London Stock Exchange Group

LSEG Response to the European Commission Proposal for a Prudential Framework for Investment Firms

Introduction

- **About London Stock Exchange Group.** London Stock Exchange Group ("LSEG" or "the Group") is a financial market infrastructure provider with significant operations in the United Kingdom, Europe, North America and Asia. Its diversified global business focuses on four key areas:

  1) Capital formation – operation of a range of regulated markets and MTFs across asset classes including London Stock Exchange and Borsa Italiana, AIM / AIM Italia, SME Growth Markets, as well as Turquoise (pan European equity trading venue) and MTS (pan-European Sovereign bond venue). Through its platforms, LSEG offers market participants, including retail investors, institutions, SMEs and larger companies unrivalled access to Europe's capital markets. The Group also plays a vital economic and social role, enabling companies to access funds for growth and development. LSEG is a passionate champion of Capital Markets Union.

  2) Intellectual property – Through FTSE Russell, the Group is a global leader in financial indexing, benchmarking and analytic services with approximately $15 trillion benchmarked to its indexes. The Group also provides customers with an extensive range of data services, research and analytics through Mergent, SEDOL, UnaVista, XTF and RNS.

  3) Post-trade services – majority ownership of the multi-asset global CCP operator, LCH Group ("LCH") and the Italian clearing house CC&G and Italian CSD Monte Titoli. LCH has subsidiaries in the UK (LCH Ltd), France (LCH S.A.), and the US (LCH LLC). LCH serves both venue and OTC trading across many asset classes notably interest rate swaps and repos inter alia.

  4) Technology services – trading, market surveillance and post trade systems for over 40 global organisations, including our own markets. Additional services include network connectivity, hosting and quality assurance testing with the capacity to analyse Fintech both from a provider and a user perspective.

- **LSEG welcomes the European Commission's (the Commission's) proposal for a Prudential Framework for Investment Firms.** We recommend that the Regulation and Directive should be more proportionate than envisaged by the EBA in its application to principal traders acting as market liquidity providers, in order to support the Commission's objectives for Capital Markets Union. The co-decision process represents a unique window to act because the EBA have declined to acknowledge the need to calibrate their advice to be consistent with the Commission's CMU objectives (i.e. to support diversification away from an overreliance on bank financing in Europe).

- **LSEG welcomes and supports many elements of the Commission's proposal.** The overall objective to be more proportionate and acknowledge the lower risks posed by different types of institutions is laudable and in particular, we welcome that the framework is simpler, more coherent and consistent than the existing Capital Requirements Regulation with far fewer categories (Class 1 are systemic and subject to CRR; Class 2 are large but non systemic and Class 3 are small non systemic – with more proportionate regimes). LSEG customers operating in the asset management sector have told us that they welcome that the framework is more consistent with the UCITS and AIFMD environment. Finally, we broadly support the governance and remuneration aspects, and in particular, that there is no extension of the CRR bonus cap also to cover investment firms because this is a proportionate reflection of the different risk incentives of banks and investment firms.

- **We recommend that the framework be enhanced with a simple fix in order that it can more easily pass the 'CMU test'** and deliver on the vision of CMU as consistently articulated by the leadership of the Commission at the highest levels. This briefing is split into three sections. First, it explains the important role played by principal traders acting as market liquidity providers; second, it reveals, based on the EBA's advice, the adverse impact that the Commission's framework would have on CMU if applied to the legislative framework without amendment; finally, it provides a simple amendment to enhance the regime in order to help it deliver on the Commission's objectives for CMU.

Part 1 – The role of proprietary traders acting as market liquidity providers

- **Capital Markets Union.** We support the objectives of CMU to deliver a more diverse financing landscape which is less over dependent on bank financing. Many positive steps have been taken to support the supply of new stock to the markets by enhancing the regulatory regime for potential issuers including SMEs in the primary markets. <u>However, this needs to be complemented with a drive on ensuring that there is also adequate liquidity in the secondary markets</u> (which is also an objective of MiFID II when it comes to stressed conditions).

- **Liquidity provision** is key to increasing efficiency and reducing costs for the benefit of the liquidity takers (i.e. the asset managers on the buy side.) Depth and breadth of liquidity is also a key pillar of re-establishing stability in stressed market conditions because if investors need to sell assets in a hurry then they need counterparties to buy them, and at a fair price. The key to achieving this is to recognise the importance of a diverse set of different types of liquidity providers including principal traders as well as banks and retail investors. The table below indicates some data on the scale of liquidity provided to LSEG markets (i.e. around a quarter of the total liquidity provision). We anticipate that the figure is potentially higher for other markets in Europe.

<u>Data showing the provision of liquidity by proprietary firms</u> *(Source: LSEG Market Analysis)*

Proprietary traders acting as market liquidity providers have contributed around **25%** of the value traded on London Stock Exchange order books in 2017 (equity, ETF and fixed income) and around **24%** of value traded on Borsa Italiana's IDEM market (derivatives).

- **Market diversity.** Banks remain important liquidity providers, however they have been moving out of this business, and therefore, other participants need to be supported to replace this void. Banks are absolutely vital to the operation of capital markets and they play an incredibly valuable role in taking deposits and transforming these into long term loans (e.g. corporate bonds, mortgages). This kind of maturity transformation is an essential part of the markets and there will always be a big demand for their more bespoke services and the large segments they are serving, much of which are over the counter and not exchange traded. However, markets work best when there is a diversity of participants with different time horizons, investment and trading strategies and balance sheet and risk management frameworks calibrated to match. Therefore, optionality in applying risk frameworks should be the guide to achieving the same market stability outcomes without harming liquidity provision. Banking risk metrics are not appropriate for all participants. This is particularly true when banks have been moving out of the market making business over the last 15 years due to increased capital requirements, and therefore, other participants need to be supported to replace this void.

- **Evolution of liquidity providing activities.** There is an evolution of market liquidity provision happening at the moment. Contemporary principal trading firms compete on the basis of their technology and intellectual property using advanced risk management technology to directly access the market on a cross asset basis. These firms deploy a wide range of strategies across markets facilitating both liquidity provision and price discovery - for other market participants, most importantly asset managers and pension funds. Their activities contribute significantly to diversifying the flow on a continuous basis, ensuring not only that competitive buy and sell prices are readily available to other investors (including in stressed conditions), which is an essential characteristic of liquidity of any given product, but are also actively executing orders. In the low volatility environment we are witnessing globally, these strategies are yielding lower returns, which makes the cost of capital an even more important factor for the feasibility of these activities. The maturity of the principal trading segment is testified to by the consolidation that has taken place in recent years, meaning that participants have an increasingly global reach and sophisticated and robust operations and technologies.

- **Supporting innovation in the market ecosystem.** Due to the new order execution requirements under MiFID II / R, which will bring more activity to the exchange-traded markets, proprietary traders are expected to have an even more important role in demonstrating market innovation, helping to deliver the regulatory objectives underpinning MiFID II / R. Principal trading firms are essentially first generation Fintech firms who have heavily invested in technology in partnership with start up sectors to the extent that typically over a third of the employees are technology staff delivering automation and process efficiencies, including for risk and valuation calculations. This means they can provide liquidity more efficiently (without undermining risk) and avoid the risk of thin, low volume trading and stale pricing which is not being executed against. Other market participants such as asset managers benefit from operating in the same ecosystem not only directly from the availability of the trading flow and efficient pricing provided by proprietary traders, but also by adopting similar new technologies and approaches to the market. This can be demonstrated by considering the operation of the market 15 years ago where the processes were many times more inefficient than they are today using the most up to date automation processes. The change from voice to electronic trading has supported higher levels of transparency around price formation and proprietary traders are active across all market capitalisation segments of the market from small caps to blue chip stocks. In all cases there is always room to improve spreads between the best bid and offer prices quoted, market size available and stability. We are beginning to see these benefits flow right through the market to also enable more order book trading for less liquid stocks such as dual admission to trading of SME Growth Market securities (e.g. as already happens on Turquoise).

Part 2 – Why there will be an adverse impact on CMU if the proposed framework is applied without amendment

- **Sevenfold increase in capital requirement for principal traders.** As drafted, the proposal works for banks, because the risk measures are based on classic risk measures for banks. This is not surprising when it is the EBA, a banking regulator which has drafted the advice and which is given many of the level 2 empowerments in the text. As demonstrated above, at least a quarter of the liquidity on market is provided by principal traders, yet these firms are facing a sevenfold increase[1] in their capital requirements. That is not proportionate and will lead to some players having to withdraw and others unable to deploy as much balance sheet as they would need to perform their core function of liquidity provision at existing levels (the volume based measured proposed are an incentive to stop trading

[1] FIA EPTA

during highly volatile days such as stressed conditions when the liquidity is needed most) whilst others will respond with an adaption of trading strategies leading to a reduction in the diversity on instruments available to be invested. Furthermore it will be barrier to the development of new products for exchange trading (particularly in rates and fixed income).

- **Lack of liquidity cushion in stressed markets – contrary to the Commission's objectives in MiFID II RTS 8.** The lack of optionality in the risk metrics proposed, especially the "Daily Trading Flow" measure will mean a consequence of fewer bids and offers quoted and a much shallower market and this could be a major problem in a stressed market where the typically long only institutions wish to exit their investments without the benefit of a liquidity cushion. This is ironic when the objective of the proposal is to introduce more proportionality. Ironically a regime that was seen as "too strict" (i.e. CRR) actually had exemptions for principal trading firms, whereas with the new 'k factor' risk approach the "more proportionate" regime does not. This is inconsistent with the objectives of MiFiD II RTS 8 whereby proprietary trading firms deploying 'market making strategies' will have to enter into market making agreements with minimum quoting requirements, adding incremental value at risk on a continuous basis, including during stressed conditions. As drafted the proposal will undermine the ability of proprietary firms to support price formation as envisaged by MiFID II RTS 8 (MiFID II Article 17(7) (a), (b) and (c) and Article 48(12) (a) and (f)), due to the significant increase in capital requirements.

- **Reduced access for pension funds.** Major pension funds are investing huge sums and frequently need access to liquid ETFs (which themselves are invested in the real economy) but also to the derivatives markets in order to be able to hedge their extensive and diverse liabilities, making their capital exposures more efficient. This is a market in which proprietary traders are particularly active not only in providing liquidity but also in terms of performing two way creation and redemption.

- **International comparison**. The European Commission should be mindful that no comparable capital regime for investment firms exists elsewhere in the world and there is therefore a risk to the international competitiveness of the EU market compared to other jurisdictions in North America and Asia. There is also a risk that undue barriers to entry are being created within the EU which will impede innovation, stifling the diversity of actors in the European capital markets, with negative impacts for both market efficiency and robustness. Furthermore, the proposed Third Country regime (Art 61) may pose undue barriers in terms of reporting requirements and should be carefully considered for proportionality.

Understanding the differences between banks and principal trading firms

There are clear differences between these two types of market participants and therefore more optionality is needed in the risk metrics to be applied.

With principal trading firms:

- **Customer funds are not at risk.** Principal trades are conducted on own account and there is no client money at risk in the case of a default, unlike banks which are deposit takers
- **There is limited potential for taxpayer liability** unlike in the case of the banks.
- **They hold a very small amount of overnight risk** compared to banks so they are not systemically important.
- **Invest in liquid, standardised and exchange traded** assets, whereas banks are more comfortable with the CRR risk measures because these assumes that positions are held more for the long term (and are therefore less efficient at netting.

- **They outsource their balance sheet to a clearing member** who ensures that exposures are fully capitalised using risk based models which already exist and properly function (Clearing Member Guarantee). GCMs take haircuts (capital required by the clearing bank to enable them to close out positions – this already assumes a distressed sale with 30% market drop
- **They generally compete on intellectual property, not leverage and most trades are hedged.** Hedging is possible because both sides of their balance sheet are liquid, as opposed to banks which generally borrow short and lend long - as the Commission have recognised with their proposals to try and address the liquidity shortfall in the non performing loan market. By contrast, with principal trading firms there are no bond or mortgage holders to be paid off in the event of failure. Clearing members handle the risk because assets are collateral for clearing member haircuts and are independent of netting.

Part 3 – LSEG Recommendations to enhance the regime to help it deliver on the Commission's CMU objectives

- **Supporting exchange traded and cleared environments and the legacy of the Financial Services Action Plan (FSAP).** We recommend that the European Commission be mindful to support the trends towards exchange traded and cleared environments. By adopting the recommendations below, the proposed new framework will complement the fact that European market structure is now much more robust than 10 years ago, with a diversity of players and a democratised possibility of market entry rather than a narrow set of universal banks. This structure, which supports innovative and competition is the legacy of the FSAP (principally MiFID II/R and EMIR) and has led to a welcome trend towards a more transparent and stable exchange traded and cleared environment.

OUR 4 KEY RECOMMENDATIONS

1. **We recommend that the framework allow for the use of risk calibrated measure as well as value based measures.** In general we feel that the greatest choice of measures should be available to support the different models that participants operate. The regulation would better achieve its objectives (and those of CMU) if were recalibrated to reflect capital requirements based on risk calibrated measures rather than value measures. We welcome that the Commission have introduced the Clearing Member Guarantee (K-CMG) as an option however as currently framed in the text it is not a real alternative to the Net Position Risk (K-NPR consistent with the banking model from FRTB or CRR Standard Approach) because as drafted whichever is greater must be used - in practice this will be always be K-NPR. *We therefore propose the simple amendment below as our key recommendation.*

LSEG Suggested Amendment on our key recommendation

CHAPTER 3

Capital Requirements for Risk to Market (RtM)

Article 19

Scope

All trading book positions of an investment firm that deals on its own account and/or trades in its own name when executing client orders shall be subject to K-NPR as defined in Article 20.

The K-factor requirement for the Risk-to-Market (RtM) requirement is ~~the higher of~~ either K-NPR or K-CMG

2. **There should not be a zero-threshold for class 2 firms.** As currently proposed, the framework creates a barrier to entry of new firms that wish to trade on own account so that even if a start up firms trades with a minimal amount of capital on own account it cannot qualify for the most proportionate 'Class 3' classification (as per Art 12 of the proposed regulation) and must feature at least in Class 2 with the higher set of capital requirements. This also disregards the substantial increase in investment firms with a MiFID license following the entry into force of MiFID II/R. We urge the co-legislators to seek a quantitative based threshold to allow more firms to access the Class 3 category whilst dealing on own account. This will support the diversity of market participants and hence liquidity and the competitiveness of European markets.

3. **More Level 2 empowerments should be given to ESMA rather than the EBA.** The key optic through which the proposal is viewed is that of banking prudential requirements. This is largely because it is based on the advice of the EBA. However, looking towards the future and the CMU goal of a more capital markets orientated ecosystem we believe that ESMA ought to be considered as the lead regulator on the level 2 empowerments (e.g. Art 23 calculation of CMG). This would also help ensure consistency with MIFID II/R.

4. **Proportionality in the third country regime.** We note that Art 61 of the proposed regulation proposes changes to the MiFIR third country regime whereby there are to be new annual reporting requirements on third country firms (e.g. on services, turnover, risk policies etc.) which are to be a pre-condition for equivalence. Though this is more about asset managers than principal traders, this is likely to be a barrier to EU clients seeking to access third country participants especially since no similar regime exists elsewhere in the world. We therefore believe these provisions should be carefully considered and either removed or replaced with a more workable solution such as a version of extra-territorial licensing by ESMA of individual third country entities rather than relying on equivalence assessments.

Conclusion

- **We believe that the regulation must pass the 'CMU test'** and therefore needs recalibrating from the advice provided by the EBA, whose remit does not include the objectives of CMU. Proprietary firms are key liquidity providers and at the forefront of new technologies allowing market access to the buyside and providing a cushion in market stressed conditions. A ready-made technical solution is already available in form of the existing clearing member guarantee model and this can be fixed in the text with a very simple two word change. We also urge lower barriers to entry by introducing a higher threshold for Class 2 firms, a greater role for ESMA rather than the EBA and more proportionality in the third country regime.

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