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To:
Balance of Competences Review
Single Market: Financial Services and the Free Movement of Capital
HM Treasury
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Copied to:
Financial Conduct Authority
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London E14 5HS

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

20 January 2014

Dear Sirs

Re: HMT Review of the Balance of Competences (Single Market: Financial Services and the Free Movement of Capital - Call for Evidence)

The City of London Law Society ("**CLLS**") represents approximately 14,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world.

The Committee's concern is not with political issues, but with the law. We have to interpret and advise our clients every day on the laws which implement the single market in financial services, and we assist them and their trade associations in tracking and responding to proposed new laws. Our perspective and comments are therefore made in our capacity and based on our experience as lawyers and focus on (i) the integrity of the EU legislative process and (ii) the clarity of EU law-making.

We have many serious concerns about the current approach to law making and implementation for the single market in financial services which we set out below. These could be addressed and it is in the interests of the UK and in particular London that they are. The single market concepts of mutual recognition and home state authorisation ought to bring tremendously beneficial effects to the EU in general, and to the UK (especially London) in particular.

It would be possible to start now to improve the position in relation to some of these issues. In particular:

(i) many of the difficulties which have arisen in recent years arise because Directives "hardwire" certain implementation dates at a point when it is simply unknown (and unknowable) as to whether there is any prospect of the necessary secondary legislation being made in the time frame envisaged. Slippages at the ESMA and European Commission (the "**Commission**") level in relation to the production of secondary legislation then impact badly and unfairly on firms who suffer from the fact that the implementation date is fixed even though the legislation has barely been made. Directives and Regulations should be drafted so that there is a simple process for changing such dates. Where secondary legislation is not made in the expected or required timetable there should be an automatic deferral of the implementation date by the same amount of time to preserve the timeline originally envisaged. There is nothing in the current legislative structures which imposes the same timing discipline on the law makers as is imposed on those who have to comply with the laws;

(ii) the Commission should publicise its compliance with the Better Regulation principles set out in the Inter-institutional agreement on better law-making (2003/C 321/01) (the "**Better Regulation Principles**"); and

(iii) HMT, the FCA and the PRA should do more to assist firms by providing their interpretation of EU 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 and would be important for enforcement purposes. Everyone knows that the law can only be definitively interpreted by the courts, but in the meantime firms and their advisers have to interpret it, and knowing how their own regulator will apply the laws pending any such clarification is very important. There are some areas in which the FCA has stated that it disagrees with views expressed by the Commission on the interpretation of EU legislation (e.g. in relation to passporting under the AIFMD). It has been helpful for firms to know the FCA view and the Committee would encourage it to publicise its views on interpretation issues more often.

1. 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?

1.1 Whilst the EU rules on financial services have not (in general) had a direct impact on the organisations or individuals represented by the Committee, the impact on the individuals and organisations whom our members and their organisations advise has been wide-ranging and significant.

1.2 Overall, we consider that in seeking to respond promptly to the recommendations of the G20, the European legislators have to some extent had to compromise on the Better Regulation Principles, and that the quality of the legislation has accordingly suffered, such that much of the recent European legislative initiatives is far from clear, simple and effective.

1.3 In particular, we consider that the pre-legislative consultation process and the quality of impact assessments have suffered:

1.3.1 pre-legislative consultation - this has been most acute in relation to secondary legislation – e.g. the 3-week consultation on possible Delegated Acts under Regulation (EU) No 236/2012 on Short Selling and certain aspects of credit default swaps (the "**Short Selling Regulation**" or "**SSR**"), and EMIR - but has also been true of primary legislation, particularly in respect of late-stage amendment; and

1.3.2 impact analyses - it appears to us that the impact assessments produced by the Commission display a paucity of empirical evidence on the impacts of individual initiatives.

1.4 Furthermore, there has been little or no attempt to assess the cumulative impact of the full range of European legislative initiatives on the entities that are subject to them. This makes any true assessment of proportionality very difficult. The existence of silos of regulation means any cost-benefit analysis as to the impact of rules has only been performed on individual pieces of legislation. However, the combined effect of EU rules has affected firms in terms of staffing, capital and how their businesses are structured. For example, UCITS, CRD IV, and MiFID all impose different requirements in relation to remuneration, yet any consideration as to the overlap has only been at a national level.

1.5 We recognise that much of the recent European legislation strives to compensate for the absence of true impact analysis by mandating that the Commission review the appropriateness and impact of legislative provisions and draw conclusions on the operation of legislation with a view to considering whether revision of the legislation is warranted. However, by the time these reviews take place, institutions and individuals have already incurred very significant initial and ongoing implementation and compliance costs. It is also worth noting that the Commission recently concluded (in its report to the European Parliament (the "**Parliament**") and the European Council (the "**Council**") on the evaluation of the Short Selling Regulation that it was too early, based on available evidence, to draw conclusions on the operation of the Short Selling Regulation framework that would warrant a revision of the legislation, and has accordingly deferred any future review until 2016.

1.6 We would also make the point that the issues with the quality of legislation mentioned in paragraph 1.2 above themselves impact on proportionality. Where legislation is vague and uncertain and its effect cannot be discerned from the intention of the legislative bodies but depends on guidance given by the European Supervisory Authorities ("**ESAs**"), there is an increased risk that legislative measures will not respond proportionately to the shortcomings that they were designed to address but will pursue other agendas. Furthermore, legislation that can only be interpreted by firms on the basis of subsequent guidance by ESAs, often given very shortly before or after compliance with a measure is required, can create significant additional costs for firms in terms of the design of systems, policies and procedures that may need to be revisited if interpretations change and a chilling effect on carrying out business whose regulatory treatment is uncertain.

1.7 We provide examples below to illustrate these points. Issues arising out of the process for and drafting of the Directive on Alternative Investment Fund Managers (the "**AIFMD**") provide recent and good examples in relation to many of the themes in our response, and could be used in response to a number of the questions in the Call for Evidence. Whilst we make some reference to it in the answer to other questions, we have drawn together most of our comments which relate to it in response to this Question.

1.8 **AIFMD**

1.8.1 In advancing its proposal for the AIFMD, the Commission accepted that Alternative Investment Fund Managers ("**AIFMs**") were not the cause of the financial crisis; the De Larosière report likewise recognised that hedge funds did not play a major role in the emergence of the crisis. Nevertheless, the Commission proposed what it acknowledged was an "ambitious programme" to extend appropriate regulation and oversight to "all actors and activities that embed significant risks".

1.8.2 The Commission sought to justify the need for such regulation and oversight on the basis that it considered that:

1.8.2.1 hedge funds had contributed to asset price inflation and the rapid growth of structured credit markets;

1.8.2.2 the abrupt unwinding of large, leveraged positions in response to tightening credit conditions and investor redemption requests had procyclically impacted declining markets and "may have" impaired market liquidity; and

1.8.2.3 some funds of hedge funds had had to suspend or otherwise limit redemptions, and that commodity funds had been "implicated" in the commodity price bubbles that developed in late 2007.

1.8.3 The Commission acknowledged that the use of investment strategies and leverage by private equity funds differed from hedge funds, and that private equity funds did not contribute to increased macro-prudential risks. The Commission's justification for the extension of regulation to private equity funds seems to be that they had experienced some challenges relating to the availability of credit and the financial health of their portfolio during the financial crisis. The same can be said of the real economy.

1.8.4 The AIFMD as enacted is undoubtedly more proportionate and tailored than the original proposal, and there are some limited exemptions and a lighter touch ‘registration’ regime for managers with limited assets under management. Nevertheless, the implementation of the AIFMD has impacted not only a very wide range of alternative investment funds ("**AIFs**") and their managers (AIFMs), but also the third parties with whom they engage, including prime brokers, depositories and auditors, amongst others. For fund managers, the requirements range from authorisation, capital requirements, selection of depositories and valuators, liability for compliance by service providers, remuneration requirements, significant initial, ongoing and exceptions based reporting to regulators and investors, specific requirements in respect of funds with limited liquidity, the imposition of compulsory methods for leverage calculation, and for many managers, significant change to operational processes, data collection and reporting.

1.8.5 In terms of subsidiarity, the Commission asserted that a common level of transparency and regulatory safeguards was required because the risks associated with the activities of AIFMs are "often" cross-border in nature, and that a harmonised framework for the safe and efficient cross-border marketing of AIF could not be established as effectively through the uncoordinated action of Member States (although it is not apparent that the latter had proved a particular issue). That said, some matters, including the application of some of the exemptions, and an option to allow certain types of fund to be marketed to retail investors in their territory and to impose stricter requirements on such marketing, have been left to the discretion of Member States.

1.8.6 As the De Larosière report recognised, in the UK, all hedge fund managers were subject to registration and regulation prior to the introduction of the AIFMD, and the largest 30 were already subject to direct information requirements often obtained on a global basis as well as to indirect monitoring via the banks and prime brokers. De Larosière considered it would be desirable for all other Member States (as well as the US) to adopt "comparable measures" – but although the use of a Directive rather than a Regulation arguably provides a nod to subsidiarity, it is plain from the extensive work that is being undertaken that the AIFMD's provisions are a far cry from the UK's pre-existing regime, and in our view go too far.

1.8.7 A report published in October 2013 by New Direction – the Foundation for European Reform – entitled "The Real Economic Impact of the EU's Alternative Investment Fund Managers Directive" notes that:

(i) a survey of UK based asset managers published by Deloitte in June 2012 found that 72% of respondents viewed the AIFMD as a threat to their business and 68% suggested that the AIFMD would reduce the competitiveness of the funds industry in Europe and would lead to fewer non-EU managers operating in the EU;

(ii) the overall asset management industry has an annual impact of €102.6 billion (GVA) and 510,000 jobs across Europe;

(iii) if Europe lost its competitive advantage in fund management because of the AIFMD, around €21.5 billion and 107,100 jobs would be at risk; and

(iv) the Commission is planning a review of the AIFMD in 2017, but by this stage any damage done will be hard to repair.

1.8.8 There are more significant points to which the AIFMD gives rise – including issues of uncertainty, poor quality legislation, and impact on extraterritorial actors. These are dealt with as follows.

1.8.9 Often, as a precursor to the ordinary legislative procedure, one would expect the Commission to undertake a pre-consultation process and publish a Green or a White Paper before proceeding to a formal proposal for legislation. This approach enables the policy thinking behind the proposed legislation to be aired and at least subject to public scrutiny. However, this did not happen in the case of AIFMD. In launching the proposed Directive, the Commission said that the proposal built on "*extensive consultation and on the 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*" but, in truth, none of the disparate studies into hedge funds, investment funds, real estate funds and private placement had specifically and holistically contemplated the proposed Directive as it was published and together could not take the place of a specific consultation and a White/Green paper. It should be noted that the Commission is the only EU body empowered to initiate legislative proposals; while the text is subject to later amendment throughout the legislative process, the importance from a political perspective of having the initiative in drafting in furtherance of the policy position cannot be underestimated. It is in recognition of this powerful position that pre-consultation is usually expected.

1.8.10 Because the AIFMD did not follow the more orthodox route from formulation of the Commission's policy position through to legislative text and because of the relative haste with which the draft Directive was put together and negotiated, many provisions were poorly thought through with certain key concepts being left undefined and uncertain. Even now, European institutions and regulators cannot agree on what the Directive says on some fundamental provisions. The most notable example of this involves the Article 6(4) AIFMD "derogation" which allows Member States to authorise AIFM to carry on discretionary portfolio management activity, in addition to AIMFD Annex 1 activities. However, there is disagreement as to whether a "passport" is available for such activity. The Commission (together with a number of Member States) thinks not. The FCA believes that such a passport *should* be available (and produced its authorisation forms on that basis). To have reached this stage, with such a fundamental disagreement between Member States and EU institutions reflects a break down in the EU legislative process.

1.8.11 Some of the greatest absurdities arise because core concepts used in the Directive were not adequately considered or delineated in it, again partly as a result of process by which it was created. Whilst one might expect that there will always be "perimeter" questions with any law, the lack of any coherent definition of the very subject matter of the Directive has led to pages of guidance, and the likelihood that some types of vehicle will be regarded as AIFs in one jurisdiction, but not another, creating clear regulatory arbitrage and an unlevel playing field. Similarly the Directive embeds terms such as "open-ended" and "leveraged" without defining them, which is left to Level 2, yet the Directive creates a fundamentally different regime for funds which are open-ended and/or leveraged. So negotiations and comments at the Directive stage were based on inherent understandings of what these common concepts mean, only to find that at Level 2 they were given an unexpected interpretation. Even worse, these flawed concepts will now be used in future legislation.

1.8.12 The initial ESMA consultation paper on its guidelines on reporting obligations under the AIFMD was not published under May 2013, which was already very close to the entry into force of the AIFMD on 22 July 2013. It was not clear at the time (and to a certain extent, still remains unclear at the date of this response) whether an AIFM which was relying on provisions granting transitional relief would be subject to the reporting obligation. ESMA, adopting the position advanced by the Commission, indicated in its consultation paper that AIFMs which existed as of 23 July 2013 could become subject to the reporting requirement immediately and would have to report for the first time by 31 January 2014. Although that position was inconsistent with the interpretation of the transitional provisions in the AIFMD which had been adopted by many legal practitioners, this nonetheless caused considerable concern amongst fund managers due to the length of time required to put reporting systems in place to collect and analyse the required information. As such, not all fund managers considered that it was practical to wait until the final guidelines had been published by ESMA in order to finalise their own reporting arrangements. In addition, there was a lack of clarity for those fund managers who were to obtain early authorisation on or after 22 July 2013 and in respect of whom the transitional provision would therefore cease to apply, but who would lack the benefit of any final guidance despite already needing to have operational systems in place from their date of authorisation. The consultation process therefore took place over an entirely unsuitable timescale, given the necessary lead time required to develop functional reporting systems.

1.8.13 ESMA published its first "final report" on the reporting guidelines under the AIFMD on 1 October 2013, after the Directive had already been in force for over two months. In a number of areas, that set of finalised guidelines created further confusion, particularly in relation to the date for first reporting and the application of the transitional provisions. In respect of the former, the text of the guidelines no longer contained the clear 31 January 2014 date for first reporting which had been set out in the consultation paper, which caused confusion about precisely when authorised AIFMs would need to submit their reports for the first time. In relation to the application of the transitional provisions, ESMA's text effectively passed responsibility back to fund managers and their advisers to determine whether such managers were subject to the reporting obligation in the transitional period, stating that: "*ESMA decided to adopt a more principles based-based approach for existing AIFMs... Existing AIFMs should take into account: (i) the transitional provisions of Article 61(1) of the Directive; (ii) the Commission's interpretation of Article 61(1) as set out in its Q&A and (iii) their authorisation status.*" Given that the purpose of ESMA's guidance was to clarify the reporting position, this wording caused an unacceptable level of uncertainty across the industry, requiring firms to anticipate the views that would be adopted by national competent authorities on this issue by reference to the specified conflicting factors, without giving any indication of the relative weight of each of these. This position was apparently the result of responses that ESMA received to the initial consultation paper, which had highlighted the fact that ESMA's earlier draft guidance appeared to be inconsistent with the transitional provisions in the AIFMD and therefore lacked a clear legal basis. If the consultation process had operated effectively and if sufficient time had been allocated for ESMA to consider the issue, one would have expected to see a detailed analysis of the relevant parts of the legislative text and full consideration of industry responses in the final guidelines, followed by a clear conclusion to guide industry participants on the nature of their regulatory obligations during the transitional period. Instead, the final text effectively disclaimed responsibility for the decision on this crucial point on timing, leaving firms without any clear basis to determine their first reporting dates. Since the FCA assumed that it could simply refer firms to ESMA's guidelines on reporting, the situation was not clarified in the UK until the FCA subsequently published a reporting update on its website on 4 November 2013, over three months after the entry into force of the AIFMD. Even then, that statement itself still did not identify a clear first reporting date, leaving firms and their advisers to attempt to deduce how and when reporting obligations applied by implication. The effects of this confusion are not recognised as a cost in the cost-benefit analysis contained in the final guidelines, despite the fact that implementing reporting systems may be expensive for many firms both in terms of financial cost and management time and therefore that the length of time available for such implementation is clearly a critical factor.

1.8.14 The "final report" published by ESMA on 1 October 2013 was understood by industry participants and practitioners to be the definitive reporting guidance, therefore permitting AIFMs to finalise reporting systems that they had already been putting in place or to commence implementation of those systems on the basis of the position set out in the report. That final guidance had itself already led to an unexpected revision of the reporting templates in Annex IV to the Delegated Regulation which had previously been understood to be in a legally binding form. This resulted in firms which had already begun developing their reporting systems having to make adjustments, potentially involving additional cost with their service providers. Further uncertainty was caused by ESMA re-publishing its final guidance on 15 November 2013 to correct certain errors in published asset codes and to highlight reporting fields which were the result of the advice contained in its opinion, rather than mandated by the original legislative texts. Although ultimately those revisions were relatively minor in nature, this unexpected revision of the guidance, which was not accompanied by any clear comparison document indicating the text that had been added, required firms and their advisors to spend additional time comparing the texts to ascertain the practical implications of the revisions. Additional amendments to the accompanying technical IT guidance and templates were published by ESMA on 4 December 2013, again causing further confusion and necessitating another review of any potential resulting changes. This constant revision of the guidance and related documents is a symptom of the insufficient time allocated for the original consultation process to permit ESMA to consider the relevant issues fully and to verify that all the information included in the guidance was appropriate and correct. There is no method by which individual firms adversely affected by ESMA's continual revisions (for example, through the cost of advisers' fees and management time in assessing the impact of each amendment) can hold ESMA accountable. In addition to the points regarding the deficiencies of the process through which the reporting templates have been developed, there is also an issue regarding their substance. Greater flexibility is needed in the reporting fields provided in order for AIFMs to note either that items are not relevant to them, or to explain how they have interpreted them. This problem may have been avoided had the consultation process in relation to reporting requirements taken place within a more appropriate timescale.

1.8.15 The ESMA guidelines on reporting also indicate how documents which are intended to be "guidance" issued by ESAs may in substance represent attempts to expand the regulatory scope in a manner for which there is no provision in the original legislative texts. Due to the extensive nature of the reporting requirements, which include information which many AIFMs might not ordinarily collate on a regular basis, many firms needed to begin developing reporting systems in advance of the publication of ESMA's final guidance and did so on the basis of the Annex IV templates which they understood to be directly applicable requirements under EU law. While those templates were reproduced in ESMA's original consultation paper, the indicative templates published with the final guidelines on 1 October 2013 were modified versions, containing additional reporting fields which had not been included in the templates set out in Annex IV to the Delegated Regulation. Respondents to ESMA's consultation had indicated that requiring AIFMs to report additional risk measures and other information would exceed the scope of the reporting requirements set out in the AIFMD and the Delegated Regulation and therefore would lack a legal basis. Nonetheless, the templates published with the final guidance incorporated fields for these additional measures on the basis of a separate opinion also published by ESMA on 1 October 2013 which encouraged Member States to exercise their national discretion to require that additional information. This subverted the consultation process with ESMA accepting the validity of respondents' criticism about the lack of a legal basis for that information under Article 24(2) and 24(4) AIFMD, but then circumventing the issue by prejudging the position that ought to be adopted by each individual Member State under Article 24(5) in order to achieve ESMA's ultimate desired result. If those additional risk measures were considered sufficiently important to be required on a mandatory EU-wide basis, the correct place for that requirement to be introduced was in either the text of the AIFMD or in the Delegated Regulation, thereby ensuring certainty and uniform application of reporting obligations. The original intended purpose of ESMA's guidance was to clarify the reporting requirements of AIFMs contained in those texts; it was not to add additional requirements which ESMA itself considered desirable. The inclusion in the final templates of both the requirements set out in ESMA's final reporting guidelines and those in its separate opinion obscured the fact that ESMA had no power to require the latter, which could only be included by reference to discretion reserved for Member States' national competent authorities.

1.8.16 In its impact assessment of the AIFMD dated 30 April 2009, the Commission identified that one of the objectives of the legislation was to harmonise regulation of AIFMs in order to remove legal and regulatory obstacles to the cross-border distribution of units or shares in AIFs. The analysis specifically noted that restrictions on marketing and promotion were one area in which pre-AIFMD national requirements inhibited such distribution. One of the principal elements of the AIFMD was then identified in the document as being the right of an authorised AIFM to market its funds to professional investors in any Member State, without Member States being able to impose additional requirements. However, although provisions for cross-border marketing were included in the AIFMD, the failure of the EU institutions to define the concept of "marketing" fully has led to different definitions being adopted by different Member States, adversely impacting harmonisation and decreasing the utility of an AIFM's cross-border marketing passport. For example, the Committee is aware of advice from an Austrian law firm that "marketing" under the AIFMD in Austria may include "soft-marketing" or pre-marketing of AIFs, which is contrary to the general view adopted by the FCA in the UK that marketing requires final or near-final documentation for the relevant AIF. Such a divergence risks preventing the marketing of a fund on the same basis throughout the EU. For example, an EU AIFM who wishes to pre-market an EU AIF across Europe would need (absent being able to rely on any transitional arrangements) to promote the relevant AIF in Austria on the basis of the marketing passport, but would not need the passport to pre-market in the UK (although it would still need to comply with the separate UK financial promotions regime). Insufficient analysis of the impact of individual Member States' interpretations of the definition of marketing during the AIFMD legislative process has therefore led to the single market objective being undermined and the inaccuracies of the assumptions in the original impact statement becoming exposed.

SSR

1.8.17 The SSR suffered similarly from the lack of a rigorous impact analysis, making it difficult to marry up the perceived problems that the legislation was designed to address with the measures taken. The measures and the way in which they have been interpreted have had a significant impact on the trading practices of a number of our clients, for example leading them to discontinue perfectly sound hedging practices in certain instruments and jurisdictions because these would be regarded as creating reportable short positions.

1.8.18 The definition of “market making” in the SSR is an example of a crucial piece of legislation that has been drafted so obscurely that ESMA has been unable to interpret it in a manner with which many significant Member States are able to agree. Reliance on the exemption is fundamental to the client facilitation activities of the organisations whom our members advise but competent authorities in France, Germany and the UK, on the one hand, and Italy and almost certainly others, on the other hand, are divided as to whether it can be used for hedging activities in OTC derivatives. Apart from the obviously problematic nature of purportedly harmonising legislation being interpreted differently in different Member States, we regard it as profoundly unsatisfactory for legislation to be drafted in a way where the basic legislative intent of significant provisions is unclear and cannot sensibly inform the interpretation of the legislation by ESAs. This puts ESAs in the position of taking policy decisions that they are not equipped to take and risks the legislation being interpreted in a way that is not proportionate to the harm against which it was originally addressed.

EMIR

1.8.19 EMIR (the Regulation on OTC derivatives, central counterparties and trade repositories) imposes significant burdens not only on financial counterparties and central clearing counterparties, but also on non-financial counterparties, who will be subject to requirements around prompt exchange of confirmations, and reporting requirements (many whose derivatives trading is largely undertaken for hedging purposes may fall below the clearing requirements threshold, but by no means all).

1.8.20 The Regulation will increase collateral amounts and operational complexity, and it seems likely that the costs to the real economy will be significantly increased.

1.8.21 Nevertheless, fundamental concepts of EMIR remain unclear and inadequately addressed by the legislation. An example is the concept of a “derivative”, which is crucial to the application of the Regulation. Where elements of derivatives are embedded within other transactions (such as loans, repos or securities) which do not otherwise fall within the scope of the legislation, the legislation leaves it unclear whether or not such transactions are intended to be covered. Given the fundamental impact of the legislation, this lack of clarity can have a chilling effect on transactions whose treatment is uncertain and means that the actual effect of the legislation is disproportionate to its intended effect.

1.8.22 This has resulted from deficiencies in the EU policy making process. Terms used in MiFID have simply been carried over to EMIR without any thought as to whether this is appropriate. MiFID lists different types of derivatives which will be financial instruments for its purposes but is almost entirely bereft of any useful definitions or explanations as to what any of the various core terms mean. At least in the context of MiFID, activities in relation to derivatives are only relevant to the extent that investment services and activities are carried on by an investment firm on a professional basis. However, EMIR simply “borrows” the MiFID list of derivatives (without any investment firm/services and activities “overlay” or without any further explanation or definition). This means that the mischief caused by the lack of clarity within MiFID becomes compounded further still, because its terms and concepts become relevant in determining whether transactions carried out by undertakings outside the financial sector are subject to the burdensome requirements of EMIR (in terms of risk mitigation and/or central clearing and reporting. This is lazy policy making, especially in the context of a Regulation that is specifically about derivatives. This raises a general concern about contagion into other areas of EU legislation – i.e. that a failure to focus on the meaning of a concept in one area can have wider implications in the future if other concepts are defined by reference to it.

1.8.23 Another example of a fundamental concept under EMIR which remains unclear is that of a "third country entity". The comments made by the Commission in its Q&A could lead to an unexpected interpretation of this concept in comparison to what it has been understood to mean prior to these comments.

1.8.24 EMIR has also caused uncertainty for firms by requiring third country CCPs to submit applications only 6 months after the Regulation setting the applicable standards came into force, and while substantial interpretative issues remained unresolved.

Solvency II

1.8.25 International businesses (many with operations in the UK and third countries (such as the US and Bermuda)) devoted substantial resources to preparing for Solvency II which was expected to have a quick implementation timetable, but the goal posts have kept moving so it has been difficult for them to prepare.

Market Abuse Regime

1.8.26 The 'market practices' safe harbour under the Market Abuse Regime is an example of the principle of subsidiarity being applied. It is important for the 'legitimate purpose' defence which depends on what constitutes 'accepted market practice'. However, the UK's own approach to interpretation means that there are no "accepted practices" in the UK, unlike in some other jurisdictions.

MiFID

1.8.27 A more positive example of EU rules applying the principle of subsidiarity is in relation to IFAs under MiFID. National discretion was put in at the UK's request and has worked well in the domestic market (i.e. the exemption for IFAs advising and arranging in relation to collectives).

2. ***How might the UK benefit from more or less EU action? Should more legislation be made at the national or EU level? Should there be more non-legislative action, for example, competition enquiries?***

2.1 Compared with other Member States, the UK is in a unique place as a large and complex financial services centre. In many areas of financial services the UK leads the way in regulation (for example, with the Retail Distribution Review) and, in addition, implements EU Directives in a timely fashion. One of the main tenets of the single market is to create a level playing field which would be a clear benefit to the competitive position of UK businesses. In addition, there are many advantages in legislation being made at an EU level in order to facilitate cross-border business and minimise differing national requirements on firms. With this background, and the increasing international nature of business, there are benefits to legislation being made at an EU level and it is essential that the UK takes a pro-active position in EU policy making as businesses inevitably will be impacted by it. The EU legislative process, however, is lengthy, and there will be clear instances when national legislation is desirable for quicker resolution of particular issues.

2.2 The benefit of EU action is subject to the following:

2.2.1 sanctioning powers for the breach of EU legislation should be harmonised and reviewed to ensure that breaches of EU obligations are enforced effectively and consistently across the EU;

2.2.2 flexibility to accommodate national differences is often necessary; however, national derogations should only be made following proper consultation and impact assessments. Similarly, while the UK often implements super-equivalent requirements that are tailored for the UK market and maintain high standards (such as the market abuse provisions), these too should be assessed in light of the global competiveness of UK businesses;

2.2.3 substantial amendments are made to EU legislation during the negotiation process but often without further consultation and impact assessments/cost benefit analysis. These should be conducted where appropriate;

2.2.4 ESAs are being granted increasing powers under EU legislation. The implications of such powers in each case should be carefully scrutinised;

2.2.5 in some cases European legislation is perceived to restrict global business which can have a particularly adverse impact on the UK as an international financial centre. For example, there are wide powers in relation to the assessment of the equivalence of third countries in the AIFMD and MiFID II. These powers should be objectively based and properly thought out; and

2.2.6 as recognised by the UK's challenge in relation to the financial transaction tax, the use of the cooperation procedure can result in extraterritorial impact and undermine the level playing field objective of the internal market.

2.3 We think that there is scope for further non-legislative action to be taken to try to ensure that a level playing field is achieved. One of the failings to date of the attempt to harmonise financial services rules has been the failure to achieve this level playing field. Examples of steps that could be undertaken might include:

2.3.1 better co-ordination at an ESA level to review Member State implementation after (say) 12 months from the coming into force of each Directive and Regulation. For example in relation to the AIFMD, there are a number of very different interpretations being taken and ESMA might (or might not) be able to provide guidance on how properly to implement the relevant Directive. This would be in addition to the ESAs' technical guidance on the Directive prior to it coming into force because, at this stage, not all of the uneven approaches are known;

2.3.2 as the Call for Evidence notes, European legislation frequently retains Member State discretions. This is often the case where political agreement has proved difficult. The best known example is the 100 Member State discretions contained in the CRD. The ESAs could play a role in reviewing whether the exercise of those discretions has distorted competition between Member States and firms, and could give guidance to Member States on how to manage any such distortions. For example, it might only be appropriate for one discretion to be exercised in the absence (or presence) of another discretion also being exercised. Or it could be that Member States could be requested not to exercise certain discretions in the interests of greater conformity; and

2.3.3 the ESAs could also provide commentary on important legal questions that arise under the Directives where different approaches are taken in different Member States. For example, where is a service provided? Does it depend upon where it is marketed – and if there is to be a reverse-solicitation exemption nationally, how should that be interpreted? Or if the characteristic performance test is to apply, how should that work? Guidance at a European level that Member States could then rely upon would enable a uniform approach to be taken to situations where, at present, there are different but similar approaches (to, for example, what amounts to reverse-solicitation). Guidance would be to the mutual benefit of EU and non-EU firms who are trying to rely upon them.

2.4 When attempting better co-ordination between non-legislative action at an EU level, it is important that the focus is on the technical aspects of the measure in question, rather than the policy implications which should be reserved for the Commission, Council and Parliament, along with Member States.

2.5 We do not consider that Competition enquiries are the right way to take non-legislative action to better co-ordinate financial services legislation.

4. 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?

4.1 The Committee is generally neutral as to the instrument used to achieve harmonisation (i.e. whether through the use of Directives or Regulations), however this is subject to the instrument being used as intended. In some cases Directives are implemented late in Member States other than the UK (the AIFMD being a recent example) or with differing interpretations. This potentially results in higher obligations and costs on firms in compliant Member States. In these cases harmonisation might be better achieved by means of EU Regulations rather than through the implementation by each Member State of Directives which can risk delays and result in national disparities. However this is not always the case and Regulations can also result in unintended national disparities, for example, where key concepts are not adequately defined.

4.2 Regarding the level of the volume and detail of EU rule-making in financial services, the Committee welcomes greater detail where the relevant policy warrants it; otherwise it welcomes leaving this to Member States' national discretion. However, the Committee is concerned that because of flaws in the EU decision making process, detail is arising for other reasons. The Committee's overall conclusion is that the legislative process at the EU level is flawed, and the problem is not whether the level of detail in EU rules is consistently too great or too general, too restrictive or too liberal, but that it is not properly informed by agreed policy considerations that have been the subject of effective consultation.

4.3 Hence proportionality is not necessarily applied. For example, on one hand we are in a position where there is too much detail regarding the record keeping requirements of market soundings even when no inside information is divulged (which serves no obvious policy objective). On the other hand, we have inconsistency on the definition of "market making" under the Short Selling Regulation, where uniformity would be of great benefit to the market and consistent with the stated policy. This is a result of the drafting being too vague, thus allowing for national variations which are not driven by the principle of subsidiarity, but rather by deficiencies in the legislation.

4.4 Further examples of national variations created by a lack of detail include both MiFID and the AIFMD in relation to financial promotion. The lack of detail in this area has allowed Member States to obstruct the passporting regime: there is not enough detail in relation to passporting itself and the fees and conditions that Member States can apply. The lack of detail means it is difficult to assess how the UK financial promotion regime applies to overseas firms passporting into the UK with a services passport. This also raises a point in relation to the need to join up silos of regulation – for example, there are directly conflicting stances in relation to prospectus requirements.

4.5 The CRD IV remuneration provisions are another example of where inadequate policy formulation and consultation has resulted in highly prescriptive rules that deny national authorities the ability to tackle misaligned incentives in a way which meets their market conditions. The rules on risk retention similarly reflect incoherent policy thinking and development, which the EBA guidance sought to address, only to be confounded by later prescriptive rule making that has swept the guidance away in place of highly prescriptive rules. This is an example of where guidance at an EU level would be preferable because it would have the capacity to deal with subtleties and nuances that the legislation does not. In addition, the final risk retention rules in the CRD and the AIFMD contain differences, particularly around the due diligence obligations for investing institutions, which were communicated to the Commission but seemingly not considered. This is another example of the flawed policy formulation process.

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

General remarks

5.1 At the moment, the EU's approach to Third Country Access has not greatly adversely affected the ability of UK firms to trade internationally. That is because most of the measures containing Third Country Access provisions have have yet to come into force. Therefore, to some extent, it is too soon to say whether or not such proposals have actually affected business on the ground.

5.2 However, we do note that inappropriate Third Country Access provisions could greatly affect the ability of UK firms to trade internationally. London, in particular, is a key international financial market and much of that business is undertaken by, or with Third Country ("**TC**") firms.

5.3 In considering the "ability of UK firms and markets to trade internationally", it is important to appreciate that benefits to the UK are not simply those arising for UK firms or even EU and TC firms (including financial institutions ("**FIs**")) with branches/affiliates in the UK, but also:

5.3.1 where TC firms/FIs do cross-border business into (or through) the UK, that reinforces the position of the UK (and London in particular) at the heart of international financial markets;

5.3.2 UK-based financial services and markets to which TC firms/FIs seek access serve the whole EU economy and not merely the interests of the UK;

5.3.3 however, the international character of financial markets is not delimited by the EU: the markets are global and regulation must recognise that; and

5.3.4 EU consumers and FIs benefit from the greater liquidity which the participation of TC firms/FIs brings.

5.4 It is therefore important that any EU regime for TC firms/FIs:

5.4.1 recognises the value their participation in our markets brings to the EU as a whole, and thereby to EU firms and consumers;

5.4.2 it is not just access rules which will discourage TC firms/FIs participation in EU markets, but applying excessive or insensitive rules to the conduct of business or related or organisational requirements; and

5.4.3 does not restrict access any more than is strictly necessary.

5.5 TCs are very diverse in their levels of financial services and markets development, and their cultures, and the EU markets TC firms/FIs serve also vary tremendously. Accordingly:

5.5.1 major differences in regulatory approach must be acknowledged and accepted;

5.5.2 a "one-size fits" all approach is inappropriate;

(i) for example, in some aspects of regulation some TC regulatory regimes may favour disclosure by firms over imposing additional duties or restrictions on firms; and

(ii) the strong reaction of Asian central counterparties ("**CCPs**") to the EMIR recognition process is an example where the EU authorities are arguably being insufficiently sensitive to these factors.

5.6 TCs, especially emerging markets, will be the source of much of financial services evolution over coming years and decades. If the EU wishes to retain a leading role in financial services, it must be sufficiently flexible to allow innovation and attract new markets and approaches – e.g. in Islamic finance or RMB instruments, emerging markets corporate finance, and use of new technologies (automated trading, for example) and business models (such as crowdfunding).

5.7 Accordingly, the impact of the EU's approach to TC access is closely related to other issues in the Call for Evidence, such as the single rule-book and the degree of action/regulation/supervision at EU level and the growth and competitiveness aspects of question 3 (on page 41). Please refer to our responses in relation to other questions for more detail of our views on this and related examples.

EU approach

5.8 HMT acknowledge different phases in the EU's approach to TC access, and the different approaches affect (or have the potential to affect) UK firms' ability to trade.

5.9 The previous approach (e.g. under MiFID), worked reasonably well, and arguably enhanced London's position in financial services. The approach strengthened the Single Market, through more robust passporting arrangements and realignment and greater clarity on responsibility for conduct rules, but in broad terms it left TC access for MSs to determine.

5.10 The early (pre MiFID II) post crisis approach to TC access may be described simply as Equivalence + Cooperation (MoU) + Reciprocity: the effects remain to be seen because the new regimes are not yet fully in operation. Our concerns so far are that the approach has:

(i) caused considerable friction with TCs, e.g. Asian nations and in relation to EMIR;

(ii) caused uncertainty for business e.g. TC CCP access; and

(iii) been applied too strictly, that "one size fits all is inappropriate" is not always recognised, e.g. use of non-EU benchmarks as proposed in Commission's Sept 2013 proposal for Benchmark Regulation. On the other hand, in respect of the AIFMD, there has been considerable success in getting MoUs in place and in applying a flexible approach to equivalence.

5.11 TC firms increasingly face a common access standard in theory but in practice this depends on:

(i) the local approach to application of rules. Despite the Lamfalussy Level 3 process to ensure consistent, timely, common and uniform implementation of Level 1 and 2 measures in Member States, application varies tremendously because of huge variations in the experience, budgets and priorities of supervisors;

(ii) politics and priorities at EU level: we anticipate that equivalence assessments and entry into MoUs may be affected by political issues; and

(iii) the attitude of national regulators.

5.12 In our view, the key aspects of Third Country measures that would adversely affect the ability of UK firms to trade internationally are as follows:

(i) A requirement for **reciprocity**. We do not need all markets to be as open for business as ours. Indeed, there may be Third Countries whose regulatory structure is evolving more slowly and where open access might, for them, be an inappropriate requirement. The EU should be encouraging more countries to be open, rather than importing reciprocity measures in an ill-judged attempt to create a balance.

(ii) **Equivalence**. Any equivalence assessment must be at a very high level. Do the rules, in general, try to achieve an appropriate degree of protection? Are they, for instance, part of the same G20 agenda? If so, no more detailed review should be necessary. In practice, any more detailed review is likely to show up relatively unimportant differences on the ground but might make an equivalence finding impossible.

(iii) Restrictions on access to deal with EU-authorised firms or financial institutions, or on organised markets based in the EU, as distinct from retail or other less sophisticated market participants.

(iv) Finally, the approach to considering reciprocity should be on an "**in-until-out**" basis. In other words, the markets should remain open unless there is a reason to close them. A requirement that all markets should be closed unless and until deemed equivalent would create not only an administrative burden but short-term barriers to entry that would damage the ability of the UK to conduct international business. It is inappropriate to give to EU institutions the power to close UK markets where the principle of subsidiarity does not require this to be the case.

5.13 We note that the newly-agreed MiFID Third Country Access provisions avoid these difficulties, and amounts to a significant new approach. It permits firms in Third Countries which have passed a high-level equivalence test (without a reciprocity requirement) to access professional and counterparty markets in all EU states on a uniform basis. The only requirements are: registration with ESMA; disclosure of non-EU status to clients; and non-exclusive submission to the jurisdiction of the courts in a Member State. For any Third Country not (or not yet) deemed equivalent, national regimes will continue to apply. Retail clients are protected differently – Member States can choose to require the establishment of local branches that would then need to comply with the EU's consumer protection rules. The UK should support strongly such an approach in future EU legislation

6 Do you think that more or less EU-level regulation in the area of retail financial services would bring benefits to consumers?

6.1 We have discussed in detail in other areas of this response some of the merits and demerits generally of the EU's developing approach to the regulation of financial services. Much of that discussion is equally relevant to the regulation of the retail sector. There is, however, a particular aspect to the regulation of the retail sector that differs from all other sectors and deserves specific consideration. The development and sustaining of the single market has been a fundamental tenet of the UK's approach to developments in EU regulation. This, and our open markets policy, have enjoyed the wholehearted backing of the City and of the industry generally over many years. Many of the detailed issues that are discussed elsewhere in this response, whether in relation to passporting rights, the use by financial services firms of branches rather than subsidiaries, the debate over the location of CCPs, depositaries and other service providers in the context of AIFMD and EMIR, the need for a level playing field under CRD and other capital requirements, or the scope for further developments in competition policy, all of these issues are underpinned by the UK's commitment to sustaining and developing the single market. By and large, however, these issues are structural. UK regulators are in principle able to negotiate on the Commission's proposals in these areas and, where necessary, reach compromises on the UK's preferred position. The differing degrees of success that UK negotiators achieve during these processes are to some extent laid bare in this response. Nonetheless, progress has undoubtedly been made through the years in our move towards a single market and overall this has been a significant benefit for the UK financial services industry.

6.2 Uniquely, however, the impact on UK retail customers is far more mixed. Some of the structural developments and reforms have undoubtedly benefited retail customers during the financial crisis, just as they have benefited other industry participants. Those regulatory developments that have been specifically aimed at changing the conduct of retail business, however, have generally been at best harmless but equally have a propensity to damage the interests of UK retail customers. Very little has been both new and beneficial for UK retail customers. The reason for this is simple. As we noted in paragraph 2.1 above, compared with other Member States, the UK is a unique place as a large and complex financial services centre. In many areas of financial services the UK leads the way in regulation (for example, with the Retail Distribution Review).

6.3 The result is that, for many years, we have had a comprehensive and sophisticated body of regulation governing the conduct of retail business. When EU regulators propose new rules to apply EU-wide in the retail area, in the majority of instances they will be seeking to cover an area that is already adequately covered in the UK by existing UK domestic rules, resulting in 'layering' of Regulations (e.g. in relation to PRIPs). When our negotiators, therefore, in the course of negotiations, put forward the UK rules as a model, some are likely to be accepted but others will be subject to objections from other Member States and are likely to be compromised. Unlike other areas where even a compromise may represent progress over the current position, from the perspective of UK retail customers such a compromise may well be retrogressive. The negotiations surrounding MiFID were an instance of this process and resulted, for example, in the unsatisfactory rules that we now have in relation to financial promotion, as noted in paragraph 4.4 above. Even where the rules as finally agreed are not fundamentally different, our regulators have fallen into the trap of simply writing out large swathes of Directive, rather than interpreting them in clear cogent English that is adapted to UK circumstances and to our laws. The cross-referencing to EU source materials, which has become increasingly prevalent, has also detracted from the clarity of drafting that is particularly desirable in the retail business sphere.

6.4 In addition, EU regulation has increased the breadth of retail protection rules to extend beyond the retail sector (for example, the definition of 'professional client' under MiFID is too narrow). This does not bring any benefit to consumers.

6.5 Our general conclusion, therefore, is that further EU-level regulation in the area of retail financial services, with the exception of regulation allowing the development of products for the retail market, such as the UCITS Directives and the Payment Services Directive, may or may not be beneficial to the industry but are unlikely to be substantially beneficial to UK consumers.

6.6 In considering the retail financial services sector we also need to consider the broader prudential picture. There is a cross-border prudential issue in relation to the protection of consumers – as illustrated through the collapse of the Icelandic banks which were able to access the UK retail market without providing the same deposit protection to consumers as UK banks would be required to provide.

7 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?

7.1 The creation of the ESAs signalled the start of a transition from a balance of competencies in which EU non-legislative bodies (the fore-runner organisations to the ESAs in particular, but also now the ECB) played an essentially consultative and coordinating role to one in which they play, or at least are intended to play, an increasingly prescriptive (i.e. rule-making) and interventionist (i.e. supervisory) role.

7.2 We have not yet had sufficient opportunity to see any of these bodies exercising the full range of their regulatory and supervisory powers and responsibilities to be able to draw comprehensive conclusions as to the effectiveness and appropriateness of their competencies. That said, we wish to make some observations based on what we have seen to date of the ESAs' evident ambitions and modes of operation, and a clear direction of travel in EU policy terms towards much greater centralisation and harmonisation (or at least intended harmonisation) of regulation and supervision.

7.3 Our frontline experience has been that the EU project to create a single rulebook for financial services, and more generally to harmonise regulatory supervision within the Union through greater use of EU Regulations in place of EU Directives, is both:

7.3.1 increasing the challenges for regulated firms and their legal advisers in assessing and advising on the scope and application of the law; and

7.3.2 we believe, compromising the ability of the UK legislator to create, and the PRA and FCA to operate, a financial regulatory system that, in seeking to achieve desired policy outcomes, takes account of the particular, and sometimes unique, features of UK financial services markets and (importantly from our perspective as legal advisers) the UK legal system.

7.4 This is leading inevitably to an erosion of legal certainty in our regulatory framework, as we are required to construe legislative drafting that is the product of extensive compromise processes (often aiming to satisfy competing national concerns and interests) through an EU law lens but for practical application in a UK law context. The erosion of legal certainty is coupled with issues of accountability resulting from the lack of transparency regarding the compromise processes, particularly the debates between ESMA and the Commission.

7.5 Against this background, an apparent inclination on the part of the ESAs for using non-formal texts, and in particular Q&A documents, in effect to set regulatory standards and to promulgate de facto rules is undesirable. Although the existence of Q&A documents is not undesirable per se, the Committee has concerns regarding the Q&A process, which is particularly important where Q&As are being used for these purposes. There is no visibility as to the process of how questions are submitted and by whom, nor how replies are determined. We would therefore welcome publication by the ESAs of information relating to the governance of the Q&A process.

7.6 Certainty of the law and of the application of the law is of course a key factor to restoring confidence in UK financial services and therefore also to encouraging investment and growth. We do not believe legal and practical certainty is mutually exclusive from achieving the international policy objectives to which the UK has committed. Equally, we do not believe harmonisation and the removal of impediments to free trade within the EU can be achieved only by unifying legal and regulatory systems within the EU.

7.7 There is a middle ground in which maximum harmonisation Directives can be used to create a framework around which guidelines and principle-based standards can then be applied in a national law context. There is certainly a role for the ESAs to play in this context in promoting and, where necessary, mediating/enforcing consistency of application of those standards across national regulators (inconsistent application of supposedly harmonised EU regulatory standards has equally in the past created legal uncertainty and unlevel playing fields which have complicated cross-border activity); but this does not need to be without prejudice to the ability of national authorities to set and construe their own rulebooks.

7.8 In order for ESAs to contribute properly to promoting the consistency of the application of harmonised EU rules across Member States, they must be sufficiently resourced. The current under-resourcing of ESMA means amongst other things that firms cannot engage with it on a bilateral basis.

7.9 Whilst the Committee supports the role of the ESAs, their increasing importance raises a greater concern regarding their accountability. It is imperative that ESAs are independent, transparent and act properly in accordance with the law. Guidance and technical standards should not seek to reintroduce provisions which were rejected at Level 1, for example the ESMA Remuneration Guidelines produced under the AIFMD apply the concepts to delegates, a concept not in the Level 1 Directive. ESAs should be subject to a requirement to observe proper constitutional arrangements.

7.10 While we recognise that ultimately the balance of legislative and supervisory competence between the UK and the EU is a policy matter on which macro political decisions must be made, from our perspective as legal advisers we are certainly concerned that the direction of travel at the EU level is evidently for ever greater transfer of rule-making and supervisory decision-making away from national regulators to bodies which at present are insufficiently accountable to and challengeable by the constituencies which they supervise.

8 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?

8.1 We recognise that the judgment on whether the UK has an appropriate level of influence at EU level is largely political. Nevertheless, it would appear that, given the facts stated by HMT, the UK does not have an appropriate level of influence in comparison to its position as the world's leading financial services centre (according to the Global Financial Centre Index in 2013, as noted at paragraph 1.18 of the HMT Balance of Competences Review). It is clear from the unsatisfactory position under the AIFMD (which impacts the UK more than any other Member State) that the UK has insufficient influence on EU legislation. We hope that the FCA and PRA will cooperate with each other effectively to ensure that the division of regulatory responsibility does not reduce or weaken UK influence in future.

8.2 Setting aside how different the rules might be in substance, we make below two points of a legal nature on how the rules would be different if the UK was solely responsible for them and also make some observations on policy issues.

8.3 First, one method of introducing flexibility into the legislative framework which has been helpful in the UK context has been the grant of waivers from the detailed application of the rules in limited circumstances (broadly, where this is justified on the grounds of the burdensome nature of the application of the rules or their not achieving the purposes for which they are made and, in each case, the waiver would not adversely affect the advancement of the regulator's statutory objectives). Whilst the depth of Level 2 legislation is now much greater than it used to be so creating a more fact specific regime, the complexity of the market means that not all circumstances can be dealt with in legislation. However, with some exceptions, e.g. those relating to pre-trade transparency under MiFIR, there is now little ability for either ESMA or national competent authorities to grant a waiver from the application of the rules and this would be different if the UK was solely responsible for the rules. Further thought on introducing a degree of fact specific flexibility within a transparent framework (as exists in the UK where the existence of waivers is published by the competent authorities) would be welcome. Any framework would of course have to respect the separation of legislative and executive powers under the Treaty.

8.4 Secondly, there is more opportunity in the UK for expert legal advice on the drafting of amendments to be taken during the negotiations through Parliament on a piece of legislation. This results from the fact that given that almost all legislation is Government sponsored, specialist Parliamentary Counsel will review all amendments to check for consistency and drafting clarity. Therefore, there is a clearer distinction between the policy decisions of the legislature and the process of encapsulating these decisions in clear and consistent legislation. Whilst the process of settling the text and translation which takes place after the text of Regulations or Directives is settled and prior to entry into the Official Journal is helpful in this regard it does not go as far in permitting lawyers to ensure clarity and consistency of definitions and provisions as would be the case in the UK legislative process. As Directives and Regulations are now much more detailed in nature the precise linkage of the provisions and clarity of definitions has become more important in our view. We would welcome the establishment of specialist Parliamentary Counsel in respect of EU legislation to address these issues.

8.5 As a general comment, we also note that in our experience it is clarity of policy across the whole of the intended scope that is fundamental to the clarity of drafting of legislation. Accordingly the comments elsewhere in this response about policy formation are key.

8.6 From a policy perspective, we also note here a concern that the approach of UK authorities (Government and regulators) may disadvantage the UK in the evolving environment. In an EU of supposedly common standards, and easier cross-border access within the EU, third country firms and EU financial institutions may perceive that the tendency of the UK to gold-plate the EU requirements in practice (see below) militates in favour of establishing in another EU Member State:

(i) we have seen firms establish in Ireland, Paris, Malta, the Netherlands and Luxembourg (and the UK approach has been a relevant factor);

(ii) from the perspective of competing for third country firms to establish here, being outside the Eurozone is already seen as a disadvantage by many – accordingly, the UK's case challenge to the ECB's location policy for clearing houses clearing Euro denominated instruments is important to minimise any such perception abroad as well as in relation to the particular issue and business in that case.

8.7 In addition we would encourage the UK authorities to have the courage of their convictions and be more proactive in promoting the UK. Many firms within the scope of the AIFMD considered where to base their principal AIFM at an early stage because business decisions have lead times for implementation. The publicity put out by regulators and governments (for example, Luxembourg, Ireland) to the effect that they would have their implementing legislation out early etc. encouraged firms to move there. Yet in the end the UK was a leader, but it had not created the impression that it would be, and it lost out as a result.

8.8 The problem of super-equivalence or gold-plating has been well documented in studies over the years. However, whereas regulators and Government have expressed an intention to move away from this approach, and under many post-crisis measures there is less opportunity for any Member State to impose additional requirements, in practice there can be super-equivalence through interpretation and supervisory application.

8.9 Following on from the previous point concerning the UK approach to regulation and supervision, we would emphasise two points:

(i) We have seen areas where the UK authorities are becoming bolder and constructive in interpreting EU legislation (for example, as noted above in relation to some aspects of AIFMD) and acknowledge this change of tone in the approach of the UK regulators to EU rules. However both historic and cultural issues lead on occasions to the UK authorities adopting interpretations and approaches which can cause unnecessary difficulties for firms in the UK. We would encourage the UK authorities to continue to reflect on the way to approach interpretation issues.

The approach to legal interpretation adopted to UK laws, which is a relatively literal and forensic approach, does not sit so easily when interpreting European laws which are not drafted under the same conventions as domestic law. This is in contrast to the purposive approach we experience from many continental regulators and their legal advisers, in line with civil law traditions. We acknowledge that elements in our own profession are also responsible for excessively literal interpretation, but that often reflects the regulator's attitude: UK private practice and in-house counsel cannot advise their clients based on an approach that is at odds with the interpretative approach of Government/regulators, given that most clients seek a non-confrontational relationship with regulators.

(ii) We have also seen UK regulators influence stricter interpretations to pursue their own objectives, in the face of the purposes and meaning of the legislation. Whilst no example springs immediately to mind in the context of third country access, we see it currently in the FCA's attempts to have fund managers treated as counterparties and therefore to report separately the trades they execute as agent for clients, even though in respect of each trade resulting from an aggregated order they will notify the dealer of the true (client) counterparties and the allocation to each, in good time for the dealer to submit its own trade report.

9 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?

9.1 In terms of initial *policy*-making process, this is not accountable. While Commission proposals for Directives or Regulations do not necessarily emerge without warning, they are rarely subject to much consultation. For instance, the proposal for the AIFMD emerged in 2009 as part of a suite of measures developed in great haste following the financial crisis; no specific pre-consultation was carried out. The proposed AIFMD (as is true of all legislative proposals) represented the Commission's *political* stance – and while this initial position was ultimately ameliorated to a certain extent during subsequent negotiations (including the involvement of the Parliament in trilogue), one should not underestimate how significant this political stance is.

9.2 While a proposal for a Directive is accompanied by a written impact assessment from the Commission, which ostensibly acknowledges the principles of subsidiarity and proportionality, no meaningful or empirical assessment of the *costs* that will ultimately be borne by the industry is carried out; in short, the political ends justify the means. There is a tendency for such impact assessments to focus on the intended regulatory *benefit* that the Commission expects, or hopes, the proposal will deliver (seeing that as the "impact"), without a true consideration of the inevitable costs that will be borne by the industry. In other words, they operate more as a detailed self-justification for the approach adopted by the Commission than an objective assessment of whether the benefits will truly outweigh the costs and, accordingly, are not genuine costs/benefits analyses. Indeed, trade associations and other respondents often find that they have to commission their own detailed cost/benefit reports as part of their responses to consultations; but this is often too late to influence conclusions.

9.3 There are issues regarding the quality of the EU policy-making process. A 'rush to legislate' has resulted in poor quality output. Drafting of legal text at Level 1 is often ambivalent at best on key issues, and sometimes the poor drafting is in fact the manifestation of a political compromise or "fudge" across Member States during the trilogue process (see below). Points of problematic and significant detail are left to be hammered out in the often-truncated Level 2 process.

9.4 Once a Directive reaches trilogue, the entire EU legislative process becomes much less transparent. While there may be periodical reports as to the status of negotiations from the press or from "insider" sources, no formal announcements appear on the websites of the European institutions. It is at this stage of trilogue negotiations that political bargaining between the EU institutions – and between the Member State representatives – results in compromise amendments to the text of the legislation, sometimes to the substantive text itself and sometimes to the recitals. Furthermore, at this stage, the Parliament can seek the introduction of quite substantial amendments to the legislation. None of these amendments are subject to any obligation to conduct an impact assessment or costs/benefits analysis despite the fact that, due to the political compromise process, they may make their way into the final text.

9.5 In the development of implementing legislation, ESMA is not able to set its own time-lines for its consultations. It is often hostage 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 assimilate a huge volume of detailed responses received from the industry – i.e. the people who have the closest, most expert understanding of the practical implications of how the implementation proposals will affect their industry and the economy generally.

9.6 Although consultations are conducted by ESMA, it is the Commission which makes the final rules, with or without regard to the recommendations of ESMA. The consultation process is therefore flawed and undemocratic since the final text proposed by ESMA is always open to being overruled or ignored by the Commission in pursuing its political goals. This is regardless of the sensible and pragmatic concerns raised by the industry and acknowledged by ESMA. In the context of the AIFMD, the final text of Commission Delegated Regulation No. 231/2013 (which finally appeared in March 2013 barely three months before the AIFMD implementation date) did not follow the recommendations that ESMA had made, *in the light of consultation responses from the industry*, in respect of a number of key areas, such as: the methodology for calculating leverage, the requirements of the Directive as regards delegation (including the detailed criteria to determine a "letterbox entity") and the extent to which "collateral" should constitute assets that can be held in custody for the purposes of the depositary provisions.

9.7 There has also been a tendency for both ESMA and the Commission, in promulgating Level 2 implementing measures, to go beyond what is mandated by the Level 1 text and, in effect, to seek to rewrite the Level 1 provisions to give effect to the Commission's political goal despite the democratic, political agreement reached at Level 1.

9.8 As ESMA often has to draft Level 2 implementing legislation against tight, and often unrealistic deadlines, this can result in unfortunate delays in the finalisation of such legislation, meaning that firms can often face the prospect of the Level 1 legislation nearing implementation without crucial Level 2 details being finalised until extremely late in the day. By way of example, the final Level 2 implementation text for the Short Selling Regulation only became available a few weeks before the implementation date, giving rise to uncertainty for the industry. A similar problem arose on the July 2013 implementation of AIFMD, as discussed at paragraph 1.8.12 above. It is an inherent flaw in the EU legislative process that the Level 1 implementation date is "hard wired" into the relevant Directive or Regulation itself. This deadline cannot be subsequently postponed without the promulgation of a further piece of legislation which then has to be approved by the Parliament and Member States through the usual legislative process. This rarely happens in practice, particularly where there is a "political" imperative behind implementing the Directive by a certain date (the delay to the implementation of Solvency II being an example of a rare exception). Against this tight and generally unmoveable Level 1 implementation deadline, ESMA has to seek to consult on and develop highly detailed Level 2 implementing legislation. Delays in the development and finalisation of that legislation, without any relaxation of the implementation deadline, means that firms and their regulators do not have sufficient time properly to implement the legislation. ESMA (and, indeed, where relevant, the other ESAs) should be given more time in which to consult with industry in order to ensure that implementing legislation, technical standards and guidance and recommendations are consistent and also capable of practical and realistic implementation. Following the finalisation of such Level 2 measures, the industry should be given a realistic time frame in which to implement requirements.

9.9 Given the wide ranging/ fundamental nature of legislation, it is critical that reviews are conducted on time and properly (especially in respect of the pre and post-trade transparency requirements under EMIR, MAR and MiFID - whether these match closely or whether firms will need to comply with different requirements).

Examples

AIFMD

9.10 The policy-making process in relation to the AIFMD is discussed in detail above.

CRD IV

9.11 There was a lack of clear information about the intended dates for implementation of CRD IV, as the legislative process suffered from an increasing number of delays due to the ambitious initial timetable. In addition, the process was also marked by an initial lack of transparency in terms of the content of the texts. In its initial consultative working document published on 26 February 2010, the Commission indicated that it would publish the legislative proposal for the CRD IV package in the second half of 2010, with the aim of implementing the relevant amendments to the CRD regime by the end of 2012. In November 2010, only shortly before the expiry of its initial proposed deadline for publication, the Commission indicated through a press statement from Michael Barnier that the proposed text for CRD IV would not be published until March 2011, in light of the Basel III agreement which had been concluded two months before in September 2010. Although a draft version of the proposals was subsequently published in March 2011, it was not made publicly available at that time, preventing wider industry participants from having the opportunity to provide feedback on the initial formulation of the rules. This was notwithstanding that the text was made available to national governments, as evidenced by the letter dated 19 May 2011 commenting on the proposals, which was signed by representatives of seven EU countries, including the UK. The Wall Street Journal reported on 17 June 2011 that the Commission had responded to the letter on 1 June 2011 in a private letter, the text of which was published in full in the newspaper. It is unfortunate that while national administrations had the ability to influence the shape of the legislative proposals at this early stage, no provision was made for wider dissemination of the text in order to gain comments from those in the financial services industry who would ultimately be affected by the legislation. The final public legislative proposal for CRD IV was only published later on 20 July 2011.

9.12 The CRD IV legislative process in the Parliament was characterised by continual postponements of the consideration of the legislative texts in plenary session as it became apparent that the original timetable was increasingly unrealistic. In total, there were no fewer than 13 revisions of the Parliament's procedural file for review of the CRD IV package, set out below, demonstrating the extent to which the length of time required to debate the legislation at the EU level had been misjudged:

Date of entry in procedural file	**Proposed date of consideration at European Parliament plenary session**
Original scheduled date	12 June 2012
9 May 2012 revision	2 – 5 July 2012
26 June 2012 revision	22 – 23 October 2012
2 July 2012 revision	10 – 13 September 2012
30 August 2012 revision	19 – 22 November 2012
14 November 2012 revision	10 – 13 December 2012
28 November 2012 revision	11 – 14 March 2013
30 November 2012 revision	10 – 13 December 2012
13 December 2012 revision	14 – 17 January 2013
10 January 2013 revision	11 – 14 March 2013
23 January 2013 revision	15 – 18 April 2013
22 February 2013 revision	20 – 23 May 2013
28 February 2013 revision	10 – 13 June 2013 (but accompanied by a press release stating that the Parliament was "likely" to consider the proposals between 15 – 18 April 2013)
4 March 2013 revision	15 – 18 April 2013

9.13 The text was eventually adopted by the Parliament on 16 April 2013, almost a year after the initial scheduled date for plenary review. The constant revisions to the procedural file affected the ability of industry participants and professional advisers to predict a clear timeline for when the final definitive legislative texts would become available, undermining certainty and hampering preparations for implementation. The legislative process would be more effective if the EU institutions were able to make realistic initial assessments of the length of time required to consider complex financial services legislation, setting much clearer public expectations of the debating process, the likely dates of publication of final texts and the full implementation period.

9.14 The original intended implementation date contained in the CRD IV legislative proposals was 1 January 2013, yet that date passed without an amended date (or any other interim arrangements) being communicated by any of the EU institutions. For example, on the 22 February 2013, the then-FSA published a statement indicating that while firms were expected to take all action that they could to prepare for CRD IV, no alternative implementation date had yet been specified at the EU level. Even after the texts had been adopted on 16 April 2013, the implementation date remained unclear due to uncertainty about how long it would take for translated versions of the text to be published in the Official Journal of the European Union. Accordingly, there was considerable confusion throughout the financial services industry about the length of time that would be available to firms to put in place the measures required to comply with the final agreed provisions in the texts. Further uncertainty was caused by the publication of revised texts by the Council on 17 June 2013 and the Parliament on 19 June 2013, correcting errors in the original adopted versions. These revised texts were not published in the Official Journal until 27 June 2013; had they been published after 1 July 2013, the implementation date for CRD IV would have been delayed by six months until 1 July 2014. The fact that the implementation date was still uncertain so late in the process, leaving just five months for implementation of a large number of very complex regulatory provisions, is a clear indication that the EU process for financial services legislation is not effective due to its failure to provide clear information and legal certainty to those who are subject to its rules.

9.15 In addition, the chaotic timetable for CRD IV left insufficient time for consultation and implementation of the relevant rules at the individual Member State level, meaning that the FCA had three outstanding consultations relating to the application of CRD IV to investment firms in the UK (CP 13/6, CP 13/9 and CP 13/12) which were addressed simultaneously in one policy statement (PS 13/10) published on 13 December 2013, just over two weeks prior to the implementation date on 1 January 2014. While this was not the fault of the FCA, it is nonetheless evident that there was insufficient time to consult on a large number of important policy decisions and rules. Due to these unrealistic time constraints, the text in PS 13/10 which explains the FCA's responses to consultation feedback is only 39 pages long (the bulk of the policy statement instead being the final adopted rules), notwithstanding the importance and technical complexity of the subject matter. The ineffective process at the EU level can therefore also have a corresponding adverse effect on rule-making processes at the national level, reducing the scope for a full democratic consultation and harming the quality of the final enacted provisions.

9.16 The CRD IV legislative process also failed to provide sufficient final guidance to industry participants on many of the extremely complex obligations to which they are subject by virtue of the final texts. For example, the final COREP and FINREP regulatory reporting requirements under CRD IV involve a very large number of reporting templates, including:

- 25 templates (with certain sub-templates) covering capital adequacy, group solvency, credit risk, operational risk and market risk;
- templates covering large exposure reporting;
- templates covering leverage ratio reporting;
- templates covering liquidity reporting; and

- 31 templates covering FINREP reporting (with a large number of sub-templates).

9.17 While it is true that not all of these templates are required to be reported by all firms, it is nonetheless difficult for firms to determine their individual reporting requirements based on the limited guidance provided in the draft implementing technical standards published by the EBA, particularly where firms are also subject to consolidated reporting obligations. Much of the guidance contained in the annexes to the draft ITS is highly technical and cross-refers back to provisions in the Capital Requirements Regulation without providing additional assistance. The FCA has indicated that it considers that it is only able to provide very limited guidance on firms' reporting obligations under CRD IV because these are contained in the Regulation, which is directly applicable and therefore leaves no scope for individual interpretation by national competent authorities. The fact that many industry participants have found the EBA's guidance unsatisfactory or incomplete can be attested by the large number of outstanding queries relating to supervisory reporting on the EBA's Single Rulebook Q&A webpage, requesting further clarification of the technical requirements. As of 8 January 2014, there were approximately 220 outstanding questions (out of 361 in total) which had been classified as relating to the EBA's guidance on supervisory reporting under CRD IV; this is a considerable number, given that in total only 91 answers to questions on the CRD IV regime have been provided by the EBA since July 2013. Although the EBA's Q&A facility is a useful tool for supervisors and firms to gain additional assistance, it is not intended to operate as a substitute for carefully considered and drafted legislation and guidance during the initial legislative process (and in addition the Committee has concerns regarding the transparency of the Q&A process, as noted at paragraph 7.5 above). In any event, the EBA aims to reply with two months of a question being posted, but the first reporting quarter for COREP has already commenced and firms therefore need to understand their reporting obligations immediately. The absence of suitable, tailored guidance may cause firms to misdirect themselves, leading to lower levels of overall compliance and a consequential failure to achieve the risk mitigation that the legislation was designed to implement.

9.18 Although the CRD IV texts contain a large number of extremely complicated granular technical provisions, the legislation nonetheless operates on an overly simplistic basis at a holistic level, applying a range of requirements designed for deposit-taking banks and investment banks to much smaller investment firms. This unfortunate position results from the insufficiently detailed analysis during the legislative process of different types of institutions, their business models and the varying level of systemic risk posed by each. This has in turn led to disproportionately large implementation costs for smaller firms, such as investment managers, who may fall within scope of CRD IV (for example, because they undertake the MiFID activity of placing), but who pose little or no systemic risk, are not exposed to the risks of proprietary trading and who have limited in-house resources to deal with their significantly increased regulatory obligations. Though the review of the application of CRD IV to investment firms, due by the end of 2015, may change the position, firms face significant additional cost before the completion of that review (and potentially thereafter). Further, the position of investment firms which fall within the scope of CRD IV has also had a consequential effect on firms which fall outside that perimeter. This is because the UK has elected to retain the CRD III prudential regime for those investment firms which are not within the scope of CRD IV. This seems likely to put those UK firms affected at a competitive disadvantage to firms in other parts of the EU.

EMIR

9.19 *ESMA does not take full account of industry concerns in developing RTS/ITS:* ESMA was required to define detailed regulatory technical standards as to the methodology adopted by CCPs in calculating margins. The majority of respondents to ESMA's consultation paper on these were strongly critical of the approach adopted by ESMA and the distinction it had made between OTC derivatives and other financial instruments. This approach had broadly involved an assumption that OTC derivatives are inherently riskier instruments than others and should therefore be subject to more stringent criteria (which would in turn result in higher margin requirements). While ESMA acknowledged that some OTC derivatives can be more liquid than some thinly-traded on-exchange derivatives and also appeared to recognise that it would be wrong for a CCP to be forced to make a distinction between two products that essentially shared the same risk profile based purely on the fact that they were traded on different venues, its final regulatory technical standards ("**RTS**") only partially addressed respondents' concerns. Indeed, those RTS maintained the fundamental distinction between OTC derivatives and other financial instruments (including exchange-traded derivatives) for the purposes of calculating margin and only allowed a flexibility to the extent that the CCP would be able to "demonstrate to its competent authority" that it would be more appropriate to use more flexible criteria. The fact that the CCP has the "burden of proof" if it wishes to adopt the more flexible criteria means that many CCPs may be disincentivised from adopting anything other than the default margin calculation criteria in the RTS, meaning that an OTC derivative traded on, e.g. an MTF will be subject to higher margin requirements than an on-exchange derivative which essentially shares the same risk characteristics.

9.20 *Commission ignores ESMA recommendations*: The Commission recently declined ESMA's recommendation that the reporting start date for exchange traded derivatives be postponed until 1 January 2015. ESMA, with an eye on the practical difficulties of implementation, argued that this would be desirable in order to allow time for guidelines and recommendations to be developed and to avoid the risk that there would be a lack of harmonisation to the reporting of such derivatives. The Commission ignored ESMA's recommendations in this regard and did not consider that a delay was justified. Although ESMA had been overruled and was unable to change things, it was clearly piqued. In writing back to confirm that it would be working towards a single reporting date, it nevertheless felt the need to fire back: "After analysing carefully your reasons for the intended rejection, we still consider that the definition of the reporting rules for exchange traded derivatives requires considerable technical guidance and adaptation that would benefit from a delay of the start reporting date". Due to delays in the legislative process, there will no longer be any "phasing in" of reporting requirements across different asset classes as originally proposed (and as *previously endorsed by ESMA, the Commission, Parliament and the Council*), nor any distinction made between OTC and exchange-traded derivatives. Instead, reporting of **<u>all</u>** exchange-traded and OTC derivatives across all five asset classes will become live on 12 February 2014 in respect of all new trades entered into from that date – and also in respect of all trades outstanding on that date which were entered into on or after 16 August 2012. The interests of achieving a political goal have outweighed the likely adverse impact, in terms of cost and operational risk, that will be imposed on the industry early this year in having to report new and historic trades across all asset classes.

9.21 *Inconsistent guidance from EU institutions*: Another area of concern to the industry and to legal practitioners is the fact that once Level 1 and Level 2 legislation has been made, guidance by way of FAQs/Q&As can be issued by both the Commission and ESMA. This gives rise to the risk of inconsistencies in the interpretation of the legislation. In the context of EMIR, both the Commission and ESMA have published FAQs/Q&As: the Commission's FAQs were most recently revised on 18 December 2013 while ESMA's Q&As were most recently updated on 20 December 2013. While there has not been a major conflict between the two sets of Q&As to date, ESMA has also published (as required by the legislation) draft RTS in a number of areas, most recently in relation to "contracts having a direct, substantial and foreseeable effect within the Union and the non-evasion provisions of EMIR" (Final Report published 15 November 2013) – i.e. in broad terms, the criteria which will determine the applicability of EMIR to counterparties established in third countries which would be financial counterparties if they were established in the European Union (such as banks and investment banks) and which enter into OTC derivatives contracts through their branches in the European Union. It is imperative that poorly drafted answers to FAQs do not undermine the Level 2 technical standards. ESMA's draft RTS (which are yet to be adopted by the Commission) set out some relatively objective and pragmatic criteria to determine when EMIR will and will not apply to trading of derivatives through EU branches of institutions established outside the EEA. The Commission's revised set of FAQs on EMIR included an unhelpful – and arguably incorrect – analysis of the meaning of "undertaking" in the definition of "non-financial counterparty" for the purposes of EMIR. The guidance implies that the term "undertaking" includes entities, regardless of their legal status, performing economic activities in the market and that "establishment" involves the actual pursuit of an economic activity through a fixed establishment in (another) Member State for an indefinite period of time. Although this may not have been the Commission's intention, reading the term "non-financial counterparty" so broadly could catch derivatives trading by any branch of a non-EU institution; there is no express carve out to give certainty in this regard. If this analysis were to be sustained by the Commission, it would lead to the conclusion that derivatives trading by an EU branch of a non-EEA institution would constitute trading by a non-financial counterparty (in all likelihood above the clearing threshold) meaning that many of EMIR's requirements would apply. This would ride roughshod over the intended regulatory structure of EMIR, which distinguishes between financial counterparties and non-financial counterparties "established" in the Union on the one hand, and third country entities not established in the Union on the other (and in respect of which, generally, EMIR only applies if, when trading with another non-EU counterparty, the "direct, substantial and foreseeable effect" criteria are satisfied). It would mean that an EU branch of a third country institution would be caught by EMIR (as a non-financial counterparty) despite the fact that contracts it enters into would <u>not</u> have a direct, substantial and foreseeable effect within the Union in accordance with the (currently draft) regulatory technical standards. While, as stated before, this is not necessarily the Commission's intention, it is illustrative of how the issuance of guidance by way of FAQs (a process which is not subject to consultation, accountability or the rigours of legislative scrutiny) may not actually clarify matters and can actually undermine the legislation as drafted. At the very least, it certainly betrays a lack of "joined up" thinking between the EU institutions.

If you would find it helpful to discuss any of these comments then we would be happy to do so. Please contact me in the first instance by telephone on +44 (0) 20 7295 3233 or by email at margaret.chamberlain@traverssmith.com.

Yours faithfully

pp. Lauren Causon

Margaret Chamberlain
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