Haut Comité Juridique
de la Place financière de Paris

LEGAL OPINION

on an issue raised by the implementation of the proportionality principle within the EU

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The "Haut Comité Juridique de la Place Financière de Paris (HCJP)" - Legal High Advisory Committee for Financial Markets of Paris* - has adressed an issue raised by the implementation of the proportionality principle within the EU.

The background to this issue is the following:

Article 14a, paragraph 4 of Directive 2009/65 (hereafter, "the UCITS Directive") provides that ESMA is to issue guidelines addressed to competent authorities or to financial market participants concerning the application of remuneration principles. Moreover, the UCITS Directive provides that when issuing these guidelines, ESMA must cooperate closely with the European Banking Authority (hereafter, "the EBA"), "in order to ensure consistency with requirements developed for other financial services sectors, in particular credit institutions and investment firms". Similar provisions regarding remuneration policies are indeed contained in Directive 2013/36/UE (hereafter, "the CRD IV Directive"), and previously, Directive 2010/76/UE amending CRD III.

Pursuant to Article 75 of the CRD IV Directive, the EBA is entrusted with the task of issuing guidelines on sound remuneration policies which comply with the principles set out in Articles 92 to 95. The EBA's predecessor, the Committee of European Banking Supervisors (hereafter, "the CEBS") had adopted in December 2010 Remuneration Guidelines which referred to the possible "neutralisation" or "disapplication" of certain remuneration principles.

In a recent EBA consultation document issued in view of the adoption of these guidelines, the EBA, referring to a letter from the European Commission, suggests changing the interpretation in force since 2010. This Commission letter, issued by DG Justice & Consumers, states that the proportionality principle, which the UCITS Directive refers to in its Article 14b, can in no way justify the non-application of one or the other rule contained in Articles 92 or 94 of CRD IV, and underlines the fact that Member States and national authorities must comply with this principle when they use the margin of discretion entrusted to them according to these principles.

The Legal High Advisory Committee for Financial Markets of Paris has examined this issue, which consists in determining what the proper interpretation of the proportionality principle is, notably regarding the remuneration-related provisions of the CRD and UCITS Directives.

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1- The HCJP first observed that the proportionality principle holds a special place in European Union law, since it is embedded in the EU Treaties.

Pursuant to Article 5, paragraph 4, of the Treaty on European Union: "Under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties."

The substance of this principle with regard to legislative matters is further clarified by Protocol (No 2) on the application of the principles of subsidiarity and proportionality; Article 5 thus provides: "Draft legislative acts shall take account of the need for any burden, whether financial or administrative, falling upon the Union, national governments, regional or local authorities, economic operators and citizens, to be minimised and commensurate with the objective to be achieved."

According to settled case law of the European Court of Justice, the proportionality principle is one of the general principles of Community law. This principle requires that measures adopted by Community institutions do not exceed the limits of what is appropriate and necessary in order to attain the objectives legitimately pursued by the legislation in question.

The proportionality principle therefore implies a two-prong test which highlights the underlying logic of the principle:

• The first prong requires that the means used must be adequate in relation to the objective pursued; this adequacy is not, by nature, a "one way" test;

• The second prong amounts to answering the following question: "is it possible to obtain the same result by less restrictive rules?"

In that perspective, the concept of proportionality cannot be understood as functioning only in "one way", contrary to what the letter of DG Justice & Consumers seems to imply. The interpretation given in this letter, according to which proportionality may only result in the worsening of the requirements imposed by the law, not only is new, but it is incompatible with the letter and the spirit of this principle, as embedded in the Treaty.

2- The HCJP then observed that the proportionality principle is contained in the relevant legislative texts applicable to the banking sector (CRD III first, then CRD IV) and the asset management sector (the UCITS Directive, as well as the AIFM Directive).

In each of these legislative texts, the wording chosen by the legislator when referring to the proportionality principle is almost identical:

• Article 14b of UCITS Directive: " (...) management companies shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities";

• Article 92 of CRD IV Directive: " (...)institutions comply with the following principles in a manner and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities"

• Annex II of the AIFM Directive: "(...)AIFMs shall comply with the following principles in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities".

The wording of these provisions is very clear: it is foreseen that the entities concerned comply with i) the remuneration principles, but ii) "in a way and to the extent" that is appropriate. An expression similar to the one used in CRD IV and UCITS V ("and to the extent") was precisely examined by the Tribunal of the European Union in the Swiss Confederation case (T-319/05). On the basis of one of the provisions at stake, the Tribunal concluded that the expression "to the extent that they concern" delimited the scope of the provisions, from which it followed that it excluded certain situations from the application of the provisions in question*. This precedent confirms that the expression "to the extent" must be interpreted as implying a possible exclusion, limiting the application of these provisions to certain situations (this is also confirmed by other provisions of the CRD IV directive; cf. infra).

The wording used to phrase the proportionality principle in Article 92 CRD IV clearly means that not all the remuneration principles foreseen under Articles 92 and 94 are meant to be applied systematically and in the same manner to all entities.

Such an interpretation is reinforced by the second part of Recital 66 of CRD IV, according to which:

"The provisions of this Directive on remuneration should reflect differences between different types of institutions in a proportionate manner, taking into account their size, internal organisation and the nature, scope and complexity of their activities. In particular it would not be proportionate to require certain types of investment firms to comply with all of those principles."

This Recital is an additional example of the scope of the proportionality principle as drafted by the legislator in this case; it encompasses the possibility of not applying all these remuneration principles, and thus to neutralise some of them.

** In its judgment of 9 September 2010 in case T-319/05, Swiss Confederation v. Commission, the Tribunal was hearing a request for annulment of the Swiss Confederation of a Commission decision authorising a decision from German authorities. The latter established a number of limitations (for instance, laying down minimum altitude requirements) for flights in the German airspace which flights had to go through when approaching Zurich airport. Before the Tribunal, the Swiss Confederation attempted to make an argument based on Article 2 of the Agreement between the European Community and the Swiss Confederation on Air Transport, approved on behalf of the Community by Decision 2002/309/EC of 4 April 2002. The relevant article from the Agreement provided that: «The provisions of this Agreement and its Annex shall apply to the extent that they concern air transport or matters directly related to air transport as mentioned in the Annex to this Agreement.» The Tribunal analysed the wording of this provision, in particular the meaning of the expression «to the extent». The Tribunal's conclusion was the following: «As is clear from its wording and, more particularly, from the expression 'to the extent that they concern' used therein, Article 2 of the Agreement delimits the scope of the provisions set out in the annex to the Agreement by excluding the application of those provisions to cases which do not concern air transport or matters directly related to air transport. It follows that neither the purpose nor effect of that article is to extend the application of the provisions in question to situations which do not come within their scope.»*

The origin of the provisions governing remuneration confirms this interpretation of the proportionality principle. Indeed, both the initial proposal of the European Commission in 2009 and the changes introduced in the text by the European co-legislator testify that the intention was to not apply all these principles to the entities concerned by these provisions:

• The Commission proposal states in its Explanatory Memorandum that the objective of the amendment of the CRD package (Directives 2006/48 and 2006/49) was to impose oblige credit institutions and investment firms to have remuneration policies that would be consistent with effective risk management. But the proposal also mentioned the fact that this new obligation was "accompanied by high level principles on sound remuneration". These provisions thus establish a general framework which must be adapted and implemented in a proportionate and flexible manner, including the possibility of neutralising a principle if such a principle is disproportionate in view of the characteristics of the entity concerned.

In that respect, it would be mistaken to see in the "neutralisation" a general exemption from the principles governing remuneration. Rather, the remuneration provisions allow for a proportionate application of these principles, with a wide range of different cases, which may go as far as excluding one or the other principle to the extent that it would not be adapted to the size, nature, scope, complexity, organisation of the entity. In any event, where the conditions established by the legislator are met, such a neutralisation should be allowed, in accordance with the case law of the European Court of Justice.

This additional information regarding the nature of these (high level) principles is all the more important since from the start, the remuneration provisions included precise, quantitative references (see for instance the principle under Point 23, paragraph (p)) of CRD III, according to which "a substantial portion, and in any event at least 40 %, of the variable remuneration component is deferred over a period which is not less than three to 5 years").

• Moreover, the relevant annex in the Commission proposal initially stated that "credit institutions shall comply with the following principles in a way that is appropriate to their size, internal organisation and the nature, the scope and the complexity of their activities". The expression "and to the extent" was not part of the Commission proposal.

But the legislative debate resulted in several changes: on the one hand, the expression "and to the extent" was added; on the other hand, a recital was inserted, which clarified the scope and meaning of the proportionality principle.

Indeed, Recital 4 of Directive 2010/76 provides that "The principles should recognise that credit institutions and investment firms may apply the provisions in different ways according to their size, internal organisation and the nature, scope and complexity of their activities and, in particular, that it may not be proportionate for investment firms referred to in Article 20(2) and (3) of Directive 2006/49/EC to comply with all of the principles."

In the light of all these factors, it becomes abundantly clear that the legislator will was not to impose the systematic implementation, without any nuances, of a series of specific, binding requirements to all entities indiscriminately, but rather to establish a general framework, the application of which is meant to be adapted to different situations depending on criteria (size, complexity…) listed in the Directive.

It therefore follows that, in full compliance with European legislation, the 2010 CEBS Guidelines (which are still in force) explicitly referred to the possibility of neutralising certain of the remuneration principles on the basis of proportionality.

It must be underlined that there was no change to the wording of the proportionality principle from CRD III to CRD IV. Since the legal text has not changed, the same interpretation of the proportionality principle should also prevail today.

3- The HCJP also observed that this interpretation of the proportionality principle, and its implementation, allowing the neutralisation of certain principles, have been confirmed and maintained as such by various institutions, i.e. the Commission as well as European supervisory authorities and national regulators.

In fact, the CEBS interpretation was confirmed and reiterated by the EBA, notably during a workshop on proportionality held in October 2013 (i.e. after the adoption and publication of CRD IV). The EBA underlined then the importance of proportionality and of the neutralisation of certain principles.

This interpretation has been implemented by national regulators and in some cases, has also been transposed into national law (for instance in Germany).

In addition, this interpretation and its implementation have never been challenged: the European Court of Justice did not receive any request challenging neutralisation. No infringement procedure was launched by the European Commission against Member States on the grounds either that their national legislation did not correctly transpose the proportionality principle, or that their national regulator did not correctly implement proportionality.

Moreover, if the European legislator had wished to change this neutralisation approach, of which it was perfectly aware, the text of CRD IV could and should have been amended. However, such has not been the case: the legislator decided to add new principles to the list first established in CRD III, but it maintained the wording it had modified in favour of proportionality (by adding “to the extent”) when it adopted the amendment to CRD III regarding remuneration (Directive 2010/76).

Neutralisation has thus only been called into question by a letter of the Commission services sent to the EBA, signed by an Acting Director General. Therefore, this is at best a “staff document” which does not bind the European Commission as an institution. Indeed, only formal acts or decisions adopted by the college of commissioners are deemed to engage the institution as such.

Furthermore, this letter of the Commission services relies on an analysis which does not take into account any precedent, or the context in which the text was adopted, or the process which eventually resulted in the wording of the text as it stands today. This letter of the services does not quote any recital or even any case-law.

Regarding any counter-arguments referring to the outcome of the United Kingdom legal challenge against the bonus cap on variable remuneration are not relevant in this debate, first because the Court did not actually address this issue, and second and foremost, because the issue raised was that of la proportionality in relation to the legislator's decision to include such a provision in European legislation, not that of determining whether proportionality as phrased in the CRD IV Directive could allow neutralisation of remuneration principles in certain cases on the basis of criteria listed in the Directive.

4- The HCJP also examined the question of proportionality in the context of the UCITS Directive and of the AIFM Directive.

It must first be recalled that the wording of UCITS regarding the proportionality principle is identical to CRD IV. This constitutes evidence showing that the same neutralisation approach can and must, in principle, apply in the context of the UCITS Directive.

In addition, the UCITS Directive contains a recital slightly different from the one contained in CRD IV, but which once again confirms that all the remuneration principles are not intended to apply to all entities.

Recital 3 of UCITS V states indeed that: "Provided that management companies of UCITS and investment companies apply all the principles governing remuneration policies, they should be able to apply those policies in different ways according to their size, the size of the UCITS that they manage, their internal organisation, and the nature, scope and complexity of their activities." This Recital does confirm that a contrario there may be cases in which a management company does not apply all the principles governing remuneration policies.

This possibility was confirmed and validated for managers of alternative investment funds, in the Guidelines on sound remuneration policies under the AIFMD. These Guidelines recall clearly the principle laid down in European legislation, according to which: "Not all AIFMs should have to give substance to the remuneration requirements in the same way and to the same extent. Proportionality should operate both ways: some AIFMs will need to apply more sophisticated policies or practices in fulfilling the requirements; other AIFMs can meet the requirements of the AIFMD in a simpler or less burdensome way."

On the basis of this interpretation, since the entry into force of the new legislative framework (July 2013), national regulators have implemented the AIFM Directive. They have granted authorisations to fund managers, taking into account the proportionality principle when doing so.

Last, it must be recalled that this interpretation of the proportionality principle is all the more appropriate for the asset management sector, since it enables the specific characteristics of this industry to be taken into account. Given the fact that fund managers do not pose the same systemic risk as CRD-regulated institutions and that fund managers are agents for their clients, it is all the more vital to adopt a proportionate approach in the context of the UCITS Directive and the AIFM Directive.

5- The HCJP has also identified other instances in European law of total "neutralisation" at Level 2 and 3 (Commission/European Supervisory Authorities /National Regulators), of a Level 1 rule (Directive/Regulation), on the basis of the proportionality principle.

Within the framework of the Single Resolution Mechanism (hereafter, "the SRM") established by Regulation 806/2014 (hereafter, "the SRM Regulation"), credit institutions are required to contribute to a single resolution fund according to the following mechanism:

"Each year the calculation of the contributions for individual institutions shall be based on:

a) a flat contribution, that is pro-rata based on the amount of an institution's liabilities excluding own funds and covered deposits, with respect to the total liabilities, excluding own funds and covered deposits, of all of the institutions authorised in the territories of the participating Member States; and

b) a risk-adjusted contribution, that shall be based on the criteria laid down in Article 103(7) of Directive 2014/59/EU, taking into account the principle of proportionality, without creating distortions between banking sector structures of the Member States."

The SRM Regulation provides also that the methodology for the calculation of these individual contributions is to be further determined in (Level 2) implementing acts. On the basis of that mandate, the Council adopted an implementing regulation, which was published in the EU Official Journal on 22 January 2015.

This implementing regulation explicitly recalls that point (b) of Article 70(2) of Regulation (EU) No 806/2014 requires the Single Resolution Board "to take account of the principle of proportionality, without creating distortions between banking sector structures of the Member States when applying the risk-adjusted contribution to the calculation of the individual contributions."

Under Article 8 of this implementing regulation, it is foreseen that certain credit institutions (whose total assets are equal to, or less than, EUR 3 000 000 000) pay a lump-sum of EUR 50 000 for the first EUR 300 000 000 of total liabilities, less own funds and covered deposits. For the total liabilities less own funds and covered deposits above EUR 300 000 000, those institutions are to contribute in accordance with Articles 4 to 9 of Delegated Regulation (EU) 2015/63.

In fact, this provision amounts to "neutralising" entirely the risk-adjusted contribution (in spite of the fact that such a contribution is foreseen in Level 1, subject to proportionality) and to only retain a flat contribution for certain small credit institutions. In the name of proportionality, the implementing regulation thus "neutralises" a provision expressly provided for by the legislation, which clearly sets out that there are two cumulative components (one based on total assets, the other based on the risk profile) for the calculation of the contribution to the SRM.

This is another illustration of the fact that the proportionality principle cannot be interpreted as a "one way" principle. This principle must be interpreted and applied in light of its context and the will expressed by the legislator.

6- Lastly, the HCJP notes that a change of interpretation would give rise to particularly serious consequences.

Generally, the principles of legal certainty and of the protection of legitimate expectations, recognised by the case law of the European Court of Justice, would act as a barrier to a significant change to the current interpretation of the proportionality principle. In fact, this interpretation, as applied to remuneration, first for credit institutions, then for other financial services, is a direct result of the 2010 CEBS Guidelines, then of the ESMA Guidelines on sound remuneration policies under the AIFMD (2013) and of the decisional practice of European authorities (ESAs and Commission), which at no point in time have expressed any reservations, or started infringement proceedings or injunction to put an end to neutralisation.

National authorities have adopted their own rules, awarded authorisation (under CRD, UCITS, AIFMD), in good faith and knowingly, in compliance with the proportionality principle, including regarding neutralisation. Economic operators have filed their applications, structured their activities, brought into line their remuneration policies and practices, in good faith and knowingly, pursuant to the authorisations granted and the consistent practice of national authorities and EU institutions.

The fact that this text and its interpretation have been there for a long time (5 years), the stability of the relevant text (from CRD III to CRD IV, and from CRD to UCITS/AIFMD), the consistency of interpretations and of the Guidelines (from CEBS to ESMA), the preciseness of the texts and the decisions, and the specific and concordant assurances emanating from sources as reliable as the national and European regulators (which are in charge of delivering authorisations) have created legitimate expectations among both national authorities, and the managers and operators concerned.

As a consequence, the violation of these expectations, by an unjustified modification which is poorly motivated, would infringe the principles of legal certainty and of legitimate expectations, as recognised in the case law. In accordance with EU law, such an infringement may engage the responsibility of the EU and of the institutions concerned (Commission, EBA, ESMA).

7- In conclusion, the Legal High Advisory Committee for Financial Markets of Paris considers therefore that the scope and substance of the proportionality principle is not "one-way" only and allows the neutralisation of one or the other of the principles governing remuneration principles, on one of the grounds foreseen in the wording of the proportionality principle.

This principle was translated in the legislation applicable to financial services in a specific manner, which confirms that proportionality work both ways.

Such an interpretation is clearly confirmed and reinforced by the context, the objectives pursued and the expressed will of the legislator, notably for banking rules, but also for the legislation relating to UCITS.

The fact that there has not been any form of challenge of this interpretation since 2010, as well as the fact that there has been no modification by the EU co-legislator of the wording of the proportionality principle, confirm yet again that the CEBS approach consisting in allowing neutralisation is the only and the correct legal translation of the proportionality principle as embedded in the European legislation.

All the above demonstrates that the new interpretation put forward by the letter sent to the EBA is wrong as a matter of law. Moreover, such an interpretation would be particularly inappropriate in the context of proportionality applied to the asset management sector, and highly detrimental since it would significantly undermine legal certainty and the legitimate expectations on which fund managers are relying.

As a consequence, the interpretation suggested by the EBA in its latest consultation paper cannot, from a legal point of view, call into question the legislative text; it therefore appears to be unnecessary to introduce any change either in CRD IV or in UCITS. ESMA Guidelines on sound remuneration policies under UCITS should reflect the Level 1 text and be in line with the approach of the Guidelines on remuneration under the AIFMD.

Lastly, in any case, if the change of interpretation suggested by the EBA was nevertheless adopted, there is no requirement that this change should also automatically be applied to the asset management sector, where the impact of the proportionality principle is even more important in light of the characteristics of this sector, since the operators of this sector do not have the same systemic dimension compared with credit institutions. The text of UCITS V is also very clear in that respect: ESMA has a duty to cooperate with the EBA, but it is not bound by the Guidelines EBA may adopt.

The Chairman, Michel PRADA