European Fund and Asset Management Association

EFAMA Position Paper

Review of the European System of Financial Supervision

Contents

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Executive summary

Proposal for a regulation amending regulations establishing the ESAs

EFAMA has, from the outset, been **strongly supportive of the creation of a harmonised European supervisory framework, with European authorities cooperating closely with national supervisors to ensure a well-functioning supervisory system**. We therefore welcome the momentum behind the Capital Markets Union for more consistent supervision and uniform enforcement of the single rulebook, which is all the more important for the European asset management industry, given the cross-border nature of activities and products.

European competitiveness as well as the impact on consumers and end investors should be at the heart of this review. We firmly believe that stronger integration of EU supervision is not a goal in itself and must be justified in terms of cost/benefit to Europe's end investors in Europe's capital markets, which are both regional and local. We fully support the ESAs having an important role to play in reducing barriers to cross-border investment and ensuring best practice coordination and convergence across the Single Market.

We welcome and strongly support the greater involvement of stakeholders through an additional role for ESAs' Stakeholder Groups and the introduction of ex-ante consultations on guidelines and recommendations. However, we are concerned that some of the measures put forward in this legislative proposal would not best serve the needs of consumers and end investors in Europe's local and regional capital markets. In this regard, we are particularly concerned with the Commission's proposals to increase ESMA's powers, particularly in relation to delegation / outsourcing arrangements and direct supervision and authorisation of ELTIFs, EUSEFs or EUVECAs. Given the fundamental lack of any conclusive evidence in the Commission's Impact Assessment regarding either any market failure or potential benefits for consumers and end investors, EFAMA believes that a more proportionate response would be for the ESAs, and ESMA in particular, to make better use of existing, and often underutilised, powers – such as enhancing the role of ESAs as fora for discussions among regulators with the aim of having practical converging solutions. Such coherence of supervisory approaches should therefore be more frequently achieved through opinions and other level 3 measures, rather than through revisions of Level 1 texts which generate long processes, many unintended consequences and regulatory costs for market participants.

In summary:

- **We strongly oppose new powers for ESMA to authorise or supervise ELTIFs, EUSEFs, and EUVECAs:** The Commission's proposal would result in a dual regulatory regime for these types of investment funds, which would undoubtedly lead to a more complex, cumbersome and expensive fund authorisation / supervision process. The current system of authorisation and supervision by NCAs is best suited to deal with the many different market structures and legal regimes of Member States.

- **We strongly oppose new powers for ESMA in relation to delegation / outsourcing arrangements into third countries:** There is no justification for giving ESMA these new powers, nor any evidence of any market failure which would necessitate such action. The

Commission's proposal create a serious risk of not only questioning but undermining existing and well-functioning delegation/outsourcing operating models, which have been central to ensuring investor choice and EU investors' access to world leading investment expertise. To address the legitimate aim of further supervisory convergence and ensure coordination and collaboration amongst NCAs, ESMA should use its existing powers to issue clear guidance to NCAs through e.g. peer reviews.

- **We believe that market participants should not directly report data to ESMA.** Regulatory reporting should remain with NCAs. However, we are supportive of a role for ESMA with regards to standardisation of regulatory reporting. We believe a framework where standardised information is provided to NCAs which then flows through the NCA and onto ESMA would provide an efficient and transparent reporting mechanism. There could be a role for ESMA as a pan-European public information centre which would make public on its website all the national regulatory regimes by topics. This would facilitate the development of cross-border activities and enhance competition, for the ultimate benefit of investors.

- **We favour a fixed floor of 40% on the EU budget contribution**, rather than a balancing maximum of 40% and **oppose direct funding by indirectly regulated entities**.

- EFAMA fully supports and welcomes the **new possibility for ex ante consultation on guidelines and recommendations, as well as the introduction of an additional role for Stakeholder Groups** in relation to sending a reasoned opinion to the European Commission in possible cases where ESMA may have exceeded its competence.

- We do not agree with the extension in the Commission's proposal of **product intervention powers under MiFIR to managers of UCITS and AIFs**.

- We believe the current proposal on the **composition and process for electing the new Executive Body may create legitimacy challenges** as the NCAs bear responsibility to their own national parliaments and investors in the event of a problem.

<u>Proposal on the revision of the ESRB founding regulation</u>

With regard the **proposal on the revision of the ESRB founding regulation**, EFAMA welcomes the Commission's proposal to maintain the ESRB current tasks of monitoring the build-up of system-wide risks and issuing non-binding warnings or recommendations. We equally believe it is crucial to ensure that the ESRB's analysis of system-wide risks, especially in the non-bank domain of financial market activities, remains evidence-based. Finally, we remain convinced that the current macro-prudential architecture should be adjusted to reflect greater financial market expertise and a greater representation of financial market supervisors.

EFAMA Position on the Proposal for a regulation amending regulations (EU) No 1093/2010, (EU) No 1094/2010 and (EU) No 1095/2010 establishing the ESAs

1. Direct supervision, powers and tools

Direct supervision by ESMA of EU regulated funds

We strongly oppose granting ESMA powers to authorise or directly supervise ELTIFs, EUSEFs, EUVECAs, or other EU regulated fund frameworks[1]. In our view, there is no conclusive evidence in the Commission's Impact Assessment regarding the benefits for investors or providers of such investment products, nor is there evidence of market failure that would justify such a change.

Our overarching concern is that this move would jeopardise the competitiveness of the EU funds industry, by creating a more complex, cumbersome and expensive process, without being of added-value to end-investors. On the contrary, we do not believe that transferring these powers to ESMA will serve the local needs of investors, for the reasons set out below.

From a regulatory point of view, even though under this Commission's proposals, EUSEF, EUVECA and ELTIF product labels would be authorised and supervised by ESMA, managers of these products would still be supervised to a large extent at Member State level. However, as ESMA would be responsible for supervising an AIFM's compliance with the relevant requirements of AIFMD in respect of the qualifying fund, ESMA would have the competence to intervene in the manager's general organisational set-up e.g. in terms of liquidity and risk management, valuation procedures or delegation, even though these organisational arrangements have been deemed appropriate by the responsible NCA. This would create huge complexity. In the case of ELTIFs where scrutiny of AIFMD compliance would even be part of each fund authorisation, it would inevitably delay the authorisation process when there are conflicting views between ESMA and the NCA in question.

Furthermore, the Regulations governing EUSEFs, EUVECAs and ELTIFs do not contain any provisions regarding the possible legal structure of fund vehicles, meaning that national rules for eligible fund structures apply to any EUSEF, EUVECA or ELTIF established in a given Member State. As the design of these fund vehicles is based on national laws and the drafting of fund documentation such as prospectuses relies on civil/contract law, ESMA would not only have to consider EU regulation for the product / EU label, but also need expertise on 28 national legal frameworks and the ability to manage complex issues in all official EU languages. An additional layer of supervision of the EU label would put in place a dual regulatory regime and create uncertainty as to which regulatory regime should lead, which would risk confusing investors or presenting investors and managers with legal conflicts. Other issues would arise from the specificities of different taxation regimes in 28 different Member States, which also impacts the choice of a fund vehicle and its fund rules.

[1] For similar reasons, we also have strong objections against granting EIOPA powers to authorise or directly supervise PEPPs (as put forward in the separate but related proposed legislation governing this new type of product). Link to EFAMA's Position Paper on the PEPP.

From a practical point of view, the application process being handled by ESMA, rather than by local NCAs, would make access to this market more challenging and complex for both smaller firms as well as EU-wide operators. Currently, authorisation and supervision of EUSEFs, ELTIFs and EUVECAs are conducted in NCAs by staff who also cover other types of fund authorisations under UCITS and AIFMD. Similar synergy and efficiency would not be possible at ESMA level. In addition, the submission of fund documents to ESMA (registration documents, investor information and annual reports) in different languages and any follow-up communication between ESMA and different stakeholders would be particularly challenging. We fear that ESMA would not be given the appropriate resources to cater for such language diversity, and translations into English would drive up costs in the authorisation of these particular funds.

Finally, proximity of the regulator to the local market and knowledge of market practices and legal structures also allows supervision to be targeted to the specific challenges and vulnerabilities. This proximity is also essential for retail investor protection as financial literacy, market experience, sensitivity to inflation, volatility, capital protection, amongst others, can vary considerably from one Member State to another.

Article 31a

Delegation, along with investor protection and diversification, is one of the key pillars responsible for the success of UCITS, and increasingly AIFs. Delegation works extremely well and has been critical in making UCITS not just a European, but a truly global, success story. It is a reliable, well-functioning and tested model, which is central to ensuring EU investors can access world leading investment expertise. Outsourcing of back office functions is also an important part of the asset management business model which allows for choice, competition, economies of scale, and enables firms to focus on core competencies. All of this provides investors with better value and choice.

The EU legislative framework for the asset management industry has set robust standards for delegation and outsourcing, including to third countries. Both the UCITS Directive and AIFMD lay down rules for investment funds and/ or management companies to delegate certain functions. Both Directives have also set-up rules for cooperation between home Member States and host Member States and require cooperation agreements between EU home Member States and third countries. Article 82 of Level 2 AIFMR provides further specific rules to avoid letter-box entities and gives ESMA the power to issue guidelines to ensure a consistent assessment of delegation structures across the Union – and these specific AIFM provisions directly deal with the stated aim of Article 31a as set out by the European Commission. This is to avoid letter-box entities. The authorisation process is clearly defined and does not foresee the possibility of the additional layer of supervision. The proposals embedded in the ESAs' review create the possibility for overlap, conflict and retroactive effects between decisions taken by local supervisors and ESMA. It is unclear how these new processes laid out in the Commission's proposal add value, or fit with already well-established and effective rules, such as AIFMD.

Moving toward a system of partial supervision by ESMA of UCITS/ AIFs in relation to third country delegation despite many other practices and activities of funds, could inadvertently create the perception on the part of investors that there is a problem to fix, specifically casting this practice in a negative light unjustifiably. In addition, this risks sending mixed messages to jurisdictions around the

globe about the openness of UCITS as a product and the EU as a jurisdiction. Furthermore, such a move potentially puts at risk capital investment in UCITS from third country investors, who are comfortable with the ability of local third country managers to manage a UCITS. It is worth noting that whilst UCITS are still the premier global framework for investment funds, they are facing increasing competition from new cross-border fund frameworks being developed globally, especially in Asia and in Latin America. Given these increasing competitive pressures, policymakers should avoid adopting any new rules that could unnecessarily or inadvertently jeopardise the competitiveness of the European industry and the global appeal of EU brands.

We are therefore very concerned regarding the proposal for the ESA's new powers under Article 31a, particularly in the context of ESMA for investment funds. We believe this would lead to a more bureaucratic, costly and inefficient process regarding delegation and outsourcing, especially into third countries, and would materially weaken the time to market for relevant activities. Compounded by the fact that there is an absence of evidence of any market failure, this proposal creates regulatory uncertainty and sends a negative message across the globe regarding the competitiveness of European asset managers. More broadly speaking, delegation/outsourcing is a trend in a wide range of industries, which has an important knock-on effect on different parts of the real economy. It is important that these business models are not micro-managed and are given the space to flourish.

The European Commission, as part of the Capital Markets Union Action Plan, is currently working to identify and address barriers to cross-border marketing and distribution of investment funds. EFAMA feels that Article 31a undermines this agenda by potentially adding an extra layer of complexity to authorisation and supervision of cross-border investment funds.

To address the legitimate aim of further supervisory convergence and ensure coordination and collaboration amongst NCAs, ESMA should use its existing powers to issue clear guidance to NCAs through e.g. peer reviews, rather than add an additional unnecessary layer which would cause delay to arrangements. ESMA's Supervisory Coordination Network could play a role in this regard.

Powers and tools

- EFAMA welcomes the proposal for **ex ante consultation on guidelines and recommendations**. However, when it comes to Q&As in particular, it is key to have more advance information, transparency, predictability and proportionality in how they are drafted. To enhance practical use of the guidance provided in the Opinions and Q&As, the ESAs should, when drafting Q&As (which are by definition non-binding), be able to consult with stakeholders (possibly through a stronger involvement of the NCAs) alongside the coordination process at ESA level. It would be helpful if the ESAs and NCAs were to consult stakeholders before and after issuing Q&As, as currently the industry – and the public at large – is not always aware of the forthcoming Questions on which the ESAs intend to provide Answers. In this regard, inspiration could be taken from the EBA's best practice which involves publishing in advance the list of questions which it is preparing Q&As on.

- There would be merit in considering giving the ESAs the power to adjust the implementation of a rule through mechanisms such as "**no-action letters**". Impracticability or impossibility of implementation of regulation has been an occurrence that has emerged several times in recent

years. This is sometimes due to lack of clarity or conflicting rules. We believe a similar mechanism to a no action letter would be an efficient means of giving market participants comfort that in relation to particular areas of uncertainty or impracticability in implementation, market participants would not be held liable if they do not or are unable to implement particular provisions at issue. Careful consideration should be given to the circumstances in which these would be used. They should not be used simply to deal with occasionally unachievable deadlines. Rather, this is a question of adequate timing being allowed for due process which needs to be addressed separately. In early 2017, the ESAs provided a "comfort letter" to NCAs in relation to enforcing the EMIR provision on the collateral of OTC uncleared derivatives. We welcomed this, and we believe this should pave the way for a more formal procedure which would allow the ESAs to deliver such comfort letters to NCAs in exceptional circumstances, in duly justified cases and on a best effort basis for market participants. EU institutions and national competent authorities need regulatory forbearance mechanisms that can be promulgated in a timely manner, in order to give market participants comfort that in relation to specific areas of uncertainty or impracticability in implementation. These mechanisms should provide legal certainty that market participants would not be held liable if they do not, or cannot, implement particular provisions.

Sanctions and fines

We are concerned with the proposal to have **ESMA collect information from market participants, investigate and organise onsite visits, and impose fines or penalty payments**, as laid out in the amendments in Article 35b to Article 35h to Regulation 1095/2010. We consider these proposals unbalanced and disproportionate for the following reasons:

- Whereas the rules regarding the powers to impose fines is laid out in quite some detail in the legislative proposal, the rules regarding rights of defense are to be adopted via level 2 measures. The power to impose fines and the defense mechanisms should be subject to the same level of scrutiny.
- In addition to the above imbalance, it is also unclear how the proposed rules regarding rights of defense would interact with the rules of different national jurisdictions, where the right of defense is based on constitutional rights.
- Giving supervisory and sanction powers to the same body has been considered confusing and unsatisfactory on previous occasions. NCAs, such as the AMF in France, faced challenges in this regard and as a result had to change their structure.
- The penalty schedule as set out in the Proposal does not leave sufficient room for real proportionality to apply; it is essential that penalties be specifically tailored to the circumstances of each breach.

Reporting

We are supportive of standardisation of regulatory reporting and believe that the ESAs have an important role to play in creating common data standards, common reporting framework and common templates. This would encourage comparability and reduce costs for market participants. It would also facilitate the exchange of information between ESMA and respective NCAs.

However, we believe that NCAs should remain in charge of collecting data from market participants under their jurisdiction, in order to have a complete overview of their own markets and to be able to continue their monitoring and supervisory functions without being dependent on ESMA for access to the relevant data.

2. Funding

We favour a fixed floor of 40% on the EU budget contribution, rather than a balancing maximum of 40%. The current 40/60 split between EU budget and other sources is the only guarantee of a strict budget control of the ESAs.

Given that the work performed by NCAs will not be reduced (and might even increase in the wake of article 31a, article 29 and the ongoing coordination efforts foreseen under the EMIR review), fees charged by NCAs and indirect fees to ESMA will add up. This would mean an additional and substantial cost for financial institutions and ultimately for all investors in UCITS and AIFs. We therefore strongly oppose direct funding by indirectly regulated entities, and would argue that recital 26's reference to contribution based on size is unduly simplistic.

Reallocation of powers between NCAs and ESAs should come with a proportional reallocation of funding, which should not imply a cost increase for the industry. Industry contributions to the ESAs should be deducted from their contributions to NCAs budgets when this is the case. In other words, changes to the funding model of the ESAs should not lead to an overall increase of the industry contribution to the financing of EU and national supervisory authorities and cost-benefit analyses of the ESA review should take this into due account.

3. Stakeholder Groups

EFAMA welcomes the introduction of an additional role for Stakeholder Groups whereby when two thirds of majority of Stakeholder Group are of the opinion that ESMA has exceeded their competence, they may send a reasoned opinion to the European Commission. However, we believe that a single majority rule would be more appropriate as Stakeholder Groups are the only competent party to alert the Commission of potential transgression of powers and the wide variety of representation of different interest groups within Stakeholder Groups means that a two thirds majority would be difficult to achieve.

We are also of the view that ESA Stakeholder Groups should have more frequent meetings in order to build trust and further develop a culture of constructive dialogue between the ESAs and their stakeholders.

The composition of Stakeholder Groups and other committees where professional experts are invited to participate also needs to be reconsidered. The value of market participant involvement in the ESAs' Stakeholder Groups should be acknowledged and reflected through the Groups' compositions.

Appointment to these groups should be more transparent and competence and knowledge of the subject matter needs to be the first and foremost consideration.
In general, the current composition of the stakeholders groups ensures a relatively balanced representation of stakeholders in the relevant sectors, although it could be argued that, given its economic importance, the asset management industry in general is underrepresented within ESMA's Stakeholder Group.

4. Product intervention powers

We do not agree with the extension in the Commission's proposal of product intervention powers under MiFIR to managers of UCITS and AIFs. EU fund framework rules already have a set of rules in place, providing for equivalent intervention powers for ESMA and NCAs:

- Recital 38 & 39 provides justification for extending ESMA temporary intervention powers of MiFIR (article 40) to UCITS and AIFMD but there appears no justification for extending to NCAs' product intervention powers (MiFIR Article 42). (Page 170 of proposal).

- UCITS (as opposed to MiFID products) and many retail AIFs, as well as EUVECAs & EUSEFs are unique in that they are subject to product regulation and provided with a product passport. They require authorisation from the fund's home state NCA. To allow another competent authority to, de facto, fetter a European passport right is illogical. It ceases to be a proper European passport.

- The UCITS Directive Article 101 and level 2 measures (Articles 6 – 11) of Commission Regulation 584/2010) provide the mechanism for host State regulators that have concerns to request on-the-spot investigations and verifications in co-ordination with the UCITS home state, suggesting there is already a safeguard that host state authorities can use. This is in addition to the requirements relating to the routine exchange of information contained in Article 12 of Commission Regulation 584/2010.

- The UCITS Directive requires the UCITS management company to comply with host state marketing requirements providing a further safeguard by providing host State competent authorities to apply additional risk warning etc. (in a non-discriminatory way) to products it feels might harm investors. This is not the case for MiFID firms where home State rules apply when sold on a cross-border basis (as opposed branch where host rules apply).

- In addition, the AIFM Directive provides inter alia for the following powers for NCAs and ESMA:
    - NCAs have all supervisory and investigatory powers that are necessary for the exercise of their functions including the right to suspend the issuance of shares/units (Art. 45 and 46)
    - NCAs approve the marketing notification of AIFs (see e.g. Art. 31(3), Art. 32(3))
    - ESMA has the power to request intervention by NCAs (Art. 47(4))
    - ESMA has its own intervention powers (Art. 47(5)) similar to MiFIR

5. Governance of the ESAs

We welcome the Commission's push for more EU-oriented decision-making by the ESAs and we are supportive in principle of the fact that under the proposed new Article 29a, the ESAs have increased general coordination power to promote convergence of day-to-day supervision by NCAs.

The current governance set-up is an equal representation of NCAs of each Member State. Given the specificities of the EU, and especially given the dynamics between large Eurozone Member States and smaller, diverse markets including non-Euro currencies, it is important that the role of all supervisors in the ESA decision-making is considered. Whilst we are supportive of further supervisory convergence, we do not support changes that would weaken the role of national supervisors in ESA decision-making.

In this regard, we believe the current proposal on the composition and process for electing the new Executive Body would dilute the power and influence of NCAs and also create legitimacy challenges. It is the NCAs who bear responsibility to their own national parliaments and investors in the event of a problem, which is particularly pertinent where the problem is one localised to a single Member State. We are also concerned regarding the role a new Executive Board would play in relation to a "strategic supervisory plan". We believe this could limit the discretion of NCAs to focus their attention and resources on risks most relevant to their local markets. We consider it crucial that NCAs retain this national discretion. At the very least, a strategic supervisory plan should be agreed by the Board of Supervisors as the central decision-making body of the ESAs.

6. ESG and Fintech

Regarding the proposal to include **ESG and Fintech** into the mandate of the ESAs, we would be mindful of such a wide and ambiguous formulation. However, we believe the ESAs could certainly help to promote ESG and Fintech, and there could be a role for the ESAs in providing general guidance on the matter.

EFAMA Position on the Proposal for a regulation amending regulation (EU) No 1092/2010 establishing the ESRB

EFAMA is grateful for the opportunity to submit comments with regard to the Commission's legislative proposal on the revision of the ESRB founding regulation.

We welcome that the European Commission's proposal has not conferred additional powers to the ESRB beyond those of broadly monitoring the build-up of system-wide risks and issuing non-binding warnings or recommendations. Moreover, we fully endorse the Commission's view that such powers are to be exercised prudently to avoid increasing "the probability of false negatives, which in turn would undermine the ESRB's credibility and hence effectiveness", as per the staff working document accompanying the recent proposal. In this regard, it is crucial to ensure that the ESRB's analysis of system-wide risks, especially in the non-bank domain of financial market activities, remains evidence-based.

Although we recognise some of the evident "data gap" challenges - ones that will be progressively overcome via the further streamlining of firm reporting requirements and more efficient data sharing among competent authorities– these should not prompt the ESRB to issue warnings or make recommendations that are not sufficiently grounded in market-based evidence. In our opinion, recent publications from the ESRB Secretariat rely heavily on hypothetical assumptions made in academic studies which are neither supported by historical data, nor by recent episodes of market volatility. Chief among these are the so-called "run-risk" or "first-mover-advantage" hypotheses, accompanied by concerns around asset "fire-sales" and their second-round effects, the unconstrained growth of fund (synthetic) leverage, to name only a few.

Furthermore, in light of the ongoing IOSCO work around the FSB's January 2017 Recommendations around the alleged "structural vulnerabilities" of asset management activities, we remain concerned with regard to the ESRB's current approach seeking to operationalise system-wide stress-tests across the asset management industry, or beyond, in the absence of reliable portfolio-level and investor-level data. By additionally also discarding the qualitative and judgmental factors that remain key components of stress-tests being implemented at the individual fund level as per existing UCITS/AIFMD requirements, attempts of this nature would inevitably yield false conclusions, and where implemented, likely increase the pro-cyclicality of the European financial system. Analogous considerations apply with regard to the imposition of macro-prudential leverage limits. In light of the Better Regulation Agenda, the ESRB and its advisory bodies should consult and engage more openly with market stakeholders as their work progresses.

When responding to the Commission's relevant consultation in October 2016, and in view of the promising future for non-bank finance under the EU Capital Markets Union project, we observed how EFAMA's feedback statement on the proposed review of the EU Macro-Prudential Supervisory framework.
the existing macro-prudential architecture based on a "strong link" between the ESRB and the ECB deserved to be adjusted to reflect greater financial market expertise at the highest instances of the new framework. More specifically, we had recommended a greater representation of financial market

supervisors at the level of the ESRB General Board and Steering Committee, beyond the one current vote reserved for the ESMA Chairperson. The fact that the Commission's recent proposal has preserved, if not reinforced, the ESRB's central bank bias is disappointing, despite attempts made to achieve a more balanced mix of expertise at a technical/expert working group level.

Finally, with regard to the formalisation of the ECB President's role as Chair of the ESRB, intended to lend greater credibility to the new macro-prudential architecture and to be supported in the Commission's view by the greater visibility of the Head of the ESRB Secretariat, we fear that the proposed changes risk personalising the conduct of EU-wide macro-prudential policy over CMU-related developments and excluding the expertise of market supervisors which already directly regulate and oversee such developments in their respective jurisdictions. If the intent of the European Commission is to enhance the capability of the ESRB to anticipate and manage the occurrence of system-wide risks, it would be legitimate to ensure that financial market authorities are more represented in the revised ESRB governance structures.

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