

Background

The European Union Capital Requirements Directive came into effect on 1 January 2007. It introduced consistent capital adequacy standards and an associated supervisory framework in the EU based on the Basel Capital Accord (“Basel II”) rules agreed by the G-10.

Implementation of the Directive in the UK was by way of rules introduced by the then UK regulator, the Financial Conduct Authority.

The CRD framework consists of three pillars:

- Pillar 1 specifies the minimum amount of capital that a financial services firm is required to maintain to support its business;
- Pillar 2 requires the firm to assess whether any additional capital should be maintained against any risks not adequately covered under Pillar 1
- Pillar 3 specifies the disclosures which the firm is required to make about its capital, its risk exposures and its risk assessment processes.

Scope

Liquidnet Europe Limited (“LNEL” or “the Company”) is an investment firm authorised by the Financial Conduct Authority to conduct investment business in the UK acting as an agency broker and operator of a ‘Multilateral trading facility’ (MTF) for equities and fixed income. By acting as agent, LNEL does not take on or hold any principal positions. LNEL’s has undertaken its capital and operational risk assessment in accordance with the Capital requirement Directive (CRD IV) and the regulatory guidance as an IFPRU (Investment Firms Prudential Sourcebook) €730k limited license Company.

Risk management objectives and policies

The directors of the Company ensure that the risks it is or might be exposed to on a day to day basis are adequately identified, managed, monitored and reported to senior management. LNEL will take all reasonable steps to identify the risks relating to its activities, processes and systems.

LNEL does not engage in any proprietary trading, portfolio management, investment advice or corporate finance activities. Trades executed for members and clients will only be in listed equity securities. LNEL has a low tolerance for operational risk and will take all reasonable steps to identify and mitigate the risks relating to the Company’s activities.

LNEL has an established governance framework in place and adopts the three lines of defence model as the primary means to structure roles, responsibilities, accountability, decision making, and ensure an effective risk management and governance framework. The board of directors is responsible for the governance of the management and control framework of LNEL. The board formally meets quarterly and holds interim board calls to oversee the strategy and risk framework of the legal entity. The Audit Committee and Risk and Compliance Committee assist the senior management of LNEL and the board in the performance of their functions.

The first line of defence includes the operational managers who own, manage and perform day-to-day risk management activities. They are responsible for implementing corrective actions to address process and control weaknesses, and maintaining effective internal control procedures on a day-to-day basis.

The second line of defence includes the oversight functions such as Compliance, Legal, Finance, Global Talent Engagement (GTE), and Market Monitoring who set and define the policies and provide guidance and assurance that the right process is being adhered to. The Compliance function facilitates and monitors the specific risks to ensure compliance to applicable laws and regulations. The Finance control function monitors financial risks and financial reporting issues. All functions may intervene independently and directly in modifying and developing the internal controls and procedures.

The third line of defence includes the independent view and perspective from internal and external audit who offer independent challenge to the levels of assurance provided by business operations and oversight functions. The scope of assurance reported to senior management and to the governing body covers a wide range of objectives including efficiency and effectiveness of LNELs operations, the safeguarding of assets, the integrity of processes and procedures, compliance with local laws, and assurance that policies are adhered to. This is also delivered through regulatory engagements on either a thematic or ad hoc basis.

The Risk and Compliance Committee is responsible for overseeing and reviewing the operational risks in the business, and the Audit Committee is responsible for reviewing all audit (internal and external), financial and capital requirements in the business. The respective committees convene quarterly in advance of the entity board meeting. The board consists of executive and non-executive directors who bring a complementary skillset to the governance framework.

Board members also attend the Risk and Audit Committee meetings to ensure key items are addressed, understood and if necessary escalated to the board for wider discussion. Strategy is similarly reviewed in detail at offsite meetings where the directors and senior executive team, including non-executive directors, are encouraged to provide credible challenge and input to the strategic direction of the firm.

Operational risk

This risk is defined as the risk of loss to the Company resulting from inadequate or failed internal processes, people and systems, or from external events; it includes legal, reputational and financial crime risks, but does not include business risk.

LNEL is exposed to various factors giving rise to operational risk. However, since the Company is a limited license IFPRU firm, it does not calculate an operational risk requirement under Pillar 1. For its Pillar 2 assessment of operational risk, LNEL has undertaken an assessment of the operational risks to which it is exposed. The assessment covers the likelihood and impact of the occurrence of the risks, an assessment of materiality, and the mitigating controls and processes in place.

Credit Risk

Credit risk refers to the likelihood of a debtor failing to return the amounts owed to LNEL. LNEL is exposed to credit risk, however in light of the regular monitoring involved and the type of members and clients LNEL engages with (majority being regulated financial institutions) the historic exposure to credit risk is de minimis and is adequately covered by the credit risk capital held under Pillar 1.

Market Risk

Market risk refers to the risk that the value of investments may decline due to changes in market variables, such as interest and currency exchange rates and equity and commodity prices.

LNEL does not engage in proprietary trading and as such does not have a trading book or hold any trading positions. Currently the only market risk exposure to LNEL is due to the foreign currency balances which give rise to foreign currency exposure requirements. LNEL's exposure to market risk is relatively insignificant; hence the Company does not hold any additional capital under Pillar 2 in relation to market risk.

Liquidity Risk

Liquidity risk is the potential that the Company may be unable to meet its obligations as they become due. This risk is mitigated by a strong balance sheet which will provide sufficient liquidity under stress tested scenarios and effective financial planning.

Business Risk

Business risk incorporates the risks to the Company arising from not being able to carry out its business plan or its desired strategy due to internal or external changes impacting the business. The external changes may result from a wider range of macro-economic, geopolitical, industry, regulatory or other factors. An evolving macro-economic environment coupled with changes in the regulatory landscape, in particular, present ongoing business risks. Whilst market volatility continued throughout 2015 in the Eurozone as well as globally, economic uncertainty and market volatility still continues to exist. It remains too early to determine what impact this may have in 2016.

On 19 December 2014, the European Securities and Markets Authority (ESMA) published final technical advice to the European Commission and a consultation paper on the MiFID II Directive and MiFIR (the Markets in Financial Instruments Regulation). There was an industry consultation period on this document. This input informed ESMA's "Final" Final draft which was sent to the European Commission in mid-2015.

Following the review of the responses and taking account of the exceptional technical implementation challenges faced by regulators and market participants, the European Commission has delayed the implementation of MiFID II to 3 January 2018. LNEL remains active in Level 2 and Level 3 lobbying with the FCA and ESMA with respect to trading obligation for shares and a double volume cap mechanism for shares and equity-like instruments, which introduces a major change to the framework for trading these instruments in the EU as well as the subject of increased trade transparency for bonds (both pre-trade and post-trade). A key business risk to manage and accurately assess is the impact MiFID II will likely have on the block trading landscape and determine how the Company positions itself accordingly.

Other regulatory changes of concern include EMIR, CRD IV, BASEL III, the Vickers Report proposals, and the expansion of a European wide financial transaction tax (FTT). Whilst the direct impact to LNEL relating to these perspectives is minimal, there remains concern and also opportunity around the macro effects thereof. LNEL remains in close contact with trade bodies and other concerned parties to keep abreast of these likely outcomes and respond accordingly.

Additional business risk surrounds the implications for financial markets on the referendum in the UK in June 2016 on whether the UK is to remain in or leave the European Union. Whilst there is currently much uncertainty associated with the potential implications, it is quite possible that uncertainty will affect the financial markets before the referendum. The business is closely monitoring developments and is confident it will be able to manage its operations through the uncertainty.

The main business risk for LNEL is a significant drop in block equity trading volume or losses from unallocated or failed trades. Business risks are assessed and mitigated as part of the Internal Capital Adequacy Assessment Process (ICAAP).

LNEL only accepts members onto the platform after performing due diligence reviews and approval procedures per the Company's risk management policies. LNEL also maintains controls to minimise the likelihood and impact of each business risk identified. Business risk is further mitigated by a deep understanding of the industry and regulatory environment by the LNEL board of directors.

Capital Resources

As an agency broker, operator of one MTF with a regulatory classification as an IFPRU €730k limited license Company, LNEL's Pillar 1 capital requirement is calculated as the higher of the credit and market risk requirements, or the fixed overhead requirement (FOR). For LNEL, the FOR is the higher figure.

As at March 2016, the Company's regulatory capital position is as follows:

Pillar 1	£'000
Credit risk	1,196
Market risk	152
Sub-total (A)	1,348
Fixed overheads requirement (B)	7,510
Total capital requirement (Pillar 1: higher of A & B)	7,510
	£'000
Common equity Tier 1 Share capital	6,986
Retained earnings	22,114
Capital reserve	686
Total capital resources	29,788

The Pillar 2 capital is calculated by the Company on a risk by risk approach. This represents any additional capital to be maintained against any risks not adequately covered under the requirements above and is assessed as part of the ICAAP.

Capital resources exclude reserves of £6,135,166 relating to stock options, RSUs and PSUs in Liquidnet Holdings, Inc. and £147,000 of reserves from the transfer of assets into the Company following the ultimate parent's acquisition of the fixed income trading platform in the previous year.

Capital Management

The Company's capital management objective is to maintain sufficient surplus capital in excess of the higher of Pillar 1 and Pillar 2 capital requirements. Pillar 2 capital requirements are determined using a risk based approach that incorporates the management's view of specific risk exposures.

The Company's approach to assessing the adequacy of its internal capital to support current and future activities is documented in the ICAAP. The ICAAP includes an assessment of all material risks faced by the Company and the controls in place to mitigate those risks. The Company stress tests the business model by considering the Company's financial forecast for the following 3 years. This includes considering multiple stress events to determine the level of capital that the Company needs and considers ultimately what would cause the business to fail and require an orderly wind-down of the operation.

The Company's ICAAP is formally reviewed and re-approved by the directors annually. If significant business changes occur between these review dates, then the ICAAP is amended and resubmitted for review and approval by the board of directors.

Management of the ICAAP

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Capital Adequacy

The Common Equity Tier 1 ratio is a measure of the Company's Tier 1 capital compared to its total risk weighted assets.

As At
31 March 2016

Common Equity Tier 1 Capital	31.73%
Tier 1 Capital	31.73%
Total Capital	31.73%

The Company's Common Equity Tier 1 capital, Tier 1 and Total capital are the same as the Company's capital base consists only of Tier 1 capital under CRD IV.

Capital Ratio due to Pillar II adjustments

The Common Equity Tier 1 capital is expressed as a percentage of the Risk Weighted Exposure Amounts, having first adjusted for the individual capital guidance (ICG).

As At
31 March 2016

Total Capital Ratio including Pillar II adjustments	24.22%
Target Total capital ratio due to Pillar II adjustments	10.48%

At 31st March 2016 the Total Capital Ratio including Pillar II adjustments of 24.22% exceeds the minimum required target of 10.48%.

Asset Encumbrance

As at the 31st March 2016 the Company held **13%** of encumbered assets as a percentage of its total balance sheet assets.