21 January 2014

Balance of Competences Review
Single Market: Financial Services and the Free Movement of Capital
HM Treasury
1 Horse Guards Road
London, SW1A 2HQ

By email: balanceofcompetences@hmtreasury.gsi.gov.uk

Dear Sirs,

Re: Balance of Competences Review – Single Market: Financial Services and the Free Movement of Capital

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Introduction

This response to HM Treasury's call for evidence entitled *'Balance of Competences Review – Single Market: Financial Services and the Free Movement of Capital'* is made by the Regulatory Committee of the British Private Equity and Venture Capital Association (the "**BVCA**"). The BVCA welcomes HM Treasury's engagement with stakeholders on this important issue. It has sought to prepare a response which makes a constructive and serious contribution to the debate about modernising, reforming and improving the balance of competences in the EU financial services field by explaining the impact of the current EU competences and legislative process on the UK's private equity and venture capital ("**PE/VC**") industry. The BVCA should note that it is generally supportive of the single market and our members (and the businesses they invest in) have experienced the benefits of this.

The BVCA and the UK PE/VC industry

The BVCA is the industry body for the UK PE/VC industry. With a membership of over 500 firms, the BVCA represents the vast majority of all UK-based PE/VC firms and their advisers. Its members have invested £33 billion in over 4,500 UK companies over the last five years. Companies backed by UK-based PE/VC firms employ over half a million people and 90 per. cent of UK investments in 2012 were directed at small and medium-sized businesses ("**SMEs**").

The UK PE/VC industry continues to be the largest in Europe. Data from the European Private Equity and Venture Capital Association (the "**EVCA**") shows that out of a total of €23.6 billion raised in Europe in 2012, €13.5 billion (that is, 57 per cent. of the total amount) was raised by funds managed in the UK. To put the UK's significance into context, it was immediately followed by France with only €3.5 billion (14.6 per cent. of the total amount) and Germany with just €1.9 billion (7.9 per cent. of the total amount).

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Many overseas PE managers, including almost all US-based PE firms, set up offices in the UK (as opposed to any other EU Member State) in order to co-ordinate their European activities. This makes an important contribution to the UK economy and helps to drive the growth agenda. The number of overseas PE managers based here, when coupled with the large number of domestic PE/VC firms, means that the importance of the PE/VC industry within the broader UK financial and professional services sector cannot be overstated. Not only does the industry directly and indirectly employ significant numbers of people but it also makes a contribution to the broader UK economy both through its investment in UK companies and the fees it generates through fundraising, investment and divestment activities.

The BVCA in the European context

As HM Treasury's call for evidence is intended to help further the analysis of what the UK's membership of the EU means for the UK national interest in the context of financial services, this response has been prepared by the BVCA as opposed to the pan-European PE/VC industry association, the EVCA. As our response makes reference to the EVCA, however, we explain briefly below our relationship with the EVCA and how the PE/VC industry responds to EU level legislative developments.

The BVCA co-ordinates its responses to EU level consultations through the EVCA and works with it and other national PE/VC associations across Europe ("**NVCAs**") when seeking to engage with institutions and regulatory bodies at the European level. The EVCA Public Affairs Executive (the "**PAE**") represents the views of the European PE/VC industry in EU level public affairs and aims to improve the understanding of the industry's activities and its importance to the European economy. It comprises representatives from the venture capital, mid-market and large buyout parts of the PE industry as well as from institutional investors and the NVCAs.

Our response

We set out below answers to the call for evidence questions which we consider are of particular relevance to the UK PE/VC industry or in respect of which we consider that we have sufficient information and evidence to provide a contribution to the current debate. We would be happy to expand upon any of the points raised in our response if HM Treasury would find it helpful. If HM Treasury would like us to do so, we would ask that it contacts Gurpreet Manku (Director of Technical and Regulatory Affairs, BVCA (gmanku@bvca.co.uk)) in the first instance.

Yours faithfully,

Margaret Chamberlain
Chair - BVCA Regulatory Committee

HM TREASURY BALANCE OF COMPETENCES REVIEW
SINGLE MARKET: FINANCIAL SERVICES AND
THE FREE MOVEMENT OF CAPITAL

Q1: How have EU rules on financial services affected you or your organisation? Are they proportionate in their focus and application? Do they respect the principle of subsidiarity? Do they go too far or not far enough?

How have EU rules on financial services affected you or your organisation?

1. EU rules on financial services have affected our members in wide-ranging and fundamental ways. Firms are affected both during the often long and uncertain legislative process pursuant to which such rules are developed (as they must both devote resources to staying abreast of current developments and because uncertainty about the future regulatory position can act as a brake on undertaking new business activities). Once the relevant rules are in force firms may need to make significant changes to their structure and/or operational processes and procedures to satisfy new regulatory requirements). We discuss how firms are affected during the legislative process in our answers to Questions 3 and 9.

2. The question of how EU rules on financial services have affected our members is extremely broad due to both the quantity and complexity of recent EU rule-making and the widely differing impact which the same rules can have on individual member firms dependent upon, amongst other things, their size, structure and the nature and extent of their cross-border activities.

3. In order to focus our response appropriately, our answer to this Question 1 does not set out a comprehensive analysis of how all EU financial services rules have affected our members. Instead, it takes two recent legislative developments – the Alternative Investment Fund Managers Directive (the "**AIFMD**" or the "**Directive**") and CRD IV (the prudential regulation package comprising the Capital Requirements Directive and the Capital Requirements Regulation) – and uses those as a way in which to demonstrate the impact which EU financial services rules can have on UK PE/VC firms.

4. When the European Commission (the "**Commission**") initially proposed the AIFMD in April 2009 it stated that the Directive was, "*an important part of the European Commission's response to the financial crisis*" and was intended to, "*create a comprehensive and effective regulatory and supervisory framework for [alternative investment fund managers] in the European Union*". Whilst the Commission: (i) recognised that the community of European alternative investment fund managers ("**AIFMs**") is "*diverse*"; (ii) acknowledged that the community comprises hedge funds, PE funds, commodity funds, real estate funds and infrastructure funds each of which,

"*invest in a wide range of assets and employ different investment strategies and techniques*"; and (iii) suggested that the Directive would take into account, "*the legitimate differences in existing business models*", these factors are not, in our view, reflected in the final legislative position which we consider is largely based on a 'one-size-fits-all' approach. Many of the Directive's requirements are not only unduly onerous when applied to firms pursing PE/VC strategies (as opposed to other strategies) but are impossible to reconcile with the way in which such firms conduct business. These issues are in part a result of the failure by EU policy and rule-makers to carry out a proper analysis of the PE/VC industry (or indeed of the alternative investment fund industry more generally) before legislating (see further our answer to Question 9).

5. Whilst some UK PE/VC firms are able to take advantage of the lighter touch registration regime for 'small' AIFMs, a large number of our members have had to, or will shortly have to, apply to the Financial Conduct Authority (the "**FCA**") for authorisation as 'above-threshold' AIFMs. Not only is the authorisation process itself a time and cost-intensive exercise – many PE/VC firms have spent a number of months carrying out the necessary analysis and working with their advisers to ensure that they are in a position to be able to apply for authorisation (a process which is itself fraught with difficulties due to the poor drafting of many of the Directive's requirements), but, once authorised, they must meet numerous ongoing operating conditions (including those relating to regulatory capital, remuneration, depositaries, valuation and marketing) and comply with transparency and reporting requirements. We would note that these firms are already regulated by the FCA under a regime which imposes proportionate capital requirements and rules relating to custody, valuation and marketing and other matters, which do to some extent reflect PE/VC specificities. We have no issue with appropriate and proportionate regulation. However the new regime imposes fundamental change. The restrictions imposed by the Directive on the activities of an AIFM (which were not the subject of consultation) have caused the number of firms to have to transfer existing businesses in the new entities with related cost and burden. All affected firms are having to restructure their existing compliance and management arrangements in ways which increase administrative burden and cost (which is ultimately borne by investors) with no corresponding benefit. For example, the depositary, risk management and leverage requirements involve significant changes to current processes and are not appropriate for PE/VC firms. These new requirements do not address any failure that has been identified in the existing UK regulation of such firms.

6. Many PE/VC firms are currently making significant and costly changes to their operational processes and procedures, and data collection and reporting systems, in order to meet the AIFMD's requirements. Efforts which would otherwise be focused on raising funds and investing those funds in the real economy are instead being diverted to satisfy administrative requirements which will offer little (if any) increase in investor protection from that available now under their existing FCA authorisation. Indeed, we understand

that a number of PE/VC firms have had to defer their next fundraise whilst they grapple with the AIFMD's requirements and ongoing uncertainties in key areas such as cross-border marketing. PE/VC firms are particularly affected because many do not have large numbers of staff yet are required to comply with (broadly) the same requirements, and grapple with the same uncertainties, as much larger asset managers.

7. Turning away from the AIFMD to consider briefly CRD IV, the aim of CRD IV is to minimise the negative effects of a firm's failure by ensuring that firms within its scope hold enough financial resources to cover the risks associated with their business. We consider that certain in-scope firms will be affected in ways which in no way further this aim.

8. Whilst not all PE/VC firms will be caught by CRD IV, those that are caught will be required to implement measures to undertake extensive reporting (COREP and FINREP). Such firms will be required to make significant investment in the necessary software in order to meet these reporting requirements, the cost of which appears to be wholly disproportionate to the value which will be derived from such additional reporting. Not only are affected firms concerned about the cost impact of such reporting but also about the ongoing uncertainties as regards what must be reported and the risk of being deemed non-compliant. Firms' concerns are compounded by frustrations caused by a failure to understand what the FCA (and other EU competent authorities) will do with the additional level of information received.

9. In short, the CRD IV reporting requirements encapsulate one of our fundamental concerns about the current approach to EU level financial services legislation, namely the regular cross-contamination of requirements between non-comparable sectors of the financial services industry. The CRD IV reporting requirements are clearly appropriate for banks given the systemic risks which they pose to European financial stability, but are wholly inappropriate in the context of the PE/VC industry. The failure of much EU level financial services legislation to differentiate appropriately between different sectors means that firms are often significantly affected for no discernible reason.

Are they proportionate in their focus and application?

10. We consider that many recent EU financial services rules are proportionate in neither their focus nor their application. This is in part because of the 'one-size-fits-all' approach often taken by EU policy- and rule-makers where the bar is set at the highest possible level in most cases, resulting in standards which are often not only inappropriate but also provide little room for realistic implementation by firms. The constant drive to set regulatory standards for non-banks to the standards required of banks, or in the case of the AIFMD to force a regime based on funds directed at retail investors onto firms which manage funds for professional investors, seems to us to be inappropriate, unnecessary

and representative of an approach which does not take account of the risks which different sectors of the financial services industry pose to broader financial stability.

11. The AIFMD is one example of where EU financial services rules are not proportionate in their focus. EU policy- and rule-makers did not have a sufficient understanding of the industry which they were seeking to regulate before embarking upon the Directive's development. This lack of understanding has resulted in an overly blunt legislative framework which focuses on the wrong issues and/or tries to regulate at least certain firms in the wrong way. Many firms have been forced to focus on and implement measures which will neither afford any increase in investor protection nor make any meaningful contribution to financial stability.

12. In terms of whether EU financial services rules are proportionate in their application, such rules do sometimes require firms to comply with them subject to the concept of proportionality. In the context of the AIFMD, for instance, this is the case for risk management (where a firm need not establish a fully functionally and hierarchically separate portfolio risk management function if it would be disproportionate to do so) and depositaries (where certain firms are able to appoint a "PE depositary"). Proportionality often does not go far enough, however, or is of limited practical assistance. Indeed, in many instances, proportionality is applied rather than the requirement being wholly dis-applied because it is fundamentally inappropriate. Proportionality should not be used as a concession by policy-makers – if a requirement is fundamentally inappropriate, it should simply not apply.

13. To illustrate our concerns with a practical example, we discuss our concerns in the context of the requirement for PE/VC AIFMs to appoint a depositary. The requirement for PE/VC firms to appoint a depositary is a read-across from the UCITS Directive. It is wholly unnecessary in a PE context where there is no evidence (at least of which we are aware) that a loss of instruments has ever resulted in any loss or detriment to investors. Extensive factual submissions were made by the industry during the AIFMD legislative process to demonstrate how PE/VC funds hold securities, why the very nature of PE/VC investment does not give rise to the custody/settlement risks associated with more liquid securities, noting the lack of any issues arising from loss of PE fund assets, and expressing concerns at the cost, which would impact on investor returns. We are not aware of any PE/VC fund investor who supported the depositary requirement. Whilst the AIFMD does impose a lighter depositary regime suitable for some PE/VC firms, the fact is that a proper risk analysis would have removed the depositary requirement for certain types of funds. The depositary provisions impose cost and administrative burdens to deal with a problem: (i) that has never emerged; and (ii) that can be demonstrated as extremely unlikely ever to emerge, given the nature of PE/VC investments.

14. Another example of the disproportionate nature of the AIFMD is its application to listed investment trusts, many of which have determined that the listed entity is itself an AIF. That can be straightforward, where the investment trust is structured and operates as a 'fund'. However, this is not the case for all such entities, many of whom are more operational in nature and are effectively holding companies for a combination of asset management and investment activities. Given that the focus of the Directive is the regulation of traditional investment funds, there are serious, irreconcilable complications when attempting to apply it to more 'hybrid' animals, such as these. The depositary requirements do not sit well, for example, and will create significant duplication given the host of legal and regulatory requirements which already apply to listed investment trusts. This highlights the failure to target and tailor EU level financial services rules to ensure that firms are not disproportionately subject to overlapping (and sometimes conflicting) rules and regulations.

Do they respect the principle of subsidiarity?

15. We understand that the principle of subsidiarity is concerned with determining the level of intervention that is most relevant in the areas of competences shared between the EU and the Member States and that the EU may intervene only if it is able to act more effectively than individual Member States. Whilst we do not consider that we are well placed to analyse from a legal perspective whether EU financial services rules respect this principle from a practical perspective we believe that in a number of areas EU legislation could – if the relevant legislation were properly consulted upon, developed and implemented – be more effective than individual Member States acting alone.

16. In the context of the AIFMD, for instance, one of the key benefits of developing the rules at an EU level could have been the availability of the cross-border management and marketing passports but, because the rules are fundamentally unclear in this area and widely varying approaches have been taken by Member States to the interpretation of the relevant rules, they are rendered much less useful.

17. The UK, for instance, considers that "marketing" under the AIFMD does not begin until a fairly late stage where (in a PE/VC context) the PPM is in fairly final form (i.e. 'pre-marketing' or 'soft' marketing does not constitute "marketing") and a UK AIFM cannot apply for the marketing passport until the relevant documentation is in "materially final form". Certain other Member States consider that 'pre-marketing' or 'soft' marketing does constitute "marketing" under the AIFMD and will only allow non-domestic firms to conduct such activities if they have the benefit of the marketing passport. UK firms are therefore in an impossible position – they require the marketing passport in some jurisdictions before the point in time at which they can apply to the FCA for it.

Do they go too far or not far enough?

18. For the reasons set out above, we consider that many recent EU financial services rules go too far. This is often a result of the 'one-size-fits-all' approach taken by EU policy- and rule-makers and a lack of appreciation of the fundamental differences between sub-sectors of the EU's financial services industry.

Q3: How have EU rules helped or made it harder to achieve objectives such as financial stability, growth, competitiveness and consumer protection?

19. We consider this to be a difficult question to answer. On the one hand, EU financial services rules can help PE/VC firms to operate beyond their national borders in the rest of the EU thereby ensuring that there are broad and deep pan-European financial services markets which contribute to financial stability, growth and competitiveness. On the other hand, however, many EU rules – at least in the short term – distort the market and have a chilling effect on growth (whilst firms consider the often uncertain regulatory position to which those rules give rise).

20. On an aggregate basis, and subject to our concerns set out below, we consider that the single market in financial services enables investment firms that have the will and ability to operate in multiple EU Member States to do so and thereby contribute to the achievement of certain objectives, particularly growth and competitiveness. Without the single market in financial services we believe that the provision of financial services to clients in other EU Member States would, in some cases, be harder and, in other cases, be impossible. In the absence of those rules, only banks and very large investment firms, which could afford to establish subsidiaries, would likely be able to operate in large parts of the EU.

21. We would, however, note that some EU rules have had the opposite effect and have made it harder for investment firms to provide financial services to clients in other EU Member States and, in our view, provide no discernible benefit. This can happen particularly when EU financial services rules do not take into account fundamental differences between Member States (e.g. the extent and nature of private pension provision) and between provision of services to different customers (e.g. public versus private equity). Examples of this are the initial plans to develop Solvency II-type rules for pension funds and, as discussed above, the extension of UCITS-type rules to private company investments through the AIFMD.

22. In addition, differing Member State approaches to interpretation and implementation of EU financial services rules can be a barrier to growth. A lack of resources and/or the will (both at EU and national levels) to ensure that new EU rules are implemented in a manner which causes least disruption and uncertainty for industry participants is often a

source of frustration and leads to cynicism about the rules themselves. Such a situation cannot be said to contribute to financial stability, growth or competitiveness. It is important that the implementation of a piece of legislation reflects agreements reached during the consultation process in order that firms have greater certainty about the regulatory position well in advance of the rules coming into effect.

23. Further concerns arise when differing Member State approaches to interpretation and implementation result in anti-competitive practices. One such example of anti-competitive behaviour is the current practice of some Member State regulators to charge fees for incoming AIFMD marketing passport notifications and/or impose other requirements (such as the appointment of a local paying agent bank) on AIFMs which wish to exercise marketing passport rights in that Member State. These were never raised as possibilities during the legislative process.

24. Finally, overly stringent EU financial services rules can result in the clearly unintended consequence of hindering growth (see, for instance, the Solvency II case study set out below) and/or driving financial services business out of the EU entirely. We consider there to be a very real risk that inappropriate regulation will cause PE/VC firms to consider the cost/benefit of having a European presence from which to operate globally. The result may well be that firms have a smaller European presence and operate their global (non-EU) business from elsewhere, raising funds from investors in non-EU jurisdictions and managing them from outside the EU, thereby causing significant harm to the EU's overall growth and financial stability. The less that PE/VC firms are based in the EU and raise money from EU investors the less incentive for them to invest in EU companies.

Case study: Solvency II – the impact on growth

It is widely accepted that investment in businesses, and particularly in SMEs, is crucial to ensuring sustained growth in the UK and European economies. PE/VC funds are key investors in SMEs. Efforts are intensifying at an EU level to promote long term investment, such as the Commission's proposed regulation for European Long-term Investment Funds, and this recognises the importance of "patient" capital as a contributor to "smart, sustainable and inclusive growth". PE/VC firms invest for the long-term with average hold periods of five years, and have continued to invest through the downturn in the UK economy. For this investment to increase, PE/VC firms need to be able to continue to raise capital without difficulty and disruption.

EU regulation aimed at investors in PE/VC funds such as banks, insurance companies and pension funds will impact investment behaviour and the rules developed for these institutions need to consider the consequential impact this has on long-term investment. Pension funds and insurance companies are significant investors in PE/VC and of the

£5.9 billion raised in 2012, they contributed 18 per cent. and 11 per cent. respectively. The implementation of Solvency II, as currently drafted, will result in additional regulatory capital requirements placed upon insurance companies (using the standard formula proposed) that invest in PE/VC and will have a detrimental impact on further capital allocations to this asset class.

In 2012, the Commission asked the European Insurance and Occupational Pensions Authority ("**EIOPA**") to examine whether the calibration and design of regulatory capital requirements for long-term investments in certain asset classes under the envisaged Solvency II regime necessitated any adjustment or reduction under the current economic conditions without jeopardising the prudential nature of the regime. On 19 December 2013, EIOPA submitted its final report to the Commission on Standard Formula Design and Calibration for Certain Long-Term Investments and confirmed its previous position which had proposed a risk calibration of 49 per cent. for insurance companies investing in PE/VC funds. The EVCA had made several representations – which the BVCA support – to EIOPA expressing its concerns with the index used (LPX 50 total return index), to determine the risk weighting for PE/VC funds. This use of this index (which includes listed companies) is inappropriate for the industry as it is not comparable to the investments made by, and characteristics of, PE/VC funds. In its response to EIOPA's discussion paper in 2013, the EVCA suggested an alternative approach using the same methodology EIOPA had adopted for the calibration of property and selected applicable indices, and this provided a risk calibration of approximately 30 per cent.

The EVCA also set out detailed rebuttals to EIOPA's justification for proposing the 49 per cent. risk charge including data from a survey EVCA conducted of 19 insurance companies (including UK companies), with an aggregate commitment of €46.4 billion to private equity (and total assets of €1,430 billion). Future investment in PE/VC funds – an established contributor to long-term growth – will be adversely affected as a consequence of Solvency II; 30 per cent. of the insurance companies surveyed with investments in PE/VC funds have put their programme on hold in anticipation of Solvency II and if this charge comes into effect, over 50 per cent. of respondents will reduce their allocations to PE/VC. In this context, it is extremely disappointing that EIOPA has chosen to retain its initial risk charge, particularly as it also recognises that data weaknesses make any conclusions difficult to substantiate.

25. In conclusion, our key messages to HM Treasury in respect of this question are that HM Treasury should:

- continue to seek to influence the debate on the single market in financial services with the purpose of ensuring it achieves its stated objectives;

- fight harder to prevent the rules which make it harder to achieve the objectives of the single market; and

- seek to improve the implementation of single market rules in the UK and at EU level.

Q4: Is the volume and detail of EU rule-making in financial services pitched at the right level? Has the use of Regulations or Directives and maximum or minimum harmonisation presented obstacles to national objectives in any cases?

Is the volume and detail of EU rule-making in financial services pitched at the right level?

26. The volume of EU financial services legislation that has been developed/published/come into effect in the last 18 months has caused major difficulties for firms. It has also caused difficulties for regulators in terms of their ability to implement on time, but the principal difficulty has been for firms because whilst the regulators only have to implement the law, firms have to comply with it. When the pressures on regulators mean that they are not able to publish their own implementation proposals until late in the day, it is the firms which bear the burden of a compressed time frame.

27. "Detail" can be a positive or a negative element, the issue with the current laws is that insufficient analysis is undertaken as to which areas should be the subject of detailed provision and which should be dealt with at a higher level. Detail should be pursued only where warranted by the relevant policy or where a lack of detail could give rise to significantly different approaches being taken by Member States. Whilst prescriptive and detailed rules do have the benefit of legal and practical certainty, they often fail to take into account the wide range of firms to which they apply and the very different nature of the financial services industry in different Member States. For example the degree of detail prescribed in Level 2 legislation often fails to reflect the fact that the legislation covers a wide range of firms, for whom compliance with some of the detail will be either inappropriate, unnecessary or simply not practicable. This is for example the case with reporting requirements, which in due turn produces reports to regulators which may not be particularly useful to them.

28. Detail is often lacking in fundamental areas whilst overly detailed and prescriptive rules are formulated to cover less substantive issues. More detail around some of the fundamental concepts in the AIFMD (such as what is meant by "marketing") would have been of considerably more use to firms than overly prescriptive detail about, for instance, the information which must be reported to Member State regulators in relation to funds being marketed. Where detail is missing around key concepts there is room for

fundamentally different approaches to be taken by Member States thereby giving rise to difficulties for firms which operate on a cross-border basis.

Has the use of Regulations or Directives and maximum or minimum harmonisation presented obstacles to national objectives in any cases?

29. We are largely neutral as to whether EU financial services rules are Regulation or Directive-based. Whilst Regulations in theory do not raise issues of late implementation by Member States or inappropriate use of discretion, they can be overly prescriptive and, as noted above, often fail to take into account the differing nature of Member States' financial services industries and domestic legal and tax systems.

30. We consider there to be a middle ground in which Directives can be used to create a framework around which guidelines and principles-based standards can then be applied in a national law context. What is vital, however, is that whatever form the rules take they are clear, prepared following an adequate consultation process and that Member State regulators broadly agree on how they should be interpreted.

Q5: How has the EU's approach to Third Country access affected the ability of UK firms and markets to trade internationally?

31. Whilst the AIFMD creates a third country regime it is too early to say whether this will affect the ability of UK firms to market their funds in third countries. As a general comment it is important that the EU's approach to Third Country issues does not give rise to the risk of "retaliation", with third countries adopting an approach which restricts EU firms. For example, EU private equity and venture capital firms raise a significant proportion of their funds from investors in jurisdictions outside the EU. If their ability to access these investors is restricted, the funds available for investment in Europe may significantly decrease. We would encourage the UK to continue its support of a constructive approach to third country issues and to build a wider understanding within Europe of the importance of such an approach to the EU generally.

Q7: What has been the impact of the shift towards regulation and supervision at the EU level, for instance with the creation of the European Supervisory Authorities? Should the balance of supervisory powers and responsibilities be different?

What has been the impact of the shift towards regulation and supervision at the EU level, for instance with the creation of the European Supervisory Authorities?

32. From the perspective of a UK PE/VC firm, the short-term impact of the shift towards regulation and supervision at the EU level has been: (i) increased complexity of regulation and two levels (at the EU and the national level) of iterative and changing

guidance; (ii) longer periods of greater uncertainty as to regulatory outcomes; and (iii) shorter timeframes for firms to comply with resulting regulation (such as the AIFMD). This has resulted in increased costs, both in terms of direct costs (such as legal and other advisory fees) and indirect costs (such as opportunity cost and delays to new business).

33. In the longer term, the stated aims of harmonisation of EU Member States' regulatory regimes and the reduction of restrictions on cross-border flows of capital and financial services products should lead to increased competition, reduced barriers to market entry, more accessible capital within the EU and be of benefit to firms, investors and consumers. These aims will, however, only be achieved if our concerns about the balance of competences and legislative process set out elsewhere in this response can be addressed.

34. Our concerns about the impact which the creation of the European Supervisory Authorities (the "**ESAs**") has had on the PE/VC industry were included in the EVCA's response to the Commission's recent Consultation Paper entitled '*Consultation on the review of the European System of Financial Supervision*'. As such, we do not set out in this response all of our concerns about the ESAs but instead focus on some of the key impacts which their creation has had on UK PE/VC firms. We would refer HM Treasury to the EVCA's response to the Commission's Consultation Paper (available here) for further detail

35. As a caveat to the comments which follow we should note that it is difficult for us to assess fully the impact of the ESAs. Firstly, our exposure to, and involvement with, all of the ESAs has not been the same. Whilst each of the ESAs conducts work which impacts the PE/VC industry the ESA with which we are most familiar (because it has the most direct impact on our industry) is the European Securities and Markets Authority ("**ESMA**"). Secondly, we do not consider that we have yet had sufficient opportunity to see any of the ESAs exercise all of the responsibilities and powers with which they have been mandated. In addition, we have seen them in operation only at the beginning of the 'cycle' of their powers (i.e. as new rules come into force). As such, it is too soon to assess fully the impact which the ESAs' creation will have.

36. Overall, whilst we consider that there is certainly a role for the ESAs to play in the context of promoting and, where necessary, mediating/enforcing consistency of application of regulatory standards amongst national Member State regulators, this should not be without prejudice to the ability of national competent authorities to exercise their oversight and supervisory responsibilities.

37. In addition, in order that the ESAs do not have an adverse effect on financial services firms they should have adequate resources, benefit from sufficient time to carry out consultations and impact assessments and be subject to a clear and transparent

governance structure where they are clearly accountable for their actions. We elaborate upon some of these factors below and further in our answer to Question 9. Whilst our comments are made in the context of ESMA, we imagine that they could equally apply to the other ESAs.

38. We are particularly concerned that ESMA is under-resourced, both financially and in terms of staff numbers. In order that firms (and ultimately investors and consumes) do not suffer from guidelines and other materials which are not adequately consulted upon and hastily drafted it is vital that ESMA has adequate resources to properly conduct its work. In addition, the Commission must allow ESMA sufficient time for investigation and proper consultation when mandating it to produce regulatory technical standards and other guidelines.

39. We also consider there to be a need for a more transparent process in instances where the Commission does not accept or requires amendments to the (often considerable) work undertaken by ESMA. In such instances, the Commission should provide a clear explanation of the reasons for its decision not to endorse or accept ESMA's output and that decision should be supported by appropriate analysis and evidence.

40. Finally, it is vital that ESMA does not have the ability to introduce through guidance and technical standards legislative provisions which were rejected during Level 1 negotiations. For example, the ESMA AIFMD Remuneration Guidelines apply the remuneration rules to delegates, a concept not provided for in the Level 1 Directive. If confidence in ESMA is not to be undermined it is vital that it is subject to proper constitutional arrangements and does not have the ability to legislate 'through the back door'. Its apparent ability to do so seriously undermines regulatory certainty and means that firms cannot be sure that the position set out in Level 1 or Level 2 materials will be the final position.

Should the balance of supervisory powers and responsibilities be different?

41. As explained elsewhere in our response, we consider that the balance of supervisory powers and responsibilities is arguably currently misaligned and that a better balance should perhaps be struck between the EU and national levels.

Q8: Does the UK have an appropriate level of influence on EU legislation in financial services? How different would rules be if the UK was solely responsible for them?

Does the UK have an appropriate level of influence on EU legislation in financial services?

42. The question of whether the UK has an appropriate level of influence on EU legislation in financial services is predominantly a political one and one which we do not consider that we are well placed to answer. Indeed, given that critical elements of EU financial services legislation are developed and made without any public visibility of the underlying process, it is frequently unclear how the final version of the relevant text has been reached. We are therefore not aware of the extent of the UK's level of influence during these critical discussions. For example, after the draft AIFMD was published for consultation a further provision was inserted imposing restrictions on the activities which could be carried out by an AIFM in addition to fund management. We do not know how this provision came to be inserted, but it has caused a number of firms to have to undertake expensive corporate restructuring. We believe it appeared almost overnight in discussions which took place between Member States. All that the UK authorities could do in the circumstances was make a few hurried calls to UK stakeholders to try to assess the implications of the provision. This is not a satisfactory way for legislation which fundamentally affects a firm's business to be made, and it is not clear to us that the UK had any real opportunity to debate the issue.

43. We would fully support HM Treasury and the FCA in seeking to ensure that they have the appropriate level of influence in formal EU-rule making procedures, particularly given the importance of the financial services sector to the UK economy. We are aware that HM Treasury has undertaken initiatives to achieve this, but this work needs to be developed to ensure that the UK has an appropriate level of influence, just as other Member States have sought to ensure that this is the case for them in respect of industries which are important to their national economies.

How different would rules be if the UK was solely responsible for them?

44. The UK's approach to financial services regulation has traditionally been evidence-based and principles focused. If the UK was solely responsible for financial services rules it would perhaps continue to take this approach in contrast to the EU's 'rules-based' approach.

45. Whilst we recognise that the financial crisis has affected the approach of all regulators and governments to regulation we would hope that, substantively, the rules would be more focused on encouraging balanced and well-regulated financial services growth (given the importance of this sector to the UK economy), together with such rules as are required to provide appropriate consumer protection.

46. In the absence of sole responsibility for the rules we consider that it would be helpful if HM Treasury and the FCA could do more to assist firms by providing their interpretation of EU financial services rules, as they do in respect of UK legislation. This need not be a binding view but some guidance as to their approach to interpreting EU legislation would

help firms in determining how to comply. There are some areas in which the FCA has publicly stated that it disagrees with views expressed by the Commission (such as in relation to the passporting of MiFID 'top-up' activities under the AIFMD). It has been helpful for firms to know the FCA view and we would encourage the FCA to publicise its views on interpretation issues relating to EU financial services rules in a greater number of cases.

Q9: How effective and accountable is the EU policy-making process on financial services legislation, for example how effective are EU consultations and impact assessments? Are you satisfied that democratic due process is properly respected?

How effective and accountable is the EU policy-making process on financial services legislation, for example how effective are EU consultations and impact assessments?

47. We are concerned that the EU policy-making process pursuant to which financial services legislation is developed is not always effective and accountable, in part because consultations and impact assessments carried out by EU institutions and regulatory bodies are often insufficient.

48. In the context of the AIFMD – a piece of legislation with far reaching and significant consequences – the initial proposal emerged as part of a suite of measures developed in great haste following the financial crisis and no specific pre-consultation was carried out. When launching the proposal for the Directive in April 2009 the Commission stated that it built on, "*... numerous insights and research that the Commission has gathered in recent years through studies and impact assessments on the functioning of the non-harmonised investment fund segment. The latest round of consultations took place in February 2009 and concerned the activities of hedge funds*".

49. In reality, none of the studies or impact assessments to which the Commission referred had properly assessed the impact of such a Directive and in no way compensated for the lack of specific consultation. In addition, and as the Commission itself stated, the most recent round of consultations prior to the Directive being developed focused on hedge funds – a factor which perhaps goes some way towards explaining the difficulty in applying the Directive's requirements to many other types of funds (and particularly PE/VC funds which pursuant fundamentally different strategies).

50. As the development of the AIFMD was not based on a well substantiated policy position or supported by full and effective consultations and impact assessments, the Directive is in many places poorly focused and difficult for firms to apply in practice. The relative haste with which the draft Directive was put together and negotiated means that many provisions have been poorly thought through, drafted in ambiguous and unclear ways and

certain key concepts have been left undefined and open to interpretation. In its rush to legislate the EU authorities sacrificed legal certainty and clarity.

51. Where formal consultations relating to the AIFMD have subsequently been undertaken they have often been conducted in haste with only very short windows for stakeholders to respond. This is particularly an issue where, for instance, ESMA is required to consult within timelines which it does not set. It is often subject to unrealistically short timeframes set by the Commission which leave little opportunity for ESMA to conduct a proper and meaningful consultation process or for it to analyse the large numbers of detailed responses which it receives from stakeholders. Such an approach to consultation undermines the effectiveness and accountability of the EU policy-making process and damages the confidence of financial services firms in the EU rule-making process.

52. In addition, when key stakeholders have sought to assist the EU authorities in developing regulation which would reflect the way in which the financial services industry functions in practice, EU authorities have often been unwilling to engage. We are aware that representatives of the professional investor community found it difficult to engage in constructive discussions with the EU authorities about the AIFMD.

Are you satisfied that democratic due process is properly respected?

53. We consider it to be very difficult to answer this question as, after a Directive or Regulation has been initially proposed by the Commission, it often becomes extremely difficult to follow its progress or understand how changes to the proposed text have been agreed. Whilst there may be periodic updates as to the status of negotiations from the press or from "insider" sources, no formal announcements tend to appear on the websites of the European institutions. Please also see the example given in paragraph 42 above.

54. Another example is the development of the proposed Regulation on Key Information Documents for Packaged Retail Investment Products (the "**PRIPs Regulation**") over the last few years. This is relevant to some of our members and the Commission published the final text of the legislative proposal in July 2012.

55. We have, however, found it extremely difficult to follow legislative developments. This is for a number of reasons but we consider that three of the key reasons are:

- reports on, or revised drafts of, the Regulation published by EU institutions (such as the European Parliament (the "**Parliament**")) are not always well publicised;

- revised drafts of the Regulation are often not prepared in blackline making it a difficult and time consuming process to ascertain what amendments have been made; and

- there have been long periods during which no reports or revised proposals have been published but, once they are published, they then appear to be adopted very quickly. By way of example, the Parliament's Committee on Economic and Monetary Affairs published a report on the PRIPs Regulation on 6 November 2013 which set out certain amendments to the text of the Regulation. The Parliament then adopted the revised text of the Regulation just two weeks later on 20 November 2013. The lack of clarity around timing and next steps makes it very difficult for firms to engage with the relevant individuals and bodies and to make timely representations about the revised drafts of legislative proposals.

56. In summary, the current way in which EU legislation is made makes it very difficult for firms to understand whether democratic due process is being followed and whether the political bargaining which takes place between the EU institutions – and Member State representatives – during the legislative process has sufficient regard to the interests of those affected. The current process makes it difficult for EU institutions and regulatory bodies to be, amongst other things, accountable and transparent.