HERBERT SMITH FREEHILLS

Response to EBA Consultation Paper EBA/CP/2015/03 (the "Consultation Paper")

We are a full-service international law firm co-headquartered in London. We set out below comments in response to the above Consultation Paper regarding draft guidelines on sound remuneration policies.

Part of our Remuneration and Incentives team's core practice focuses on the regulatory requirements concerning financial services remuneration, and we advise a wide range of financial services firms on this topic.

We have set out below responses to two questions asked in the Consultation Paper, in respect of proportionality and long-term incentive plans. As a general comment, however, in our view it is important to appreciate that the Capital Requirements Directive ("**CRDIV**"), and therefore the remuneration principles, apply to wide range of investment firms which are not part of a banking group, including stand-alone investment firms (which are regulated only on a solo basis) and investment firm groups (where the consolidation group includes investment firms but no credit institution), as well as solo-regulated investment firms which are subsidiaries of non-financial service parent companies. It is, therefore, important that the final EBA guidelines are able to be applied to investment firms in all of these categories, and are not prepared solely with credit institutions and subsidiaries of credit institutions in mind.

1. PROPORTIONALITY AND "NEUTRALISATION" (QUESTION 5 OF THE CONSULTATION PAPER)

Question 5 invites respondents to "*provide their comments on the chapter on proportionality, with particular reference to the change of approach on "neutralisations" that was required following the interpretation of the wording of the CRD.*"

1.1 Introduction

Article 92(2) of CRDIV states that competent authorities shall ensure that institutions comply with the "*following principles* (i.e. the remuneration 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*". This is the "proportionality principle".

We acknowledge that there are different possible interpretations of Article 92(2), which we discuss below at 1.2. For the reasons we set out below, in our view, the intention behind Article 92(2) was to permit the partial application of the remuneration principles, so that in some cases (where it is appropriate) an institution would be permitted to comply with some but not all of the remuneration principles. This has, unfortunately, been termed "neutralisation", which has, in our view, lead to a misunderstanding of the way in which Article 92(2) applies.

The operative provisions of CRDIV must be read in conjunction with the recitals because, as set out below, in our view, if asked to rule on this issue the Court of Justice would need to have regard to the recitals in interpreting the operative provisions. Recital 66 to CRDIV expressly addresses the interpretation of the proportionality principle, and in considering the interpretation of Article 92(2), it is therefore imperative that proper regard is had to Recital 66. This is discussed in detail at 1.3 below. Whilst we have considered below the European Commission's letter to the EBA dated 23 February 2015 on this issue, no reference to Recital 66 is made in that letter, and we would suggest that the EBA requests that the European Commission address this point specifically.

The Consultation Paper also includes certain statements in respect of the proportionality principle which we address at 1.4 below. In particular, the Consultation Paper suggests that an express waiver would be required in order for "neutralisation" to be permissible and that the proportionality principle applies to only some of the remuneration principles. In our view, neither of these statements is supported by the text of CRDIV.

1.2 **Interpretation of Article 92(2)**

1.2.1 **The remuneration principles (collectively) have to be applied to the extent appropriate**

In our view, the intention behind the drafting of Article 92(2) is that the phrase "*to the extent appropriate*" relates to the remuneration principles collectively, and not to each remuneration principle separately. This means that Article 92(2) requires institutions to comply with the remuneration principles (collectively) to the extent that is appropriate, so that (where it is appropriate) an institution may be required to apply some of the remuneration principles but not others.

Article 92(2) does not state that institutions must comply with each of the remuneration principles to the extent that is appropriate, and it is therefore not the case that Article 92(2) requires every remuneration principle to be applied to some extent.

As further discussed below at 1.3, the interpretation of Article 92(2) that the remuneration principles (collectively) have to be applied to the extent appropriate (so that, where appropriate, an institution may apply some, but not all, of the individual remuneration principles) is expressly supported by Recital 66, which states that "*In particular it would not be proportionate to require certain types of investment firms to comply with all of* [the remuneration] *principles."*

Further, we consider that, this interpretation was the basis for the Committee of European Banking Supervisors' ("**CEBS**") interpretation of the equivalent wording in the previous Capital Requirements Directive ("**CRDIII**"). CEBS stated that: "*The effect of the proportionality principle is that not all institutions have to give substance to the remuneration requirements in the same way and to the same extent*". The CEBS guidelines also referred to the "*proportionate implementation of the remuneration principles*". The CEBS guidelines therefore recognised that the remuneration principles (collectively) need to be applied to the extent that is appropriate and this means that in some cases a firm may apply some, but not all, of the individual remuneration principles. In our view, this was, and remains, the correct interpretation of the operative provision that is now Article 92(2) (noting that the operative provision was not amended substantively when CRDIV was introduced and, further, the wording in what is now Recital 66 was in fact strengthened, as discussed below at 1.3.3).

1.2.2 **Alternative interpretations of Article 92(2)**

In the Consultation Paper, the EBA has come to a different preliminary interpretation of Article 92(2), and instead interprets Article 92(2) as if it stated that institutions must comply with each of the remuneration principles to the extent that is appropriate. As set out above, this does not seem to reflect the intention behind the drafting of Article 92(2).

As an example, on page 12 of the Consultation Paper, the EBA states that: " … *the application of the proportionality principle needs to be interpreted in a way that, of the possible manners and degrees to apply the corresponding remuneration principle, the most appropriate …should be applied. However, the principle itself cannot be disapplied*". A similar analysis is relied on in the European Commission's letter to the EBA dated 23 February 2015. This analysis does not seem to reflect the intention behind the drafting of Article 92(2), which in our view does not require that each remuneration principle (singular) be applied to the extent appropriate, but instead that the remuneration principles (i.e. collectively) be applied to the extent appropriate.

For completeness, even if the words "each of" had been included in Article 92(2) by the legislators, in our view the phrase "to the extent appropriate" could still be capable of two meanings: it could mean (as the EBA contends) that each principle must be applied to some extent, or it could mean that institutions have to apply a remuneration principle if appropriate (or, put another way, for some institutions it would not be appropriate to apply the remuneration principle at all). In that case, therefore, there would still be different possible interpretations of Article 92(2). It would therefore still be necessary to interpret that ambiguity in light of Recital 66, which clearly indicates that the latter interpretation would have to be the intended outcome.

1.3 Recital 66

The most authoritative and important source for interpreting the operative legislative provisions is the recitals to CRDIV, and Recital 66 addresses the proportionality principle expressly. Recital 66 states that:

> "*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****."*

Recital 66 therefore makes clear that "in particular" it would be proportionate for some investment firms not to apply some of the remuneration principles. However, the words "In particular" mean that the potential for partial application of the remuneration principles is not limited only to investment firms, and so could in some cases also be appropriate for credit institutions (depending on size, internal organisation and complexity).

As above, we consider that it has been misleading to refer to a principle of "neutralisation". The intention behind the drafting of Article 92(2) seems to us that in some cases (where appropriate) firms may be required to only partially apply the remuneration principles. It is not, therefore, the case that those firms are "disapplying" or "neutralising" some of the principles; rather, Article 92(2) makes clear that in some cases some firms are not required to apply some of the principles when considered collectively.

1.3.1 References to Recital 66 in the Consultation Paper and the European Commission's letter

As mentioned above, in interpreting Article 92(2), proper regard should be had to Recital 66. We note that the Consultation Paper mentions Recital 66 only once (on page 11), but this reference is in passing, and the Consultation Paper does not at all refer to the content of Recital 66, or explain its relevance (or indeed, does not purport to explain why the express words of Recital 66 are being ignored).

Further, we note that the European Commission's letter to the EBA of 23 February 2015 does not address Recital 66 at all. It is therefore not clear whether, to date, the European Commission has given proper regard to Recital 66 in considering the interpretation of Article 92(2), and we would suggest that the European Commission is now asked to address this specifically.

1.3.2 Effect of recitals

The importance of recitals is clearly enshrined in EU law.

Whilst recitals cannot be relied on to derogate from the actual provisions of an act, they are used by the Court of Justice to interpret provisions and determine the legislator's intent.[1] In *Moskof*[2] and *CCAA*[3], the Court of Justice used the recitals to resolve ambiguity regarding the nature and scope of provisions in the legal act. For example, in *CCAA*, the court relied on the recitals to justify an interpretation of an operative legislative provision that was wider than the literal meaning of that operative provision.

Therefore, whilst Recital 66 is not itself operative, in our view it is clear that in interpreting Article 92(2) the Court of Justice would have regard to Recital 66 (which, as above, includes a clear statement that ***it would not be proportionate to require certain types of investment firms to comply with all of those principles*****).**

[1] Tadas Klimas and Jurate Vaiciukaite, *Law of Recitals in European Community Legislation*, ILSA Journal of International & Comparative Law, Vol. 15, 2008, p. 16.
[2] Case C-244/95, *P. Moskof AE v Ethnikos Organismos Kapnou*, 1997 E.C.R. I-06441.
[3] Case C-288/97 *Consorzio fra i Caseifici dell'Altopiano di Asiago v Regione Veneto*.

1.3.3 Amendment to Recital 66 when CRDIV was introduced

The equivalent wording to Recital 66 that was included in CRDIII (Recital 4 of 2010/76/EU), stated: "*… in particular, … 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* [remuneration] *principles."*

When CRDIV was implemented, the legislators amended this wording, so that Recital 66 states that: "*In particular it **would** not be proportionate to require certain types of investment firms to comply with all of* [the remuneration] *principles."*

Therefore, in introducing Recital 66, the legislators amended this wording to place even greater emphasis on the fact that in some cases it would not be proportionate for some investment firms to comply with some of the remuneration principles.

1.4 Statements in the Consultation Paper in respect of proportionality

The Consultation Paper includes certain statements in respect of the proportionality principle which, in our view, are not correct, as discussed below.

1.4.1 The terms of the CRD do not explicitly grant a right for "neutralisation"

The Consultation Paper indicates that the terms of the CRD do not explicitly grant a right for certain of the remuneration principles to be "neutralised". This statement seems to treat Article 92(2) as if it were not an operative provision and also, for the reasons set out above, does not seem to align with the intention behind the drafting (which refers to the principles collectively being required to be applied to the extent that is appropriate).

The purpose of Article 92(2) is to explain the extent to which the principles set out in Article 92(2) and Article 94 must be applied. Where Article 92(2) means that it would not be appropriate for a certain institution to have to apply all of those provisions, there would be no need for further express wording within Article 92(2) or Article 94 in order for that institution to be able not to apply certain of those provisions: instead, Article 92(2) would mean that certain of those principles would simply not need to be applied.

1.4.2 The proportionality principle does not permit non-compliance with CRDIV

The Consultation Paper states that the principle of proportionality cannot lead to the non-application of the CRDIV rules (page 6).

As set out above, in our view, Article 92(2) is intended to operate such that the remuneration principles must be applied to the extent that is appropriate, so that, in some cases, an institution may be required to apply some, but not all, of the remuneration principles.

On the basis of this reading, the legislation lists certain remuneration principles (in Article 92(2) and 94) and then (in Article 92(2)) sets out when those principles must be applied. Therefore, where it is deemed appropriate for an institution to apply some, but not all, of the remuneration principles, in accordance with Article 92(2), such an institution is not breaching CRDIV by applying only some of the remuneration principles. Rather, such an institution is applying CRDIV to the extent to which that institution is required to do so, based on the express wording of an operative provision (i.e. Article 92(2)).

Again, as set out above, in our view the intention behind Article 92(2) is that it states that, in some cases, only partial application of the remuneration principles will be required (and that this better describes the intention of Article 92(2) than the term "neutralisation").

1.4.3 Reliance on the European Parliament's resolution of 3 July 2013

The Consultation Paper refers to the European Parliament's resolution of 3 July 2013.

That resolution asked the EC and EBA to "*ensure full and comprehensive implementation of … the provisions on … remuneration … to continue the reform of banks' … remuneration culture" and "to ensure … that … remuneration systems at all levels of a bank reflect its overall performance*".

In our view, it is not correct that this resolution supports the conclusion that Article 92(2) does not permit partial application of the remuneration provisions.

Firstly, as set out above, in our view the correct interpretation of Article 92(2) is that, for some institutions, it will be appropriate for the institution to apply some, but not all, of the remuneration principles. As further set out above, this does not mean that such an institution is not complying with the remuneration principles (collectively) nor does it mean that such an institution is breaching CRDIV. Instead, such an institution is fully complying with CRDIV to the extent to which it is required to do so as set out in Article 92(2).

Secondly, the European Parliament resolution does not constitute an operative provision of CRDIV. Whilst we understand that the EBA has had regard to the text of the resolution in interpreting Article 92(2), the EBA must also have regard to Recital 66, and the text of Recital 66 sets out an express and very clear statement of how the legislators intended Article 92(2) to apply.

Thirdly, the text from the European Parliament resolution set out above explicitly refers to "*banks*". This compares with the statement in Recital 66 which states that: "*In particular it would not be proportionate to require certain types of investment firms to comply with all of* [the remuneration] *principles."* As set out above, it is very important to note that this sentence from Recital 66 begins "*In particular*" and so does not only apply to investment firms. However, when considering how Article 92(2) applies to investment firms, Recital 66 is absolutely clear: it would not be proportionate for some investment firms to have to apply all of the remuneration principles. This principle is not affected in any way by the European Parliament resolution, which refers to "*banks*".

In this regard, as set out in our introductory comments, it is important to note that the CRDIV applies to a wide range of investment firms that are not subsidiaries of, or in the same group as, a credit institution.

1.4.4 Proportionality applies differently to different remuneration principles

The European Commission response states that the view that "neutralisation" is not permissible applies "*in particular*" to the principles set out at Article 94 (see page 12). Further, the Consultation Paper states (without explanation being provided as to why) that the bonus cap "*is not subject to the proportionality principle*" (page 38, paragraph 72).

In our view, neither of these statements is supported by the text of CRDIV.

The proportionality principle is set out in Article 92(2), and applies to the remuneration principles set out in Article 92(2) and, by incorporation in the introductory wording in Article 94(1), to the remuneration principles set out in Article 94(1).

There is nothing in the text of CRDIV that indicates that Article 92(2) applies any differently to any of these principles. In particular, the bonus cap is included in Article 94(1), and so the proportionality principle as set out in Article 92(2) applies to the bonus cap in exactly the same way as it applies to all of the other remuneration principles.

2. LONG TERM INCENTIVE PLANS (QUESTION 8 OF THE CONSULTATION PAPER)

Question 8 of the Consultation Paper asks whether the requirements regarding categories of remuneration are appropriate and sufficiently clear. We set out below comments in response to this question specifically in respect of long-term incentive plans, as discussed in paragraph 120 of the Consultation Paper.

2.1 **Interaction with investor expectations**

The model of long-term incentive plans expected by investors in listed companies (particularly in the UK but also globally) is that an "award" will be granted at the start of a set performance period. The award will be expressed by reference to a number of shares. Whether, and if so what proportion of, those shares "vest" (and become due to be transferred to the employee) will depend on performance conditions assessed over the performance period. At the end of the performance period, the resulting shares are transferred to the participant.

For investors, this structure achieves a number of aims: (1) it provides an (uncapped) link to share price, and therefore aligns participants' interests with those of investors; (2) the employee is motivated to achieve the specific strategic goals represented in the performance conditions which are set; and (3) those performance conditions are set prospectively, so there is certainty from the date of award the conditions which will apply.

The draft guidelines in paragraph 120 seem not to be compatible with this structure of an LTIP, given primarily that the value of the shares when they "vest" is required to be taken into account for the purposes of the cap on variable remuneration.

If published in this form, therefore, for listed financial institutions the guidelines may create a conflict between the regulatory requirement and investors' expectations.

2.2 **Transitional provision**

If paragraph 120 of the guidelines is maintained in its current form, it is vital that the guidelines also include transitional provisions. The two key reasons for this are:

2.2.1 *existing contractual arrangements will not include the ability to limit the value (or number of shares) that is delivered on vesting which will be required in order to ensure that institutions can comply with the cap on variable remuneration.*

LTIP awards are granted as a contractual right for the employee to receive a value or number of shares on vesting, determined by reference to the conditions specified in that contract. Existing LTIP awards do not have an ability for the company to reduce the value or number of shares to be delivered on "vesting" in order to ensure that the cap on variable remuneration is complied with. It is therefore vital that, if maintained in its current form, paragraph 120 of the Consultation Paper applies only to new LTIP awards granted in performance years commencing after regulators in member states implement the revised EBA guidelines.

2.2.2 *the value of existing LTIP awards will already have been taken into account by institutions in calculating the variable remuneration for Material Risk Takers in the year of grant in compliance with the cap on variable remuneration, and so that the value of such existing awards must not also be counted for the purpose of the cap on variable remuneration on vesting, as to do so would "double count" these awards.*

In accordance with existing guidelines from regulators in member states, for the purposes of complying with the cap on variable remuneration, LTIP awards are taken into account in the year of award, based on the value of the LTIP award at that time (assuming the LTIP award will vest in full). Institutions have, therefore, designed their remuneration structures accordingly. Were the value of those existing LTIP awards to have to be taken into account again in the year of vesting this would "double count" the value of these LTIP awards. Again, therefore, it is vital that, if maintained in its current form, paragraph 120 of the Consultation Paper applies only to new LTIP awards granted in performance years

commencing after regulators in member states implement the revised EBA guidelines.

Further information

We would be very happy to discuss the issues raised in this response with the EBA. If this would be of assistance, please contact Mark Ife, Partner, Remuneration and Incentives, at mark.ife@hsf.com or +44 20 7466 2133, or Bradley Richardson, Senior Associate, Remuneration and Incentives, at bradley.richardson@hsf.com or +44 20 7466 7483.

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