

RESPONSE FROM SCOTTISH FINANCIAL ENTERPRISE TO THE DAVIDSON REVIEW OF THE IMPLEMENTATION OF EU LEGISLATION (MAY 2006)

Scotland has a distinguished history in financial services that dates back over 300 years. It is now one of Europe's leading financial centres and the second largest financial hub in the UK next to London. The international financial services industry based in Scotland has a long-held reputation for innovation and excellence, and provides financial products and services to businesses, private and public organisations and individuals across the world.

The financial services industry is of major importance to the Scottish economy. In the last five years (2000 to 2005) financial services in Scotland grew by 36% while the overall Scottish economy grew by 9% and the whole of the UK financial services industry grew by 15% in the same period. The financial services industry accounts for one in 10 Scottish jobs, with over 113,000 people directly employed in the industry and over 100,000 more employed in support services.

Scottish Financial Enterprise (SFE) is the independent organisation, formed in 1986, that supports and represents the interests of Scotland's financial services industry. Our members encompass all sectors of the industry including banks and building societies, general insurance, life assurance and pensions, investment managers, asset servicing, corporate finance and broking services, professional advisors and support services.

The competitiveness of Scotland as a business base for financial services companies - and thus Scotland's ability to attract and retain the financial services investment that is so vital to the Scottish and UK economies - is affected significantly by the policies determined at Scottish, UK and EU levels. While devolved powers affect key issues such as the quality of the workforce and transport and communications infrastructure available to the industry, the regulation of financial services is a reserved matter for Westminster. However, some of the most consequential regulation in the UK originates from European Directives for financial services. These measures are adopted into UK law (largely through secondary legislation and more rarely through primary legislation), incorporated into the FSA handbook or implemented through guidance notes (by government departments or the regulator).

There is a great deal of logic in this arrangement. Issues like education and regional infrastructure are often intrinsically local. In contrast, standards for UCITS and capital adequacy are issues where individuals, firms and Member States within the EU have a collective interest in achieving a parity that transcends national borders.

SFE and its member companies maintain regular contact with policymakers, standards bodies and regulators at both an EU and UK level. In Scotland we have established a pioneering approach that brings government, the industry and the trade unions together in partnership to deliver the Strategy for the Financial Services Industry in Scotland. This successful initiative aims to ensure that Scotland continues to flourish as an international financial services centre and provide a world-class environment for the industry.

SFE has consulted with its member companies about both the stock and flow of implementing EU measures and legislation, and is pleased to respond to this Review.

1./2. General/Examples of over-implementation

SFE believes that the over-implementation of EU legislation is a vital concern for the UK. The global nature of financial services and capital markets and the mobile nature of the financial services industry mean that Scotland and the UK could lose current and potential industry investment to competing financial centres if the UK regulatory regime is not

favourable. Given the importance of financial services investment to the Scottish and UK economies, government and regulators must be constantly vigilant on this issue.

We believe that progress has been made in recent years to address the problems of excess with regard to the implementation of EU legislation. Scottish and UK governments, as well as regulators, are recognising that burdensome, unnecessary or poorly interpreted legislation and regulation drives business away from the economy instead of attracting investment and jobs to it. However this does not mean that gold-plating and over-enforcement of EU Directives do not occur.

Over-implementation can happen at each stage in the process. The starting point for Directives should be to use 'copy-out' as a first resort unless there is compelling evidence to suggest otherwise (e.g. the language is too ambiguous or there is a specific need for elaboration). In 2004's Pre-Budget Statement, the government made a commitment to this approach, however it remains largely unclear whether copy-out is always the starting point. In cases when it is not adopted, there should be a thorough consultation on the 'elaboration', including a cost-benefit analysis, impact analysis and input from stakeholders (detailed and specific where necessary).

Some of our members believe that the approach of the UK in implementing European regulation is to use the safest interpretation so as not to run even a remote risk of falling foul of the European Commission. However, indications are that there is some progress in this regard. SFE understands from recent discussions with civil servants that confidence is growing within certain government departments to interpret European legislation more liberally and in a way that is advantageous to businesses. We welcome this.

MiFID

SFE believes that the list of phenomena described by the Davidson Review is comprehensive. However, SFE members have highlighted how, in certain instances, problems can emerge with process. An ongoing (flow) example of this is the Markets in Financial Instruments Directive (MiFID). Because of ongoing disagreement and political negotiations at EU level, the timescale for implementation has slipped which has made the process of implementation very untidy.

One international fund manager, operating in 14 jurisdictions within Europe (11 of which are members of the European Union) has found particular difficulty with the process and timings for the transposition of MiFID. The implementing measures have been published but, as of the closing date of this submission, final language and details have yet to be agreed.

Despite this, national regulators are pushing ahead with transposition and implementation at Member State level. HM Treasury published its consultation document on changes to primary legislation on 15 December 2005, closing on 31 March 2006. This meant that the consultation on the changes to primary legislation was due before firms knew the details of implementation. While it is not essential that firms have sight of the final implementing measures before action is taken on the primary legislation, it would have been helpful. There were only 39 business days after the draft European-level implementing measures were published for firms to respond to the proposed changes to primary legislation. Furthermore, HM Treasury has indicated that no further formal consultation will take place. Also notable is that nearly two months after the UK-level consultation has closed, there still no agreed and final text from the policymakers in Brussels as to how the FSA should implement this legislation.

It is understandable that the FSA and Treasury have different roles in this process. The Treasury's is to negotiate and change domestic statute so as to ensure compliance for the UK's regime with MiFID, while the FSA's is to implement these changes, largely through modifying its Conduct of Business rules. The Commission's decision to extend the deadlines for Member State legislation and the effective dates to 31 January 2007 and 1 November 2007, respectively, was welcome. Additionally, firms and trade bodies that have been actively engaged have benefited from sharing information about ongoing developments through contact with civil servants and FSA officials. The close collaboration between the FSA and HM Treasury and the first-hand knowledge of the likely outcomes of deliberations is well-represented in the consultation document from the Treasury. However, it was not well reflected in the consultation timings which could have allowed firms to better understand the directions from a European level that the FSA would be following in implementing the changes to the primary legislation before consulting on those changes.

The process and timings have led to a significant and material amount of uncertainty in firms about the statutory and regulatory framework from 1 November 2007. Only recently has the FSA published its Discussion Paper on best execution requirements - one of the most significant changes to the regulatory regime enshrined in MiFID. Other details of how MiFID will be implemented are not due out until later in the year.

In some financial services firms this has led to a planning blight and confusion about what operational steps will be needed until the implementing measures are finally adopted.

In essence, because the UK government's consultation has been undertaken despite the lack of clarification on final implementation detail from Brussels, it has made it very difficult for firms to respond effectively. This process of transposition and implementation without final approval of the rules and regulations at a European level needs to be reviewed. While the UK Government cannot be held responsible for the lack of finality on the implementing measures, the decision to forge ahead with the consultation in such a nebulous situation has not been particularly helpful to firms.

Generally our member companies want the UK to meet the deadlines of the European Commission. However to do so on such a rushed timescale, when such an important and foundational piece of legislation is being considered, seems short-sighted and overly rigid. If more time and certainty are needed for firms to respond adequately to the consultation and adapt their strategies and systems, we believe it should be granted.

We are aware that some other organisations with which we work are making detailed representations to the Review about several issues specifically relating to their particular sectors of the financial services industry. We will not expand on those points here, however we wish to confirm the concerns of our members about the implementation of:

- Capital Requirements Directive
- Distance Marketing Directive
- Insurance Mediation Directive
- Life Assurance Directive
- Market Abuse Directive
- Prospectus Directive
- Third Non-Insurance Life Directive

There is scope for a full review of the implementation of all of these Directives. It would be most helpful if the review could be conducted in the context of 'copy out', although it should be noted that major changes may not actually be desired by the industry (even if it means less regulation and compliance obligations), because of the cost to companies of changing the regime.

3. Simplification

SFE's member companies would like to have more collaboration and dialogue between government, regulators and the industry at UK and EU level. This will be mutually beneficial to all parties involved and will likely lead to better regulatory outcomes. In the UK, firms, regulators and government departments spend a tremendous amount of resources on the development and implementation of regulation. With more up-front dialogue and communication, this process could be streamlined and each stakeholder's views could be better understood from the outset, through the consultation and refinement process and at implementation.

4. International comparison

One of our member companies (an investment manager that operates in multiple domiciles) has advised us that, because of the compliance requirements of the Prospectus Directive in the UK, it was cheaper to domicile their fund in Luxembourg and sell it in to the UK than to have the fund domiciled and sold here. Another large investment manager indicated that because of the requirements for listing in the UK and the associated expense, their 'natural choice' was to domicile their fund in Dublin but control it from Edinburgh. SFE would be pleased to facilitate further communication of specifics if the Review team would find that useful.

5. Other information

Origin of policy development

Members have raised various issues about the origin and implementation of policy. While we are aware that the scope of the Review does not extend to policy formulation, some consideration of this is necessary to understand the qualms that some financial services companies have with implementation. For some firms, involvement and contribution of necessary technical expertise from the outset can be challenging and resource-intensive, particularly when this requires engagement at EU level and across several Member States.

The relationship between the FSA and Europe

The relationship between the FSA and Europe is an issue that some firms have raised. Because the FSA is recognised across Europe as a highly sophisticated regulator, there is a tendency for it to have a disproportionate influence on policy relative to the UK's size or even the size of the financial market here. However, European legislation and regulation is inevitably a compromise position of Member States' views. These two facts mean that many of the issues covered by the new measures emanating from Europe are either redundant to those already in place in the UK or are exceeded by the UK's regulatory regime. However, this does not mean that the FSA's task is straight forward. Complications can inevitably arise from having such a high starting point. In some instances, having a stricter regime benefits the UK while in others it places the UK at a competitive disadvantage. Compare this with new Member States which may have nascent or nearly non-existent regimes (in some cases because of the historical lack of need for capital markets). It can be argued that theirs is, comparatively, an easier task as they are not saddled with the burden (which SFE Members recognise is not insignificant) of superimposing EU legislation and regulation on the top of an existing domestic regime.

Further comment

Scottish Financial Enterprise would be very pleased to provide further comment on any of the issues we raise in this response and to facilitate engagement with our member companies. Please contact:

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