EU Directive

PRUDENTIAL SUPERVISION OF INVESTMENT FIRMS – DIRECTIVE

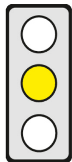
cep**PolicyBrief** No. 2018-25

Centrum für Europäische Politik

KEY ISSUES

Aim of the Directive: The supervision of investment firms will become more adapted to their respective business models and risks.

Affected parties: Investment firms and their customers, banks



Pro: (1) Dividing investment firms into three classes may counteract the consolidation of the sector brought about by regulation.

(2) Full harmonisation of the provisions on initial capital, with which investment firms have to comply, reduces distortions of competition.

Contra: (1) Graded regulation risks causing distortions of competition.

(2) Regulating the remuneration of the "main players" in investment firms constitutes major intervention in the freedom of contract. In addition, it puts European investment firms at a disadvantage in the competition for qualified staff.

The most important passages in the text are indicated by a line in the margin.

CONTENT

Title

Proposal COM(2017) 791 of 20 December 2017 for a **Directive** of the European Parliament and of the Council **on the prudential supervision of investment firms** and amending Directives 2013/36/EU and 2014/65/EU

Brief Summary

- **Context and objectives**
  - Investment firms – e.g. asset managers – provide services – e.g. investment advice, portfolio management – which enable investors to access the capital markets. In this regard, they often provide services typically provided by banks but, unlike banks, they do not take deposits or make loans. (Explanatory Memorandum, p. 1 and 2)
  - About half of EU investment firms are based in the United Kingdom. Eight investment firms, "largely" concentrated in the UK, control around 80 % of the assets of all EU investment firms. (Explanatory Memorandum, p. 1)
  - Investment firms and banks are currently subject to similar legislative provisions, in particular the Capital Requirements Directive [2013/36/EU, cep**PolicyBrief**] and the Capital Requirements Regulation [(EU) No. 575/2013, see cep**PolicyBrief**]. According to the Commission, however, the provisions do not take sufficient account of the business models and risks of investment firms. (Explanatory Memorandum, p. 2-4)
  - The Commission therefore wants a regulatory framework more calibrated towards investment firms which focuses on their business models and risks and will prevent the "harmful regulatory arbitrage" arising from companies relocating their business operations to the EU in the wake of Brexit (Explanatory Memorandum p. 4).
  - This regulatory package includes
    - a Regulation with prudential requirements for investment firms [COM(2017) 790, see cep**PolicyBrief**] and
    - a Directive with provisions relating to the supervision of investment firms (this cep**PolicyBrief**).
- **Division of investment firms into three classes**
  - In future, investment firms will be divided into three classes (for details see cep**PolicyBrief** Part 1):
    - Class 1 covers all systemically relevant investment firms.
    - Class 2 covers non-systemically relevant investment firms that do not fall into class 3.
    - Class 3 covers (non-systemically relevant) "small and non-interconnected investment firms".
  - In future, class 1 investment firms will be treated as credit institutions. They will therefore have to comply with the provisions applicable to banks [Capital Requirements Directive 2013/36/EU and Capital Requirements Regulation (EU) No. 575/2013]. (Explanatory Memorandum, p. 3)
  - In future, the rules on the prudential supervision of class 2 and 3 investment firms will be covered by this Directive instead of the Capital Requirements Directive. In this regard, the existing rules applicable to investment firms under the Capital Requirements Directive will undergo minor changes. (Explanatory Memorandum, p. 4)

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► **Re-authorisation of class 1 investment firms as credit institutions**

– In future, an investment firm that satisfies the requirements for classification as a class 1 investment firm over a period of twelve consecutive months will require authorisation as a credit institution (Art. 57 (6) No. 1).
– Investment firms that are already authorised as such on entry into force of the Directive, must apply for authorisation as a credit institution within one year of entry into force (Art. 57 (6) No. 3).
– Where the requirements for classification as a class 1 investment firm are not fulfilled over a period of five consecutive years, the competent authority may withdraw authorisation as a credit institution (Art. 57 (6) No. 7).

► **Level of initial capital for class 2 and 3 investment firms**

– Until now, in certain cases, Member States could reduce the prescribed level of initial capital with which investment firms have to comply. In future, the level of initial capital for class 2 and 3 investment firms will be fully harmonised. (Explanatory Memorandum, p. 11, Recital 9)
– In future, investment firms will have to have initial capital of € 750,000 if they (Art. 8 (1))
  - deal on their own account ("proprietary trading"),
  - issue financial instruments on a firm commitment basis, i.e. include financial instruments on their books that have no purchasers ("issuing business"), or
  - operate multilateral or organised trading platforms ("operating a MTF or an OTF").

  Investment firms with these activities, which are already authorised on entry into force of the Directive, must attain the initial capital within 10 years at the latest (Art. 59 (1)).
– In future, investment firms that do not hold client money or securities will have to have initial capital of € 75,000 if they (Art. 8 (2))
  - offer investment advice or portfolio management,
  - execute orders relating to financial instruments on behalf of their clients,
  - accept and procure orders relating to financial instruments or
  - place financial instruments without a firm commitment ("placement business").
– In future, all other investment firms will require initial capital of € 150,000 (Art. 8 (3)).
– The Commission can adjust the amounts for initial capital by way of implementing act following the examination procedure (Art. 8 (4)).

► **Changes to the remuneration rules**

– Until now, the "main players" in investment firms have generally been subject to the remuneration rules of the Capital Requirements Directive [2013/36/EU, see cep**PolicyBrief**].
– "Main players" are
  - the management,
  - risk takers, i.e. employees who assume positions of high risk,
  - staff engaged in control functions and
  - employees in at least the lowest remuneration bracket of senior management and risk takers.

Class 1 investment firms

– Main players in class 1 investment firms remain subject to the remuneration rules of the Capital Requirements Directive [Art. 92 et seq. Capital Requirements Directive 2013/36/EU, see cep**PolicyBrief**).

Class 2 investment firms

– For main players in class 2 investment firms, remuneration rules will be introduced which differ from those of class 1.
– As before, there must be an "appropriate" ratio between the fixed and variable remuneration (Art. 94 (1) (g) Capital Requirements Directive 2013/36/EU, Art. 28 (2)).
– At the same time, until now, variable remuneration was limited to a maximum of (Art. 94 (1) (g) Capital Requirements Directive 2013/36/EU)
  - 100% of the fixed remuneration, or
  - 200% of the fixed remuneration where "shareholders, owners or members" approve.

  In both cases, the Member State could specify a lower maximum amount.

  These maximum limits for variable remuneration have been abolished and replaced by the following provisions:
  - In future, the ratio between variable and fixed remuneration must be "appropriate", taking particular account of the business activities of the investment firm and associated risks (Art. 28 (1) (i) and (2)).
  - In future, fixed remuneration must be high enough to allow the investment firm to operate a "fully" flexible policy on variable remuneration; this includes paying no variable remuneration (Art. 28 (1) (i)).
– Until now, at least 50% of variable remuneration had to consist inter alia of shares or ownership interests (Art. 94 (1) (l) Capital Requirements Directive 2013/36/EU). In addition, until now, at least 40% of variable remuneration - at least 60% in the case of particularly high levels of remuneration - was deferred for three to five years depending on the business cycle, activities and risks (Art. 94 (1) (m) Capital Requirements Directive).

In future, the following will be exempt from both of these provisions (Art. 30 (1) (k) and (l), and (4)):
- class 2 investment firms with a maximum average asset value of € 100 million over the preceding four years and
- employees with variable remuneration below € 50,000 where the variable remuneration component does not exceed one fourth of the total remuneration.

The competent authorities may however decide that the exemptions do not apply (Art. 30 (4)). The EBA, in consultation with ESMA, will adopt guidelines on this (Art. 30 (7)).

– Until now, class 2 investment firms that receive state support could be required by the competent authorities to set upper limits on the remuneration of members of the management bodies. They were also only supposed to receive variable remuneration where it was "justified". (Art. 93 (b) and (c)) In future, an investment firm that receives state support will have to set upper limits on remuneration. Payment of variable remuneration is subject to the approval of the competent authorities. (Art. 29 (b) and (c))

Class 3 investment firms

Other than the rudimentary rules of the Markets Directive applicable to all investment firms [2014/65/EU, see cep**PolicyBrief**], class 3 investment firms do not have to (Art. 23 et seq.)
– comply with any remuneration rules if they have been classified as class 3 for two years;
– otherwise they are subject to the class 2 remuneration rules.

Statement on Subsidiarity by the Commission

According to the Commission, investment firms "routinely" provide their services across EU borders. Separate rules in the Member States could give rise to distortions of competition and thus to discrimination and lead to a fragmentation of the internal market.

Policy Context

In the 2017 Mid-Term Review of the Capital Markets Union Action Plan [COM(2017) 292], the Commission announced the creation of a more effective supervisory framework for investment firms. The proposals are the outcome of a review of the provisions of the Capital Requirements Regulation (CRR) applicable to investment firms (Art. 493 (2), Art. 498 (2) and Art. 508 (2) and (3)).

Legislative Procedure

20 December 2017	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Directorates General:	DG Financial Stability, Financial Services and Capital Markets Union (leading)
Committees of the European Parliament:	Economic and Monetary Affairs, Rapporteur: Markus Ferber (D, EVP)
Federal Ministries:	Federal Ministry of Finance (leading)
Committees of the German Bundestag:	Finance (leading)
Decision-making mode in the Council:	Qualified majority (acceptance by 55% of Member States which make up 65% of the EU population)

Formalities

Legal competence:	Art. 53 TFEU (Freedom of establishment);
Type of legislative competence:	Shared competence (Art. 4 (2) TFEU)
Procedure:	Art. 294 TFEU (Ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

The division of investment firms into three classes – proposed both for this Directive and the parallel Regulation (see cep**PolicyBrief**) –, graded according to their systemic relevance, aims to ensure that their regulatory framework is appropriate and proportionate. It has advantages and disadvantages. The grading **may on the one hand counteract a consolidation of the sector brought about by regulation** which threatens smaller investment firms due to the relatively high level of fixed-costs to which regulation gives rise. Such consolidation would be detrimental to financial stability because investment firms that are "too big to fail" have an incentive to take excessive risks. The division of investment firms into classes can also be justified by the fact that, for reasons of financial stability, non-systemically relevant investment firms require less strict safeguards against insolvency than is the case for systemically relevant investment

firms. **On the other hand, graded regulation** always **harbours the risk of distorting competition** and regulatory arbitrage**.**

Initial capital provides a buffer to absorb, in particular, the main risks of business operations and allows for orderly liquidation in the event of insolvency. In this regard, the emphasis is placed primarily on protecting customers and creditors of the firms rather than, as in the case of bank regulation, protecting tax payers. Since the initial capital constitutes a requirement for authorisation, it is also a barrier to market entry for these firms.

Full harmonisation of the initial capital to be held by investment firms reduces the existing **distortions of competition** because Member States can no longer introduce special rules.

The mandatory **regulation of the remuneration of "main players" in investment firms** is misguided. Firstly, it **constitutes major intervention in the freedom of contract.** In a market economy, it should be left up to the contracting parties to agree on the appropriate remuneration. **In addition, it puts European investment firms at a disadvantage in the** global **competition for qualified staff** – on the one hand, with other investment firms outside the EU and, on the other, and in particular, with service providers in closely related sectors, including those inside the EU, that are subject to less strict remuneration rules. As a result, human capital will migrate to less regulated sectors.

The fact that the strict remuneration rules are retained for class 1 investment firms but relaxed for firms in classes 2 and 3 gives rise to new distortions of competition, with the main players in class 1 investment firms now having the incentive to move to investment firms in classes 2 and 3. The remuneration rules should therefore be reversed and made uniform for all classes of investment firm.

As proposed by the Commission, the state should be able to intervene in the remuneration structure of investment firms that receive state support. The question here, however, is why, in the event of a crisis, a class 2 investment firm, which by definition is not classified as systemically relevant, should receive any state support at all.

Legal Assessment

Legislative Competency

Art. 53 (1) TFEU (self-employed activities) is the relevant legal basis.

Subsidiarity.

Unproblematic.

Proportionality with respect to Member States

Unproblematic.

Compatibility with EU Law in other respects

The remuneration rules may be in breach of the freedom to conduct a business [Art. 16 Charter of Fundamental Rights of the EU (CFR)]. Contractual freedom falls within the scope of protection. The remuneration rules constitute interference. Following an action for annulment by the UK, the CJEU considered the question of whether it is lawful to stipulate a maximum rate of variable remuneration (Case C507/13). In his Closing Submissions, the Advocate General in the case concluded that such a stipulation was lawful. The UK withdrew its application before a judgement could be passed.

Impact on German Law

Changes are necessary, particularly to the Remuneration Ordinance for Institutions (InstitutsVergV) and the Banking Act (KWG).

Conclusion

Dividing investment firms into three classes may, on the one hand, counteract the consolidation of the sector brought about by regulation. On the other hand, graded regulation risks causing distortions of competition. Full harmonisation of the provisions on initial capital, with which investment firms have to comply, reduces distortions of competition. Regulating the remuneration of the "main players" in investment firms constitutes major intervention in the freedom of contract. In addition, it puts European investment firms at a disadvantage in the competition for qualified staff.