STAKEHOLDER CONSULTATION ON SMART REGULATION IN THE EU

RESPONSE FROM ICAS TO THE EC

21 September 2012
Introduction

1. The Institute of Chartered Accountants of Scotland (ICAS) welcomes the opportunity to comment on “Smart Regulation in the EU”. We are a professional body for over 19,000 members who work in the UK and in more than 100 countries around the world. Our members represent different sizes of accountancy practice, business, financial services and the public sector. Almost two thirds of our working membership work in business, many leading some of the UK’s and the world’s great companies.

2. Our Charter requires its committees to act primarily in the public interest, and our responses to consultations are therefore intended to place the public interest first. Our Charter also requires us to represent our members’ views and to protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Executive Summary

3. We support the European Commission (EC) commitment to Better Regulation and welcome the aims of this consultation paper. The better the quality of the policy proposals, the more productive the consultation process and ultimately the more effective and beneficial the resulting regulation. We have used examples detailed in Annex 1 to illustrate our views and identify areas for improvement. These are:
   - Alternative Investment Fund Managers Directive (AIFMD)
   - Audit Policy
   - State Aid Rules
   - Statutory Audits of Annual Accounts
   - Solvency II (impact on pensions)

4. We support well-designed regulation and directives as they serve an important role across Europe. We also recognise that the recent financial crisis has shown a need for greater intervention in areas such as banking services. It is therefore all the more important that the focus is on achieving high quality, targeted and effective regulation. Our examples have identified scope to improve the following areas:
   - Clearer articulation of the problem, evidenced with examples to inform a clear policy objective for formulating proportionate actions. Our examples (particularly the AIFMD) show that this is not always the case in practice.
   - A more thorough and inclusive approach to option appraisal setting out the pros and cons of each option to help identify the most effective and proportionate response to meet the policy objective would be welcome. Options should be balanced so that non regulatory options including “do nothing”, are always assessed to demonstrate the case for and against intervention. It would be helpful for the options appraisal to be open to consultation to identify further evidence, gaps and assist the feasibility analysis.
   - The examples cited suggest that Better Regulation principles are not fully embedded in EC policy development. As an important tool to achieving high quality proposals we would welcome greater consistency in their application. This should include gathering evidence from a wide range of sources, early expert engagement, pre-consultation, comprehensive consultation and adequate timescales. These would result in ‘policy papers’ outlining the recommendations for action. Only following consultation on this stage would draft proposals (if they are ultimately recommended) be published.
   - Greater quantification and rigour in the development of impact assessments and for these to accompany consultation papers to help develop the evidence base and inform the feasibility analysis.
   - Post implementation reviews are useful to ensure that the policy is still fit for purpose and in alignment with strategic objectives to maximise the effective delivery of priorities.
   - To support accountability and generate greater trust in the consultation process we would welcome the publication of EC feedback on concerns raised, greater transparency on the
basis for conclusions and how engagement has influenced the final outcome. We would also welcome greater consistency in the type of information published.

- A clearer demonstration of applying a principles based approach to European legislation as in our view, it would support alignment with different approaches across national jurisdictions; it is also harder to defeat a well-crafted principle than a specific rule that can be technically bypassed.

**Section I Enhancing the quality of EU legislation**

*Collecting evidence and monitoring results/ Evaluation/ Impact Assessment*

**Objective setting, scope and evidence gathering**

5. The AIFMD is an example of a highly complex and wide-ranging proposal given greater urgency in a period of financial crisis. The distinction between banking and other financial services such as fund management did not appear to be fully understood hence banking rules (on say capital requirements and remuneration) are applied without properly assessing the distinction between the two. Although evidence existed of the role of banks in the financial crisis and need for greater regulation, this was not mirrored across other parts of the financial services sector.

6. Our views are that the original aims of the AIFMD should have been more rigorously tested to make them clearer and this has been compounded by bolting on additional objectives to the original proposal (such as tax reciprocity and regulation of overseas funds). The lack of clarity resulted in criticisms that results were disproportionate, flawed\(^1\) and also creating uneven playing fields where for example, private equity takeovers of companies are regulated differently from sovereign wealth funds and corporate takeovers. The [BVCA submission](http://www.bvca.com/) to the House of Lords inquiry notes: “*Our clear view is that the directive does not offer a proportionate response to any identified risks (para 3.1)*…”

7. A clearer policy objective supported by specific examples of actual circumstances occurring to justify the proposals, across the spectrum of instruments would have helped determine effective and proportionate proposals.

8. The scope of the AIFMD proposals and range of non-uniform instruments it addresses is extensive. The variety of issues covered within the scope of AIFMD (e.g. tax transparency, remuneration requirements and disclosure etc.) have not only increased the complexity of the Directive but increased the risk that insufficient scrutiny is undertaken for each separate objective, need and proposal for intervention. As shown in Annex 1, the proposals resulted in various criticisms. In this example, a single Directive to do everything does not appear to be the most effective approach to validate and respond proportionately to each issue identified.

9. A concern was also cited of the use of sweeping statements, for example, the EC asserts:

> “*Investments in AIF are typically regarded as entailing a level of risk or other characteristics that render them unsuitable for retail investors. Access to many types of AIF has therefore traditionally been restricted to professional or institutional investors*\(^2\).”

10. In reality investment trusts have been primarily a retail product since 1868 in the UK (the UK being one of the largest financial markets in Europe). Secondly, the House of Lords inquiry\(^3\) notes concerns over coverage of all non-UCITS funds “...*this one size fits all approach fails to acknowledge the differences in how AIFs are structured and operate.*” Assessment of the Member State context appears incomplete. Such facts need to be crystal clear in the minds of the policy developer if regulation is to be fit for purpose, align with existing arrangements, for

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stakeholders to be convinced proper impact analysis has been undertaken and that proposals are based on sound evidence and quality research.

11. The gathering of evidence from a wide range of relevant sources and early stakeholder engagement is essential for developing proposals which are fit for purpose, especially for topics which are complex, sensitive or may impact on economic growth. Various approaches (using both oral and written methods) are used to enhance understanding of subject matter and refine proposals by organisations such as the Takeover Panel, Scottish Government, Financial Reporting Council, International Accounting Standards Board (IASB) and International Auditing and Assurance Standards Board (IAASB). Considerable technical expertise resides in trade bodies, which generally welcome good regulation that is fit for purpose. Examples of possible techniques include using expert groups, hearings, strategic meetings, roundtables, workshops and pre-consultation discussion documents (including option appraisals)

12. We have found this approach to be effective in improving the quality of proposals and time spent responding to consultations. Although we recognise that the EC does use these tools, the application could be more consistent and stakeholder groups wider. Crucially, enough time must be allowed to consider objections properly, and amend proposals for further consultation in the light of comments made. Efforts to ensure best practice is applied more consistently would be welcomed.

Options appraisal

13. We welcome the EC recognition of alternatives to regulation in its Better Regulation policy (EC) and encourage the development of more innovative approaches to regulation and formulation of non-regulatory alternatives. The European Parliament highlighted in its assessment of the Statutory Audit Directive that “less radical alternative options have not been explored...the Commission does not seem to pay enough attention to unintended effects of its options”

14. Concerns from our members, the House of Lords review, trade bodies and Scottish Financial Enterprise identified that the AIFMD proposals included duplication and conflict with existing company law, the Markets in Financial Instruments Directive and Takeover Directive. This raises the question of why alternative approaches for addressing objectives, (including an assessment of “no intervention”) more aligned to existing legislation were not explored and consulted on to reduce the risk of a disproportionate response. The theme of duplication is echoed by the Solvency II example in Annex 1.

15. The AIFMD example suggests that a clearer policy objective with a more thorough appraisal of options (both regulatory and non-regulatory) would have helped identify if it were more appropriate to use a mix of other mechanisms such as guidance, bank risk reporting (a topic of Basle Regulations) and the Consolidated Admissions and Reporting Directive for listed securities, however, such alternatives were never floated or consulted upon. We would welcome policy papers, open to consultation, which set out options to address defined problems that are evidenced by examples and present a case for the preferred option.

16. We are supportive of the Scottish Government policy of “minimum intervention” whereby the risk and benefits of “no action” are assessed and non-regulatory options are considered and challenged first, before submitting for ministerial approval. This not only reduces business impact but reduces the risk of unintended consequences inherent in regulation.

17. We would encourage further development of non-regulatory options to balance and inform option appraisals. Examples of alternatives include the Financial Reporting Council’s use of

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4 Annex 1 paragraph 23
6 SFE letter to the Commissioner on 13 May 2010
“comply or explain”, self-regulation and self-assessment (such as for tax) which are based on the concept that responsibility starts at home. The “comply or explain” regime has been found to assist companies’ compliance with best practice Codes whilst allowing them freedom to explain any instances where they feel this is not appropriate in their particular situation.

18. The Financial Reporting Council (FRC) report7 a high level of compliance with the “comply or explain” regime contained in the Corporate Governance Code due to its impact on reputation (and sometimes audit reports). On occasion, explanations offered by companies could be improved. This was highlighted by Grant Thornton in its recent research publication8. The FRC are responding to this with its proposal to provide greater guidance as to what constitutes an acceptable explanation when a company decides not to follow the requirements of a specific principle9.

19. Our consultation submission on “Gender imbalance in corporate boards in the EU” cites examples for a minimal intervention approach to attain policy objectives and a sliding scale of sanctions for those not delivering “from ‘naming and shaming’ of all those who do not comply or where explanations for not achieving targets, using the ‘comply or explain model’, are not sufficiently robust or convincing ...Legal sanctions should only be considered in the most severe cases10.”

20. The inclusion of a more thorough and balanced option appraisal as part of the (pre-) consultation process which includes the pros and cons of all options including “do nothing” and non-statutory intervention would help to demonstrate that actions to meet the policy objective are proportionate and respect the principle of “do no harm”.

21. The options appraisal should also help to conclude whether sufficient evidence exists to make an informed decision on preferred option. A good example of an evidence based approach to policy development is the open and inclusive style of the Better Regulation Bill consultation by the Scottish Government where an answer for a statutory response to late payments is not provided, but available evidence is shared and consultees are invited to provide views, further evidence and suggestions.

Planning

22. For the AIFMD, time pressure was cited as a reason for an insufficient impact assessment although compliance costs were assessed from £1bn to £20bn. The reason for haste was we understand, a fear of potential systemic risk at a time of economic turbulence, but no evidence for the existence of systemic risk in investment funds themselves was ever provided. Our view is that the policy development process should be proportional, evidence and risk based so that the greatest effort and resource input is targeted on potential regulation with the greatest actual evidenced risk and impact rating. An initial assessment matrix could support the planning process by including factors to determine a high/medium/low rating. Examples may include:

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7 http://www.frc.org.uk/press/pub2709.html
8 http://www.grant-thornton.co.uk/pdf/corporate_governance.pdf (page 7)
9 The Corporate Governance Code
10 Paragraph 17
Risk
- Complexity
- Level of uncertainty and quality of evidence
- Whether precedents exists
- Resource availability
- Sensitivity and media profile
- Potential for bias / other pressure

Impact
- Business/ other stakeholder impact
- Costs of introduction and compliance
- Value of compliance and benefits obtained
- EC strategic priorities (some flexibility is desirable to respond to changing market conditions, for example growth, reducing red tape)

Impact Assessment
23. A general view from our members is that regulation costs more to implement than initially planned. This underlines the importance of robust Impact Assessments (IA). An example is the significant underestimation of costs for the AIFMD in the initial EC IA. The Commission IA states that “Due to uncertainty about costs, it is not possible to assess or to quantify precisely the impact of the proposal on the competitiveness of EU-domiciled AIFM”\(^{11}\). This was challenged by subsequent impact assessments commissioned by the European Parliament (EP) and Financial Services Authority\(^{12}\) (FSA) in the UK. Both identified compliance costs would increase to a much greater degree than the EC first acknowledged. The EP Economic and Monetary Affairs Committee estimated a wide spread from €1.1bn to €22bn\(^{13}\). Additionally, our understanding is that the cost of “depositaries” is still uncertain which fundamentally undermines the completeness of the cost benefit analysis.

24. We would urge that more rigorous quantification is required in EC IAs and greater challenge on the viability and even approval for regulation, where insufficient evidence is available or impacts affect growth priorities (for example unknown costs, loss of jobs in the investment sector and increased costs for pensioners estimated by subsequent FSA and EP IAs\(^{14}\)).

25. Significant criticisms and flaws were highlighted by additional impact assessments commissioned by the EC Impact Assessment Board\(^{15}\) and European Parliament\(^{16}\) to address gaps in the initial EC impact assessment for AIFMD\(^{17}\). This found:

> “The Commission Impact Assessment’s analysis of the policy problem was vague, sweeping, and inadequate as a basis for justifying regulation…Although it argued there was a strong case for additional regulation the rationale for a directive of this form is weak…It found the Directive poorly constructed, ill-focused, and premature”\(^{18}\).

26. Serious concerns were also raised by the UK House of Lords Inquiry, Scottish Financial Enterprise and media articles as noted in Annex 1. The House of Lords report concluded in its review of the AIFMD proposals:

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\(^{11}\) Page 51 box 10 & 11
\(^{13}\) see Annex 1 paragraph 5
\(^{14}\) Annex 1 paragraph 6
\(^{15}\) EC Impact Assessment Board assessment March 2009
\(^{16}\) European Parliament assessment of the EC proposals 2009
\(^{17}\) Annex 1 – paragraph 4 onwards
\(^{18}\) Annex 1 paragraph 4 onwards
“Had the Commission followed its own Better Regulation principles, the shortcomings of the Directive could have been dealt with at a much earlier point or might not have been there in the first place”\(^{19}\).

27. Weaknesses in the EC IA process are also echoed by the EC IA for Statutory Audit\(^ {20}\) including a lack of evidence for the proposed policy change. The EC Better Regulation agenda should be firmly embedded in policy development and show greater demonstration of evidence driving the proposals to enhance the quality of outputs as it is costly and time-consuming for stakeholder groups to investigate and report on these gaps. These examples show that IA best practice is not consistently applied by the EC.

28. This high level review control provided by the EC Impact Assessment Board (IAB) and European Parliament to challenge and review the proposal and IA is important, however serious concerns remain as to how such serious deviations from the EC Better Regulation policy can occur for a major proposal, without being addressed internally first. For the AIFMD, it is reported that this was due to “the tight schedule for adoption...as part of the Commission’s response to the financial crisis” (page 1 of EC IAB Assessment).

29. We support the principle of “getting it right first time” i.e. preventative rather than detective controls as more efficient than additional redrafting and review (for the regulator as well as stakeholders). We would urge that proposals are not passed onto the next stage of approval until sufficient evidence and a robust cost benefit analysis has been undertaken. Although the financial crisis added a sense of urgency, we believe this gives more reason for circumspection rather than haste to ensure an appropriate and evidence based response which leads to sustainable improvements, particularly where evidence was weak and many industry observers concluded they played a limited role in the crisis\(^ {21}\). A professional judgement framework (paragraph 35) could be used to highlight areas for strengthening before progressing further.

30. Impact assessments are essential to test the feasibility of proposals and should be embedded in the policy development cycle and support planning. Current practice for the Scottish and UK Government\(^ {22}23\) is that a business and regulatory impact assessment accompany the consultation document for a new piece of legislation. These are designed to inform and assess the impact on and encourage comment from those who may be affected by the proposals. The IA should evolve as further evidence is gathered, supporting the rationale for the preferred option both before and during consultation, to be updated and published as appropriate.

31. The IA for Audit Policy\(^ {24}\) did not accompany the consultation but was published the following year\(^ {25}\). The initial EC IA for AIFMD was widely criticised. For both examples, a robust impact assessment would have helped clarify arguments and supported internal review to challenge the feasibility of the case before going to a public consultation. The better quality deliverable for the public, the more productive the consultation process and ultimately the more beneficial the resulting regulation. Our case studies suggest that better regulation principles are not fully embedded and consistently applied in EC policy development.

32. Examples of duplication with existing legislation were identified for the AIFMD in paragraph 14. We suggest that impact assessments should examine the impact of any directive on other existing directives/legislation and set out how they are to work in tandem. This would have

\(^{19}\) Annex paragraph 1  
\(^{20}\) Annex 1 – paragraph 22  
\(^{21}\) House of Lords Inquiry report chapter 1  
\(^{22}\) http://www.scotland.gov.uk/Topics/Business-Industry/support/better-regulation/partial-assessments  
\(^{23}\) BIS example  
\(^{24}\) Annex 1, paragraph 16  
\(^{25}\) Annex 1 paragraph 19
identified a central problem of the AIFMD – that AIFMs of Investment Trusts and Boards of Investment Trusts are governed by different directives with potential for conflict.

33. An impact assessment focuses on the single piece of regulation under review. In practice, the impact on business is more than just the one regulation but the cumulative effect of all relevant regulations to date. For a greater focus on the end-user perspective, to support better regulation and help streamline the impact on business, we suggest that the IA also considers the aggregate impact of policy. The UK Government’s approach to EU legislation notes in its’ general principles “The government’s approach to EU legislation notes in its’ general principles “The government’s approach to EU legislation notes in its’ general principles”26 “The government’s approach to EU legislation notes in its’ general principles”26 “The government’s approach to EU legislation notes in its’ general principles (“The government’s approach to EU legislation notes in its’ general principles”26). They have also committed to the one-in one-out approach as part of its better regulation agenda to reduce the overall burden of regulation.27

34. We also believe that an impact assessment could be a more evolutionary and comprehensive exercise to have flexibility to include consideration of changing market and strategic priorities, for example currently economic growth and jobs is high, so this should be reflected accordingly. New proposals should not hinder business growth or add to problems experienced by SMEs in the current funding climate. (See example in Section II).

Strategy

A principles based approach to development and judgement

35. We support the concept of a principles (as opposed to rules) based approach to decision making28. The EC has the challenge of legislating for many Member States and jurisdictions. A higher level more principles based approach may be more suited in this context to work with, rather than risk duplicating, existing laws. (For examples see paragraph 14, 32, and the criticisms of a one-size fits all approach in AIFMD and gender diversity mandatory quotas).

36. A principles based approach has been found to be successful in guiding consistent application of accounting internationally through the definition of short overarching principles as opposed to a plethora of rules and clauses. It can also be more efficient. The reduction in complexity permits a certain level of discretion to take into account local circumstances, which is fine, as long as it is not inconsistent with the overall purpose and spirit of the principle.

37. In some cases a lighter touch approach may be more appropriate - where evidence exists that national codes are effective. This can leave more resource available to tackle the areas where greater regulation is needed. The FRC undertook a review in March 201229 with their counterparts across other Member States. This demonstrates that national codes are all developed and monitored in different ways, but they are all delivering results (compliance rates were reported as UK 96%, Austria 91%, Denmark 84%, Portugal 80% and Spain 78%). Moreover, they are all setting out standards that are much higher than those set out in law.

38. This should be considered in the legislation needs assessment at European level – is further legislation still required or would more targeted measures be more appropriate to focus on the 10-15% rather than risk duplication and overlap by legislating on top?

39. Using the example of gender diversity, if the European level sets the desired direction for more diverse boards, then a principles based approach would allow different jurisdictions, which are at different stages in meeting this objective, the freedom to apply different regimes and targets to suit their circumstances and achieve sustainable progress. Regulation/ sanctions may only kick in for more serious non-compliance. This supports the principles of “responsibility starts at home” and “minimal intervention”.

26 http://www.bis.gov.uk/policies/bre/improving-eu-regulation/guiding-principles-eu-legislation
27 http://www.bis.gov.uk/policies/bre
28 http://icas.org.uk/principlesnotrules/
29 FRC report not published but a hard copy is available on request; a copy has already been shared with EC
40. A judgement framework can assist both the policy setter make judgements and the Member States enact legislation locally. If the principle is sufficiently clear, this can assist interpretation, reduce gold plating and abuse (it is harder to defeat a well-crafted principle than a specific rule that can be technically bypassed\(^\text{30}\)).

41. ICAS have published a [*Professional Judgement Framework for Financial Reporting*](http://www.ifrs.org/news/announcements-and-speeches/Pages/convergence-or-not-speech.aspx). Certain principles may be of relevance to the policy development process as it flags factors which can affect the soundness of a judgement where there is a degree of uncertainty and subjectivity including:

- Whether precedents exist\(^\text{31}\);
- Sensitivity of judgement to changes in assumptions;
- Acting ethically and being subject to undue pressures;
- Whether the proposal is one which you would be happy to defend against possible reputational risk;
- Considering the possibility of bias in the judgement process;
- Whether reassessment is required and when (consider identification of trigger points for sunsetting reviews); and
- Shortcomings in the decision making process (e.g. time pressures), these should be documented as it is likely to increase the risk.

42. In addition to the principles of subsidiarity and proportionality in EC law, we believe the approach to policy development should also include the following policies:

- Minimal intervention;
- Evidence based;
- Do no harm (unless clearly balanced by greater good);
- Quality driven (lower volume, high quality, avoid haste);
- Cost benefit;
- Transparency (processes and decision making); and
- Responsibility starts at home / self-regulation.

43. We would encourage a clearer demonstration of applying a principles based approach when consulting publicly to help support the rationale for regulation, drive efficiency and reduce red tape for business.

*Extent and transparency of follow up*

See our comments in Section III.

**Section II Enhancing the effective implementation of EU legislation**

*Facilitating implementation and compliance / informing the public / improving enforcement*

44. We welcome the statement in the consultation paper that “*knowledge about the way in which EU law is implemented on the ground in the Member States should play a greater role in the process of policy evaluation and design*\(^\text{32}\)” and support the use of post implementation reviews and sunsetting clauses (see [*UK Government Department BIS example*](http://www.ifrs.org/news/announcements-and-speeches/Pages/convergence-or-not-speech.aspx)) to help moderate regulatory burdens and check that the regulation is:

- Still fit for purpose, (the policy objective is still relevant, the regulation is still the best option to meet the policy objective, whether additional evidence has come to light which may affect the judgement)

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\(^\text{31}\) Pages 9,10

\(^\text{32}\) Page 6
- Aligned to current strategic priorities
- Supports current thinking on better regulation and streamlining on businesses
- Reflects best practice principles.

As well as to identify:
- Regulatory design problems
- Variances in implementation & whether further action is required to promote consistency
- Best practice and to help its dissemination.

45. For greater efficiency, we would encourage a risk based approach to post implementation reviews (perhaps selected according to risk/impact evaluations noted in paragraph 22) and targeted on those regulations with greater impact/ compliance cost/ complexity.

46. To further embed the post implementation assessment, the IA / regulation could identify suitable trigger points / timescales for future review periods as considered in the professional judgement framework (paragraph 35). This may serve as an incentive for higher quality, lower volume regulation; a balance which would be warmly welcomed by our members and business.

Example of historic legislation hindering funding initiatives
47. All countries across the Eurozone are suffering from low growth. Both the UK Government and European Commission have prioritised growth. The EC Better Regulation website cites that:

"the Commission has launched a comprehensive strategy on better regulation to ensure that the regulatory framework in the EU contributes to achieving growth and jobs..."

48. The purpose and intentions of EC State Aid Rules, to ensure that government interventions do not distort competition and trade inside the EU, are important. In practice, however, our experience is showing that these Rules have inadvertently served to dilute or limit a number of UK growth initiatives.

49. Specific examples of growth initiatives which have been severely diluted to comply with EC State Aid Rules are set out in Annex 1. These relate to funding initiatives to support small and early stage business in the face of tighter bank lending conditions. Small and medium-sized enterprises (SME) account for 99.9% of all enterprises and 58.8% of private sector employment. The role of SMEs is crucial in a successful growth and employment strategy. Tax reliefs are vital to secure equity investment in SMEs. Initiatives to boost to such investment are required to effectively drive forward start-ups and develop small businesses, which in turn provide the most dynamic increases to employment.

50. The concern is that the original purpose of the Rules has moved beyond their intention not to distort competition and trade inside the EU through large scale government intervention and are now having unintended consequences on SME’s whose impact on competition within the EU is negligible or nil.

51. Strategic priorities today are different from the days when this law was conceived. Now economic priorities are to stimulate growth. Affirming the alignment of historic laws with current priorities and taking action to remedy contradictions is important to maximise the effective delivery of strategic priorities.

52. Economic conditions suggest that it is timely for historic laws (including State Aid Rules) to be subject to a reassessment to align more closely with growth objectives (over competition) and to modify or remove those laws which stifle that overarching priority. For existing regulations, a targeted, risk-based audit could be one way to help identify pockets of regulations which do not encourage growth. Those which do not pass these criteria should be modified or repealed. We

33 BIS population estimates for UK and regions 2011
recognise that the EC has taken some steps in this direction already. This needs to go further for example, reviewing the appropriateness of the €200k de minimis level – is this sufficient in the current economic climate to stimulate growth?

*Improving enforcement*

53. Please refer to our statement in paragraph 40.

**III Consulting the Public**

*Minimum standards / Scope/ Timing/ Representatives/ Feedback / Results*

54. Anecdotal evidence from members has identified a feeling of impotence regarding the ability to influence EC proposals as well as a deficit of trust in the process and extent to which proposals are thoroughly evidence-based. As part of a quality driven and transparent approach to regulation, public awareness and effective engagement is essential to develop a quality outcome. In recognition of the time and effort which stakeholders invest in responding to consultations we would welcome greater transparency on the basis for conclusions and how engagement has influenced the final outcome or stakeholders may tire of providing evidence.

55. An on-going example is the EC gender diversity proposal for quotas on boards. A press announcement in informs us that the draft legislation is based on the decision to proceed with mandatory quotas for companies above a certain threshold, despite vigorous opposition of this regulatory approach by some countries including the UK.

*Timing and content of consultations*

56. The AIFMD example shows some inconsistencies in how the EC undertakes consultations and deviations from the EC’s own better regulation procedures including a shorter consultation period (6 weeks), exacerbated by timing this over the Christmas holiday period. This is not an isolated event and is echoed in criticisms of the consultation period for the Quantitative Impact Study consultation from the European Insurance and Occupational Pensions Authority (EIOPA) as well as the Europe 2020 Strategy.

57. For a complex proposal such as the AIFMD, with such significant costs and consequences for a sizeable European industry this cannot be construed as effective/good practice consultation. Scottish Government policy is to provide a 12 week consultation period which we believe is a more reasonable timescale for straightforward proposals. For more complex areas, the policy development stage would require at least that, followed by a similar period of initial consultation on detailed regulations, which might be followed by further rounds if proposals change. Consultation of complex and wide-ranging material over the Christmas holiday period does not demonstrate effective planning. A consultation and engagement strategy should be one aspect of a risk assessment to ensure that the methods and timescales are adequate and proportionate.

58. Secondly, the AIFMD consultation was not fully comprehensive; it covered hedge funds but not all Alternative Investment Funds which not only weakens the exercise but undermines confidence in the consultation process. An industry representative body states at the House of Lords inquiry that “(They)...do not believe any substantive consultation was conducted before the directive was published and that the regulation suffers as a result”.

34 Financial Times 4 September 2012
35 Media article by National Association of Pension Funds
37 Annex 1 para 13
59. Greater consistency in the application of consultation good practice would be welcomed especially for high profile and high impact proposals where one would expect greater alignment with best practice.

Transparency

60. Variations in the type of information published have been noted. As an example, for Audit Policy, a summary of responses, the number and copies of all responses received is available on the EC website. In some cases, a summary of consultation feedback is provided which helps to identify the balance of consultees and risk of bias. This was not available for the AIFMD. Publication of full responses is also undertaken by the International Federation of Accountants (e.g. IPSASB), UK Department of BIS and the Financial Reporting Council. Our view is that the full consultation responses should be published for all public consultations (unless the responder specifically requests to opt-out) plus any letters of representation.

61. Significant concerns with the AIFM proposal and process were identified and reported, by the European Parliament as well as through consultation, resulting in some amendments. For transparency and accountability we believe that where significant amendments are required or the process for drafting and consulting the proposed directive has been flawed/deviated from best practice without good cause, it is important to publish a response on the website demonstrating how these concerns have been heard and detailing what steps the EC have taken. This would need to be specific and not use “boilerplate” language. This was not found for the AIFMD (a response from the EC following the House of Lords inquiry is available on the UK Parliament site\textsuperscript{38}). This should support a further round of open consultations to test if the proposals are fit for purpose. As an example, the UK Department of Business Industry and Skills (BIS) published a discussion paper and government response.

62. Greater transparency and feedback on concerns raised would help to generate trust in the consultation process. A complete audit trail should be fully documented on the website, in a consistent manner. This should cover the full cycle from the original proposal, European Parliament IA, the EC response to points raised, consultations issued, consultees, respondees, all responses (where permission is provided to publish), key points raised and the EC response to the consultation findings, what has been amended as a result of feedback (if not why, to demonstrate that due consideration has been given) through to final proposals and outcome as well as policy for post implementation review. This would support accountability, more open government and help demonstrate if the revised proposal and amendments are fit for purpose. (An example from the Scottish Government is that subsequent versions of statutory guidance may be supported by a covering letter summarising the key changes resulting from consultation).

IV Progressing together

63. Identification of all relevant consultation topics can be ad-hoc. Awareness of EU evaluations and consultations could be further facilitated by national governments, perhaps by filtering and highlighting relevant EC consultations on local websites or by providing updates, alerts, links, pointers to roadmaps, providing opportunities to receive views/concerns to inform whether a co-ordinated national approach is required. (Perhaps a Europe page on the new UK Government Business Portal or on the UK BIS / Scottish Government business web pages could be used).

\textsuperscript{38} EC VP response to Lord Roper June 2010
ANNEX 1

CASE STUDIES

I The Alternative Investment Fund Managers Directive


“Had the Commission followed its own Better Regulation principles, the shortcomings of the Directive could have been dealt with at a much earlier point or might not have been there in the first place. The Government must put pressure on the Commission to ensure that future proposals are subject to the better regulation agenda.”41

Purpose and scope

2. The scope of the proposals is wide-ranging and covers non-uniform instruments. Criticisms of the proposals include a need for greater clarity of purpose supported by specific and relevant examples of problems to address. Additional objectives were bolted on to the original proposal such as tax reciprocity and regulation of overseas operations/ funds.

3. Concerns over duplication and conflict with existing company law, the Markets in Financial Instruments Directive and Takeover Directive were cited by our members and Scottish Financial Enterprise42. The Chief Executive of the BVCA in a statement43 dated October 2010 reiterates concerns that:

“This remains, though, a defective Directive. The EU has taken a hostile interest in the wrong industry at the wrong time and for the wrong reasons. No serious analyst has concluded that private equity (let alone venture capital) caused the economic crisis or served to enhance it. These regulations will needlessly increase costs and disproportionately impose burdens. .. There are many sections in this text which are ambiguous, inconsistent or incoherent. ..

Europe is still at risk of actively discouraging this sort of investment at precisely the moment when it needs to ensure a collective economic recovery. .. Private equity and venture capital stand ready to play a powerful and positive role in Europe's economic future. The question remains whether the EU wants this to occur.”

Impact assessment

4. The EC impact assessment on the AIFMD was concluded as falling short of expected standards by the EC Impact Assessment Board assessment March 2009. The European Parliament’s Economic and Monetary Affairs Committee (EMAC) commissioned European Economics to produce two further impact assessments on the Directive44 concluding that:

- “The Commission Impact Assessment’s analysis of the policy problem was vague, sweeping, and inadequate as a basis for justifying regulation
- Although it argued there was a strong case for additional regulation the rationale for a directive of this form is weak
- It found the Directive poorly constructed, ill-focused, and premature”.

39 http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm#proposal
40 As does the Open Europe Report - AIFM Directive 2009
42 SFE letter to the Commissioner on 13 May 2010
43 http://www.bvca.co.uk/Newsroom/features/BVCAStatementontheAIFMDirective
5. The Commission Impact Assessment states that “Due to uncertainty about costs, it is not possible to assess or to quantify precisely the impact of the proposal on the competitiveness of EU-domiciled AIFM”\textsuperscript{45}. This was challenged by subsequent impact assessments commissioned by the European Parliament and Financial Services Authority\textsuperscript{46} (FSA) in the UK. Both identified compliance costs would increase to a much greater degree than the EC first acknowledged. EMAC estimated from €1.1bn to €22bn.

6. The FSA report on the impact of the AIFM Directive across Europe\textsuperscript{47} also identifies staggering costs (one-off compliance costs €3.2bn on AIFMs and on-going compliance costs of around €311m). These costs pass on to investors leading to reduced returns affecting pensioners as well as growing business. It raises fears that it will make Europe a relatively unattractive location in which to conduct private equity or venture capital business.

7. Concerns raised by the House of Lords inquiry include:

- “The Directive will seriously damage the EU and UK economies unless it is fully compatible with the global approach to the regulation of fund managers and the Government should withhold agreement on the Directive until these concerns are addressed”\textsuperscript{48}.

- “On 29 April 2009, following a limited consultation process, the Commission published a draft Directive proposing a regulatory regime for Alternative Investment Fund Managers (AIFMs) ... Since the onset of our investigations into the Directive, we have been concerned with the speed of legislation and the effects this proposal could have on the global financial market”\textsuperscript{49}.

Content

8. Other criticisms include the one-size fits all solution which is not compatible with the different funds, their different existing forms of governance and their characteristics; inconsistencies such as clauses addressing private equity acquisitions but noting on corporate takeovers which some view as an unbalanced approach to a theme.

9. The Directive as originally proposed covers all non-UCITS funds. “We are concerned that this one size fits all approach fails to acknowledge the differences in how AIFs are structured and operate. The Directive should be tailored in a way that respects the differences between the types of funds it covers to avoid unintended regulatory consequences”\textsuperscript{50}.

10. Co-ordination with global regulatory regimes was lacking which is cited as exposing the EU and UK economies to serious damage and a situation where the European AIF industry loses competitiveness\textsuperscript{51}.

11. Scottish Financial Enterprise reiterated “major areas of concerns...if the directive goes ahead unaltered, it will have a major negative impact on Scotland’s financial services industry and its customers” in a letter to the Commissioner on 13 May 2010\textsuperscript{52}, including:

- Scope - duplication and conflict with existing company law
- A disproportionate approach to depositary requirements
- Third country provisions – the scale of restrictions on EU investor choice risking protectionism and adverse consequences on EU investors and the worldwide market
- Remuneration disclosures – “fundamentally flawed”.

Consultation weaknesses – speedy and incomplete

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\textsuperscript{45} Page 51 box 10 & 11
\textsuperscript{48} Summary – last para.
\textsuperscript{49} Page 8 - para 4
\textsuperscript{50} http://www.publications.parliament.uk/pa/ld200910/ldselect/ldeucom/48/4803.htm
\textsuperscript{51} See summary of the House of Lords report
12. The consultation period was shorter than the norm – 6 weeks over the Christmas and new year period 2008/09 instead of 8 weeks. The reason provided was “a desire to proceed quickly”52. In addition, the consultation focuses on hedge funds although Alternative Investment Funds actually include other areas.

13. The British Venture Capital Association (BVCA) represents over 230 private equity and venture capital firms; the UK accounts for 60% of private equity activity in Europe53. An extract of the BVCA submission to House of Lords inquiry notes: “The BVCA does not believe any substantive consultation was conducted before the directive was published and that the regulation suffers as a result (5.1)”.

Other comments from the BVCA

14. Assessment of proposals:
   
   - “Our clear view is that the directive does not offer a proportionate response to any identified risks (para 3.1)...The Directive has the potential to drive investment away not just the UK, but from the EU a whole (9.1)
   
   - The logical result of this is that the scale of private equity investment in the EU will reduce. This would have a greater impact on the UK given the preponderance of private equity investment from the UK... These funds are making investments in to highly innovative businesses, in areas like cleantech, bio science, digital and advanced manufacturing. Any threat to the funding of these businesses would have negative consequences, not just for these companies, but for the next generation of innovation (9.2/3)”.

Outcome

15. The report was issued to the EC. The response EC VP response to Lord Roper House of Lords EU Committee 25 June 2010 notes the UK comments but does not specify what has/ has not been taken on board.

16. The Directive has been voted in by the European Parliament (November 2010) and should be transposed into national law and applied by member states from 2013.

II Audit Policy – Lessons from the Crisis54

17. The Green Paper with proposals was published in October 2010. The impact assessment was not published until November 201155. The consultation period was 8 weeks in line with EC Better Regulation policy.

18. The consultation submissions and a summary were published (unlike for the AIFMD) however there has not been a subsequent consultation or report to communicate the EC response to stakeholders comments or the outcome.

19. The European Parliament response in May 201156:

   “4. Sees as yet no sufficient basis for a final assessment, and therefore reminds the Commission that more use of regulations and a wide-ranging, in-depth impact assessment are needed, looking at the various political options, focusing on practical issues in line with the principles of ‘better law-making’, ...to clarify the segmentation of the impact assessment study for the various groups, such as SMEs, SIFIs and other listed and non-listed companies; ... an assessment should be made of the impact on the users of audit reports, such as investors and SIFI regulators; calls on the Commission to analyse the added value generated by both the proposed regulation and

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52 http://ec.europa.eu/internal_market/consultations/2008/hedge_funds_en.htm
53 http://admin.bvca.co.uk/library/documents/BVCA_Submission_AIFMD.pdf
the progressive harmonisation of auditing standards and practices in the European single market”.

III State Aid Rules

Examples of growth initiatives restricted by EC State Aid Rules
These initiatives are trying to encourage alternative non-bank funding for small & start-up businesses unable to get a bank loan in the current economic climate.

<table>
<thead>
<tr>
<th>Title</th>
<th>Purpose</th>
<th>Policy limitation by State Aid Rules</th>
<th>Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 SEED Enterprise Investment Relief</td>
<td>To provide tax incentives for high net worth individuals to invest in early stage companies</td>
<td>Limiting the business size thresholds to £200k.</td>
<td>The asset threshold of £200k is low, which will restrict eligibility to low asset businesses and exclude hi-tech or manufacturing businesses that may wish to invest in the early stages in productive assets rather than finance them through loans.</td>
</tr>
<tr>
<td>2 SEED Enterprise Investment Relief</td>
<td></td>
<td>Extending the tax relief from equity to loans to help access the billions of pounds held in savings accounts.</td>
<td>Reduces the numbers of businesses who can benefit.</td>
</tr>
<tr>
<td>3 Enterprise Funding Guarantee</td>
<td>To encourage bank lending to business by providing a government guarantee for a substantial part of the loan</td>
<td>In practice the government guarantee of 75% is restricted to 13% of the total loan book in the event of a default due to State Aid restrictions.</td>
<td>The 13% level is too low a guarantee to match the level of risk and uncertainty in the current conditions. The scheme is not lending as much as envisaged, particularly to the higher risk, early businesses who need this funding to grow and create jobs.</td>
</tr>
</tbody>
</table>

IV Statutory Audits of Annual Accounts...Public-Interest Entities Directive


21. The European Parliament’s legal affairs committee (JURI) commissioned their own impact assessment unit to do an appraisal of the Commission’s impact assessment accompanying the proposals for the Audit Directive and Regulation. This was published in July 2012.

22. Criticisms of the Commission’s impact assessment raised in the Executive Summary (page 5) include:

“...the underlying drivers for the proposed policy change in the audit market seem to be less clearly evidenced. In particular, the causal link between an alleged general problem of deficiencies in audit quality in the EU and the worldwide financial crisis is not clearly demonstrated. Moreover, the Commission states that the competition on the market for audit
services (especially audit of public-interest entities) is distorted as a result of the existence of a high level of market concentration. However, the existence of high market shares not being problematic per se, one might reasonably have expected the Commission, as the EU competition authority, to have provided a more thorough analysis of the market for audit services and to have made a more closely substantiated case for a possible distortion of the competition. Only when such problems are properly analysed is one able to assess whether the proposed actions could be reasonably expected to deal with the identified problem adequately”.

“...for certain preferred policy options, there seems to be a proportionality problem. In particular, in the case of the proposed mandatory rotation for auditors and the proposed separation between audit and non-audit services to PIEs, the IA presents as preferred options those whose positive impacts are contested by a majority of stakeholders. Since neither the costs of these proposals, nor their expected benefits are fully quantified, the Commission does not seem to provide sufficient evidence that the preferred options are necessarily the most beneficial for the concerned market. Less radical alternative options have not been explored in the same detail. Moreover, the Commission does not seem to pay enough attention to unintended effects of its options”.

V Application of Solvency II capital adequacy regime for the insurance industry to occupational pension schemes

23. The ICAS Pensions Committee believes that the existing UK regime is sufficiently strict on defined benefit pension schemes and affords a high level of protection to scheme members, for example, through the work of the Pensions Regulator, the Pension Protection Fund and the existence of various regulations including recovery plan requirements. Assuming that Solvency II, if implemented in the UK, would operate alongside the UK’s existing regime, its implementation would be an additional as well as unnecessary burden on pension schemes.

24. Moreover, the potential impact on European equity and bond markets should not be underestimated, as a likely sell off in both corporate equities and corporate bonds in favour of government gilt issues will have serious consequences for private sector costs of capital as well as adding yet further distortion to the market yields available from UK and other gilts. UK index-linked gilts, for example, are now tending to show negative real yields because of the distortions caused by imbalances in supply and demand and also the impact of quantitative easing programmes. These market yields are often used by actuaries as a benchmark for discounting the net present value of future pension accruals, so the impact on both assets and liabilities is adversely correlated to an extreme.

25. This example highlights that solutions to issues do not necessarily need come from the EC and that the EC should look more closely at the potential consequences of its proposals including the unintended ones before pursing policy positions. EC proposals use up considerable time and resource, and in today’s economic climate the EC should perhaps be more mindful of this fact. The holistic balance sheet approach has been criticised on consultation, as it was verbally beforehand, and as a result it is expected to delay further progress towards applying Solvency II to pensions.