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EU prop trader regime could capture foreign firms

Group capital rules may be applied to third-country arms of EU market-makers

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There is growing unease among proprietary traders that new European Union prudential rules could end up being applied to their operations in the US and Asia, plus the UK after Brexit, potentially leaving them with much higher capital than their foreign rivals.

The concerns stem from the EU's proposed group **capital requirements for investment firms** and a tougher approach to equivalence for those based in third countries.

"It is certainly a concern, and… at odds with the whole capital markets union objective – the idea that we want to make European markets more competitive globally. You won't achieve that through some kind of extraterritorial application of these rules," says one industry source.

Three sources say the combination of the investment firms regime and a harder line on third-country access is obliging principal trading groups in the UK to consider more substantial Brexit relocations of their activities to the EU27 than originally planned. The rationale is to simplify the capital-planning exercise by reducing the size of non-EU activities.

"As part of Brexit planning, you have got to look at your EU versus non-EU business, and how you structure that," says an executive at one UK-based principal trading firm. "Obviously, part of that involves a lot of capital planning, because your total capital after Brexit could certainly be higher. The more entities you have to add into the mix, the harder it is in terms of capital efficiency."

The European Commission proposed the Investment Firms Regulation (IFR) in December 2017, including a group capital requirement modelled on Article 15 of the Capital Requirements Regulation (CRR), which was adopted in 2013.

That article is a derogation from a preceding section on consolidation requirements, setting out the conditions that investment firms must meet to avoid consolidating all their entities. It does not explicitly set out the investment firm group capital treatment of non-EU subsidiaries, but instead says the parent in an EU member state must hold enough capital to cover the full book value of any holdings in investment firms that are not consolidated.

Two sources say the wording of Article 15 caused confusion and differing practices among non-bank liquidity providers.

Nobody knows what is intended – it is a bit of an opaque concept

Bart Joosen, Loyens & Loeff

Bart Joosen, a lawyer at Loyens & Loeff in Amsterdam, says **Dutch prop traders** received confirmation that they could use the capital requirements applied to their non-EU subsidiaries by host regulators. If there are no suitable local capital requirements – as is the case for certain types of securities firms in the US and Singapore – then the EU firm will need to hold capital at group level equal to the book value of the third-country entity.

The EC adopted a shortened version of the CRR group capital rules in Article 7 of the IFR, but there is a concern around conditionality added by the EC in Article 8. This article allows the competent authority regulating an investment firm to impose full consolidation of capital requirements across the group. That would mean parents in Europe applying the new **k-factors** contained in the IFR to all of their operations, including those based in third countries.

Competent authorities will have the discretion to apply k-factor consolidation if "there are significant material risks to customers or to market, stemming from

the group as a whole, which are not fully captured by the capital requirements applicable to the investment firms in the group on an individual basis".

The nature or threshold of these "significant material risks" is undefined. "Nobody knows what is intended – it is a bit of an opaque concept," says Joosen.

K-factor consolidation

This raises anxiety over how Article 8 will be applied – concerns inflamed by French lawmakers in the European Parliament and the Council of the EU, who have **been pushing** for k-factor consolidation without applying the test set out in Article 8.

French members of the European Parliament justified their stance by arguing the group capital test in Article 7 could lead to insufficient parent capital where a group contains entities in a third country. In other words, the call for mandatory consolidation was designed explicitly to apply European prudential standards to the non-European operations of EU principal trading groups – creating profound competitive challenges.

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Industry source

"Capital requirements in the US, for example, are really very low, so it would put European firms at a tremendous disadvantage," says the industry source.

Even firms headquartered outside the EU with operations in Europe are concerned their third-country parent might be captured by k-factor consolidation.

Marco Bragazzi, finance director at the European arm of US-headquartered Tower Research Capital, says US prop traders are not required to report on a consolidated basis in their home market. Consequently, Europe would be the only jurisdiction in the group requiring consolidation, potentially capturing the whole global balance sheet.

Parliament rejected the French proposal for mandatory k-factor consolidation. It is still theoretically on the table in the council, although the idea was not contained in the Austrian presidency's proposed compromise on October 9. Even if it is not approved in the final text, the support this idea received from

some national governments suggests at least some competent authorities will want to make use of the Article 8 discretion.

No equivalence

Fears over how the EU will apply capital requirements to third-country non-banks are being exacerbated by uncertainty over whether foreign proprietary traders will be allowed to operate in Europe using equivalence decisions by the EC. Today, foreign investment firms can operate in the EU if their home jurisdiction has rules equivalent to the Markets in Financial Instruments Regulation (Mifir), which entered into force alongside the second Markets in Financial Instruments Directive (Mifid II) in January.

In the IFR compromise text agreed by parliament in September, two types of investment firm activity were removed from the Mifir equivalence framework: dealing on own-account and underwriting securities issuance.

If carried through into the final IFR, this absence will leave each individual national regulator to decide whether to let third-country principal traders join exchanges in that jurisdiction, depending on whether the competent authority regards prop trading as a service to clients – an activity that must be accompanied by a Mifid II licence and subject to the investment firm capital regime.

“The German stock exchanges have always said if you want to have membership and do trades on your own account, then they want you to submit your Mifid II authorisation or passport. We have seen similar notes in Italy,” says Joosen at Loyens & Loeff.

In contrast, the Amsterdam Stock Exchange membership rules are more accommodating for non-EU firms and do not require a Mifid II licence. But the EU’s ongoing **re-examination of equivalence** in light of Brexit could bring the curtain down on that kind of generosity.

In a letter about Brexit sent to the EC on September 26, and published on October 1, Steven Maijoor, chair of the European Securities and Markets Authority (Esma), specifically noted: “The Mifir regime does not ensure a consistent and convergent level of protection to investors interacting with third-country [investment] firms, and therefore we would like to support the EC in any analysis concerning any further harmonisation regarding the rules applicable to third-country firms providing investment services.”

This could point the way towards the EC and Esma taking a view on whether non-bank liquidity providers are providing an investment service, and therefore

imposing a harmonised regime that might force prop traders to obtain a Mifid II licence in all EU jurisdictions.

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