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FEATURE

Regime change: a new framework for investment firms

Investment firms have so far been subject to prudential standards originally designed for banks. But Europe is now enacting reforms that separate firms into new classes and adjust the resulting obligations by size and activity. The industry has broadly welcomed the new regime, although concerns have arisen about the unintended consequences for some market participants.

EDITORIAL

Stéphane Giordano and Bertrand de Saint Mars | AMAFI

The Covid crisis that erupted just over a year ago had a substantial impact on market liquidity. Equity spreads increased by some 30% between February and mid-March 2020, while market depth shrank by around 10% overall, with a marked decline on the SME segment. Bond spreads widened by 40% or so, as the number of available quotes shrank by a quarter. Money market funds endured a full-blown liquidity crisis, prompting ESMA to hold a *consultation* on reforming the regulatory framework for this segment.

Markets have perked up since then. But since the shock occurred outside the financial sector – in contrast to those of 2007-2008 and 2010-2011 – the health crisis has shown just how fragile liquidity can be. And this at a time when developments in prudential standards have prompted traditional liquidity providers to pull out. In many cases, they have been replaced by shadow banking participants, with all the risks that this entails. Numerous mechanisms contribute to liquidity, and any analysis must be fine-grained enough to show that their relative importance varies considerably across market segments. With this in mind, there are concerns about some of the pathways discussed in the European Commission's and ESMA's guidance for the review of MiFID 2 regime, which underpins the operating framework for markets and their participants. For AMAFI, the challenge is to ensure that any changes are decided solely on the basis of conclusive cost-benefit analyses.

Europe's new prudential framework for investment firms

Sandra Sebag

After years of lobbying, investment firms will at last have their own prudential regulatory framework. Back in 2005, European regulators took the prudential regime designed for the banking sector under the Basel Accords and applied it both to credit institutions and to investment firms. However, the rules were deemed ill-suited to the latter. Compared with banks, not only are most of these firms exposed to limited risk by virtue of their size and activities; they also have a narrower business scope, since they neither take deposits nor lend. The European institutions finally listened to the industry's concerns and crafted a new regime specifically for investment firms. Two key pieces of legislation will come into force on 26 June this year: Regulation (EU) 2019/2033 of 27 November 2019 on the prudential requirements of investment firms and Directive (EU) 2019/2034 of 27 November 2019 on the prudential supervision of investment firms. The transposition process is under way.

Who is affected?

The European Council estimates that some 6,000 investment firms operate in the European Economic Area, forming a diverse population that includes brokers, own-account dealers, depositaries, custodians, ETF providers and general asset managers. Ultimately, the reforms will affect many of the participants that do business in the financial markets. Under the new framework, firms are to be divided into three new classes.

The largest, systemically-important firms are categorised as Class 1. These are firms with total assets of more than €30 billion, either individually or as a part of a group, and that deal on own account and/or provide underwriting services as defined by MiFID 2. They must be authorised as credit institutions, comply with the Capital Requirements Directive and Regulation, and be overseen through Europe's single supervisory mechanism. In all, 30 or so investment firms would qualify as Class 1 entities, including a dozen belonging to groups with a non-EU parent. Based on impact assessments, France's prudential regulator, ACPR, believes that fewer than ten firms in France – including subsidiaries of French and foreign institutions – are likely to be Class 1-compliant, although that number could still change. National competent authorities will also have discretion to place smaller firms engaging in bank-like activities and having total assets of between €5 billion and €15 billion into a Class 1 sub-category known as Class 1 minus.

Class 2 institutions will be subject to a new prudential regime based on specific metrics, or K-factors, for each business. They will be required to assess specific exposures – such as trading, custody and counterparty risk or assets held for retail clients – which will then incur capital requirements. Class 3 firms are smaller, non-interconnected entities and will be subject to a regime based on fixed overheads, with the minimum capital requirement set at one-quarter of the previous year's fixed overheads. This category includes investment firms that do not deal on own account and that have low asset levels, making them subject to lighter requirements.

The main goal of the reforms is to tailor the prudential regime to the size and specific characteristics of individual participants and ensure a level regulatory playing field for all firms doing business in Europe.

Varying obligations

While the industry has welcomed the reform overall, the changes will have detrimental effects for many firms, bar a few exceptions such as BNP Paribas Arbitrage, a Paris-based financial services provider. Says Guillaume Arbre, the firm's Chief Governance Officer: "We hope to be covered by an extension of our regulatory capital and liquidity exemptions because although we are a subsidiary, our business is consolidated as part of the BNP Paribas group. So our parent shares our obligations". From an operational perspective, the firm will still have to file a new authorisation application and submit new regulatory reports, but the impact looks to be measured. "We are awaiting clarifications so that we can prepare our new application," says Arbre. "In parallel, we are starting to analyse the new reports we will be required to submit, since we are leaving the jurisdiction of the ACPR and will be supervised instead by the European Central Bank. However, since the scope of our business will remain the same and we will not move into lending, the new reports should be fairly streamlined."

But not everyone in the business shares this view. "The new rules mean deep-seated changes," explains Laurence Martinez, a senior adviser in the accounting department of Crédit Mutuel Arkéa, a French bank. "For some firms, the biggest issue is not so much capital requirements but the need to prepare a new authorisation application, which is a fiendishly complex process." The requirement to seek authorisation as a credit institution, a status entailing restrictions that could further undermine already delicate business models, is another of the reform's unintended consequence for subsidiaries of banking groups, especially those specialised in small-business and mid cap financing. Moreover, complexity is not confined to Class 1; Class 2 firms are also affected. Compliance, for instance, might be challenging and costly to achieve in some businesses, such as asset custody. Although not previously considered as a standalone business, securities custody is counted under the K-factors according to the new rules, which could push up capital requirements.

> *"The main goal of the reforms is to ensure a level regulatory playing field for all firms doing business in Europe"*

Postponement needed

In view of these issues, AMAFI and investment firms are asking for the new rules to be pushed back to the end of the year to give everyone enough time to prepare and take the necessary organisational decisions. If capital needs to be raised, firms will have to convene their decision-making bodies and then actually carry out the increase. This will entail knowing the exact amount required and securing the consent of shareholders, a process that will take time. Time is likewise needed for the authorisation procedure. "We are still awaiting full documentation and supervisory guidance on putting together authorisation applications. In the meantime, we have set up a taskforce to make headway in this area, pending release of final clarifications," says Laurence Martinez. A further complexity is the need to upgrade information systems, but IT providers are saying they are not fully ready for the reforms.

Following the UK's lead

There is also a UK-sized argument for postponement. In light of industry feedback highlighting concerns about the overall volume of regulatory reform in 2021, the Treasury, the Prudential Regulation Authority and the Financial Conduct Authority issued on 16 November 2020 a joint statement announcing that implementation of the new UK Investment Firms Prudential Regime (IFPR) would be postponed to 1 January 2022. A month later, in the summary to its December 2020 consultation on a new UK prudential regime for MiFID investment firms, the FCA wrote: "When the UK was a member of the EU, we strongly advocated introducing [an investment firm] regime, and we were heavily involved in policy discussions on creating the regime. [...] We support the aims of the Investment Firms Directive/Investment Firms Regulation. We propose that the IFPR will achieve the same overall outcomes". However, since the new regime is being introduced post-Brexit, the FCA also said that it was right to consider what amendments were appropriate to account for the specifics of the UK market. In other words, while Britain's framework is expected to be broadly aligned with the EU regime, the City – until recently the EU's primary financial centre – is working on rules that will make it more competitive, including in relation to EU issuers and investors. To give one key example, the Treasury and the Prudential Regulation Authority have said that whereas the Investment Firms Regulation obliges systemically-important European investment firms to re-authorise as non-deposit taking credit institutions, systemic firms in the UK will not be required to do so, as the existing PRA supervisory framework is deemed to achieve the same outcomes as those targeted by the IFR. Since the initial aim of the new legislation was to put all investment firms in Europe on an equal footing, industry participants in continental Europe are calling for the same delay as that decided by the UK to ensure that everyone is subject to the same ground rules.

French regulators are keenly aware of these concerns. They want the transition to the new prudential regime to be as painless as possible and hope firms will not be forced to change their business models. Since Class 1 firms will have to comply with bank rules even though they do not engage in a full range of banking activities, notably lending, Pascal Jourdain, an international banking specialist at the ACPR, says domestic legislation will need to be amended so that investment firms' new status reflects their specific characteristics. But he also reiterates

that the reform is an opportunity for financial firms to review their organisation, while observing there are other factors in the mix. Brexit, for example, is prompting some firms to relocate activities to the European Union.

A more proportionate and fit-for-purpose prudential framework for investment firms has been a long time coming. Thus the new regime is good news and the modifications are broadly welcome. Taking the time now to get everything right will ensure that Europe's regime change goes as smoothly as possible.

ICSA

Interim meeting, 10 February 2021

The International Council of Securities Associations (ICSA) met in mid-February with Paul Andrews, Secretary General of the International Organization of Securities Commissions (IOSCO), to discuss IOSCO's work *programme* for 2021 and 2022. The meeting was held virtually because of the health crisis.

Priority work areas were discussed, including cryptocurrencies, artificial intelligence and market fragmentation. The meeting also afforded an opportunity to stress the systemic risks connected with services provided by non-bank financial institutions, as well as the ways in which widespread remote-working might affect supervision, fraud detection and operational resilience. Sustainable finance is another major issue for IOSCO, which plans to focus on improving the consistency and comparability of sustainability reporting. With Paul Andrews set to stand down as head of IOSCO at the end of February, participants thanked him for his excellent work and receptive attitude.

Arnaud Eard

IOSCO

Market data

AMAFI responded in late February *(AMAFI / 21-14)* to IOSCO's consultation on several broad issues relating to market data in equity markets. Key questions included the definition of core data and how they are used, along with questions of access and consolidation.

AMAFI reiterated the specific features of the European model and stressed major concerns, which the association recently raised in its feedback to ESMA's consultation on guidelines for MiFID 2 / MiFIR obligations on market data *(AMAFI /21-04)*. A major challenge is to ensure that, from a pricing perspective, these data are made available on a "reasonable commercial basis". It is likewise important to simplify and standardise market data agreements and establish a framework for external audits engaged by market data providers.

Emmanuel de Fournoux, Mehdi Ounjema

EUROPE

INVESTMENT FIRMS

Prudential regime

Entry into application

As our feature article shows (p 3), implementing Europe's new regime for investment firms, which comprises the Investment Firms Regulation (IFR) and the Investment Firms Directive (IFD), is a major project for AMAFI. The association is meeting regularly with the Treasury and the prudential regulator, ACPR, to discuss transposition of the IFD into French law and the practical arrangements required to switch investment firm classes to the new regime. While some operational solutions are now emerging, with just months to go until the 26 June 2021 deadline, concerns remain. Given that some answers can only come at European level, the new regime's entry into application should be delayed by a few months.

Remuneration

In connection with the new regime, the European Banking Authority (EBA) is consulting on guidelines for sound remuneration policies for Class 2 investment firms.

Since the proposed guidelines are closely modelled on those put forward in connection with the fifth Capital Requirements Directive, on which EBA also consulted recently, AMAFI partly based its response *(AMAFI / 21-19)* on the feedback it submitted in January *(AMAFI / 21-07)*. Among the top priorities are Brexit-related implications for competitiveness and the capacity of EU participants to attract talent. In terms of the proposals for gender-neutral pay policies, AMAFI argued that EBA had overstepped its mandate in areas linked to gender neutrality, such as access to training and internal mobility. Pointing to IFD's sector-specific focus, the association said that the guidelines were not an appropriate vehicle for dealing with these questions.

Arnaud Eard, Emmanuel de Fournoux

ALGORITHMIC TRADING

ESMA's proposals

In the context of its MiFID 2 review report, ESMA launched a consultation on algorithmic trading. AMAFI responded by saying that it was broadly satisfied with the regulatory framework established by the directive in this respect (AMAFI / 21-18). However, the proposals put forward by ESMA are likely to make the framework more complex, especially for direct electronic access services, market making agreements and the tick size regime, with no apparent benefits for orderly market operation or investor protection.

Accordingly, AMAFI argued in favour of maintaining MiFID 2 provisions on algorithmic trading as a whole, while encouraging the adoption of industry best practices to address the improvement areas highlighted by ESMA. These concern the rules that trading venues are responsible for introducing and supervising, namely procedures governing liquidity provision, speedbumps, and distribution of post-trade private and public data feeds.

Emmanuel de Fournoux, Mehdi Ounjema

BREXIT

Derivatives trading obligation

Following up on the *letter* sent in late December 2020 by a coalition of European associations including AMAFI, the French Banking Association (FBF), and sister associations from Germany (BDB), Ireland (BPFI) and Italy (ASSOSIM), the association teamed up once again with its partners to alert the European Commission to the *question* of temporarily suspending the applicability of Europe's derivatives trading obligation (DTO) to UK branches of European institutions.

Referring to data collected since 1 January 2021, AMAFI and its partners illustrated and underlined the detrimental impact of uncoordinated application of European and UK DTOs on the liquidity of affected instruments and, ultimately, on the competitiveness of European firms. The situation is even more problematic because it runs counter to the European Union's goals of increasing financial sovereignty and enhancing the capacity of EU financial markets to participate effectively in financing the economy as part of the Capital Markets Union reboot.

Further compounding these concerns, Britain's Financial Conduct Authority recently extended the temporary authorisation granted to third-country branches operating in the UK, allowing them to execute transactions on European trading venues when trading for EU customers.

Arnaud Eard

EUROPE

MIFID 2

MiFID 2 Review – AMAFI's priorities

As part of the review of the MiFID 2 framework launched last summer, the European Commission published on 26 February its Quick Fix Directive. This legislative act amends MiFID 2 rules on disclosure obligations, product governance and position limits with a view to supporting the post-Covid crisis recovery.

Overall, the quick fix addresses a number of issues. But the outcome is only partially satisfactory, since some of the crucial issues highlighted by AMAFI *(AMAFI / 20-03* and *AMAFI / 20-32)* remain unresolved. These will therefore need to be dealt with during the overall review of the MiFID 2 framework, due at end-2021 for MiFIR and end-2022 for MiFID 2.

AMAFI has been working to that effect for several months. On investor protection, it is building on discussions held in 2019 *(AMAFI / 19-109, 19-110, 19-111)*. The aim is to reiterate and clarify the priorities identified in light of the measures already taken, especially regarding inducements (see below).

The main market-structure issues concern the transparency regime for non-equity markets. Here, the goal is to ensure a satisfactory tradeoff between liquidity and transparency, since each could considerably affect the other, thereby undermining the capacity of these markets to fulfil their roles in financing the economy and hedging risk. Other issues involve the territoriality of transactions in derivative instruments subject to the trading obligation, as well as the creation of a European consolidated tape.

Inducements

AMAFI published in late February a memo on inducement payments in the context of order execution or reception/transmission services *(AMAFI / 21-13)*. The memo reflects discussions within the association's Private Banking Compliance Committee on the legitimacy of inducements relating to the marketing of financial instruments distributed without investment advice. The aim is to identify the arrangements that institutions put in place to evidence the quality of service they provide to end customers.

Meanwhile, cross-market work is continuing to appraise inducement practices, especially the resulting costs for investors. These efforts are being conducted in close coordination with professional associations in Germany.

Pauline Laurent, Adélaïde Fischmeister, Emmanuel de Fournoux

PRIIPs

PRIIPs review

Reaching out to the European Commission in particular, AMAFI kept up its efforts to highlight issues identified in the revised draft regulatory technical standards (RTS) that have been approved by the European supervisory authorities. Based on the latest information, the standards look likely to be adopted by the Commission and published in the course of the year. As a result, AMAFI is trying to ensure that participants have time to make the necessary modifications, especially if the changes are reckoned to be particularly significant, such as those affecting structured products.

Pauline Laurent

CSDR

Buy-in mechanism

The European Commission recently consulted participants on the review of the Central Securities Depositories Regulation *(CSDR)*. For AMAFI, the key issue is to scrutinise the rules on mandatory buy-ins *(AMAFI / 21-09)*, which are part of market discipline measures. While AMAFI supports the introduction of a buy-in mechanism at European level, market participants cannot satisfactorily implement the arrangements as currently set out in the regulation. In particular, AMAFI believes that central counterparties and/or undelivered buyers should not be able to activate the buy-in procedure.

Emmanuel de Fournoux

FRANCE

ANTI-MONEY LAUNDERING

Annex to ACPR guidelines

The ACPR has finalised and published the *Annex* on market transactions to its *guidelines on KYC aspects*. This is a significant development for market activities and AMAFI members. The aim of the measures is to capture the specific features of these activities in order to implement tailored due diligence measures, which are inherently different from those applicable to banking and retail services, and so improve the effectiveness of participants' anti-money laundering/counter-terrorist financing (AML/CTF) systems.

The document, which takes into account the most recent comments made by the association, meets AMAFI's key goals because it states, in a written ACPR policy, that:

▶ In the case of financial intermediation, no business relationship exists between an executing broker and the end customers of a referring intermediary, where the intermediary sends customer orders to the executing broker as part of an order reception-transmission service;

▶ In the case of financial instrument distribution, no business relationship exists between the manufacturer and the distributor's end customer;

▶ In the event that dual Market Abuse and AML reports are made to France's securities regulator, AMF, and the French financial intelligence unit, Tracfin, respectively, these reports may have the same content, but the money laundering risk profile of the affected customer need not be downgraded in every case.

Request for clarification

AMAFI sent to the appropriate French authorities (DGT, INPI, DGFIP and ACPR) a list of issues requiring clarification following transposition of the Fifth AML/CTF Directive and publication of the new *cross-sector executive order on AML/CTF internal control*.

Adélaïde Fischmeister

DAC 6

AMAFI professional guide

The *DAC 6* Directive on the mandatory automatic exchange of information between tax authorities introduces a new obligation to report certain potentially aggressive cross-border tax planning arrangements identified by the presence of predetermined "hallmarks". The directive has been transposed into French law through Articles *1649 AD* to *1649 AH* of the General Tax Code. Market participants are concerned by this reporting obligation, which primarily applies to intermediaries, but also affects taxpayers in some cases.

To help members implement their obligations, AMAFI has prepared a guide to the DAC 6 rules applied to financial intermediation. Drawing on discussions by working groups coordinated by its Tax Committee and approved by the Board, AMAFI has now released its DAC 6 Professional Guide *(AMAFI / 21-08)*, which collates all this work. The guide comprises three documents:

▶ A summary of the work and a description of the main proposed interpretations *(AMAFI / 21-08a)*;

▶ Book 1, which sets out the DAC 6 legislative, regulatory and policy framework *(AMAFI / 21-08b)*;

▶ Book 2, which proposes a common interpretative framework for activities typically undertaken by market participants with regard to DAC 6 *(AMAFI / 21-08c)*.

Built around an iterative process, the guide may be updated in the future to incorporate relevant new information. An English version of the summary will shortly be available. AMAFI will also publish an English translation of Book 2, which Dentons, a law firm, has kindly prepared.

Eric Vacher, Maguette Diouf

AMAFI

NEW MEMBERS

▶ **PrimaryBid SA**, an investment firm offering order reception-transmission services. Its senior managers are Kieran D'Silva (Chairman of the Board of Directors), Anand Sambasivan (Chief Executive Officer) and François de Wiljes (Deputy Chief Executive Officer).

▶ **RiverRock Securities SAS**, an investment firm whose activities include order reception-transmission and execution, dealing on own account and investment advice. Nicolas Gaumont-Prat (Chairman) and Mikaël Mallion (Deputy Chief Executive Officer) are its senior managers.

▶ **Square**, a strategy, organisation and management consulting firm. Its senior manager is Jérome Boucheron (Chairman).

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AMAFI documents quoted in this Newsletter and flagged with a reference number are on our website at

www.amafi.fr

Most of them, notably AMAFI's responses to public consultations, are freely available, but some are restricted to members only.

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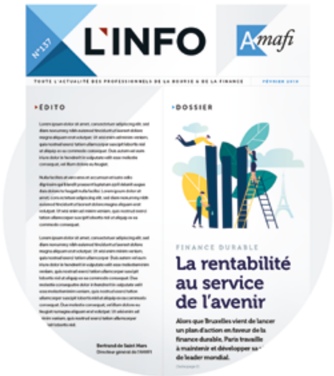
http://www.amafi.fr/en



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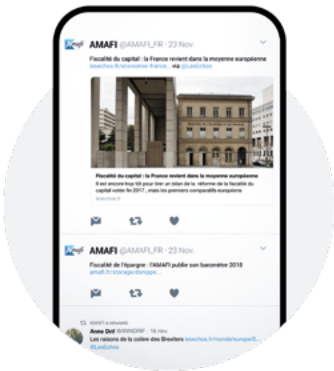

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