolidated situation. Pursuant to Art. 7(5) of IFR the EBA was tasked with specifying the scope and methods for prudential consolidation for purposes of calculating the various capital requirements, including the K-factor requirements. The EBA notes that the proposed RTS on consolidation was based on existing material under CRR. We believe, however, that basing views of IF consolidation on banking regulations found in CRR may be incongruous with this new prudential regime, which, as noted by the EBA, was initiated because of the need for proportionality. The risks presented by banking activities are fundamentally different from the vast majority of activities in which IFs engage. Thus, we encourage the EBA to be open to alternative views of consolidation that are more proportionate, such as, for example, including only the activities of EU entities when calculating the various K-factors instead of broadly applying the K-factors methodology to non-EU entities that happen to be part of an EU group. Simply put, the broad application of this prudential regime to non-EU entities that are part of an EU group is undesirable. It puts EU headquartered firms at a competitive disadvantage vis-à-vis non-EU headquartered firms without a corresponding reduction in risk that could potentially justify such a result. In our view, it would be more desirable from both a risk management and competition perspective to rely on equivalence and mutual recognition frameworks rather than apply a K-factor regime to third country subsidiaries of EU entities that already must satisfy robust third-country prudential requirements.

### K-Factors

The IFR/IFD regime is designed to be more risk-sensitive and proportionate. Ideally this allows competent authorities to address the particular risk IFs present while allowing IFs to contribute meaningful liquidity to Europe and to compete globally. In order to accomplish these goals the K-factors must be properly calibrated (i.e., risk-sensitive and proportionate).

### *K-DTF*

In general, we remain concerned that the daily trading flow (K-DTF) observations may, at times, penalize hedging activity and discourage market-making firms from providing liquidity, especially during volatile environments and periods of high volume. This is partly due to K-DTF being calculated on a gross basis by summing the absolute value of all individual buys and sells during a trading day. In our view, K-DTF would be more risk-sensitive if based on an end-of-day net basis. However, we recognize that this general point is more relevant for purposes of the level 1 text. That said, we believe a goal of the RTS should be to calibrate K factors in a manner that mitigates potential negative consequences, including the possibility that IFs are forced to limit their liquidity provision in order to limit their K-DTF calculation, which would harm individual investors. Thus, we encourage authorities to review feedback received from the industry on this and other points as failure to do so may have serious consequences for liquidity provision in European markets.

One area where the EBA may be able to mitigate potential negative consequences of K-DTF is in relation to stressed market conditions. Art. 15(2) prescribes coefficients (i.e., multipliers) applicable to the various K-factor calculations. Pursuant to Art. 15(5) of IFR the EBA was tasked with developing the draft RTS to specify when the K-DTF coefficient should be adjusted lower in the event of a “stressed market condition”. As noted by the EBA, the K-DTF calculation is based on an IF’s volume of transactions. The purpose of adjusting the K-DTF coefficient lower during times of market stress is to serve as an incentive to IFs to continue to trade during periods of extreme volatility.

The draft RTS would allow a coefficient adjustment only when there are “exceptional circumstances” pursuant to point (a) of Art. 3 of Commission Delegated Regulation (EU) 2017/578. Not only is this MiFID concept of “exceptional circumstances” rarely triggered, but also this concept appears to be contrary to the very purpose of adjusting the coefficient (i.e., incentivizing liquidity provision). For example, when exceptional circumstances are called under MiFID it is specifically designed to relieve IFs of their obligation to provide liquidity on a regular and predictable basis. Thus, linking coefficient adjustments to “exceptional circumstances” appears to be a direct contradiction. The former seeks to incentivize liquidity and the latter forgives lack of liquidity. We recommend the EBA instead adopt a statistical method that takes into consideration the historical norms of trading activity to determine whether the stressed market conditions are of a type that should result in a coefficient adjustment.

Lastly, we want to register our support of the draft RTS on K-DTF specifying that for the purposes of exchange-traded options the premium paid or collected – rather than the notional value of the contract – will be used when calculating K-DTF pursuant to Art. 33. We agree with the EBA that trading and settlement of exchange-listed options is akin to other “cash trades” such as stocks and should be treated as such for purpose of the K-DTF calculation.

### *K-CMG*

Art. 21 of IFR allows firms to calculate the Risk-to-Market (RtM) based on positions subject to clearing (K-CMG) rather than net position risk (K-NPR) provided that the conditions of Art. 23 are met. Art. 23(1) provides that competent authorities shall allow the use of K-CMG if, among other things, the “competent authority has assessed that the choice of the portfolio(s) subject to K-CMG has not been

made with a view to engaging in regulatory arbitrage of the own funds requirements in a disproportionate or prudentially unsound manner.” The draft RTS provide that this anti-regulatory arbitrage provision will be satisfied if a number of conditions are met, such as, for example, confirmation that the IF uses the K-CMG calculation for a portfolio of positions assigned to a trading desk for a continuous period of at least 24 month; that K-CMG is consistently applied; and policies and procedures are in place to ensure consistent application. These particular requirements appear to be reasonable; however, Art. 4(1)(e) of the draft RTS on K-CMG also obligates IFs to calculate and compare K-NPR to K-CMG and to justify the difference between the two figures.

While we fully support the notion that prudential requirements should not create the opportunity for regulatory arbitrage, we are concerned that Art. 4(1)(e), as proposed, fails to recognize the fact that some trading strategies will naturally give rise to differences between K-NPR and K-CMG calculations. There is a significant difference between regulatory arbitrage and the prudent implementation of requirements for capital efficiency purposes. In our view, regardless of whether there are large or small difference between K-NPR and K-CMG calculations, applying K-CMG to portfolios – when the remaining requirements of Art. 23 IFR are otherwise met – is in furtherance of capital efficiency, not regulatory arbitrage. Therefore, we strongly recommend that the draft RTS be amended to provide that the differences between K-NPR and K-CMG are alone insufficient to prevent the application of K-CMG.

Additionally, Art. 23 specifies that K-CMG shall be the third highest amount of total margin required on a daily basis by the clearing member from the IF over the preceding three months. Art. 23 also instructs the EBA to draft RTS to specify the calculation of the amount of the total margin required and the method of calculation of K-CMG. The draft RTS provides that the amount of total margin “shall be the required amount of collateral in the collateral account comprising the initial margin, variation margins and other financial collateral, as required by the clearing member’s margin model from the investment firm.” We are concerned that this definition of total margin may be overly prescriptive. We encourage the EBA to consider input from IFs and clearing members on this point. There are a variety of margin models implemented by clearing members, and we believe it’s necessary to ensure the RTS on K-CMG is drafted in a manner that allows broad application of K-CMG.

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Cboe Europe greatly appreciates the opportunity to provide comments on the draft RTS prudential requirements for investment firms. We believe these recommendations, if adopted, will strengthen the prudential regime and help ensure European markets and European investment firms remain globally competitive. Please do not hesitate to contact us if you have questions or wish to discuss these comments further.

Sincerely,



David Howson  
President  
Cboe Europe