ICAEW REPRESENTATION 19/16

EC Call for evidence, EU Regulatory Framework for Financial Services

ICAEW welcomes the opportunity to comment on the *Call for evidence, EU Regulatory Framework for Financial Services* published by European Commission on 30 September 2015, a copy of which is available from this link.

ICAEW is listed in the EU Transparency Register (ID number: 7719382720-34).

This response of 29 January 2016 has been prepared on behalf of ICAEW by the Corporate Finance Faculty and includes contributions from the Financial Services Faculty, the Finance and Management Faculty and the Business Law Committee. Information about these areas of expertise may be found in the Appendix.

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MAJOR POINTS

Proposed points

1. We commend the Commission for instigating a review of the combined impact of post-financial crisis regulatory reforms. Through this initiative, the Commission acknowledges the scale of work that has been, and continues to be, necessary to implement and apply the reforms. The results of the review should provide valuable lessons for framing future policy proposals.

2. We have taken the opportunity to highlight specific challenges that arise from the application and consequences of certain regulations, as described in paragraph 5. We also highlight two general points, which we hope provide useful, overarching comments.

3. First, the pace and depth of recent reforms have brought to the fore some **structural issues** relating to:

    - Minimum harmonisation directives. These can be vital to enable flexible interpretation, in order to better reflect existing national financial services structures. However, the extenuating conditions post-crisis have created the space for inherent disadvantages of such directives to result in incremental burdens to market participants. For instance, variations in national interpretation and gold plating (as per A, Issue 1, Example 1 below), and overlap or duplication (as per D, Issue 12, Example 1 below). Both these lead to uncertainty which is a barrier to growth and can offset value-add. It also encourages people to find ways of getting around legislation.

    - Coinciding of EU-level reforms with the evolution of national frameworks. Regulatory reforms should minimise potential for confusion and scope creep. Scope creep means that, amid rafts of changes to be implemented, it can be difficult for businesses and other market participants to attribute burdens, complexities or other inefficiencies to individual rules or regulations - to the EU or to national rules. We observed signs of this when we questioned our members on challenges within retail financial services. While many in the industry described the increasing costs and time of managing regulatory change and compliance, the data did not easily point to UK domestic rules or to EU regulation. Future EU policymaking ought to anticipate and make more allowances for the fact that national frameworks also evolve and create costly and burdensome change for market participants.

4. Second, reforms since the financial crisis were necessary but they have tended to favour protection at the expense of the personal and business growth. To a large degree, regulations have created an environment that only those investors, businesses and consumers who are able access to costly advice, can understand and navigate. We have found this issue to be particularly prevalent in the regulation of retail financial services (products and distribution channels). We would like to share with the Commission ICAEW's response to the UK Financial Conduct Authority's Financial Advice Markets Review. Many of the issues in the UK may resonate in other Member States and we to draw the Commission's attention to our proposals for increasing consumer engagement, simplifying regulation and reducing the barriers to entry and costs of doing business.

5. In our response to the Commission's Green Paper on Capital Markets Union, we stated our support for future 'public good' measures that facilitate the flow of information, or help to create suitable conditions to boost capital markets across the EU. Accordingly, the principal issues covered in our response, relate to connecting businesses with innovative and competing channels of capital (in this case, venture capital and private equity and challenger banks), and creating a regulatory environment for financial services that is both accessible and responsive to differing needs. Our recent response to the Commission's review of the regulation for European Venture Capital Funds (EuVECA) is also relevant.

RESPONSES TO SPECIFIC QUESTIONS

A. Rules affecting the ability of the economy to finance itself and grow

Issue 1 – Unnecessary regulatory constraints on financing

Example 1

6. Changes in the EU State Aid Rules, with which the UK's tax-advantaged venture capital schemes must comply, mean that fewer high-growth, high-risk companies qualify for tax reliefs. In turn, investment appetite for supporting such companies is dampened, as the investment risk is not mitigated by a tax break.

To which Directive(s) and/or Regulation(s) do you refer in your example?

7. General Block Exemption Regulation (GBER) and implementation of changes thereto in the UK's Finance No. 2 Act 2015.

Please provide us with an executive/succinct summary of your example:

8. Changes to the UK's well-established tax-advantaged venture capital schemes have been introduced by way of the UK's Finance Act No 2 2015, to ensure continuing compliance with the GBER. The UK's schemes are: Venture Capital Trusts (VCT), Enterprise Investment Scheme (EIS) and Seed Enterprise Investment Scheme (SEIS). Changes from updates to the GBER and, in some cases, the UK's application, significantly reduce the number and range of companies that qualify for such support. This outcome is, seemingly, at odds with the objective of Capital Markets Union, of broadening the range and availability of finance for SMEs.

9. Principal changes are:

   - All investors must be independent of the company at the time of the first share issue; an individual claiming tax relief under EIS or VCT schemes must be independent of the company and hold no other shares (apart from subscriber shares) in the company at the time that individual invests in the company.
   - Maximum permitted age rule. Companies must raise their first investment under EIS or VCT within seven years of making their first commercial sale, or 10 years if the company is a 'knowledge intensive' company. However, no age limit will apply to companies raising an investment where the amount of the investment is at least 50% of the company's annual turnover, averaged over the previous five years and which deploy funds raised for entering 'a new product or geographic market'. The age limit will also apply to any business that has been owned previously by another company any current or previous subsidiary, or any future subsidiary if the proposed new risk finance funds are to be employed in it.
   - A lifetime limit caps the total investment a company can receive through tax-advantaged schemes, to £20m for 'knowledge intensive' companies and £12m for other qualifying companies. This is in addition to the annual limit of £5m.
   - EIS and VCT funds are prohibited from being used to acquire existing businesses regardless of whether it is through a share purchase or asset purchase. The prohibition on management buyouts and share acquisitions is also extended to protected money-status VCT funds.
   - EIS or VCT funds must be invested not only for the purpose of a qualifying trade, but also to promote business growth and development.

10. It is important to note that the complexity of the UK's tax-advantaged schemes prevents access to such forms of state aid to all but those who can afford to take professional advice. Indeed, the subjectivity of some of the qualifying tests and scope for national interpretation, is delaying, in the case of the UK, the release of government guidance. This renders even the most experienced advisers unclear as to the precise conditions for EC approval of state aid and reduces their confidence in such schemes.

Please provide us with supporting relevant and verifiable empirical evidence for your example:

First commercial sale

11. First commercial sale is a complex test which involves looking at group companies and any acquired trades, as well as investigating whether any exceptions to the test apply. Companies can fall into the maximum permitted age restriction as a result of the first commercial sale being determined by reference to, inter alia:

    - an existing subsidiary
    - a former subsidiary which has no relevance to the existing group
    - an acquisition where it is intended to utilise EIS and/or VCT funds
    - entities past and present.

12. Our members have cited cases where acquisitions have triggered commencement of the first commercial sale and seven-year period and which has the maximum permitted age test to come into operation. In one such case, a group commenced sales of its current product in 2013 but the seven-year period was commenced in 1988. This was due to an acquisition of another trading company, which turned out not to fit in with its plans and was sold in the same year. The disposed company, which had no relevance to current operations, means the group must now raise funds for a totally different product and market.

The ‘knowledge intensive’ test

13. Companies reporting under IFRS must capitalise development expenditure and will fail the ‘knowledge intensive’ research and development test, which looks only at costs written off. Companies admitted to trading on AIM are included in this category.

The turnover test in the maximum permitted age rule

14. Dependent on the growth profile of a company, the turnover test can produce quite random results. For example, a group wishing to raise £1m pre-IPO funding may, because of the test, be required to raise £4m, or another, unrealistic level of finance.

15. Another issue is the interaction of the turnover test with the UK’s annual limit of £5m which, taken together, rule out groups with an average turnover of over £10m from raising EIS/VCT funds, as the annual limit would be breached.

‘A new product or market’ condition in the maximum permitted age rule

16. In the experience of our members, the UK government is interpreting this GBER provision as meaning ‘a new product *market* or geographical market’ or a combination of both. This means that not only must there be a new product, but it must be sold to a different type of customer, eg to corporates rather than existing retail customers. This would amount to a complete change in direction for the company eg, a healthcare company now having to make washing machines.

17. As this condition is to a large extent subjective, it poses an undesirable challenge for advisers and the tax authorities. It also creates a new challenge for technology companies that are in the course of developing and/or marketing a new(ish) product. Hitherto this development could have been funded by EIS/VCT funds but now such companies may not raise further EIS/VCT funds for continued development and/or marketing, as this may not constitute a new product.

Investor independence

18. This discriminates against those investors who invested before the company had considered applying for qualifying status, while discouraging individuals who may have been prepared to make follow-on, tax-efficient investments. We support the UK government’s commitment to review the approach to replacement capital.

Acquisitions

19. The prohibition on using state-aided funds for business acquisitions fails to acknowledge that acquisitions can be vitally important. This is the case for growing technology companies, where an acquisition may complement the technology of the existing business and allow the development of further applications and markets.

20. The prohibition risks creating a different gap in financing available to SMEs as described in a letter from the British Private Equity and Venture Capital Association (BVCA) to the UK Treasury. Moreover, as the available investment opportunities reduce, VCT managers will find it more difficult to attain the 70% qualifying investment level within 3 years that is necessary to maintain their VCT status. This is a serious risk factor that would not have been prevalent when they raised their funds.

21. Furthermore, the existing legislation which prohibits receipt of royalties and licence fees unless the greater part of the intellectual property (IP) from which they derive was created by the current group creates a particular problem for technology companies. Where such companies have grown through acquisition and do not qualify as a material acquired company which continues to receive royalties, this may disqualify the group as a whole as the company was not part of the group when its IP was created.

If you have suggestions to remedy the issue(s) raised in your example, please make them here

22. The remedies are to remove either the age restrictions or the use of the sale or acquisition of any entity for determining the date of first commercial sale. The state aid qualifying conditions should be simplified and clear guidance provided for the grounds approval.

Example 2

23. In reality there are higher capital requirements for challenger banks to provide more lending. These requirements represent a barrier to growth and inhibit competition.

To which Directive(s) and/or Regulation(s) do you refer in your example?

24. Capital Requirements Regulation and Directive (CRR and CRD), and Basel Accord.

Please provide us with an executive/succinct summary of your example:

25. The Basel Accord principles in the CRR/CRD, as implemented in the UK by the Prudential Regulatory Authority, result in challenger banks having higher capital requirements to lend, of a magnitude of c. 10 times in some cases, for some asset classes, eg residential mortgage lending.

26. This is because banks will either hold capital based on a standard formula or using internal models. Larger banks have been able to spend money on modelling resources and have the data history to support model development so are more likely to use the internal rating based approaches (models) which consistently generate lower capital requirements. Smaller banks may have not invested in the project spend to develop advanced credit models and may be newer entities and so less able to demonstrate that their models would perform well through an economic cycle. While technically, there has been no prohibition or compulsion to apply for an internal models approach, the costs associated with model development and ongoing management means smaller banks are less likely to use models and more likely to use the Standardised approach (formula).

27. In theory there is no good reason why a bank using models should have lower capital requirement than a Standardised bank as the model approach should just lead to a more risk sensitive approach and, perhaps, more dynamic capital requirements. However the Standardised approach was mis-calibrated and history has shown that Standardised capital requirements are too high.

Please provide us with supporting relevant and verifiable empirical evidence for your example:

28. History has shown that Standardised capital requirements were too high. For example, for residential mortgages a model firm might only hold 3-14% risk weighted assets (RWAs) for mortgage assets but a Standardised bank would need to hold 35% according to the standard formula.

29. Higher capital requirements make lending £100 of assets more expensive for a Standardised bank, as shown below:

    Capital to be held = Assets x RWAs x 8%

    Capital to be held by Standardised bank against £100 of loans
    £100 x 35% x 8% = £2.8

    Capital to be held by model bank against £100 of loans
    £100 x 3% x 8% = £0.24

30. The ability of challenger banks to offer alternative channels for business finance is being reduced, as described by the British Bankers Association and one such challenger bank, Hampshire Trust Bank.

If you have suggestions to remedy the issue(s) raised in your example, please make them here

31. It has been recognised that the Standardised approach was mis-calibrated and a review of the standardised approach is underway. The EU, through the European Central Bank (a Basel committee member), can give views on the final calibration and allow full consideration to ensure that capital requirements are closer for internal ratings banks and Standardised banks.

32. We draw your attention to the UK's Parliamentary Treasury Committee letter to the PRA and its proposals for actions for financial services regulators.

Example 3

33. The market for corporate deposits risks fragmentation and the associated risks are being driven away from regulated entities.

To which Directive(s) and/or Regulation(s) do you refer in your example?

34. Capital Requirements Regulation and Directive (CRR and CRD), and Basel Accord.

Please provide us with an executive/succinct summary of your example:

35. One of the effects of changes to global liquidity regulations is the likely probability that banks will be deterred from holding 'non-operating' deposits and for funding from corporate treasuries to be 'looking for a home'. Funding that, under the Basel liquidity rules, would be defined as less reliable, is not attractive as deposits to banks as they carry greater liquidity requirements (LCR). Banks are declining major corporate deposits, and those deposits are shifting to other institutions. The associated risk also shifts away from the regulated bank sector.

Please provide us with supporting relevant and verifiable empirical evidence for your example:

36. A publication by JP Morgan explains how banks are being driven away from deposit-taking, while the Financial Times has reported on increasing signs of this fragmentation of the deposit-taking market (€16.6tn).

Example 4

37. EU investors are being deprived of choice as non-EU fund managers are favouring global investors rather than comply with the regulation of marketing to EU investors.

To which Directive(s) and/or Regulation(s) do you refer in your example?

38. Alternative Investment Fund Managers Directive (AIFMD).

Please provide us with an executive/succinct summary of your example:

39. Increasingly the impact of the AIFMD is to deter non-EU fund managers and leave EU investors on the sidelines. As there is abundant interest from LPs/ investors globally, non-EU managers are content to stay clear of Europe, thus depriving EU investors of choice.

Please provide us with supporting relevant and verifiable empirical evidence for your example:

40. Our members have observed examples of ‘reverse solicitation’ as a mechanism for avoiding the impact of the marketing restrictions under AIFMD. They have also pointed to examples of non-EU managers avoiding marketing funds in Europe to EU investors.

If you have suggestions to remedy the issue(s) raised in your example, please make them here

41. The legislation should provide a clear and concise definition and guidance on what constitutes a real and valid ‘reverse solicitation’ for the purposes of the AIFMD.

B. Unnecessary regulatory burdens

Issue 5 – Excessive compliance costs and complexity

Example 1

42. Unnecessary regulatory burdens have a practical cost impact and create uncertainty for businesses, both of which are barriers to growth.

To which Directive(s) and/or Regulation(s) do you refer in your example?

43. MiFID II (and MiFID).

Please provide us with an executive/succinct summary of your example:

44. Many financial services regulatory reforms introduced learnings from the financial crisis and aimed to address abuses in market practice. Notwithstanding the need to update legislation so that the regulatory environment keeps pace with and, where possible, anticipates market changes, a far more considered approach is needed for determining the incremental value of such changes.

45. Both major pieces of legislative change and incremental changes have a real cost impact and recent changes have added unnecessary burdens that are not mitigated by positive outcomes. Implementation of changes can also have a significant time impact and implementation dates must reflect this.

Please provide us with supporting relevant and verifiable empirical evidence for your example:

46. MiFID introduced a reclassification of the terminology for different client groups. This resulted in the need to change and update customer/client contracts. In the midst of other changes made at the time, it is questionable whether the expected value from this change warranted the required changes to documents, the education of staff in the financial services industry and the briefing of clients.

47. The implementation of MiFID II is currently set for 3 January 2017. Discussions are taking place between the Commission, European Parliament and Council of the European Union about a possible overall delay in the implementation of MiFID II to January 2018. The Commission has not yet made a legislative proposal to introduce a delay. The delay in the date of implementation of this massive piece of legislation date may provide breathing room but it is prolonging the pain of implementation, thus creating uncertainty and ongoing distraction for businesses. This is on top of the challenges for compliance teams to get the businesses to focus on necessary structural changes and relevant training.

If you have suggestions to remedy the issue(s) raised in your example, please make them here

48. As well as having a reasonable and supportable expectation of producing substantive value, changes should have realistic dates for implementation, proportionate to changes to documentation, processes and the necessary education of staff and clients.

C. Interaction of individual rules, inconsistencies and gaps

Issue 12 – Overlaps, duplications and inconsistencies

Example 1

49. Minimum harmonisation can result in substantial swings between treatment in Member States and particular care should be given to definitions and concepts in such directives and regulation.

To which Directive(s) and/or Regulation(s) do you refer in your example?

50. Takeovers Directive and Transparency Directive.

Please provide us with an executive/succinct summary of your example:

51. Minimum harmonisation provides for flexible interpretation in excess of a threshold, in order to better reflect existing national financial services structures. The downside is inconsistency in implementation across Member States, and gold plating.

52. Inconsistency in implementation forms a barrier to information and capital flows between Member States, a phenomenon that Capital Markets Union is seeking to reduce.

Please provide us with supporting relevant and verifiable empirical evidence for your example:

53. In implementing the Takeover Directive, the UK's Takeover Code requires disclosure of 1% interests in offeror and offeree company securities and all significant positions. Most other Member States have applied the minimum threshold provided for under the Transparency Directive, of 3%.

54. Other examples are optionality, different squeeze-out thresholds, different approach on concert parties and exemptions available, variations in timetables applicable during a bid and, of course, the ability for Member States to intervene to block a bid.

If you have suggestions to remedy the issue(s) raised in your example, please make them here

55. The test as to whether definitions and key concepts warrant minimum harmonisation should be carefully reviewed to help investors and consumers understand the rationale to differences between Member States.

APPENDIX

Corporate Finance Faculty

Recognised internationally as a source of expertise on corporate finance issues and for its monthly *Corporate Financier* magazine, the Faculty is responsible for ICAEW policy on corporate finance issues including submissions to consultations. The Faculty's membership is drawn from professional services groups, advisory firms, companies, banks, private equity, law firms, consultants, academics and brokers.

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The Committee includes representatives from public practice and the business community. It is responsible for ICAEW policy on business law issues and related submissions to legislators, regulators and other external bodies.