EBA/DP/2024/01

3 June 2024

Discussion Paper

Call for advice on the investment firms prudential framework

Contents

List of acronyms

AIFM	Alternative investment funds managers
CA	Competent authorities
CASP	Crypto-assets service providers
CfA	Call for advice
CRR	Capital requirements regulation
CFSP	Crowdfunding service providers
CVA	Credit valuation adjustment
ECSP	Crowdfunding service providers regulation
EMIR	European market infrastructure regulation
FHC	Financial holding company
FINREP	Financial reporting framework
FOR	Fixed overheads requirements
FRTB	Fundamental review of the trading book
GAAP	Generally accepted accounting principles
GL	Guidelines
K-AUM	K-factor assets under administration
K-ASA	K-factor assets safeguarded and administered
K-DTF	K-factor daily trading flow
K-CMH	K-factor client money held
K-CMG	K-factor clearing member guarantee
K-COH	K-factor client orders handled
K-CON	K-factor concentration risk in trading book
K-NPR	K-factor net position risk
K-TCD	K-factor trading counterparty default
IFD	Investment firms directive
IFR	Investment firms regulation
IHC	Intermediary holding company
MiCAR	Market in crypto-assets regulation
MiFID	Market in financial instrument directive
MFHC	Mixed financial holding company
MTF	Multilateral trading facility
NCA	National competent authorities
OTF	Organised trading facility
RtC	Risk-to-Client
RtF	Risk-to-Firm
RtM	Risk-to-Market
RTS	Regulatory technical standards
SREP	Supervisory review and evaluation process
UCITS	Units in collective investment in tradable securities

Responding to this Discussion Paper

The EBA invites comments on all proposals put forward in this paper and in particular on the specific questions stated in the boxes below (and in the Annex of this paper).

Comments are most helpful if they:

- respond to the question stated;
- indicate the specific point to which a comment relates;
- contain a clear rationale;
- provide evidence to support the view expressed;
- describe any alternatives the EBA should consider; and
- provide where possible data for a cost and benefit analysis.

Submission of responses

To submit your comments, click on the 'send your comments' button on the consultation page by 3 September 2024. Please note that comments submitted after this deadline, or submitted via other means may not be processed.

Publication of responses

Please clearly indicate in the consultation form if you wish your comments to be disclosed or to be treated as confidential. A confidential response may be requested from us in accordance with the EBA's rules on public access to documents. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the EBA's Board of Appeal and the European Ombudsman.

Data protection

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Disclaimer

The views expressed in this discussion paper are preliminary and will not bind in any way the EBA in the future development of the advice. They are aimed at eliciting discussion and gathering the stakeholders' opinion at an early stage of the process.

Executive summary

Reasons for publication

Article 60 of Regulation (EU) 2019/2033 (IFR) and Article 66 of Directive (EU) 2019/2034 (IFD) mandate the Commission to submit a report to the Council and to the Parliament regarding multiple aspects of the IFD and IFR. In its report, the Commission may include a legislative proposal to amend the prudential framework applicable to investment firms.

The report by the Commission shall include an all-encompassing assessment of the provisions of the IFR and IFD. Against this background, on 1 February 2023 the Commission submitted a Call for Advice (CfA)[1] to the EBA and ESMA aimed at covering the elements mentioned in those two articles. In accordance with that request, the answer to the CfA should be submitted to the Commission by 31 May 2024.

The Commission is seeking advice from the EBA and ESMA on the following areas:

a) Categorisation of investment firms including the conditions to qualify as small and non-interconnected investment firms and the conditions to qualify as credit institutions.

b) The adequacy of the IFR/IFD prudential requirements, including the scope of K-factors, on prudential consolidation and liquidity requirements.

c) Interactions with the CRR/CRD, implications of the adoption of the banking package, especially on the application of the market risk framework, variable remuneration and investment policy disclosure.

d) Future proofing IFR/IFD regime, in particular with reference to the impact of crypto-assets to investment firms activities as well as UCITS/AIF.

e) Considerations on the risk related to ESG factors.

f) Specific considerations on commodity and emission allowance dealers and on energy firms.

Furthermore, the Commission expects the EBA and ESMA to assess the impact of the proposed changes against the current framework, in terms of own funds, requirements, operational and administrative costs incurred by Investment firms, clustered with respect to the classes of Investment firms, size, levels of consolidation, geographical location and activities.

Against that background, and given the need to collect feedback more systematically, the EBA and ESMA favor a public discussion and is therefore issuing this discussion paper. This discussion paper was prepared on the basis of considerations related to prudential requirements elaborated by the

[1] Call for advice to the EBA and ESMA for the purposes of the reports on the prudential requirements applicable to investment firms, 1 February 2023 (link).

EBA and competent authorities responsible for the prudential requirements of investment firms and in close cooperation with ESMA and market authorities.

It is worth noting upfront that the EBA is of the overall opinion, that the current framework reaches the original general objectives, providing a robust and risk-sensitive prudential framework tailored to the size, activities and complexity of the MiFID investment firms while, at the same time, introducing substantial simplification in the calculation and reporting methodologies reducing the burden on participants in the market of investment services. Nonetheless, market participants and supervisors highlighted a number of issues or areas of potential improvements of the prudential framework that may lead to changes to either the IFR and IFD or to the related delegated regulations.

Therefore, this discussion paper addresses the elements highlighted by the supervisory community as priorities for possible improvements as well as several more detailed technical elements in all areas. Specifically:

- Section 1 discusses the categorisation of investment firms, with particular emphasis on the coherence in the definitions of the applicable thresholds. The section does not elaborate on the categorisation of investment firms that have to apply for a credit institution authorisation (Class 1), as they are subject of dedicated technical standards that will be developed following the adoption of the banking package. Nonetheless, the thresholds concerning the investment firms that have to apply the CRR (without a credit institution authorisation) as well as the monitoring of all those thresholds are part of the IFR. Therefore, this document includes an analysis regarding those thresholds and considers suggestions for improving definitions and coherence in calculations and monitoring.

- Section 2 covers the conditions for investment firms that qualify as small and non-interconnected, including the criteria for their categorisation as well as considerations regarding the transition period from one category to another.

- Section 3, in the context of analysing the adequacy of the own-funds requirements, looks into the definitions related to the fixed overheads requirements, the parameters and the mechanic of their calculation as well as the length of the wind down period.

- Section 4, also in the context of assessing the adequacy of the own-funds requirements, reviews the existing K-factors and recommends improvements in definitions or calculation methodologies.

- Section 5 touches upon the possibility to include new K-factors, to cover risks currently only addressed under the pillar 2 framework or as possible alternatives to existing K-factors.

- Section 6 discusses the implications of the adoption of the Banking Package (CRR3/CRD6) concerning the introduction of the FRTB and how this would be applicable to investment firms. Furthermore, this section discusses the boundary between trading book and banking book positions, considering that there is no K-factor on banking book positions in the IFR and the risk of regulatory arbitrage.

- Section 7 aims at assessing the existing liquidity requirements and investigate the possibility of improving the risk sensitivity of the requirements arising from certain activities or services. Liquidity requirements are harmonised at Union level under the IFR, but the methodology is based on a fraction of the fixed-overheads requirements, and therefore it might not be always reflecting the liquidity needs related to certain activities.

- Section 8 covers all the element of the IFR framework for prudential consolidation of investment firm groups, suggesting improvements to the existing text and extending the scope in line with similar provisions of the CRR as well as a possible extension of the scope to crowdfunding and crypto service providers.

- Section 9 includes an analysis of the interactions of IFD and IFR with other regulations. This includes the potential investment firms exposures to crypto-assets and the provision of services related to those assets, the role of other providers of financial services, the interaction with the own funds requirements applicable to AIFMs and UCITS management companies providing ancillary MiFID services. A sub-section addresses specifically the interaction of MiCAR and IFD/ IFR in the areas where investment firms may provide services related to crypto-assets.

- Section 10 is dedicated to aspects related to remuneration in relation to investment firms, AIFMs and UCITS management companies, including the scope of application, remuneration policies, the requirements on variable remuneration, their oversight, disclosure and transparency.

- Section 11 summarises the remaining elements, including reporting as well as references to topics that are not addressed in this document as they are already covered by other EBA publications (e.g., risks related to ESG factors and investment policy disclosure for investment firms). The part of the CfA on commodities markets will not be covered by this document and will be developed at a later stage.

Next steps

Considering all the elements above, there is a need for a dedicated data collection. This discussion paper will therefore be accompanied with a data collection. This data collection will supplement the feedback received as part of the consultation on this discussion paper.

Following the public consultation, the EBA and ESMA plan to publish the final report in response to the Commission's call for advice by December 2024.

1. Categorisation of investment firms

1. The CfA requires, in its section B1, for the EBA and ESMA to analyse a number of elements related to the categorisation of investment firms as credit institutions or the conditions under which investment firms can be subject to CRR prudential requirements. In particular, the following topics are brought up:

- Appropriateness and effectiveness of the categorisation of investment firms;
- Consistency of the thresholds;
- Definition of consolidated assets and subsequent impact;
- Overview of investment firms that have been authorised as credit institutions based on the EUR 30 bn threshold in accordance with point (b) of Article 4(1) of the CRR and in application of Article 8a of the CRD; as well as the use of the following legislative provisions:
    - The discretion of competent authorities to subject investment firms to the CRR requirements under point (b)(iii) of Article 4(1)(1) of the CRR in the light of potential risks of circumvention and potential risks for the financial stability of the Union;
    - Articles 1(2) and 1(5) of the IFR mandating CRR requirements for investment firms dealing on own account or underwriting financial instruments under certain conditions; and,
    - The discretion of competent authorities to subject investment firms to the CRR requirements under Article 5 of the IFD.

2. Due to the recent changes in the CRR3 definition of credit institution, some topics are better suited for the regulatory package on the EUR 30 bn threshold the EBA is expected to develop in that context. Therefore, this discussion paper does not elaborate on the definition of consolidated assets and subsequent impact.

1.1 Background

3. The introduction of the IFR and IFD had the purpose of establishing a dedicated prudential framework for investment firms, and thereby taking into account the deficiencies that were identified with applying the CRR/CRDIV to investment firms during the European Commission's review of the prudential framework for investment firms in 2017. In this regard, since the requirements in the CRR/CRDIV were largely calibrated to secure the lending and deposit-taking functions of credit institutions through economic cycles, these requirements do not effectively capture the actual risks faced by the majority of EU investment firms, who do not

conduct these activities as their main business. Furthermore, while there is some overlap between the services credit institutions and investment firms can provide, and the failure of larger investment firms can result in the same overall financial stability/systemic risks as large credit institutions, their primary business models are quite different, making them qualitatively different institutions.

4. In this context, the co-legislators identified, in line with the EBA report on investment firms[2], three issues with the CRR/CRDIV as a prudential framework for investment firms, namely its complexity and disproportionality, its lack of risk sensitivity concerning the activities of investment firms, and the differing national transpositions of, and the use of options in, this regulatory framework. Consequently, the co-legislators set three objectives for the review, namely:

   a) Setting more appropriate, risk-sensitive prudential requirements that cover the risks actually posed and incurred by investment firms across all types of business models in a more tailored and comprehensive way than the CRR/CRDIV framework.

   b) Establishing a framework that accommodates investment firms for the business they conduct and to avoid regulatory arbitrage in the situation where the identification of investment firms, and the subsequent prudential requirements applied to them, is subject to an overly complex, or insufficiently clear process.

   c) Creating a streamlined regulatory and supervisory toolkit to facilitate effective supervisory oversight by competent authorities regarding the actual risks posed and incurred by investment firms.

5. One of the means through which these objectives were intended to be achieved in the introduction of IFD/IFR, was a new categorisation of investment firms. At the time, the CRR/CRDIV differentiated between 11 categories of investment firms. The EBA recommended to replace this categorisation by three main ones with the aim of pursuing the general objective of enhancing proportionality through indicators related to systemic importance and the ability to run 'bank-like' activities.[3] In that regard, the EBA observed that the full CRD/CRR requirements should be applied to systemic, interconnected and bank-like investment firms because these firms are exposed to credit risk, counterparty credit risk and market risk for positions taken on own account be it for the purpose of external clients or not.[4]

6. At the time, the EBA therefore recommended to construct the categorisation in such way that it differentiates between firms that are deemed systemic or otherwise present a clear risk to financial stability in normal conditions, firms considered of lesser systemic importance, or not 'bank-like' investment firms, and small and non-interconnected firms that warrant a very

[2] See paragraph 2.4 of the EBA Report on Investment Firms: Response to the Commission's Call for advice of December 2014', EBA/Op/2015/20 ('EBA 2015 report')(link).

[3] See paragraph 2.5.2 of the EBA 2015 report.

[4] See Recommendation 1 on page 85 of the EBA 2015 report.

simple regime, that allows the smaller investment firms to be wound down in an orderly manner.[5]

7. Regarding the first category of investment firms, the IFR identifies these as the largest and most interconnected investment firms and have business models and risk profiles that are similar to those of significant credit institutions, i.e. they provide 'bank like' services and underwrite risks on a significant scale.[6] Furthermore, systemic investment firms are large enough to, and have business models and risk profiles which, represent a threat for the stable and orderly functioning of financial markets on a par with large credit institutions.[7] Due to these considerations, it is concluded that the CRDV/CRR regime is an appropriate prudential framework for those firms that are conducting activities of dealing on own account or underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis.

8. In addition, a differentiation has been made in the first category between investment firms that conduct one or both of the aforementioned activities and meet a EUR 30 bn threshold for their consolidated assets (so-called "Class 1" investment firms), investment firms that conduct one or both of the aforementioned activities and meet a EUR 15 bn threshold in terms of their consolidated assets[8], investment firms included in the supervision on a consolidated basis of a credit institution[9] or meet a EUR 5 bn threshold and are designated by their competent authorities following specific criteria according to Article 1(2) or Article 1(5) IFR (so called "Class 1 minus" firms).[10] The 30bn threshold was chosen by the European legislators as that would then give the ECB a direct mandate to supervise those investment firms that provide 'bank-like' services, despite outcomes that have, at times, diverged from this aim.[11]

9. Regarding the second category of investment firms (so called "Class 2" firms), these are the firms that neither classify as Class 1 nor 3 firms. The European Commission described these as firms that either deal on own account and incur market and counterparty credit risk, safeguard and administer client asset, or hold client money or are above the following size-thresholds (assets under management under both discretionary portfolio management and non-discretionary (advisory) arrangements higher than EUR 1.2bn; client orders handled of at least

[5] See paragraph 2.5.3 of the EBA 2015 report.

[6] The IFR and IFD proposals did not contain a clear elaboration on the bank-like nature of these activities, especially since these activities are not included in the original definition of credit institution in the CRR. The Class 1 regime could benefit from a further refinement and explanation on what activities should classify as bank-like. This would then also help with determining an adequate threshold.

[7] Recital 9 of the IFR.

[8] Article 1(2) of the IFR.

[9] Article 1(5) of the IFR.

[10] Article 5 of the IFD.

[11] Pages 14 and 23 of the draft IFR Proposal for a Regulation of the European Parliament and of the Council on the prudential requirements of investment firms and amending Regulations (EU) No 575/2014, (EU) No 600/2014 and (EU) No 1093/2010. Brussels, 20.12.2017. COM (2017) 790 final, 2017/0359 (COD)

EUR 100mn/day for cash trades and/or at least EUR 1bn/day for derivatives; balance sheet total higher than EUR 100mn; total gross revenues higher than EUR 30mn).

10. Regarding the third category of investment firms, these are the firms that do not conduct investment services which carry a high risk for clients, markets or themselves and where their size means they are less likely to cause widespread negative impacts for clients and markets if risks inherent in their business materialise or if they fail (so called "Class 3" firms).[12] The actual conditions that have to be fulfilled are listed in Article 12 of the IFR.

11. Both Class 2 and 3 investment firms are subject to the IFR and IFD. Class 3 firms are subject to a requirement to hold the higher of a permanent minimum requirement[13] consisting of an ongoing requirement at the level of the required initial capital and the fixed overhead requirement.[14] Class 2 investment firms are also subject to a K-factor requirement that may be the higher capital requirement.[15] The table below describes the requirements:

Class	Undertakings qualified as credit institutions (Class 1)	Undertakings subject to CRR for various reasons, of which systemic relevance (Class 1-minus)	Non systemically important investment firms not qualifying as small and not interconnected (Class 2)	investment firms small and not interconnected (Class 3)
Classification criteria	Activity 3 and/or 6 MiFID + Assets equal at least to € 30 billion at individual or consolidated level Both EU and extra-EU assets are taken into account for the threshold	Activity 3 and/or 6 MiFID + Assets between € 15 billion and € 30 billion at individual or consolidated level or inclusion in the supervision on a consolidated basis of a credit institution or Assets equal at least to € 5 billion at individual or	investment firms not meeting the criteria for any of the other classes	Meeting all the requirements under Article 12 of the IFR

[12] Recital 17 of the IFR.

[13] See Article 11(1)(b) and Article 14 of the IFR.

[14] See Article 11(1)(a) and Article 13 of the IFR.

[15] See Article 11(1)(c) and Article 15 of the IFR.

		consolidated level; and Decision by NCA subject to Article 5 of the IFD criteria investment firms subject to Article 1(5) IFR Only EU assets are taken into account for the thresholds		
Applicable framework	CRR/CRD	CRR/CRD (Title VII-VIII)/IFD	IFR/IFD	IFR/IFD with lower prudential requirements and some simplifications
Authorization	CRD	MiFID	MiFID	MiFID
Supervisory Authority	ECB if operating within the Banking Union	NCA	NCA	NCA

1.2 Effectiveness of the categorisation of investment firms

12. In light of the constant interactions with stakeholders in the investment firms' ecosystem, it is apparent to the EBA that the IFR/IFD framework is working well and is effectively tailored to the size and activities of investment firms. However, there are concerns related to the lack of clarity on the classification of Class 1 investment firms, particularly before a stable framework for the calculation and monitoring of the EUR 30 bn threshold was established.

13. As amendments to the definition of credit institution according to the CRR have been the subject of political negotiations in the context of the CRR3, and due to the fact that the relevant technical standards will have to be revised in light of the revisions to be brought to the CRR/CRD text, this discussion paper will not include a discussion on the elements pertaining to the scope and methodology for calculating the EUR 30 bn threshold.

14. Finally, a description of the investment firms population as categorised on the basis of the thresholds applicable today and based on supervisory data is presented in the Annex of this document.

1.3 Consistency of the thresholds

15. One of the longstanding issues related to the system of thresholds in the IFR/IFD has been represented by the inconsistency in the definition of the thresholds, resulting in a significant lack of clarity with regards to i) how each threshold is calculated; and ii) how they are supposed to work together.

Harmonisation of the thresholds in the IFR/IFD framework

16. The EUR 30 bn threshold, the 15 bn threshold and the 5 bn threshold, as detailed in the beginning of this section, are fundamental for the functioning of the prudential regime for investment firms. It is therefore of utmost importance that the thresholds constitute a continuous scale of reference for the categorisation of investment firms and thus they ought to be calculated based on a similar scope and based on a similar methodology. However, as shown in the table above, there are significant differences in how the IFR text approaches each of these three thresholds, which may result in inconsistent application of the thresholds across jurisdictions and opens the door to significant regulatory arbitrage. Hence, the need to harmonise the scope of the calculation of the three thresholds.

17. As mentioned in the introduction to this Section, the EUR 30 bn threshold has been the object of careful scrutiny and as such is also the threshold that is the most detailed in the CRD text in terms of scope: the group test is carried out at the European level, i.e. by including all undertakings established in the EU (and all their branches and subsidiaries anywhere else) that have total assets lower than EUR 30 bn. Given that it reflects the agreement reached by the co-legislators, it makes sense to use the EUR 30 bn threshold to benchmark the harmonisation of the three thresholds in the framework. Therefore, the scope of calculation of the EUR 15 bn threshold and the EUR 5 bn threshold should include all undertakings established in the EU (and all their branches and subsidiaries anywhere else), in line with the total assets constraint corresponding to the threshold which is being analysed (i.e. either the EUR 15 bn or the EUR 5 bn one).

18. This proposal for harmonisation is brought forward in particular in the context of the EUR 30 bn threshold in conjunction with the EUR 15 bn threshold, where the IFR text now clearly provides for two different scopes of calculation (i.e. one explicitly includes and the other explicitly excludes assets of subsidiaries in third countries belonging to EU undertakings), which could be considered counterintuitive given that the consequences of the two thresholds are similar (i.e. both involve the application of the CRR: one through a re-authorisation as credit institutions and the other by simply applying the CRR to the investment firm).

19. In the context of the EUR 5 bn threshold, this proposal for harmonisation is meant to bring clarity and certainty with regards to scope and calculation, as the IFR text is silent with regards to both aspects. Since this particular threshold serves two purposes (i.e. for applying the CRR to systemically-relevant investment firms based on Article 5 of the IFD and for the reporting of the information needed to monitor the EUR 30 bn threshold), it is particularly relevant to have a harmonisation of the scope of the threshold in order to allow consistency in any of the

analysis and in the monitoring of the thresholds. This would provide for a coherent scale on which investment firms may place themselves, therefore enabling comparability throughout the whole scale and smoothing out cliff effects and inconsistencies, particularly for investment firms that have total assets in the vicinity of any of the thresholds.

20. Furthermore, the EBA proposal for the harmonization harmonisation of the thresholds does not include a harmonization harmonisation of the waiver and opt-in clause that the latest version of the EUR 30 bn threshold includes. This is mainly because the national discretion in Article 5 of the IFD already functions as an opt-in clause of the Class 1 minus investment firms and an opt-in is needed as an anti-circumvention failsafe provision. Moreover, the lack of a waiver provides a more conservative framework on the part of the total assets scale where most of the investment firms population is concentrated (i.e. up to EUR 15 bn).

21. Based on the IFR text, it appears necessary that the language defining all three thresholds be aligned, which also means that, conceptually, the thresholds should be aligned from a methodological perspective. A harmonisation of the notions of 'total value of assets' vs 'total value of consolidated assets', 'consolidated assets' vs 'combined[16] assets' could thus be useful going forward.

22. Furthermore, the scope of the consolidated assets (and the total assets, for that matter) in the context of the EUR 5 bn threshold is not clear from the IFR text. For a more efficient supervision, and for ease of reporting and monitoring, it should be clarified in the IFR what the scope is in the context of the calculation of the EUR 5 bn threshold, both at solo and group level. This is also due to the fact that the notion of group remains a global one, based on the considerations presented during the work on the 1st and 2nd version of the EUR 30 bn threshold package.

1.4 Additional issues related to the categorisation of investment firms

Categorisation of Class 1 minus firms

23. The Call for Advice requests an analysis of the use of Article 1(2) and 1(5) of the IFR mandating CRR requirements for investment firms dealing on own account or underwriting financial instruments (i.e., Class 1-minus investment firms). In this regard, it is relevant to recall that Recital 42 of the IFR states that "*it is possible that large investment firms which are not of systemic importance, but which deal on own account, underwrite financial instruments or place financial instruments on a firm commitment basis have business models and risk profiles that are similar to those of other systemic institutions. Given their size and activities, it is possible*

[16] The notion of "combined" should be clarified in the IFR text as referring to the addition of amounts without any deductions (e.g. accounting for intragroup transactions), as it is used to identify different concepts in different phrases in the IFR text (e.g. in the definition of credit institution, as well as in Article 12(2) of the IFR).

that such investment firms present some risks to financial stability and, although their conversion into credit institutions is not deemed to be appropriate in light of their nature and complexity, they should remain subject to the same prudential treatment as credit institutions." Furthermore, the IFR has been created to address the risk and vulnerabilities specifically inherent to investment firms, which are only partially addressed by international regulatory standards set for large banks by the Basel Committee on Banking Supervision (with reference to Recital 2 of the IFR).

24. Considering these two competing considerations, it is warranted and opportune to investigate whether supervisors' experiences with supervising Class 1-minus investment firms provide support for a finding that one of these considerations prevails over the other. To this end, a qualitative survey will be circulated to NCAs whether, since the IFR has entered into force, the supervision of Class 1-minus investment firms has, in their view, demonstrated that these firms have a similar risk profile as credit institutions and whether they have posed risks to financial stability. This will be supplemented by a quantitative survey among supervisors to assess whether the transition to Class 1-minus investment firms has actually led to higher capital requirements.

25. In addition, the Call for Advice also requests an analysis of the discretion of competent authorities to subject investment firms to the CRR requirements under Article 5 of the IFD. The aforementioned qualitative survey will therefore be combined with a data collection directed to competent authorities to specify whether and how many times they have exercised this discretion with an accompanying questionnaire which gives the opportunity to elaborate on the supervisory experiences with exercising this discretion. This will give valuable insights in how NCAs have assessed the criteria mentioned in Article 5(1) of the IFD.

Monitoring of the thresholds

26. Based on the requirements in Article 55 of the IFR, currently only undertakings with total assets above EUR 5 bn should report their information to the EBA in order to enable the monitoring of both the EUR 30bn threshold and the EUR 15 bn threshold. The discussion on the scope and methodology of the calculation of the EUR 5 bn threshold notwithstanding (as it has been covered above), a floor on the data to be reported to the EBA brings about a number of issues:

    a) There will be no information available for the investment firms whose total assets are below EUR 5 bn;

    b) The data will be transmitted to the EBA for the relevant calculation only if the investment firms are part of investment firm groups;

    c) Articles 55(1) and 55(2) IFR do not require relevant institutions other than investment firms (i.e. credit institutions performing MiFID (3) and (6) activities) to report the value of their total assets to the EBA;

d) The combined reading of Articles 55(1) and 55(2) IFR suggests that a double threshold of EUR 5 billion for the reporting to the investment firm's authorities is set up both at the individual level and at the group level. However, entities below EUR 5 billion could be considered for the discretion at the competent authority level in line with 4(1)(b)(iii) of the CRR;

e) Investment firms of banking groups are excluded from the reporting framework developed under Article 55 as specified in the level 2 provisions as any investment firm, part of a banking group falls under the scope of CRR;

f) Obligation for the EBA to notify the entities passing the threshold is difficult to carry out in the context where not all the data is available for the calculation; burden of proof should fall on entities.

27. It could be envisaged to remove the reference to the EUR 5 bn threshold from the IFR text for undertakings part of a group in order to enable the reporting from all relevant investment firms and thus an accurate monitoring of the thresholds, in particular if the notification obligation from the EBA to the investment firms breaching the EUR 30 bn threshold or the EUR 15 bn threshold is maintained in the IFR text. Without information enabling top-down calculation of the thresholds' values, there is no need for the EBA to notify anyone on a breach they already have knowledge of and a significant reputational risk for the EBA to notify on something it cannot double-check. Removing this floor would nonetheless result in an intensified reporting to the EBA for investment firms with less than EUR 5 bn in total assets, although it should be clarified that in any case investment firms have to carry out all the calculations in any case as this is required by the IFR text. So, this perceived increase in complexity is in reality a marginal amendment to the reporting requirements for each investment firm.

Question for public consultation

Q1: What would be the operational constraints of potentially removing the threshold?

Notification requirement from the EBA to the investment firms surpassing the threshold

28. In the context of Article 55(3) of the IFR, the EBA has the obligation to notify investment firms when they surpass the EUR 30 billion threshold either on an individual or on a group basis. On top of the points raised above in the context of the lack of harmonisation of the thresholds and of the existence of a EUR 5 bn threshold for reporting of the information needed for the monitoring of the EUR 30 bn threshold, the burden of proof of breach of threshold is on the investment firms that have in any case the obligation to 'verify the value of their total assets on a monthly basis', in line with requirements in Article 55(1) and (2) of the IFR. This could be done by, on the one hand, further clarifying the NCAs capacity to ask for information to the satisfaction of the supervisors, as well as the possibility for investment firms that fail to provide the necessary information to be in a category with more stringent requirements, on the other hand.

2. Conditions for investment firms to qualify as small and non-interconnected

29. The CfA requires the EBA and ESMA Report to "provide, where applicable, per Member State, an overview of investment firms currently qualifying as "small and non-interconnected" together with an estimation of their corresponding own funds requirements per risk category, should they be subject to K-factors. The report should include an assessment of the appropriateness of the prudential treatment of investment firms qualifying as "small and non-interconnected" as well as of the conditions for such qualification."

30. Class 3 entities are considered, in general, as not posing significant risks to clients, the market or themselves. Therefore, Article 11(2) of the IFR alleviates the prudential requirements for these firms and removes these entities from the scope of own funds requirements based on the K-factor system and from some parts of the IFD. Small and non-interconnected investment firms therefore must only maintain own funds based on a maximum rule between the required permanent minimum capital (PMC) in Article 14 of the IFR or the own funds amount calculated on the basis of their fixed overhead requirement (FOR) according to Article 13 of the IFR.

31. There are nine conditions that must be met cumulatively in order to qualify as a small and non-interconnected investment firm in line with Article 12 of the IFR:

    a) AUM measured in accordance with Article 17 is less than EUR 1,2 billion;

    b) COH measured in accordance with Article 20 is less than either:

        i) EUR 100 million/day for cash trades; or

        ii) EUR 1 billion/day for derivatives;

    c) ASA measured in accordance with Article 19 is zero;

    d) CMH measured in accordance with Article 18 is zero;

    e) DTF measured in accordance with Article 33 is zero;

    f) NPR or CMG measured in accordance with Articles 22 and 23 is zero;

    g) TCD measured in accordance with Article 26 is zero;

    h) The on- and off-balance-sheet total of the investment firm is less than EUR 100 million;

    i) the total annual gross revenue from investment services and activities of the investment firm is less than EUR 30 million, calculated as an average on the basis of the annual figures from the two-year period immediately preceding the given financial year.

32. Article 12 of the IFR also provides a regulation to avoid circumventions. The conditions (a) (b) (h) and (i) shall apply on a combined basis for all investment firms that are part of the group.

Currently the notion of "group" taken into account includes also investment firms located in a third country.

33. Finally, Article 12 of the IFR contains an elaborated and differentiated system regulating the cases when firms do not meet one of the conditions described above any more as well as the case when a firm has not met one of these conditions yet but subsequently meets all the conditions. The regulation provides proportionality for firms not meeting the conditions set for small and non-interconnected firms anymore. Where an investment firm no longer meets the conditions set out in points (a), (b), (h) or (i), but continues to meet the conditions set out in points (c) to (g) of that paragraph, it shall cease to be considered to be a small and non-interconnected investment firm after a period of three months. This gives the firm time to adopt the enlarged regulations it has to comply with. Conversely, where an investment firm no longer meets any of the conditions set out in points (c) to (g), it will have to comply with the enlarged framework immediately when exceeding the threshold. Where an investment firm, which has not met all of the conditions for a small and non-interconnected firm subsequently meets them, it could be considered to be a small and non-interconnected investment firm only after a period of six months from the date on which those conditions are met. This period secures that the firm now permanently meets the condition set out for small and non-interconnected firms.

34. All conditions have been formulated quantitatively and not qualitatively. The conditions (a) to (g) are based on the fact that they have actually occurred. However, while the conditions (a) to (g) determine the level of risk that a firm may have to be classified as small and non-interconnected, the conditions (h) and (i) follow a different approach. They classify an investment firm as small and non-interconnected not by the risks the K-factor system stands for but upon size. The idea behind was that from a certain size onwards a firm cannot be regarded as small and non-interconnected anymore.

2.1 Discussion on the conditions for qualifying as a Class 3 investment firm

35. Based on the evidence gathered so far, feedback from both the industry and the supervisors shows that the Class 3 categorisation criteria function well and the framework is achieving its aim of de-complexifying the prudential treatment of small investment firms. Nonetheless, conditions (h) and (i) in Article 12 of the IFR may be analysed under the following aspects: i) usefulness; ii) calibration; and iii) scope of calculation. Additionally, a transitional provision, as well as implications for the methodology of the calculation of certain K-factors could be further discussed.

36. It might be useful to assess whether the condition (h) and (i) are needed. Under the former Article 4(2)(c) of the CRR, specific MiFID investment firms were exempted from the CRR. Those firms only provided the following services: Reception and transmission of orders in relation to

one or more financial instruments; Execution of orders on behalf of clients; Portfolio management; Investment advice. Moreover, they were not allowed to provide safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management and excluding maintaining certain securities accounts; nor were they permitted to hold money or securities belonging to their clients, so that they may not at any time place themselves in debt with those clients. Finally, the firms only providing advice and /or reception and transmission of orders only had to have Initial Capital while the others had to comply with the FOR.

37. The conditions of Article 12(1)(a) to (g) of the IFR correspond in their way to the specification of the former Article 4(2)(c) of the CRR. This means that the number of CRR-exempted firms was greater than the number of small and non-interconnected investment firms under IFR now because under the CRR the categorisation did not include conditions dependent on size, such as those in Article 12(1) (h) and (i) of the IFR do. Since in the period from 2013 to 2021 no significant problems were known that would have occurred as a result of the described CRR categorisation, it is worth discussing, whether the conditions (h) and (i) are needed at all. Nonetheless, having criteria reflecting more than one feature, and size-related information is particularly relevant for a framework built around the value of total assets (such as the IFR/IFD framework is) and the EBA does not consider it necessary to eliminate these two conditions.

38. In terms of assessment of whether the thresholds of specific conditions of Article 12(1) of the IFR should be reconsidered and given that no remarks on their functioning have been received, the EBA does not consider them problematic at this stage.

39. Regarding the scope of application, it should be clarified whether the criteria of Article 12(1)(a) and (b) of the IFR should only refer to investment firms within the European Union when applying Article 12(2) of the IFR. In this case, investment firms, which are part of the group but located outside the European Union would not be considered when measuring the conditions in points (a) and (b). As Article 12(2) of the IFR intends to avoid circumventions from the categorisation, it should be assessed, whether such kind of firms in the group create circumvention. Investment firms, part of the group, but established outside the European Union are covered by consolidation but do not have to comply with the IFR. They are also not allowed to provide services into the EU without permission. If they intend to provide investment services or perform investment activities with or without any ancillary services to retail clients or to professional clients, they have to establish a branch to be authorised (17). This branch would then be in the scope of Article 12(2) of the IFR.

17 *For further details see the MiFID II regime for the provision of investment services and activities in EU jurisdictions by third-country firms under Articles 39-43 of MiFID II.*

40. As Article 12(2) of the IFR intends to avoid arbitrage, these considerations as such cannot be made for the criteria (h) and (i) of Article 12(1) of the IFR. Regarding these criteria, an investment firm would be able to shift assets or revenue to a firm of the group outside the EU in order to avoid the application of some provisions in the IFR/IFD. On the other hand, if only the criteria (h) or (i) would make a firm not to be a small and non-interconnected one anymore, the K-factor system in the IFR still would not be applicable.

Question for public consultation:

Q2: Would you suggest any further element to be considered regarding the thresholds used for the categorisation of Class 3 investment firms?

2.2 Transition of investment firms between Class 3 and Class 2 categories

41. Two issues have been flagged notably by CAs on the transition of an investment firm from Class 3 to Class 2: i) the lack of a transitional period regarding the application of prudential requirements corresponding to the categorisation as Class 2; and ii) the frequency of the migration of investment firms between the two classes.

42. With regards to a transitional period for investment firms between Class 3 and Class 2 categories, it has been pointed out by supervisors that a three-month transition period could be granted to all investment firms no longer meeting the conditions set in Article 12(1) of the IFR. In their view, it is not clear why some investment firms have to comply with the full requirements of IFR/IFD immediately and others do not. Nonetheless, the transition from Class 3 to Class 2 cannot happen without notice or by accident, given that in some cases there is a need for authorisation ahead of using some K-factors, while the investment firm is expected to have a firm grasp of the evolution of its activity at all times. Moreover, the calculation of K-factor requirements in line with Article 12(3) of the IFR already includes transitional periods where this is considered relevant. An additional transition period would thus stand in the way of a prudent management of investment firms, since a move from Class 3 to Class 2 would represent an acknowledgement of an increase in activity of the investment firm and the investment firm is expected to manage the additional risks coming from the additional activity in line with the regulatory framework.

43. As far as the frequency of the migration between the two Classes is concerned, this may happen for entities that are close to the thresholds that separate the two Classes. As it currently stands, the conditions that must be met cumulatively in order to qualify as a small and non-interconnected investment firm in line with Article 12 of the IFR, do not contain any provision to prevent an entity to be requalified more than once during the same year. Consequently Article 12 of the IFR leaves room for firms to be requalified several times with a financial year, in case of thresholds being continuously breached upwards or downwards, so that classifications may, in certain circumstances, be quite volatile. A given investment firm

may be classified as Class 3 at the start of the financial year, as a Class 2 within the financial year, and again as a Class 3 by the end of the financial year, and vice versa. As continuous reclassifications of investment firms in this context are an undesirable outcome for all stakeholders, the conditions of Article 12 IFR should be reviewed in order to prevent an investment firm from being requalified several times during the same financial year or over a 12-month period, as the case may be. Consequently, a "freeze" period could be implemented, whose effect would be that the investment firm would be required to be classified as a Class 2 investment firm for a period of at least one year following its reclassification, regardless of whether the conditions of Article 12 IFR for becoming a Class 3 investment firm would be met within this timeframe.

Question for public consultation:

Q3: Do you have any views on the possible ways forward discussed above regarding the transition of investment firms between Class 2 and Class 3 should be introduced?

3. Fixed overheads requirements (FOR)

The CfA requires[18] to assess the adequacy of the prudential requirements and specifically refers to the calculation of the fixed overheads requirements.

3.1 Background

44. The own funds requirements on basis of the fixed overheads (FOR) laid down in Article 13 of the IFR finds its origins in Article 4 and Annex 4 of Directive 93/6/ECC on the capital adequacy of investments firms and credit institutions. It remained essentially largely unchanged by Article 21 of Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions and Article 97 of the CRR. According to the FOR, an investment firm must have an amount of own funds equal to a quarter of its fixed overhead. Two methods for calculating the FOR were possible under both directives.

45. The subtractive approach has been then determined as the relevant method for calculating the FOR according to Article 13 of the IFR. While under the CRR the items for deduction were determined exclusively by the Delegated Regulation under the application of Article 97 of the CRR, under the IFR some deduction points are already listed Article 13(4) of the IFR. The Delegated Regulation 2022/1455[19] then adds further items for deduction. The experiences of the years since 2014 have been taken into account and the wording of the deductible items that are being used have been adjusted accordingly. While the Delegated Regulation (EU) 2015/488 under the CRR listed eight items that can be deducted for the total expense, under Art 13(4) of the IFR and the Delegated Regulation (EU) 2022/1455 the number of items for deduction was, also as a result of the experience of the previous years, increased to fourteen.

46. The purpose of the FOR is to provide a 'minimum' to the requirements resulting from the K-factors methodology. The level of such minimum was set under the assumption that an investment firm would be required to hold own funds for an assumed wind down period, or a period for restructuring, of three months. The underlying idea is that this would aim at ensuring that the firms hold enough capital to close its operations in an orderly manner, as during such a period, the investment firm may not generate sufficient revenue to sustain its clients' operations properly. This is directly relevant to mitigating the risk to clients.

47. Under Article 96(2) of the CRR, the FOR acted also as a substitute to cover operational risk for investment firms dealing on own account (that fulfilled the criteria given in Article 96(1) a) and

[18] See section B.1.a) of the CfA.

[19] Commission Delegated Regulation (EU) 2022/1455 of 11 April 2022 with regard to regulatory technical standards for own funds requirement for investment firms based on fixed overheads (link).

b) of the CRR) as the provisions covering operational risk did not apply to investment firms. The function of a substitute for operational risk has been abandoned under IFR as the K-Factors under Risk-to-Market (RtM) and Risk-to-Firm (RtF) had been regarded as sufficient.

48. For the purposes of the Call for Advice, the analysis covers the following general and specific elements:

    a) Three months wind-down period;

    b) Deductibles related to specific business models;

    c) Expenses related to tied agents;

    d) Expenditures related to non-MiFID activities;

    e) Expenses related to exchange rate differences;

    f) Other elements.

3.2 Three months wind-down period

49. As stated above, the FOR set a minimum to the capital requirements of an investment firm based on the idea that such amount should be the same as the capital that might be needed for an orderly wind-down of the firm's operation in a three-month period. Such length, however, is assumed to be the same for all business models. It might be useful to analyse, whether the three-month period is still appropriate for all types of investment firms or whether some type of firms may need a longer period.

50. For this analysis, one should bear in mind that the FOR is not the relevant own funds requirement when the own funds requirement on the K-Factor basis results in a higher amount of own funds requirements. Furthermore, the SREP guidelines for investment firms explicitly require competent authorities to consider wind-down capital and address specific cases under which the possibility of a wind-down period extending beyond the envisaged 3 months.

51. In the context of the data collection to be carried out in parallel with the public consultation on this discussion paper, competent authority may be asked to provide a history of the cases when the wind-down period was longer than 3-months. The aim of this data collection is to assess whether the quantitative data regarding historic winding down periods support the three months set in the IFR for calculating the FOR. This information may also be useful to conclude on whether a differentiation is justified due to a difference in business models or rather because of firms' size.

Question for public consultation

Q4: Should the minimum level of the own funds requirements be different depending on the activities performed by investment firms or on firms' business model? If yes, which elements should be considered in setting such minimum?

3.3 Deductibles related to specific business models

52. It seems appropriate to reflect whether the current number of deductible items are sufficient for the purpose of the FOR or whether further items are to be developed. To that end, one may argue that different business models of investment firms would justify dedicated treatments.

53. On the one hand, Delegated Regulation (EU) 2022/1455 introduces specific requirement for market making firms, which is an example of a special treatment for a particular activity. On the other hand, fixed overheads requirements arise from how two investment firms set up their internal organisation, even maintaining similar business models in terms of services provided and activities carried out.

54. Furthermore, it is worth noting that identifying deductibles and relating them to business models would make the FOR calculation more complex, by multiplying the calculation methods and the cases to be considered. As an additional drawback, such approach would, potentially, reduce the consistency of application of those requirements.

Question for public consultation

Q5: Is it necessary to differentiate the deductibles by activity or by business model for the purpose of calculating the FOR? If yes, which items should then be considered and for what reasons?

3.4 Expenses related to tied agents

55. One might question whether expenses of tied agents should be added to the investment firm's total expenses and so increasing them. The reason behind is, that firms delegate activities to tied agents they otherwise carry out themselves.

56. In general, one has to distinguish between:
    a) expenses coming from the specific tied agent activity as described in Article 29 (1) of MiFID; and
    b) expenses coming from other activities the investment firm may has outsourced to the tied agent.

57. As the tied agent acts on behalf of the investment firm when providing investment service, the investment firm derives an economical advantage out of that activity from which it usually pays the fees to the tied agent. In this case, the fees paid to tied agents are already covered by income gained of the activity of the tied agent.

58. This justifies deducting fees from the investment firm's costs in the calculation of the fixed overheads. In case fees paid to the tied agents for a tied agent activity in the meaning of Article

29 (1) of MIFID are not covered, e.g., the tied agent purely promotes the investment firm's business, such costs are variable because they do not occur in a wind-down scenario.

59. However, in cases in which the investment firm has outsourced own activities not described in Article 29 (1) of MiFID to the tied agent, either the firm pays the tied agent, then the payment is an expense of the investment firm and within the FOR or, in case the investment firm does not pay, it has to take expenses for the outsourced activity into account under Article 1 (5) of the Delegated Regulation (EU) 2022/1455, which leads to the result, that such cost are also within the FOR calculation.

60. In case a breakdown of such costs is not available, an investment firm should be required to add to the figure representing the total expenses, only its share of the third party's expenses as it results from the business plan of the investment firm, as per Article 1(5) of the Delegated Act 2022/1455.

61. If considered by the point of view of the FOR being the amount of fixed costs expected for a three month wind-down period, a preliminary conclusion would be that adding expenses of the tied agent coming from the activity as described in Article 29 (1) of MiFID or other activities, as described before, to the firm's own expenses may be questionable because the investment firm can usually terminate the tied agent in the wind-down period. Nonetheless, this might not always be the case, as it might depend on the contractual agreement between the investment firm and the tied agent.

Questions for public consultation

Q6: Are expenses related to tied agents material for the calculation of the FOR to the extent to require a dedicated treatment for their calculation? If yes, are the considerations provided above sufficient to cover all the relevant aspects?

3.5 Expenses related to non-MiFID activities

62. Investment firms may provide additional services outside the scope of MiFID investment services; examples would be crowdfunding service in the meaning of Regulation (EU) 2020/1503 or other services whose legal basis for the providing firms require the FOR. Another example would be investment firms offering, on the basis of the equivalence criterion, the services under MiCAR and which are not subject to the own funds requirements set for CASP. Currently, MiCAR-services related expenses are already included in the calculation of the FOR, as set out in the Delegated Regulation 2022/1455, as they are not carved-out. There might be therefore a case on whether only the expenditures resulting from the investment firm's MiFID activities and services should be used for the calculation of the FOR, excluding the costs arising from other activities.

63. One element to be considered is therefore, on the one hand, that the expenses resulting from non-MiFID activities could be regarded as not necessary for the wind-down period. On the other hand, although that might be true when having exclusively the winding down of the investment services in mind, it could be problematic with view of the wind-down of the investment firm itself. For example, in cases where most costs come from business outside MiFID service or related service, ignoring these costs could lead to a disorderly wind-down of the investment firm itself. This would be in contrast with the objective of the FOR of protecting clients from a disorderly wind-down of the investment firm.

64. Furthermore, as the FOR is calculated on basis of the investment firm's financial statement, it seems often difficult to distinguish for some expenses, from which part of the business they come from. In cases it is possible to distinguish, it may lead to further administrative effort and costs.

65. Should the calculation of the FOR allow the possibility to exclude costs related to non-MiFID activities, an option could be to set the costs according to the ratio of the income from the different business areas.. Difficulties would arise also under this approach. For example, the ratio of the income from the different business areas might be volatile in time, making the calculation of FOR also more volatile. Furthermore, such approach would lead to further administrative effort and costs on investment firms' side.

Question for public consultation

Q7: Should the FOR be calculated distinguishing the costs related to non-MiFID activities, which criteria should be considered? What kind of advantages or disadvantages would this have in practice?

3.6 Expenses related to foreign exchange rates difference

66. One example of a further deductible item is related to foreign-exchange rate differences. These are relevant for the money, with amounts in foreign currency, belonging to clients and for which the investment firm provides custody services in accordance with MiFID. The question is then whether fluctuations related to exchange rate changes should be considered as fixed costs or as variable costs. When they are variable costs, they should be eligible for deduction from the total costs for the purposes of the FOR.

67. To see how these costs might be eligible for deductions from total costs, it is worth recalling the requirements of the directive on the safeguard of financial instruments and funds

belonging to clients[20]. Article 2(1) of the Delegated Directive 2017/593 prescribes: "investment firms […] to keep records and accounts enabling them at any time and without delay to distinguish assets held for one client from assets held for any other client and from their own assets". However, Article 3 of that directive allows a certain degree of divergence: "If the applicable law of the jurisdiction in which the client funds or financial instruments are held prevents investment firms from complying […] Member States shall prescribe requirements which have an equivalent effect in terms of safeguarding clients' rights.

68. Therefore, in the first case (i.e., in case client money is segregated in accordance with the applicable conditions in Article 2 of the Delegated Directive 2017/593), there is a case in supporting that costs related to foreign-exchange fluctuations should be considered as a deductible from the total costs for the FOR calculation. However, in cases where the derogation in Article 3 of the same directive was used, it appears more difficult to support the same conclusion.

69. If the considerations above are noteworthy, since this aspect does not appear neither in the current text of the IFR, nor of the Delegated Regulation (EU) 2022/1455, it might be appropriate to consider including it, together with the two conditions explained above.

Question for public consultation

Q8: Should expenses related to fluctuation of exchange rates be included in the list of deductions for the calculation of the FOR? If yes, which criteria should be considered in addition to the ones suggested above?

3.7 Other elements

70. According to Article 13(2) of the IFR, a competent authority may adjust the amount of capital requirements where the competent authority considers that there has been a material change in the activities of an investment firm. In Article 3 of the Delegated Regulation (EU) 2022/1455 there are provisions that specify what absolute or relative amount is to be considered as a material change. However, it would be useful to provide some clarification and guidance regarding what should be taken into account when adjusting the capital requirements in such a case. This clarification may, for example, point out, that not every exceedance of the thresholds set out in Article 3 of that Delegated Regulation is relevant. The reason being that exceeding the threshold may be caused by an increase or decrease of the firm's business activity other than the provision of investment services.

[20] Commission Delegated Directive (EU) 2017/593 of 7 April 2016 supplementing Directive 2014/65/EU with regard to safeguarding of financial instruments and funds belonging to clients, product governance obligations and the rules applicable to the provision or reception of fees, commissions or any monetary or non-monetary benefits (link).

71. Other element to be clarified is that Article 1, paragraph 1, of the Delegated Regulation (EU) 2022/1455 states: "*the 'figures resulting from the applicable accounting framework' shall refer to figures of an investment firm's most recent audited annual financial statements after distribution of profits or annual financial statements where investment firms are not obliged to have audited financial statements*". In the current practice, the expression 'after distribution of profit' seems to lead to different interpretations. Some firms understand that profits must be deducted from the total expenses; some others believe 'after' stands for a time criterion, i.e., only after the balance sheet has been approved and profits have been distributed, the investment firm is allowed to calculate FOR coming from the costs as represented in the balance sheet.

72. A further correction would be to amend Article 13(4) of the IFR, with specification that items could be deducted only in case they are included into total expenses, to avoid any possible misreading.

4. Review of existing K-factors

73. With the CfA, the Commission expects[21] an assessment of whether all relevant risk categories pertaining to the activities and operations of an investment firm are adequately captured by the K-factors methodology. In particular, the assessment should consider whether the range of operational risks that are faced by investment firms are adequately reflected in their own funds requirements.

74. This section provides a description of the main points of discussion regarding the existing K-factors and presents the possible way forwards. Section 5 discusses the possibility to introduce new K-factors.

4.1 Background

75. The calculation of own funds requirements via K-factors is one of the key innovations brought by the IFR/IFD regime. The K-factors under Risk-to-Client (RtC) capture client assets under management and ongoing advice (K-AUM), client money held (K-CMH), assets safeguarded and administered (K-ASA), and client orders handled (K-COH). The K-factor under Risk-to-Market (RtM) captures net position risk (K-NPR) in accordance with the market risk provisions of the CRR or, where permitted by the competent authority for specific types of investment firms which deal on own account through clearing members, based on the total margins required by an investment firm's clearing member (K-CMG). Investment firms have an option to apply K-NPR and K-CMG simultaneously on a portfolio basis.

76. The K-factors under Risk-to-Firm (RtF) capture an investment firm's exposure to the default of its trading counterparties (K-TCD) in line with the provisions for counterparty credit risk based on the CRR, although slightly simplified. Concentration risk in an investment firm's large exposures to specific counterparties is addressed by K-CON which is based on the provisions of the CRR that apply to large exposures in the trading book. K-DTF captures the transactions that an investment firm enters through dealing on own account or the execution of orders on behalf of clients in its own name.

77. The overall own funds requirement under the K-factors is then the sum of the requirements of the K-factors under RtC, RtM and RtF. In principle, all MiFID core investment services and activities should have a K-factor associated with them[22], but this might not always be explicit. K-AUM, K-ASA, K-CMH, K-COH and K-DTF relate to the volume of activity referred to by each

[21] See section B.1.c) of the Call for advice.

[22] The list of core services investment firms can provide or perform is in Section A, Annex I of MiFID (link).

K-factor. If a firm does not undertake the relevant activity, the amount of the K-factor requirement equals zero.

4.2 Client Orders Handled (COH): Placing of financial instruments without firm commitment

78. The K-COH does not specify explicitly all the activities that should be taken into account in its calculation, which may raise problems of interpretation of the IFR and technical standards. In particular, the investment service: 'Placing of financial instruments without a firm commitment basis' (point (7) of Section A of Annex I to Directive 2014/65/EU) is not explicitly mentioned in relation to any K-factor.

79. Concerning the placing without commitment, slightly different transpositions of MiFID in national regulations lead to different readings on if and how the K-COH would capture this particular service. Investment firms would then have the possibility to decide how to capture this service in their calculations.

80. An investment firm performing this activity for another entity performs only a 'sales' function in that the investment firm agrees to sell the financial instruments of a third party to the public, without the investment firm having an obligation to buy any of the financial instruments that could not be sold to the public. There is also a level playing field issue, since only minor differences distinguish placement agents from firms transmitting or executing orders, as in one case the service is connected to the issuance of financial instruments as opposed to the secondary market sale of these instruments.

81. Furthermore, the risk faced by the investment firm itself while performing this activity is limited, but this is not necessarily the case for the investment firm's clients. There is therefore also a risk for clients.

82. There might be therefore a case in clarifying the IFR definitions stating explicitly that the activities related to the placing without a firm commitment basis should either be captured under the COH or, should the process be carried out on the book of the investment firm, under the DTF, so that the activity is always to be captured under one or the other K-factor.

4.3 Client Orders Handled (COH): Name give-up operations

83. 'Name give-up' is an informal term where the order execution service whereby the institution puts the two counterparties to the transaction in touch with each other without interposing itself and just receives a commission.

84. The EBA has already clarified this point in a QnA[23] by specifying three cases to be considered depending on whether the activity should be taken into account in the calculation of the K-COH.

85. It would be beneficial that this activity is explicitly mentioned either in the IFR or in the relevant delegated regulation[24] as well as the three possible cases of treatment mentioned in that QnA.

4.4 Client Orders Handled (COH): contract related to market-making activities

86. Investment firms authorised to trade on its own account as part of market making are mandated to provide liquidity by buying and selling securities on the market but acts solely on behalf of third parties. The gains or losses linked to the transactions are posted to the issuer's account and the investment firm's remuneration is a flat fee.

87. A clarification may be needed on whether liquidity contracts are included in the K-factors, as the interpretation seems unclear and differs across investment firms. As a result, under one interpretation, some investment firms that assumes that that activity is not explicitly covered by an existing K-factor, calculates a zero own funds requirement against that activity. Other firms, however, seem to assume that those activities should be included in the calculation of the K-COH or of the K-DTF. Because of these different interpretations, there is a risk of regulatory arbitrage.

88. It is therefore worth considering that this activity is explicitly mentioned in the IFR text and covered by a K-factor, being either the K-COH and K-DTF.

4.5 Assets under management and ongoing advice (K-AUM): definition of ongoing advice

89. ‘Investment advice’ is defined in IFR via reference to MiFID, Article 4(1), point (4). ‘Investment advice of ongoing nature’, however, is not a MiFID definition, and it is defined in Article 4.1(21) of the IFR as: ‘investment advice of an ongoing nature’ means the recurring provision of investment advice as well as the continuous or periodic assessment and monitoring or review of a client portfolio of financial instruments, including of the investments undertaken by the client on the basis of a contractual arrangement’. Subsequently, the term ‘Assets under management’ for the purposes of the IFR, is defined in in Article 4.1(27) as: ‘the value of assets that an investment firm manages for its clients under both discretionary portfolio

[23] See QnA QA2021_6316 (link)

[24] Commission Delegated Regulation (EU) 2022/25 of 22 September 2021 with regard to regulatory technical standards specifying the methods for measuring the K-factors (link).

management and nondiscretionary arrangements constituting investment advice of an ongoing nature'.

90. Concerns were raised on whether the wording 'recurring provision of investment advice' in those definitions is clear enough to ensure a harmonised application, in particular because it impacts the calculation of the K-AUM.

91. Various options could be considered in clarifying this terminology. For example, the recurring provision of investment advice could be conditioned to the existence of a contract with the clients envisaging the provision of that services on a non-occasional basis. This would result in a narrow interpretation of that definition. On the opposite side of the spectrum, the regulation may define what constitute a 'non-recurrent' advice, so to have a broader interpretation of that definition. In both cases, it is not clear whether these specifications would facilitate the implementation of the K-AUM calculation or rather they would add complexity because of the additional constraints.

92. In seeking for a clarification, it should be kept in mind that, should the IFR include a narrow definition, this could lead to a very limited application of the concept of ongoing advice for the purpose of calculating the AUM, which might not be in line with the original EBA advice[25] and might result in an increase of the risk to clients.

Question for public consultation

Q9: Should the concept of 'ongoing advice' be further specified for the purpose of calculating the K-AUM? If yes, which elements should be taken into account in distinguishing a recurring provision of investment advice from a one-off or non-recurring one?

4.6 Assets under management and ongoing advice (K-AUM): delegation

93. An exemption from the general measurement of the AUM is envisaged in Article 17(2) of the IFR. However, whereas the first subparagraph of Article 17(2) refers to the AUM, the second subparagraph states that 'assets shall be excluded from the total amount of assets under management' if another financial entity has formally delegated the management of assets to the investment firm. There is no reference to the delegation of non-discretionary ongoing advice, which is part of the K-AUM.

94. This is reflected accordingly, and more explicitly, in the wording of Article 2 (2) of the Delegated Regulation (EU) 2022/25. The result is that assets under advice are excluded from the

[25] See Opinion of the European Banking Authority in response to the European Commission's Call for Advice on Investment Firms, Recommendation 28, p.8 (link).

exception of the second subparagraph of Article 17 (2) of the IFR, even if the delegation of assets under portfolio management is, considering the risk, comparable to the delegation of assets under advice.

95. Therefore, including providing advice into the exemption of Article 17 (2), subparagraph 2 of the IFR would avoid double counting of assets, as the delegated assets under advice are already covered by the own fund requirement of the financial institution that asked for advice from the investment firm. Should the IFR be updated in this sense, it could be considered to delete Article 2 (2) of the Delegated Regulation (EU) 2022/25 accordingly.

96. The impact of such change would then be that the investment firms, avoiding double counting of the assets related to AUM, would have lower own funds requirements on the basis of that K-factor. On the flip side, however, the number of 'small and non-interconnected firms' (Class 3) may potentially increase because the level of AUM is considered in one of the thresholds.

4.7 Daily Trading Flow (K-DTF)

97. The K-DTF should also capture the operational risks connected to trading (as explained in Recital 26 of the IFR: 'K-DTF captures the operational risks to an investment firm in large volumes of trades concluded for its own account or for clients in its own name in one day which could result from inadequate or failed internal processes, people and systems or from external events'). Nonetheless, Article 4(33) of the IFR defines the DTF as: 'daily trading flow means the daily value of transactions that an investment firm enters through dealing on own account *or* the execution of orders on behalf of clients in its own name[...]'. In this sense, the K-DTF is similar to the other K-factors in capturing the activities performed by an investment firm as the volume of operations (then multiplied by given coefficients) and it is not limited to operational risk only.

98. Despite the fact that the K-DTF is not conceptually different from other K-factors, some market participants expressed concerns on the effectiveness of the K-DTF in setting the capital requirements for firms trading on own account and/or executing orders on behalf of clients in their own name. The example gives the impression that, in certain cases, K-DTF seems to lead to outcomes consisting of either low amounts of capital requirements, or to counterintuitive results if compared across investment firms. For example, it can be questioned if the current design of K-DTF measures the actual risk of trading large volumes of trades as the current calculation is made by the amount of trades multiplied by value of trades. For example, this results in a higher K-DTF requirement for a firm that concludes a single trade of EUR 1 bn than a firm concluding 1 bn trades of EUR 0,01 each. In this example, it may be argued that the large number of transactions in the second case may result in a profile that is not less risky than the first case, despite the overall volume of operations being lower.

99. Supervisory data is not granular enough to fully investigate this issue, as the data only provides insight into the DTF amount and not the underlying value of transactions and the number of

transactions themselves. Before suggesting any correction to this K-factor, it is advisable to gather at least some qualitative information to understand if those inconsistencies exist and what their source is. A detailed quantitative analysis via a data collection would be a major exercise, however, and unlikely to lead to conclusive results given the frequency and complexity of the operations.

100. However, evidence and analysis may be provided by market participants, highlighted the drawbacks. Against those elements, if provided, the K-DTF calibration could be revised, or an alternative K-factor could be developed for the purposes of the IFR/IFD review.

101. One further aspect to consider in the calculation of the K-DTF is that certain investment firms conclude buy/sell transactions simultaneously, with the firm's remuneration being made thanks to the price difference. In these cases, the investment firm therefore finds the buyer and seller of the securities to conclude the transaction and only interposes its balance sheet over the settlement period, e.g., for a maximum of 5 days. It is implicit, in the current definition of the K-DTF, that both legs of this operation are to be taken into account in the calculation. This could be clearly mentioned either in the IFR text or in the relevant delegated regulation[26].

Questions for public consultation

Q10: Does the K-DTF provide a proper level of capital requirements for the provision of the services Trading on own account and execution of order on behalf of clients on account of the investment firm? If not, what elements of the calculation of the K-DTF present most challenges?

Q11: Would you have any examples where the calculation of the K-DTF based on comparable activities or portfolios results in very different or counterintuitive outcomes? If yes, how could the calculation of the K-DTF be improved?

4.8 Concentration risk in the trading book (K-CON): scope restricted to the trading book

102. Another issue is represented by the scope of K-CON: Article 36(1) of the IFR limits the application of the K-CON only to financial instruments in the trading book of an investment firm, leaving out of scope non-trading book instruments. The current scope of application

[26] Commission Delegated Regulation (EU) 2022/25 of 22 September 2021 with regard to regulatory technical standards specifying the methods for measuring the K-factors (link).

leaves incentives for arbitrage since investment firms have a capital advantage in booking instruments in the non-trading book.

103. In the CRR, credit institutions are subject to a different treatment of concentration risk depending on whether the financial instruments are booked in the trading book or in the non-trading book: items in the trading book face a prudential treatment similar, though proportionate, to the one envisaged in the IFR, while for items in the non-trading book, Article 395 of the CRR mandates a hard limit that cannot be breached by credit institutions. Section 6.3 discusses the role of the definition of trading book and its demarcation in more details.

104. The design of K-CON currently explicitly ignores significant concentration risks that are not part of the trading book. These can be very significant for certain investment firms providing individual portfolio management, which might not be exposed to concentration risks via the trading book, but might be via the non-trading book, relatively to their balance sheet. Since opportunities for regulatory arbitrage should be limited to the extent possible and all material risks should be capitalised, a possible way forward could be recommending extending the K-CON scope of application also to the non-trading book positions of an investment firm, or to provide a 'hard limit', similar to the one envisaged for credit institutions in the CRR. If this option is pursued, the notion of "client" for the purpose of Part Four of the IFR should be revised in order to avoid unintended consequences (e.g. including segregated accounts in the scope of K-CON).

4.9 Concentration risk in the trading book (K-CON): notion of 'client'

105. The notion of 'client' that is considered in determining counterparty risk exposures (K-TCD) and concentration risk exposures (K-CON) needs to be clarified in the IFR. Several interpretations are possible depending on the IFR articles.

106. In Recital 22 of the IFR, it is stated that 'the K-factors under the denomination RtF reflect an investment firm's exposure to counterparty default risk (K-TCD) in accordance with the simplified provisions on counterparty credit risk based on Regulation (EU) No 575/2013, to the concentration risk related to an investment firm's large exposures to specific counterparties based on the provisions of that Regulation that apply to large exposures in the trading book (K-CON), and to the operational risks related to an investment firm's daily trading flow (K-DTF)'.

107. This suggests that concentration risk applies to all large exposures in the trading book, while the definition of concentration risk appears to be limited to client exposures. Article 4(1)(31) of the IFR refers to 'concentration risk' (or CON): 'exposures in an investment firm's trading book to a client or group of connected clients in excess of the limits set out in Article 37(1)'. Finally, Article 4(1)(4) of the IFR includes the following definition: 'client means a client within the meaning of Article 4(1)(9) of Directive 2014/65/EU, except that for the purposes of Part 4 of this Regulation, 'client' means any counterparty of the investment firm'.

108. On the basis of the definition of the notion of client, some investment firms may consider all their intra-group or external cash credit positions towards clearing members as a concentrated risk on its non-client partners. This interpretation does not appear to be erroneous in the sense of Article 4(1)(4) of the IFR, which applies to the calculation of concentration risk, according to which any counterparty, even a bank counterparty and an intra-group counterparty excluding financial instrument transactions, is a client.

109. On the other hand, it is not entirely clear whether the calculation of large exposures should take into account the balances of an investment firm's accounts with its banks, for example with a broker that is in the same group and the initial margin accounts with its clearing agents. These transactions would therefore not be accounted as transactions with counterparties.

110. The consideration of separate accounts is clear (i.e., they are excluded from the calculation of large exposures) and, from a strict reading of the IFR/IFD, the exposures to banks/counterparties related to cash positions, security deposits, should also be included in the concentration risk even though these 'partners' are not clients as such. In the context of the Call for Advice, it may be beneficial to explore if the inclusion of the latter is proportionate and fit for the business model of investment firms.

4.10 Clearing Member Guarantee (K-CMG)

111. In accordance with the IFR, the K-NPR captures net position risk in line with the market risk provisions of the CRR. As an alternative methodology, the IFR allows certain investment firms that deal on own account through a clearing member, to set their capital requirements based on the total amount of margins required by that clearing member (K-CMG), where authorised by the investment firm's competent authority.

112. Further criteria have to be met for the use of the K-CMG, in accordance with Article 23 of the IFR as well as the related Delegated Regulation (EU) 2022/244.[27] Furthermore, the IFR includes some constraints on the calculation of the margins (and therefore of the K-CMG), which include that the margin models used by that clearing member has to be designed to achieve a level of prudence similar to that required in EMIR[28] and a multiplier of 1.3 has to be applied to the amount of collateral requested by the clearing member.

113. Diverging from the approach based on the K-NPR would raise level playing field issues because, among others, certain investment firms trading on own account (even with similar business models to those applying the IFR) can be subject to CRR, where the K-CMG approach is not

[27] Commission Delegated Regulation (EU) 2022/244 of 24 September 2021 with regard to regulatory technical standards specifying the amount of total margin for the calculation of the K-factor 'clear margin given' (K-CMG) (link)

[28] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (link).

allowed. Nonetheless, it is worth recalling that this aspect was clear to the co-legislators when the K-CMG was agreed during the development of the IFR.

114. It is also worth recalling that the IFR does not fully implement the EBA recommendation which envisaged that, for position risk, 'the overall capital requirement for RtM would then be the higher of K-NPR and K-CMG'.[29] Therefore, there is room for regulatory arbitrage, with an investment firm opting between K-NPR and K-CMG only because one is lower. Some of this is constrained by the requirements in Delegated Regulation 2022/244, which limits how the permission for the use of the K-CMG is granted. Nonetheless, an analysis of the currently provided K-CMG permissions and possible risks of regulatory arbitrage is recommended.

115. The relevant information can be obtained, on a qualitative basis, from competent authorities who have experience in granting or declining the use of the K-CMG. On a quantitative basis, investment firms should be able to provide the history of how many times the K-CMG requirements were not enough to cover the losses of the portfolios associated to it. Should the collateral collected by the clearing members adequate, the data should show no or a very limited number of cases where the required amounts were not sufficient. Should that not be the case, it may be that the level set for the collateral collected by the clearing member is not sufficient; by the point of view of the IFR, that would indicate a need to either review the methodology or to correct the 1.3 coefficient.

4.11 Assets under safekeeping and administration (K-ASA)

116. Another element highlighted by some competent authorities concerns the K-ASA. It was noted that, if the current calibration of the K-factor coefficient for K-ASA is too high, then this would put investment firms in a competitive disadvantage with respect to peers, including banks, that do not have the same 'direct' capital requirement.

117. Nonetheless, it should be kept in mind that the ASA are related to the risks of clients experiencing losses because of failure of the investment firms in safekeeping the securities. Credit institutions have capital requirements, including those against operational risk, that should cover losses resulting from inadequate or failed internal processes, people and systems or from external events. They are also subject to multiple other requirements. In this sense, it is not obvious whether there is a competition issue in this specific area.

118. Because of that, revising the definition or the calibration of the K-ASA in the context of the IFR revision would require some strong evidence. Nonetheless, since most of the investment firms provide multiple services, a one-to-one comparison (i.e., comparing the requirements for banks and requirements under IFR specifically for the safekeeping and administration of assets) may be challenging, because of the limited data available.

[29] The EBA opinion EBA-OP-2017-11 in response to the European Commission's call for advice of September 2017 – Annex, paragraph 152, p.48 (link).

Questions for public consultation

Q12: What are the elements of the current methodology for the calculation of the K-ASA that raise most concerns? Taking into account the need to avoid complexifying excessively the methodology, how could the calculation of the K-ASA be improved to assess those elements?

Q13: Clients' asset protection may be implemented differently in different Member States. Should this aspect be considered in the calculation of the K-ASA? If so, how should that be taken into account in the calculation?

5. Risks not covered by existing K-factors

119. This section discusses risks or activities that are not captured by existing K-factors and could therefore suggest the need for new K-factors. It should be recalled that the decision to leave some risks (and therefore K-factors) outside the Pillar 1 framework was a conscious decision when IFR was developed. The question is therefore on whether the experience of the competent authorities so far justifies modifying the current framework, whether such risks could be captured under the existing K-factors or rather be left to the supervisory review process.

5.1 Non-trading book positions

120. Other than items subject to exchange and commodity risk, non-trading assets and commitments are not considered in Pillar 1 capital requirements in the IFR/IFD framework, although they may be relevant for some investment firms. The current K-factor regime does not envisage any capital requirement for exposures outside the trading book, other than for items subject to exchange and commodity risk referred to in Article 21(4) of the IFR, which include for instance loans to customers, exposures to credit institutions, illiquid financial assets, financial instruments held for purposes other than trading, or off-balance sheet commitments (e.g., capital or performance guarantees).

121. On the one hand, one could argue in favour of the introduction of a new K-factor as these exposures entail some level of credit risk that is not a Pillar 1 requirements (although not overlooked, as the SREP guidelines[30] do address them). Furthermore, this characteristic of the framework creates an incentive for regulatory arbitrage. On the contrary, simple own funds requirements, inspired by the standardised approach for credit risk, would ensure appropriate levels of capital for these exposures, reduce the incentive to arbitrage while, depending on how implemented, not diverge from the principle of proportionality.

122. On the other hand, these risks have deliberatively and explicitly been kept outside the Pillar 1 requirements for investment firms as part of creating a proportional regime customised to the specific nature of investment firms. This is visible in other parts of the regime as well, including Article 29 of the IFD ('Treatment of risks'), which requires investment firms to have robust strategies, policies, processes and systems for the identification, measurement, management and monitoring of risks. One may also argue that, in most of the cases, those exposures should be limited for an investment firm, and the remaining cases could be addressed under Pillar 2

[30] Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) under the Investment Firms Directive (link).

because of their specificities. For non-trading book exposures, it may be envisaged the introduction of a simplified credit risk framework, similar to the standardised approach for credit risk in place for credit institutions. A materiality threshold may also be established in order to apply the credit risk framework in a proportional fashion.

5.2 Non-trading book positions in crypto-assets

123. Exposures in crypto-assets relate to the previous section on the possibility to introduce a new K-factors for activities not currently accounted for in the IFR. For instance, the risks related to crypto-asset transactions placed in the banking book are not captured by the current K-factor regime. Should they be included in the calculation of own funds requirements, their capitalization may not be straightforward.

124. A new K-factor could be introduced based on the volume of crypto-assets in the non-trading book to capture the risk related to the potential loss of value resulting from the volatility of crypto-assets. Alternatively, in order to avoid introducing a new K-factor, the risk stemming from crypto assets may be capitalised widening the scope of K-NPR by including in the calculation crypto assets in the non-trading book for the sole purposes of own funds requirements.

125. For a better alignment to credit institutions, investment firms could be asked to treat crypto assets in line with the treatment envisaged for credit institutions under the banking standards[31]. It could be considered that for investment firms, other than those small and non-interconnected, holding Group 2[32] crypto assets over a predefined amount, the capitalisation is based on the 1,250% risk weighting factor. Holdings over a certain amount of Group 1 crypto assets could be addressed by the aforementioned extension of the scope of K-NPR.

Questions for public consultation

Q14: Should crypto-assets be included into K-factor calculation, either as a new K-factor or as part of K-NPR?

5.3 Operational risk for firms calculating the K-DTF

126. In the IFR framework, operational risk is explicitly capitalised for firms trading on own account or executing orders for clients on own name via the K-DTF. The K-DTF is addressed in Section 4.7. However, K-DTF results, in the opinion of some competent authorities, in disproportionally low own funds requirements. Nevertheless, it has been observed that operational risk may be a significant source of losses for trading activities, for example via execution errors, pricing

[31] Prudential treatment of crypto-asset exposures (SCO60), 16 December 2022, BCBS, (link).

[32] Idem. See in particular page 2 summarising the Group 1/Group 2 structure.

mistakes, rogue trading frauds, IT failures, cyber-attacks. Therefore, an alternative K-factor could better account of the operational risk than the K-DTF.

127. One option would be reverting to the basic indicator approach, calculating own funds requirement as a percentage of the average over the three years of the relevant indicator (as set out for banks in Article 316 of Regulation (EU) No 575/2013). However, as the relevant indicator used for this approach might be too broad (as the DTF applies to investment firms trading on own account or investment firms that execute orders on behalf of clients in their own name), an alternative would be to use the standardised approach and refer only to the category 'trading and sales'.

128. Another option would be the approach originally envisaged in Article 96 of the CRR, where these investment firms would then have to capitalise the K-Factors under RtM and add the FOR requirement (rather than applying the maximum between FOR and K-factors, as per current IFR framework).

129. Furthermore, it should be noted that, most often, investment firms were not previously subject to the operational risk framework under CRR. Therefore, there is merit considering the introduction of a threshold over which this risk would apply rather than applying it to all investment firms engaged in trading activities.

Questions for public consultation

Q15: In the context of addressing operational risk for investment firm trading on own account, is there any further element to be considered to ensure that the requirements are proportionate to their trading activities?

Q16: The discussion paper envisages the possibility to rely on alternative methodologies with respect to the K-DTF. If the respondents suggest an alternative approach, how would this refer to the two activities addressed under the K-DTF (trading on own account and execution on own account on behalf of the clients)?

5.4 Investment firms operating trading venues

130. In principle, all MiFID investment services and activities should have a K-factor associated with them. However, there is no K-factor associated with operating an MTF or an OTF (MiFID services 8 and 9) which gives rise to a concern that the risk associated with operating a trading venue may not be adequately addressed by the current IFD/IFR.

131. It is worth recalling that also this specific aspect was not overlooked in the development of the IFD/R, but rather a deliberate recommendation aiming at maintaining the framework as simple as possible.

132. However, because of their specific role as trading venues, a few elements should be considered. Firstly, all MTFs and OTFs could be excluded from the definition of small and non-

interconnected investment firms, so that they would have the requirement to always calculate and apply the K-factors relevant to them. In this case the definition of 'small and non-interconnected investment firm' in Article 12 of the IFR would need to be amended.

133. Second, depending on how the trading venue operates, it is possible to envisage that they should be required to calculate either the K-COH or the K-DTF, in accordance with whether or not they operate on their own name. However, MTF operators may not receive and transmit, execute or deal on own account as they operate a multilateral system bringing together buyers and sellers in a way that results in a contract. For the MTF that only to facilitates transactions via a system, without receiving transmitting or executing the transaction, a different K-factor would need to be considered.

134. Finally, it should also be considered that investment firms on the basis of the equivalence criterion under MiCAR could operate a trading platform for crypto-assets and they would not be charged with any own funds requirement under MiCAR.[33]

135. In practical terms, this would increase the capital requirements with respect to the ones applicable today. As it is not possible to estimate the cost of such change, an ad-hoc data collection is necessary before concluding on a policy recommendation.

5.5 Investment firms providing other prudentially regulated or non-regulated services

136. In some cases, investment firms are authorised or permitted to provide also other services and activities, which are not covered by the prudential requirements of the IFD and IFR. However, these could pose potential risks to clients. It is therefore relevant to review and assess whether these activities should be covered by separate (potentially new) K-factors, which would also include the non-core activities of investment firms.

137. As contemplated in Sections 5.4 and 9.1, there could be a case for considering K-factors suitable for other regulated services which investment firm can provide, such as the provision of services under MiCAR, covering not only transactions with crypto-assets above, but also provision of other services relating to crypto-assets especially credit granting by extending crypto-asset based facilities and/or facilities backed by crypto-asset collateral.

138. Similarly, in case of provision of crowdfunding service, the IFR could explicitly cover the cases where the investment firm is also authorized to provide crowdfunding services. Article 11 of ECSPR lays down the prudential requirements for crowdfunding services providers. However, these do not apply to investment firms covered by the IFR. Therefore, it may be appropriate to assess whether to include specific prudential requirements for investment firms providing

[33] The interaction of IFR with other regulations is also addressed in Section 9.

services related to crowdfunding, or explicitly establish which K-factor covers these activities and the risks posed to clients.

Questions for public consultation

Q17: When addressing other activities an investment firm may perform, which elements, on top of the discussed ones, should be also taken in consideration?

6. Implications of the adoption of the Banking Package (CRR3/CRD6)

6.1 Adoption of the fundamental review of the trading book for investment firms

139. The CRR2 transposed into the EU law the revised Basel standard on the calculation of the capital requirements for market risk, called the fundamental review of the trading book (FRTB). The FRTB includes an alternative standardised approach and an alternative internal model approach.

140. In the CRR2, the use of the FRTB is for reporting purposes only, and is mandatory for institutions whose size of on- and off-balance-sheet business that is subject to market risk is equal to or higher than each of the following thresholds, on the basis of an assessment carried out on a monthly basis using data as of the last day of the month according to Article 325a(2) of the CRR:

a) 10 % of the institution's total assets;

b) EUR 500 million.

141. Under the CRR3, the use of the FRTB will be mandatory also for capital requirement purposes, starting 1 January 2025. For institutions below the thresholds, the simplified standardised approach will be available, which consists in the current standardised approach, with new risk category specific multipliers for each risk category that increase capital requirements. Under the IFR, investment firms will continue to use the current standardised approach (i.e. the method envisaged in the CRR2) and will not be subject to the new simplified standardised approach envisaged in the CRR3. In this regard, the review of the IFR should amend the relevant provisions in order to introduce the simplified standardised approach for investment firms.

142. For investment firms, capital requirements for market risk are calculated under K-NPR and K-CMG. Article 22, par. (b) and (c) of the IFR gives the optionality for investment firms to use the FRTB (either alternative standardised or alternative internal model approach). However, Article 57(2) of the IFR shifts the use of the FRTB for investment firms until the latest date between 26 June 2026 and the date of application for banks as capital requirements.

143. The discussion on the use of the FRTB for investment firms is limited only to class 2 investment firms authorised to perform activities (3) and (6) of MiFID, since class 3 investment firms cannot have a positive K-NPR or K-CMG, and class 1 minus and class 1 investment firms are subject to CRR (thus already in scope of the FRTB).

144. The FRTB is characterised by a high granularity and risk sensitivity, counterbalanced by a material complexity in its implementation and use.

145. With regards to Class 2 investment firms, three options may be available:

a) introduce the FRTB alternative standardised approach as a mandatory methodology for firms that breach an absolute threshold to be defined following the data collection (the relative threshold is not meaningful for investment firms since their non-trading book activities are ancillary to the trading book business);

b) introduce the FRTB alternative standardised approach as an optionality for investment firms, regardless of the size of their trading book, subject to the approval of the NCA;

c) disapply the use of the FRTB for investment firms.

146. For options a) and b), the use of the FRTB alternative internal model approach may be allowed, subject to all the requirements envisaged for banks. In addition, when the use of the FRTB is mandatory (option a) or authorised (option b) it should be applied to the whole trading portfolio (and to the FX and commodity risk in the non-trading book), i.e. the CMG should no longer be allowed for those investment firms.

147. While option a) is in line with the 'same risk, same rules' approach, option b) appears to be more proportional considering that investment firms do not hold clients' deposits. Option c) would ensure the simplicity of the framework, avoiding the calculation of an additional threshold.

6.2 Credit valuation adjustment for investment firms

148. Basel 3 introduced new methodologies for the calculation of the credit valuation adjustment (CVA), replacing the existing methodologies. These methodologies have been transposed in the EU via the CRR3. In ascending order of complexity, the CVA methodologies in the CRR3 are the following:

a) Simplified approach;

b) Basic approach (without hedges or with hedges);

c) Standardised approach.

149. For investment firms, the CVA is capitalised according to Article 32 of the IFR, applying a multiplication factor of 1.5 to K-TCD.

150. Under the CRR3, in continuity with CRR and CRR2, there are financial instruments exempted from the CVA capital requirements (i.e., transactions with sovereigns, with pension funds, with non-financial counterparties and intragroup transactions), that are matched in the IFR.

151. The simplified approach in the CRR3 uses the same logic of the IFR methodology, applying a multiplication factor to the counterparty credit risk capital requirement. Banks can use this methodology only if the value of the aggregate derivative portfolio (taking all instruments at absolute market value and without netting) is below EUR 100 million and 5% of the total asset.

152. The basic approach in its 'unhedged' version needs basic information on the financial instruments subject to CVA capital requirement and a simple calculation and aggregation methodology. In the 'hedged' version, the data requirements and the calculation and aggregation methodology are materially more complex. Banks can use these methodologies regardless of the size of their derivatives business, provided that they use only one methodology ('unhedged' or 'hedged') for the entire portfolio.

153. The standardised approach is the most advanced and, despite its name, banks need the approval of the CA to use this methodology, which employs a methodology comparable to the FRTB standardised approach. The CA can authorise the parallel use of the basic approach for parts of the derivative portfolio.

154. For investment firms, the following options may be considered:

a) Introduce the CRR3 CVA methodologies and their thresholds for all investment firms in scope of the CVA via a direct link to the CRR3;

b) Introduce the CRR3 CVA methodologies on a voluntary basis, subject to the approval of the NCA;

c) Introduce the CRR3 CVA methodologies only for investment firms subject to FRTB (if FRTB will be implemented in the IFR revision);

d) Do not introduce the CRR3 CVA methodologies.

155. Option a) and c) would align the treatment of CVA for both banks and investment firms, while option b) and d) would ensure the continuity and the proportionality of the framework.

156. If options a) to c) are implemented, the scope of CVA in the IFR should be closely aligned to that of the CRR3 in order to avoid inconsistencies across the two frameworks.

6.3 Definition of trading book

157. The trading book is defined in Articles 4(1)(54) and (55) of the IFR. These definitions are closely aligned with the definitions in the CRR2.

158. However, for investment firms the definition of the trading book is of paramount importance for two additional reasons that are not applicable to banks:

a) Under the IFR, only items in the trading book, plus items subject to exchange and commodity (see Article 21(4) of the IFR) risk in the non-trading book, are subject to Pillar 1 own funds requirements;

b) In order to hold items in the trading book, investment firms may need a dedicated MiFID authorisation;

c) In addition, in the CRR3 the definition of the trading book has been changed in order to implement the FRTB. Under the FRTB, the so called 'boundary' of the trading and non-trading book is strictly regulated, with items presumptively booked in the trading or in the non-trading book, with very limited room to move items between the books.

159. The definition of trading book for investment firms should be reviewed in light of the peculiarities of the investment firm's business and applicable regulation. One option may be to reference to the boundary referred to in the CRR3.

160. Furthermore, it should be better specified which items should not be considered trading book items when held by investment firms that do not hold an authorisation pursuant to points (3) or (6) of the MiFID, as under Article 29(4) of the CRD, which was not replicated in the IFD. For instance, bonds that have a risk weight equal to 0% under the standardised approach of the credit risk in the CRR2, held to maturity only to invest the own funds and the liquidity of the investment firms, should not be considered as trading book items. Similarly, minority holdings held for industrial purposes should not be considered as trading book items as well. Any capitalisation of these items, when their size is considered relevant by the NCA, may be performed under Pillar 2.

161. The list of items mentioned in the previous paragraph may include the following financial instruments:

a) financial instruments that are assigned 0% risk weight according to Title II, Part three, Chapter 2, Section 2 of CRR 2;

b) assets eligible for the liquidity requirements according to Article 43 of the IFR;

c) equity instruments that fulfill the definition of large market capitalisation according to Article 7(1) of the Commission Delegated Regulation (EU) 2022/2058, up to a maximum of 25% of the own funds of the investment firm.

162. One possible way forward would be to introduce a limit up to which an investment firm that does not hold an authorisation pursuant to points (3) or (6) of the MiFID can invest in financial instruments should be the sum of the own funds of the investment firm and of its liquidity requirements. When this limit is breached, the investment firm should immediately notify to the competent authority and define a plan to reduce the exposure. The rationale is that investment firms not holding a license pursuant to activities (3) and (6) of MiFID II, Annex I(A) should invest only their own funds and their liquidity, so any excess sum should not be allowed. However, the value of the instruments may increase over time, so there should be some "soft"

mitigation mechanism to reduce the exposure, without forcing the investment firm to require a license pursuant to activities (3) and (6) of MiFID.

7. Liquidity requirements

7.1 Background

163. With the introduction of the IFR/IFD, a specific liquidity requirement became applicable to investment firms in Article 43 of the IFR. This requirement requires investment firms to hold an amount of liquid assets equivalent to at least one third of the FOR. In this regard, the IFR/IFD Review will be an occasion to analyse the functioning of this requirement. It is worth recalling that liquidity requirements are also covered by the SREP guidelines for investment firms as well as by the technical standards on specific liquidity measurements.[34]

164. In broad terms, investment firms face different liquidity risks compared to credit institutions because their operations and business models are quite different. Additionally, their funding structures are different. For example, credit institutions may fund their operations using deposits which can be easily withdrawn, while investment firms commonly use equity as their main source of funding. Both can use debt, such as bonds, note, loans, etc., but for small investment firms it is often not a feasible option.

165. Since liquidity requirements may apply to small and non-interconnected investment firms as well, the IFD/IFR liquidity requirements should not be set out relying on excessively complicated methods. Nonetheless, some analyses could be performed to better understand the liquidity profiles of investment firms.

7.2 Level of liquidity requirements

166. As stated above, under Article 43 of the IFR, liquidity requirements are set at one-third of the FOR, regardless of the size of the investment firm and the activities performed. The issue is whether the current liquidity requirements are fit for purpose. The requirement to hold just one third (i.e. one month) of the FOR in liquid assets is very soft and there may be merit in considering increasing it. While this approach has the advantage of being very simple, it is not tailored to the activities and liquidity risk of all investment firms because it relies solely on the level of fixed overheads requirements.

167. In order to keep the framework easy to implement, one option would be to increase the liquidity requirements in line with the level of FOR, e.g., three months (or more) instead of only one. This would be in line with the argument that a three-month wind-down period is deemed feasible for an investment firm and the FOR requirement would ensure that the investment firm would have sufficient own funds as well as liquid assets to withstand these

[34] Commission Delegated Regulation (EU) 2023/1651 of 17 May 2023 with regard to regulatory technical standards for the specific liquidity measurement of investment firms under Article 42(6) of that Directive (link).

wind-down period. However, such an approach would not help understanding the adequacy of the current liquidity framework and on whether this is appropriate for the very diverse set of investment firms' business models.

168. Having that in mind, it might be useful to reflect on the liquidity profiles of investment firms. That requires an examination how they are exposed to liquidity risks considering the business activities they pursue and their clientele, including the implications for a firm's liquidity profile if it does not have external clients.

169. The appropriateness and granularity of the liquidity requirements should be assessed. For example, it would be useful to assess both the qualitative as well as the quantitative dimension of the liquidity requirement in Article 43 of the IFR.

170. The qualitative aspect should focus on the question if the liquidity risk management of investment firms is of sufficient strength or could benefit from additional requirements in the IFR or the risk management parts of the IFD. In this sense, the EBA considered whether the elements of the Delegated regulation on specific liquidity measurement for investment firms[35] could be included in the scope of application of the liquidity framework, as it already gives greater emphasis on the activities performed by investment firms. A preliminary analysis, however, suggests that it is difficult to translate most of the elements in those technical standards into the liquidity requirements, as they are often designed for addressing very specific cases.

171. The quantitative dimension is also complex. Ideally, an analysis could be carried out testing whether the current liquidity requirements lead to investment firms having a sufficiently prudent level of liquid assets and whether the one-month time horizon is sufficient. However, such analysis would be very demanding and often disproportionate for most investment firms.

Questions for public consultations

Q18: Investment firms performing MiFID activities 3 and 6 (trading on own account and underwriting on a firm commitment basis) are more exposed to unexpected liquidity needs because of market volatility. What would be the best way to measure and include liquidity needs arising from these activities as a liquidity requirement?

Q19: Investment firms performing the activities of providing loans and credit to clients as an ancillary service in a non-negligeable scale would be more exposed to liquidity risks. What would be the best way to measure such risk in order to take them into account for the purposes of the liquidity requirements?

Q20: Investment firms, providing any of the MiFID services, but exposed to substantial exchange foreign exchange risk may be exposed to liquidity risks. What would be the best

[35] Commission Delegated Regulation (EU) 2023/1651 of 17 May 2023 with regard to regulatory technical standards for the specific liquidity measurement of investment firms under Article 42(6) of that Directive (link).

way to measure such risk in order to take them into account for the purposes of the liquidity requirements?

7.3 List of high-quality liquid assets

172. In the list of assets eligible for meeting the liquidity requirements in Article 43, paragraph 1(c) of the IFR does not include the requirement that those assets should be unencumbered. This is inconsistent with the other elements of that list.

173. The same Article 43 of the IFR, paragraph 1(d), refers to 'short-term deposits' without a definition tailored for this particular application. Although such definition could be deduced from similar wording in other regulations, in this context it would be reasonable to assume a deposit could be eligible if the full amount is available within one month, as this is the horizon of the liquidity requirements. If the liquidity requirements' horizon changed in the IFR following the considerations above, such definition should be adjusted accordingly.

7.4 Third country service and liquidity providers

174. Furthermore, it might be relevant to assess whether and to what extent the liquidity profiles of investment firms are affected by their activities in third countries or their dependencies on third country service and liquidity providers.

175. Given the various activities of investment firms, it has merit reflecting upon the sort of liquidity exposures they have, how these are influenced by their activities in third countries and their dependency on service providers located therein.

176. Should that be the case, this aspect may be reflected in the IFR or in the relevant delegated regulation.[36]

Questions for public consultation

Q21: Are there scenarios where the dependency on service providers, especially in third countries, if disrupted, may lead to unexpected liquidity needs? What type of services such providers perform?

Q22: Are there scenarios where the dependency on liquidity providers, especially in third countries, would lead to unexpected liquidity needs? Could you provide some examples?

[36] Commission Delegated Regulation (EU) 2023/1651 of 17 May 2023 with regard to regulatory technical standards for the specific liquidity measurement of investment firms under Article 42(6) of that Directive (link).

7.5 Exemption under Article 43 of the IFR for small and non-interconnected investment firms

177. It is worth noting that the liquidity requirements in the IFR may be interpreted in two different ways. In accordance with Recital (28) of the IFR: 'all investment firms should have internal procedures to monitor and manage their liquidity requirements. Those procedures are intended to help ensure that investment firms can function in an orderly manner over time, without the need to set aside liquidity specifically for times of stress'. This recital highlights the 'going concern' view in setting the liquidity requirements.

178. On the other hand, since the level of liquidity requirements are set to a fraction of the FOR, one may argue in favour of interpreting those requirements as an amount of liquidity to be kept ensuring an orderly wind-down (or 'gone concern') for at least one month, although this is not mentioned in the IFR.

179. The IFR allows the possibility to exempt small and non-interconnected investment firms from liquidity requirements in accordance with Article 43(1), subparagraph 2. Competent authorities should grant the use of that derogation only in accordance with the relevant EBA guidelines.[37]

180. That framework, exempting small and non-interconnected investment firms from liquidity requirements on an 'ad-hoc' basis, seems to be in line with the aforementioned Recital (28) of the IFR. There is however a case to consider removing completely the possibility of the exemption in Article 43 of the IFR, under the assumption that all investment firms, including the small and non-interconnected ones, should have some liquid assets available, no matter how small, to always ensure an orderly wind-down.

181. Data on the number of investment firms to which the derogation has been granted should be available at the level of the EBA[38], or can be collected ad-hoc. Those data should provide an overview of the number of firms that are authorised to derogate from the liquidity requirements and whether there is any inconsistent application with the Union.

Questions for public consultation

Q23: What other elements should be considered in removing the possibility of the exemption in Article 43 of the IFR?

[37] Guidelines on the criteria for the exemption of investment firms from liquidity requirements in accordance with Article 43(4) of Regulation (EU) 2019/2033 (link).

[38] In accordance with Article 43(1) of the IFR, the EBA is notified when an investment firm is exempted from the liquidity requirements.

7.6 Other potential amendments

182. On specific legislative amendments in other EU acts as a consequence of IFR and IFD that were not covered by the original acts, in Articles 5(a)(iii) and 5(c) of the Delegated Regulation (EU) 2017/1943, which specifies information and requirements for the authorisation of investment firms, there is a reference to the capital and liquidity requirements under the CRR. This should be supplemented with a reference to the requirements under the IFR. As investment firms can also be subject to the CRR, a reference to that regulation should be left in Article 5 of the RTS.

8. Prudential consolidation

183. The topic of prudential consolidation has been discussed at length before the EBA provided its RTS on the scope and methods for prudential consolidation of investment firm groups under Article 7 of the IFR[39]. During the work carried out by the EBA, it became clear that several elements provided by the IFR text needed to be amended in order to limit arbitrage opportunities, as well as to provide for the wide range of situations existing across jurisdictions as far as structures and composition of investment firm groups are concerned. Notably, there are two main directions for the amendment of the IFR text that could boost the effectiveness of the prudential consolidation of investment firm groups:

- Finetuning the definitions based on which prudential consolidation is built and carried out;
- Amending the IFR text by including provisions in line with the amendments carried out in the CRR, in order to enable further comparability between the banking and the investment firms' regulatory framework.

8.1 Finetuning of definitions in the IFR

The definition of investment holding company (IHC)

184. In the context of the definition of IHC in Article 4(1)(23) of the IFR, the focus is on financial institutions (FI) which can become IHC in specific conditions. However, it has been flagged there are cases where, instead of a FI, a tied agent (TA) or an ancillary services undertaking (ASU) is at the head of the group. In this case, based on the current definition, it would not be possible for a TA or an ASU to be at the head of a group, since the definition on Union parent IHC is based on the IHC definition as well. It is the EBA's recommendation to amend the IFR text to include these two types of undertakings in the definition of IHC, in order to allow the proper consolidation of investment firm groups with this specific structure.

185. Moreover, entities exempted from a MiFID authorisation in line with Article 3(1) of MiFID should be included in the scope of consolidation (as it is carrying out a MiFID service, RTO) and should be allowed to be at the top of an investment firm group, provided there is a relationship in the sense of Article 22 of the AD with any other entity within the group. Therefore, the definition of IHC should be amended to allow the inclusion of this specific type of entity. In addition, the definition of "consolidated situation" in Article 4(1)(11) of the IFR should also be amended for the same reasons.

[39] EBA-CP-2020-06 CP on draft RTS on prudential requirements for Investment Firms.docx (link).

Intermediate IHC

186. It has been brought to the EBA's attention that the application of the definition of IHC may trigger the supervision of undertakings which appears to be unnecessarily complex and burdensome compared to the prudential stakes.

187. In particular, the definitions of IHC and parent IHC do not consider the possible inclusion of the investment firm group within the supervision perimeter of a parent Credit Institution, Financial Holding Company (FHC) or Mixed Financial Holding Company (MFHC). As a result, in case where such regulated entities have an investment firm subsidiary held indirectly through one or several non-regulated entity(ies), this entity or one of these entities may qualify as IHC (if its subsidiaries are exclusively or mainly investment firms or financial institutions) and therefore be subject to IFR consolidated requirements in addition to the consolidated requirement that apply to the parent Credit Institution, financial holding company (FHC), mixed financial holding company (MFHC), see example below.

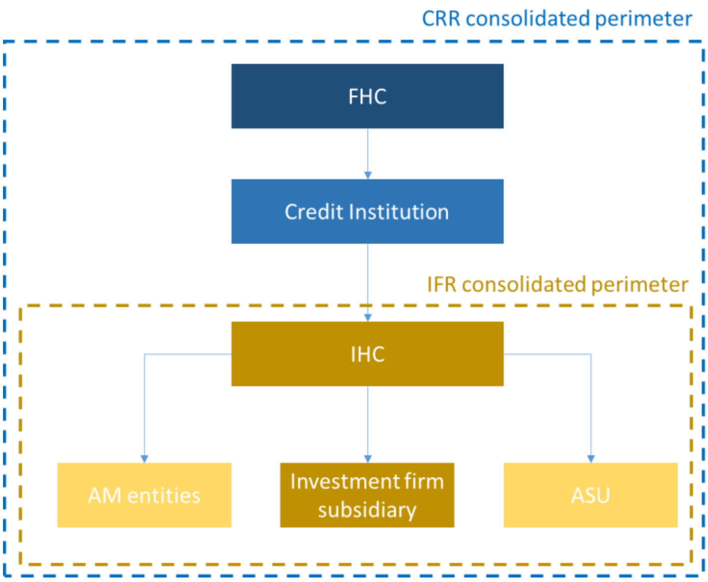

Figure 1: CRR and IFR perimeters

188. In such cases, the application of IFR requirements on a consolidated basis at this "IHC level" may be considered as unnecessary and unduly burdensome considering especially that the undertakings which are included in the consolidated perimeter of that IHC would be properly considered under the applicable rules: where the ultimate parent is a Credit Institution, Financial Holding Company (FHC), Mixed Financial Holding Company (MFHC), subsidiaries that are investment firms, financial institutions (including non-regulated financial institution) and ancillary services undertaking would be included in the consolidated perimeter under CRR (article 18 of CRR). Concerns exist that, based on the above, a group may easily adjust its legal structure to locate the entities outside the IFR consolidated perimeter.

189. Nonetheless, it is the EBA opinion that the IFR prudential consolidation rules are intentional with regards to the consolidation of IF-related activities under a 'specialised' parent undertaking.

Definition of Union parent investment firm (UPIF)

190. One aspect of consolidation and possible unintended consequences in definitions, is the definition of "union parent investment firm" (UPIF) in Article 4(1)(56) of the IFR. This definition is similar to the definition of "union parent investment holding company" (UPIHC) in Article 4(1)(57) of the IFR::

- (56) 'Union parent investment firm' means an investment firm in a Member State which is part of an investment firm group and which has an investment firm or a financial institution as a subsidiary or which holds a participation in such an investment firm or financial institution, and which is not itself a subsidiary of another investment firm authorised in any Member State, or of an investment holding company or mixed financial holding company set up in any Member State;

- (57) 'Union parent investment holding company' means an investment holding company in a Member State which is part of an investment firm group and which is not itself a subsidiary of an investment firm authorised in any Member State or of another investment holding company or mixed financial holding company set up in any Member State;

191. However, the UPIF definition states that the UPIF needs to have at least one subsidiary that is an investment firm or a financial institution. This scoping does not acknowledge that not all subsidiaries of UPIF's will be investment firms or financial institutions. In some cases, the subsidiaries of a UPIF are ancillary services undertakings or tied agents. If that UPIF only has ancillary services undertakings or tied agents as subsidiaries, then no prudential consolidation will apply as the investment firm does not qualify as a UPIF.

Ancillary services undertakings and potential for regulatory arbitrage to avoid consolidation

192. The current IFR definition allows organisation arbitrage as the ancillary services undertaking (ASU), while included in the definition of "consolidated situation", are not considered for the purpose of qualifying Investment holding company. As a result, in cases where a parent undertaking has one investment firm subsidiary and one ASU subsidiary, that would provide the technical infrastructure for the investment services provided and considered as representing the main activity, that undertaking would not qualify as an IHC and therefore no need to comply with the IFR on a consolidated basis. The supervision in that case would be limited to the investment firm on a solo basis. In light of recent cases which led to review the definition of ASU and financial institution as part of CRR revision underway, it seems therefore important to ensure that similar adjustments are considered for IFR, i.e., to include ASU in the definition of financial institutions.

193. Additionally, in application of the definition of "Union Parent Investment Firm" ("Union parent investment firm' means an investment firm in a Member State which is part of an investment firm group and which has an investment firm or a financial institution as a subsidiary or which holds a participation in such an investment firm or financial institution"), an investment firm which only has ASU subsidiaries would not be required to comply with the IFR on its consolidated basis.

8.2 Missing elements in the IFR as compared to the CRR: proportional consolidation and step-in risk, other entities to be included in the scope

194. As discussed during the elaboration on the RTS on IFR consolidation, the limitation induced by IFR definitions of "investment firm group" and "consolidated situation", referring only to article 22 of Directive 2013/34/EU, i.e., to entities under exclusive control, prevents the application of proportional consolidation or step-in consideration as part of IFR pilar 1 requirements, thus deviating from the CRR consolidation requirements applicable to credit institutions under CRR. Such limitation is not warranted and ultimately results in considering this limitation as part of Pillar 2 requirements as the risk related to jointly controlled investment firms, for instance, still need to be addressed. The revision of the IFR consolidation framework should therefore be considered to align it with Article 18 of the CRR to the extent possible, in order to avoid the unwanted consequences that the current wording of the IFR has led to.

195. The concept of "mainly" for determining the type of holding company should be elaborated upon in the IFR in order to provide guidance. As a comparison, the definition of a financial holding company in the CRR depends on whether the subsidiaries "are mainly institutions or financial institutions where at least one of them is an institution and where more than 50 % of the financial institution's equity, consolidated assets, revenues, personnel or other indicator considered relevant by the competent authority are associated with subsidiaries that are institutions or financial institutions" (Article 4(1)(20) of the IFR).

8.3 Group capital test

196. While the EBA is currently elaborating a set of guidelines regarding the group capital test, several jurisdictions pointed out that further elements are needed to fully operationalise this IFR feature.

197. Article 8 of the IFR allows the use of the group capital test instead of the prudential consolidation when the CA assesses that the group structure of the investment firm group is sufficiently simple and that it does not pose a significant risk to the clients or to the market. These conditions are not further elaborated in the IFR and CAs have different opinions on how to apply the provisions of Article 8.

198. Furthermore, the application of the group capital test leads to a derogation from the application of Article 7 of the IFR, including the requirement that the "Union parent investment firms, Union parent investment holding companies and Union parent mixed financial holding companies shall comply with the obligations laid down in Parts Two, Three, Four, Six and Seven on the basis of their consolidated situation" and consequently the investment firm group would not be subject to the application of the rules on variable remuneration, on group governance and on management of the risk on the consolidated basis of the group, but on an individual basis in accordance with Article 25 of the IFD, unless on the basis of Regulation (EU) 2019/2033 an investment firm determines that it meets all of the conditions for qualifying as a small and non-interconnected investment firm set out therein.

199. From an analysis performed by the EBA, the group capital test is currently used also by a few international groups with their headquarters in the EU. By using the group capital test, the remuneration, governance and risk management obligations only apply to the licensed EU group entities, including investment firms, AIFMs and UCITS management companies that are subject to governance requirements. This creates a level playing field for the non-EU group entities with their non-EU competitors. This advantage no longer applies when the application of the group capital test is limited. This is especially relevant for the investment firm sector since no global standards on prudential regulations exist, as compared to Basel for credit institutions. The requirements for third country entities can therefore differ significantly from the requirements in the EU. However, it should be noted that the scope of the group capital test is to provide a simpler alternative to the prudential consolidation, and specific level playing issue with non-EU entities may be better addressed in specific parts of the framework.

200. Given the wide implications of the use of the group capital test, that go beyond the own fund requirements, it is advisable to limit its use to small investment firm groups by setting in the IFR text hard limits on the number of undertakings that a group can contain, and on the maximum value of the total assets of the group, to be eligible for the derogation. The EBA should be mandated to develop a draft RTS to specify the methodology for the calculation of own funds requirement under the group capital test, and to list the cases when an investment firm group, though within the limits set in the IFR text, should be allowed or not to use the group capital test. The issue of the level playing field with non-EU group entities on the remuneration, governance and risk management obligations may be addressed separately, disentangling the use of the group capital test from the simplifications that may be granted on these issues.

8.4 Consolidation of Crowdfunding services providers

201. With the ECSPR already being in force since November 2021, the IFR/IFD framework should clearly define how crowdfunding service providers (CSFPs) are taken into account as part of an investment firm group. In several instances, there are some overlapping requirements coming from multiple regulations (ECSPR, IFR/IFD, etc.) which should be streamlined to facilitate the

co-existence of all these types of entities and ensure clarity with regards to the applicable regulatory provisions.

202. For instance, CFSPs are currently not in the scope of entities to be consolidated. Their inclusion could only be achieved through a clarification in the IFR. Amending the definition of “financial institutions”, however, would not be appropriate in this case. However, the definition of ‘consolidated situation’ could achieve the desired result.

203. Moreover, should CFSPs be part of an investment firm group, they could be factored in in the following manners:

- Nominal Initial capital: 25,000 EUR in line with ECSP requirements;
- FOR: ¼ FO – Article 13 (1), (4) IFR;
- Specific K-factors, depending on services provided, as follows: placing of securities – K-COH/K-DTF; reception and transmission of securities – K-COH.

Possible way forward

204. It should be considered whether the definition of “consolidated situation” could be amended to take into account CSFPs.

9. Interactions of IFD and IFR with other regulations

205. The discussion on the future proofing of the IFR/IFD regime can be developed along two main lines:

- External coherence: Ensuring that the framework is well integrated into the regulatory backdrop and its interplay with other regulatory provisions, and
- Content adjustment: Enabling the adjustment of the framework to an ever-changing landscape of the industry by clarifying how new players fit into the regulatory provisions.

Interaction with the AIFM and UCITS Directives

206. Regarding the future proofing of the IFR/IFD regime, it is essential to identify regulatory loopholes that allow entities to conduct investment firm activities or provide investment firm services without being covered by the IFR/IFD.

207. Capital requirements for UCITS Management Companies and AIFMs are set out in Article 7 of Directive 2009/65/EC and Article 9 of Directive 2011/61/EC. In summary, AIFMs and UCITS Management Companies are required to hold:

a) Initial Capital Requirement: at least EUR 125,000;

b) Additional capital of 0.02% of excess assets over EUR 250 million subject to a limit of EUR 10 million (in respect of collective portfolios managed only, individually managed portfolios are excluded);

c) Own Funds must at no time be less than the amount prescribed in Article 13 of the IFR.

208. Nonetheless, the UCITS/AIFM Directives only reference the expenditure requirements in line with the IFR, while conversely MiFID directly sets in the IFR text the initial capital requirements for management companies. There may be merit in reflecting on whether IFR could also contain direct specifications regarding capital requirements in this particular case.

209. Under Article 6(3) of Directive 2009/65/EC and Article 6(4) of Directive 2011/61/EC UCITS Management Companies and AIFMs may provide the following services:

a) Management of portfolios of investments, including those owned by pension funds in accordance with mandates given by investors on a discretionary client-by-client basis;

b) non-core services comprising:

i) investment advice;

ii) safe-keeping and administration in relation to shares or units of collective investment undertakings;

210. Additionally, AIFMs may also provide reception and transmission of orders in relation to financial instruments. However, there are no capital requirements arising in relation to the provision of these additional services.

211. UCITS management companies and AIFMs can be authorised, on top of their specific services, to carry out individual portfolio management, which is a MiFID service. Nonetheless, when this is the case, the own funds requirements established in UCITS and AIFM directives may not always take into due account the investment services performed by UCITS asset management companies and AIFMs (i.e. individual portfolio management, investment advice, safe-keeping and administration and – for AIFMs only – reception and transmission of orders), thus resulting, in certain cases, in an asymmetric treatment as compared to investment firms providing the same MiFID services and having to set aside corresponding regulatory capital under the K--factor. . In addition, it has been observed that the scale of the top-up services is not always warranting categorising them as ancillary to the main business of the entity. Therefore, there is a need to reconsider situations based on all the services provided by an entity.

212. In this context, there could be two options for the way forward: either impose capital requirements on the UCITS asset management companies and AIFMs providing ancillary services as well, or introduce requirements limiting the amount of provided ancillary services by UCITS management companies and AIFMs.

Possible ways forward

213. It is first necessary to conduct an analysis on the incidence of the MiFID activities performed by asset managers and a comparison of the own funds requirements under the IFR/IFD applicable to investment firms and those under UCITSD and AIFMD applicable to asset managers. Information on this topic will be collected via a dedicated data collection. The second step would be to explore the different options that could address any regulatory deficiencies identified above. To this end, it is necessary to assess what the implications and effects would be if, for example, specific requirements of the IFR/D were extended to asset managers, considering the specific investment services and activities that those latter can perform. In this analysis, due attention should be paid to avoid duplications of requirements and to ensure proportionality, taking into account the specificities of the framework applicable to UCITS management companies and AIFMs.

Question for public consultation

Q24: Do you have any views on the possible ways forward discussed above concerning the provision of MiFID ancillary services by UCITS management companies and AIFMs?

9.1 Interaction of MiCAR and IFD/ IFR

Background

214. The EBA's review of the IFR/IFD aims to assess the role the IFR/IFD could play in regulating crypto-assets and crypto-asset services provided by investment firms under the Markets in Crypto-assets Regulation (MiCAR).In particular, there could be room for the IFR/IFD to regulate governance arrangements, risk management processes, and transparency requirements for investment firms when they are involved in the trading of crypto-assets or provide services related to crypto-assets.

215. The review should focus on crypto-asset services that may be provided by investment firms that therefore would qualify as a crypto-asset service provider under MiCAR. The review should not cover the issuance of crypto-assets as investment firms are not authorised to issue them (those that do not qualify as financial instruments, deposits or other products indicated in Article 2, paragraph 4, MiCAR), and which would require a separate authorisation under MiCAR.[40]

216. The authorisation requirement for crypto-asset service providers under MiCAR does not necessarily apply to investment firms. Specifically, an investment firm may provide crypto-asset services in the Union equivalent to the investment services and activities for which it is specifically authorised under MiFID, provided that it notifies the competent authority of the home Member State in accordance with Article 60(3) and (7) of MiCAR. In such cases, some of the other requirements under MiCAR, beside the authorisation requirement, for crypto-asset services providers do not apply to the investment firm. Other MiCAR requirements do however still apply to the investment firm. Similar notification requirements apply within MiCAR to UCITS and AIFM.

Requirement under MiCAR not applicable to an investment firm

217. Entities referred to in paragraphs 1 to 6 of Article 60 of MiCAR that provide crypto-asset services are not subject to the authorisation requirements under Articles 62, 63, 64 MiCAR, prudential requirements under Article 67 of MiCAR and qualifying holding requirements under Articles 83 and 84 MiCAR. Regarding the prudential capital requirements, MiCAR sets permanent minimum capital requirements – which depending on the type of crypto-asset services provided, range from EUR 50 000 to EUR 150 000, according to Annex IV of MiCAR – or one quarter of the fixed overheads of the preceding year.

[40] If an investment firm wishes to *issue* crypto-assets that are within the scope of MiCAR, then it may qualify as an issuer of crypto-assets, in which case the investment firm must meet requirements under MiCAR depending on the specific type of crypto-asset issued, which may include prudential requirements in the case of e-money tokens and asset-referenced tokens.

218. The minimum capital requirements under the IFR/IFD that apply to an investment firm are higher (Article 9 IFD), when compared to the equivalent services, than those under MiCAR.

Capital requirements under IFR/IFD and interaction with crypto-assets services providers (CASPs)

219. The IFD provisions on capital requirements have not been amended by MiCAR. Some clarifications of such requirements could be beneficial regarding the fixed overhead requirement and if it includes the part of the investment firms that provides crypto-asset services.

220. Questions may also arise regarding the impact of the provision of crypto-asset services by an investment firm on its K-factor requirements under the IFR. For instance, whether K-CMH applies also to client money held in relation to crypto-asset services (provided that the client money is not deposited on a (custodian) bank account in the name of the client itself). Similarly, it may be doubted whether K-COH applies only to the reception and transmission of client orders in financial instrument, or whether it may also capture the reception and transmission of client orders in crypto-assets.

Questions for public consultation

Q25: Are differences in the regulatory regimes between MICAR and IFR/IFD a concern to market participants regarding a level playing field between CASPs and Investment firms providing crypto-asset related services? In particular, are there concerns on the capital and liquidity requirement regimes?

221. The EBA report should therefore explore the need to clarify the impact of the provision of crypto-asset services on the capital requirements under the IFR, specifically in relation to the application of the K-factors, such as K-COH, K-AUM, K-CMH, K-ASA and K-NPR.

222. Furthermore, the adequacy of the current prudential reporting should be assessed including whether some adaptations would be needed to reflect activities and services related to crypto assets.

Requirement under MiCAR that are applicable to an investment firm

223. MiCAR requirements that also apply to an investment firm include governance arrangements (Article 68 MiCAR), safekeeping of clients' crypto assets and funds (Article 70 MiCAR), operation of a trading platform for crypto-assets (Article 76 MiCAR) and specific obligations in respect of specific crypto-asset services (Title V, Chapter 3, MiCAR).

224. The relation between these two frameworks may require further clarification. It may be questioned if, and if so to what degree, the ICAAP (Article 24 IFD) and SREP (art. 36 IFD)

requirements under the IFD also encompass crypto-asset services provided by an investment firm.

Possible changes to IFD

225. The relevant texts should therefore clarify the overlap between the MiCAR and the IFD and whether the requirements under the IFD (including ICAAP and SREP) should also relate to crypto-asset services provided by an investment firm.

Questions for public consultation

Q26: Sections 5.2, 5.4 as well as this Section 9.1 all touch upon how crypto-assets (exposures and services) may influence the IFD and the IFR. Is there any other related element that should be considered in the review of the investment firms' prudential framework?

10. Remuneration and its governance

10.1 Remuneration

226. Article 66 IFD requires that “by 26th June 2024 the Commission in close cooperation with EBA and ESMA, shall submit a report, together with a legislative proposal if appropriate, to the European Parliament and to the Council, […] on the provisions in Articles 30 to 34 on remuneration in this Directive and in Article 51 of Regulation (EU) 2019/2033 (IFR) as well as Articles 14a, 14b and 69 in Directives 2009/65/EC (UCITS Directive) and Articles 13, 19 and Annex II of Directive 2011/61/EU (AIFMD) with the aim of achieving a level playing field for all investment firms, including the application of those provisions; …”. It needs to be considered that some investment firms are subject to the remuneration requirements under Articles 74, 92, 94 and 95 of Directive 2013/36/EU as they fall under Article 2(2) IFD. All those Directives set out requirements on a minimum harmonisation basis, hence, the national implementation of the Directives may have an additional impact on the level playing field for different firms in the investment services sector. A general review between the remuneration framework of investment firms and the remuneration framework for credit institutions, that are subject to CRD and the limitation of the ratio between variable and fixed remuneration of 100% (200% with shareholders approval) is not intended under this discussion paper, the review should be focused on the consequences of the different frameworks for investment firms under IFD and other asset managers (Investment firms class 1 minus that are subject to CRD requirements, class 2 that are subject only to IFD requirements on remuneration and class 3 that are subject only to the MiFID remuneration requirements, UCITS management companies and AIFMs that are subject to their sectoral specific requirements).

227. While being based on the same principles, the detailed provisions on remuneration policies and variable remuneration under the aforementioned Directives[41] differ. When analysing the differences and the impact of the different requirements on a level playing field, it needs to be taken into account that also Directive 2014/65/EU (MiFID) contains requirements on investment firm’s remuneration policies for sales staff that aim at eliminating any conflicts of interest with regard to the distribution of different financial instruments and to avoid detrimental effects of such conflicts for investors. Similar requirements that aim at avoiding conflicts of interest are also included in the UCITS Directive and in the AIFMD. Moreover, MiFID II delegated regulation 2017/565 contains additional requirements on remuneration that apply to all investment firms and (by virtue of Article 1(1) of the mentioned MiFID II delegated regulation) to UCITS management companies and AIFMs when providing MiFID services in

[41] Articles 30-34 IFD, Articles 92-95 CRD, Article 13 AIFMD, Articles 14a and 14b of UCITS Directive.

accordance with Article 6(3) of UCITS Directive and Article 6(4) of AIFMD. Therefore, such provisions should have no impact on the level playing field.

228. The sections below provide an overview of the main aspects and differences of the remuneration regimes for the different types of firms that are concerned by the review. For each of the material parts of the remuneration provisions, where differences in the regulatory regime exist, the EBA in close cooperation with ESMA is investigating, if such differences have an impact on the level playing field, in particular, with regard to the firms' ability to recruit and retain talent and with regard to the costs for the application of the requirements. The responses to the discussion paper will inform, together with remuneration benchmarking data and data collected on the application of gender-neutral remuneration policies, the EBA's and ESMA's response to the respective call for advice of the European Commission.

10.2 Scope of application

229. Investment firms subject to the IFD, do under the EU legal framework not fall under the provisions of the AIFMD or UCITS Directive. These two Directives establish a specific remuneration framework for the respective firms. While the remuneration provisions within the UCITS Directive and the AIFMD apply to nearly all EU asset management companies, unless the exceptions for sub-threshold AIFMs under Article 3 AIFMD apply, the IFD requirements on remuneration do not apply to investment firms that qualify as small and non-interconnected (class 3 investment firms). For those investment firms only the remuneration requirements under MiFID are applicable. Other investment firms (class 2) apply the remuneration framework under IFD and the largest investment firms (class 1 minus) have to apply the CRD remuneration provisions in accordance with Article 2(2) IFD, in addition to the MiFID II requirements.

230. The different scope of application could lead to an unlevel playing field between small and non-interconnected investment firms subject to IFD and UCITS management companies that are subject to the UCITS Directive or alternative asset management companies that are subject to AIFMD, while all three different types of firms are active in areas that are relatively similar in terms of business models and risk profiles. . While the ESMA guidelines on remuneration policies allow for a proportionate application of the remuneration provisions for UCITS management companies and AIFMs, small or non-complex UCITS and AIFM that are subject to the UCITS Directive or AIFMD would have less legal certainty regarding the proportionate application of derogations from certain remuneration requirements compared to small and - non-interconnected investment firms to which specific derogations apply, where implemented under national law, under IFD. Yet, the supervisory community does not have any practical evidence causing problems due to this legal differences with regard to the application of remuneration requirements in these firms.

231. Another difference exists between the IFD and CRD in the application of remuneration requirements on a consolidated basis that also includes entities located in third countries.

Article 109 CRD provides that firms that are subject to a specific remuneration framework are not subject to the group wide remuneration requirements, unless Article 109 (5) or (6) applies. The IFD does not contain a similar provision. Hence, firms that are subject to a specific remuneration regime, e.g., under AIFMD or UCITS Directive, that fall in the scope of consolidation of an investment firm, would still have to comply on a group wide basis with the group wide remuneration policy and not just with their specific remuneration framework.

Questions for public consultation

Q27: Is the different scope of application of remuneration requirements a concern for firms regarding the level playing field between different investment firms (class 1 minus and class 2), UCITS management companies and AIFMs, e.g., in terms of the application of the remuneration provisions, the ability to recruit and retain talent or with regard to the costs for the application of the requirements?

10.3 Remuneration policies

232. All four Directives (CRD, IFD, UCITS Directive, and AIFMD) include some provisions on remuneration policies for all staff and specific requirements on the variable remuneration for staff who has a material impact on the risk profile of the firm, which aim to align the variable remuneration with the risks of the firm in the longer run and promote sound and effective risk management. All Directives contain provisions that require to align the remuneration of staff in control functions to control objectives.

233. All Directives include comparable provisions on the governance arrangements for the adoption of the remuneration policy by the management body and the involvement of the remuneration committee in significant firms that exceed a certain size. Article 33 IFD requires investment firms, where the value of its on and off-balance sheet assets is on average above EUR 100 million over the four-year period immediately preceding the given financial year, to establish a remuneration committee that is responsible for the preparation of decisions regarding remuneration. Under AIFMD and UCITS Directive a similar requirement is applicable to companies that are significant in terms of their size or of the size of the funds that they manage, without a specific threshold being set.

234. While the IFD contains a specific requirement that the remuneration policy must be gender-neutral, such a requirements is not included in the UCITS Directive or AIFMD. However, the general principle of "equal pay for equal work or work of equal value" is directly included in the Treaty on the functioning of the European Union[42] and requires that "each Member State shall ensure that the principle of equal pay for male and female workers for equal work or work of equal value is applied."

[42] Article 157 TFEU, OJ C 202, 7.6.2016, pp. 47-360.

235. The specific provisions under three Directives (IFD, Directive on UCITS and AIFMD) apply to those categories of staff, including senior management, risk takers, control functions and any employee receiving total remuneration that falls within the remuneration bracket of senior management and risk takers whose professional activities have a material impact on the risk profiles of those firms or of the 'assets' that they manage – those staff members are also referred to as "identified staff". Under the CRD the criterion on the remuneration bracket has been removed in the past and does not any longer apply. The identification of risk takers under CRD is regulated by the Commission Delegated Regulation (EU) 2021/923 of 25 March 2021 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards setting out the criteria to define managerial responsibility, control functions, material business units and a significant impact on a material business unit's risk profile, and setting out criteria for identifying staff members or categories of staff whose professional activities have an impact on the institution's risk profile that is comparably as material as that of staff members or categories of staff referred to in Article 92(3) of that Directive. The scope of identified staff is further specified for investment firms under the Commission Delegated Regulation (EU) 2021/2154 supplementing Directive (EU) 2019/2034 of the European Parliament and of the Council with regard to regulatory technical standards specifying appropriate criteria to identify categories of staff whose professional activities have a material impact on the risk profile of an investment firm or of the assets that it manages. For UCITS management companies and AIFMs more high-level identification principles are set out in ESMA Guidelines on sound remuneration policies under the UCITS Directive and AIFMD[43].

Questions for public consultation

Q28: Are the different provisions on remuneration policies, related to governance requirements and the different approach to identify the staff to whom they apply a concern for firms regarding the level playing field between different investment firms (class 1 minus under CRD or class 2 under IFD), UCITS management companies and AIFMs, e.g. in terms of the application of the remuneration provisions, the ability to recruit and retain talent or with regard to the costs for the application of the requirements?

10.4 Requirements on variable remuneration

236. IFD, UCITS Directive and AIFMD, as well as Directive 2013/36/EU (CRD) – which is applicable for class 1 minus investment firms with respect to the requirements on governance and

[43] Notably:
- Guidelines on sound remuneration policies under the UCITS Directive (ESMA 2016/575)
- Guidelines on sound remuneration policies under the AIFMD (ESMA 2016/579)
- Guidelines on sound remuneration policies under the UCITS Directive and AIFMD (ESMA 2016/411).

remuneration – include requirements regarding the link between performance and variable remuneration, risk alignment, pay out in instruments and under deferral arrangements as well as the application of malus and claw back. All Directives require an appropriate balance between the fixed and variable elements of remuneration, where CRD limits the ratio between the variable and the fixed remuneration.

237. While the instruments that must be awarded for a part of the variable remuneration are equivalent for all firms, it is possible that competent authorities approve for investment firms the use of alternative arrangements for the pay-out in instruments fulfilling the same objectives. At the same time Member States have the derogation under IFD to restrict the use of certain instruments for variable remuneration. Provisions that allow for alternative arrangements that could be used rather than the instruments listed in the Directives do not exist under the UCITS Directive or AIFMD. Differently, firms subject to CRD have to use also other instruments for the pay out of variable remuneration that are specified by a Commission delegated Regulation[44]. Also, for investment firms a Commission Delegated Regulation[45] specifies the instruments and alternative arrangements that can be used for the pay-out of variable remuneration, while the UCITS Directive and the AIFMD do not contain a mandate to develop such standards. However, some specifications have been provided in ESMA Guidelines on sound remuneration policies under the UCITS Directive and AIFMD.

238. The IFD offers the possibility for class 2 investment firms, that are in general subject to the remuneration provisions, not to apply certain remuneration rules if certain conditions are met, in particular a threshold[46]. In addition, Member States have the discretion to modify the threshold within a certain range. At the same time, some investment firms may be subject to the CRD as they fall under Article 2(2) IFD, which also has a similar exemption mechanism to the IFD, but applies different thresholds[47]. The IFD and CRD frameworks were calibrated to take into account investment firms' and respectively credit institutions' characteristics and therefore the different thresholds set under IFD and CRD. Such derogations apply independently of the concrete business model, when the criteria are met. The different

[44] Commission Delegated Regulation (EU) No 527/2014 of 12 March 2014 supplementing Directive (EU) No 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the classes of instruments that adequately reflect the credit quality of an institution as a going concern and are appropriate to be used for the purposes of variable remuneration.

[45] Commission Delegated Regulation (EU) 2021/2155 of 13 August 2021 supplementing Directive (EU) 2019/2034 of the European Parliament and of the Council with regard to regulatory technical standards specifying the classes of instruments that adequately reflect the credit quality of the investment firm as a going concern and possible alternative arrangements that are appropriate to be used for the purposes of variable remuneration.

[46] Point (a) of Article 32(4) of the IFD provides an exemption where the value of an investment firm' on and off-balance sheet assets is on average equal to or less than EUR 100 million over the four-year period immediately preceding the financial year considered.

[47] Point (a) of Article 94(3) of the CRD provides for an exception where an institution is not a large institution as defined in point (146) of Article 4(1) of Regulation (EU) No 575/2013 and the value of the assets of which is on average and on an individual basis in accordance with this Directive and Regulation (EU) No 575/2013 equal to or less than EUR 5 billion over the four-year period immediately preceding the current financial year; the threshold can be increased by the Member States up to EUR 15 bn under certain conditions.

implementation by Member States could potentially have an impact on the level playing field between different investment firms, i.e. as thresholds differ between Member States or as investment firms can be either subject to the derogations to the requirements to pay out parts of the variable remuneration in instruments and under deferral arrangements under IFD or CRD.

239. While IFD and CRD include explicitly derogations for investment firms regarding the requirements to pay out a part of variable remuneration of identified staff in instruments and under deferral arrangements, the UCITS Directive and the AIFMD do not include such derogations. The co-legislators should investigate if there is a need for an alignment across those directives.

240. Moreover, the thresholds set within the IFD and CRD are subject to national discretion and may have been implemented differently between Member States. Such threshold effects could potentially impair the level playing field and lead to regulatory arbitrage. So far, the EBA is not aware of any distortions to the market that different thresholds may have caused.

241. Moreover, the thresholds for derogations for the application of the deferral and pay out in instruments requirements for individual staff members differs between IFD and CRD. While both stipulate EUR 50k of variable remuneration as a baseline criterion for the derogation, IFD specifies that the derogation is only applicable if it does not represent more than one fourth of that individual's total annual remuneration. Differently, CRD specifies that the derogation is only applicable if it does not represent more than one third of the staff member's total annual remuneration. ESMA Guidelines on sound remuneration policies under the UCITS Directive and AIFMD do not foresee additional criteria in addition to the absolute threshold. The difference in the criteria for the application of derogations could cause an unlevel playing field for recruiting and retaining staff and regarding the costs for applying the deferral and pay out in instruments requirements.

Questions for public consultation

Q29: Are the different provisions, criteria and thresholds regarding the application of derogations to the provisions on variable remuneration, and that they apply to all investment firms equally without consideration of their specific business model, a concern to firms regarding the level playing field between different investment firms (class 1 minus under CRD and class 2 under IFD), UCITS management companies and AIFMs, e.g., in terms of the application of the remuneration provisions, the ability to recruit and retain talent or with regard to the costs for applying the deferral and pay out in instruments requirements? Please provide a reasoning for your position and if possible, quantify the impact on costs and numbers of identified staff to whom remuneration provisions regarding deferral and pay out in instruments need to be applied.

10.5 Oversight, Disclosure and Transparency on remuneration and remuneration policies

242. The requirements on the oversight of remuneration policies, disclosure and transparency differ between the different Directives/Regulation to some extent.

243. IFD and UCITS Directive include specific requirements for disclosures in the annual report with regard to the remuneration policy and the determination of bonuses, while the disclosures under AIFMD are more limited and concern mainly the effective amounts awarded. The granularity of the provisions within IFD and UCITS Directive differs significantly and requires from investment firms subject to IFD a higher level of granularity regarding the single components of variable remuneration as compared to other firms subject to this review.

244. Differently to AIFMD and the UCITS Directive, the IFD specifically requires remuneration benchmarking, high earner reporting and the monitoring of the gender pay gap. Article 14b(2) 2nd subpar UCITS Directive empowers ESMA to request information from competent authorities on the remuneration policies and practices referred to in Article 14a of this Directive in accordance with Article 35 of Regulation (EU) No 1095/2010. The AIFMD does not include such empowerment.

245. Different disclosure requirements should per se not have a material impact on the ability to attract and retain staff, but data collections, disclosures and information to be prepared for competent authorities bear costs that differ depending on the different firms and may therefore still have an impact on the level playing field.

Questions for public consultation

Q30: Are the different provisions regarding the oversight on remuneration policies, disclosure and transparency a concern for firms regarding the level playing field between different investment firm, UCITS management companies and AIFMs, e.g., with regard to the costs for the application of the requirements or the need to align these underlying provisions? Please provide a reasoning for your position.

11. Other elements

11.1 Extending reporting requirements to financial information

246. Article 54 of the IFR requires investment firms to report on a periodic basis information regarding: a) level and composition of own funds; (b own funds requirements; (c own funds requirement calculations; d) the level of activity in respect of the conditions set out in Article 12(1), including the balance sheet and revenue breakdown by investment service and applicable K-factor; e) concentration risk; f) liquidity requirements.

247. Except for point d), all other points are related to the prudential requirements and do not include financial (accounting) information. Accordingly, the technical standards on the reporting requirements[48] for investment firms are limited to the mentioned items.

248. Competent authorities report that such information is of interest for supervisory purposes, and, in several instances, financial reporting is therefore required based on national laws to supplement the IFR requirements. However, reporting that information is not a requirement neither under the IFD nor the IFR. Therefore, in some member state, it might be difficult for an authority to impose such requirement solely based on national laws because, for example, it might not be part of the IFD transposition.

249. There is therefore a case to investigate whether it would be beneficial to extend the reporting requirements to include accounting and financial information in the European legislation.

250. In this sense, it is worth noting that the reporting requirements may be a source of considerable burden for small investment firms. Therefore, should the reporting requirements be extended to financial information, it is arguable that they remain based on the applicable accounting standards, which may be local GAAP, without forcing all investment firms using local accounting standards toward double calculations.

251. To facilitate member states in their national implementation, it would be easier to include in the IFD the requirements for the member states to collect financial information for supervision of investment firms, so that a clear legal obligation is provided in the EU legislation.

252. Alternatively, the requirement may be included in Article 54 of the IFR, together with the other reporting requirements. Should that be the way forward, it should be noted that Article 54, paragraph 3 would then apply to financial reporting as well, as part of the mandate for the EBA for an implementing technical standard. By this point of view, it is worth noting that the CRR

[48] Commission Implementing Regulation (EU) 2021/2284 of 10 December 2021 laying down implementing technical standards for the application of Regulation (EU) 2019/2033 with regard to supervisory reporting and disclosures of investment firms (link).

does not require FINREP reporting at solo level, but only at consolidated level. This was the case also in the past, when the CRR was applicable to investment firms as well.

253. Another element to consider is the frequency of such reporting obligations. Quarterly reporting of financial information could be set for all investment firms, including for small and non-interconnected (Class 3) investment firms. The rationale is that quarterly reporting would enable supervisors to monitor investment firms´ financial situation and how their capital develops during the year and whether it is still sufficient to meet the capital requirement higher than PMR or FOR.

Question for public consultation

Q31: What would be costs or benefits of extending existing reporting requirement to financial information? Which other elements should be considered before introducing such requirement?

11.2 Firms active in the commodity markets currently not subject to prudential requirements

254. In section 5 of the CfA, 'Specific considerations on commodity and emission allowance dealers and on energy firms', the European Commission suggests investigating two aspects. Firstly, the EBA-ESMA report in response to the CfA could provide insights on the market structure and the profile of energy firms operating in these markets.

255. Second, since some of these firms are exempted from MIFID, the Commission seeks advice on how the current prudential regime, in particular in the fields of liquidity risk and concentration risk, could be extended to energy firms trading actively on commodity markets.

256. Since this topic is not directly related to the review of the IFD/R, it will be subject of separate publications from ESMA and EBA.

257. A first part of the work would consist in providing an overview of the market structure of certain markets, and a report will be published separately from the EBA-ESMA response to the CfA regarding the IFD/R (i.e., this discussion paper). Concerning the second element, only in a second step there will be a possibility to investigate the opportunity of recommending that certain prudential requirements may apply to currently unregulated firms operating in the commodity markets.

258. In this sense, preliminary views of market participants on these aspects should be collected. Should the situation arise for which such firms become subject to prudential requirements, a separate recommendation will be provided to the European Commission, as an ancillary response to the CfA, specifying the necessary details.

Question for public consultation

Q32: Should there be the need to introduce prudential requirement for firms active in commodity markets and that are not currently subject to prudential requirements? how could the existing framework for investment firms be adapted for those cases? If a different prudential framework needs to be developed, what are the main elements that should be considered?

11.3 Elements of the CfA not covered by this report

259. While there is a specific request in the CfA on the role of ESG factors in the Pillar 1 prudential requirements for investment firms, the EBA advice is already included in the ESG report developed in accordance with the mandate of Article 34 of the IFR.[49]

260. Finally, concerning the request in the CfA on investment policy disclosure, the EBA does not have the intention to provide a specific response as this topic is already the subject of a dedicated EBA technical standard.[50]

[49] Report on the role of environmental and social risks in the prudential framework, EBA, 12 October 2023, (link).
[50] Regulatory Technical Standards on disclosure of investment policy by investment firms, (link).

Annex - MiFID investment firms in the EU

Overview

261. This section provides a high-level overview of the population of investment firms and investment firm groups currently subject to the IFD/R framework or CRD/CRR framework. The section does not cover investment firms that qualify as credit institutions according to Art. 4(1) point (b) CRR and transitioned to a credit institution authorisation according to Art. 8 CRD (so-called Class 1).

262. The data source is the European Centralised Infrastructure of Supervisory Data (EUCLID). The data sample is therefore complete to the extent that it includes the register of all the MiFID investment firms and Union parents of investment firm groups subject to the prudential requirements of IFD/R framework and CRD/CRR.

Investment firms

263. Table 1 presents the number of investment firms that are currently subject to IFD/R or CRD/CRR framework on an individual basis.

Table 1: Number of investment firms by Member State, as of 31 December 2023

Member state	Number of investment firms	Member state	Number of investment firms
AT	61	IE	84
BE	31	IT	59
BG	34	LT	11
CY	249	LU	83
CZ	24	LV	9
DE	732	MT	71
DK	47	NL	202
EE	9	PL	33
ES	159	PT	33
FI	43	RO	18
FR	91	SE	95
GR	44	SI	3
HR	5	SK	22

Member state	Number of investment firms	Member state	Number of investment firms
HU	10		
		Total	**2262**

Sources: EUCLID supervisory data (2023 Q4) and EBA calculations.
Notes: The table does not cover investment firms that qualify as credit institutions according to Art. 4(1) point (b) CRR and transitioned to a credit institution authorisation according to Art. 8 CRD (so-called Class 1).

264. Table 2 shows the number of investment firms that are currently subject to IFD/R or CRD/CRR framework on an individual basis by the categories defined in the IFR:

a) Investment firms subject to CRD/CRR ('Class 1 minus'), but not required to apply for a credit institution authorisation;

b) Investment firms subject to IFD/R, other than those small and non-interconnected ('Class 2');

c) Small and non-interconnected investment firms ('Class 3').

Table 2: Number of investment firms by class, as of 31 December 2023

Class	Number of investment firms
Class 1 minus	7
Class 2	960
Class 3	1295
Total	2262

Sources: EUCLID supervisory data (2023 Q4) and EBA calculations.
Notes: The table does not cover investment firms that qualify as credit institutions according to Art. 4(1) point (b) CRR and transitioned to a credit institution authorisation according to Art. 8 CRD (so-called Class 1).

265. As explained in Section 1, Class 3 investment firms are subject to the own funds requirements at least equal to the maximum between the permanent minimum capital (PMCR) and the FOR. Class 2 investment firms are subject to the own funds requirements at least equal to the maximum between PMCR, FOR and K-factors requirements.

266. Table 3 shows the number of firms by classification and 'constraining' requirement.

Table 3: Number of investment firms by constraining requirement and classification, as of 31 December 2023

	Class 2	Class 3
PMCR	255	271
FOR	438	865

	Class 2	Class 3
K-factors	186	
Total	**879**	**1136**

Sources: EUCLID supervisory data (2023 Q4) and EBA calculations.
Notes: The table only covers investment firms subject to the IFD/IFR. The table does not cover the full population of investment firms due to data unavailability.

Investment firm groups

267. Table 4 shows the number of investment firms groups currently subject to IFD/F framework on a consolidated basis. It includes the investment firms groups that have already obtained an authorisation to use the group capital test[51].

Table 4: Number of investment firm groups by Member state, as of 31 December 2023

Member state	Number of investment firm groups	Member state	Number of investment firm groups
AT	15	IE	1
BE	8	IT	8
BG	4	LT	0
CY	36	LU	1
CZ	6	LV	0
DE	27	MT	5
DK	0	NL	50
EE	3	PL	0
ES	46	PT	0
FI	21	RO	0
FR	15	SE	24
GR	0	SI	1
HR	0	SK	0
HU	0		
		Total	**271**

Sources: EUCLID supervisory data (2023 Q4) and EBA calculations.
Notes: The table does not cover investment firms that qualify as credit institutions according to Art. 4(1) point (b) CRR and transitioned to a credit institution authorisation according to Art. 8 CRD (so-called Class 1).

268. Table 5 shows the number of investment firms groups split in classes based on the applicable own funds requirements. There is no investment firm group that reports CRD/CRR templates, i.e., no 'Class 1 minus' investment firm group:

[51] See Section 8.3 of this document.

Table 5: Number of investment firm groups by class, as of 31 December 2023

Class	**Number of investment firm groups**
Class 2	154
Class 3	74
Group capital test	43
Total	271

Sources: EUCLID supervisory data (2023 Q4) and EBA calculations.
Notes: The table does not cover investment firms that qualify as credit institutions according to Art. 4(1) point (b) CRR and transitioned to a credit institution authorisation according to Art. 8 CRD (so-called Class 1).

269. Table 6 shows the number of investment firm groups by classification and constraining requirement.

Table 6: Number of investment firm groups by constraining requirement and classification, as of 31 December 2023[52]

	Class 2	**Class 3**
PMCR	12	8
FOR	94	49
K-factors	21	
Total	**127**	**57**

Sources: EUCLID supervisory data (2023 Q4) and EBA calculations.
Notes: The table only covers investment firm groups subject to the IFD/IFR other than those subject to the capital group test. The table does not cover the full population of investment firm groups due to data unavailability.

[52] Notes: The table does not cover the full population of investment firms due to data unavailability.

Annex - Summary of questions for public consultation

Q1: What would be the operational constraints of potentially removing the threshold?

Q2: Would you suggest any further element to be considered regarding the thresholds used for the categorisation of Class 3 investment firms?

Q3: Do you have any views on the possible ways forward discussed above regarding the transition of investment firms between Class 2 and Class 3 should be introduced?

Q4: Should the minimum level of the own funds requirements be different depending on the activities performed by investment firms or on firms' business model? If yes, which elements should be considered in setting such minimum?

Q5: Is it necessary to differentiate the deductibles by activity or by business model for the purpose of calculating the FOR? If yes, which items should then be considered and for what reasons?

Q6: Are expenses related to tied agents material for the calculation of the FOR to the extent to require a dedicated treatment for their calculation? If yes, are the considerations provided above sufficient to cover all the relevant aspects?

Q7: Should the FOR be calculated distinguishing the costs related to non-MiFID activities, which criteria should be considered? What kind of advantages or disadvantages would this have in practice?

Q8: Should expenses related to fluctuation of exchange rates be included in the list of deductions for the calculation of the FOR? If yes, which criteria should be considered in addition to the ones suggested above?

Q9: Should the concept of 'ongoing advice' be further specified for the purpose of calculating the K-AUM? If yes, which elements should be taken into account in distinguishing a recurring provision of investment advice from a one-off or non-recurring one?

Q10: Does the K-DTF provide a proper level of capital requirements for the provision of the services Trading on own account and execution of order on behalf of clients on account of the investment firm? If not, what elements of the calculation of the K-DTF present most challenges?

Q11: Would you have any examples where the calculation of the K-DTF based on comparable activities or portfolios results in very different or counterintuitive outcomes? If yes, how could the calculation of the K-DTF be improved?

Q12: What are the elements of the current methodology for the calculation of the K-ASA that raise most concerns? Taking into account the need to avoid complexifying excessively the methodology, how could the calculation of the K-ASA be improved to assess those elements?

Q13: Clients' asset protection may be implemented differently in different Member States. Should this aspect be considered in the calculation of the K-ASA? If so, how should that be taken into account in the calculation?

Q14: Should crypto-assets be included into K-factor calculation, either as a new K-factor or as part of K-NPR?

Q15: In the context of addressing operational risk for investment firm trading on own account, is there any further element to be considered to ensure that the requirements are proportionate to their trading activities?

Q16: The discussion paper envisages the possibility to rely on alternative methodologies with respect to the K-DTF. If the respondents suggest an alternative approach, how would this refer to the two activities addressed under the K-DTF (trading on own account and execution on own account on behalf of the clients)?

Q17: When addressing other activities an investment firm may perform, which elements, on top of the discussed ones, should be also taken in consideration?

Q18: Investment firms performing MiFID activities 3 and 6 (trading on own account and underwriting on a firm commitment basis) are more exposed to unexpected liquidity needs because of market volatility. What would be the best way to measure and include liquidity needs arising from these activities as a liquidity requirement?

Q19: Investment firms performing the activities of providing loans and credit to clients as an ancillary service in a non-negligeable scale would be more exposed to liquidity risks. What would be the best way to measure such risk in order to take them into account for the purposes of the liquidity requirements?

Q20: Investment firms, providing any of the MiFID services, but exposed to substantial exchange foreign exchange risk may be exposed to liquidity risks. What would be the best way to measure such risk in order to take them into account for the purposes of the liquidity requirements?

Q21: Are there scenarios where the dependency on service providers, especially in third countries, if disrupted, may lead to unexpected liquidity needs? What type of services such providers perform?

Q22: Are there scenarios where the dependency on liquidity providers, especially in third countries, would lead to unexpected liquidity needs? Could you provide some examples?

Q23: What other elements should be considered in removing the possibility of the exemption in Article 43 of the IFR?

Q24: Do you have any views on the possible ways forward discussed above concerning the provision of MiFID ancillary services by UCITS management companies and AIFMs?

Q25: Are differences in the regulatory regimes between MICAR and IFR/IFD a concern to market participants regarding a level playing field between CASPs and Investment firms providing crypto-asset related services? In particular, are there concerns on the capital and liquidity requirement regimes?

Q26: Sections 5.2, 5.4 as well as this Section 9.1 all touch upon how crypto-assets (exposures and services) may influence the IFD and the IFR. Is there any other related element that should be considered in the review of the investment firms' prudential framework?

Q27: Is the different scope of application of remuneration requirements a concern for firms regarding the level playing field between different investment firms (class 1 minus and class 2), UCITS management companies and AIFMs, e.g., in terms of the application of the remuneration provisions, the ability to recruit and retain talent or with regard to the costs for the application of the requirements?

Q28: Are the different provisions on remuneration policies, related to governance requirements and the different approach to identify the staff to whom they apply a concern for firms regarding the level playing field between different investment firms (class 1 minus under CRD or class 2 under IFD), UCITS management companies and AIFMs, e.g. in terms of the application of the remuneration provisions, the ability to recruit and retain talent or with regard to the costs for the application of the requirements?

Q29: Are the different provisions, criteria and thresholds regarding the application of derogations to the provisions on variable remuneration, and that they apply to all investment firms equally without consideration of their specific business model, a concern to firms regarding the level playing field between different investment firms (class 1 minus under CRD and class 2 under IFD), UCITS management companies and AIFMs, e.g., in terms of the application of the remuneration provisions, the ability to recruit and retain talent or with regard to the costs for applying the deferral and pay out in instruments requirements? Please provide a reasoning for your position and if possible, quantify the impact on costs and numbers of identified staff to whom remuneration provisions regarding deferral and pay out in instruments need to be applied.

Q30: Are the different provisions regarding the oversight on remuneration policies, disclosure and transparency a concern for firms regarding the level playing field between different investment firm, UCITS management companies and AIFMs, e.g., with regard to the costs for the application of the requirements or the need to align these underlying provisions? Please provide a reasoning for your position.

Q31: What would be costs or benefits of extending existing reporting requirement to financial information? Which other elements should be considered before introducing such requirement?

Q32: Should there be the need to introduce prudential requirement for firms active in commodity markets and that are not currently subject to prudential requirements? How could the existing framework for investment firms be adapted for those cases? If a different prudential framework needs to be developed, what are the main elements that should be considered?