30 September 2014

EU Sub-Committee A (Economic and Financial Affairs)
House of Lords
London
SW1A 0PW

Dear Sirs,

Re: Inquiry into the EU financial regulatory framework – call for evidence

Introduction

This response to the House of Lords EU Sub-Committee on Economic and Financial Affairs is made by the Regulatory Committee of the British Private Equity and Venture Capital Association (the "**BVCA**").

We have sought to prepare a response which makes a constructive and serious contribution to the debate about modernising, reforming and improving the regulatory framework surrounding financial services by explaining the impact of current EU rules on the UK's private equity and venture capital ("**PE/VC**") industry. The BVCA is generally supportive of the single market and our members (and the businesses they invest in) have experienced the benefits of this.

The BVCA is the industry body for the UK PE/VC industry. With a membership of over 500 firms, we represent the vast majority of all UK-based PE/VC firms and their advisers. Our members have invested £33bn 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 €23.6bn raised in Europe in 2012, €13.5bn (that is, 57 per cent of the total amount) was raised by funds managed in the UK.

As this call for evidence is intended to help further the analysis of what EU regulation 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, which aims to improve the understanding of the industry's activities and its importance to the European economy as a whole.

We set out below answers to the call for evidence 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 the Sub-Committee would find it helpful. If the Sub-Committee would like 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,

Sheenagh Egan
Chair – BVCA Regulatory Committee

HOUSE OF LORDS EUROPEAN UNION COMMITTEE
EU ECONOMIC AND FINANCIAL AFFAIRS SUB-COMMITTEE (SUB-COMMITTEE A)
INQUIRY INTO THE EU FINANCIAL REGULATORY FRAMEWORK

1. In order to focus our response appropriately, our submission 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 to illustrate the impact which EU financial services rules can have on PE/VC firms.

Topic 1: Broad assessment of the EU regulatory framework

Volume

2. 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 PE/VC 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 timeframe.

3. **We consider that many recent EU financial services rules are not proportionate in either their focus or 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. This results in standards which are often not only inappropriate but also provide little room for realistic implementation by firms.

Proportionality

4. 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 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.

5. 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 many firms in the wrong way. Such firms have been forced to focus on and implement measures which will neither afford any increase in investor protection (as acknowledged by many investors) nor make any meaningful contribution to financial stability.

Impact

6. On an aggregate basis, we consider that the single market in financial services enables investment firms to operate in multiple EU Member States should they wish to do so. This contributes 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.

7. However, we would note that in some cases the opposite is true: **some EU rules 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 the extension of UCITS-type rules to private company investments through the AIFMD.

Legislative process:

8. **We are concerned that the EU policy-making process for developing financial services legislation is not always effective and accountable, in part because consultations and impact assessments carried out by EU institutions and regulatory bodies are often insufficient.**

9. 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. As a result of this the Directive is in many places ill-focused and difficult for firms to apply in practice. 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.

10. 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, the European Securities and Markets Authority ("**ESMA**") is required to consult within unrealistically short timelines set by the Commission. 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.

11. 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.

The European Supervisory Authorities (ESAs):

12. 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.

13. 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.

14. **It is vital that ESAs do not have the ability to introduce through guidance and technical standards legislative provisions which were rejected during Level 1 negotiations.** For example, the European Securities and Markets Authority ("**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.

Topic 2: Interconnections, overlaps and gaps in the EU regulatory agenda

Interconnections

15. The CRD IV (the prudential regulation package comprising the Capital Requirements Directive and the Capital Requirements Regulation) 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. They 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.

16. 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 such reporting will entail, 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.

Overlaps

17. A clear example of overlaps in the regulatory framework occurs when a fund and/or its manager is listed on an EU market and regulated under the AIFMD. Those entities which are listed in the UK are already subject to: the FCA's Listing Rules for the purposes of Part VI of the Financial Services and Markets Act 2000; the FCA's Disclosure and Transparency Rules, and the FRC's UK Corporate Governance Code. As well as the additional compliance burden placed on entities affected, there could be scenarios where the differing sets of requirements do not fit well together or are unduly complex, for example when looking at the governance arrangements of a regulated, unlisted manager and its listed funds.

Unintended consequences of regulation:

18. Overly stringent EU financial services rules can result in the clearly unintended consequence of hindering growth 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.

BVCA

Topic 3: The EU Single Rulebook and the consequences for the Single Market

Subsidiarity:

19. **We consider that the balance of supervisory powers and responsibilities is arguably misaligned at present and that a better balance should perhaps be struck between the EU and national levels**.

20. 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 are not 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 be more effective than individual Member States acting alone, but only if the relevant legislation were properly consulted upon, developed and implemented (see *Legislative Process* above).

21. 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.

22. The UK, for instance, considers that "marketing" under the AIFMD does not begin until a fairly late stage (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.

Third-country access:

23. 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 PE/VC 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.

Topic 4: The implications for the UK

Impact of regulatory shift to EU level:

24. **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 of iterative and changing guidance (at the EU and the national level); (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).**

25. 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 in theory lead to increased competition, reduced barriers to market entry, more accessible capital within the EU and be of benefit to firms, investors and consumers. However, these aims will only be achieved if our concerns about the legislative process set out elsewhere in this response can be addressed.

UK influence:

26. 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.**

27. 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.

28. 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.