Frankfurt am Main,
19 November 2014

BVI's preliminary position on the reform of the European Supervisory Authorities (ESAs) and the European System of Financial Supervision (ESFS)

BVI[1] fully supports the process of EU integration in the area of financial services and thus welcomes the establishment and further evolvement of the European System of Financial Supervision. In our opinion, the foundation of the ESAs with bundled regulatory and supervisory powers over the financial sectors was an adequate response not only to the failures in the financial supervision exposed by the financial crisis, but also to the progressing achievement of the EU Single Market. Therefore, BVI takes great interest in the further enhancement of the regulatory frameworks in which the ESAs operate.

General remarks on the ESAs' regulatory role

We appreciate the ongoing efforts by the ESAs to contribute to the single rulebook in the EU financial legislation. Nonetheless, we do not support the concept under which the ESAs shall be considered universally competent to deal with any shortcomings or potential issues of concern in the EU financial markets regardless of the existence or non-existence of relevant acts of EU law. In our view, such overstretching of the ESAs' regulatory remit has no basis in the ESAs' founding acts and might conflict with the principle of separation of powers endorsed by the EU Treaties.

In particular, the ESAs' work on technical advice to the delegated acts requested by the Commission sometimes stretches the limits of the superior EU legislation to an untenable extent. A recent example of such conduct is the approach to third-party payments and other inducements proposed by ESMA in its Consultation Paper on MiFID II/MiFIR[2]. The list of negative criteria tabled by ESMA in order to assess the legitimacy of inducements would, if applied to dealing commissions, lead to an effective ban of the commission-based distribution services in Europe. This outcome clearly conflicts with the EU legislator's decision in the Level 1 MiFID II text to allow for the co-existence of commission-based distribution alongside the independent advice based on adequate information about the nature of the distribution channel. Even more astoundingly, ESMA also qualifies investment research provided to portfolio managers as inducements under MiFID, even though such treatment will probably have major implications for the research market in Europe. Such push from the ESMA's side appears to disregard the intention of the EU institutions which have not touched upon the question of research in the course of the MiFID II legislative proceedings. Given the relevance of the issue for the research coverage of European undertakings, especially in the SME sector, and for the quality of services by European portfolio managers, it should be clear that the decision upon the regulatory approach to research requires the involvement of the EU legislative bodies.

Further instances of the ESAs' regulatory actions with questionable or even no basis in the EU legal frameworks can be found in the supervisory guidelines adopted by ESMA. We refer to those specific cases in our detailed comments in section 1 below.

[1] BVI represents the interests of the German investment fund and asset management industry. Its 82 members manage assets in excess of EUR 2.2 trillion in retail funds, institutional funds and asset management mandates. As such, BVI is committed to improving the overall conditions for investors, while at the same time promoting a level playing field for all investors across all financial markets. BVI members manage, directly or indirectly, the assets of 50 million private clients over 21 million households. BVI's ID number in the EU Transparency Register is 96816064173-47. For more information, please visit www.bvi.de.
[2] Consultation Paper from 22 May 2014 (ESMA/2014/549).

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Appropriate checks and balances

The mentioned examples raise the question upon the existence of proper checks and balances mechanisms needed to ensure separation of powers. In relation to delegated acts prepared by the ESAs, the decision upon specific regulatory measures is taken by the Commission who has the power to reject or amend the ESAs' technical advice. Furthermore, the EU Parliament and the Council are formally entitled to object to a delegated act adopted by the Commission within a period of usually three months. In practice, however, the technical advice submitted by the ESAs is usually endorsed by the Commission without major adaptations due to the long preparation phase at the ESAs' level and the correspondingly short timeframe for potential corrective actions by the Commission.

The situation is however much worse in relation to the supervisory guidelines which effectively determine the operating conditions in the financial markets. The guidelines rely on the "comply or explain" principle in relation to national competent authorities (NCAs), but in many instances are also addressed directly to market participants. As regards the guidelines, the ESAs' founding acts foresee neither a formal endorsement procedure involving control by other EU institutions nor other means of institutional or individual appeal. Depending on the details of implementation at national level, the guidelines may or may not be subject to review by the courts. In Germany, the prevailing view should be that an individual may only be entitled to proceed against the administrative decision taken by the NCA on the basis of the guidelines, but will never be able to initiate judicial scrutiny of the guidelines as such, e.g. as regards their potential invalidity in formal terms.

This non-existence of a proper control mechanism in relation to supervisory guidelines amounts to a clear deficiency in institutional terms as it assigns disproportionately strong regulatory powers to the ESAs despite of them lacking democratic legitimation. Thus, the ESAs' review process should be used to take remedial action in this regard for which we make suggestions in section 1 below.

Material limits of the ESAs' regulatory work

Moreover, in relation to any regulatory activity undertaken by the ESAs, it is obvious from the institutional point of view that substantial decisions concerning the EU frameworks for the financial markets must be taken by the EU institutions involved in the legislation process at Level 1. As enshrined in Article 290 (1) second paragraph of the Lisbon Treaty, the "essential elements of an area shall be reserved for the legislative act and accordingly shall not be subject of a delegation of power." Accordingly, the delegation of power must be clear, precise and detailed and should generally aim at supplementing certain non-essential elements of the legislative act[3]. In light of these strict procedural standards, it should be clear that delegated acts must not add new elements to or substantially alter the relevance of provisions endorsed in the EU Level 1 frameworks. As a matter of course, the same should apply to other regulatory work conducted by the ESAs at Level 2 or Level 3 of the Lamfalussy process.

In order to enhance legal certainty for both the ESAs and market participants affected by their regulatory actions, we recommend that the EU Regulations establishing the ESAs be supplemented by a provision setting the execution of tasks and powers by the ESAs in clear

[3] As acknowledged in the Communication from the Commission to the European Parliament and the Council on implementation of Article 290 of the Treaty on the Functioning oft he European Union from 9. December 2009 (COM(2009)673 final), section 3.

relations to the superior acts of EU law. Specifically, Article 8 could be supplemented by a new paragraph 3 which could be phrased as follows:

> ***(3) In executing the tasks set out in paragraph 1, the Authority shall observe the material limits set forth in the Community acquis.***

Specific comments in relation to the Commission's Report

In addition to our general observations made above, we consider that some aspects of the ESAs' Regulations require further analysis in light of the Commission's Report on the operation of the ESAs and the ESFS from August 2014. We would like to highlight our concerns relating to the work of ESMA as the competent ESA for fund and asset management.

1. **Control of supervisory guidelines**

The supervisory guidelines issued by the ESAs under Article 16(1) of the ESA Regulations have effectively become a new regulatory tool which can have significant impact on national laws as well as the operating conditions of the markets and their participants. This situation is not compatible with the principle of separation of powers given that the ESAs lack democratic legitimacy as regulators and that there is no right of appeal in respect of the guidelines endorsed by EU law.

Based on our experience with the ESMA work, we would like to make the following observations in relation to the guideline practice:

- In some instances, guidelines have been issued without a clear – or even without any – legal basis in EU legislation. This pertains especially to the ESMA Guidelines on ETFs and other UCITS issues[4] which deal with significant aspects of securities lending and repo transactions even though the EU primary law (the UCITS Directive) does not contain any rules for these investment techniques. Another example of such wide understanding of ESMA's competences are the ESMA Guidelines on remuneration policies and practices under MiFID[5]. These guidelines are based on the MiFID I regime which contains no reference to individual remuneration.

- The ESMA Guidelines on remuneration policies and practices under MiFID are also critical in terms of the quasi-legislative powers executed by the ESAs. The guidelines have been issued in advance of the agreement between the EU institutions on the Level 1 text of MiFID II which stipulates general principles of proper remuneration[6]. In our view, it is highly questionable for a supervisory authority to anticipate the final outcome of the legislative proceedings at Level 1 by creating a "fait accompli" in form of guidelines on the same subject matter.

- According to Article 16(1) of the ESAs Regulations, the guidelines are meant to establish consistent, efficient and effective supervisory practices in the EU. However, in some cases, the guidelines prompt significant interventions in established market practices without any

[4] Guidelines on ETFs and other UCITS issues, revised version dated 1 August 2014 (ESMA/2014/937).
[5] Guidelines on remuneration policies and practices (MiFID) from 11 June 2013 (ESMA/2013/606).
[6] Cf. Article 24(10) of Directive 2014/65/EU (MiFID II).

involvement of the EU institutions. An example of such effects are the ESMA Guidelines on ETFs and other UCITS issues which stipulate that securities or cash received through repo transactions shall be treated as collateral and not used for investment purposes or in order to collateralise other transactions. Such treatment of the repo transactions has never before been practiced or even properly discussed in the EU. The ESMA Guidelines on this issue have effectively deterred UCITS from engaging in repos. Another example of measures with vast regulatory implications are the ESMA Guidelines on sound remuneration practices under the AIFMD which extend the application of the remuneration principles beyond the "categories of AIFM staff" as foreseen by the Level 1 Directive to third party personnel providing services under delegation agreements[7]. Such extensive approach to remuneration policies is hardly feasible for globally operating fund managers who need to cooperate with local specialists outside their group structures.

- Article 16(3) of the ESAs Regulations requires national authorities to make every effort to comply with the guidelines. This requirement sets the "comply or explain" mechanism effectively out of force. There are very few instances in which national authorities have declared their non-compliance with ESMA guidelines, and according to our knowledge, none relating to standards adopted after controversial debates. In Germany, compliance with the ESMA Guidelines on ETFs and other UCITS issues has eventually required changes to the primary national law. **In our view, such factual binding effect combined with the wide understanding of the ESAs' powers as indicated above leads to a situation in which the ESAs hold quasi-legislative powers and on top are in the position to initiate regulation on any topic they deem relevant.**

- In addition, as elaborated above, guidelines issued by the ESAs are neither subject to control or endorsement by EU institution nor submitted to any right of appeal by the affected market participants or NCAs. This means that ESA guidelines, once issued, can be revised only by the decision taken by the Board of Supervisors of the relevant ESA (which has recently happened in case of the ESMA Guidelines on ETFs and other UCITS issues). This non-existence of checks and balances mechanisms is not acceptable from a governance perspective. Moreover, deprival of legal protection might have significant practical consequences for market participants who, even in instances of being direct addressees of the guidelines, are only entitled to challenge the decisions of NCAs taken in compliance with the relevant guidelines.

In its Report, the Commission has clarified that the two objectives for issuing guidelines set out in Article 16(1) of the ESAs Regulations, namely to establish "consistent, efficient and effective supervisory practices" and to ensure the "common, uniform and consistent application of Union law" have to be read cumulatively.

While appreciating this statement, we believe that a mere clarification of the ESAs' powers within the existing framework is not sufficient to deal with the shortcomings identified above. The regulatory experience so far demonstrates that there is a clear need for a formal control and review mechanism in relation to the supervisory guidelines. Such mechanism could be facilitated by either of the following:

[7] Cf. Guidelines on sound remuneration policies under the AIFMD from 3 July 2013 (ESMA/2013/232), para. 18.

- **Introduction of a right of action against supervisory guidelines issued under Article 16 of the ESAs Regulations**

  The entitlement to such right of action could be entrusted to national authorities and possibly also to individual market participants in case the latter were directly affected by the relevant guidelines. The claim should be founded upon violation of superior EU law or disregard of the ESAs' competences in relation to the guideline-setting.

- **Introduction of a complaint procedure against supervisory guidelines to be initiated by the EU Commission**

  Given its constitutional role as guardian of the Treaties, the EU Commission could also be empowered to submit complaints or otherwise take action against supervisory guidelines issued by ESAs in case of potential incompatibilities with the EU law. Market participants should be able to contact the Commission in order to report on irregularities in the ESAs' work.

- **Requirement for supervisory guidelines to be generally endorsed by the EU Commission**

  Another way of action would be to require supervisory guidelines under Article 16 to be generally endorsed by the Commission in order to qualify for practical application in accordance with the "comply or explain" principle. Such formal endorsement should also encompass a substantive right of review in terms of compliance with the relevant EU legislation.

2. Addressees of the supervisory guidelines

The ESAs' powers to issue guidelines or recommendations addressed to financial market participants under Article 16 of the ESAs Regulations should be confined to areas of direct EU supervision.

The ESAs' supervisory guidelines progressively include NCAs and financial market participants among their addressees. As regards the regulatory work of ESMA, this practice can be observed in the Guidelines on ETFs and other UCITS issues, on key concepts of the AIFMD[8], on sound remuneration policies under the AIFMD and on remuneration policies and practices (MiFID). Such two-pronged application creates significant confusion among UCITS and AIF managers as well as other affected market participants submitted to the supervision by NCAs at national level. For example, it is unrealistic to assume that market participants can be bound to follow the relevant ESA guidelines if the competent NCA does not take any action to transpose them into supervisory practice or if it declares its full or partial non-compliance with the guidelines. Non-compliance with certain standards set out by the guidelines is often due to conflicting national legislation. In such cases, it cannot be expected from market participants to observe the ESA guidelines if legal acts determining the conditions of their operations require them to do otherwise. Furthermore, the ESAs have no means to enforce market participants' compliance with the guidelines without collaboration with the competent NCA. In the instances specified above, market participants subjected to the guidelines are explicitly exempted from the requirement to submit a "comply or explain" statement to the relevant ESA.

[8] Guidelines on key concepts of the AIFMD from 13. August 2013 (ESMA/2013/611).

On balance, we do not conceive situations in which combined application of the supervisory guidelines to NCAs and market participants creates added value in any regard. Hence, the possibility to issue guidelines directed to financial market participants should be relevant only in relation to institutions subject to the direct supervision by the relevant ESA. Such interpretation is already implied by the wording of Article 16(1) of the ESAs Regulations which refers to national authorities or financial market participants as potential addressees of guidelines and recommendations. For the avoidance of doubt, we suggest providing additional clarification by complementing recital 26 of the ESAs Regulations by a new third sentence which could read as follows:

"In areas subject to the Authority's direct supervision, the Authority should be also entitled to issue guidelines or recommendations addressed to financial market participants."

3. Financing of the ESAs

Abolishment of EU and national contributions to the ESA's budgets is not the right way forward in terms of either political accountability or sound and sustainable financing of the ESAs' task.

The ESAs are established as independent authorities committed solely to the interest of the Union. However, in view of the key relevance of the ESAs' work for the EU regulatory agenda and the extensive powers of the ESAs to intervene into the EU market practice we believe it very important that the ESAs remain accountable in political terms to the EU institutions. EU contributions to the financing of the ESAs are an important factor in promoting such accountability.

Direct supervisory tasks executed by the ESAs are still very limited. Therefore, the potential to increase the level of funding from fees and levies to be charged from the supervised entities is rather small. Moreover, covering the financial needs of the ESAs solely from this source is not commensurate, given that a great deal of work at the ESAs is committed to regulatory work with much wider effects on the EU markets and their participants.

4. Composition of stakeholder groups

While recognising the need for a balanced composition of the ESAs' stakeholder groups, we caution against reducing the representation of market participants subject to the ESAs' regulation and supervision.

In many areas, the ESAs' regulatory work has reached the level of technical details which requires continuing involvement of experts, especially practitioners. It is very difficult to change the essential concept of a regulatory approach once it has been agreed by the ESAs as an official draft for public consultation. The stakeholder groups facilitate a regular exchange of views on the pending initiatives and are thus important corrective factors contributing to practicability of the ESAs' regulatory actions. We deem it essential that the stakeholder groups include representatives from every financial sector affected by the regulation or supervision of the relevant ESA.