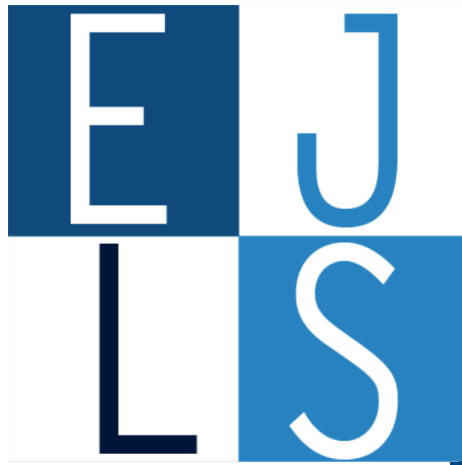




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Editorial

Jan Zglinski
On Failure

I

Articles

Raphael Bitton
Intelligence Agents, Autonomous Slaves and the U.S.
Supreme Court's Wrong (and Right) Concept of Personal
Autonomy 4

Sergii Shcherbak
How Should Bitcoin Be Regulated? 41

Mandana Niknejad
European Union Towards the Banking Union, Single
Supervisory Mechanism and Challenges on the
Road Ahead 84

Zygimantas Juska
Obstacles in European Competition Law Enforcement:
A Potential Solution from Collective Redress 114

Jaime Rodriguez Meda
Transparency in the Staff Selection Procedure of the EU
Institutions: Comments on the Pachitits Case 140

Book Review

Emma Linklater
Murray, Piper and Robertson:
Putting Intellectual in its Place 174

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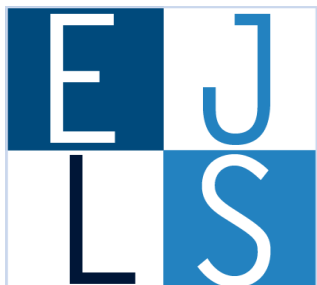
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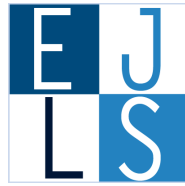
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European Journal of Legal Studies
Vol. 7 No. 1 (Summer 2014)

TABLE OF CONTENTS

EDITORIAL

Jan Zglinski
On Failure

I

ARTICLES

Raphael Bitton
Intelligence Agents, Autonomous Slaves and the
U.S. Supreme Court's Wrong (and Right) Concept
of Personal Autonomy

4

Sergii Shcherbak
How Should Bitcoin Be Regulated?

41

Mandana Niknejad
European Union Towards the Banking Union,
Single Supervisory Mechanism and Challenges
on the Road Ahead

84

Zygimantas Juska
Obstacles in European Competition Law
Enforcement: A Potential Solution from Collective
Redress

114

Jaime Rodriguez Medal
Transparency in the Staff Selection Procedure
of the EU Institutions: Comments on the Pachtitits
Case

140

BOOK REVIEWS

Emma Linklater
Book Review: Murray, Piper and Robertson.
Putting Intellectual Property in its Place: Rights
Discourses, Creative Labor, and the Everyday

174

EDITORIAL: ON FAILURE

Jan Zglinski*

It is probably as much a trait of the academic profession as a mirror of the times we live in that the contributions featured in this issue circle around one theme: failure.

Failure has many faces. It can be personal as in the case of Dimitrios Pachtitis, a young Greek who missed out on being short-listed for the second stage of an EPSO competition by just 3 points (discussed in: Jaime Rodriguez Medal, 'Transparency in the Staff Selection Procedure of the EU Institutions: Comments on the Pachtitis Case'). It can also be institutional. Sergii Shcherbak's article on Bitcoin, very timely in light of the latest warnings issued by the European Central Bank, the Banca d'Italia and the French police, is both a plea for the regulation of the virtual currency as well as a demonstration of the EU's and Member States' apathy in this field ('How Should Bitcoin Be Regulated?').

Sometimes failure is constrained. It only concerns an individual act or event, such as a court decision (Raphael Bitton, 'Intelligence Agents, Autonomous Slaves and the U.S. Supreme Court's Wrong (and Right) Concept of Personal Autonomy'). Other times, it is systemic, i.e. ranges over entire areas of the law, economy or society at large. The financial crisis has been the most startling illustration of such failure in recent history (Mandana Niknejad, 'European Union towards the Banking Union, Single Supervisory Mechanism and Challenges on the Road Ahead').

In a somewhat paradoxical line, Bob Dylan says that 'there is no success like failure [...] and failure is no success at all'. The latter seems immediately plausible – if failure means to not achieve an aim, it surely is the exact opposite of success. The former less so. How can failure, at the same time, be an achievement? What, if any, are the benefits of failing?

Much more than success, failure forces two things upon us: reflection and reaction, both of which are intimately connected. When reflecting on our or someone else's failure, we have to contemplate what went wrong and why it did so. When reacting to failure, there are essentially two routes we can take. The first one entails re-defining the *means* to success: how to achieve our goal by means other than those initially chosen? Zygimantas Juska's piece is an example for this type of response ('Obstacles in

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European Competition Law Enforcement: A Potential Solution from Collective Redress'). Given the ineffectiveness of traditional techniques of enforcement in EU competition law, he suggests the introduction of collective action as an alternative instrument. The aim remains the same, ie the fight against anti-competitive behaviour; it is the means that change.

The second route is more challenging, yet also potentially more rewarding. It entails re-defining the *meaning* of success. Failure can serve as an occasion to critically examine whether our initial goals were worth pursuing in the first place. One might feel reminded of Hannah Arendt:

The disappearance of prejudices simply means that we have lost the answers on which we ordinarily rely without even realizing they were originally answers to questions. A crisis forces us back to the questions themselves and requires from us either new or old answers, but in any case direct judgments.¹

What seemed appealing initially might, upon closer inspection, not look so attractive anymore. Our original aim might, however, also survive our questioning, based on reasons old and new. Re-affirming this aim, in spite of the experience of failure, might, perhaps ironically, render our conviction even firmer. It is the reflective process, rather than the actual result, that is crucial. The response to the recent financial crisis, in this light, will seem deplorable to many. The collapse of the banking sector, the dramatic shortage in public resources (and the resulting need to prioritize) and mass unemployment presented an excellent yet largely missed opportunity to re-think important issues such as social welfare, equality and the mechanisms underlying our economic systems. Instead of contemplating the present-day meaning of success, we concentrated on the means to achieve what might be an already out-dated understanding of it.

I. BOARD: CHANGE AND CONTINUITY

Before I leave the reader to explore the content of this issue, a few words on some major changes in the masthead. Tiago Andreotti, Javier Alexis Galán Avila and Rebecca Schmidt have left the editorial board. I want to take this opportunity to thank them for the excellent work they have done, the fruits of which are a series of first-rate EJLS issues as well as the successful completion of what has been a long-term project of the journal: the new webpage, which finally gives us a new digital face. The new board members, namely Lucila Almeida (Managing Editor), Emma Linklater (Executive Editor), Afroditi Marketou (Head of Section Comparative Law)

¹ Hannah Arendt, *Between Past and Future* (Penguin 1977) 174.

and myself, are deeply committed to continuing their legacy. Yet, 'jedem Anfang wohnt ein Zauber inne', as Hesse says. Change can be the source of fresh energy and excitement, both of which we want to use to the journal's benefit. In this vein, our first change concerns style. We hope you will enjoy the new layout we have given the EJLS.

INTELLIGENCE AGENTS, AUTONOMOUS SLAVES AND THE U.S. SUPREME COURT'S WRONG (AND RIGHT) CONCEPT OF PERSONAL AUTONOMY

Raphael Bitton*

This paper traces the boundaries of consent in the relations of recruited intelligence agents and their handlers. The U.S. Supreme Court considered these relations to be contractual. However, such a contract, according to the Supreme Court, is unenforceable. An Agent's autonomy largely underpins the argument for the prima facie legitimacy of Human Intelligence (HUMINT) relations with each agent. Autonomy is also an essential element in recognizing the formulation of a recruitment contract. Sketching its boundaries in the human intelligence context (namely between the spy recruited typically within enemy ranks and the recruiter) raises the paradoxical question: How free is the free choice to give up freedom of choice? In contrast to the common deontological approaches, this paper offers an account of personal autonomy which incorporates the examination of dignity-compromising (dehumanizing) influences on the choice-making process of the agent. If being autonomous is an exclusive human condition, then a condition in which a person is both dehumanized while making his choice, yet remains autonomous nonetheless, must be wrong. Hence, it is argued that any hierarchical model of personal autonomy should be interpreted as if incorporating a test of a dignity-compromising influence on the desires-setting or choice-making process of a person. The case of voluntary intelligence agents, as in the case of consenting slaves, emphasizes a distinction between two points in time: Before and after making the choice to become an agent. This paper's interpretation of autonomy suggests that even the most agreeable intelligence agent is not autonomous during the second phase due to the influence of the irreversibility problem. The very fact that the potential choice to reverse is being held by another person (the handler) is a humiliating influence on agent's choice to proceed and therefore suggests the agent is non-autonomous. The U.S. Supreme Court's classification of handling relations as contractual is, therefore, wrong. However, by denying the binding promissory power of the handling 'contract', the Supreme Court is in fact right. Due to lack of autonomous will, these relations cannot formulate a contract to start with.

Keywords: Autonomy, Consent, Dignity, Intelligence Agents, U.S. Supreme Court.

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TABLE OF CONTENTS

I. INTRODUCTION	5
II. THE CONSENTING INTELLIGENCE AGENTS.....	10
III. THE AUTONOMY AND CONSENT CORE ARGUMENT	13
IV. AGENTS AND THE PARADOX OF RESPECT FOR AUTONOMY	15
V. THE HIERARCHICAL MODEL OF PERSONAL AUTONOMY.....	17
VI. A DIGNITY BASED INTERPRETATION OF AUTONOMY	23
VII. DIGNITY AND SELF-RESPECT	28
VIII. AGENTS AND THE RESPECT-BASED APPROACH TO AUTONOMY ...	34
IX. CONCLUSION	37

II. INTRODUCTION

In its historical *Totten* case concerning claims of intelligence agents, the U.S. Supreme Court considered the relations of a recruited agent and his handler to be contractual in nature. However, such a contract, according to the Supreme Court, is unenforceable in court.¹ Over a century later, the Supreme Court reaffirmed its ruling in the *Tenet* case.² It seems that the new rule even bans the very filing of any contractual claim of an intelligence agent against the intelligence agency. In addition to being anachronistic, the Supreme Court's reasoning seems inconsistent. Its secrecy-based reasoning should have similarly applied to claims of contractors in ultra-secret projects or to claims of intelligence agencies' employees.³ This paper seeks a compelling explanation for this ruling: To start with, is a contract between a handler and an intelligence agent

¹ *Totten v US* 92 US (1875) 105. This case started as a 'simple' contractual claim against the federal US Government filed by the estate manager of a former intelligent agent. The agent, Lloyd, was recruited and handled by Lincoln himself. Apparently, the promises made by the government in return for the spying services were not kept. The US Supreme Court ruled that a contract between a handler and an intelligence agent is beyond judicial scrutiny. Court's decision was very much based on the argument that judicial scrutiny of such contract is detrimental to state's interests. In addition, the Court found such contracts to include an implied condition of mutual understanding of its unenforceable nature.

² *Tenet v Doe* 544 US (2005) 1; *Goung v United States* (1988) 860 F 2d 1063 (Fed Cir). In the case of *Tenet*, two former spies – a husband and a wife – claimed that the CIA was in breach of its commitment to pay them a life-long pension upon their defection. Surprisingly, the Supreme Court reaffirmed the status of agent-handler contract to be beyond judicial scrutiny.

³ *Webster v Doe* 486 US (1988) 592; *United States v Reynolds* 345 US (1953) 1.

possible? Are intelligence agents sufficiently autonomous even when acting voluntarily?

I argue that on the one hand, the U.S. Supreme Court is right in determining the intelligence contracts to be unenforceable. On the other hand, I argue that the Supreme Court's ruling is fundamentally wrong since the agent-handler relations cannot be contractual. By using a proposed dignity-based interpretation to the hierarchical model of personal autonomy, I argue, in a somewhat paradoxical manner, that such relations cannot form a contract. I show that the agents are typically being non-autonomous through the process, irrespective of the recruitment and handling being based on voluntary consent.

The term 'agent' is frequently used to describe different agents in the realm of espionage and intelligence. This paper deals with recruited agents only. These are individuals who serve as human intelligence sources. They are recruited and handled by highly trained officers of an intelligence agency – the handlers. A handler is an employee and a citizen of the country she works for. The recruited agent, in contrast, is in many cases (but not always) a member of the forces or government of the adversary, such as an officer of the adversary army. Once recruited, such an agent will be covertly handled so he can routinely communicate information to his handler, perform for her tasks beyond enemy lines and get his instructions.⁴ For example, a handler can be a Central Intelligence Agency (CIA) case-officer. She is an official of the American government, as an employee. She is expected to collect information from human sources, namely from agents she manages to recruit. An exemplary recruited agent can be, for instance, an Iranian Scientist who works for the Iranian defense industry. If recruited successfully, this scientist agent can communicate valuable secret information to the handler. Naturally, bringing a person to agree to work against his own people and community is a complicated task. The reasons for the agent's consent vary; greed, revenge, ideology or pursuing excitement, are all good examples to the motivation of agent's consent. This paper analyzes such agreement. I argue that such agreement can never be autonomously given even when made by the most willing agent.

⁴ The handler-agent relations are unique. In most cases, if caught, the agent will face criminal charges of espionage and even death. He will be considered to be a traitor by his community. The recruitment task is therefore extremely challenging. The handler, initially and typically viewed by the designated agent as 'the enemy', is expected to convince the designated agent to assume the enormous risk and switch loyalties.

The question of the freedom of choice of the agent goes far beyond the doctrinal level of determining if a contract with the handlers has been formed. Although not a 'justification' in the regular sense, one of the very first arguments raised in supporting Human Intelligence (HUMINT) is the consent argument.⁵ It rests on the alleged agents' informed and free consent to recruitment. The agent is described as an autonomous person voluntarily and knowingly accepting the offer to serve as a recruited agent. While consent does not justify the consensual act, it does carry the potential to remove objections to the act grounded in potential damages to the agent. Since we assume X weighs her interests best, it makes no sense to raise objections to X's autonomous act, arguing for negative consequences to X. Painting the relations with the agent in contractual colors therefore has a moral and legal objective. It intends to relax concerns of potential observers. They should gather from such contractual relations that both parties have freely calculated the mutual balance of risks and benefits and that such balance has been independently judged to be beneficial to each of the involved.

It is believed that most recruited agents are indeed being recruited and operated voluntarily. Normally, no apparent means of coercion is involved.⁶ Are these agents therefore deemed autonomous agents? As mentioned, the U.S. Supreme Court adopted the contractual approach to HUMINT based on the consent of the agents and hence on the view that these agents are autonomous.⁷ The essence of this paper is to rethink this contractual presumption.⁸ It questions the very possibility of an

⁵ H Klehr, 'Reflections on Espionage' (2004) 21 Social Philosophy and Policy 141, 156-158. HUMINT is a code word in the world of espionage for HUMAN INTelligence, namely intelligence gathered from human sources. It should be noted that HUMINT is a far broader activity than handling agents. It includes all information collection that is based on interaction with humans, such as handling agents, interrogating people, questioning people, meetings or even getting informative anonymous phone calls. This paper, as mentioned, deals solely with one type of HUMINT: running (handling) recruited intelligence agents. For the various sources of intelligence and the theory of their use, see: M Herman, *Intelligence Powers in Peace and War* (Cambridge UP 1996).

⁶ See S Wood, 'Americans Who Spied Against Their Country Since World War 2' (1992) Defense Personnel Security Research Center. These findings match similar empirical research: MF Wiskoff and CC Fitz, 'The Defense Investigative Service's Issue Case Data Base: Analysis of Issue Types and Clearance Adjudication' (1991) US Department of Defense, Defense Investigative Service, Monterey, CA.

⁷ In its *Totten* case, the Supreme Court even anchored the secrecy-based reasoning to the 'contract' itself. The Court assumed that this contract included an unwritten understanding that both parties' lips must remain sealed. *Totten v US* (n 1) at 107.

⁸ One methodological comment is required concerning philosophical autonomy and legal autonomy. One could possibly argue that the US Supreme Court is not necessarily wrong but rather merely applying a 'legal' concept of autonomy,

autonomous agent, regardless if voluntary. It is mainly centered on the paradox of respecting people's free choice to step into freedom-limiting situations. In other words, certain types of intelligence agents force us to answer the paradoxical question: How free is the free choice to give up freedom of choice?

In the course of re-contextualizing intelligence agents' contractual freedom, it is necessary to review the philosophical models of personal autonomy. I begin with presenting the basic hierarchical model of autonomy and its modern enhancements. I then suggest a new approach and interpretation to these models of autonomy, centered on a dignity-based test of potential influences over the preferences and desires setting and identification process of a person. As opposed to a mainstream deontological approach, I argue against viewing dignity as a derivative of autonomy.⁹ I also argue against Dan-Cohen's view of dignity and autonomy as independent notions. While common deontological approaches find us to be respect-worthy as a result of our capacity for autonomy, I believe our autonomous capacity is conditional upon our being respected.

My conclusions suggest that voluntary intelligence agents are non-autonomous agents and therefore their consent could not serve as a counter-argument against objections to their recruitment. This is mainly related to dignity undermining influences on either their decision to be recruited (such as the easy case of manipulation) or on their decision to continue operations (like the irreversibility of the relations).

supposedly different in content from the philosophical meaning of personal autonomy. I disagree. While a legal argument calling for limiting autonomy in certain cases may be reasonable, I believe a legal argument cannot be reasonable if calling instead for limiting the notion of autonomy itself. While I am aware of the existence of opinions to the contrary and even to legal fictions, this paper is written as a philosophical analysis of law. It views law from the philosophical perspective and it addresses autonomy accordingly. If law needs to have a different concept of autonomy or even if Court could answer the current argument with a 'legal argument' is far beyond the scope of this paper.

⁹ See, for instance, Hill's description of mainstream deontological approaches viewing dignity as a derivative of autonomy in the Kantian sense: 'Immanuel Kant held that autonomy is the foundation of human dignity and the source of all morality; and contemporary philosophers dissatisfied with utilitarianism are developing a variety of new theories that, they often say, are inspired by Kant'. TE Hill, *Autonomy and Self-Respect* (Cambridge UP 1991), 43. See similar opinions on autonomy being the ground – according to Kant – for dignity at: TE Hill, *Dignity and Practical Reason in Kant's Moral Theory* (Cornell UP 1992), 38-41; C Korsgaard, 'Fellow Creatures: Kantian Ethics and Our Duties to Animals' (2004) 25 *The Tanner Lectures on Human Values* 26, 81-83; CM Korsgaard, *Creating the Kingdom of Ends* (Cambridge UP 1996); AW Wood, *Kant's Ethical Thought* (Cambridge UP 1999).

If my new interpretation of agents' autonomy is correct, then a contractual approach to HUMINT relations might be majorly weakened. Under an autonomy-based approach to contracts, there cannot be a valid basis to the contractual approach if indeed recruitment or further operation of an agent is not a reflection of free will (even if no means of coercion is applied).¹⁰ This stands in contradiction to the U.S. Supreme Court's understanding of handling relations as contractual, as reflected by the *Totten* and *Tenet* cases.¹¹

In section II, I present various types of intelligence agents who voluntarily accept their recruitment and handling. These exemplary relations reflect a spectrum of the autonomous will of such agents. In section III, I briefly present the basic moral meaning of consent. Section IV outlines the basic meaning of the notion of personal autonomy. It presents the inherent difficulty in determining if voluntary intelligence agents are indeed autonomous. The basic idea of autonomy seems to fail to tell us what makes a difference between, for example, a voluntary intelligence agent and a voluntary elite soldier. For instance, a volunteer to the French Foreign Legion, an elite military unit, agrees to be subjected to the will of her commanders. That is the essence of being commanded as a soldier. What makes her more autonomous than the Iranian scientist who agrees to accept the will of his handler as a recruited agent?¹² In section IV, I suggest Frankfurt's hierarchical model of personal autonomy as the source for an answer. In section V, I suggest a dignity-based interpretation of the hierarchical model. This interpretation, as is argued, shows why in

¹⁰ T Gutmann, 'Some Preliminary Remarks On a Liberal Theory of Contract' (2013) 76(2) Law & Contemporary Problems; C Fried, *Contract as Promise: A Theory of Contractual Obligation* (Harvard UP 1981); TM Scanlon, 'Promises and Contracts' in P Benson (ed), *The Theory of Contract Law: New Essays* (Cambridge UP 2001) 86, 92; RE Barnett, 'A Consent Theory of Contract' [1986] Colum L Rev 269; A Ripstein, 'Private Order and Public Justice: Kant and Rawls' (2006) 92(7) Virginia Law Review 1391; R Bigwood, 'Undue Influence: "Impaired Consent" or "Wicked Exploitation"?' (1996) 16 Oxford J of Legal Studies 503.

¹¹ *Totten v US* (n 1) ; *Tenet v Doe* (n 2). In *Totten*, the US Supreme Court went as far as concluding that the President of the United States and hence the entire executive branch, bears the authority to engage on behalf of the US with contracts with human sources.

¹² Elite units are military units of Special Forces. They are assigned the more complicated and dangerous military tasks. Their soldiers are typically volunteers. In volunteering, they assume both the entailed risks and the total subjection to their commanders. They work for their country. In contradistinction, the recruited agent typically works for an intelligence agency of an adversary nation against his own country. But apparently, both the volunteer soldier and the volunteer agent make a similarly free decision to assume risks and give-up freedom.

contradiction to Dan-Cohen's argument there cannot be autonomous slaves. Accordingly, I show why there cannot be autonomous intelligence agents. I conclude by illuminating the conclusions that follow from the proposed dignity-based interpretation.

In a way, the entire debate over the autonomy of intelligence agents is no more than a good excuse for promoting the understanding of other servile relations characterized by self-imposed limitations on the scope of freedom, such as prostitution and sale of organs. I argue that the proposed interpretation of the hierarchical model of autonomy can enhance our understanding of these common types of relations.

III. THE CONSENTING INTELLIGENCE AGENTS

Discussing the theory of personal autonomy may lead to abstract notions. However, the dilemmas of the HUMINT world are far from being abstract and are chillingly real. I therefore use a few illustrative practical examples throughout this paper, all of which are of recruited agents consenting to their recruitment approaches or to being further handled.

I begin with two illustrative agents. Both are anonymous. One is evidently real, although his identifying details are unknown. Let us call him X. X is a recruited double agent operated by the CIA inside the Soviet Union. In one of his meetings with his case officers, he is anxious and nervous. He has a real reason to believe the KGB is suspecting him. Apparently, he is expected to go through a debriefing and even a polygraph check by the KGB handlers upon his return. He asks for cessation of his activity as an agent. His case officers are not willing to lose his valuable services yet. They convince him he can easily learn how to outsmart a polygraph. They take him through a fake polygraph check and show him fake successful results. The agent relaxes and agrees to further operate as an agent and travel back to the Soviet Union.¹³ A more trivial example while discussing autonomy is the false flag recruitment. In such a case, the agent is recruited and misled to believe he is assisting a friendly state, while actually being operated by the enemy.¹⁴

¹³ DL Perry, 'Repugnant Philosophy – Ethics, Espionage and Covert Action' in J Goldman (ed), *Ethics of Spying: A Reader for the Intelligence Professional* (Scarecrow Press 2006), 225-226.

¹⁴ As an example for this technique, let us imagine an agent who is an Iranian General whom the CIA wish to recruit. The American case officers have reason to believe the General is antagonistic toward America and likely to refuse. Knowing his sympathy towards France, they approach him pretending to be officers of the French Secret Service. He agrees and eventually is recruited and is handled for years. His operation is fully based on consent. In fact, the general even likes being an agent and the only

Alternatively, one can think of agents who have more understanding of the intelligence game or agents who express a clear desire to be operated. First is Aldrich Ames, a senior American CIA officer stepping into a Soviet embassy and offering his information services for money. His operation resulted in considerable damage to American intelligence, including the arrest and execution of a few American recruited agents. Numerous intelligence operations were frustrated.¹⁵ Ames initiated his own recruitment. As a senior intelligence professional, he was fully aware of the rules of the intelligence game and its risks.

Avishay Raviv is another agent, recruited by the Israeli General Security Agency ('GSA') and operated within circles of right wing extremists during the early 90's. Raviv had been identified as suffering from personality and behavioral issues, including an obsessive ascription of importance to the relations with his handlers.¹⁶

In order to further complicate the example, let us imagine a new agent, with extreme servile aspects of Raviv's personality. Let us call him the monk-agent. Just like the monks of St. Ignatious of Loyola described by Taylor, he is willingly subjecting his will to the will of his handlers¹⁷. According to the Ignatian rules, monks are required to fully subordinate their wills to the will of their abbots. Personal discretion is believed by this order to be exposing the monks to the temptations of Satan. Another good analogy is the servile woman presented first by Thomas Hill.¹⁸ She takes

abnormality with his activity is the fact that he mistakenly believes to be working for the French Service.

¹⁵ US Senate Select Committee on Intelligence, 'An Assessment of the Aldrich H Ames Espionage Case and its Implications for US Intelligence', Report of the 103rd Congress, 2nd Session (1 November 1994) <www.intelligence.senate.gov/pdfs103rd/10390.pdf> accessed 8 July 2014; D Wise, *Nightmover: How Aldrich Ames Sold the CIA to the KGB for \$4.6 Million* (HarperCollins Publishers 1995); P Earley, 'Confessions of a Spy: The Real Story of Aldrich Ames' (GP Putnam's Sons 1997); T Weiner, D Johnston and NA Lewis, *Betrayal. The Story of Aldrich Ames, an American Spy* (Rockland MA, Wheeler Public 1996); V Cherkashin and G Feifer, *Spy Handler: Memoir of a KGB Officer; The true story of the man who recruited Robert Hanssen and Aldrich Ames* (Basic Books 2005); BB Fischer, 'Spy Dust and Ghost Surveillance: How the KGB Spooked the CIA and Hid Aldrich Ames in Plain Sight' (2011) 24 Intl J of Intelligence and Counter Intelligence 268.

¹⁶ Criminal Case 2070/99 *State of Israel v Avishai Raviv*, Jerusalem Magistrate Court, unpublished

¹⁷ I use this example mainly because it is also specifically relevant to the HUMINT context of the discussion on autonomy. On the monks of Saint Ignatious of Loyola as described by Taylor, see: JS Taylor, *Personal Autonomy: New Essays on Personal Autonomy and its Role in Contemporary Moral Philosophy* (Cambridge UP 2005), 1-29.

¹⁸ TE Hill Jr, 'Servility and Self-Respect' in Hill, *Autonomy and Self-Respect* (n 9).

pleasure and fully consents to devoting herself to taking care of her husband's needs and promoting his interests. This type of subjection in the cases of the servile woman, the monk and the monk-agent, is absolute. They all willingly accept the will of another person, whether a husband, an abbot or a handler, to be their own.¹⁹

Acceptance of the handler's will is held to be superior to the monk-agent's, as if it were a self-imposed imperative. The agent is guided by the belief that acting in accordance with the case officers' will is practically the right route. This example is philosophically complex, since whenever the monk-agent implements his handlers' will, he is in fact positive in his feeling of indirectly implementing his own will. The radical nature of the monk-agent example by no means indicates that this is a rare occurrence. While such an extreme instance of servility is probably rare, I believe a more moderate type of a servile agent is quite common.²⁰

All of these exemplary agents have agreed to their recruitment. None of them faced any apparent means of coercion in order to motivate this consent. But we can already easily identify the first two agents as non-autonomous. Under any account of autonomy or consent, both false flag recruitment and the fake polygraph check are considered as critical external intervention with free will. As a result of the clear intervention, both agents adopted a will they mistakenly identified as their very own. Are Ames and the monk-agent autonomous persons distinctively making a free choice? This question places us in a junction allowing us two alternative routes, neither of which seems to offer an easy ride.

Both types of agents are well informed and express clear consent to their recruitment. Accepting a concept of personal autonomy that determines the monk-agent to be non-autonomous seems almost an inherent logical error. After all, the monk-agent is aware of the handler's level of control of his will, and yet, deems such control to be a genuine reflection of his very

¹⁹ According to Hill, the servile person acts in violation of the duty to his own self. The argument presented in this paper is different in the sense that I argue against the view that his choice for servility is autonomous in the first place. Rather than arguing like Hill, that this choice is autonomous yet unacceptable (although Hill argues such choices are rarely autonomous), I argue that the choice for servility is never autonomous.

²⁰ According to certain HUMINT professionals, a typical concept of running an agent requires absolute control of the agent's will and mind (W Hood, *Mole* (WW Norton & Company 1982), 29; Perry, 'Repugnant Philosophy' (n 13). The concern of a certain level of servility as part of humint relations is fortified due to the fact that a substantial number of recruited agents are "walk-ins", namely volunteers who initiate their recruitment. See Wood (n 6); Fitz and Wiskoff (n 6).

own will. On the other hand, considering the monk-agent to be autonomous intuitively seems just as wrong. Our intuition rejects seeing servility as possibly co-existing with exercising free will.

IV. THE AUTONOMY AND CONSENT CORE ARGUMENT

The importance of consent within legal and moral analysis of practical issues cannot be exaggerated. In many cases, signs of consent are the only differentiating element between severe harmful acts on the one hand and acceptable practices on the other.²¹ It is consent that distinguishes between rape and normal sexual intercourse, between slavery and employment relations or between theft and donation. Accepting consensual acts does not mean labeling them as justified or right.²² It does however reflect the exceptional authoritative power society refers to personal acts of consent and reflection of human will.²³

If we respect people's autonomy and believe that an agent's choice to accept a recruiting offer is an exercise of such autonomy, so the argument goes, we should respect the agent's choice. We are expected to refrain from objecting to the recruitment as long as it is consensual and as long as the ground for arguing against operating the agent is relying on potential harm to the agent. Just as we do respect a young woman's choice to volunteer for an elite military unit, irrespective of the related risks and potential damages, so we should respect an agent's consent to assume the risky and morally problematic task of a recruited intelligence agent.²⁴

²¹ P Young, *The Law of Consent* (North Ryde NSW, Law Book Co 1986).

²² Hill, *Autonomy and Self-respect* (n 9), 49.

²³ See for example an attempt to offer a complete Kantian consent-based criminal theory: DAJ Richards, 'Human Rights and the Moral Foundations of the Substantive Criminal Law' (1978) 13 Georgia L Rev 1395. On another front, a wide-range paternalistic legislation practically fixes new borders to personal autonomy on a daily basis. Most western states prefer to force us to fasten seat belts while driving rather than simply respect our personal choice not to do so. The deliberation process in setting such a rule is not focusing on the question: "Are the persons autonomous while fastening seat belts?" The debate is rather focusing on the question of what the counter arguments are for not respecting the driver's choice on the matter.

²⁴ At this point, I conduct this analysis based on a general assumption that autonomy does have an important positive value irrespective of the tough debate over the nature of this value, whether of an intrinsic or of an instrumental value. I simply assume people's choices should be respected and therefore not protested, for the very reason of being their own. By that, I do not mean to say that any act is justified, provided it is autonomous. Other considerations may obviously prevail. But so long as we don't hold under the circumstances any prevailing counter considerations, autonomy should be respected. By that, the consent argument does not argue for human collection as justified, but rather as permissible. L Hawort, *Autonomy: An*

Cases of what seem to be clear autonomous acts, which still need to be rejected based on other prevailing considerations, seem to erode the moral status of personal autonomy. Scholars frequently ask us to balance personal autonomy against competing values. Dan-Cohen even further uses these examples in order to call for ascribing a lower level of importance to personal autonomy in comparison to other values, such as dignity.²⁵ It is the trivial cases of people accepting the unacceptable that mostly shake the foundations of the notion of autonomy as a morally validating concept. Take the case of *Brown*, where a husband was prosecuted and charged for beating his wife regardless of an alleged prior consent of the woman. Allegedly, the wife expressly asked her husband to beat her each time she got drunk.²⁶ Dan-Cohen uses the case of *Brown* as a building block for a new normative scale. In this scale, dignity is superior to autonomy, while the two notions remain independent.²⁷

The link I wish to propose between autonomy and dignity suggests a different approach to the *Brown* case than Dan-Cohen's. For now, I will only mention that according to my suggested approach, the wife is not autonomous to start with and therefore the case represents no contradiction between autonomy and dignity. Another important conclusion drawn from the case of *Brown* is that our moral attitude to personal choices is context-sensitive. While we may respect the choice of a woman to practice martial arts and to be consensually beaten as part of her training, we refuse to respect a similar choice of a woman in the family relations context.²⁸ Any suggested account of personal autonomy must, therefore, be sensitive to different contexts, such as the differences between sports and married life.²⁹

Accordingly, our interpretation of autonomy must eventually show special sensitivity to consent in the specific human collection context. However, the starting point for such analysis must be a preliminary review of the

Essay in Philosophical Psychology and Ethics (New Haven, Yale UP 1986); G Dworkin, 'Is More Choice Better than Less?' (1982) 7 *Midwest Studies In Philosophy* 47, 55-56

²⁵ M Dan-Cohen, 'Defending Dignity' in M Dan-Cohen, *Harmful Thoughts-Essays on Law, Self and Morality* (Princeton and Oxford, Princeton UP 2002) 150, 154-157.

²⁶ *State v Brown* 364 A 2d 27 (N.J. Super Ct Law Div 1976), *aff*, 381 A 2d 1231 (N.J. Super Ct App Div 1977).

²⁷ Dan-Cohen (n 25), 154-157.

²⁸ One can view this point as a source of strength to the authoritative power of autonomy, since it illustrates consent's flexibility and sensitivity to different contexts.

²⁹ A similar issue arises in contracts law in cases where the formation of the contract is 'proper' and yet we refuse to validate the deal based on its content. RE Barnett, 'A Consent Theory of Contract' (1986) 86 *Columbia L Rev* 269.

notion of autonomy in general.³⁰ In order to determine if voluntary intelligence agents are indeed autonomous, a deeper understanding of the notion of personal autonomy is required.

V. AGENTS AND THE PARADOX OF RESPECT FOR AUTONOMY

Autonomy is generally defined as a personal condition related to the psychological ability for self-government.³¹ The link between the notion of autonomy and the notion of freedom is obvious. Being autonomous may also be involved with the right that such psychological condition is not interfered with.³² The basic concept of autonomy therefore means both a psychological condition of self-government and a right-based concept of avoiding external interference with such condition.³³

The typical handler-agent relations seem at first glance to be in contradiction to both meanings of autonomy. The substantial level of control and the potential mental manipulation derogate the psychological competence of self-government. And it seems to be externally interfering with the agent's capability to produce the conditions for self-government:

But the highest in the tradecraft is to develop a source that you 'own lock, stock and barrel'. According to the clandestine ethos, a 'controlled' source provides the most reliable intelligence. 'Controlled' means, of course, bought or otherwise obligated. Traditionally it has been the aim of the professional in the clandestine service to weave a psychological web around any potentially fruitful contact and tighten that web whenever possible.³⁴

Achieving this goal requires a well-learned technique of gradually draining signs of independence:

³⁰ J Christman, 'Constructing the Inner Citadel: Recent Work on the Concept of Autonomy' (1988) 99 *Ethics* 1, 109.

³¹ J Feinberg, *Harm to Self, Vol. III in The Moral Limits of Criminal Law* (New York, Oxford UP 1986), 28.

³² T Hill, 'The Importance of Autonomy' in EF Kittay and DT Meyers (eds), *Women and Moral Theory* (Rowman and Littlefield 1987) 129-138, at 133.

³³ Meyer for instance suggests a similar distinction between the two 'internal' and 'external' meanings of autonomy. He prefers to define them as 'positive' and 'negative' meanings of autonomy. See: M Meyer, 'Stoics, Rights, and Autonomy' (1987) 24 *American Philosophical Quarterly* 3, 267.

³⁴ G Drexel Jr, 'Ethics and Intelligence', in J Goldman (ed) J Goldman (ed), *Ethics of Spying: A Reader for the Intelligence Professional* (Scarecrow Press 2006), 6.

The officer is painstakingly trained in techniques that will convert an acquaintance into a submissive tool, to shred away his resistance and deflate his sense of self-worth.³⁵

At this point, I cannot avoid re-citing Hood's very clear description of the meaning intelligence organizations ascribe to the term 'control':

No espionage service can tolerate the merest whiff of independence or reserve on the part of an agent... With a new agent, the case officer's first task is to maneuver him into a position where there is nothing that can be held back – not the slightest scrap of information nor the most intimate detail of his personal life. Until this level of control has been achieved, the spy cannot be said to have been fully recruited.³⁶

Obviously, this is an extreme description of the reality of HUMINT relations. If all handling relations had matched this description, moral analysis of HUMINT would have been trivial. And deep philosophical debates about personal autonomy would not be necessary. However, agents have their own cards to play. They source the information. Some of them, as in the case of Ames, are intelligence professionals. But even in the case of far more moderate handling, a substantial level of control is maintained. Accordingly, if intelligence agents seem to be non-autonomous under both meanings of autonomy – even in moderate cases of handling – then how can one accept (not object to) human intelligence collection on the ground of respecting the agent's autonomy? Similarly, as opposed to the Supreme Court's perception of handling relations, how can a non-autonomous agent be seriously viewed as a party to a contract?

A counter argument points at other choices people make in life which also result in limiting personal freedom. And yet, we still expect such choices to be respected. The young woman electing to join an elite military unit is a good example of such a choice.³⁷ It is safe to assume that her scope of freedom for self-government will be dramatically limited as a soldier compared to her civilian life. So, can there be choices, which we do find autonomous and therefore respect-worthy, irrespective of such choices resulting in limitation on the agent's scope of autonomy?

³⁵ *ibid* 7.

³⁶ Hood (n 20), 29; Perry, 'Repugnant Philosophy', (n 13) at 230.

³⁷ For the sake of clarity, I shall assume this is a unit of volunteers. All a candidate needs to do in order to quit is to announce her will to quit, as ringing the bell symbolizes in the film *GI Jane*.

I believe an answer may lie within further analysis of the nature of the psychological condition of autonomy. I argue that a valid source for a normative distinction between the young drafted woman and a common intelligence agent could be partially found in the separate models of personal autonomy of Frankfurt and Dworkin.³⁸ I then offer a new perspective on the hierarchical model of autonomy, which in my view, may assist in answering the main questions of this paper: Is the consensual intelligence agent autonomous? What distinguishes between our respect to the autonomy of an elite soldier and the autonomy of an agent? Facing these questions, we are puzzled by the need to determine the scope of the freedom to give up freedom. This is where the hierarchical model of personal autonomy becomes relevant.

VI. THE HIERARCHICAL MODEL OF PERSONAL AUTONOMY

The hierarchical model of Frankfurt is based on the distinction between first level desires (or Lower-Order Desires, 'LOD') and second order desires (Higher-Order Desires, 'HOD').³⁹ The actual actions of a person are the objects of the Lower-Order Desires. For example, I want to walk and therefore walking is the object of my Lower-Order Desire. On the other hand, the objects of Higher-Order Desires are Lower-Order Desires and not actual actions. In such a case, an agent wants to desire. She controls the process of producing preferences. A person not only produces desires to desire; she can strongly identify with such desires. This is the basis for Dworkin's 'full formula of autonomy'. It considers a person to be autonomous if she identifies with her desires in a process that is completely internal.⁴⁰

This model assists us in making a rational distinction between the young woman draftee and the intelligence agent. The difference lies in the HOD and the identification process. Unlike the young draftee, we have strong grounds to doubt the authenticity of the HOD of the designated agent to desire to act as an intelligence agent. The false-flag recruitment of an agent is a perfect example of a discrepancy between LOD to work for the adversary and the HOD to desire to work for a friendly state. Such discrepancy is a result of deception, which disassociates our control of

³⁸ H Frankfurt, 'Freedom of the Will and the Concept of a Person' (1971) 68 *The J of Philosophy* 5; G Dworkin, 'The Concept of Autonomy', in R Haller (ed), *Science and Ethics* (Amsterdam, Rodopi 1981), 203.

³⁹ Although both Frankfurt and Dworkin initiated hierarchical models, the concept of hierarchy of desires is mainly related to Frankfurt and most of the following debates are centered on Frankfurt's model. Therefore when referring in this paper to the hierarchical model, I refer to Frankfurt's model.

⁴⁰ Dworkin, (n 38), 212.

actions from our control of the will. Both choices, of the young draftee and the designated intelligence agent, will result in limitations on their LOD. However, based on the hierarchical model of Frankfurt, this in itself does not render them non-autonomous. It is the suspected influence over the HOD of the intelligence agent, which raises a doubt concerning his autonomous status.

For now, the hierarchical model managed to explain why the agent recruited under obvious manipulation is not autonomous, though formally showing consent. His desire to will to be handled by State *X* does not match and identify with his first order desire to be handled by State *Y*. But the model does not filter out all instances of manipulation. If the handler is sophisticated enough, she will lead the agent into confirming the maneuvered desire as though initially preferred by the agent, and as though it were his very own.

The hierarchical model manages to filter out desires, which do not match the actual HOD. But it faces difficulties when the manipulation ‘takes over’ the very HOD. The hierarchical model is expected to duplicate its erroneous outcome with regard to the monk-agent. Apparently, the model will determine such agent as autonomous. This is a result of the monk-agent identifying with his desire to accept the will of his handler. He wants to will whatever the handler desires. In contrast, I assume most readers intuitively find this agent to be non-autonomous. Something very wrong seems to be involved. But the hierarchical model seems blind to it and incapable of filtering out such consensual relations. At this point, a deeper analysis of the model and its alleged failures is required.

The hierarchical model is exposed to problems known as the problems of manipulation, authority and regression. Critics attack the requirement of identification of HODs and LODs.⁴¹ They point to the need to be autonomous in the first place for this very act of identification. We can easily imagine a person who is ‘freely’ matching her HODs to her LODs and yet she has done so as a result of some manipulation. But the problem of manipulation can also carry a broader form, setting endless circles of intervention around the agent’s biography. A deeper look at his life story might show powerful influences on this identification process by his education, socioeconomic status and many other background factors.⁴²

⁴¹ I Thalberg, ‘Hierarchical Analyses of Unfree Action’ [1978] *Canadian Journal of Philosophy* 211, 219–220.

⁴² This critique is obviously linked to the far broader determinism-free will old debate. I believe this critique applies to all potential models of autonomy and not merely to Frankfurt’s and Dworkin’s. Actually, it questions the potential maximal level of personal freedom in general, namely it raises doubts on how free a person can

Another threat to the stability of the hierarchical model is its alleged exposure to regression. If autonomy requires identification between HODs and LODs, it may also require even Higher Order Desires in order for the agent to be the author of his HODs (HOD₂) and these in turn will require an even higher level of desires in an endless form (HOD₂ to HOD_n, while n could be infinitely increased). Apparently, autonomy cannot be determined, since it is dependent upon identification between an endless string of desires and higher desires.

The mirror image of the regression problem is the authority failure. If the source of authority of the LOD is internal to the agent's self (HOD), then the regression problem will lead us in endless checks of approvals against the endless levels of desires. However, if – in order to escape the problem of regression – we point to an external source of authority of a desire, this might be far more detrimental to autonomy. LOD approved by a source external to the agent's self could hardly be viewed as representing the agent's very own will. Apparently, the hierarchical model falls either into endless regression or else into external authority.

But this does not necessarily mean the model of Frankfurt collapses. Logically, there are two paths for solving the regression problem. The first path would be to present a method for determining a cut-off point in the endless string of levels of desires by way of reason. The second path would be to fine-tune the hierarchical model in order to show why proper review of the HODs could be sufficient, namely, how the HODs could escape the regression problem by resting on a solid (and internal) source of authority.⁴³

A common case study for reviewing the models of personal autonomy is the case of consensual enslavement. The case of enslavement seems alarmingly relevant to the debate over the consensual recruitment of

be rather than on how autonomous a person can be under a specific model of autonomy.

⁴³ Frankfurt attempted to answer the regression problem with a different approach than the one suggested above. According to Frankfurt, there is no need for higher level desires on top of HODs as long as the identification between HODs and LODs is 'decisive'. In this manner, Frankfurt is taking the first approach I have referred to for solving the regression problem, namely by suggesting a method for cutting the endless string of desires higher than the HOD. It seems that Frankfurt's first attempt to cut the regressed level of HODs is mainly by way of fiat rather than by way of reason. As mentioned, the route that this paper suggests is different, since I am offering an internal source of authority, namely dignity and self-respect. H Frankfurt, 'Identification and Wholeheartedness', in DF Schoem (ed), *Responsibility, Character and Emotions* (Cambridge UP 1987) 27-45; Christman (n 30).

intelligence agents. The case of intelligence agents, as in the case of slaves, emphasizes an important distinction between two different points in time relevant to freedom of the will. The first is the one point shortly before making a choice. The second point in time is soon after, as the choice has been made. Both the voluntary agent and the consensual slave may be free upon assuming the task. But it seems that both the agent and the slave face a problem of freedom soon after making a choice.⁴⁴

Using the consensual slave, Dan-Cohen suggests an extreme thought experiment. If we respect the slave's autonomy, we apparently need to respect his choice to be a slave. Since his scope of autonomy soon after making this choice is expected to be restricted, Dan-Cohen further imagines a consensual slave whose scope of autonomy is not derogated compared to his non-slave free counterpart, for example, due to his master's 'liberal' approach and relatively flexible terms of slavery.⁴⁵ Since our moral intuition rejects such a situation regardless of this 'liberal' approach, Dan-Cohen urges us to reach a conclusion on the limited importance of autonomy compared to other values, such as dignity. In contrast, I argue against the very idea of the consensual slave to start with. For obviously if one can point at an autonomous slave, one can theoretically point at an autonomous intelligence agent.

I contend that the idea of Higher Order Desires reveals the emptiness of the idea of consensual enslavement. By allowing the slave to be 'autonomous' within a 'reasonable' scope compared to a non-slave person, a virtual (and external) higher level of desires is being created.⁴⁶ While the slave is capable of setting his HODs and identifying them with his LODs (due to his master's 'liberal' rules of slavery), he is still not autonomous. The power of the master is equivalent to the creation of a virtual third and higher level of desires higher than the slave's HODs. The slave's owner now controls the higher level of HODs. The slave's owner externally sets

⁴⁴ Dan-Cohen (n 25), 154-157. The volunteer soldier seems to avoid the limitation of her freedom of the will soon after making her choice to be recruited. I further elaborate on this distinction between the two temporal phases of the choice when subsequently discussing the example of consensual enslavement.

⁴⁵ In order to refrain from status issues, Dan-Cohen even further defines the slave as autonomous de-facto. This way, the oxymoronic status of autonomous slave is avoided. The slave is not autonomous de-jure, but arguably autonomous de-facto. M Dan-Cohen, *ibid*, 156-157.

⁴⁶ Obviously, the reference to this third level of desires as virtual is strictly illustrative. The model does not recognize any level of desires higher than the HOD. However, this virtual level acts as if there is a third level of desires and by that assists us in understanding in such a case how non-authentic are the HOD's and realize that the HOD's stem from an external source of authority.

the scope of the slave's HODs and can minimize that scope to zero at any given time subject to her sole discretion.

As opposed to Dan-Cohen's view, I believe the slave under these conditions is not autonomous while another person exercises such a dramatic control over the slave's HODs. In the hierarchical model's terms, one can define it as a situation in which the slave's HODs stem from a higher level of desires, which is both irreversible and located outside the boundaries of the slave. Therefore, the specific consensual slave is not autonomous. The problem of irreversibility is particularly relevant to handler-agent relations, which in many cases resemble 'liberal ownership'. These relations seem friendly, pleasant and cooperative. And yet, the handler could revoke that condition at any time.⁴⁷ In contrast, the agent – just like the consensual slave – cannot unilaterally bring the relations into an end. His handlers hold the incriminating information. They can always respond with 'burning' the agent and revealing his true position.

Dan-Cohen does refer to this issue of irreversibility of the slavery status and the consequent fragile freedom granted by the owner, since this freedom is fully subject to the owner's sole decision to revoke. Dan-Cohen suggests a hypothetic counter party to the consensual slave, enjoying a similar level of freedom, which due to some illness, could be abruptly and randomly revoked.⁴⁸ Apparently, this non-slave autonomous person shows us that even under the condition of potential revocation of freedom, a person, and therefore also the consensual slave, is still deemed autonomous. I argue against viewing a common denominator to a slave with relative freedom and to the person who might, at any minute, lose some of his freedom due to some illness. As I mentioned, many intelligence agents resemble the 'autonomous slave'. They typically enjoy a high level of freedom while controlled. However, the handler remotely controls the scope of this apparent freedom.

All formulas of autonomy, including the hierarchical model of Frankfurt, emphasize the psychological aspect of autonomy. Autonomy is very much

⁴⁷ For a first hand account of the irreversibility problem in the HUMINT context, see M Klingberg and M Sfard, *The Last Spy* (Hebrew Edition, Maariv 2007), 224-225. Prof Klingberg was an epidemiologist and vice president of the top-secret biological defense institute in Israel. Klingberg was also a senior agent recruited by the KGB and operating within the top-secret institute. For around 30 years, he communicated to the Russian intelligence invaluable secret scientific information from Israel. In his book, he describes his helpless efforts to bring his handling into an end, understanding that his voluntary handling could turn at any minute into being coercion-based.

⁴⁸ Dan-Cohen (n 25), 156.

related to a state of mind and the ability to transform it into preferences, desires and choices. The very awareness of the slave that his state of mind is constantly conditional upon a third party's approval creates a new derogated state of mind and sense of freedom. This is all similarly relevant to a case in which the slave's produced HODs and consequent LODs eventually match the master's will after all. It is the slave's awareness to the potential limitation that counts, not the actual influence it might (or might not) have over the content of the slave's will.

The influence of the virtual third and higher level of desires controlled by the master comes into effect in both a positive and negative manner. The negative manner is obvious: the HODs of the slave – or the intelligence agent in the case of this paper – can only be produced and implemented as long as the master – or the case officer – approves them and chooses not to interfere. But there is also a positive and active manner of interfering with the slave's process of setting desires and identifying with them. The very fact that the slave is aware of the veto power of the master and her power to bring immediate cessation to his scope of freedom influences, by itself, the psychological process of a free person.

The slave is also constantly aware of the irreversibility of his situation, of this dependence upon the master's good will and ever-temporary scope of freedom he will never control. This sense of clear subjection is fed into the slave's process of producing desires and identifying with them in a recursive manner. To use an illustrating case from another field, consider a journalist in a totalitarian country, notified by the totalitarian regime that his writing topics and expressed opinions are subject to the absolute censorship power of the army. And let us also suppose that for two years, the topics and opinions elected by the journalist did not justify censorship from the regime's perspective, namely the censorship prerogative is in force yet remains unexploited. Could this totalitarian regime seriously claim that the journalist exercised the right of free speech? I believe that this journalist exercises free speech no more than Dan-Cohen's illustrating autonomous slave exercises autonomy.

The idea of the virtual creation of a third and superior level of HODs also assists in explaining the distinction I have suggested between a soldier volunteering into an elite unit and a recruited intelligence agent. As this is a special unit of volunteers, which encourages only those who really want to stay, in being able to quit and stop obeying her commanders, the soldier

is autonomous.⁴⁹ She is capable of identifying her HODs with her LODs. There is no higher level of desires subjecting her HODs. On the other hand, just as the 'consensual' slave has a virtual third and higher level of desires controlled by his master, so has the intelligence agent. He is not autonomous since the very nature of the relations with the handler creates this irreversible third and virtual higher level of desires externally controlled by his handler. But why is it that the virtual third level of desires I present derogates and sometimes even nullifies autonomy? What is the difference between the consensual slave and the intelligence agent on one hand, and the sick person Dan-Cohen describes on the other hand? The answer, so I would like to argue, may be found in the proposed dignity-based approach to models of personal autonomy.

VII. A DIGNITY BASED INTERPRETATION OF AUTONOMY

It is a belief shared by leading scholars that the hierarchical model constitutes the right foundation for understanding the psychological process of free action based on freely set desires.⁵⁰ However, its fine-tuning towards a coherent model continues. Generally speaking, the authority problem with regards to the HOD reflects an apparent logical no-through road. If the source for authority of the HOD is internal – namely stemming from another psychological event happening *within* the boundaries of the agent – then we need another verification of that other psychological event being freely initiated. This is the essence of the regression problem, since every relevant internal source of authority must be endlessly authenticated against a higher-level source (or desire). On the other hand, if the source for authority of the HOD is external to the agent, then how can one determine such a process of endorsing a desire as autonomous? This is where the modern attempts to enhance the hierarchical model come into the picture.

Both Frankfurt and other scholars made attempts to amend the model in order to meet its challenges. Dworkin argued that his demands for both procedural freedom and substantive freedom within his model avoid all three problems, including the problem of manipulation.⁵¹ However, on top

⁴⁹ Again, in this example the assumption is that the elite unit is a unit of volunteers which even encourages candidates during training to quit so only those who really want do stay.

⁵⁰ See Taylor's excellent summary on the current approaches to the hierarchical model and of its most recent and promising versions in his introduction to *Personal Autonomy*. JS Taylor (n 17), 1-29.

⁵¹ In short, the demand for procedural freedom requires that manipulation and deception do not influence the identification process. G Dworkin, 'Autonomy and Behavior Control' (1976) 23 *Hastings Center Report*; Taylor (n 17), 4.

of failing to filter out cases such as the monk-agent, his requirement is too general, telling us to avoid wrong interventions in the autonomous desires-setting process, while it fails to tell us how to practically identify wrong interventions.⁵²

Frankfurt's second attempt was to suggest a satisfaction-based analysis of identification.⁵³ This enhanced hierarchical model determines a person to be autonomous in reference to a desire, if that person accepts this desire as his own. The HOD under this approach is not normatively superior to the LOD. It is rather connected with a descriptive relation. The HOD, being descriptive and only describing the LOD as owned by the discussed person, apparently manages to avoid the problem of authority. By not being superior to the LOD and by not making a normative judgment on the LOD, we are no longer concerned with the level of authority they represent.⁵⁴

Frankfurt's amended approach is still exposed to the manipulation problem.⁵⁵ Apparently, the monk-agent will comply with Frankfurt's requirement of satisfaction-based identification. Since the monk-agent is knowingly and willingly accepting the handler's (abbot's) will as his own, his HOD will identify with his LOD and describe them as his own. In such a case, we are left with a model confirming the monk-agent as autonomous, while we intuitively disagree.

Additional promising attempts to cure the inherent problems of the hierarchical model are related to Christman, Bratman and Kelstrom. They all attempted to show that the HODs stem from an authoritative source over the LOD. Christman's model requires non-resistance of the person to the development of the desire accompanied by minimal rationality and lack of influence on self-reflection. Apparently, his model is also prone to fail in the case of the monk-agent, since it cannot reject consensual and total subjection to the will of another person, which is not the result of direct interference.⁵⁶

⁵² G Dworkin, *The Theory and Practice of Autonomy* (Cambridge UP 1988)); Taylor, (n 17), 7-8.

⁵³ Frankfurt made two attempts of addressing the criticism on his model. The first suggested that a decisively made HOD could escape the problems of regression and authority.

⁵⁴ H Frankfurt, 'Reply to Gary Watson' in S Buss and L Overton (eds), *Contours of Agency* (MIT Press 2002), 160; Taylor (n 17), 9.

⁵⁵ Taylor, *ibid*, 11.

⁵⁶ J Christman, 'Defending Historical Autonomy: A reply to professor Mele' (1993) 23 *Canadian Journal of Philosophy* 281; JS Taylor, *ibid*, 10.

Bratman's and Ekstrom's models both find a source for the authority of the HOD within the self of the person. Bratman's model requires that the person decides to treat his desire as reason-giving while being compatible with the person's other perceptions pertaining to what to treat as reason-giving.⁵⁷ Ekstrom's model finds a person autonomous on HODs that cohere with her other perceptions that constitute her core and true self.⁵⁸ At first glance, both last models of Bratman and Ekstrom have the potential of escaping the major problems of the basic hierarchical model: regression, authority and manipulation.⁵⁹ I believe resorting to the core self as a source of authority carries new types of risks. A new type of manipulation arises – manipulation and intervention in the constitution process of the self. Socioeconomic background, parenting approach, health condition and education are all examples of elements influencing the constitution of the core self and over which the person had limited control, if any at all.⁶⁰ This point leads me to raise another objection to these two enhanced models; their over-subjective approach.⁶¹ They both represent a subjective analysis of autonomy and are dependent upon the person adopting a certain approach to her desire in order to be autonomous.

Intuitively, I believe that autonomy is a notion with strong sociological roots. Society sets the limits of autonomy. It influences a person's perception of her own autonomy and its limits. And yet, under these subjective models, social perceptions are not relevant in determining an autonomous decision or action.⁶² On the other hand, the subjective

⁵⁷ M. Bratman, 'Identification, Decision, and Treating as a Reason' (1996) 24(2) *Philosophical Topics* 1, 9-11.

⁵⁸ L.W. Ekstrom, 'A Coherence Theory of Autonomy' (1993) 53(3) *Philosophy and Phenomenological Research* 599, 603-606.

⁵⁹ See Taylor's excellent outline in Taylor (n 17) at 13.

⁶⁰ Both models could also face difficulties in cases of a sharp and revolutionary change in a person's personality and structure of the self, while still no autonomy-nullifying influence has been involved.

⁶¹ It is worth noting that the two models are not purely subjective. They do allow us, for example, to determine a person as non-autonomous although the person himself believes he is exercising free will, as in the case of the monks.

⁶² On the sociological aspects of the notion of autonomy, see: C. Mackenzie and N. Stoljar, 'Introduction: Autonomy Refigured', in C. Mackenzie and N. Stoljar (eds) *Relational Autonomy: Feminist Perspectives on Autonomy, Agency, and the Social Self* (Oxford UP 2000), 3-31; J. Christman, 'Relational Autonomy, Liberal Individualism and the Social Constitution of Selves' (2004) 117 *Philosophical Studies* 143. This apparent social indifference of the models adds to their over rigidity. They seem to be blind to different views of autonomy that are influenced by changes of society, context, time and place. And yet being anchored to the core self of the person, the models of Bratman and mainly Ekstrom's, show sufficient flexibility in determining different levels of autonomy for different people in similar circumstances.

approach makes sense, since an external source of authority over the agent's choice-making process seems to contradict the essence of autonomy. Attempting to solve these problems is far beyond the reasonable scope of this paper. However, a new interpretation of the hierarchical account of autonomy – any coherent account – could be most helpful in understanding the true nature of common aspects of 'running' an agent, like control, manipulation, servility and irreversibility.

Arguably, the HOD of the person is expected to confirm the authenticity of the endorsement of the LOD of a person. In order to verify the authenticity of the HOD, most recently proposed hierarchical models of autonomy tried to verify that the endorsement process was either free of external intervention or that the agent verifies or reaffirms his ownership of the LOD. I am not certain that an external intervention is by itself an autonomy-nullifying element. Take for example people who give other persons, like friends or spouses, a dominant influential position in their lives. Is the less dominant friend really non-autonomous?⁶³

Clearly, not every influence on desires setting is compromising autonomy, not even every causally critical influence. I further argue that not even any manipulation denies autonomous decision-making.⁶⁴ At the same time, I am not convinced that the verification of the lack of external influence should stem strictly from the discussed person's self. The case of the monk-agent may suggest that some cultural institutions may have a relevant normative position on the matter. This is why I suggest the notion of humanity or dignity as the verification tool for determining unacceptable intervention in the endorsement and identification process.

⁶³ This line of thought may seem similar to Raz's theory concerning the service conception of authority. However, Raz's argument deals mainly with the question of *when is x's authority over y legitimate*, while this paper seeks an answer to a more fundamental question: *is x exercising authority over y (or alternatively is y autonomous)*. Regardless of the different focus of the arguments, Raz deals – as a peripheral question – with the issue of identifying authority. For example, from his reference to this question it seems clear that the case of person x accepting person y's judgment rather than exercising x's own judgment isn't a case of y's authority over x, unless x permanently subjects his judgment to y's superior judgment. J Raz, 'The Problem of Authority: Revisiting the service conception' (2006) 90 Minnesota L Rev 1003, 1018. The main task of this paper is to tackle Dan-Cohen's argument according to which (and in contrast to Raz), autonomous slavery is theoretically possible, for if autonomous slavery is indeed possible as Dan-Cohen contends, it is obvious that so is the case with autonomous handling.

⁶⁴ On the philosophical analysis of manipulation, showing different types of manipulation with apparently different moral outcomes, see: R Noggle, 'Manipulative Actions: A conceptual and moral analysis' (1996) 33 American Philosophical Quarterly 43.

I suggest a similar route initially suggested by Frankfurt, only in the opposite direction. The original idea of Frankfurt in suggesting the hierarchical model was to sketch a unique concept of a person.⁶⁵ The idea is that persons are unique in their way of exercising their free will. By accurately describing the way human will is autonomously exercised, we could end up with a clear concept of a person. This attempt has obviously been proven to be unsuccessful. Apparently, we face difficulties in drawing the complicated concept of a person out of the model of free action. I argue that the task should have been set in the opposite direction.

As complicated as it may be, we do have a good understanding of the concept of a human and of humanity. We rarely argue the question of what are human beings. While this is difficult for us to define, we share social intuitions about what a human being is, and what humanity is. It is human autonomy, which we actually find difficult to define. But having a concept of humanity or dignity (as a representative notion of humanity) could assist us in making this definition. If autonomy is a unique human virtue, and if we recognize humanity or dignity, then an autonomous decision should be one taken without a dehumanizing interference. In this respect, I use dignity as a concept of humanity.⁶⁶ Therefore, I would like to offer a perception of autonomy that incorporates dignity-compromising influences on the choice-making process.

This theoretical and moral approach will result in preventing occasions where one makes a choice under dignity-undermining conditions while still considered to be autonomous. The reason is that unless such an interpretation is adopted, a human being adopting a desire under a dehumanizing effect might be determined autonomous after all. If being autonomous is an exclusive human status, we might reach in such a case an impossible condition in which a creature is both dehumanized in relation to trait X (autonomy), yet holds an exclusively human status in relation to trait X.

The hierarchical model seems the right mechanism to make this verification. As mentioned, this paper is absolutely not targeting the goal of suggesting a new model of personal autonomy. My proposal of the dignity-based review of autonomy could be incorporated, however, as an addition to most coherent models. Therefore, the account I suggest should

⁶⁵ Frankfurt (n 38), 6-7.

⁶⁶ While I elaborate on this issue in later stages, it is nevertheless important to note at this stage that I am aware that identifying dignity with humanity is not necessarily a common and non-controversial approach.

be viewed as an interpretation relevant to most successful models rather than as an independent and comprehensive model by its own.

I am suggesting that the hierarchical model of personal autonomy should be interpreted so a person *A* is autonomous in reference to a desire *X* if and only if: (1) *A* endorses desire *X* as his own (under the terms of a coherent model); and (2) if, at the time of endorsing desire *X* as his own, *A* was not under an influence pertaining to *X* (whether internal or external to *A*) which amounts to violating *A*'s dignity, and is related to fulfilling (1).

This interpretation of the hierarchical model leads to a few conclusions relevant to both the understanding of the notion of autonomy in general and agents' handling in particular. This interpretation suggests a new source for dealing with the regression and authority problems: humanity. We may not need to resort to any higher level of desires since the dignity-based review is definite. The use of human dignity as a representing notion of humanity is a potential source of authority. Humanity is both an internal and an external source of authority for the desires-setting process of a person.⁶⁷

VIII. DIGNITY AND SELF-RESPECT

Using the term 'person' requires further clarification. One could argue that, as opposed to my suggestion, it is not at all clear what a 'person' means, in contrast to what 'homo sapiens' means. In the philosophical literature, not every biological human being is automatically deemed a moral person. Typically, some cognitive criteria must be met for a biological human being to be recognized by philosophers as a person in the moral sense.⁶⁸ Others, like Peter Singer, are located at the other end of the

⁶⁷ We may also avoid the debate on the relations between internal influences (like drug addiction) or external influence (like coercion). The notion of compromised dignity may contain the two sorts of threats to freedom of the will. Both the uncontrolled need for drugs and the subjection to external coercion seem to be derogating the influenced person's dignity while making his choice.

⁶⁸ The Kantian list of human traits being the source of the moral uniqueness of human beings reveals a capacity-based approach to persons, like the human capacity for self-legislation. This however did not prevent Kant from reaching the ultimate conclusion that as a result every human being deserves intrinsic value for the very fact of being human, although we do know these moral and cognitive traits Kant refers to are differential in reference to different individuals. I Kant, *Groundwork for the Metaphysics of Morals* (first published 1785, Yale UP 2002) 4:428, 36; 4-434-35, 42-43. Korsgaard offers a non-gradable Kantian approach to human rational capacity irrespective of people's actual differences in such capacities in CM Korsgaard, 'Fellow Creatures: Kantian ethics and our duties to animals' (2004) 25 The Tanner Lectures on Human Values 81-82.

debate on human uniqueness, arguing that there is no such uniqueness.⁶⁹ There is an immediate link between this question and the question of what is respect or dignity. If only persons are legitimate claimants of dignity or self-respect, then one can hardly deal with defining the content of dignity unless simultaneously dealing with what makes a person.

It follows from my argument that people recognize a person, namely the claimant of self-respect more easily than philosophers do. I am aware of the common perceptions of dignity and of self-respect, which do not necessarily overlap.⁷⁰ I argue for a smaller gap between the two concepts, if any. I believe Margalit's definition of one (dignity) being a behavioral expression of the other (self-respect) is a move in this direction.⁷¹ However, for the sake of clarity, my argument will refer to dignity as self-respect. Therefore, by referring to dignity-compromising effect, like Margalit, I mostly mean humiliation.

This only opens the gate for many more questions. Who deserves self-respect? Is self-respect gradable? How do we determine one's humiliation? Do we cling to the humiliated person's subjective response to humiliation, or is an objective standard involved? Clearly, these are very important questions worthy of a more thorough and separate attention than what could be reasonably included within the discussion over the autonomy of intelligence agents. I will mainly state my answers to these questions rather than suggest a full philosophical or legal argument to support them. Luckily, Margalit's thorough account of self-respect offers many of the missing arguments in his *Decent Society*.⁷²

I agree with Margalit's account of self-respect deeming every human being as worthy of self-respect, solely for the very reason of being human. Accordingly, I disagree with many philosophers who view certain cognitive demands as prior conditions for this moral status. I argue for the basic respect people deserve, whether professors or comatose, mentally ill, intelligent and educated adults or young children. It is indeed their basic and non-gradable right not to be humiliated. In agreement with Statman, I believe it takes a person with cognitive capacities to humiliate. However,

⁶⁹ As a result, Singer wishes to convince us that from the moral standpoint, humans and animals should be deemed equal. P. Singer, 'All Animals are Equal' in T. Regan and P. Singer (eds), *Animal rights and human obligations* (USA, Pearson 1989), 148-162.

⁷⁰ D. Statman, 'Humiliation, Dignity and Self-Respect' (2000) 13(4) *Philosophical Psychology* 523, 523-526. Also see Statman's reference to Feinberg's claims-based approach to dignity versus respect in J. Feinberg and J. Narveson, 'The nature and value of rights', (1970) 4 *The Journal of Value Inquiry* 243, 252-253.

⁷¹ A. Margalit, *The Decent Society* (Harvard UP 1996), 51-53.

⁷² *ibid*, 57-112.

as opposed to Statman, I see no further capacity required in order to be humiliated, other than simply belonging to the human species.⁷³

I argue for a combined subjective and objective approach to determining humiliation. It is essential to take account of the agent's subjective sense of humiliation when such sense of humiliation affects his decision process. However, as the cases of the monk-agent and the servile woman suggest, an objective review of humiliation is of similar relevancy:

The servile woman sees it as her duty to serve her husband, take care of his needs and advance his career, and the fulfillment of these tasks brings her great pleasure and satisfaction. According to the psychological – subjective concept of self-respect, her husband's behavior and demands do not injure her self-respect; hence they are not humiliating. According to the moral – objective concept, however, the situation is humiliating, as it reflects an undermined sense of self-respect by the servile woman.⁷⁴

Self-respect as a parameter in the hierarchical model of autonomy is therefore both a subjective and a social concept. The self-respect of person *A* is, in my opinion, both self-reflective as well as dependent upon social conventions of humanity. Person *A* can therefore be mocked and hence humiliated without necessarily feeling humiliated. It is sufficient that *A*'s surroundings deem it to be the case. In this sense, I follow Dan-Cohen's concept of collectivizing the notion of dignity:

Once an action-type has acquired a symbolic significance by virtue of the disrespect it typically displays, its tokens will possess that significance and communicate the same content even if the reason does not apply to them... As long as certain actions are generally considered to express disrespect, one cannot knowingly engage in them without offending against the target's dignity, no matter what one's motivations and intentions are.⁷⁵

The idea that self-respect reflects the equal right not to be humiliated leads to the conclusion that the concept of self-respect is not gradable.⁷⁶ Therefore, there are no persons more self-respect worthy than others. This obviously does not mean that each individual is equally humiliated by the

⁷³ Statman (n 70), 524-526.

⁷⁴ *ibid*, 527

⁷⁵ Dan-Cohen (n 25) at 162.

⁷⁶ Holding this position, I no doubt support the type of justification for self-respect to all humans embedded in the value we, humans, ascribe to the trait of being human while no other criteria is required. Margalit (n 71), 77

same humiliating act. The dignity violation review in the suggested interpretation of the hierarchical models applies to the environmental conditions apparently influencing the endorsement and identification process of the LODs by the HODs. Therefore, not every compromise to self-respect (namely humiliation) automatically means a risk to one's autonomy, unless it affects the identification process with one's desires.

Another very important implication of the suggested approach to autonomy is the sort of link it creates between the notion of autonomy and the notion of dignity. As opposed to scholars who argue for independence of the two notions, under this formula the mutual relations seem more interdependent.⁷⁷ This is the major difference between Dan-Cohen's approach and the one I suggest. While Dan-Cohen manages to imagine a situation where a person could be severely deprived of his dignity while making his choice and yet remain autonomous, my interpretation to the hierarchical models suggests it is totally impossible. In contrast to my proposed interpretation of autonomy, Dan-Cohen could define the consensual slave, the servile woman and the monk-agent as autonomous, although humiliated while making their choices.⁷⁸

Addressing the irreversibility of the status of the slave and the reversibility of the rights granted by the 'liberal' owner, Dan-Cohen suggests a free counterpart to the 'autonomous' slave, who, due to some physiological disorder, might be deprived at any given time of his freedom of movement or choice. Dan-Cohen further asks us to imagine an owner of the slave who hardly ever changes her mind, and therefore is not likely to revoke the 'liberal' conditions of the slave. Dan-Cohen's arguments are most relevant to recruited agents. Handling relations are, as argued, largely irreversible. These relations typically allow some 'freedom' to the agent, however such scope of freedom is largely determined by the handler's revocable discretion.

Dan-Cohen is right in arguing that it is the status of slavery that undermines the slave's dignity, as opposed to the physiological condition of his free counterpart. And yet, I wish to convince that this severe derogation of any person's dignity cannot leave him autonomous while such humiliation influences his choice-making process. Under my suggested interpretation, the slave is not autonomous in his acts and

⁷⁷ For an approach arguing autonomy and dignity to be independent notions, see Dan-Cohen (n 25).

⁷⁸ To a certain extent, I believe it is this paper's suggested interpretation of current models of autonomy that best promotes Dan-Cohen's agenda of raising the value of dignity to the higher place it deserves in the moral analysis of law.

decisions, since the influence on him while making and identifying with his choices is dignity derogating.

I strongly resist disassociating the humiliation from its effect on the slave or agent's choice. We assume that the physiological defect of his counterpart does limit the scope of his potential choices and influence them. I argue, however, that it does not affect his autonomy since (to a certain level) we do not regard such limitation of choice as humiliating. This is why, in my opinion, most disabled people, although deprived of a wide range of potential objects of desires, are still autonomous.⁷⁹ The dignity-based interpretation of the hierarchical model of autonomy allows us to draw a distinctive line between the disabled person and the slave (or agent). And this distinction is irrespective of the fact that in theory, they do enjoy same scope of practical freedom.

The common deontological approach refers to a narrow conceptualization of autonomy, namely to the Kantian sense of autonomy as the human capacity for self-legislation, of setting rules of a universal value:

...the dominant trend in the deontological branch of liberalism has been to focus on autonomy. For the most part, dignity, if mentioned at all, has been seen as a matter of deferring to people's autonomy, and thus had no independent role to play.⁸⁰

Dan-Cohen deviates from this common approach by suggesting that dignity is not a derivative of autonomy but rather an independent value.⁸¹ The interpretation I suggest reflects deviation from both approaches. The conclusion from my suggested interpretation is that dignity is not different

⁷⁹ I do recognize however that from a certain level of physical limitation, disability may turn a person into non-autonomous. I believe the dignity-based interpretation of the hierarchical model of autonomy deals well with identifying this transition. It is the crucial point from which disability derogates the person's dignity which (in reference to his choice making procedure) turns him into a non-autonomous person.

⁸⁰ Dan-Cohen 25), 158. Dan-Cohen further refers to scholars challenging this approach: RG Wright, 'Consenting Adults: The problem of enhancing human dignity non-coercively' (1995) 75 Boston U L Rev 1397. As to mainstream deontological approaches viewing dignity in the Kantian sense of a reflection of the notion of autonomy, see: TE Hill, *Autonomy and Self-Respect* (Cambridge UP 1991), 43; CM Korsgaard, *Creating the Kingdom of Ends* (Cambridge UP 1996); AW Wood, *Kant's Ethical Thought* (Cambridge UP 1999).

⁸¹ Dan-Cohen argues that his argument for dignity as an independent notion in relation to autonomy is actually Kant's. According to Dan-Cohen, the mainstream of deontological readers of Kant misunderstand Kant's description of dignity as respect to autonomy and hence setting dependence relations between dignity and autonomy. Dan-Cohen (n 25), 158-159.

to autonomy, at least not in the simple sense. Another conclusion is that autonomy is a broader notion than the Kantian autonomy to which most deontologists refer. It is much broader than the power to self-legislate. It is a notion reflecting the humanity of a person as a human being and as a person qua member of human society.

The suggested concept may also point out some of the limits of models of basic philosophical notions such as autonomy. These notions maintain recursive relations with social conventions. On the one hand, the notion of autonomy is a building block in the construction of social norms and social language. On the other hand, the outcome of this construction process is an important feedback and input in the construction of the notion of autonomy. As a result, autonomy's defining models cannot be static and scientifically accurate. Autonomy can only be based on dynamic, context-based and flexible foundations such as dignity or self-respect.

A point which needs to be discussed is obviously related to the definition of 'dignity' or, more accurately, what acts constitute humiliation and undermining of self-respect. It seems that if the interpretation of a model of autonomy now rests on an open concept, such as dignity, the new interpretation might not be helpful. Instead of asking, 'what is autonomy' we may be engaged in the question of 'what is dignity' or 'what is humiliation'? I believe this is not the case. After all, the entire argument is based on the assumption that we do intuitively recognize humanity and humiliation.

Humiliating a person, as concluded from the suggested concept and as suggested by Margalit, is treating a human being as nonhuman. We identify such occasions, just as we intuitively and immediately identify a creature as a human being and a human as sad or laughing or in pain. If we do not recognize dehumanized humans, this means we cannot recognize humans as well:

There are various ways of treating humans as nonhuman: (a) treating them as objects; (b) treating them as machines; (c) treating them as animals; (d) treating them as subhuman...⁸²

The apparently blurred boundaries of the notion of dignity are not necessarily related to vagueness but rather to dignity being a dynamic notion. Self-respect (or dignity) reflects both a social and a personal perception of humanity. It therefore changes with time, place and context. We should therefore view this notion as dynamic and flexible rather than

⁸² Margalit (n 71), 89.

opaque. As I commented earlier, a definition of a notion such as dignity could never be scientifically accurate. And neither should it be.

Taking these insights back to the practical dilemmas concerning our group of voluntary agents, the questions remain: Have these apparently voluntary agents really made autonomous decisions? Can they ever be an autonomous party to a contract with a handler as the Supreme Court presumed?

IX. AGENTS AND THE RESPECT-BASED APPROACH TO AUTONOMY

The case of the false-flag recruitment seems relatively easy. A person driven into such an unreal environment is put into an unreasonable position. Just imagine what the agent will feel should the truth be revealed to him: he would feel angry, a loser, and a fool; humiliated. He just found out he has served the devil. We would think the same – the critical influence on his preferences and desires setting while considering being an agent was humiliating. Such an agent is therefore not autonomous.

The combined subjective and objective measurement of self-respect allows us to reach this conclusion regardless of the agent himself not being aware of his humiliation upon making his choice.⁸³ On a lower scale, similar conclusions may arise with regard to X, the agent that was convinced based on a fake polygraph check that the risk he was facing was reasonable. X identified with a desire to continue his activity in a process that was affected by a humiliating influence. He is anything but an autonomous agent.⁸⁴

Raviv's case is a little more complicated. Does taking advantage of his personality disturbance constitute an influence on his preferences-setting process amounting to humiliation? In my opinion the answer would probably be positive. However, Raviv's criminal verdict gives us reason to

⁸³ As in the case of the seamless rape in the case of Minkowski, even if the agent is being handled under a false flag for his entire life, he is still humiliated while deciding to adopt the will to be handled and hence non-autonomous. This is a result of the objective element in defining humiliation. The reference to Minkowski is Dan-Cohen's (n 25). *State v Minkowski*, Cal. App. 2d 832; 23 Cal. Rptr., 92.

⁸⁴ The first two cases of agents, namely the cases of the manipulated agents are easily dealt with by the hierarchical model of personal autonomy. They're clearly non-autonomous agents based on the model. In contra-distinction, the monk-agent and agents with a strong element of servility, are the cases where the model is error prone since the agent reaffirms the deprivation of his will as a genuine reflection of his very own will.

believe Raviv himself does not feel the same.⁸⁵ Raviv liked being an agent, and it is quite clear he does not view the influence on his choice as humiliating. This reveals a point of strength of the proposed interpretation to models of autonomy. Self-respect is a notion capable of absorbing both the agent's attitude to her choice, alongside society's attitude to the very same choice.

The monk-agent or Raviv may find the level of influence over their desires-setting process reasonable. At the same time, an objective observer aware of the social perception of such a condition may have a different view. She may consider their condition to be humiliating to a critical level of influence over the agent's choice making. This is why the proposed interpretation is manipulation resistant: In most modern societies, driving a challenged person into a dramatic and life-risking choice is considered to be a humiliating influence, irrespective of the formal prior consent of the recruit. This is why most of us won't find Raviv to be an autonomous agent once we become aware of his personality challenges.

The suggested interpretation also offers a new perspective on the monk-agent. As with Raviv's case, the dignity-based review allows us to overrule the monk-agent's personal perception by measuring it in relation to social concepts of humiliation. In most societies, substantial subjection of the will – regardless of it being genuinely consensual – is dehumanizing. It matches Margalit's definition of humiliating practices, such as treating people as if objects or machines, regardless of their willingness to be used as such. The fact that a servile person *A* adopts desires X_i to X_n on a constant basis purely due to adopting somebody else's will is putting *A* in a dehumanized condition while adopting his desires. He seems programmed and mechanical; not human and humiliated.

The case of Ames reveals another dimension of the proposed interpretation to personal autonomy. As opposed to recruited agents like Kilngberg, Ames didn't hold even an apparent moral justification for his activity. He personally approached the Soviets and offered his information and services for money. Other than pure greed, there seems to be no influence on Ames' recruitment choice, let alone a humiliating one.

What type of agent could be more autonomous in his choice to serve another state than Ames? He is a senior intelligence professional aware of all the methods and risks of the HUMINT relations. His skill made handling tricks, manipulation or tight control quite irrelevant. Due to his seniority, relations with his handlers should be quite balanced. Have we finally met an agent operating autonomously on his own will? Have we

⁸⁵ *State of Israel v Avishai Raviv* (n 16).

managed after all to describe a case of two autonomous parties who freely form a contract between a handler and an agent in accordance with the way the Supreme Court viewed handling relations? Not necessarily.

Ames, like most recruited agents, was exposed to the influence of the irreversibility of his status once recruited. Like the ‘autonomous’ slave of Dan-Cohen, it seems that we should similarly consider Ames not to be an autonomous agent.⁸⁶ From what we know, Ames was autonomous in the first phase of electing to be an agent, partly because there was no evident humiliating influence on his desire to will to act as a Russian recruited agent. However, as the case of Markus Klingberg reveals, almost all agents, like the consensual slaves, face a problem of irreversibility.

The only way out of the agent status is through the consent of the handlers, since they have the incriminating information and the ability to ‘burn’ the agent. No agent could be positive that the consent for cessation of his operations, even in a case where it is expressly given, is indeed genuine and will be respected. Applying pure cold rationality may lead the agent to adopt a more balanced approach to this problem of irreversibility, since the intelligence organization has many reasons to refrain from burning the agent.⁸⁷ Having said that, the risk to the agent of an assessment error in this regard is, in most cases, too high.⁸⁸

As previously contended, the irreversibility problem of intelligence agents is analogous to the two temporal phases of consensual slavery. First is the

⁸⁶ While this point needs to be further analyzed in a different paper, it is my intuitive feeling that a dignity-based influence test, as proposed, may lead to a more balanced conclusion. In examining Ames’ dignity while under this influence to continue his services, I believe a dignity-based influence review may take into account his culpability and moral guilt.

⁸⁷ Applying pure logic, the agent should normally assume that his handlers would not punish his unilateral cessation of activity by way of exposing him. After all, such a move is not in the interest of the handlers and the intelligence organization they represent. His arrest might result with embarrassment to the handling organization. It might expose HUMINT methods and even serve as an intimidating experience that might be reducing the willingness of potential agents to be recruited in the future. However, stakes are too high. Taking the risk that his handlers might make an exception or find a sophisticated way of addressing these concerns is not necessarily smart. There is also the risk that the handling organization will take extreme moves to secure secrecy, including getting rid of the agent.

⁸⁸ For example, Marwan Ashraf’s death raised many speculations, some of which connected his death to Israeli intelligence officers disclosing the fact that he served the Israelis as a recruited agent. U Bar-Joseph, ‘The Intelligence Chief who went Fishing in the Cold: How Maj. Gen.(res.) Eli Zeira Exposed the Identity of Israel’s Best Source Ever’ (2008) 23 *Intelligence and National Security* 226.

deliberation and consent phase of accepting the enslavement. Second comes the phase following the consent, a phase during which the slave or the agent may consider cessation of the enslavement or handling relations. My interpretation of autonomy suggests that the agent is not autonomous during the second phase, even though he does not aspire to reverse his status or even expressly wishes to proceed as an agent.

The very fact that the potential choice to reverse is being held by another person is a humiliating influence on the agent's choice to proceed and therefore suggests he is non-autonomous. This condition is very similar to the virtual third level of desires that is created when a 'liberal' master owns a slave. The scope of freedom of choice allowed de-facto does not erase the slave's understanding that his practical freedom is at the mercy of his master.

The case of Markus Klingberg illustrates in vivid terms the irreversibility problem.⁸⁹ According to his version of the events, it takes him more than four years to gain the courage to confront his handler and announce that he wishes to quit. His handler does not use coercive language, but neither does he accept the announced cessation. Klingberg's words allow us a rare view into the situation from the agent's perspective:

I quickly analyzed the situation. If I refuse, I'm taking the risk of bringing the situation to boiling temperature. They may give up. They may not insist. And maybe they won't. Maybe they won't give up...The presumption behind these relations was that they are voluntarily established and hence their strength. Not once, the question of "what if" crossed my mind. What if I wish to quit. That I could quit just the way I joined...Actually, it was the first time where for a second, I raised in my mind the option of the Russians moving to the level of extortion. But I immediately rejected it. It was obviously the worst alternative. At least this way, when we maintain voluntary relations, there's respect and appreciation and the meetings could be conducted in good spirit. The move into a different level of relations will have enormous consequences. The voluntary relations leave some flexibility on my end...No. I decided I won't refuse. That the relations with the Russians must not turn into coercion.⁹⁰

X. CONCLUSION

⁸⁹ On the case of Markus Klingberg, an Israeli defense scientist who was in fact a recruited Russian agent for around 30 years (n 47).

⁹⁰ Klingberg and Sfard (n 47), 224-25.

From to the proposed analysis, it follows that all recruited agents, from the 'simple' walk-ins like Ames to the complicated monk-agents, are not autonomous. Obviously, the immediate conclusion is that the Supreme Court's classification of handling relations as contractual is wrong. Even the most senior and professional recruited agents that voluntarily accept the recruitment seem to be inherently non-autonomous.

One possible explanation to what seems to be an inconsistent rule in *Totten* and *Tenet* cases may be that Court is in fact aware of the wrong conceptualization of the handling relations as contractual. Court may be aware of the inconsistency reflected by the view of a contract between non-autonomous parties. Determining such a handling 'contract' to be unenforceable diminishes the effect of such wrong classification of the relations. By denying the binding promissory power from the handling 'contract' the Supreme court is in fact right, because due to lack of autonomous will, these relations cannot form a contract to start with. Whether out of mere legal intuition or a clear legal strategy, the Supreme Court sets a wrong rule and then cures the rule by forcing a contradicting legal result. By that, the Supreme Court is wrong and right about handling contracts and about personal autonomy.

What could be the reason for this dual-head approach of the Supreme Court? This is obviously open for various possible explanations and should be the target of future research. I may outline briefly some of the potential explanations. First, this inconsistency could be another instance of the inherent problem of inconsistency in the law-espionage relations, which has been characterized in recent literature.⁹¹ Specifically, in this case, the view of a non-enforceable contract allows the law to portray a legitimate type of relations without pouring any legal substance into them. The contractual color aims at creating the impression of autonomous persons freely consenting to their valuable tasks.

At the same time, determining such contract to be non-binding aims to avoid the discrepancy between this concept of autonomous handling and handling in reality. It allows the law to be simultaneously present and absent in the realm of espionage. Had the Supreme Court simply ruled that this realm is beyond judicial scrutiny, it could have been construed as placing a label of illegitimacy over this national activity. The dual-head approach of labeling the handling relations as contractual yet unenforceable allows the Court to refrain from developing a law of intelligence (had the contract been recognized as enforceable) and at the

⁹¹ R Bitton, 'The Legitimacy of Spying Among Nations' (forthcoming) (2014) 29 American University Journal of International Law.

same time to avoid a questionable status of illegitimacy (had the court ruled that these relations exist in a legal vacuum).⁹²

This paper's focus on handling contracts demonstrates a problem of inconsistency in the relations of law and espionage. From this analysis, it does not follow that law cannot or should not regulate espionage. To the contrary, just like regulating warfare, legal regulation of spying is extremely necessary. It does however show clearly, that as in the case of warfare, the regulation of handling relations cannot be based on the personal autonomy of the players. But if the parties to collection of intelligence from human sources are not autonomous and hence one cannot classify their relations as contractual, what legal groundwork correctly underpins them?

Answering this question is left for further research. Intuitively, the answer seems to lie in the universal requirements of necessity and proportionality. According to this view, what removes objection to the handling of an agent is not his consent but rather the condition of necessity. The agent's consent is still required, when relevant and possible. However, it is required in order to comply with the requirement of proportionality and not for recognizing the formation of a contract. For handling a voluntary agent, although not an autonomous one, is ever less harmful than handling by coercion.

Until requirements like necessity and proportionality constitute the basis for a new law of espionage, law and espionage will remain in the legal twilight zone. This undefined zone allows a comfortable position to both spies and judges, away from the constraints of consistency. In the relations of law and espionage, where one can be voluntarily acting and not

⁹² Theoretically, an autonomous agent is not totally impossible. This can be remotely possible if for some rare reason the agent assumes he is not subject to the irreversibility effect (for example, due to circumstances that ensure safe cessation) and if the handling of such an agent does not involve tight control, manipulation, subjection, servility or coercion. A contract among autonomous parties for handling relations is feasible in such rare cases. For example, the dignity-based test reveals autonomous agents on the far extreme point from Ames – 'soldier-agents'. During World War II, the British intelligence recruited many agents from occupied European countries. Many of these agents had interests that completely overlapped those of their handlers. There had usually been no humiliating influence on their choice to become agents. Irreversibility was not an issue. Circumstances made all manipulation and agent running tricks unnecessary. Actually, as a result, their relations with their handlers resembled more the relations of elite soldiers with their commanders. RV Jones, *Most Secret War: British Scientific Intelligence 1939-45* (London, Hodder & Stoughton 1979); RV Jones, 'Intelligence Ethics', in J Goldman (ed), *Ethics of Spying: A Reader for the Intelligence Professional* (Scarecrow Press 2006), 24-25.

autonomous, where law can be at once present and absent, it is no wonder the Court can be both right and wrong.

HOW SHOULD BITCOIN BE REGULATED?

Sergii Shcherbak*

The lack of clarity about Bitcoin's legal framework has meant that none of the regulators across the EU have yet achieved sufficient clarity in the legal treatment of Bitcoin and its stakeholders. This uncertainty poses a number of substantial risks to Bitcoin stakeholders and creates challenges for regulatory authorities. Therefore, there is a need for a clear strategy for Bitcoin's regulation aiming to ensure the maximum possible balance between the interests of Bitcoin stakeholders longing for the preservation of Bitcoin's benefits and mitigation of relevant risks, and the interests of regulators striving for ensuring the compliance of Bitcoin stakeholders with the law. In this paper, the author develops such a strategy. Its implementation provides for the official recognition of Bitcoin as an unregulated technology, the recognition of that Bitcoin users interacting between each other and Bitcoin miners are outside the regulatory scope, and the efficient application of existing legal mechanisms to Bitcoin merchants, Bitcoin exchanges and the relations between these categories of Bitcoin stakeholders with Bitcoin users. Thus, the balanced regulation of Bitcoin is achieved in the form of a partial regulation of the usage of Bitcoin at different levels of Bitcoin's functionality.

Keywords: Bitcoin, Banking Regulation, EU Law, Payment Systems, Regulation.

TABLE OF CONTENTS

I. INTRODUCTION	42
II. EXPLANATION OF BITCOIN	43
1. <i>Is Bitcoin Legal?</i>	43
2. <i>What Is Bitcoin and How Does It Work?</i>	44
a. A bitcoin and Bitcoin. The Bitcoin Protocol	44
b. Is Bitcoin Anonymous?	45
c. High Volatility	46
d. Bitcoin Versus Traditional Payment Systems	46
e. Bitcoin Stakeholders and the Mechanism of Bitcoin Transactions	47
3. <i>Closing Remarks</i>	50
III. LEGAL ANALYSIS OF BITCOIN AND BITCOIN STAKEHOLDERS	51

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1. <i>Introductory Remarks</i>	51
2. <i>Bitcoin As Money/Currency/Digital Cash</i>	51
3. <i>Bitcoin as a Commodity/Good</i>	53
4. <i>Bitcoin as a Payment Service Provider/E-Money/Payment Service/Payment System</i>	54
5. <i>A Bitcoin as a Financial Instrument</i>	61
6. <i>Bitcoin and E-Commerce</i>	68
a. Bitcoin as an Information Society Service	68
b. Bitcoin Merchants and Their Customers	70
c. Bitcoin Exchanges and Their Customers.....	73
7. <i>Closing Remarks</i>	75
IV. STRATEGY FOR REGULATION OF BITCOIN	77
1. <i>The Balance of Interests</i>	77
2. <i>Initial Considerations</i>	77
3. <i>The Strategy of the Balanced Regulation</i>	79
a. Aspect 1 — The Conceptual Level.....	79
b. Aspect 2 — The Level of User Interaction.....	79
c. Aspect 3 — The Level of Interaction Between Users and Merchants.....	80
d. Aspect 4 — The Level of Interaction Between Users and Exchanges	81
4. <i>Closing Remarks</i>	82
V. CONCLUSION.....	82

I. INTRODUCTION

Bitcoin, the first decentralised virtual currency based on a peer-to-peer network, is essentially a novel online payment system with unique properties substantially distinguishing it from other online payment systems. However, Bitcoin's legal framework is very unclear, which has entailed that none of the regulatory bodies across the EU have yet achieved sufficient clarity in the legal treatment of Bitcoin and its stakeholders. This vagueness and uncertainty pose a number of substantial risks to Bitcoin stakeholders and create challenges for regulatory authorities: Bitcoin users remain legally unprotected as consumers; Bitcoin transactions are often conducted in circumvention of traditional contract and tax law; the properties of Bitcoin and the lack of its clear regulation are often exploited by criminals who use Bitcoin for the purposes of money laundering etc.

Therefore, there is a need for a clear strategy of Bitcoin's regulation aiming to ensure the maximum possible balance between the interests of Bitcoin stakeholders longing for the preservation of Bitcoin's benefits and the mitigation of the relevant risks, and the interests of regulators striving for ensuring the compliance of Bitcoin stakeholders with the law. In this paper, the author develops such a strategy of balanced regulation.

The sought balanced regulation should determine the legal issues surrounding the concept of Bitcoin, clarify the legal statuses of and the legal rules applicable to Bitcoin stakeholders, and provide regulatory authorities with legal tools for overseeing the compliance of Bitcoin stakeholders with applicable law. In order to develop the strategy of Bitcoin's balanced regulation, the author analyses the aspects of Bitcoin's functionality from technical and legal perspectives. The legal analysis is carried out using the traditional legal dogmatic method.

The structure of the paper is as follows: In the introduction and section II, the author provides briefly information on the legality of Bitcoin and an overview of Bitcoin's functionality. Section III encompasses the legal analysis of Bitcoin and Bitcoin stakeholders. In section IV, the author's strategy of the implementation of the sought balanced regulation of Bitcoin is provided. In the conclusion, the author's findings are summarised. Within the paper, the focus is on the regulation of Bitcoin within the European Union (EU).

II. EXPLANATION OF BITCOIN

1. *Is Bitcoin Legal?*

Notwithstanding that the concept of Bitcoin lacks clear legal framework, the EU regulatory bodies tend to agree that Bitcoin is legal. The European Central Bank in its comprehensive research on virtual currencies¹ has defined Bitcoin as 'unregulated digital money'² which falls 'within central banks' responsibility as a result of characteristics shared with payment systems that give rise to the need for at least an examination of developments and the provision of an initial assessment'.³ The European Banking Authority has designated virtual currencies, including Bitcoin, as 'a form of unregulated digital money that is not issued or guaranteed by a

¹ European Central Bank, *Virtual Currency Schemes* (ECB Publications 2012) <www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemes201210en.pdf> accessed 17 April 2014.

² *ibid*, 5.

³ *ibid*, 47.

central bank and that can act as means of payment'⁴. In Germany, the Federal Ministry of Finance has announced that Bitcoin is a 'unit of account' and a kind of 'private money' which can be used in 'multilateral clearing circles'.⁵ In Finland, the State Accounting Board has determined that Bitcoin transactions are subject to business accounting rules.⁶

2. *What Is Bitcoin and How Does It Work?*

a. A bitcoin and Bitcoin. The Bitcoin Protocol

Introduced in 2008⁷ and launched in 2009, Bitcoin constitutes both a virtual currency and a digital payment system within which transactions in this currency are made. Bitcoin as a virtual currency is denominated in virtual units of account called bitcoins. Bitcoin as a payment system is not controlled and/or owned by any entity and is based on a decentralised peer-to-peer network which consists of users and functions under the Bitcoin protocol.

The Bitcoin protocol solely determines the rules under which the Bitcoin network operates, the same way as any protocol functioning on the Internet determines rules for a specific technology. For example, Voice over IP (VoIP) protocols form the underlying set of rules for Internet telephony, and Simple Mail Transfer Protocol (SMTP) serves as an essential part of the set of rules for email communication. The Bitcoin protocol is open-source, which means that the review and modification of the protocol's code can be carried out by any developer.⁸ However, the open-source nature of the protocol does not imply that any modification of the protocol instantaneously becomes an effective rule for the Bitcoin network. If this scenario was possible, anyone would be able to change the way Bitcoin functions by merely modifying the protocol's code in any arbitrary way. However, Bitcoin's security measure is the principle of consensus of the majority, which means that new modifications become

⁴ European Banking Authority, *Warning to consumers on virtual currencies* (EBA 2013) <www.eba.europa.eu/documents/10180/598344/EBA+Warning+on+Virtual+Currencie s.pdf> accessed 17 April 2014.

⁵ Letter from Federal Ministry of Finance of Germany to Frank Schaeffler (7 August 2013) <www.frank-schaeffler.de/wp-content/uploads/2013/08/2013_08_07-Antwort-Koschyk-Bitcoins-Umsatzsteuer.pdf> accessed 17 April 2014.

⁶ State Accounting Board of Finland, *Digitaalisen vertaisvaluutan käsittelystä kirjanpidossa* (State Accounting Board of Finland 2012) <<http://ktm.elinar.fi/ktm/fin/kirjanpi.nsf/717602942eb71ebdc22570210049e02b/f3aa8c34418d93e3c2257aado040df3?OpenDocument>> accessed 17 April 2014.

⁷ See Satoshi Nakamoto, 'Bitcoin: A Peer-To-Peer Electronic Cash System' (*Bitcoin.org*, 2008) <<http://bitcoin.org/bitcoin.pdf>> accessed 17 April 2014.

⁸ 'Who Created Bitcoin?' (*Bitcoin.org*) <<https://bitcoin.org/en/faq>> accessed 17 April 2014.

effective rules if only these modifications are embraced by the majority of users of the network.⁹ The majority of users embrace these new modifications by starting using the modified protocol-based client software, that is Bitcoin wallets, discussed in more detail in section II.2.e below. Logically, the users tend to embrace only those modifications which are not detrimental. Therefore, the Bitcoin protocol is practically impossible to amend in a way that contradicts the interests of the majority of users of the Bitcoin network.

The Bitcoin protocol ensures that bitcoins are created within the Bitcoin network at a pre-determined pace and with the pre-programmed supply: roughly every 10 minutes 25 new bitcoins are put into circulation. However, the base amount of bitcoins periodically created decreases by half every four years. To clarify, within the period from 2017 to 2020, only 12.5 bitcoins will be created at the same pace. A bitcoin is highly divisible, since it can be divided into 100 million units called satoshi. Due to the previously described properties of the Bitcoin protocol, the last satoshi will be created in 2140, and the total maximum amount of bitcoins ever created is about 21 million. Bitcoin has deflationary properties due to the limited supply, and can be used in any kind of transactions due to the high level of divisibility.¹⁰

b. Is Bitcoin Anonymous?

All Bitcoin transactions are made public in the online public ledger called the blockchain. The information available in the blockchain includes the details of every Bitcoin transaction. These details do not include information which could directly identify the parties of a transaction, but include the exact time and the estimated amount of the transaction, and also the transactors Bitcoin addresses used for sending and receiving bitcoins. Though the identifying information is not public, the other available data can be used to track the transaction to certain individuals.¹¹ Since the complete anonymity of the transacting parties is not achievable, Bitcoin can be classified as partly anonymous.

⁹ 'Could Users Collude Against Bitcoin?' (*Bitcoin.org*) <<https://bitcoin.org/en/faq>> accessed 17 April 2014; 'How Could the Bitcoin Protocol Be Changed? Has This Ever Occurred?' (*Bitcoin Beta*) <<http://bitcoin.stackexchange.com/questions/3945/how-could-the-bitcoin-protocol-be-changed-has-this-ever-occurred>> accessed 17 April 2014.

¹⁰ See 'Controlled Supply' (*Bitcoin wiki*) <https://en.bitcoin.it/wiki/Controlled_supply> accessed 17 April 2014.

¹¹ Elli Androulaki and others, 'Evaluating User Privacy in Bitcoin' in Ahmad-Reza Sadeghi (ed), *Financial Cryptography and Data Security: 17th International Conference, FC 2013, Okinawa, Japan, April 1-5, 2013, Revised Selected Papers* (Berlin Heidelberg, Springer 2013).

c. High Volatility

Resulting from its decentralised nature and qualities inherent to the Bitcoin protocol, Bitcoin as a virtual currency is not backed by any entity, is not redeemable for any commodity and has no intrinsic value. Bitcoin is a very volatile virtual currency, which can be seen from substantive fluctuations of its exchange value.¹² According to the European Central Bank, Bitcoin's exchange value 'with respect to other currencies is determined by supply and demand'.¹³

d. Bitcoin Versus Traditional Payment Systems

Bitcoin was originally designed as an alternative to traditional centralised electronic payment systems which suffer 'from the inherent weaknesses of the trust based model'.¹⁴ Such traditional digital payment systems have a number of properties: transaction costs are high, which makes small online transactions impracticable; the processing of transactions is time-consuming; transactions are reversible, which allows chargeback fraud¹⁵; privacy of transactions is not achievable, since a payment service provider possesses identifying information on transactors; there tend to be territorial limitations of use, which makes impossible to send funds online from and to certain locations.

At the same time, Bitcoin provides the opportunity to conduct online transactions directly between transactors, not involving any trusted party such as a payment service provider. Bitcoin, in turn, essentially functions as digital cash: a transaction is private unless the parties transact with such Bitcoin stakeholders as Bitcoin exchanges (see the next section); the processing of the transaction may be instantaneous or very fast; the transaction is irreversible, which makes chargeback fraud impossible; there are no or insignificant transaction costs, which enables the practicability of small casual online payments; there are no territorial limitations, which means that bitcoins can be sent and received from and to any location. Therefore, Bitcoin has several advantages over traditional digital payment systems.

¹² See 'Market Price (USD)' (*Blockchain.info*) <<https://blockchain.info/charts/market-price>> accessed 17 April 2014.

¹³ European Central Bank (n 1), 6.

¹⁴ Nakamoto (n 7), 1.

¹⁵ See 'Chargeback Fraud' (*Wikipedia*)

<http://en.wikipedia.org/wiki/Chargeback_fraud> accessed 17 April 2014.

e. Bitcoin Stakeholders and the Mechanism of Bitcoin Transactions

Bitcoin is used by an ever-increasing number of Bitcoin stakeholders who can be conditionally divided into four main categories: users, miners, exchanges, and merchants.

Users are the persons who use bitcoins to buy goods and services from Bitcoin merchants, store bitcoins, or buy or sell bitcoins for traditional currency through Bitcoin exchanges. To become a Bitcoin user, one needs to obtain a Bitcoin wallet by, for example, downloading a free open-source client software on a computer or a smartphone, or signing up for a free online service providing web wallets.¹⁶ These software or web wallets are used as a storage for bitcoins and as a user client ensuring the interaction between the Bitcoin user and the Bitcoin network. The installation and usage of a Bitcoin wallet does not require the provision of any identifying data from a user. The wallets, just as the Bitcoin network, operate under the Bitcoin protocol. Operating principles and functions of the wallets are usually the same in essence irrespective of the wallet type or provider. The Bitcoin wallets are interoperable with each other.

The user is provided with two keys generated by the wallet: a private key and a public key. The private key is generated only once. It is secret and used as a password for the wallet. The public key, in turn, is generated any number of times on demand of the user. The public key is the user's Bitcoin address serving as a kind of a bank account for receiving and sending bitcoins. Therefore, the user may use different Bitcoin addresses for different transactions.

A bitcoin can be perceived as a record of transactions taken place within the Bitcoin network ('a chain of digital signatures'¹⁷) up to the moment when the bitcoin has been placed on the holder's Bitcoin address, or, put this another way, when the holder has obtained ownership over this bitcoin. When one Bitcoin user (the payer) sends bitcoins to another Bitcoin user (the payee), the payer digitally signs the message about the current transaction with her/his secret private key. The message in whole contains the information on: all the previous transactions related to these bitcoins; the amount of the bitcoins sent to the payee; and the payee's Bitcoin address which is the payee's public key.

Then, the payer sends the message about the current transaction not to the payee but to the Bitcoin peer-to-peer network, where the message

¹⁶ See 'Choose your Bitcoin Wallet' (*Bitcoin.org*) <<http://bitcoin.org/en/choose-your-wallet>> accessed 17 April 2014.

¹⁷ Nakamoto (n 7), 2.

should be included in a cluster of digital information called a 'block'. The block contains messages about other current transactions within the Bitcoin network, given these messages have not been included in any prior block. The block constitutes a kind of a mathematical puzzle, as every message is signed by payers' private keys and is, thus, based on public key cryptography.¹⁸ After the message about the current transaction has been included into the block, this block should be placed into the Bitcoin public ledger called the 'blockchain'. The blockchain, as the name suggests, constitutes the chain of blocks. The blockchain is publicly accessible online.¹⁹

To be included into the blockchain, the block should be 'solved' by the Bitcoin miners. Solving the block basically means finding the unique answer to the mathematical puzzle constituting the block.²⁰ The *miners* are those Bitcoin stakeholders who contribute the processing power of their computer systems to this process. When the block is solved, it is immediately placed into the blockchain. When the block is included into the blockchain, it means that all transactions, the information on which has been initially included into the block, are deemed confirmed by one block. Since every subsequent block contains the reference to the prior one, the transaction is confirmed by every block following the block into which the transaction has been initially included. This mechanism prevents the possibility of forgery and double spending of bitcoins.²¹ Usually, a number of blocks should be solved to confirm the transaction.²² When the message is sent, the payer's bitcoins are immediately sent to the payee, but the payee can spend these bitcoins only after the transaction has been confirmed.

The Bitcoin protocol ensures that one block is solved, or, in other words, the unique answer to the mathematical puzzle is found, roughly every 10 minutes.²³ This interval is kept standard with time, since the difficulty of blocks automatically adjusts to the computational powers of computer systems exploited by miners. As these computational powers tend to

¹⁸ See 'Public-Key Cryptography', *Wikipedia*

<http://en.wikipedia.org/wiki/Public-key_cryptography> accessed 17 April 2014.

¹⁹ See 'Home: Welcome to Blockchain' (*Blockchain.info*) <<https://blockchain.info>> accessed 17 April 2014.

²⁰ See 'Blocks' (*Bitcoin wiki*) <<https://en.bitcoin.it/wiki/Blocks>> accessed 17 April 2014.

²¹ See 'Double-Spending' (*Bitcoin wiki*) <<https://en.bitcoin.it/wiki/Double-spending>> accessed 17 April 2014.

²² See 'Confirmation' (*Bitcoin wiki*) <<https://en.bitcoin.it/wiki/Confirmation>> accessed 17 April 2014.

²³ See n 20.

increase²⁴, so does the difficulty of the mathematical puzzles to solve. The amount of bitcoins, mentioned in section I.2.a. above, constitutes a kind of *reward* for solving a block. When the block is solved, the generated reward in the amount of 25 bitcoins (currently) is automatically sent to the randomly chosen Bitcoin address of the miner who has been contributing to the process of solving the block. The acquisition of the reward is always registered as the first transaction of the block and constitutes the essence of the Bitcoin mining.²⁵ The bitcoins obtained in this way are considered to be mined by the miner. Moreover, the miner may also receive an additional reward in the form of a transaction fee if it has been initially assigned by a payer for the priority confirmation of a transaction.

Another category of Bitcoin stakeholders is *Bitcoin exchanges* which provide the online trading platforms where the registered members can exchange their bitcoins for traditional currency and vice versa. A Bitcoin exchange is connected to the Bitcoin network and acts as an intermediary involved in the exchange transactions directly between its members. To become a member of the exchange, the Bitcoin user has to register an account on the exchange platform. In order to use services provided on the platform, including purchasing and selling bitcoins, or placing the member's funds on and withdrawing the member's funds from the member's account through a bank transfer, the member of the exchange usually has to verify his registered account. The account verification generally requires the submission of the member's identifying information including a valid ID to the exchange.²⁶ Currently the most popular European exchanges have implemented know-your-customer and anti-money laundering policies.²⁷

Bitcoin merchants, in turn, are businesses which accept bitcoins as a medium of exchange for goods and services and are connected to the Bitcoin network. There are a number of available Bitcoin electronic payment processors providing Bitcoin merchants with the possibility to accept

²⁴ See 'International Technology Roadmap for Semiconductors: 2011 Edition, Executive Summary' (according to the document, the number of transistors on a processor chip is doubling every 3 years since 2013, thus overcoming Moore's law, 2011) 86, 91, 95 <www.itrs.net/Links/2011ITRS/2011Chapters/2011ExecSum.pdf> accessed 17 April 2014. See also Gordon Moore, 'Cramming More Components Onto Integrated Circuits' (1965) 38(8) *Electronics* 114.

²⁵ See 'What is Bitcoin Mining?' (*Youtube*) <www.youtube.com/watch?v=GmOziH6IzIs> accessed 17 April 2014.

²⁶ See 'Privacy Policy' (*Bitstamp*) <www.bitstamp.net/privacy-policy/> accessed 17 April 2014.

²⁷ *ibid.* See also 'Coinfloor Terms and Conditions' (*Coinfloor*) <<https://coinfloor.co.uk/legal>> accessed 17 April 2014; 'Terms of Service of Bitcoin-Central.Net' (*Bitcoin-Central*) <<https://bitcoin-central.net/page/tos>> accessed 17 April 2014.

bitcoins in business.²⁸ Considering the nature of Bitcoin transactions, a Bitcoin merchant does not usually check the identity of a customer. The only thing usually required from the customer is the provision of a valid e-mail address to ensure the subsequent commercial communication, and, in case of a physical delivery of goods or services, a valid delivery address. Therefore, Bitcoin merchants do not tend to implement know-your-customer and anti-money laundering policies.

Importantly, since the roles of the Bitcoin stakeholders listed above are conditionally assigned according to the kind of activity of a Bitcoin stakeholder, it is typical that the same Bitcoin stakeholder would fall under or even combine certain different roles from time to time. For example, Bitcoin users carry the roles of miners as long as these users contribute the computational powers of their computer systems to the Bitcoin network. Conversely, miners act as users when they spend bitcoins previously mined.

3. *Closing Remarks*

It can be concluded from the discussion above that Bitcoin constitutes both a very volatile virtual currency and a partly anonymous digital payment system within which transactions in this currency are made. Bitcoin as a virtual currency is denominated in bitcoins. Bitcoin as a payment system is not controlled and/or owned by any entity and is based on a decentralised peer-to-peer network operating under the Bitcoin protocol which is practically impossible to amend in a way that contradicts the interests of the majority of Bitcoin stakeholders.

Bitcoin has several advantages over traditional payment systems: transactions can be private; there are no or insignificant transaction costs; there are no territorial limitations; the processing of transactions is instantaneous or very fast; transactions are irreversible.

The main categories of Bitcoin stakeholders are users, miners, exchanges, and merchants. To become a Bitcoin user, one needs to register a Bitcoin wallet which serves as a storage for bitcoins and a user client ensuring the interaction between the Bitcoin user and the Bitcoin network. The creation of bitcoins within the network is carried out under the Bitcoin protocol through rewarding the Bitcoin miners who confirm Bitcoin transactions.

In the next section, the legal analysis of Bitcoin and Bitcoin stakeholders is carried out.

²⁸ BitPay is one of the most popular merchant tools implemented to accept bitcoins in business, and currently supports over 30 thousand businesses and organisations; <<https://bitpay.com>> accessed 17 April 2014.

III. LEGAL ANALYSIS OF BITCOIN AND BITCOIN STAKEHOLDERS

1. *Introductory Remarks*

In this section, the legal analysis of Bitcoin's functionality is carried out from the perspective of relevant EU supranational legislation and underlying conceptual framework. The legal analysis aims to demonstrate the overall lack of clarity about Bitcoin's legal framework, reflect the author's attempts at determining the applicability of relevant legislation to Bitcoin and its stakeholders, and, more importantly, deliver research data necessary for determining the regulatory scheme in the final Section. The legal analysis method allows to determine the degree of Bitcoin's legal commonality with conceptual and legal categories covered by the relevant legislation.

2. *Bitcoin As Money/Currency/Digital Cash*

There are three known essential functions of money: a medium of exchange, a unit of account, and a store of value.²⁹ In 2012, the European Central Bank defined virtual currencies, including Bitcoin, as 'a type of unregulated, digital money'³⁰, which 'act[s] as a medium of exchange and as a unit of account within a particular virtual community'³¹, but does not clearly 'fulfil the 'store of value' function in terms of being reliable and safe'.³² More recently, the European Banking Authority have designated virtual currencies, including Bitcoin, as 'a form of unregulated digital money that is not issued or guaranteed by a central bank and that can act as means of payment'.³³

Though the issue is controversial, one can argue that Bitcoin has all the essential functions of money: Bitcoin serves as a medium of exchange when bitcoins are sent to merchants in exchange for goods and services; Bitcoin

²⁹ See European Central Bank, *Virtual Currency Schemes* (ECB Publications 2012) 10 <www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemes201210en.pdf> accessed 17 April 2014; 'Money' (*Wikipedia*) <<http://en.wikipedia.org/wiki/Money>> accessed 17 April 2014.

³⁰ European Central Bank (n 29), 13.

³¹ European Central Bank (n 29), 11.

³² *ibid.*

³³ European Banking Authority, 'Warning to consumers on virtual currencies' (EBA 2013) 2 <www.eba.europa.eu/documents/10180/598344/EBA+Warning+on+Virtual+Currencies.pdf> accessed 17 April 2014.

functions as a unit of account when merchants denominate the prices of certain goods and services in bitcoins; and Bitcoin is used as a store of value when users hold bitcoins to send or sell them in future, relying on a positive leap forward in the exchange price of the bitcoins (see section II.2.c. above).

There are three known types of money: commodity money, representative money, and fiat money.³⁴ Commodity money is the money whose intrinsic value is determined by the commodity the money is made of. The supply of commodity money is naturally limited, which may cause deflation increasing the value of this money. Silver or ancient gold coins are examples of commodity money. Representative money is the money whose intrinsic value is backed by a certain commodity this money is redeemable for.³⁵ Tokens or certificates that can be exchanged for a fixed quantity of gold are representative money.³⁶ Finally, fiat money is not made of or backed by any commodity, and has no intrinsic value. Fiat money is a legal tender put into circulation and backed by a government. Nowadays, fiat money constitutes the basis of modern economies. The supply of fiat money is not naturally limited. Currency is a form of fiat money, and is a fungible, transferable, divisible and recognisable legal tender. In its turn, cash is a tangible form of currency. Currency is centralised, since it is issued and backed by a government. The exchange value of the currency directly depends on the government policy and the national economy.

As has been noted, Bitcoin has all the essential functions of money. At the same time, Bitcoin is, like commodity money, scarce and endowed with deflationary properties, since its supply is initially limited by the Bitcoin protocol (see section II.2.a. above). Bitcoin has, like fiat money, no intrinsic value backed by any commodity. A bitcoin is a denomination of Bitcoin-currency which is, in turn, a form of Bitcoin-money. It can be argued that Bitcoin is, like a legal tender, fungible, transferable, divisible (even to a much higher extent than fiat, that is traditional, currencies), and somewhat recognisable. Bitcoin fundamentally functions as digital cash. Since Bitcoin functions digitally, the concept of cash as a form of currency, and the concept of currency as a denomination of cash, merge into the one concept of Bitcoin.

At the same time, Bitcoin's lack of intrinsic value backed by a commodity

³⁴ See 'Money' (n 29); Jodi Beggs, 'Types of Money' (*About.com*)

<<http://economics.about.com/od/money/a/Types-Of-Money.htm>> accessed 17 April 2014.

³⁵ *ibid.*

³⁶ See 'Representative Money' (*Fact Index*)

<www.fact-index.com/r/re/representative_money.html> accessed 17 April 2014.

distinguishes Bitcoin from commodity money. Bitcoin is, unlike fiat money, not backed by any entity. Bitcoin is decentralised, since it is not issued by any entity but created by the dispersed Bitcoin community itself. Furthermore, Bitcoin is, unlike representative money, not redeemable for any commodity.

Considering that Bitcoin shares certain common properties with commodity money and fiat money, and carries some novel characteristics not peculiar to any analysed type of money, it can be argued that Bitcoin may constitute a novel type of money and a new type of currency, not yet recognised anywhere as a legal tender.

3. *Bitcoin as a Commodity/Good*

Since the supply of Bitcoin is initially limited, and bitcoins are created by Bitcoin miners at an ever-decreasing pace due to the Bitcoin protocol, one may assume that Bitcoin shares common features with commodities. Though the EU supranational legislation does not provide a conventional definition of a commodity, this category is generally recognised as a homogeneous fungible good whose value is determined by supply and demand.³⁷

As Bitcoin is traded on exchange platforms for fiat currency, one may assume that Bitcoin is a good. Its standard definition can be found in the Agreement on the European Economic Area (EEA Agreement)³⁸ which defines a good as ‘both materials and products’.³⁹ A material is defined as ‘any ingredient, raw material, component or part, etc., used in the manufacture of the product’.⁴⁰ A product means ‘the product being manufactured, even if it is intended for later use in another manufacturing operation’.⁴¹

Bitcoin does not fall under the definition of a material, since Bitcoin is not tangible and is not used in any manufacturing process. Whether or not Bitcoin can be considered a product depends on the degree of congruence of the Bitcoin mining activity with the activity of manufacturing. Manufacture, pursuant to the EEA Agreement, is ‘any kind of working or

³⁷ See ‘Economics A-Z terms: Commodity’ (*The Economist*)

<www.economist.com/economics-a-to-z/c/#node-21529407> accessed 17 April 2014.

³⁸ Agreement on the European Economic Area [1994] OJ L1/3.

³⁹ Protocol 4 on the rules of origin to the Agreement on the European Economic Area [1994] OJ L1/54, art 1 point (d).

⁴⁰ Protocol 4 (n 39), art 1 point (b).

⁴¹ Protocol 4 (n 39), art 1 point (c).

processing including assembly or specific operations'.⁴² From this perspective the Bitcoin mining seems to be essentially similar to the process of manufacturing. But, the concept of manufacturing has been always considered from the industrial angle, which implies that there should be a certain manufacturer which intends to use produced goods and/or sell them to consumers. If so, Bitcoin cannot be classified as a good, since there cannot be determined a certain entity which produces bitcoins. However, if one considers the essence of the process, but not the implication stated previously, the Bitcoin mining may fall under the definition of manufacturing, and, therefore, Bitcoin may be theoretically considered a good.

Assuming that Bitcoin is a good, one can argue that Bitcoin is, just as a commodity, homogenous and fungible good, since Bitcoin is denominated in bitcoins, which are the units of the same nature. Bitcoin's value is determined by supply and demand. Therefore, Bitcoin may also theoretically fall under the definition of a commodity.

As can be seen from the discussion above, Bitcoin may in theory fall under the statutory definitions of a commodity and a good. However, though certain EU regulators have acknowledged that Bitcoin may be used as an article of commerce⁴³, both the EEA Agreement and the Harmonised Commodity Description and Coding System⁴⁴ perceive commodities and goods as tangible items and do not cover digital concepts such as Bitcoin.

4. *Bitcoin as a Payment Service Provider/E-Money/Payment Service/Payment System*

Since Bitcoin is essentially a platform for digital payments, one may assume that Bitcoin is a payment service provider. The Payment Services Directive (PSD)⁴⁵ is applicable to payment services provided within the EU.⁴⁶ The PSD distinguishes several categories of payment service

⁴² Protocol 4 (n 39), art 1 point (a).

⁴³ 'Merkblatt - Hinweise zum Zahlungsdiensteaufsichtsgesetz (ZAG)' (BaFin 2011) <www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Merkblatt/mb_111222_zag.html> accessed 17 April 2014.

⁴⁴ 'HS Nomenclature 2012 Edition' (World Customs Organization) <www.wcoomd.org/en/topics/nomenclature/instrument-and-tools/hs_nomenclature_2012/hs_nomenclature_table_2012.aspx> accessed 17 April 2014.

⁴⁵ Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC [2007] OJ L319/1 ('PSD').

⁴⁶ PSD (n 45), art 2 para 1.

providers, among which are credit institutions, e-money institutions, and payment institutions. Pursuant to the Credit Institutions Regulation (CIR)⁴⁷, which stipulates prudential requirements for credit institutions and investment firms supervised under the Credit Institutions Directive (CID)⁴⁸, a credit institution means ‘an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account’.⁴⁹ The E-Money Directive (EMD)⁵⁰, which integrates e-money institutions into the regulatory framework of the PSD⁵¹, designates an e-money institution as a ‘legal person that has been granted authorisation [...] to issue electronic money’.⁵²

Bitcoin can neither be classified as a credit institution nor an e-money institution, as Bitcoin is not a legal entity. To the contrary, as we have seen before, Bitcoin is a decentralised virtual currency circulating within the Bitcoin peer-to-peer network which operates under the Bitcoin protocol and is not controlled or owned by any entity. Therefore, it should be analysed whether Bitcoin may constitute e-money.

The EMD defines e-money as

electronically [...] stored monetary value as represented by a claim on the issuer which is issued on receipt of funds for the purpose of making payment transactions [...], and which is accepted by a natural or legal person other than the electronic money issuer.⁵³

The EMD distinguishes several categories of e-money issuers, among which are credit institutions and e-money institutions. Pursuant to the EMD, ‘electronic money issuers issue e-money at par value on the receipt of the funds’⁵⁴. Moreover, e-money issuers shall redeem, at any moment

⁴⁷ Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 [2013] OJ L176/1 (‘CIR’).

⁴⁸ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC [2013] OJ L176/338 (‘CID’).

⁴⁹ CIR (n 47), art 4 para 1 point 1.

⁵⁰ Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC [2009] OJ L267/7 (‘EMD’).

⁵¹ *ibid*, recital 9.

⁵² *ibid*, art 2 point 1.

⁵³ *ibid*, art 2 point 2.

⁵⁴ *ibid*, art 11 para 1.

and at par value, the monetary value of e-money held upon request of the e-money holder⁵⁵.

Considering whether the statutory definition of e-money is applicable to Bitcoin, it can be argued that Bitcoin is a monetary value stored electronically and accepted by a person other than the issuer. But it is clear that Bitcoin is not a monetary value represented by a claim on the issuer, and is not issued on receipt of funds. Moreover, 'issuing' is not the term to be applicable in the case of Bitcoin, since this term is usually used within the context of the centralised putting into circulation, and bitcoins are not issued by any entity but created by the disseminated community of Bitcoin miners, which essentially means that the Bitcoin network produces bitcoins itself without receipt of any funds. Furthermore, the principle of redemption of the monetary value of e-money set out in the PSD cannot be applied in the case of Bitcoin, since there is no legal entity in charge of issuing bitcoins on receipt of funds and the redemption of the monetary value of bitcoins upon request of the holder. Therefore, the current statutory definition of e-money is not applicable to Bitcoin. It can be concluded that Bitcoin clearly falls outside the scope of the EMD. Besides, the European Central Bank have also argued that the EMD does not seem to be applicable to Bitcoin.⁵⁶

The PSD does not regulate the issuance of e-money or amend the prudential regulation of e-money institutions and payment institutions — the new category of payment service providers introduced by the PSD — are not allowed to issue e-money.⁵⁷ Payment institutions are also not entitled to take deposits and are subject to the single licensure⁵⁸ and the effective anti-money laundering requirements.⁵⁹ A payment institution is designated by the PSD as 'a legal person that has been granted authorisation [...] to provide and execute payment services throughout the Community'.⁶⁰ At the same time, a payment service, as determined by the PSD, includes, *inter alia*, services for execution of payment transactions and services for money remittance.⁶¹

Since Bitcoin is not a legal entity and is not controlled and/or owned by any legal entity, Bitcoin cannot be classified as a payment institution. However, considering the information stated above, one can assume that

⁵⁵ *ibid*, art 11 para 2.

⁵⁶ European Central Bank (n 29), 43.

⁵⁷ PSD (n 45), recital 9.

⁵⁸ *ibid*, recital 10.

⁵⁹ *ibid*, recital 11.

⁶⁰ *ibid*, art 4 point 4.

⁶¹ *ibid*, Annex.

Bitcoin may be classified as a payment service since Bitcoin allegedly falls under the classification of a service for execution of payment transactions, and a money remittance service.

A payment transaction is defined by the PSD as ‘an act, initiated by the payer or by the payee, of placing, transferring or withdrawing funds, irrespective of any underlying obligations between the payer and the payee’.⁶² Funds, as defined by the PSD, means the ‘banknotes and coins, scriptural money and e-money’.⁶³ As has been concluded above, Bitcoin is not e-money. It means that bitcoins are not funds within the statutory meaning prescribed by the PSD. Nevertheless, assuming that Bitcoin is money and a currency (see section III.2. above), it is reasonable to examine the issue further, since in this case a Bitcoin transaction constitutes a transfer of funds from the Bitcoin payer to the Bitcoin payee irrespective of any obligations between the transactors. This approach leads to the assumption that the Bitcoin transaction may be classified as a payment transaction within the meaning of the PSD. However, it should be considered if a Bitcoin user might be classified as a payer or a payee under the PSD.

A payer, according to the PSD, means ‘a natural or legal person who holds a payment account and allows a payment order from that payment account, or, where there is no payment account, a natural or legal person who gives a payment order’.⁶⁴

First, it is important to analyse whether a Bitcoin payer holds a payment account within the meaning of the PSD or not. Pursuant to the PSD, a payment account is ‘an account held in the name of one or more payment service users which is used for the execution of payment transactions’.⁶⁵ As has been mentioned in section II.2.e. above, the interaction between Bitcoin users and the Bitcoin network is carried out through Bitcoin wallets. The installation and usage of a Bitcoin wallet does not require the provision of any identifying data from a user (see sections II.2.b. and II.2.e. above). Moreover, the wallet itself does not constitute a Bitcoin address used for receiving or sending bitcoins; the wallet generates such addresses on demand of the user. Since the Bitcoin address is essentially used for the execution of Bitcoin transactions, one may assume that the Bitcoin address is a payment account kept within the Bitcoin wallet. But, pursuant to the PSD, a payment account should be tied to the identity of the user. Since

⁶² *ibid*, art 4 point 5.

⁶³ *ibid*, art 4 point 15.

⁶⁴ *ibid*, art 4 point 7.

⁶⁵ *ibid*, art 4 point 14.

the Bitcoin address is not held in the name of the user, this address does not constitute a payment account within the meaning of the PSD. Neither does the Bitcoin wallet.

The next issue to consider is whether the execution of a Bitcoin transaction may include the placement of a payment order. A payment order, according to the PSD, is 'any instruction by a payer or payee to his payment service provider requesting the execution of a payment transaction'.⁶⁶ It can be argued that the execution of a Bitcoin transaction does not include the placement of a payment order, since a Bitcoin user just sends the message to the Bitcoin network, not to any legal entity, and the network represented by miners ensures the processing, clearing and settlement of the transaction. Therefore, the Bitcoin payer cannot be considered a payer within the meaning of the PSD, as the Bitcoin payer does not hold a payment account and/or place a payment order.

A payee, according to the PSD, is 'a natural or legal person who is the intended recipient of funds which have been the subject of a payment transaction'.⁶⁷ Assuming that bitcoins are funds, one can assume that the Bitcoin payee is a payee within the meaning of the PSD. However, reverting to the definition of a payment transaction under the PSD, a Bitcoin transaction would be considered a payment transaction only if the Bitcoin transaction is initiated by a payer or a payee. It is the Bitcoin payer who initiates the Bitcoin transaction by signing and sending the message about the transaction. However, since the Bitcoin payer does not fall under the category of a payer envisaged in the PSD, the Bitcoin transaction does not meet the definition of a payment transaction under the PSD. This fact entails that Bitcoin does not fall under the classification of a payment service for execution of payment transactions within the meaning of the PSD, even if one considers bitcoins to be funds pursuant to the PSD.

The next issue to analyse is whether Bitcoin may constitute a payment service for money remittance within the meaning of the PSD. Money remittance is defined by the PSD as:

a payment service where funds are received from a payer (criterion 1), without any payment accounts being created in the name of the payer or the payee (criterion 2), for the sole purpose of transferring a corresponding amount to a payee or to another payment service provider acting on

⁶⁶ *ibid*, art 4 point 16.

⁶⁷ *ibid*, art 4 point 8.

behalf of the payee, and/or where such funds are received on behalf of and made available to the payee (criterion 3).⁶⁸

As we have seen, bitcoins are not funds as defined by the PSD, and a Bitcoin user cannot fall under the category of a payer pursuant to the PSD. However, to better understand the extent of potential applicability of the PSD to Bitcoin, the issue can be reasoned from the assumption that bitcoins constitute funds and the Bitcoin payer may be classified as a payer within the meaning of the PSD.

Applying this approach, one can argue that the Bitcoin transaction constitutes the process of transferring the payer's funds to the payee. Thus, the first criterion of the definition of a money remittance may be fulfilled. Second, since it has been reasoned that Bitcoin wallets and Bitcoin addresses do not constitute payment accounts within the meaning of the PSD, the second criterion of the above definition may also be fulfilled. Third, the definition of money remittance provides for the receipt of funds from the payer for their subsequent transfer to the payee. This criterion is used in the context of services provided by a payment service provider as a legal entity. According to the PSD, money remittance is 'usually based on cash provided by a payer to a payment service provider, which remits the corresponding amount [...] to a payee or to another payment service provider acting on behalf of the payee'.⁶⁹ But, in the case of Bitcoin, it is clear that the funds of the payer are not received by any trusted party to ensure their transfer to the payee. These funds are generated by the Bitcoin network itself. Moreover, Bitcoin users solely determine the purpose of use of their bitcoins which already exist within the Bitcoin network. Since the transfer of funds from the Bitcoin payer to the Bitcoin payee does not involve any trusted party, the third criterion of the above definition of money remittance cannot be fulfilled. Therefore, Bitcoin cannot be classified as a money remittance service within the meaning of the PSD, even if one assumes that bitcoins are funds and the Bitcoin payer is a payer under the PSD.

The other important issue to analyse is whether Bitcoin may fall under the statutory definition of a payment system. According to the PSD, a payment system means a 'funds transfer system with formal and standardised arrangements and common rules for the processing, clearing and/or settlement of payment transactions'⁷⁰. Pursuant to the PSD,

⁶⁸ *ibid*, art 4 point 13.

⁶⁹ *ibid*, recital 7.

⁷⁰ *ibid*, art 4 point 6.

payment service providers should have the possibility ‘to access the services of technical infrastructures of payment systems.’⁷¹

Applying the assumption that bitcoins are funds, Bitcoin can be perceived as a funds transfer system. The question may be whether standardised arrangements and common rules stipulated in the above definition pertain to Bitcoin. As can be reasoned from sections II.2.a. and II.2.e., the Bitcoin protocol solely determines the rules under which Bitcoin operates. Under the Bitcoin protocol, Bitcoin transactions are processed, cleared, and settled by the community of Bitcoin miners. It can be argued that these rules somewhat constitute common rules and standardised arrangements within the meaning of the PSD, even though they are not explicitly communicated to Bitcoin users prior to or during the usage of Bitcoin. That is why Bitcoin theoretically may fall under the definition of a payment system stipulated in the PSD, if one assumes that bitcoins constitute funds.

As has been concluded before, Bitcoin cannot be classified as a payment service within the meaning of the PSD. Even if it could, the provision of payment services is deemed to be a priori carried out by payment service providers.⁷² However, if one assumes that bitcoins are funds within the relevant statutory meaning, Bitcoin may fall under the definition of a payment system envisaged in the PSD. But, again, payment systems are provided by payment service providers.⁷³ Since it is impossible to determine a certain service provider in the case of Bitcoin, Bitcoin clearly falls outside the scope of the PSD. Incidentally, the European Central Bank has also concluded that the PSD is inapplicable in the case of Bitcoin.⁷⁴ Moreover, the new European Commission’s Proposal⁷⁵, which incorporates and repeals the effective PSD, does not intend to change the situation: The concept of Bitcoin is still not covered by the proposed new version of the PSD.⁷⁶

Since Bitcoin is not a legal entity and is not controlled and/or owned by

⁷¹ *ibid*, recital 16.

⁷² *ibid*, art 29.

⁷³ *ibid*, recital 46.

⁷⁴ European Central Bank (n 29), 43.

⁷⁵ European Commission, ‘Proposal of 24 July 2013 for a Directive of the European Parliament and of the Council on payment services in the internal market and amending Directives 2002/65/EC, 2013/36/EU and 2009/110/EC and repealing Directive 2007/64/EC’ COM (2013) 547 final.

⁷⁶ *ibid*, 9-12.

any legal entity, the Anti-Money Laundering Directive (AMLD)⁷⁷, which sets out anti-money laundering requirements in relation to, inter alia, credit institutions, investment firms, and other financial institutions, is also not applicable to Bitcoin.

5. *A Bitcoin as a Financial Instrument*

Since Bitcoin carries a value derived from the market demand and supply, one can assume that Bitcoin represents the ownership over a financial asset, and therefore is a financial instrument. The Markets in Financial Instruments Directive (MFID)⁷⁸ ‘cover[s] undertakings the regular occupation or business of which is to provide investment services and/or perform investment activities on a professional basis’⁷⁹, and protects investors within the EU⁸⁰. The MFID applies to, inter alia, investment firms and credit institutions providing payment services.⁸¹ Since Bitcoin is not an undertaking, the MFID is not applicable to Bitcoin itself. At the same time, the degree of legal commonality of a bitcoin with a financial instrument may determine the extent of the applicability of the MFID to Bitcoin stakeholders.

As can be seen from section II.2.e. above, the Bitcoin stakeholders encompass such main categories as, inter alia, merchants, and exchanges. According to the MFID, an investment firm is ‘any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis’.⁸² Bitcoin merchants do not comply with this definition, since the legal relationship between a merchant and a Bitcoin user is limited to the purchase of certain goods and services by means of the Bitcoin transaction. The question is whether Bitcoin exchanges may comply with the above classification of an investment firm. As has been mentioned, the degree of a bitcoin’s legal commonality with a financial instrument should clarify the issue.

⁷⁷ Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing [2005] OJ L309/15 (‘AMLD’).

⁷⁸ Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [2004] OJ L145/1 (‘MFID’).

⁷⁹ MFID, recital 7.

⁸⁰ *ibid*, recital 31.

⁸¹ *ibid*, art 1.

⁸² *ibid*, art 4 para 1 point 1.

Pursuant to the MFID, the concept of a financial instrument includes, *inter alia*, transferable securities.⁸³ The MFID defines transferable securities as:

those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as [*inter alia*] securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.⁸⁴

Securities are essentially a cash financial instrument, which means that the value is determined directly by the relevant market.⁸⁵ In the case of Bitcoin, it can be argued that Bitcoin's value is determined directly by supply and demand in the financial market (see section II.2.c. above). Bitcoin is also negotiable, since its exchange price is very volatile which can be seen from a wide range of available ask and bid prices.⁸⁶

At the same time, the definition of transferable securities excludes instruments of payment. The MFID does not provide the definition of an instrument of payment. It is possible to apply the wording of the PSD, which defines a payment instrument as 'any personalised device(s) and/or set of procedures agreed between the payment service user and the payment service provider and used by the payment service user in order to initiate a payment order'.⁸⁷ It is important to establish, first, whether the legal relations between Bitcoin users and Bitcoin exchanges imply that the users act as payment service users, and the exchanges act as payment service providers.

According to the PSD, a payment service user is 'a natural or legal person making use of a payment service in the capacity of either payer or payee, or both'.⁸⁸ In this situation, the legal status of a Bitcoin user who has entered the legal relations with a Bitcoin exchange directly depends on the fact whether the exchange is a payment service provider which provides the

⁸³ *ibid*, annex I (C).

⁸⁴ *ibid*, art 4 para 1 point 18 (emphasis added).

⁸⁵ See 'Financial instrument' (*Wikipedia*)

<http://en.wikipedia.org/wiki/Financial_instrument> accessed 17 April 2014.

⁸⁶ See 'Markets' (*Bitcoin Charts*) <<http://bitcoincharts.com/markets/>> accessed 17 April 2014.

⁸⁷ PSD (n 45), art 4 point 23.

⁸⁸ PSD (n 45), art 4 point 10.

user a payment service related to Bitcoin. The PSD distinguishes several categories of payment service providers, among which are credit institutions, electronic money institutions, and payment institutions.

Pursuant to the CIR, a credit institution means ‘an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account’.⁸⁹ A deposit is generally considered to be a repayable sum of money placed by a person on a person’s individual account in a credit institution for the purposes of safekeeping. According to the Court of Justice of the European Union,

the term ‘other repayable funds’ [...] refers not only to financial instruments which possess the intrinsic characteristic of repayability, but also to those which, although not possessing that characteristic, are the subject of a contractual agreement to repay the funds paid.⁹⁰

One may assume that a Bitcoin exchange accepts member’s funds as a deposit or other repayable funds, since the member’s funds are kept on the member’s verified individual account and withdrawn, that is repaid, on demand of the member.⁹¹ However, the exchange does not grant any credits for its own account (see section II.2.e. above). Therefore, the Bitcoin exchange does not meet the definition of a credit institution prescribed by the CIR.

As has been mentioned in section II.2.e. above, to use an exchange platform, a Bitcoin user should become a member of the platform by registering and verifying an account. The status of a member encompasses both the status of a seller, and the status of a buyer. The seller is the member who creates an ask position on the exchange platform to sell bitcoins. A buyer is a member who, alternatively, creates a bid position on the exchange platform to buy bitcoins. When these two positions, the ask and the bid, are met, or, in other words, when the prices of the ask and the bid match, a bitcoins exchange transaction takes place. Bitcoin exchanges usually imply that they do not act as any party in such transactions and their role is limited to the provision of the trading platforms. In this case, the exchange acts as an intermediary, while the buyer and the seller are the parties of the agreement on bitcoins exchange transaction.⁹²

⁸⁹ CIR (n 47), art 4 para 1 point 1 (emphasis added).

⁹⁰ Case C-366/97 *Romanelli* [1999] ECR I-855, para 17 (emphasis added).

⁹¹ See ‘Coinfloor Terms and Conditions’ (*Coinfloor*) <<https://coinfloor.co.uk/legal>> accessed 17 April 2014.

⁹² See ‘Terms of Use’ (*Bitstamp*) <www.bitstamp.net/terms-of-use/> accessed 17 April 2014; ‘Terms of Service of Bitcoin-Central.Net’ (*Bitcoin-Central*)

Since a Bitcoin exchange usually acts as an intermediary in bitcoins exchange transactions, the exchange does not take part in the creation of any funds, including e-money issuance, within the exchange platform. Therefore, Bitcoin exchanges fall outside the categories of an e-money issuer and e-money institution respectively.

Another issue to analyse is whether a Bitcoin exchange may be legally classified as a payment institution. Payment institutions are designated by the PSD as ‘a legal person that has been granted authorisation [...] to provide and execute payment services throughout the Community’.⁹³ As has been mentioned in section III.4. above, payment institutions are not entitled to take deposits or issue e-money. At the same time, payment services, according to the PSD, include, inter alia, services for execution of payment transactions, and services for issuance and/or acquisition of payment instruments.⁹⁴

As for the services for execution of payment transactions, it is important to define whether transactions within an exchange platform can be classified as payment transactions. The PSD defines a payment transaction as ‘an act, initiated by the payer or by the payee, of placing, transferring or withdrawing funds, irrespective of any underlying obligations between the payer and the payee’⁹⁵. Funds, as defined by the PSD, are the ‘banknotes and coins, scriptural money and e-money’⁹⁶.

As has been discussed in section II.2.e. above, a member of an exchange can top up his/her verified account with fiat currency through a bank transfer. It can be argued that the money placed on the member’s account constitutes funds.

A payer is defined as ‘a natural or legal person who holds a payment account and allows a payment order from that payment account, or, where there is no payment account, a natural or legal person who gives a payment order’.⁹⁷ A payee, pursuant to the PSD, is ‘a natural or legal person who is the intended recipient of funds which have been the subject of a payment transaction’.⁹⁸ Pursuant to the PSD, a payment account is ‘an account held in the name of one or more payment service users which is used for the

<<https://bitcoin-central.net/page/tos>> accessed 17 April 2014.

⁹³ PSD (n 45), art 4 point 4.

⁹⁴ *ibid*, Annex.

⁹⁵ *ibid*, art 4 point 5.

⁹⁶ *ibid*, art 4 point 15.

⁹⁷ *ibid*, art 4 point 7.

⁹⁸ *ibid*, art 4 point 8.

execution of payment transactions’.⁹⁹ A payment order, according to the PSD, is ‘any instruction by a payer or payee to his payment service provider requesting the execution of a payment transaction’.¹⁰⁰

It can be argued that the member’s verified account is held in the name of the member and used for the execution of bitcoins exchange transactions. It also can be reasoned that the member submits the exchange an instruction to execute a payment transaction when the member places the ask/bid price on the exchange platform. Therefore, the member may be regarded as a payment service user and thus both as a payer and a payee within the meaning of the PSD. Since it is a payer or a payee who initiates a bitcoins exchange transaction, and the transaction necessitates the transferring of funds from the payer (buyer) to the payee (seller), the bitcoins exchange transaction falls under the definition of a payment transaction prescribed by the PSD. Therefore, the Bitcoin exchange provides the services for execution of payment transactions which are payment services under the PSD.

The next issue to examine is whether a Bitcoin exchange provides services for issuance and/or acquisition of payment instruments. The PSD defines a payment instrument as ‘any personalised device(s) and/or set of procedures agreed between the payment service user and the payment service provider and used by the payment service user in order to initiate a payment order’.¹⁰¹

As can be seen from the previous discussion, a Bitcoin exchange can be classified as a payment service provider, and its members can be defined as payment service users within the meaning of the PSD. An exchange provides its members with technical tools to place ask/bid prices on the exchange platform. Since, as has been concluded above, the placement of ask/bid prices can be regarded as a payment order, such tools may be classified as payment instruments. Therefore, it can be argued that the Bitcoin exchange provides the services for acquisition of payment instruments which are payment services under the PSD.

The analysis carried out above discovers a number of important facts.

First, Bitcoin exchanges are not credit institutions within the meaning of the CIR as the exchanges do not provide services for granting credits for their own account. Therefore, the CIR together

⁹⁹ *ibid*, art 4 point 14.

¹⁰⁰ *ibid*, art 4 point 16.

¹⁰¹ *ibid*, art 4 point 23.

with the CID are not applicable to Bitcoin exchanges as credit institutions.

Second, Bitcoin exchanges may be classified as payment institutions, since they provide members with payment services. Such a classification means that Bitcoin exchanges can be regarded as payment service providers under the PSD. Therefore, the PSD may be applicable to Bitcoin exchanges. Incidentally, the Bank of France has argued that Bitcoin exchanges should be regarded as payment service providers pursuant to the PSD.¹⁰² The above classification entails that the AMLD laying down the anti-money laundering requirements in relation to, *inter alia*, financial institutions including payment service providers¹⁰³, may also be applicable to Bitcoin exchanges.

Third, members of a Bitcoin exchange may have the legal statuses of payment service users, since such members use the payment service provided by the exchange which is a payment service provider.

Fourth, bitcoins do not fall under the definition of a payment instrument specified in the MFID, as they cannot be regarded as a set of instructions for the placement of a payment order within the exchange platform. This fact allows us to continue analysing Bitcoin from the perspective of the definition of transferable securities envisaged in the MFID.

Again, the MFID defines transferable securities as:

those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as [*inter alia*] securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.¹⁰⁴

It has been concluded that Bitcoin is negotiable, since its exchange price is

¹⁰² Bank of France, '*Les dangers liés au développement des monnaies virtuelles: l'exemple du bitcoin*' (Bank of France 2013)

<www.banque-france.fr/fileadmin/user_upload/banque_de_france/publications/Focus-10-stabilite-financiere.pdf> accessed 17 April 2014.

¹⁰³ AMLD (n 77), art 3 point 2; PSD (n 45), art 91 para 1; CID (n 48), Annex I para 4.

¹⁰⁴ MFID (n 78), art 4 para 1 point 18 (*emphasis added*).

very volatile which results in a wide range of available ask/bid prices. As has been discussed in section II.2.e. above, a holder of bitcoins can send these bitcoins to another Bitcoin user directly not involving any intermediary, or sell these bitcoins to another Bitcoin user through an exchange platform. The settlement of such transactions necessitates the transfer of the ownership over the bitcoins sent from the payer to the payee or sold from the seller to the buyer respectively. Since bitcoins can be acquired and sold with the concurrent transfer of the ownership over them, bitcoins are transferable. Therefore, one of the criteria of transferability is met, and bitcoins may be classified as transferable securities within the meaning of the MFID. Since transferable securities are the form of financial instruments, bitcoins may be classified as financial instruments under the MFID.

The next issue to analyse is to what extent the MFID may be applicable to Bitcoin exchanges which provide the platforms for trading bitcoins. The MFID applies to, *inter alia*, credit institutions providing investment services and activities, and investment firms¹⁰⁵ designated as ‘any legal person[s] whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis’.¹⁰⁶ As we have seen, Bitcoin exchanges do not fall under the category of credit institutions within the meaning of the CIR. It is therefore important to determine whether Bitcoin exchanges may be classified as investment firms providing investment services and/or performing investment activities.

The MFID distinguishes a number of investment services and activities, among which is the ‘[r]eception and transmission of orders in relation to one or more financial instruments’.¹⁰⁷ A Bitcoin exchange provides a platform for trading bitcoins. It has been concluded that the members of the platform place payment orders in relation to bitcoins by submitting relevant ask/bid prices on the exchange platform. Therefore, it can be argued that the Bitcoin exchange receives and transmits the payment orders in relation to bitcoins. Since bitcoins may be regarded as financial instruments, such services may meet the definition of investment services and activities provided above. As the Bitcoin exchange is a legal entity whose regular business is the provision of such services to third parties, the Bitcoin exchange may fall under the definition of an investment firm, and the member of the Bitcoin exchange may be considered a client of the

¹⁰⁵ *ibid*, art 1.

¹⁰⁶ *ibid*, art 4 para 1 point 1.

¹⁰⁷ *ibid*, annex I (A).

investment firm¹⁰⁸ under the MFID. Therefore, the MFID may be applicable to Bitcoin exchanges considered investment firms. Moreover, the CIR together with the CID may also be applicable to Bitcoin exchanges as investment firms, since both the CIR and the CID are applicable to credit institutions and investment firms.¹⁰⁹

Interestingly in Germany, the Federal Financial Supervisory Authority (BaFin) and the Federal Ministry of Finance have also argued that a bitcoin may be classified as a financial instrument within the meaning of the German Banking Act¹¹⁰ which defines financial instruments as, inter alia, securities.¹¹¹

6. *Bitcoin and E-Commerce*

a. Bitcoin as an Information Society Service

Considering the nature of Bitcoin and Bitcoin transactions, it is reasonable to assume that Bitcoin is an information society service (ISS) within the meaning of the E-Commerce Directive (ECD)¹¹² that constitutes a substantial part of the EU legislation covering ISSs. In defining an ISS, the ECD refers to the ISS Directive¹¹³ which, in turn, designates an ISS as ‘any service normally provided for remuneration (criterion 1), at a distance (criterion 2), by electronic means (criterion 3) and at the individual request of a recipient of services (criterion 4)’.¹¹⁴

First, Bitcoin is not a service provided for remuneration, since Bitcoin is publicly accessible and is not provided by any entity which could implement the relevant remuneration policy. Second, it can be argued that

¹⁰⁸ *ibid*, art 4 para 1, point 10.

¹⁰⁹ CID (n 48), arts 1, 2 para 1, 3 para 1 points 1, 2, 3; CIR, arts 1, 4 para 1 points 1, 2, 3.

¹¹⁰ 1961 German Banking Act (*Gesetz über das Kreditwesen*) (‘FRG’), s 1.

¹¹¹ *ibid*; ‘*Merkblatt-Hinweise zum Zahlungsdiensteaufsichtsgesetz (ZAG)*’ (BaFin 2011) <www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Merkblatt/mb_111222_zag.html> accessed 17 April 2014; Letter from Federal Ministry of Finance of Germany to Frank Schaeffler (7 August 2013) <www.frank-schaeffler.de/wp-content/uploads/2013/08/2013_08_07-Antwort-Koschyk-Bitcoins-Umsatzsteuer.pdf> accessed 17 April 2014.

¹¹² Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market (Directive on electronic commerce) [2000] OJ L178/1 (‘ECD’).

¹¹³ Directive 98/34/EC of the European Parliament and of the Council of 22 June 1998 laying down a procedure for the provision of information in the field of technical standards and regulations and of rules on Information Society services [1998] OJ L204/37 (‘ISS Directive’).

¹¹⁴ ISS Directive, art 1 para 1 point 2.

Bitcoin as a virtual payment system is provided at a distance, since, according to the ISS Directive, ‘at a distance’ means ‘that the service is provided without the parties being simultaneously present’.¹¹⁵ Third, ‘by electronic means’, pursuant to the ISS Directive, means ‘that the service is sent initially and received at its destination by means of electronic equipment for the processing [...] and storage of data, and entirely transmitted, conveyed and received by wire, by radio, by optical means or by other electromagnetic means’.¹¹⁶ Bitcoin seems to meet this criterion as well. Fourth, ‘at the individual request of a recipient of services’ means ‘that the service is provided through the transmission of data on individual request’.¹¹⁷ The relation of Bitcoin user to the Bitcoin network should be analysed to determine whether Bitcoin meets the last criterion of the definition of an ISS stipulated by the ISS Directive.

A Bitcoin user, as has been mentioned in section II.2.e. above, interacts with the Bitcoin network by means of a Bitcoin wallet. It can be assumed that the installation of the Bitcoin wallet constitutes a kind of a request for the service. It should be noted that the ISS Directive distinguishes a number of services that are not considered to be provided at the individual request of a recipient. These are the services ‘provided by transmitting data without individual demand for simultaneous reception by an unlimited number of individual receivers (point to multipoint transmission)’¹¹⁸, and include TV broadcasting, radio broadcasting, and teletext.¹¹⁹ One may assume that Bitcoin combines the elements of services provided and not provided at individual request. On the one hand, the Bitcoin user installs the Bitcoin wallet, gets a generated Bitcoin address, and sends a message about an upcoming transaction to the Bitcoin network, which constitutes a request for the service for the processing of the upcoming transaction. On the other hand, by the analogy with the definition given by the ISS Directive, Bitcoin is a payment platform available free of charge and accessible anywhere and anytime to anyone having the necessary technical equipment such as computers or smartphones (see section II.2.e. above).

As we see, the legal presence or absence of an individual request within the provision of a certain service both depend on whether the service is transmitted to the user via a somewhat shielded point-to-point channel or is transmitted to the public through a generally accessible point-to-multi-

¹¹⁵ *ibid.*

¹¹⁶ *ibid.*

¹¹⁷ *ibid.*

¹¹⁸ *ibid.*, annex V para 3.

¹¹⁹ *ibid.*

point connection. In the case of Bitcoin, there is no point-to-point channel of the transmission of the service, since the user receives the service from the Bitcoin network supported by the community of Bitcoin miners. From the other perspective, a point-to-multi-point transmission also does not take place in the Bitcoin scheme, since the service is not centralised. It can be argued that Bitcoin as a service is transmitted to the user through a kind of multi-point-to-point platform, whose concept is not considered by the ISS Directive. Therefore, Bitcoin does not meet the first criterion and the fourth criterion of an ISS and is not an ISS under the ISS Directive. Moreover, both the ISS Directive and the ECD regard ISSs as services provided by ISS providers which are natural or legal persons. There is no Bitcoin provider as Bitcoin has a dispersed nature and is not controlled and/or owned by anyone. Consequently, the ECD and the ISS Directive are definitely not applicable to Bitcoin itself. Incidentally, the European Central Bank have also concluded that the ECD does not seem to cover Bitcoin transactions.¹²⁰

The other question is whether the ECD may be applicable to the Bitcoin stakeholders such as merchants and exchanges. Since Bitcoin is not an ISS, the determination of whether the Bitcoin stakeholders are ISS providers solely depends on the nature of services provided by these stakeholders.

b. Bitcoin Merchants and Their Customers

Bitcoin merchants are retail and online businesses that sell goods/services for bitcoins. The acceptance of bitcoins by the merchant is usually carried out through the Internet-connected Bitcoin electronic payment processor (see section II.2.e. above) which denominates the prices of merchant's goods and services in bitcoins and carries out the checkout process including either the forwarding of the received bitcoins to the merchant's Bitcoin wallet or the conversion of these bitcoins into traditional fiat currency with its subsequent transfer to the merchant's bank account. The conversion of the bitcoins is carried out in accordance with the Bitcoin exchange price effective at the time of the checkout.

Importantly, a Bitcoin user who buys goods or services from the Bitcoin merchant enters a traditional contractual relationship with this merchant by concluding corresponding contracts. The only distinctive feature of these legal relations is the payment aspect, since the payment for goods or services is carried out through the irreversible Bitcoin transaction. Therefore, the mere fact that the payment is made in bitcoins does not affect the applicability of traditional contract law to the relations between

¹²⁰ European Central Bank (n 29), 44-45.

the Bitcoin merchant and its customer.

The applicability of the business-specific legislation such as the ECD to this contractual relationship solely depends on the nature of the merchant's business activity. If the merchant is a retail business accepting bitcoins from the customers directly on its premises, the traditional national contract law will be applicable to such legal relations. At the same time, if the Bitcoin merchant provides ISSs and is an ISS provider under the ECD, both the national contract law and the ECD will be applicable to the merchant. Moreover, the requirements of the Consumer Rights Directive (CRD)¹²¹ that covers the contracts concluded between the traders and the consumers should also be taken into account. While it is clear that the CRD is not applicable to Bitcoin itself, as there is no legal entity in charge of Bitcoin, the CRD is applicable to the Bitcoin merchants which act as traders within the meaning of the CRD, whereas their customers have the status of consumers within the meaning of the CRD.¹²²

However, there are certain unclear issues stemming from the consumer's payment in bitcoins. For example, it is unclear how to apply taxation rules to such Bitcoin transactions. Though certain national regulatory authorities within the EU have argued that Bitcoin transactions are subject to taxation under the relevant tax law, none of these regulatory bodies have clarified in what way this taxation should be implemented.¹²³ As we have seen, the Bitcoin merchant has two available options on receipt of the bitcoins from the consumer: Option one is to forward these bitcoins to the merchant's wallet, and option two is to convert the bitcoins into fiat currency with its subsequent transfer to the merchant's bank account. One can argue that the latter option makes it possible to impose a tax on the corresponding sum placed on the merchant's bank account after the settlement of the Bitcoin transaction. But if the merchant chooses the former option, it is unclear how it would be achievable – within a certain

¹²¹ Directive 2011/83/EU of the European Parliament and of the Council of 25 October 2011 on consumer rights, amending Council Directive 93/13/EEC and Directive 1999/44/EC of the European Parliament and of the Council and repealing Council Directive 85/577/EEC and Directive 97/7/EC of the European Parliament and of the Council [2011] OJ L304/64 (CRD).

¹²² *ibid*, art 2 points 1, 2.

¹²³ See Letters from Federal Ministry of Finance of Germany to Frank Schaeffler (20 June 2013, 7 August 2013) <www.frank-schaeffler.de/wp-content/uploads/2013/08/2013_06_20-Antwort-Bitcoin-Koschyk.pdf> accessed 17 April 2014; Tax Administration of Finland, 'Virtuaalivaluuttojen tuloverotus' (Tax Administration of Finland 2013) <http://vero.fi/fi-FI/Syventavat_veroohjeet/Verohallinnon_ohjeet/Virtuaalivaluuttojen_tuloverotus> accessed 17 April 2014.

financial reference period — to levy a tax on the sum denominated in bitcoins held in the merchant's Bitcoin wallet.

The lack of clarity on the issue of taxation of Bitcoin transactions entails the uncertainty of the mechanism of compliance with the relevant requirements of the ECD and the CRD. Pursuant to the ECD, '[...] where information society services refer to prices, these are to be indicated clearly and unambiguously and, in particular, must indicate whether they are inclusive of tax and delivery costs'.¹²⁴ At the same time, the CRD states that prior to the conclusion of a contract the trader should provide the consumer with, *inter alia*, the 'total price of the goods or services inclusive of taxes, or where the nature of the goods or services is such that the price cannot reasonably be calculated in advance, the manner in which the price is to be calculated'.¹²⁵ Currently, these requirements simply cannot be met because it is unclear for the merchants whether and how they should withhold a tax from Bitcoin transactions.

On the other hand, it is unclear how the reimbursement of the sums paid by the consumer should be carried out by the merchant in the case if the consumer exercises the right of withdrawal envisaged in the CRD. In this case, according to the CRD:

[t]he trader shall reimburse all payments received from the consumer [...]. The trader shall carry out the reimbursement (...) using the same means of payment as the consumer used for the initial transaction, unless the consumer has expressly agreed otherwise and provided that the consumer does not incur any fees as a result of such reimbursement.¹²⁶

The payments received from the consumer should mean the precise amount of money paid by the consumer to the merchant. But it is still unclear whether the bitcoins paid may constitute money in the traditional legal meaning. This makes the perspective of the reimbursement of the sums to the consumer very uncertain. Moreover, even if one qualifies Bitcoin as money and subject to the reimbursement principle under the CRD, there are still definite risks faced by the merchant and by the consumer. First, if the merchant has to carry out the reimbursement using the same means of payment, this actually means that the repayment should be carried out in bitcoins. Since the Bitcoin transaction is irreversible, the

¹²⁴ ECD (n 112), art 5 para 2.

¹²⁵ CRD (n 121), arts 5 para 1 point (c), 6 para 1 point (e).

¹²⁶ *ibid*, art 13 para 1.

possible reimbursement would be carried out only through a new separate Bitcoin transaction but not by means of the cancellation of the initial one. In this case, the merchant and the consumer face substantial economic risks due to Bitcoin's high volatility. Second, in case if the reimbursement should be made using other payment methods, it would be unclear how the amount of money to be paid should be calculated: whether on the basis of the Bitcoin exchange price effective at the moment of reimbursement or on the basis of the Bitcoin exchange price effective at the moment of the settlement of the initial Bitcoin transaction. The lack of clarity on this issue also poses considerable economic risks to both the merchant and the consumer. Furthermore, the lack of clarity about the mechanism of the merchant's compliance with the requirements of the CRD concerning the process of reimbursement of the consumer's payments necessitates substantial legal risks to the merchant.

c. Bitcoin Exchanges and Their Customers

As has been reasoned above, the possibility of legal classification of Bitcoin exchanges as ISS providers depends solely on the nature of services provided by such exchanges. The ISS Directive defines an ISS as 'any service normally provided for remuneration, at a distance, by electronic means and at the individual request of a recipient of services'.¹²⁷ It can be argued that the services for trading bitcoins are provided for remuneration, since the exchange usually charges a commission from an amount of any such transaction converted into fiat currency.¹²⁸ The services provided by the Bitcoin exchange are provided at a distance and by electronic means. It can be reasoned that the bitcoins exchange services provided by the Bitcoin exchange are provided at the individual request of a recipient of these services, since the member of the exchange submits an instruction to execute an exchange transaction by placing an ask/bid price on the exchange platform. Therefore, the bitcoins exchange services may be regarded as ISSs within the meaning of the ECD. Since the ECD designates an ISS provider as 'any natural or legal person providing an information society service'¹²⁹, Bitcoin exchanges may fall under this definition. Consequently, the ECD requirements may be applicable to Bitcoin exchanges.

The Consumer Financial Services Directive (CFSD)¹³⁰, which covers the

¹²⁷ ISS Directive (n 113), art 1 para 1 point 2.

¹²⁸ See 'Fee Schedule' (*Bitstamp*) <www.bitstamp.net/fee_schedule/> accessed 17 April 2014.

¹²⁹ ECD (n 112), art 2 point (b).

¹³⁰ Directive 2002/65/EC of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services

distance marketing of consumer financial services and recognises a financial service as ‘any service of a banking, credit, insurance, personal pension, investment or payment nature’¹³¹, may also be applicable to Bitcoin exchanges, since, as has been concluded above, they may be classified as payment service providers under the PSD and investment firms under the MFID.

Importantly, the potential applicability of the ECD and the CFSD complements the potential applicability of the PSD or the MFID together with the CIR and the CID to Bitcoin exchanges, since both the ECD and the CFSD ‘contribute [...] to the creating of a legal framework for the on-line provision of financial services’.¹³² Moreover, according to the PSD, consumers should also be protected pursuant to, *inter alia*, the ECD and the CFSD, and ‘the additional provisions in [these] Directives continue to be applicable’.¹³³

Another question is whether the CRD may be applicable to Bitcoin exchanges. Importantly, the CRD is not applicable to contracts for financial services.¹³⁴ A financial service is defined as ‘any service of a banking, credit, insurance, personal pension, investment or payment nature’.¹³⁵ As has been concluded in section III.5. above, the services for trading bitcoins may fall under the definition of investment services and activities under the MFID. Therefore, if one reasons from the assumption that bitcoins are financial instruments, the CRD is not applicable to bitcoins exchange transactions within the exchange platforms. However, if one reasons from the fact that bitcoins may be money, a currency, a good, or a commodity, the issue of the applicability of the CRD to Bitcoin exchanges should be revised.

The CRD is applicable to ‘any contract concluded between a trader and a consumer’.¹³⁶ Since a user interacts with an exchange online, and online contracts the CRD is applicable to are distance contracts¹³⁷, one may assume that a contract which may be concluded by the Bitcoin user with/on the Bitcoin exchange is a distance contract which is defined as:

any contract concluded between the trader and the

and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC [2002] OJ L271/16 (‘CFSD’).

¹³¹ *ibid*, art 2 point (b).

¹³² ECD (n 112), recital 27.

¹³³ PSD (n 45), recital 22.

¹³⁴ CRD (n 121), art 3 para 3 point (d).

¹³⁵ *ibid*, art 2 point 12.

¹³⁶ *ibid*, art 3 para 1.

¹³⁷ *ibid*, recital 20.

consumer under an organised distance sales or service-provision scheme without the simultaneous physical presence of the trader and the consumer, with the exclusive use of one or more means of distance communication up to and including the time at which the contract is concluded.¹³⁸

The issue to analyse is whether bitcoins exchange transactions are subject to distance contracts between the Bitcoin exchange and its members. Bitcoin exchanges usually imply that a bitcoins exchange transaction constitutes an agreement between the buyer and the seller, and the exchange acts as a mere intermediary not being any part of this agreement (see section III.5. above). If one considers the bitcoins goods, or commodities (see section III.3. above), one can assume that the seller acts as a trader in the exchange transaction, and the payer acts as a consumer. However, the CRD defines goods as ‘any tangible movable items’.¹³⁹ It means that bitcoins are not goods within the meaning of the CRD, and the CRD is not applicable to the agreement between the buyer and the seller. Even if one ignores the fact that the bitcoins do not meet the definition of goods under the CRD, it would still be unclear whether the contract between the buyer and the seller would comply with such an above criterion as the conclusion ‘under an organised distance sales or service-provision scheme’¹⁴⁰, since the exchange transaction is carried out when the seller’s ask price randomly matches the buyer’s corresponding bid price on the third party exchange platform. Therefore, the CRD is not applicable to bitcoins exchange transactions and Bitcoin exchanges providing the tools for the execution of such transactions.

7. *Closing Remarks*

As can be seen from the above discussion, the issue of legal classification of Bitcoin and Bitcoin stakeholders is very complex. As concerns Bitcoin, it may constitute a novel type of money and a currency, may be considered a good, a commodity, and may fall under the statutory definition of a transferable security which is a financial instrument. If one assumes that Bitcoin is money or a currency, Bitcoin may also be classified as a payment system, but this reasoning does not affect the inapplicability of the PSD in relation to Bitcoin since payment systems are a priori provided by payment service providers which are legal entities. At the same time, it has been proved that Bitcoin cannot be classified as a payment instrument, an e-money/e-money institution, a credit institution, an investment firm, a

¹³⁸ *ibid*, art 2 point 7.

¹³⁹ *ibid*, art 2 point 3.

¹⁴⁰ *ibid*, art 2 point 7.

payment service/payment service provider, or an ISS/ISS provider. Therefore, the PSD, the EMD, the CIR, the CID, the CRD, the ECD, the CFSD, the ISS Directive, and the AMLD are not applicable to Bitcoin.

The legal analysis carried out above also sheds some light on the issue of legal treatment of Bitcoin stakeholders. As has been argued above, a Bitcoin exchange may be classified as a payment institution, a payment service provider, an ISS provider, or an investment firm. This fact necessitates that the CIR, the CID, the PSD, the ISS Directive, the ECD, the CFSD, the MFID, and the AMLD are potentially applicable to Bitcoin exchanges. At the same time, it has been concluded that a Bitcoin exchange cannot be considered a credit institution, an e-money issuer/e-money institution, or a trader within bitcoins exchange transactions. Therefore, neither the EMD nor the CRD is applicable to Bitcoin exchanges.

In the case of Bitcoin merchants, the applicability of national contract law and the requirements of the CRD is not affected by the mere fact that the payment for goods or services is made in bitcoins. If a merchant provides an ISS to the customers, the ECD requirements will also be applicable to the merchant. However, the lack of clarity of the ECD and the CRD in relation to Bitcoin transactions poses substantial economic and legal risks to Bitcoin merchants.

Bitcoin users and miners, not involved into any legal relations with either Bitcoin exchanges or Bitcoin merchants, do not have any legal statuses under the analysed legislation. However, a Bitcoin user or a miner, who is a member of an exchange platform and who uses this platform for trading bitcoins, may have the status of a payment service user given that the Bitcoin exchange is a payment service provider. Therefore, the PSD, the ECD, and the CFSD may be applicable to such legal relations. However, if the Bitcoin exchange is considered an investment firm, the member of the exchange may be regarded as a client of the investment firm under the CIR, the CID, and the MFID, and these laws together with the ECD and the CFSD would be applicable to such legal relations. In this case, the PSD would not be applicable, since investment services and activities are not payment services, and an investment firm is not a payment service provider within the PSD (see section III.4. above).

When the Bitcoin user or the miner enters legal relations with a Bitcoin merchant, such relations are covered by the national contract law and the CRD, and the user or the miner is considered a consumer. Depending on the nature of the merchant's business activity, the applicable law may also include the ECD. But, once again, the lack of clarity in the ECD and the

CRD in relation to Bitcoin transactions poses substantial economic risks to the consumers.

In the next section, the author focuses on the possible strategy of the regulation of Bitcoin which aims to reach the balance between the interests of Bitcoin stakeholders and regulatory bodies.

IV. STRATEGY FOR REGULATION OF BITCOIN

1. The Balance of Interests

In analysing the issue of regulation of Bitcoin, it is important to consider the interests of Bitcoin stakeholders and the relevant interests of regulatory bodies.

It can be argued that Bitcoin stakeholders are not only interested in the preservation of the existing benefits Bitcoin may offer, but also in the mitigation of existing economic and legal risks within the usage of Bitcoin: Bitcoin users are interested in being legally protected in relations with other Bitcoin stakeholders; Bitcoin exchanges are interested in the clear determination of their legal statuses and the legal requirements they should comply with; Bitcoin merchants are interested in the presence of a clear mechanism of compliance with the effective legal requirements of the applicable legislation. At the same time, regulatory bodies are interested in obtaining the efficient legal tools necessary for ensuring the compliance of Bitcoin stakeholders with the relevant legal requirements. Both the Bitcoin stakeholders and the regulatory bodies can be considered the participants in the issue of the regulation of Bitcoin. The best solution to the issue will be the regulation ensuring the balance of the participants' interests. The sought balanced regulation of Bitcoin would mitigate the existing risks and facilitate the development of the innovative potential of Bitcoin.

2. Initial Considerations

Relying on the conducted legal analysis, one may assume that the major obstacle on the way toward the balanced regulation is the uncertainty of the legal classification of Bitcoin, since this uncertainty hurdles the determination of what legal rules should apply to Bitcoin, in what way and to what extent, and how and what regulatory bodies should oversee the compliance of Bitcoin stakeholders with these rules. Reasoning from this assumption, it is important to recall the relevant legal findings from the previous section.

Bitcoin as a concept may theoretically be considered money, a currency, a

good, or a commodity. Interestingly, the determination of Bitcoin as money and a currency also entails the classification of Bitcoin as a payment system. It means that Bitcoin shares common properties with all the above categories. At the same time, the clarity of the legal classification of Bitcoin is impossible to reach by simply changing the wordings of the relevant statutory definitions, since EU law does not even imply the possibility of existence of the concept of decentralised payment mechanisms. The mere recognition of Bitcoin as one of the above categories within the current legal framework would not have any practical effect, since Bitcoin still would contradict the traditional angle of legal reasoning based on the centralised approach to money, payments, and financial services. Therefore, it does not seem to be possible to include the concept of Bitcoin into the current legal framework.

Then, one may assume that the regulation of Bitcoin requires the implementation of a conceptually new legislation. However, such legislation would not affect or change the decentralised nature of Bitcoin based on a global peer-to-peer network functioning under the Bitcoin protocol (see section II.2. above). Moreover, the requirements of such legislation would be practically impossible to impose on the Bitcoin network, since it is practically impossible to amend the Bitcoin protocol without the consensus of the majority of Bitcoin stakeholders (see section II.2.a. above). It is hard to imagine how modifications of the protocol, representing the interests of certain European regulatory bodies, can be embraced by the majority of the Bitcoin community being international *per se*. Therefore, it is practically impossible to impose on Bitcoin any regulatory requirements—aiming to reach the balance between the interests of Bitcoin stakeholders and the interests of regulatory authorities—by merely modifying the Bitcoin protocol's code. Even if this scenario were possible, the protocol's open-source nature would pre-empt any warranty of that the protocol would not be subsequently amended in any other way considered more beneficial for the majority of Bitcoin stakeholders.

Therefore, it is not the lack of clarity about Bitcoin's legal classification that hinders the implementation of regulation, but the *a priori* unregulated nature of Bitcoin itself. This conclusion leads to another question: is the balanced regulation mentioned above practically achievable? The answer is yes, reasoning from the consideration that the balanced regulation is the partial regulation of the usage of Bitcoin ensuring the maximum possible balance between the interests of Bitcoin stakeholders and the interests of regulatory bodies, but is not a full comprehensive regulation covering all the aspects of the usage of Bitcoin. As has been concluded above, such full regulation is achievable only on paper through the implementation of a conceptually new legislation which, as we have seen, would not have any

practical effect.

3. *The Strategy of the Balanced Regulation*

The sought balanced regulation of Bitcoin can be reached through the implementation of the strategy comprising of four interconnected aspects covering different levels of the functionality of Bitcoin.

a. Aspect 1 — The Conceptual Level

At the conceptual level, Bitcoin may be considered by analogy with decentralised neutral technologies such as email or Internet telephony which also function within the Internet at a protocol level (see section II.2.a. above).¹⁴¹ These technologies are decentralised, not owned or controlled by any entity, and are unregulated. However, the services based on these technologies are provided by the respective email and VoIP service providers which are usually subject to legal regulation. These services, in turn, provide users with the access to the underlying technologies. The situation is different in the case of Bitcoin: there are no Bitcoin providers, since Bitcoin is itself a publicly accessible technology and a service. This difference is not relevant in the light of the above analogous consideration, since the regulation covers not email and Internet telephony as technologies but the services based on these technologies. As there are no Bitcoin providers and Bitcoin is publicly accessible, Bitcoin should be officially recognised as an unregulated technology.

The above measure should be carried out through the release of relevant official statements on the treatment of Bitcoin by regulatory bodies. This measure is the only reasonable solution possible at the conceptual level of Bitcoin's functionality.

b. Aspect 2 — The Level of User Interaction

The implementation of the above approach to Bitcoin will mean that Bitcoin users who transact directly between each other should be considered unregulated and unprotected. Bitcoin miners also should be officially excluded from the scope of regulatory scrutiny. At the same time, to mitigate the existing risks, the user community should be officially informed of the underlying principles of Bitcoin's functionality and the risks stemming from the usage of Bitcoin. The risks may be explained by

¹⁴¹ See 'Simple Mail Transfer Protocol' (*Wikipedia*) <http://en.wikipedia.org/wiki/Simple_Mail_Transfer_Protocol> accessed 17 April 2014; 'Voice over IP' (*Wikipedia*) <http://en.wikipedia.org/wiki/Voice_over_IP> accessed 17 April 2014.

drawing analogy with cash which can be irreversibly transferred in private without any records, obligations, and responsibility. Therefore, it should be explicitly communicated that Bitcoin users use Bitcoin at their own risk.

The above measures should be achieved through the issuance of relevant official statements and/or warnings by regulatory bodies. These measures will mitigate the risks posed by Bitcoin users' lack of information on the principles of Bitcoin's functionality, and exclude potential legal risks faced by Bitcoin miners because of the initiation of creation of bitcoins.¹⁴²

c. Aspect 3 — The Level of Interaction Between Users and Merchants

Bitcoin merchants and the legal relations between Bitcoin merchants and their consumers are subject to the requirements of the relevant law (see section III.6.b. above). However, there are a number of risks stemming from the consumer's payment in bitcoins. The legal analysis has determined such problems as the lack of clarity concerning the applicability of taxation rules to Bitcoin transactions, and the uncertainty of the mechanism of reimbursement of consumer's payments by the merchant when the consumer exercises the right of withdrawal.

As for the first problem, since the profit of the Bitcoin merchant as a taxpayer can be denominated either in fiat currency or in bitcoins, the only visible solution to tax the merchant's profit is to impose the tax on the sum denominated in fiat currency. Therefore, Bitcoin merchants should be allowed to accept bitcoins as a payment only on conditions that the bitcoins will be subsequently converted into traditional currency with the following placement of the funds on the merchant's bank account. The tax amount to be paid should be calculated from these funds. The total price inclusive of all taxes should be interpreted in accordance with the Bitcoin exchange price effective on the date of the transaction. To enforce the requirement that the received consumer's bitcoins should be converted into fiat currency, the merchants also should be obliged to implement know-your-customer and anti-money laundering policies. This measure will ensure that the merchants conduct the relevant record keeping concerning the details of every transaction. This measure will also ensure that the merchants possess the identifying information on their consumers, and

¹⁴² See Tax Administration of Finland, '*Virtuaalivaluuttojen tuloverotus*' (according to the document, the income from mining of bitcoins should be taxable as earned income under the Finnish tax legislation, Tax Administration of Finland 2013) <http://vero.fi/fi-FI/Syventavat_veroohjeet/Verohallinnon_ohjeet/Virtuaalivaluuttojen_tuloverotus> accessed 17 April 2014.

will, thus, mitigate the risks related to the use of Bitcoin for the purposes of money laundering.

As regards the second problem, to mitigate the relevant risks faced by the merchant and the consumer the amount of reimbursement of the payments received from the consumer should constitute the total price paid by the consumer calculated in the way described above. Although this approach contradicts the-same-means-of-payment principle stipulated in the CRD¹⁴³, it is the only visible way to reimburse the payments while mitigating the economic risks faced by the both parties, and the legal risks faced by the merchant.

The above requirements should be envisaged in relevant official guidance issued by regulatory bodies. Moreover, since the legal analysis carried out herein is limited by the scope of the paper, there may be other relevant issues stemming from the lack of clarity about the current legislation in respect of Bitcoin transactions. The official guidance should therefore also include the determination and clarification of such issues. The above measures will mitigate the existing economic and legal risks related to the use of Bitcoin by Bitcoin merchants and their consumers.

d. Aspect 4 — The Level of Interaction Between Users and Exchanges

A Bitcoin exchange may be considered a payment institution which is a payment service provider being under the scope of the PSD and the AMLD. The Bitcoin exchange may also be recognised as an investment firm being under the scope of the MFID, the CIR, the CID, and the AMLD. When the provision of payment or investment services is carried out online, the ECD and the CFSD are also applicable.

The designation of Bitcoin exchanges as one of the above statutory categories together with the subsequent bringing of them under the scope of the above legislation will ensure the implementation of know-your-customer and anti-money laundering policies by such exchanges, which will substantially lessen the scale of the usage of Bitcoin for the purposes of money laundering. This measure will also ensure a certain level of legal protection of the members of the exchange who will be considered payment service users or clients of the investment firm. In particular, the safety of the funds denominated in fiat currency and kept on the members' payment accounts will be within the exchange's responsibility.¹⁴⁴ At the same time, the safeguarding of bitcoins placed on the members' accounts will not be guaranteed due to the unregulated technical nature of Bitcoin

¹⁴³ CRD (n 121), art 13 para 1.

¹⁴⁴ PSD (n 45), art 9; MFID (n 78), art 13 para 8.

(see section IV.2. above). This is the issue Bitcoin exchanges should be obliged to notify their customers of prior to the use of the exchange platforms.

Since the analysis of the business activities of Bitcoin exchanges carried out herein is limited by the scope of the paper, there may be a number of other relevant issues stemming from the unregulated nature of Bitcoin. The practical solutions to such issues in the light of the above legislation should also be officially determined and clarified.

The above measures should be implemented through the issuance of relevant statements on the treatment of Bitcoin exchanges by regulatory bodies. These measures will mitigate the existing economic and legal risks faced by Bitcoin users and Bitcoin exchanges.

4. *Closing Remarks*

The balanced regulation of Bitcoin that is sought is achievable in the form of the partial regulation of the usage of Bitcoin through the implementation of the described strategy which covers four different levels of Bitcoin's functionality and, particularly, the rational application of existing legal mechanisms to Bitcoin stakeholders by regulatory authorities.

V. CONCLUSION

In analysing the issue of the regulation of Bitcoin, the author has carried out the technical analysis of the functionality of Bitcoin and the legal analysis of Bitcoin and the Bitcoin stakeholders. The technical analysis has shown that Bitcoin is a novel decentralised payment mechanism functioning under the Bitcoin protocol which is practically impossible to amend in a way that contradicts the interests of the majority of Bitcoin stakeholders. The legal analysis has discovered, *inter alia*, that Bitcoin shares common properties with a number of existing conceptual and statutory categories. However, regardless of this fact, it is impossible to bring Bitcoin under the scope of current legislation, since the current legal framework is based on the centralised approach to money, payments, and financial services, and does not imply the existence of decentralised payment mechanisms. At the same time, the implementation of a conceptually new legislation on Bitcoin would not have any practical effect, since it is practically impossible to impose the requirements of such legislation on Bitcoin, and Bitcoin as a technology cannot be regulated. Nevertheless, the legal analysis has also shown that some legislation can be applicable to Bitcoin stakeholders.

In consideration of the technical analysis and the legal findings, the author has argued that the balanced regulation of Bitcoin aiming to ensure the balance between the interests of Bitcoin stakeholders and the interests of regulatory bodies is achievable in the form of the partial regulation of the Bitcoin usage by Bitcoin stakeholders through the implementation of the proposed strategy comprising of four interconnected aspects which cover different levels of Bitcoin's functionality such as the conceptual level, the level of user interaction, the level of interaction between users and merchants, and the level of interaction between users and exchanges. The implementation of these aspects provides for the official recognition of Bitcoin as an unregulated technology; the recognition of that Bitcoin users who interact directly between each other within the Bitcoin network, and Bitcoin miners are outside the scope of regulation; the reasonable application of existing legal mechanisms to Bitcoin merchants, Bitcoin exchanges, and the relations between these categories of Bitcoin stakeholders with Bitcoin users.

The implementation of the proposed strategy will substantially mitigate the risks within the usage of Bitcoin by Bitcoin stakeholders, and provide regulatory authorities with the legal tools necessary for overseeing the compliance of Bitcoin stakeholders with applicable law. The implementation of the proposed strategy constitutes the essence of the sought balanced regulation of Bitcoin.

EUROPEAN UNION TOWARDS THE BANKING UNION, SINGLE SUPERVISORY MECHANISM AND CHALLENGES ON THE ROAD AHEAD

Mandana Niknejad*

The financial crisis in the Eurozone has posed a serious challenge to the viability of the existing legal structure, which serves as the grounds for the European Union's (EU) Member States' economic cooperation. The EU's financial and banking institutions and its decision-making bodies' failure to predict, and to prevent this economic crisis, has led the Union's decision-makers to conclude that they must reinforce the supervisory powers of the European Central Bank (ECB). The consequent establishment of the Single Supervisory Mechanism has increased ECB's expectations from the administration of the European banks. However, as in any attempt at crisis management, the EU Member States face an important question: are the proposed solutions compatible with the existing structures that were put in place by current treaties? On the one hand, the European financial market's vulnerability to each Member State's crises indicates that it requires a higher degree of centralization in supervisory matters. On the other hand, all Member States, including the non-Eurozone EU Member States, reasonably expect that the ECB's powers be limited to the matters in which they have agreed to relinquish their sovereign rights, and that they participate effectively in the decision-making process. The final resolution establishing the Single Supervisory Mechanism seems to meet some of these expectations. However, questions about this mechanism's compatibility with existing treaties, as well as with EU standards for the ECB's accountability, remain far from being fully resolved.

Keywords: Accountability, Banking Regulation, Banking Supervision, Equal Treatment, EU Law, Legitimacy, Single Supervisory Mechanism, Sovereign Debt Crisis.

TABLE OF CONTENTS

I.	INTRODUCTION	85
II.	HOW DID THE SOVEREIGN DEBT CRISIS EMERGE AND WHAT ARE THE EUROPEAN UNION'S RESPONSES?	88
III.	HOW CAN THE ESTABLISHMENT OF A SUPRANATIONAL SUPERVISOR BE A SOLUTION TO THE BANKING CRISIS?.....	91

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IV.	WHY WAS THE ECB CHOSEN TO ACT AS THE SINGLE SUPERVISOR OF THE EUROPEAN BANKING UNION?.....	93
V.	WHAT TASKS ARE CONFERRED ON THE ECB?	96
VI.	THE ECB'S NEW MANDATE AND ITS CHALLENGES.....	97
VII.	THE SCOPE OF THE SSM AND ITS CHALLENGES	100
VIII.	THE IMPACT OF THE ESTABLISHMENT OF THE SSM ON OTHER EU INSTITUTIONS (THE EBA)	105
IX.	IS THE SINGLE SUPERVISORY MECHANISM ADEQUATELY INDEPENDENT AND ACCOUNTABLE?.....	108
X.	CONCLUSION	III

I. INTRODUCTION

Economic integration and financial issues have always been central to the European Union's development. There is no doubt that economic interests have been the driving force behind European countries' integration process. It may even be argued that the economic policies' effects have gone far beyond the objectives of economic growth and development, influencing all aspects of the EU states and their citizens' lives. One of the encouraging results of economic integration and collaboration has been the region's increased political stability. The region had previously been the scene of devastating wars and political and economic rivalries.¹ On the other hand, these economic incentives also have negative consequences. Despite its advantages, the monetary union of seventeen European states creates a unique economic situation; a financial crisis in any state crosses national boundaries and affects all other states of the Union. The current sovereign and private sector debt crises in Greece, Ireland, Italy, and Spain, and the attempts of economically stable countries (such as Germany and France) to rescue them, are the best examples of economic integration's undesirable results. The EU Commission, well aware of these problems, has described the debt crisis in the following terms:

Doubts about the sustainability of public debt, economic growth prospects, and the viability of credit institutions have been creating negative, mutually reinforcing market trends... The situation poses specific risks within the euro area, where the single currency increases the likelihood that developments in one Member State can create risks for economic development and the stability of the

¹ 'How the EU Works' (*European Union website*) <<http://europa.eu/about-eu/>> accessed 28 May 2014.

Euro area as a whole.²

Despite the critical situation that all members of the EU find themselves in, the EU and its members are unwilling to withdraw from the path they have been on for the past five decades. They are determined to overcome the problems they face and have proposed a higher level of cooperation and integration. In order to 'restore confidence in banks and in the euro',³ EU members have introduced the 'Single Supervisory Mechanism' (SSM), which gives the European Central Bank (ECB) significant regulatory and supervisory powers. The SSM decreases national financial authorities' powers and transfers jurisdiction from the national level to the Union's monetary entity. On March 19th 2013, the Commission's proposal for the SSM was adopted by the joint meeting of the EU Parliament, the Commission, and the Council of Ministers. On September 12th 2013, after a series of consultations and amendments, the EU Parliament adopted a legislative resolution on a proposed Council regulation. This resolution would confer specific tasks on the ECB with regards to policies related to the prudential supervision of credit institutions.

Despite the severity of the debt crisis and the necessity of concerted rescue action by all EU members, it was not easy for the Union to finalize the supervisory plan, and its establishment faced some substantial challenges. One of the EU States main concerns stems from their desire to maintain their internal sovereignty over issues touching upon the interests of national businesses. Needless to say, this is not a new challenge. Since the Union's establishment, some Member States have been reluctant to transfer their authority to EU institutions, although some have also been eager to join the single market of the EU zone. In fact, the economic privileges are not enough motivation for states to limit their national sovereignty.⁴ In the case at hand, the German government's resistance to including its regional bank in the SSM sheds light on the problem's complexity. The Council Regulation that conferred specific tasks on the ECB regarding policies on prudential supervision of credit institutions establishes the supervisory mechanism. It states that banks and financial institutions with assets of more than 30 billion euro are under the ECB's supervision. This means Germany has used its leverage to limit the ECB's supervisory jurisdiction's scope, while its government has been a strong

² European Commission, 'Proposal for a Council Regulation Conferring Specific Tasks on the European Central Bank Concerning Policies Relating to the Prudential Supervision of Credit Institutions', COM (2012) 511 final, para 1.2. ('Commission Proposal').

³ *ibid.*

⁴ Jurgen Habermas, 'Why Europe Needs a Constitution' (2011) (*October New Left Review*) <www.newleftreview.org/A2343> accessed 28 May 2014.

proponent of the mechanism.⁵ The British government's vote against the proposal shows its reluctance to be subjected to the ECB's supervision. The UK prefers to protect its central bank's sovereign rights by limiting them to the financial business conducted in London, the financial capital of Europe.⁶

It is also worth noting that the EU's encroachment upon its Member States' internal sovereignty is not their only concern. Since the Union's foundation, the Member States' internal affairs have come more and more under the control of EU regulations and directives. According to statistics, 70% of national agencies that play a significant role in European citizens' everyday lives are affected by the EU's regulations. These regulations, however, have not been subjected to 'timely and careful public opinion or will-formation' at the national level where these regulations' real effects are felt.⁷ Thus, the extent to which the ECB is held accountable for its actions with regards to the EU's members is highly significant.⁸

In light of the above-mentioned arguments, this paper intends to analyze the legal aspects of the Single Supervisory Mechanism (SSM), and to consider its positive and negative effects on the EU. However, prior to the legal analysis, it is necessary to present an outline of the financial crisis the EU is struggling with. Subsequently, the economic and financial crisis that has hit Europe in recent years and the European Union's responses to this problem will be discussed first. Then, because one of these responses has been the establishment of a Single Supervisory Mechanism (which is the main focus of this paper), ways this plan can help the EU overcome the crisis will be discussed.

The majority of this paper will be devoted to arguments about difficulties the Union faces with regards to the SSM's establishment within the EU. It is possible to criticize the existing Treaties' legal structure, and there may also be a conflict with the ECB's mandate. As the established entity for carrying out supervisory tasks, the ECB is also responsible for setting monetary policies. Therefore, achieving these two mandates' objectives is a

⁵ Toby Vogel, 'EU Reaches Deal on Banking Supervision' (*The European Voice*) <www.europeanvoice.com/article/2013/march/eu-reaches-deal-on-banking-supervision/76697.aspx> accessed 28 May 2014.

⁶ House of Lords European Union Committee, 'European Banking Union: Key issues and challenges', HL 7th Report of Session 2012-2013, Chapter 2 paras 88-7 ('HL EU Committee Report on EU Banking Union')

⁷ Habermas (n 4).

⁸ Gabriele Steinhauser and Laurence Norman, 'Single Supervisor? Not so Fast' (*The Real Time Brussels*, 27 March 2013) <<http://blogs.wsj.com/brussels/2013/03/27/single-supervisor-not-so-fast/>> accessed 28 May 2014.

concern for some European countries. The legal boundaries that are set by EU legal principles—such as equal treatment for all EU Member States—are another example of these challenges. This may be another obstacle to conferring supervisory authority to the ECB, because according to the existing treaties, the ECB supervises banks located within the so-called Eurozone.

Another issue that has raised concerns is the mechanism's accountability, which seems difficult to reconcile with the central bank's independence in the EU. The Member States' concerns, and the measures that the Council and the EU Parliament have taken to soothe these concerns, will be discussed in detail.

Furthermore the effect the SSM's establishment has on other agencies with similar mandates in the banking sector (ie the European Banking Authority) will be discussed. There are similarities in the two agencies' mandates; thus, raising the risk of their mandates overlapping, or of the EBA being marginalized as banking supervision becomes centralized. Moreover, non-participating Member States will risk being outvoted by participating Member States, as the latter will follow the same policy the SSM sets for the Eurozone. It is to be noted, however, that, the Commission's proposals have been amended several times since the first draft's publication, and these issues have been addressed as much as possible in the latest version adopted by the Parliament. After explaining the challenges the EU is struggling with, the most recent amendments addressing the above mentioned issues will be discussed in this paper.

II. HOW DID THE SOVEREIGN DEBT CRISIS EMERGE AND WHAT ARE THE EUROPEAN UNION'S RESPONSES?

Looking back at the history of the financial crisis that hit Europe in 2008, a long period of credit growth and low risk premiums can be seen. This was the result of prospering economic activity and sufficient liquidity in the markets. As the Commission has stated:

Strong leveraging, soaring asset prices and the development of bubbles in the real estate sector also shaped this financial situation. Stretched leveraged positions and maturity mismatches rendered financial institutions very vulnerable to corrections in asset markets, deteriorating loan performance and disturbances in the wholesale funding markets.⁹

⁹ European Commission, 'Economic Crisis in Europe: Causes, Consequences and Responses' DG Economic and Financial Affairs, (2009) 7 European Economy

In response to this situation, banks became worried about their counterparts' creditworthiness. Therefore, the 'intrabank market virtually closed and risk premiums on intrabank loans soared'.¹⁰

This caused overall credit conditions to deteriorate, which diminished economic activity. Also, the credit market's sudden collapse left many banks unable to repay their loans, thereby forcing governments to intervene in the banking sector. This massive transfer of liability overwhelmed governments' balance sheets and resulted in the EU Member States' debt crisis.¹¹

The introduction of the Euro as the common currency for 17 EU members and the establishment of the EMU (European Monetary Union) are two of the major driving factors in aggravating the crisis. The main argument for this idea is the 'Impossible Trinity' which consists of the 'absence of co-responsibility for public debt'¹², the strict 'no monetary financing' ¹³rule and the interdependence of bank and sovereign.¹⁴

This Impossible Trinity makes the Euro-area vulnerable to crisis, because trouble with sovereign solvency will result in shocks to bank solvency. The Central Bank is not empowered to provide liquidity to the sovereigns in order to stall the self-feeding debt crises.¹⁵

Moreover, by establishing the European Monetary Union (EMU) aimed at creating a single currency and a harmonized monetary policy, the European Union has not made a common fiscal policy one of its mandates. This requires the economically weaker countries to deal with the same monetary policy as the strongest, with no means to adapt their exchange rate in response to their financial situation. On the other hand, deficits in

<http://ec.europa.eu/economy_finance/publications/publication15887_en.pdf>
accessed 28 May 2014, 1-8.

¹⁰ *ibid.*

¹¹ Benoite Cœuré, 'Banking Union and Fiscal Union in Europe: Outlook and Implications for Global Partners' Asia-Europe Economic Forum Conference on European Troubles, Bruegel 2013
<www.ecb.int/press/key/date/2013/html/sp130121.en.html> accessed 28 May 2014.

¹² Consolidated Version of the Treaty on the Functioning of the European Union [2010] OJ C83/47 ('TFEU') art 129(1) and Protocol (No 4) on the Statute of the European System of Central Banks and of the European Central Bank [2008] OJ C115/230 art 123.

¹³ *ibid.*, art 125.

¹⁴ Jean Pisani-Ferri, 'The Euro Crisis and the New Impossible Trinity' (2012) Bruegel Policy Contribution, 1- 4.

¹⁵ *ibid.*, 9.

troubled countries may contaminate the whole market, as all countries are using the same currency. This was one of the main factors in the spread of the crisis among the Eurozone Member States.

Analyzing the crisis and its roots requires a deep financial approach, which is not feasible within the space of this paper. Leaving this task to the financial policy-makers, it should be mentioned that the European policy makers responded actively to the management of the crisis.

Following the Greek financial rescue package and the establishment of the temporary European Financial Stability Mechanism (EFSM) and European Financial Stability Facility (EFSF), a number of different policy options were discussed. These included how to establish financial rescue mechanisms, how to strengthen the Stability and Growth Pact, and how to enhance banking supervision with the goal of making the banking system more robust in the face of sovereign defaults.¹⁶

Moreover, after the Greek debt crisis, some Member States initiated austerity measures to meet the requirements for bailout loans so that they could receive the loans and overcome financial problems. These measures included reducing public pensions and expenditures on public services and increasing government revenue by imposing higher taxes to compensate for the budget deficit. Over time, these measures inflicted severe economic suffering on troubled countries: 'they resulted in more unemployment and economic activity, the economy of the 17 European Union countries that use the euro descended into more recession.'¹⁷

As the lender of last resort, the ECB took important standard and non-standard measures to support the states in crisis by injecting liquidity into the market. This was done by giving cheap loans and buying governments bonds, and the ECB was criticized repeatedly for acting outside of its mandate. One of those measures was the Outright Monetary Transactions program, by which the ECB arguably circumvented the prohibition against direct government financing by the central bank. However, undoubtedly, the ECB efficiently ameliorated the crisis, even though its new measures were not compatible with its main mandate, which is safeguarding price stability.

¹⁶ Deborah Zandstra, 'The European Sovereign Debt Crisis and its Evolving Resolution' (2011) 6 (3) *Capital Markets LJ* 285.

¹⁷ 'European Leaders Change Views on Austerity' (*CBC News*, 15 March 2013) <<http://www.cbc.ca/news/business/story/2013/03/15/austerity-eu.html>> accessed 28 May 2014.

On September 12th 2012, the European Commission published three documents: a communication entitled 'A Roadmap towards a Banking Union'; a proposal for a Council regulation based on Article 127(6) to create the Single Supervisory Mechanism and conferring a central role on the ECB; and a proposal for a regulation in the European Parliament and the Council amending the 2010 regulation that established the EBA to allow for the creation of the SSM.

Finally, at the Euro summit from December 12-14th 2012 in Brussels, the roadmap for deepening the economic and monetary union in the Eurozone was adopted by the European Council. According to this roadmap, financial ministers agreed to the creation of the Single Supervisory Mechanism as the first step towards building a banking union for Europe, shifting the prudential supervisory task to the ECB. Negotiations continued through the following weeks, and finally the Commission proposal for the 'Single Supervisory Mechanism' was adopted by the joint session of the Commission, the EU Parliament members, and the Council of Ministers on March 19, 2013. Certain issues regarding the creation of the Single Supervisory Mechanism and the ECB's role at the centre of this mechanism will be addressed in the following discussions.

III. HOW CAN THE ESTABLISHMENT OF A SUPRANATIONAL SUPERVISOR BE A SOLUTION TO THE BANKING CRISIS?

In this section, the necessity of establishing the SSM will be considered. The EU banking system's shortcomings, which led to the financial crisis, will be discussed, and the ways in which the SSM's establishment will address these deficiencies will be explained.

There are many reasons why a supranational supervisory mechanism for European banks is necessary. In fact, the EU has felt the need to break the connection between banks and sovereign states since it turned out to be impossible for national governments to maintain financial stability and market integration. This was because the national authorities lacked important information about the activities of financial institutions that cross national boundaries. It has also been proven that national states are unable to deal with the international crisis, and their policies do not provide the solution needed to manage an international financial crisis. These rationales will be discussed in detail below.

As the heads of Member States at the September Euro summit announced, the Euro crisis revealed the need to break the vicious cycle between banks and sovereigns.

This element is visible in increasing debt levels of sovereigns that had to provide support for struggling banks as well as losses of banks from being exposed to sovereigns under stress. Therefore, there was the need to weaken the spillover chain between banks and sovereigns by taking responsibility for the stability of the banking system.¹⁸

There are many ways in which this objective could be better pursued at the EU level. The main reason it is necessary to create a banking union with a supervisory mechanism at the EU level has to do with the importance of financial stability and market integration, which are not occurring at the same time at the national level. This is what Shoenmaker calls ‘the financial trilemma.’¹⁹ This theory suggests that policymakers can choose only two of the three following objectives: financial stability, financial integration and national financial policies (such as bank supervision and resolution). This is because ‘national financial policies usually fail to recognize the externality generated by cross-border banks in difficulty.’²⁰ In fact, financial integration at the EU level gives rise to the supranational interdependence of financial agents. Regulating these supranational relations requires extra information about the activities of institutions located outside the jurisdiction of the national authorities. No national central bank or parliament has access to all the required information about financial institutions located outside of its territory. However, the activities of these banks influence the banking sector and they cannot exercise authority over the cross-border financial institution. At the same time, the national supervisory institution does not have enough information about the financial institutions that are established in its territory, and whose activities go beyond national boundaries. Monitoring these institutions is difficult for the national mechanisms. Therefore, the national authorities are not able to extend robust supervisory mechanisms to these cross-border entities, and may provide troubled banks across the border with capital flow while having no control over the capital injection’s effects.²¹ Another possibility is that the national authorities may not provide enough funds to troubled institutions due to a lack of information and control, which in turn leads to financial instability.²² Moreover, national supervisors are more vulnerable to regulatory capture.²³ Both of

¹⁸ Vitor Constâncio, ‘Establishing the Single Supervisory Mechanism’ (The BAFT-IFSA 2013 Europe Bank-to-Bank Forum, Frankfurt, 29 January 2013) <www.ecb.int/press/key/date/2013/html/sp130129_1.en.html> accessed 28 May 2014.

¹⁹ Dirk Schoenmaker, ‘The Financial Trilemma’ [2011] 111 *Economics Letters* 57 at p 58-59.

²⁰ *ibid.*

²¹ *ibid.*

²² *ibid.*

²³ Benoit Cœuré, ‘The Way Back to Financial Integration’ (International Financial

these elements undermine financial stability, and therefore, combining these three objectives is not possible at the national level. In this regard, Benoît Cœuré, member of the ECB's executive board stated that:

‘by setting the incentives correctly, a fully-fledged banking union permits an internalization of this externality, making sure that banks strengthen their capital and liquidity on sunny days and can continue to lend on rainy days.’²⁴

Additionally, in a highly integrated financial system such as the European Union, reducing moral hazard²⁵ and excessive risk-taking requires a consistent set of regulatory incentives, based not only on common rules but also on integrated supranational powers in banking supervision. Therefore, integration in the banking sector that underlies the financial integrated market is necessary to stop reckless risk-taking by banks in the internal market.²⁶

Supervision at national levels was fragile during the financial crisis.²⁷ In fact, the national banking system preferred to protect national banks in crisis, and decided to hide information from the public, which in turn resulted in ‘delaying loss recognition’, magnifying the eventual losses.²⁸ The widespread tendency of national regulators and supervisors to side with their troubled banks and to hide information from the public is rooted in the intention to protect creditors, shareholders and managers.

IV. WHY WAS THE ECB CHOSEN TO ACT AS THE SINGLE SUPERVISOR OF THE EUROPEAN BANKING UNION?

As the Council's proposals indicate, the SSM will be composed of the

Integration and Fragmentation: Drivers and Policy Responses Conference, 12 March 2013) <www.ecb.europa.eu/press/key/date/2013/html/sp130312.en.html> accessed 28 May 2014.

²⁴ *ibid.*

²⁵ Moral hazard: A situation where a party will have a tendency to take risks because the costs that could incur will not be felt by the party taking the risk. In other words it is the tendency to be more willing to take a risk, knowing that the potential costs or burdens of taking such risk will be borne, in whole or in part, by others.

²⁶ Zandstra (n 16), 285-316.

²⁷ Jacopo Carmassi et al, ‘Banking Union: A Federal Model for the European Union with Prompt Corrective Action’, (2012) 282 CEPS Policy Briefs 1-6.

²⁸ Richard J Herring and Charles W Calomiris, ‘How to Design a Contingent Convertible Debt Requirement’ (2013) 25 J of Applied Corporate Finance <http://fic.wharton.upenn.edu/fic/Policy%20page/25.Calomiris_forthcoming.pdf> accessed 28 May 2014.

European Central Bank and national competent authorities.²⁹ In fact, the final regulation states that the supervisory board is composed of the ECB Chair, Vice Chair, four other ECB representatives, and a representative from each Member State participating in the supervisory mechanism.³⁰ However, the question remains: why was the ECB chosen by European authorities to play such an important role in the future banking union?

First, one of the policy makers' main concerns was avoiding the lengthy treaty amendment process. In fact, if they decided to create a new institution, they would have been left with no choice other than to introduce a new treaty. However, at the height of the crisis, the Union needed to take corrective actions in a timely manner, as treaty amendment - from writing the preliminary draft to ratifying the final act by the national authorities - takes a long time, allowing the crisis to deteriorate. As article 127(6) TFEU recognizes the ECB's supervisory powers over the EU's financial institutions, EU Member States believe that it is not necessary to ratify a new treaty to establish the legal basis for the prudential supervisory tasks that are to be assigned to the ECB in 2014. It is also worth noting that some EU members, including Germany, at first believed that the existing legal basis provided by EU treaties falls short of the SSM's demands, and that treaty amendment is inevitable.³¹ The UK Parliament holds the same opinion, although the UK has voted against the mechanism.³² Recently, the German policy has changed. Although Germans still believe that treaty change is essential, they have agreed to the establishment of the mechanism within the current legal regime in order to respond to the crisis in a timely manner. They still believe that treaty amendments should be made in the future. Yet, in their view, resolution of the financial crisis through the SSM is now more important than the existing treaties' inconsistency with the supervision mechanism: 'The need for urgent reactions to the crisis especially after Cyprus bailouts in March 2013, and the long process of making amendment in EU treaties

²⁹ Council of the European Union, 'Council Agrees Position on Bank Supervision', Press Release, December 2012
<www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/134265.pdf> accessed 28 May 2014.

³⁰ Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions' 2013, not yet published in the Official Journal
<www.europarl.europa.eu/document/activities/cont/201309/20130912ATT71209/20130912ATT71209EN.pdf> accessed 26 September 2013 ('Council Regulation on Conferring Tasks'), art 19.

³¹ Jim Brunsten, 'EU Set to Clash on Bank Deal as Germany Sees Treaty Limit' (*Bloomberg Business Week*, April 2013) <www.businessweek.com/news/2013-04-13/eu-set-to-clash-on-bank-deal-as-germany-sees-treaty-limit> accessed 28 May 2014.

³² HL EU Committee Report on EU Banking Union (n 6).

is the reason of this policy change.’³³

Alternatively, Berlin has proposed a two-stage plan in which treaty change is at first not a requirement. Instead, the ‘network of national authorities’ will start after three conditions are met: first, the new EU supervisor is operational; second, EU banks are fully capitalized to Basel III levels; and third, new standards are agreed upon for national resolution authorities and funds.

The other reason for choosing the ECB as supervisors is that, according to Art 127(1) TFEU, the ECB’s primary mandate is to preserve price stability, and the most important tool the ECB has to achieve this objective is defining and applying monetary policy for Eurozone members. It is arguable that ‘this responsibility for monetary policy creates for the central bank an intrinsic and deep interest in a stable functioning system.’³⁴ In other words, ‘confidential information on the health of the banking system is useful in predicting inflation and unemployment’, and therefore, in adopting a monetary policy in accordance with the needs of the system.³⁵ The debt crisis is the best example of the effects the banking system’s instability has on the euro’s value and on price stability. EU Member States and financial institutions are supposed to conduct their business with one common currency and each state is individually in charge of banking supervision. In this context, it is not plausible to imagine that all of these separate financial policies could lead to the emergence of one common framework guaranteeing the EU monetary system’s stability without the intervention of a supranational institution. In other words, without the single supervisory scheme, the ECB is obliged to carry out a task for which it does not have the necessary means. The Commission has presented the same argument in defence of the proposal for the SSM. It states:

The objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore be better achieved by the EU. Recent events have clearly demonstrated that only supervision at the European level can ensure appropriate oversight of an integrated banking sector and a high level of financial stability in the EU and the Euro area in particular. The

³³ Peter Spiegel, ‘Schäuble Warns EU Bank Rescue Agency Needs Treaty Changes’ (*Financial Times*, May 2013) <www.ft.com/intl/cms/s/0/366eff18-bb03-11e2-b289-00144feab7de.html#axzz2VkzXp73N> accessed 28 May 2014.

³⁴ Constâncio (n 18).

³⁵ Vasso Ioannidou, ‘A First Step Towards a Banking Union’ in Thorsten Beck (ed) *Banking Union for Europe Risks and Challenges* (Centre for Economic Policy Research, Tilburg University 2012) available at <www.voxeu.org/sites/default/files/file/Banking_Union.pdf> accessed 5 June 2014, 90.

provisions of this proposal do not go beyond what is necessary to achieve the objectives pursued. The ECB is entrusted with the supervisory tasks, which need to be exercised at EU level to ensure uniform and effective application of prudential rules, risk control and crisis prevention. National authorities will continue to carry out certain tasks, which can be better performed at national level.³⁶

On the other hand, conferring supervisory competence on the ECB will help it fulfil its central banking duties; a central bank, as ‘the lender of last resort’, should be able to provide a huge amount of money in a short period of time during crises. In order to do this, the central bank must know the banks’ financial situations. Therefore, equipping it with supervisory authorities is undoubtedly beneficial, given that information submitted to the ECB by other institutions is not sufficiently reliable, as they are not responsible for the EU zone’s financial stability and their actions are not motivated by the same incentive.³⁷

V. WHAT TASKS ARE CONFERRED ON THE ECB?

As mentioned earlier, implementing the new roadmap will shift specific supervisory tasks to the Union level in the Euro area, notably those that are key to preserving financial stability and detecting risks to banks’ viability. The ECB will become responsible for tasks such as authorizing credit institutions, compliance with capital, leverage and liquidity requirements, and supervising financial conglomerates. The ECB will be able to intervene early by requiring banks to take remedial action when they breach or risk breaching regulatory capital requirements.³⁸

Prior to the Council’s adopting of the SSM, the legal basis for conferring tasks of prudential supervision to the ECB was article 127(6) TFEU. Since the March 19th 2013, the Council Directive has been another legal document establishing supervisory jurisdiction. Therefore, in addition to pursuing its primary mandate of maintaining price stability by defining and applying monetary policy within the Eurozone, the ECB’s mandate will be extended to preserving financial stability through prudential supervisory mechanisms.

According to article 4(1)(a) to (k) of the Regulation, the ECB will be given ‘exclusive competence’ for a specific list of key supervisory tasks

³⁶ Commission Proposal (n 2), 2.

³⁷ Ioannidou (n 35), 92.

³⁸ European Commission, ‘Commission Proposes New ECB Powers for Banking Supervision as Part of a Banking Union’ Press Release IP/12/953, 12 September 2012 <http://europa.eu/rapid/press-release_IP-12-953_en.htm> accessed 28 May 2014.

contemplated by the CRD IV package, including: authorizing and licensing credit institutions, assigning acquisitions and disposals of holdings in credit institutions, ensuring compliance with the EU capital, liquidity and related requirements. In particular cases, these tasks will also include the following setting higher or additional requirements; applying capital buffers; overseeing robust and sound internal governance; internal assessment and risk management arrangements; strategies; processes and mechanisms, carrying out stress tests; conducting consolidated supervision; participating in supplementary supervision of financial conglomerates, and carrying out supervisory tasks related to early intervention (in coordination with national resolution authorities).

Under the Commission's proposal, the ECB's list of 'exclusive competences' would also have extended to coordinating and expressing the common position of the competent authorities of Member States participating in EBA decision-making contexts on issues related to tasks conferred on the ECB. The other difference between the Council and the Commission's view of the list of tasks entrusted to the ECB is that under the Council's proposal, it is the national authorities – not the ECB – that have the power to apply capital buffers and other macro-prudential tools. The reason for this division of tasks can be seen from the Council's point of view: The national authorities are in a better position to assess the specific circumstances faced by local financial systems. Meanwhile, national authorities have to duly consider any objections from the ECB. Furthermore, if necessary, the ECB has the power to apply higher capital buffers and more stringent macro-prudential measures than those applied by national authorities.

According to the Council's amendments, national supervisors would remain in charge of tasks not conferred on the ECB, for instance, those related to consumer protection, money laundering, payment services, and branches of third country banks. The EBA would retain its power to further develop the single rulebook and ensure convergence and consistency in supervisory practice, which will be discussed shortly.

VI. THE ECB'S NEW MANDATE AND ITS CHALLENGES

In the previous sections, the practicality of choosing the ECB as the single supervisor of the EU banking system was discussed, as was the existing treaties' compatibility with the Single Supervisory Mechanism, with the ECB having the mandate to preserve price stability and set monetary policies according to the treaties. However, now that EU members are determined to enforce such a drastic change in the ECB's structure and mandate, consequences are inevitable. These challenges will be briefly

discussed in this section, and the resolutions proposed by EU bodies in response to these concerns will be presented.

First of all, when the Commission proposed the SSM, there were concerns about the hazards of bringing monetary policy and prudential supervision together. The fear was that a 'central bank's concern for the health of banks jeopardizes its price stability objective.'³⁹ Also, conducting monetary policy could affect the central bank's supervisory responsibilities. A good example of this can be seen during recessions, when instead of putting pressure on credit institutions and making credit conditions more demanding, central banks would lower supervision to support monetary policy objectives. In the case of the recent financial crisis, some experts believe that central banks are tempted to provide crisis-ridden banks with funds as they try to prevent the financial system's collapse. Yet, such a lax monetary policy can lead to 'generating an inflationary bias impairing its credibility, and also contribut[ing] to more risk-taking by banks (moral hazard), and in turn breed[ing] future financial instability.'⁴⁰

EU legislators have not disregarded this potential conflict. In the proposal the Commission stressed the importance of exercising these two functions separately.⁴¹ To properly divide the tasks, the Commission's proposal has created a supervisory board within the ECB, whose role is to plan and execute the supervisory tasks conferred on the ECB. The Council draft, on the other hand, conferred the responsibility of preparing supervisory tasks on the supervisory board and their adoption on the ECB's governing council.⁴²

Some critics regard the structure and legality of these bodies with suspicion. However, the key point is that the difficulty of the tasks conferred on the ECB is still a matter that is up for discussion, notwithstanding the structure of the decision-making process that the Commission and Council have proposed. Even though a special body is in charge of preparing decisions related to supervision, in the end, decisions will not be adopted if the governing council objects. The governing council, which is the decision-making body of the ECB, is primarily responsible for formulating monetary policy for the Eurozone Member States. Therefore, the division of tasks between supervisory measures and

³⁹ Carmassi (n 27).

⁴⁰ Benoit Cœuré, 'Monetary Policy and Banking Supervision' ('Central Banking: Where Are We Headed?' Symposium in honor of Stefan Gerlach's contribution to the Institute for Monetary and Financial Stability, Frankfurt, February 2013) <www.ecb.int/press/key/date/2013/html/sp130207.en.html> accessed 28 May 2014.

⁴¹ Commission Proposal (n 2), art 18(2).

⁴² Council Regulation on Conferring Tasks (n 30).

monetary policymaking is not guaranteed under the current legislation.

One of the main criticisms of conferring supervisory tasks on the ECB has to do with the conflict of interest that arises from the tension between the adoption of monetary policy and the exercise of macro prudential supervision. The Commission's opinion was that special bodies should be designated for decision-making. However, the Council has amended this resolution to create more equal rights for those Member States who are outside of the banking system.

In this regard, the Commission's proposal anticipated the establishment of a supervisory board in the ECB. This board consisted of representatives from all participating Member States who would have the power to make supervisory decisions and carry out tasks of prudential supervision.⁴³ The Governing Council, or the ECB's decision-making body would still have been in charge of making decisions, but the Commission has envisioned the possibility of delegating 'clearly defined supervisory tasks and related decisions' about an individual institution or set of institutions to the Supervisory Board under the Governing Council's authority.⁴⁴

According to the Council's proposal, the supervisory board will carry out preparatory supervisory tasks and propose draft decisions, which will be formally adopted by the Governing Council. The definition of participating Member States also includes those non-Eurozone members that have entered into close cooperation with the SSM.⁴⁵ However, the Council's text does not delegate tasks and related decisions about specific institutions from the Governing Council to the Supervisory Board. The Governing Council is in charge of making final decisions that are prepared by the supervisory board.

Critics consider this close relationship between the Governing Council and the supervisory board (more precisely, the dependence of the latter on the former) problematic. As the Governing Council's primary responsibility is to formulate monetary policy,⁴⁶ granting the Governing Council exclusive decision-making power 'appears to breach the ring-fence that should be maintained between supervision and monetary policy.'⁴⁷

⁴³ *ibid*, art 19.

⁴⁴ Commission Proposal (n 2), art 19(3).

⁴⁵ Council Regulation on Conferring Tasks (n 32), arts 1(1) and 19(1).

⁴⁶ *ibid*, art 12.

⁴⁷ Ellis Ferran and Valia SG Babis, 'The European Single Supervisory Mechanism' (2013) University of Cambridge Faculty of Law Research Paper 10/2013, <<http://ssrn.com/abstract=2224538> or <http://dx.doi.org/10.2139/ssrn.2224538>> accessed 26 September 2013, 14.

There are also some concerns about the impracticality of multiple layers of governance arrangements, keeping in mind the members of the Governing Council's expertise and qualifications in setting monetary policy.⁴⁸

Furthermore, it should be noted that while TFEU and ECB statutes authorize the Governing Council and the executive board of the ECB to conduct monetary policy,⁴⁹ no equivalent institutional structure is provided in legal texts for the ECB's supervisory tasks. Therefore:

Establishment of a new body with wide discretionary decision making powers such as the supervisory board can reasonably be considered to be a step beyond the modalities of internal organization. That the space for institutional creativity does not extend that far appears to be the reasoning behind the approach followed by the Commission and the Council; Indeed the Council has been more conservative in its views than the Commission, because its text does not allow for the delegation of specifically defined supervisory tasks.⁵⁰

Similarly, even a secret opinion from the EU Council's top legal advisor revealed by the Financial Times shows that the plan goes 'beyond the powers permitted under law to change governance rules at the European Central Bank, and without altering EU treaties it would be impossible to give a bank supervision board within the ECB any formal decision making power suggested by the Council.'⁵¹

VII. THE SCOPE OF THE SSM AND ITS CHALLENGES

Another crucial criticism of the Commission's proposal for establishing the Single Supervisory Mechanism is that this mechanism's scope may threaten the internal market's integrity and the equal treatment of the states within and outside of the Eurozone. There is also disagreement on the type and number of financial and credit institutions that the SSM should have authority over in those states that are already Eurozone members. The Commission has amended its proposal to compensate for problems arising due to the SSM's scope.

In terms of scope, the most important point is that the Supervisory

⁴⁸ *ibid.*

⁴⁹ TFEU (n 12), art 9(3).

⁵⁰ Ferran and Babis (n 47).

⁵¹ Alex Barker, 'Europe Banking Supervisor Plan Illegal' (*The Financial Times*, October 2012) www.ft.com/intl/cms/s/o/d62db344-179f-11e2-9530-00144feabdco.html#axzz2RKFcVPMR accessed 28 May 2014.

Mechanism, as the Lisbon Treaty (articles 127-133) states, is responsible for supervising the banking systems of those Member States whose currency is the Euro. Therefore, the Council and the Commission's legislative texts do not provide for the ECB's supervision of non-Eurozone Member States. However, the Council's proposal provides for cooperation arrangements with limited participation rights in the SSM, and this is bolstered by the Council, as the unequal treatment of non-Eurozone Member States in the former is partially remedied by the latter. The treatment of the ins and outs of the SSM's proposed design will be discussed in further detail, but for now it is important to point out the risk of fragmenting the internal market that may be caused by the non-unified model of banking system supervision among Member States.

It is argued that this division between participating states and states that opt out of the mechanism is not covered by the Treaty. Article 127(6), which grants the ECB supervisory powers, is not restricted to the Eurozone and may therefore apply to all Union members because the transitional provisions of Article 139(2c) make it explicit that Article 127(6) is not subject to provisional measures and Member States are not allowed to deviate from the rule in Article 127(6). In other words, under the Treaty, the ECB is a Union institution, while restricting its monetary functions to certain Member States is a 'temporary' situation permitted by the deviation from treaty obligations. The Roadmap called for 'an integrated financial framework that covers all EU Member States, whilst allowing for specific differentiations between Euro and non-Euro area Member States; but it is neither consistent with this objective nor the common European objective of preserving the internal market.'⁵²

As previously mentioned, the SSM was introduced as the supervisor of banks within the Euro area. However, Member States whose currency is not the euro are also invited by the Commission proposal to participate in close cooperation agreements with the SSM. The Commission proposal included some unequal elements with respect to non-Eurozone members that voiced their discontent and their reluctance to cooperate with the system. For example, a Member State that enters into a close cooperation agreement with the SSM is bound to bring its national regulations in line with the ECB's guidelines and instructions and provide information requested by the ECB. It must also agree to adopt national legal acts to ensure that its bank prudential supervisor will be obliged to adopt any measures the ECB requests in relation to credit institutions. The ECB can decide to terminate close cooperation but the Member State has no such right. Most importantly, articles 19(1) and 19(5) of the Commission's

⁵² Carmassi (n 27), 3.

proposal limit the supervisory board's decision-making authority to participating Member States. Obviously, the fact that the proposal did not recognize the right of these states to participate in supervisory board activities and did not provide any incentive for EU members to join the SSM means it would not help to reach the objective of financial integration and stability.

In order to help reach its objectives, the Council agreed to make some amendments to the Commission's draft. It decided to assign every participant Member State a seat on the supervisory board, and to grant them equal voting rights in preparing drafts of decisions. It has left the task of adopting these decisions to the Governing Council as provided by ECB regulations. Other than the aforementioned doubts about the legality of establishing a new board within the ECB's institutional framework, the non-Eurozone members' concerns do not seem to have been alleviated yet.

The Governing Council of the ECB is composed of the ECB's six-member executive board and the governors of the participating national central banks, and there are no voting rights for national competent authorities whose currency is not the euro. This resulted in further dissatisfaction among some officials involved in the talks who were 'unimpressed with the prospect of voting powers for a committee that cannot take decisions, arguing it fell well short of a realistic political solution.'⁵³

A number of safeguards have been prepared to compensate for the non-Eurozone Member States' lack of decision-making authority on the governing council. First, the supervisory board's draft decisions are communicated to the Member States concerned. If one Member State objects to the decision, the governing council will invite that Member State's representative to the meeting. Also, all Member States may appeal to the European Court of Justice. In any case, contrary to the Commission's proposal, which only provided the ECB with the right to terminate cooperation,⁵⁴ the right to exit the cooperation agreement is provided for Member States under certain circumstances.⁵⁵ The expedited exit procedure provided in article 6(6abb) of the Council's regulation applies in those situations where a non-Euro area country has a major objection to a supervisory decision impacting the country. These safeguards are only intended to be used in 'duly justified, exceptional cases.' However, the regulatory bodies may only extend participation rights to non-Eurozone Member States this far under the existing legal

⁵³ *ibid.*

⁵⁴ Commission Proposal (n 2), art 6(5).

⁵⁵ Council Regulation on Conferring Tasks (n 30), art 6(6).

framework, and the decision-making right of states which intend to participate in the system cannot be afforded due to legal obstacles.

Moreover, some non-Euro area Member States were concerned that centralizing macro-prudential tools in the ECB would prevent them from taking appropriate macro-prudential regulatory action in response to issues specific to countries outside the Euro area, especially with regards to capital buffers. The Council's regulation in response to this concern gives national regulators wide discretionary power, and gives the ECB no authority to block their measures.⁵⁶ Meanwhile, the ECB can apply more stringent requirements for capital buffers to Euro area Member States. This seems to violate the EU's legal principle of equal treatment; setting regulations that better serve countries out of the area sounds 'counter intuitive'⁵⁷ and raises the question of whether or not a safeguard against unequal treatment and an incentive for tying Europe to a plan to make a more robust union justifies differential treatment.

Amongst Eurozone Member States, the SSM's scope is still a source of disagreement between the mechanism's proponents and some Member States. Supervisory authority, as established by the Commission's proposal on the prudential supervision of all credit institutions established in Member States whose currency is the Euro, is conferred on the ECB.⁵⁸ Germany first raised the idea of the Single Supervisory Mechanism⁵⁹ because it was not satisfied with bailing countries out of debt when they failed to abide by the fiscal compact and endangered financial stability within the Union. The mechanism was originally designed for a banking system in which there was supervision at the EU level. On the other hand, the German Chancellor did not agree with the scope of the supervision the Commission proposed, which France and the ECB advocated. The German government believes that national Member States should still bear the responsibility of day-to-day supervision of the smaller banks, leaving only large banks under the ECB's direct supervision.⁶⁰ The Council adopted the German point of view and narrowed the scope of the SSM's

⁵⁶ *ibid*, art 4(1).

⁵⁷ Zsolt Darvas and Guntram B Wolff, 'Should Non-Euro Area Countries Join the Single Supervisory Mechanism?' (*Bruegel Policy*, March 2013) <www.bruegel.org/publications/publication-detail/publication/773-should-non-euro-area-countries-join-the-single-supervisory-mechanism/> accessed 28 May 2014.

⁵⁸ Commission Proposal (n 2), art 4 (1).

⁵⁹ Finnish Ministry of Finance, 'Joint Statement of the Ministers of Finance of Germany, the Netherlands and Finland', Press release 175/2012, September 2012 <http://www.vm.fi/vm/en/03_press_releases_and_speeches/01_press_releases/20120925JointS/name.jsp> accessed 28 May 2014.

⁶⁰ Valentina Pop, 'Banking Union: The German Way or No Way' (*EU Observer*, 10 December 2012) <<http://euobserver.com/economic/118468>> accessed 28 May 2014.

supervision to banks whose total assets (balance sheet) were more than €30 billion, whose assets exceeded 20% of the GDP of the Member State of establishment participating in the SSM, unless the total value of these assets was below €5 billion, or credit institutions considered by the competent national authority to be significant to the national economy. In addition, ‘unless justified by particular circumstances,’ the ECB will directly supervise the three most significant credit institutions of each participating state. Although the day-to-day supervision of less significant banks is left to national authorities, according to the Roadmap the ECB would still be ultimately responsible for the Union’s financial stability, which would include these banks. In addition, the ECB would have been given supervisory authority and power to pre-emptively intervene with all banks.⁶¹

The reason for this narrowing lies in concern over the ECB’s capacity to manage the prudential supervision of 6200 banks and institutions in the Eurozone.⁶² It can also be regarded as questioning the sovereignty of Member States, with a view that centralizing the oversight of banks violates the Member States’ sovereign rights. This interference with sovereignty should be minimized as much as possible. As a case in point, to ensure that financial institutions meet the required standards, the ECB is entitled to pre-emptively intervene and require institutions to execute its directives. These micro-level interventions can overlap with the national authorities’ powers.⁶³ However, Member States that use the common currency have already voluntarily surrendered their monetary sovereignty to the Union level,⁶⁴ and in keeping with the previous changes and the creation of the EMU, further centralization appears to be the only way to escape the crisis at this level.

⁶¹ Carmassi (n 27), 5.

⁶² The German Finance Minister has stated in December 2012 that ‘I think it would be very difficult to get an approval by the German Parliament if you would leave the supervision for all the German banks to European banking supervision... Nobody believes that any European institution will be capable to supervise 6,000 banks in Europe.’ James Kanter, ‘European Finance Ministers Deadlock on Plan to Oversee Banks’ (*New York Times*, 4 December 2012) <www.nytimes.com/2012/12/05/business/global/daily-euro-zone-watch.html> accessed 28 May 2014.

⁶³ European Parliament, ‘Banking Union and Single Supervisory Mechanism, Monetary Dialogue’ Directorate General for Internal Policies PE 492/449, October 2012 <<http://www.europarl.europa.eu/document/activities/cont/201210/20121024ATT54390/20121024ATT54390EN.pdf>> accessed 28 May 2014, 54.

⁶⁴ Rosa Maria Lastra, ‘The Evolution of the European Central Bank’ Mary School of Law, Legal Studies Research Paper No. 99/2012, 1267 <<http://ssrn.com/abstract=2020545>> accessed 28 May 2014.

One of the major concerns, stemming from the two-level supervisory design the Council proposes, is that the 'allocation of supervision of less significant banks to national authorities or the outsourcing of labour from the ECB to national authorities may not afford the ECB with sufficient visibility of emerging problems quickly enough for timely intervention.'⁶⁵ Therefore, the home bias that can lead to supervisory forbearance will not be eliminated, and that was one of the main objectives of establishing a supervisory mechanism at the EU level. Thus the only resolution the Council proposes is that the ECB be in charge of issuing regulations, guidelines and general instructions to guide supervision by national authorities. Furthermore, the ECB retains some direct supervisory powers with regards to 'less significant' banks. These include bank authorizations and withdrawal of authorization, assessment of acquisitions and disposal of holdings.⁶⁶

Additionally, the ECB's initial remit will not extend to insurers, investment firms, central counterparties, other providers of market infrastructure or entities engaged in 'shadow banking' activities. This is due to the fact that Article 127(6) TFEU only allows for the ECB to be conferred with tasks related to credit institutions and other financial institutions while insurance undertakings are specifically excluded. This issue is a matter of questioning the system, as these institutions' functions pose a risk to the whole mechanism. However, extending the system's remit to include these bodies is not possible within the current treaty's framework and requires treaty amendment. Since the amendment process is normally lengthy, it is not possible to predict whether or not these institutions' activities will be covered by the ECB's supervisory jurisdiction.

VIII. THE IMPACT OF THE ESTABLISHMENT OF THE SSM ON OTHER EU INSTITUTIONS (THE EBA)

The European Banking Authority (EBA) is established by Regulation (EU) 1093/2010. It is in charge of writing non-binding guidelines and recommendations, conducting peer reviews, mediating disputes between supervisors on a non-binding basis, promoting supervisory cooperation, convergence and coordination, facilitating home/host Member State relations, and providing opinions to Union Institutions.

Therefore, it could be anticipated that centralizing banking supervision in

⁶⁵ Ferran (n 47).

⁶⁶ Council Regulation on Conferring Tasks (n 30), art 5(4).

the Eurozone would have an effect on the EBA. For this reason, when the Commission issued the single supervisory proposal, it also proposed an amendment to the EBA's regulation. First of all, there is the risk of conflict and overlap between the two bodies' mandates with respect to rule-making power, which both the EBA and the ECB enjoy. In recital 26 of the ECB's regulation, the Commission confines the ECB's exercise of its rule-making powers to situations in which the EBA's technical standards are not detailed enough to provide for the ECB's functions. Moreover, the ECB is to develop a 'supervisory manual' for national authorities under its remit, while the EBA is responsible for developing the single supervisory handbook for the entire Union. Ferran argues that '[u]navoidably, the larger degree of supervisory convergence within the SSM will call for arrangements different from those that are applied at EU27 level.'⁶⁷ Therefore, the mandate of each should be more precisely determined and the ECB's impact on the EBA should not be underestimated.

One major concern of non-participating Member States regarding the SSM's establishment and its effect on EBA is the risk that non-Eurozone states may be outvoted by SSM Member States that follow the same policy:

Authorities of the SSM Member States that vote in the EBA's Board of Supervisors may retain their autonomy, but in practice, it is likely that coordination will be sought in a manner that their votes are in line with policies adopted by the SSM as a whole.⁶⁸

It is predictable that:

Eurozone national authorities will increasingly coalesce around a common position as the ECB puts its stamp on Euro Area supervisory practices, procedures, policies, and philosophies, since this growing uniformity can be expected to spill over into regulatory thinking as well.⁶⁹

This raises the risk that non-Eurozone Member States may be outvoted by SSM Member States in EBA decision-making in cases that require simple majority in Articles 41 and 44 of the EBA's regulation. This includes decisions about breach of law, settlement of disagreements, and the election of the Management Board. Thus, the Commission proposed an independent panel to take charge of decision-making, whose decisions are

⁶⁷ Ferran (n 47), 22.

⁶⁸ HL EU Committee Report on EU Banking Union (n 6).

⁶⁹ Ferran (n 47), 25.

to be adopted unless rejected by at least three votes from participating Member States and three from non-participating Member States. Under the Council's regulation the independent panel consists of seven members, which do not represent the authorities concerned and which do not have any interest in the case. There is no minimum number of panel members from non-participating member States. In Article 1(7a), the Council introduces a new provision that the Board of Supervisors of EBA shall strive for consensus when making its decision, notwithstanding the voting arrangements set out for the EBA in this Regulation.

However, decisions about technical standards continue to be made by Qualified Majority Voting. In the Council's regulation, meeting the QMV requirement calls for at least a simple majority from representatives of participating Member States and a simple majority from representatives of non-participating Member States.

The Commission's proposal also emphasizes the EBA's power to resolve cross-border disputes between supervisors. According to the proposal, the EBA's decisions are not binding on the ECB, although it has to show proper justification in case of non-compliance.⁷⁰ This regulation again casts doubt on the equality of Ins and Outs, but it was not possible to eliminate inequality because of the principle of the ECB's independence, which is found in TFEU Article 130 and which prohibits the ECB from taking instructions from EU institutions or bodies. Therefore, Eurozone Member States are in a better position than non-Euro Member States when it comes to compliance with EBA instructions, due to the ECB's independence.

Generally, it has been argued the ECB's emergence as a powerful coordinating force in supervision could still have disturbing long term implications for the EBA, notwithstanding all the required amendments with respect to equal treatment and preventing mandates from overlapping. Rather than being a crucial single market cohesion mechanism, the EBA itself may become marginalized.⁷¹ In order to prevent this, certain organizational and structural amendments must be made to ensure that the EBA can operate effectively when the interests of Member States participating in the SSM diverge from those of Member States, which do not join the SSM. Therefore, legislative proposals need to provide more guarantees for the two institutions' coexistence and their successful operation in their own remit.

⁷⁰ Council Regulation on Conferring Tasks (n 30), art 3.

⁷¹ Ferran (n 47), 23.

These guarantees seem to be provided in the latest draft of a proposed amendment to EBA regulation adopted by the EU Parliament, according to these amendments:

The EBA Regulation will ensure that the EBA can continue to fulfil its mission effectively as regards all Member States. In particular, the EBA is enabled to exercise its powers and tasks not only vis-à-vis national supervisors but also vis-à-vis the ECB as a European institution. Voting arrangements that ensure that the EBA decision-making structures continue to be balanced and effective and preserve the interests of all its members will be adopted as well.⁷²

IX. IS THE SINGLE SUPERVISORY MECHANISM ADEQUATELY INDEPENDENT AND ACCOUNTABLE?

The SSM's effects on the Central Bank's independence, which has been provided for in Article 130 TFEU, have led scholars to question the wisdom of conferring supervisory authority to the ECB. Whether or not the SSM meets the accountability requirement is another major concern for European countries, since the ECB's new mandate requires a higher level of accountability. The new initiative may cause conflict between these two issues, and the important question is how to strike a balance between them. The Commission has taken measures to address the accountability concerns in its proposal and in forthcoming amendments. These concerns and measures are discussed below.

The second of the Basel Committee's core principles for effective banking supervision recognizes operational independence, transparent processes, sound governance, adequate resources, and accountability as the essential parameters for central banking systems.

Safeguarding the ECB's independence from any other union institutions, bodies, offices or agencies, and any government of a Member State is a principle laid out in Article 130 of TFEU. The ECB's independence has been strongly emphasized since its establishment, and as a result, the reporting requirements and general accountability of the ECB were limited. The ECB was following the German Bundesbank and became one

⁷² Legislative Observatory, '2012/0242(CNS) - 12/09/2013 Text adopted by Parliament' (EU Parliament Website, 12 September 2013) <<http://www.europarl.europa.eu/oeil/popups/summary.do?id=1302957&t=d&l=en>> accessed 28 May 2014.

of the most independent central banks in the world.⁷³

The Commission's proposal restates the guarantee of the ECB's independence in the Single Supervisory Mechanism (Article 16 of the ECB regulations). This may seem controversial with respect to tasks conferred on the ECB under the new supervisory mechanism, since the new mandate requires a substantial level of accountability to provide for the objectives of effective banking supervision for the Euro area. This is not comparable to the degree of accountability required for setting monetary policy. Therefore, creating the SSM necessitates a shift in the ECB's accountability to national and Union authorities.⁷⁴

The new legal framework should provide a balance between independence and accountability for the ECB in the new context. The question is, to what extent have the proposals been successful in achieving this aim?

The Commission proposal has made the SSM accountable to the European Parliament, and to the Council. It also requests annual reports to the Parliament, the Council, the Commission and the Eurogroup. It gives European Parliament committees the power to require the Chair of the Supervisory Board to appear before them, and it imposes an obligation on the ECB to respond to questions put forward by the European Parliament or the Eurogroup.⁷⁵ In addition to these grounds, the Commission's proposal has added reporting requirements for evaluating supervisory fees. It has also obliged the Chair of the Supervisory Board to appear before the Eurogroup and the representatives of non-Euro participating Member States upon their request. Finally, it requires the European Court of Auditors to take the supervisory tasks conferred upon the ECB into account when examining the operational efficiency of the ECB's management.⁷⁶

Since the supervisory authority has been transmitted to the Union level in the new plan, the Commission paid attention to the ECB's accountability at that level as well, resulting in a lack of accountability for the ECB at the national level. The Council's regulation, on the other hand, has filled this gap by requiring the ECB to forward annual reports to the members' national parliaments. Also, according to the Council's regulation, Member

⁷³ Damien Chalmers, Gareth Davies and Giorgio Monti, *European Union Law* (2nd ed, Cambridge University Press 2010), 732.

⁷⁴ Stijen Verhelst, 'The Single Supervisory Mechanism: A Sound First Step in Europe's Banking Union?' (2013), Egmont Institute, March 2013 <<http://www.egmontinstitute.be/papers/13/eur/1303-Single-Supervisory-Mechanism.pdf>> accessed 26 September 2013.

⁷⁵ Commission Proposal (n 2), arts 17 and 21.

⁷⁶ Council Regulation on Conferring Tasks (n 30), arts 17(2), 17(4), 17(8).

States' national parliaments can request Member States to respond to their observations and questions when they are sent to them. Moreover, a national parliament may invite the Chair or a member of the Supervisory Board to participate in an exchange of views with a representative of the national competent authority.⁷⁷

As it has been illustrated, national parliaments can still be involved in bank supervision in the future; however, this will impose a more indirect form of accountability compared to their authority over the national supervisory institutions. Therefore, the Member States are left with no option other than to surrender their sovereignty and transfer competence to the supranational level within the Union. Specifically, the ECB's measures related to individual supervision decisions have a significant impact on an individual Member State's banking sector, and therefore decisions should be made based on a high degree of credibility with respect to national authorities. What has been provided so far is indirect accountability to governments of the Member States. The 'transfer of the competence from the national to the Union level without transferring the accountability'⁷⁸ was a source of concern for the European Member States. This concern has been addressed in the latest agreement between members of the European parliament and the Council's joint session. The agreements include amendments on a variety of aspects of democratic accountability.

First, a stronger accountability mechanism was developed through the co-appointment and dismissal of the chair and vice-chair by the EP, as well as by the European Parliament providing better access to information. Also the new deal gives a more powerful role to the national parliaments. Another improvement is that it provides 'better access to documents for the EU supervisory authorities vis-à-vis banks and for the EP and national parliaments vis-à-vis the EU supervisor authorities'⁷⁹. Moreover, this agreement also divides staff between monetary policy and supervision and ensures the accountability of the ECB's supervisory arm, as well as strengthening the EBA in relation to the ECB to obtain information.⁸⁰

Democratic accountability is essential to the Parliament; as seen a month after the deal with the Council was reached, it delayed the final vote on the

⁷⁷ Council Regulation on Conferring Tasks (n 30), art 17aa(3).

⁷⁸ European Parliament, 'Banking Supervision Deal Struck by EP Negotiators and Irish Presidency' Press Release Economic and Monetary Affairs, 19 March 2013, www.europarl.europa.eu/news/en/pressroom/content/20130318IPRO6653/html/Banking-supervision-deal-struck-by-EP-negotiators-and-Irish-Presidency accessed 28 May 2014.

⁷⁹ *ibid.*

⁸⁰ *ibid.*

proposal's adoption 'until an agreement [was] reached with the ECB ensuring due democratic accountability of the ECB's supervisory arm.'⁸¹ Finally, the regulations adopted by the Parliament on September 12th, as envisioned in Article 17(b) and 17 (c) of the Council regulation amended by the Parliament, provide for:

arrangements on the practical modalities to exercise scrutiny, including on access to information including summaries of discussions in the Supervisory Board, cooperation in investigations and information on the selection procedure of the Chair of the Supervisory Board.⁸²

The role of national parliaments is strengthened in the regulation's latest amendments, and the adopted regulation ensures that:

The ECB when submitting reports to the European Parliament and the Council shall simultaneously forward that report directly to the national parliaments of the participating Member States. National parliaments may address to the ECB their reasoned observations on that report and may request the ECB to reply in writing to any observations or questions submitted by them to the ECB in respect of the tasks of the ECB.⁸³

X. CONCLUSION

The recent financial and economic crisis has clearly shown that the financial market's integration in the EU requires greater supervision of the banking system. However, this example does not necessarily suggest that the new level of supervision can only be achieved by transferring supervisory competence from the national authorities to EU institutions such as the ECB. Some experts have fought for the reinforcement of existing national supervision schemes and the improvement of communication among these national entities, enabling them to extend

⁸¹ Alliance of Liberalism and Democrats for Europe Groups (ALDE), 'No Single Supervisory Mechanism Until an Agreement is Reached with the ECB' (March 2013) <www.alde.eu/press/press-and-release-news/press-release/article/no-single-supervisory-mechanism-until-an-agreement-is-reached-with-the-ecb-41491/> accessed 28 May 2014.

⁸² European Commission, 'Legislative Package for Banking Supervision in the Eurozone – Frequently Asked Questions', MEMO/13/780, 12 September 2013 <http://europa.eu/rapid/press-release_MEMO-13-780_en.htm?locale=en> accessed 26 September 2013.

⁸³ *ibid*, 73.

their supervisory powers to supranational financial activities. However, as it has been discussed, this is not the path the European countries have chosen. As a matter of fact, they have decided to strengthen the ECB's competence as the ultimate supervisor of the EU banks and greatly increase its supervisory power.

There are arguments in support of as well as against the ECB's appropriateness for such a purpose. It is worth mentioning that both proponents and detractors' arguments are rooted in the same line of thought. The SSM's proponents have focused on its legal basis, which is derived from Article 127 of TEFU. Opponents point to the same treaty and argue that the existing legal body cannot authorize the extension of the ECB's powers. Those experts who have supported the SSM also argue that enforcing monetary policies is not practically possible, particularly in times of crisis. Unless the ECB as the monetary policy maker was endowed with the power to supervise the banking system whose fate is so closely tied to monetary policies' stability, enforcement would not be possible. The SSM's opponents believe that the enforcement of monetary policy should not be mixed with the supervision of the banking system as these two roles may require incompatible plans of action.

The range of the ECB's supervisory powers can be discussed from two points of view. First, the subject matter over which the ECB has jurisdiction has been broadened as its supervisory role is not limited to macro-prudential powers, but rather now includes many different micro-prudential functions. Although it has been stated that the national authorities are still in charge of regulation and supervision at the national level, the ECB's powers allow it to require national entities recognize its assessments and obey its demands. Due to the vast scope of the ECB's supervisory authority, there is concern about the overlap between the ECB and the EBA's roles and it is quite possible that the EBA will be gradually marginalized.

The personal jurisdiction of the ECB's prudential powers has also been extended. The ECB is now empowered to deal directly with hundreds of financial institutions, which are established in the territory of the states participating in the SSM. Political matters do influence the ECB's personal jurisdiction to some extent. The German government is not willing to relinquish supervisory authority over the German regional bank, and it has managed to impose its will on other Member States. The Commission and the Council have proposed some solutions for the asymmetry of power between the Member States, which join the SSM, and those, which opt out of the scheme, and for the unequal treatment of states not in the Eurozone. In fact, the Council's regulation has attempted to compensate

for these states' disadvantaged position by introducing a new mechanism in the decision making process. Only time will tell whether these solutions will be able to strike a balance between the ins and outs, or between the Eurozone states and other Member States. For now, it can only be predicted that the Eurozone Member States will have greater leverage in the ECB's decision-making process.

The ECB will take over as the supervisor of euro area banks in November 2014 as part of the Single Supervisory Mechanism. Alongside with the creation of the SSM, the European Parliament has recently passed pieces of legislation with the intention to pursue the idea behind the creation of the banking union which is 'making banks safer and more transparent, and to lift the burden of bank bailouts from taxpayers' shoulders.'⁸⁴ This package consists of Bank Recovery and Resolution Directive (RRD), Single Resolution Mechanism (SRM) and Deposit Guarantee Schemes (DGS).

According to these regulations the

basic salary-to-bonus ratio will be raised to curb speculative risk-taking by banks. EU banks will also be required to set aside more and better capital as a cushion against hard times. The costs of a bailout will be absorbed by a bank-financed €55 billion single resolution fund, to be established gradually over 8 years.⁸⁵

However, the efficiency and practicality of these measures in complementing the single supervisory mechanism is yet to be discovered. Arguably, 'even if a full framework is implemented, the ultimate key to successful reform and financial stability lies in the attitude of banks.'⁸⁶ As has been said,

'[t]he changes must be matched with real willingness by the financial sector to learn from the crisis... Any attempt to clean up the financial sector's malpractices will fail when the roulette with people's money is allowed to continue.'⁸⁷

⁸⁴ European Parliament, 'Parliament votes reform package to strengthen EU Banks' Press Release, 16 April 2014, <www.europarl.europa.eu/news/en/news-room/content/20130416IPRO7333/html/Parliament-votes-reform-package-to-strengthen-EU-banks> accessed 28 May 2014.

⁸⁵ *ibid.*

⁸⁶ Emily McGregor, 'A Super Tuesday for the EU?' (*Lexology*, May 2014) <www.lexology.com/library/detail.aspx?g=1cb0b1fb-e6f2-4e1c-b1eb-b8c437b37828> accessed 28 May 2014.

⁸⁷ *ibid.*

OBSTACLES IN EUROPEAN COMPETITION LAW ENFORCEMENT: A POTENTIAL SOLUTION FROM COLLECTIVE REDRESS

Zygimantas Juska*

The primary focus of this article is to review the main obstacles in competition law enforcement in the European Union and to investigate how the development of collective redress could effectively facilitate enforcement of EU competition law. Arguably, antitrust enforcement remains sub-optimal due to the insufficient deterrent effect of EU antitrust fines and obstacles facing victims of competition law infringements in bringing damages actions. Central to my work, therefore, is the belief that collective actions constitute an attractive vehicle to solve, or at least diminish, the inefficiencies of antitrust enforcement. The paper explores some options as to how to design collective redress mechanisms in order to influence the ability to bring successful collective claims. This would, in turn, consider the advantages of opt-out collective actions in tackling the issues related to low participation rates, lack of funding and sub-optimal deterrence. From this perspective, the article moves on to propose collective actions as a potential remedy to facilitate access to justice, to deal with a wide range of legal and economic issues and to mitigate dysfunctional compensatory mechanism of EU antitrust enforcement.

Keywords: Antitrust Fines, Collective Redress, Competition Enforcement, Damages, EU Law.

TABLE OF CONTENTS

I. INTRODUCTION	II5
II. THE EXISTING OBSTACLES AND SHORTCOMINGS IN COMPETITION LAW ENFORCEMENT	II7
1. <i>Public Enforcement</i>	II7
2. <i>Private Enforcement</i>	I2I
3. <i>Tort Remedies and Deterrence in European Private Antitrust Enforcement</i>	I24
4. <i>Synopsis</i>	I27
III. COLLECTIVE REDRESS IN THE EUROPEAN UNION: A POTENTIAL VEHICLE TO MITIGATE OBSTACLES IN ANTITRUST ENFORCEMENT	I28

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1. <i>Legal Design of Collective Redress Mechanisms</i>	128
IV. ASSESSMENT: OPT-IN VS OPT-OUT	130
1. <i>Legal Framework for Opt-Out Collective Redress in Antitrust</i>	134
V. COLLECTIVE REDRESS AS A POTENTIAL REMEDY TO MITIGATE DEFICIENCIES OF EU COMPETITION LAW ENFORCEMENT.....	135
VI. CONCLUSION	137

I. INTRODUCTION

European competition law is primarily enforced by public authorities – the European Commission at the EU level, and the national competition authorities (NCAs) at the national level. However, private enforcement is gaining popularity in Europe. Increased importance attributed to a more favourable legal regime of private enforcement has created more incentives for the European Commission to facilitate damages actions by removing perceived obstacles for victims of anticompetitive conduct. And yet, the discovery of the merits of private antitrust enforcement has culminated in the European Commission eventually concluding a package on private damages actions in antitrust cases in June 2013. The most important milestone was reached on 17 April 2014 when the European Parliament overwhelmingly adopted a Directive on antitrust damages actions¹ for breaches of EU competition law in order to facilitate damages actions in the national courts of the EU's Member States. Once the Directive is approved by the EU Council of Ministers, Member States will have two years to implement the provisions of the Directive in their national legal systems. The Directive seeks to ensure that victims of antitrust infringements can obtain effective compensation and to optimise the interaction between public and private enforcement of EU competition rules while at the same ensuring the protection of investigation tools, such as passing on, access to evidence and discovery rules, interaction with leniency. Surprisingly, the collective redress mechanism is not envisaged by this Directive. With a view to remedy this situation, the European

¹ European Parliament, 'Proposal for a Directive of the European Parliament and of the Council on certain rules governing actions for damages under national law for infringements of the competition law provisions of the Member States and of the European Union' COM (2013) 404 final. Together it was published with: European Commission documents 'Communication from the Commission on quantifying harm in actions for damages based on breaches of article 101 or 102 of the Treaty on the functioning of the European Union' [2013] OJ C167/07 and the Staff Working Document 'Practical Guide on quantifying harm in actions for damages based on breaches of article 101 or 102 of the Treaty on the functioning of the European Union' [2013] SWD 205, 11.06.2013. The law is stated as 7 July 2014.

Commission published a Recommendation on collective redress² in relation to establishing a European horizontal framework for collective redress mechanisms. It is clear, however, that truly effective compensation may be somewhat limited, if binding collective redress procedures are not included, in particular for consumers who suffered a harm of low value.

In the first place, this paper considers determination of the existing obstacles and shortcomings in competition law enforcement. First, designing the concept of effective deterrence of EU antitrust fines requires consideration of current statistics of the European Commission and building up on the central findings of the law and economics literature.³ For the sake of simplicity, the economic calculations are based on the comparison of cartel overcharge and maximum possible fine. Second, it defines the reasons why private parties are not well equipped to enforce their rights. This target is achieved through analysing the common obstacles in cartel damage litigation that apply to all jurisdictions. In addition, this paper also argues that an effective antitrust enforcement should consider the option of framing private damage claims more directly as a means of deterrence. Central to my work, therefore, is the belief that an introduction of a unified system of collective redress, based on *opt-out* measures, might be an attractive alternative to enhance deterrence and to mitigate deficiencies of competition law enforcement.

The following questions will be clarified in this paper:

1. Which factors can influence the design of successful collective redress?
2. What is the potential added value of a unified model of collective redress based on opt-out measure for improving deterrence and effectiveness in the European competition law?
3. To what extent can collective actions mitigate deficiencies of private enforcement by individual parties?

² European Commission, 'Recommendation on common principles for injunctive and compensatory collective redress mechanisms in the Member States concerning violations of rights granted under Union Law' [2013] OJ C3539/3). Together it was published with the 'Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions "Towards a European Horizontal Framework for Collective Redress"' COM (2013) 401/2.

³ M Mariniello, 'Do European Fines Deter Price Fixing?' [2013] Bruegel Policy Review 4; F Smuda, 'Cartel Overcharges and the Deterrent Effect of EU Competition Law' (2012) Centre for European Economic Research No. 12-050; M Boyer and R Kotchoni 'How Much Do Cartels Typically Overcharge?' (2012) CIRANO Scientific Series 15, Montreal.

4. How realistic is it that collective actions can facilitate EU competition law enforcement?

The paper is structured as follows. Section II provides an overview of major obstacles and shortcomings in competition law enforcement. Section III determines the added value of collective redress for improving private damages claims, deterring anti-competitive conduct and enforcing EU competition law. Section IV shows that EU-style collective redress should be formed on an opt-out basis or at least on a hybrid of opt-out/opt-in, while the pure opt-in measure should be avoided. Section V intends to demonstrate that collective redress is a potential remedy to mitigate deficiencies of competition law enforcement. This work ends with a short conclusion summarizing key insights.

II. THE EXISTING OBSTACLES AND SHORTCOMINGS IN COMPETITION LAW ENFORCEMENT

This section provides an overview of the major obstacles of two enforcement models of competition law: on the one hand, public enforcement principally aimed at deterrence, and, on the other hand, private enforcement principally aimed at compensation. By drawing arguments from the current statistics from the European Commission and from the empirical results of law and economics, it is possible to identify first an insufficient deterrent effect of EU antitrust fines and to argue that these fines should be complemented with other measures to increase deterrence, in particular with more effective and more deterrence-oriented approach of damages claims. From this perspective, this chapter develops a better understanding of the reasons why private individuals are not well equipped to enforce their rights.

I. *Public Enforcement*

In the European Union, the imposition of fines and leniency programs are the principal means of increasing effectiveness of cartel prosecution and deterring infringers from engaging in anticompetitive behaviour. This discussion, however, will be limited to showing the impact of fine spectrum on deterrence while the debate on leniency is not taken into consideration.⁴ The fines guidelines were introduced by the European

⁴ This article intends to demonstrate that the major obstacle in EU competition law enforcement relates to insufficient effect of EU antitrust fines. Although the fines are already high, they do not effectively deter infringers from engaging in anticompetitive behaviour. It should be emphasized that leniency programs proved to be very successful in fighting cartels in the European Union. In essence, the leniency policy offers companies involved in a cartel – which self-report and hand

Commission in June 2006.⁵ The major factor which concerns the deterrent effect of the fines imposed by the Commission is to set the fine based on firm's annual sales and the duration of its alleged participation in the cartel. Under this mechanism, the Commission indicates that the maximum fine can only amount to up to 10% of the infringing undertaking's worldwide turnover of the preceding business year.

At the same time, useful insights regarding the current successes in more effective deterrence may be derived from the current statistics of the European Commission. There is evidence that the amount of fines imposed on convicted cartels has dramatically increased in the recent years. From 1990 up until March 2014, the European Commission imposed fines totalling 22.02 billion euros on companies engaged in cartel violation within the European Economic Area.⁶ The total amount of fines imposed on convicted cartels rose from 832 million euros over the period 1990 - 1999 to 12.8 billion euros over the period 2000 - 2009. The increasing trend in fining policy is also evident in the last 4-year period (2010 - 2014) during which the European Commission gradually fined of the total amount of 8,4 billion euros. Even at their unprecedented high level, the insufficient deterrent effect of the EU antitrust fines should be observed. During the last decade, the number of discovered cartels is increasing tremendously without any indication of slowing down. This is demonstrated by the fact that recently imposed fines are based on the new fine guidelines, which concern the aim for higher fines and thus deterrence. To make the discussion more fruitful, it should be observed that 9 of the top 10 fines have been in the last 6 years. As regards the 10% threshold, it must be borne in mind that this legal maximum was attained in 4 large cases out of 13 fined in the last decade.⁷ The resulting problem is

over evidence – either total immunity from fines or a reduction of fines which the Commission would have otherwise imposed on them. The current EU leniency policy is set out in the EU Leniency Notice [2006] OJ C298/17 and continues the work of successful 2002 Leniency Notice [2002] OJ C298/17; both of these replaced the less successful 1996 Leniency Notice [1996] OJ C207/4). This is notably because the 2002 Leniency Notice facilitated conditions for full immunity from fines and set out to grant automatic immunity from fines to the first reporting cartel, while the 2006 Notice introduced the discretionary marker system. Both Leniency notices increased the rate of detection and significantly strengthened the deterrence.

⁵ European Commission, 'Guidelines on the Method of Setting Fines Imposed Pursuant to Article 23(2) of Regulation No 1/2003' [2006] OJ C210/2.

⁶ European Commission, 'Cartel Statistics' (last updated 19 March 2014) <<http://ec.europa.eu/competition/cartels/statistics/statistics.pdf>> accessed 20 December 2013. The fine statistics are not adjusted for Court judgments.

⁷ M Allain, M Boyer, R Kotchoni and J Ponssard, 'Are Cartel Fines Optimal? Theory and Evidence from the European Union' (2013) CIRANO 2013S-24, 2 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2342180> accessed 11 January

that the fines calculated by the Commission had to be reduced.

Furthermore, the law and economics literature estimates fine levels to be structurally below the adequate level to achieve optimal fine.⁸ Key parameters for calculating the deterrent effect of current fines are therefore the price increase (cartel overcharge) compared with the maximum possible fine. Relying on the results estimated by Smuda (given the upper limits of fine and probability of detection), the expected fine can sum up to a maximum of 11.46% of affected sales per year in comparison with a mean of overcharge rate of 21.9%.⁹ Under the estimated results, the overcharge rate is higher than the maximum possible fine; also, it demonstrates that the gain from collusion outweighs expected punishments. Furthermore, Connor finds a mean of overcharge rate of 50.4% for very successful cartels (so-called 'Connor database'). To that extent, Boyer and Kotchoni amended the Connor database in order to determine more accurate results, whereby the estimation was reduced up to 45.5%.¹⁰ In both scenarios, however, cartels are not deterred from the collusion even if the probability rate would be 100%.¹¹ Other estimations

2014; for further discussion see also A Riley, 'The Modernisation of EU Anti-Cartel Enforcement: Will the Commission Grasp the Opportunity?' CEPS Special Report/January 2010 <http://aei.pitt.edu/14570/1/Modernisation_Final_e-version.pdf> accessed 18 February 2014.

⁸ See for a thorough discussion Mariniello (n 3); Allain, Boyer, Kotchoni and Ponssard (n 7); Boyer and Kotchoni (n 3); Smuda (n 3); JM Connor and RH Lande, 'Cartel Overcharges and Optimal Cartel Fines' (2008) 3 Competition Law and Policy 2203.

⁹ Smuda (n 3). To consider whether the collusion outweighs expected punishments author provides the following equation: $OvRate(i) \cdot (P_{collusion} \cdot x) < \pi \cdot \gamma (P_{collusion} \cdot x)$. Here, π – the probability of detection, $P_{collusion}$ – the price during collusion, x – the amount of sold goods, $OvRate(i)$ – the average overcharge rate over the entire cartel period, γ – maximum possible fine (30% + (25%: cartel duration). The upper limits of fine and probability of detection is 33% (0,33) while the average duration of cartel is 5,7 years. As such, the average cartel can amount up to of maximum $0,33 \cdot [30\% + (25\% : 5,7)] = 11,46\%$ in comparison with a mean overcharge rate of 21.9% of selling price per year.

¹⁰ For further discussion on Connor database and its amendment, see Boyer and Kotchoni (n 8).

¹¹ Connor and Lande (n 8) estimate state probabilities of detection ranging between 10-33% in economic theory, while E Combe, C Monnier and R Legal calculate a range between 12.9 and 13.2% for the European market (see E Combe, C Monnier and R Legal, 'Cartels: the Probability of Getting Caught in the European Union' (2008) Bruges European Economic Research papers 12). Essentially the probability of detection takes on a major role in estimating the deterrent effect of EU antitrust policy. The magnitude of detection probability guides how the optimal sanction should be structured. This value is of particular importance for directors and/or managers who are willing to join or create a cartel. In addition, public authorities are

found that in the period between 2001-2012 cartels caused 18.4 billion euros worth of harm to the European Economy, which seems extremely low in comparison with €209 billion of the total affected EEA sales.¹²

Perhaps the most obvious solution would be to increase the fines as well as turnover for maximum of 10%. However, the input received through that increase might undermine the undertakings' ability to pay, thereby inducing undesirable social costs (such as bankruptcy, losses of jobs and lessening competition in the market).¹³ It clearly emerges that current fine levels should be complemented with other measures to enhance deterrence. In fact, a more effective and more deterrence-oriented private enforcement should be considered. This may include a rule similar to the US' trebling of antitrust damages under the Clayton Act¹⁴ or opt-out collective redress mechanisms. Before delving into the details of these alternatives towards a more-deterrence-oriented approach, it is both necessary and instructive to review the existing obstacles in private antitrust enforcement.

better suited to design an optimal policy regarding the fight against cartels, if approximate probability rate is known. It seems clear that excluding the choice of detection from the EU antitrust enforcement would negatively affect the overall discussion on deterrent effect of current fines. This is notably because the determinants of deterrence include: i) the probability of detection ii) price during collusion iii) the amount of sold goods iv) the average overcharge rate. These elements are interchangeable; without one of them, the fine and deterrence estimation is impossible. Particularly, the introduction of leniency programs in the European Union has contributed to reinforce the probability of detection. Given the fact that full immunity is granted only to the first applicant, it causes lack of assurance within the cartel if slight deviations appear from the cartel plan, for instance the 'empty chair example'. For further discussion, see JA Chavez, 'The Carrot and the Stick Approach to Antitrust Enforcement' [2006] Practising Law Institute Corporate Law and Practice Course Handbook Series, May PLI Order No. 8736.

¹² Mariniello (n 3). The author observes that affected sales include sales by all market members (that is not necessarily cartel members).

¹³ W Wils, 'Is Criminalization of EU Competition Law the Answer?' (2005) 28 World Competition 2, 148; L Talev, 'What Threats Exist to the Successful Operation of the EU 2006 Leniency Notice?' (2010) unpublished <www.varadinovlaw.com/en/wp-content/uploads/2010/12/clasf_paper_talev_leniency_final_10-09_2010.doc> accessed 5 January 2014.

¹⁴ The entirety of the Clayton Antitrust Act of 1914 is codified at 15 U.S.C. §§ 12-27 (2009). Section 4 of the Clayton Act is codified at 15 U.S.C. § 15 (2009). See for a thorough discussion CL Sagers, *Examples & Explanations: Antitrust* (Aspen Publishers 2011); RJR Peritz, *Competition Policy in America: History, Rhetoric, Law* (Oxford University Press 2001).

2. *Private Enforcement*

The Commission estimates that only 25% of the final cartel and antitrust prohibition decisions taken by the Commission in the period 2006-2012 were followed by private damages actions.¹⁵ Moreover, far from reaching all victims, the majority of these actions were brought by large companies or public entities whereas SMEs and consumers normally did not engage in legal actions for reparation of their harm. It can thus be stressed that the lack of effective compensation has created a considerable cost for the European consumers and businesses. Simple estimates that the cost of ineffective right to damages (so called 'foregone compensation') for consumers and SMEs from hard-core cartels between 2006 and 2012 is in the range of 25 - 69 billion euros.¹⁶

To enable a better understanding of the shortcomings of private enforcement, this discussion would reveal reasons why private parties are not well equipped to enforce their rights. There are indeed three main obstacles facing victims of competition law infringements in bringing damages actions: (i) cost and (legal) uncertainty, (ii) complexity of causality, and (iii) disclosure rules. Each of these factors will be discussed in turn.

First, it is generally assumed that private individuals will only commence legal actions if they expect a positive cost-benefit ratio. With respect to antitrust damages claims, it is easy to recognize that private parties face large legal costs to start and develop their case, thereby legal proceedings often exceed the expenses of their claims, creating the so-called 'rational apathy' problem. Further complicating the picture, in the European Union there is a predominant 'loser pays' principle.¹⁷ A crucial issue, in this respect, is that the judge applies the 'loser pays' principle on a case-by-case basis, meaning that the final decision is less predictable for the claimants.

¹⁵ European Commission, 'Staff Working Document Impact Assessment Report: Damages actions for breach of the EU antitrust rules Accompanying the proposal for a Directive of the European Parliament and of the Council on certain rules governing actions for damages under national law for infringements of the competition law provisions of the Member States and of the European Union' [2013] SWD 203 final, para. 52.

¹⁶ CE Mosso, 'The Commission's Proposal for a Directive on Antitrust Damages Actions' (Conference on 'Antitrust Damages: the European Commission's proposal', Bruegel, Brussels, 20 June 2013).

¹⁷ The 'loser-pays' principle is the most widely adopted allocation method for legal costs in the EU Member States. According to this principle, the losing party should pay the other party's legal costs (court and lawyers' fees). Although this instrument is an effective safeguard against unmeritorious claims, but it actually exacerbates the problem of funding in private damages actions. The 'loser pays' principle is currently applied in all of the EU Member States, as well this principle is predominant in collective action mechanisms, if presently exist in the State.

If the claim is unsuccessful, individual claimants face significant exposure to the other side's costs.¹⁸ Furthermore, private parties stand isolated against large companies because large and powerful companies have better legal support, resources and broader investigative powers. From this perspective, it should be observed that in less developed and smaller countries, for example in the Eastern Europe, business relations are more formal, meaning that private parties might be afraid to start a lawsuit against powerful firms because of potential retaliation. As regards consumers, they are often unaware that they are being, or have been, harmed by hard-core cartels (price-fixing, quantity limits or bid rigging). Even if consumers are aware of the infringement, the harm caused by price-fixing cases, for example, often produce scattered and low-value damage to a multitude of consumers. As a consequence, only few of them can afford taking a legal action since the expected benefits outweigh the expected costs.

The second characteristic feature of typical private antitrust cases is the fact-intensiveness and confrontation with complex causality assessments, both legal and economic. The principal purpose is to prove the causality between the antitrust infringement and the harm suffered by the claimant. The burden of proof typically lies with the claimant, who has to demonstrate that the infringing conduct has resulted in the damage claimed. This is a daunting task, particularly given that a majority of the Member States require proving causation with near certainty (99.9% probability).¹⁹ This burden is even more complicated, given the fact that claimants stand isolated against antitrust violators who generally are much more aware of the infringement. Even if damages actions were followed-on by a previous public antitrust decision, claimants still need to adduce clear evidence of causation and loss to recover damages.²⁰ Another issue that concerns assessing causation is the 'but-for' test. The test examines the hypothetical scenario if the infringement of Article 101 or 102 TFEU had not occurred: the assessment of the position of the injured party with the position in which this party would have been but for antitrust infringement (often referred as 'counterfactual scenario'). Developing an actual counterfactual scenario requires evaluation of how the market evolved without the antitrust infringement. Estimation has to rely on a

¹⁸ P Collins, 'What are the Problems with EC Antitrust Damage Actions in Europe? Does the Private Pillar Require Reinforcement?' (2007) unpublished <<http://vartotojuteises.lt/content/download/412/2587/file/Philip%20Collins%20Paper.pdf>> accessed 10 January 2014.

¹⁹ HA Abele, GE Kodek, GK Schaefer, 'Proving Causation in Private Antitrust Cases' (2013) 7 J of Competition Law & Economics 4, 848-49.

²⁰ See for example, case *Enrol Coal Services Ltd v English Welsh & Scottish Railway Ltd* [2010] EWCA Civ 2.

number of determinants: (i) market context; (ii) type of harm; and (iii) types of claimants. Conducting such an analysis requires a thorough understanding of economic variables (such as prices, sales volumes, profits, costs or market shares). This is certainly not an easy task, given the fact that the results rely on many assumptions.²¹ Furthermore, the analysis of causation is an essential element for the quantification of actions for damages. Claimants often face difficulties in quantifying precisely the harm caused by the infringement of the competition law as a result of numerous factors, such as evidentiary obstacles, lack of access to information or robust estimation of damage.²² Furthermore, legal provisions for proving damages and causality are too general to be directly applicable to a private antitrust case.²³ A separate standing issue is that the claimants are put off by the complex economic analysis; something which is a significant burden for private parties. The economics and financial literature has developed a wide array of methods and models for quantifying damages. For example, in the OXERA study prepared for the European Commission, the methods and models are classified into three broad groups: comparator-based, financial-performance-based, and market-structure-based.²⁴ For these reasons, it is argued that the whole causation procedure requires more resources and expenses to elaborate legal proceedings than is expected.

The third characteristic concerns issues related with disclosure rules. As a general rule, much of key evidence is often held exclusively by the allegedly

²¹ See for example, Joined Cases C-104/89 and C-37/90 *Mulder and others v Council and Commission* [2000] ECR I-203. The Court assessed the hypothetical scenario: 'the loss of earnings is the result not of a simple mathematical calculation but of an evaluation and assessment of complex economic data. The Court is thus called upon to evaluate economic activities which are of a largely hypothetical nature. Like a national court, it therefore has a broad discretion as to both the figures and the statistical data to be chosen and also, above all, as to the way in which they are to be used to calculate and evaluate the damage', para 79.

²² I Lianos, D Geradin, *Handbook on European Competition Law: Enforcement and Procedure* (Edward Elgar Pub 2013), 255.

²³ Abele, Kodek and Schaefer (n 19), 853.

²⁴ Oxera, *Quantifying Antitrust Damages*, Study Prepared for the European Commission, December 2009 <http://ec.europa.eu/competition/antitrust/actionsdamages/quantification_study.pdf> accessed 14 July 2014. According to this study: 1) Comparator-based approaches use data from sources that are external to the infringement to estimate the counterfactual (cross-sectional comparisons, time-series comparisons and combination of both models); 2) Financial-analysis-based approaches use financial information on comparator firms and industries, benchmarks for rates of return, and cost information on defendants and claimants to estimate the counterfactual; 3) Market-structure-based approaches use a combination of theoretical models, assumptions and empirical estimation.

infringing undertakings, making it difficult for a claimant (if aware of the evidence at all) to obtain disclosure of documents. These materials are crucial in successful antitrust damages actions in which infringing conduct tends to be secretive. From the domestic perspective, the rules on disclosure vary between States making it difficult to assess whether and under what conditions the State is willing to give access to documents. In civil law countries (such as Germany, Lithuania or Austria) the rules on disclosure provides only limited access for the plaintiffs to the internal information of the defendants. Contrary to current shift in civil law countries, the disclosure rules in English courts have rigorous disclosure regimes in place, yet it requires parties to disclose documents that may help for claimants to prove the alleged overcharge they paid.

In order to mitigate these deficiencies of private enforcement, the European Parliament eventually adopted the Directive on antitrust damages actions on 17 April 2014. The text was agreed between the European Parliament and the Council during the ordinary legislative procedure. Once the Directive is approved by the EU Council of Ministers, Member States will have two years to implement the provisions of the Directive in their national legal systems. As already pinpointed at in the introduction, from the perspective of consumer protection it is rather disappointing that the adopted text does not include any provisions on collective redress. In the area of antitrust where illegal behaviour may generate scattered and low-value loss to a number of consumers and where the individual proceedings may not be proportionate, the added value of a binding approach on collective redress would be a significant event.

3. *Tort Remedies and Deterrence in European Private Antitrust Enforcement*

This paper argues that effective antitrust enforcement should consider a more active role of private damage claims more directly as a means of deterrence. An effective deterrence – comprising both of public and private enforcement – might guarantee that the antitrust violation never actually occurred. It clearly emerges that preventing anticompetitive conduct is the best way to ensure the welfare of consumers, competitors and other market participants. Even if we assume that the Europeans developed a perfect private enforcement system, such a system cannot restore all the social benefits that stem from well-functioning competitive markets and that are lost when competition is lessened or distorted.²⁵ Therefore, if there is a conflict between the antitrust objectives, deterrence needs to prevail over compensatory objectives.

²⁵ P Buccirossi and M Carpagnano, 'Is it Time for the European Union to Legislate in the Field of Collective Redress in Antitrust (and how)?' (2013) 4 *Journal of European Competition Law & Practice* 1, 13.

However, the Commission observed that the pursued aim of private actions is mainly to serve as a compensatory function, while deterrence is viewed solely as an effect of enhancing public intervention tools. However, it is equally true that if private actions, of both the follow-on and standalone type, do not contribute through further deterrence, they serve the same function as the tort remedies have in national jurisdictions.²⁶ Furthermore, regulating tort actions traditionally remains the domain of domestic rules, and the Commission has stressed the alarming importance of the absence of a European Tort Law. More importantly, national tort actions proved to be practically ineffective in European antitrust enforcement. Basedow observes, in this respect, that ‘the remedies provided by private law have turned out to be insufficient or even totally inadequate for the protection of competition’.²⁷ The matter is that actions in tort cannot have functions other than exclusively the compensatory one. It is necessary to go beyond mere compensation in order to achieve a more deterrence-oriented approach and thus effective antitrust enforcement. One option may include a rule similar to the US’ trebling of damages for infringements of antitrust law under the Clayton Act.²⁸ Under this system, the successful plaintiffs are able to recover compensatory damages as much as three times of actual damages. As such, both deterrence and compensation functions are effectively pursued. It seems clear that awarding civil plaintiffs treble damages is a fuel for more active litigation in the EU. On this point it ought to be recalled that private damage action is

²⁶ E Camilleri, ‘A Decade of EU Antitrust Private Enforcement: Chronicle of a Failure Foretold?’ (2013) 34 *Eur Competition L Rev* 10, 533. The author observes that this situation implies for private law remedies to gain an unprecedented strategic position, in particular the one happens for the tort remedy. Although the current system sets private enforcement at the centre of the stage of antitrust enforcement, but it is seemingly unfit to play such a unprecedented strategic role. For further discussion on tort actions of antitrust enforcement, see F Marcos and A Graels, ‘Towards a European Tort Law? Damages Actions for Breach of the EC Antitrust Rules: Harmonising Tort Law through the Back Door?’ (2008) 16 *Eur Rev of Private L* 3; T Ottervanger, ‘Designing a balanced system: Damages, Deterrence, Leniency and Litigants’ Rights’ as cited in M Marquis (ed) *Perchance to Dream: Well Integrated Public and Private Antitrust Enforcement in the European Union* (2013) European University Institute, 18 <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2371338> accessed 15 July 2014.

²⁷ J Basedow, *Private enforcement of EC Commission* (Kluwer International 2008), 1.

²⁸ The US Supreme Court has repeatedly stated that the private right of action for treble damages under the antitrust laws serves two purposes: compensating injured victims of unlawful conduct and attracting enforcement resources to supplement the government’s deterrence-oriented efforts. Further discussion of the treble damages regarding the objectives of compensation and deterrence, see *Tex. Indus., Inc. v. Radcliff Materials, Inc.*, 451 US 630, 636 (1981); *Brick Co. v. Illinois*, 431 US 720, 746 (1977).

is an economic activity for which funding is crucial to success or failure of any proceedings. Because of the predominance of the ‘loser pays’ principle in the Member States, feasible alternatives are required so as to incentivize private parties to start a claim. If successful claimants are able to recover compensatory damages as much as three times of actual damages, it definitely acts as an incentive to start a private claim. Furthermore, punitive damages are of particular importance in collective actions, where the total costs for bringing collective damages actions can be extremely high because of the complexity of legal and economic assessments in such cases, the involvement of multiple parties, and the difficulty in allocating the proceeds.²⁹

Regarding these factors it should be recalled that the European Commission also previously attempted to introduce double damages (a form of punitive damages) for horizontal cartels in the 2005 Green Paper on damages, but it was severely criticized by the Member States and was no longer included as a proposal in the 2008 White Paper. As a matter of EU jurisprudence, the CJEU acknowledged that the imposition of punitive damages in response to harm caused by antitrust violations would not be contrary to European public order.³⁰ Despite the positions taken by the Court, punitive damages still seem to be an alien concept to the European litigation culture. First and foremost, punitive damages are in conflict with the fundamental principle of damages actions in the EU; that is to compensate for injury actually suffered.³¹ Second, punitive damages are also not in line with the general principles of Civil Law in the Member States, which prevent any unjust enrichment.³² Finally, in the United States where

²⁹ C Leskinen, ‘Collective Actions: Rethinking Funding and National Cost Rules’ (2011) 8 CMLR 1, 95.

³⁰ Joined Cases C-295/04 to 298/04 *Vincenzo Manfredi and Others v Lloyd Adriatico Assicurazioni SpA and Others* [2006] ECR I-6619, [97] and [98].

³¹ The Commission’s 2008 White Paper on damages for breach of EU competition law (COM (2008) 165) ruled that all victims of infringements of EC competition law have access to effective redress mechanisms so that they can be fully compensated for the harm they suffered. Full compensation is, therefore, the first and foremost guiding principle. The Commission welcomes the confirmation by the Court of Justice of the types of harm for which victims of antitrust infringements should be able to obtain compensation. In the *Manfredi* case (n 30), the Court emphasised that victims must, as a minimum, receive full compensation of the real value of the loss suffered. The entitlement to full compensation therefore extends not only to the actual loss due to an anti-competitive price increase, but also to the loss of profit as a result of any reduction in sales and encompasses a right to interest, [95] and [97].

³² The Court of Justice decided, in Case C-47/07 P, *Masdar (UK) Ltd v Commission of the European Communities* [2008] ECR I-9761, that a person who has suffered a loss which increases the wealth of another person without there being any legal basis for that enrichment has the right, as a general rule, to restitution from the person

punitive damages are a motivating power in private enforcement, damages actions are intended to at least partly substitute for public enforcement actions while in the EU there is a clear distinction between the roles public and private enforcement. Notably, public enforcement serves the punitive objective-function. This function is pursued through the imposition of fines, which punish the infringers and deter them from breaching the law in the future. Conversely, private enforcement and more specifically damages actions primarily serve the objective of compensation, while deterrence is only seen as a welcome side-effect. It is agreed that punishment and deterrence are not the elements of civil remedies in the EU. For these reasons, punitive damages are generally considered incompatible with the public policy (*ordre public*).³³ In addition, the award of punitive damages breaches the fundamental principle of *ne bis in idem*.³⁴

4. Synopsis

In formulating the concept of imperfect antitrust enforcement, it has been observed that current fine levels are sub-optimal to ensure deterrence. A logical implication of this remark would seem to be that since European antitrust follow-on actions constitute the tort remedies and given that the recovery of punitive damages is problematic in the EU, the unified model of collective redress is the most realistic alternative for a more deterrence-oriented approach. Another problem concerns procedural and legal obstacles due to which private parties are not well equipped to enforce their rights. From this perspective, it seems that collective redress is also a

enriched, up to the amount of the loss. Legal redress for unjust enrichment, as provided for in the majority of national legal systems, is not necessarily conditional upon unlawfulness or fault with regard to the defendant's conduct [44-47]. As regards national jurisdictions, see, for instance, sec. 812-822 of German Civil Code; sec. 6.242 of Lithuanian Civil Code; sec. 1145 and 1158 of Spanish Civil Code.

³³ On December 1st 2010 The French Court de Cassation in case, *Schlenzka v SA Fountain Pajot*, case n°1090, held that '*an award of punitive damages is not, per se, contrary to public policy*, adding however that this principle does not apply *when the amount awarded is disproportionate with regard to the damage sustained and the debtor's breach of his contractual obligations*'. Taking the example of prohibition of punitive damages in Germany, see RA Schütze, 'The Recognition and Enforcement of American Civil Judgments Containing Punitive Damages in the Federal Republic of Germany' (1989) U Pennsylvania J of Int Business L 11(3).

³⁴ The legal principle of *ne bis in idem* restricts the possibility of a defendant being prosecuted repeatedly for the same cause of action. The English Court in case, *Devenish etc. v. Sanofi -Aventis etc.*, [2007] EWHC 2394 (Ch), held that the principle of *ne bis in idem* precludes the award of exemplary or punitive damages. For further discussion, see W Wils, 'The Relationship between Public Antitrust Enforcement and Private Actions for Damages' (2009) World Competition 32(1), 21-22; W Wils, 'The Principle of *Ne Bis in Idem* in EC Antitrust Enforcement: A Legal and Economic Analysis' (2003) 26 World Competition, 131.

potential remedy to mitigate the deficiencies of private antitrust enforcement by individual parties.

III. COLLECTIVE REDRESS IN THE EUROPEAN UNION: A POTENTIAL VEHICLE TO MITIGATE OBSTACLES IN ANTITRUST ENFORCEMENT

This section aims to provide arguments as to why collective redress is an attractive alternative to solve, or at least diminish, the inefficiencies of antitrust enforcement. First, it explains the particular milestones that affect the ability to bring successful collective claim. Furthermore, it aims to provide an initial characterization of the ability of collective claims to act as an incentive for deterrence. Finally, it demonstrates that collective redress is a potential remedy to mitigate deficiencies of private antitrust enforcement by individual parties.

1. *Legal Design of Collective Redress Mechanisms*

From the European standpoint, the last few years have seen rapid developments in the area of collective redress in the Member States. Currently, twenty states have their own collective redress schemes.³⁵ However, even where it is available, the implemented systems have not been very successful because the number of collective actions is very low. Based on the results provided by the Lear Study,³⁶ to date there have been collective redress cases for antitrust infringements in only six countries while the trial stage has been reached only in Austria, Spain, France, and the UK. It emerges clearly that the ability to bring a successful collective claim depends on the type of collective actions introduced, particularly whether it provides sufficient incentives to bring collective action and possibilities for funding.

The first and foremost feature in antitrust regards how precisely claimants need to be identified for an action before the court: on an opt-in or an opt-out basis. Most of the countries have adopted opt-in mechanisms which require explicit consent from the victims to join the action. The major reason that inspired the Member States to choose an opt-in model is that there are advantages of limiting the risk of unmeritorious actions. Furthermore, an opt-in measure respects an individual right to be part of the litigation or not (so-called ‘party disposition principle’), whereby this

³⁵ Buccirosi and Carpagnano (n 25), 4.

³⁶ Lear Study, ‘Collective Redress in Antitrust’, Study for the European Parliament DG Internal Policies department A (2012) <<http://www.learlab.com/EN/publications.html>> or <<http://www.europarl.europa.eu/committees/en/studies.html>> accessed 22 February 2014.

measure is under the Article 6 of the ECHR. However, few countries (the UK, Portugal, Denmark and the Netherlands) have adopted 'opt-out' measure, whereby victims are deemed included in the action unless someone declares himself or herself not to be involved. A second feature concerns legal standing for the entities that might be allowed to start a collective action.³⁷ In some countries group actions can be commenced by public authorities, for instance in Finland (Ombudsman) and Hungary (Hungarian Competition Authority), whilst in other jurisdictions, such as France, Sweden and Greece, representation is provided by national private organizations, such as consumer associations. Other countries have legal standing for a combination of a mixed approach: private organizations and harmed persons (Bulgaria, Italy, Spain, and the UK), public authorities and associations (eg the Netherlands). A third option involves funding of legal costs that may affect the ability and the incentives of claimants to initiate collective actions. A potential solution concerns the availability of contingency and conditional fees. This mechanism represents the American solution to the funding problem. Under this mechanism, the necessary means of funding are well ensured because client pays contingent fees to a lawyer only if there is a favourable result. However, it is equally true that contingency fees bring incentives for unmeritorious claims. Despite this fact, contingency fees have increased its popularity, utilized in some fashion in 12 out of 27 Member States (even if not in a pure US version) and now form permit arrangements between some claimants and their lawyers on the basis of some form of success fee.³⁸ England and Wales, for instance, have adopted conditional fee arrangements under which lawyers can obtain a success fee in addition to the initial legal fee, which is usually around 25-50% of an awarded judgment if they win.³⁹

³⁷ Under the Commission Recommendation 2013/396/EU (n 2), the Member States should designate representative entities to bring representative actions on the basis of clearly defined conditions of eligibility. These conditions should include at least the following requirements: (a) the entity should have a non-profit making character; (b) there should be a direct relationship between the main objectives of the entity and the rights granted under Union law that are claimed to have been violated in respect of which the action is brought; and (c) the entity should have sufficient capacity in terms of financial resources, human resources, and legal expertise, to represent multiple claimants acting in their best interest.

³⁸ Buccirossi and Carpagnano (n 25), 6.

³⁹ CEPS, EUR and LUISS, 'Making Antitrust Damages Actions More Effective in the EU: Welfare Impact and Potential Scenarios', Report for the European Commission DG COMP/2006/A3/012, Final Report, Brussels, Rome and Rotterdam, 2008

http://ec.europa.eu/competition/antitrust/actionsdamages/files_white_paper/impact_study.pdf accessed 14 July 2014. Recent reports in the UK support the need for an effective funding mechanism for litigation. For further debate on this topic, see further the recent report 'Review of Expenses and Funding of Civil Litigation in

Lawyers do not get anything if they lose and only get a normal fee indexed on the hourly billing plus a success fee which cannot exceed the normal fee. These conditional fees are linked to an ‘after-the-event insurance’, which would pay the adversarial party’s costs in the event of losing the case. Another solution includes third-party funding (a company, bank or hedge fund), which could pay all or a part of the costs of an action in exchange to retain a share of a successful claims.⁴⁰ In England and Wales, external financial options are being offered by diverse investors. In 2012, there were ten active dedicated TPLF investors operating in the U.K., with three additional investors, Juridica, Burford, and IMF, making occasional investments. Most funders operating in the U.K. are relatively new, with the exception of Allianz, which has been funding claims since 2002.⁴¹

IV. ASSESSMENT: OPT-IN VS OPT-OUT

The European Commission recommends that collective redress in the EU should be based on the opt-in model, while the opt-out should be ‘justified by reasons of sound administration of justice’.⁴² According to the Commission, the opt-in measure should be preferred because it:

- limits the risk of abusive litigation and unmeritorious claims;
- preserves the principle of party disposition; and
- guarantees that the judgment will not bind other potentially qualified claimants who did not join.

On the other hand, the opt-in measure tends to result in a low participation rate because the victims must express their wish to join the collective action, thus requiring them to spend time and money to start and develop the case. As such, it is unlikely that all victims will participate in collective action under the opt-in measure; as such, the compensatory objective is not achieved effectively. Several cases in national jurisdictions regarding the experiences of consumer organisations clearly indicate that opt-in collective actions are practically unworkable. Taking the example of the UK, the *Replica Football Shirts* case⁴³ demonstrates the reluctance of

Scotland’ (2013) <<http://scotland.gov.uk/About/Review/taylor-review/Report>> accessed 15 July 2014.

⁴⁰ Leskinen (n 29), 95-96.

⁴¹ C Veljanovski, ‘Third-Party Litigation Funding in Europe’ (2012) 8(3) J of L, Economics & Policy, 410-413.

⁴² European Commission Recommendation 2013/396/EU (n 2); Articles 21-25 stress the need to form claimant party by ‘opt-in’ principle.

⁴³ Case No 1078/7/9/07 *Consumers Association v. JJB Sports Plc* [2009] CAT 2.

consumers to take part in opt-in proceedings. The consumer association (*Which?*) brought an action in the collective interest of consumers who overpaid for football shirts due to a price-fixing cartel. Despite its efforts, *Which?* managed to collect claims for only 600 consumers, which was considered a very low proportion of victims who suffered harm by the anti-competitive behavior. After this failure, *Which?* announced they would not take part in collective actions in the future if it is based on the opt-in measure. In France, the finding of a price-fixing agreement among three mobile operators (Orange France, SFR, and Bouygues Telecom) had a potentially negative impact on 20 million consumers.⁴⁴ However, consumer association *UFC Que Choisir* only managed to collect claims for 12,350 consumers. Hence, in countries where consumer associations have standing to bring damages claims, an opt-in model seems to be inappropriate to ensure sufficient participation rate for victims, in particular for cases involving multiple claims of low value (such as the harm caused by price fixing). In addition, in large-scale cartel agreements it is impossible in practice to get the consent of all harmed consumers, in particular when consumers cannot be easily identified. Due to low participation rate, consumer organizations pose a considerable obstacle of limited financial resources, thus limiting themselves to bringing damages actions due to uncertain financial perspective.

In such circumstances, this paper argues that opt-out collective actions are better suited to tackle the issues related with low participation rates, lack of funding and sub-optimal deterrence. In the first place, an opt-out scheme generally ensures that the group of claimants will be sufficiently large since the action is brought on behalf of the whole group, unless someone declares not to be involved. Taking the example of the US, an average opt-out rate is very low (less than 0.2%) in consumer class actions, since in any case these claims cannot be litigated individually.⁴⁵ In other words, opt-out collective actions increase access to justice, in particular for consumers involved in multiple claims of low value. It must be added, however, that the ones who are likely to opt-out are large companies or the individuals who have suffered significant harm. In addition, if the consumer association is designated and membership fees are used for financing litigation, the budget of the action depends on the members' willingness to pay fees. The members are required to be a part of the

⁴⁴ C Hodges, *The Reform of Class and Representative Actions in European Legal Systems. A New Framework for Collective Redress in Europe* (Hart Publishing 2008), 84.

⁴⁵ For further discussion on opt-out rates, see T Eisenberg and G Miller, 'The Role of Opt-outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues' (2004) New York University Law and Economics Research Paper No. 04-004; S Issacharoff, 'Preclusion, Due Process and the Right to Opt-out' (2002) 77 Notre Dame L Rev 1057, 1060.

consumer association and to pay membership fees to receive damages. As such, an opt-out model seems to be a more realistic alternative to ensure the action for damages financially viable due to a larger group of claimant willing to pay fees.

Furthermore, the preference given to opt-out schemes are likely to score better in terms of deterrence. As it is clear, the deterrence of collective redress depends on the size of the group of victims. If only a limited number of victims joined the proceedings, the deterrence will remain sub-optimal. Since the group of victims is larger under the opt-out measure, the size of the sanction expected under an opt-out system will be larger than under an opt-in system. As such, collective redress actions, based on an *opt-out* measure, can more effectively influence the potential companies' willingness to violate competition rules in the future. But if a company has already become part of a cartel, it can influence their tactics and negotiations as well as the amounts to be obtained in a settled action.⁴⁶ Whatever approach is taken, this paper argues that giving the right to consumer associations to claim damages on behalf of end-consumers gives impetus for the substantial deterrent effect. The potential cartelist will know that he might face private actions from consumers and the expected cost of the infringement will increase, and this combination of factors might act as an incentive for cartelists to contemplate twice before violating the competition rules.

Despite the positive aspects, opt-out proceedings also have two potential disadvantages. First, this measure might jeopardize the right of access to the courts under Article 6 of the European Convention for Human Rights (ECHR).⁴⁷ Second, the opt-out measure may increase the number of unmeritorious claims. For these reasons, the introduction of an EU-style collective redress mechanism could also be combined with the flexible hybrid of the opt-in/opt-out systems. The inspiration might be drawn from the examples of the UK and from the Danish model. In 2014, The

⁴⁶ DL Tzakas, 'Effective Collective Redress in Antitrust and Consumer Protection Matters: a Panacea or a Chimera?' (2011) 48 Common Market L Rev, 1136; R Korobkin and C Guthrie, 'Psychological Barriers to Litigation Settlement: an Experimental Approach' (1994) 93 Michigan L Rev, 107.

⁴⁷ Article 6 para. 1 ECHR establishes that 'in the determination of his civil rights and obligations or of any criminal charge against him, everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law'. On the contrary, the opt-out mechanism requires that a deliberate action is taken to withdraw from a judicial action. Therefore uninformed people may find themselves bound by a judgment they did not even know was about to be issued. For further discussion, see Lear Study (n 36).

Consumer Right Bill⁴⁸ extended the jurisdiction of the Competition Appeal Tribunal (CAT) in the UK. First and foremost, the CAT has exclusive jurisdiction to determine whether a collective action should proceed on an opt-out or opt-in basis.⁴⁹ Second, the CAT is permitted to authorize a person or entity to commence collective actions regardless of being a public or a specified body. However, opt-out collective actions are not permitted to be brought by law firms. Another innovative provision is that the Bill established a collective settlement procedure in the CAT which encourages settlements.⁵⁰ If the settlement is reached, it has a binding effect on consumers, unless they opt-out. Besides the UK, another inspirational example of an opt-out class action system includes the one in Denmark. Opt-in group actions can be brought either by individual claimants, by any representative organization or by the Consumer Ombudsman. However, the judge may be granted, on a case-by-case basis, the discretion as to whether the opt-out model is necessary to guarantee that a significant proportion of injured parties are compensated for the damages suffered.⁵¹ The Danish rules prescribe that only a public authority

⁴⁸ Consumer Rights Bill (HC Bill 29), Second reading - the general debate on all aspects of the Bill - took place on 1 July. This stage is a formality that signals the start of the Bill's journey through the Lords. The Bill aims to make consumers better informed and better protected when they're buying. Online version is available here: <www.publications.parliament.uk/pa/bills/lbill/2014-2015/0029/lbill_2014-20150029_en_1.htm> The law is stated as 7 July 2014.

⁴⁹ Schedule 8, para 5 of the Consumer Rights Bill (HC Bill 29). The Competition Appeals Tribunal (CAT) can already hear opt-in collective actions under the existing section 47B of the Competition Act 1998 (CA 98). Paragraph 5 of the Consumer Rights Bill replaces section 47B of the Competition Act 1998 so as to provide space for opt-out collective proceedings, as well as continuing to provide for opt-in collective proceedings.

⁵⁰ The function of a collective settlement regime is to introduce a procedure for infringements of competition law, where those who have suffered a loss and the alleged infringer may jointly apply to the CAT to approve the settlement of a dispute on an opt-out basis. The collective settlement regime will operate on the same opt-out principles as the opt-out collective proceedings.

⁵¹ The Danish Administration of Justice Act (2007). For further discussion, see E Werlauff, *Class Actions in Denmark*, (2009) 622 *Annals of the American Academy of Political & Social Science* 202. Opt-out class actions are only permitted as an exception to the main rule stipulated in Section 254 e, subsection 5 of The Administration of Justice Act: 1) the constituent claims must be so small that they are unlikely to be brought as individual actions because the risk or cost of litigation is disproportionate to the size of the individual claims; 2) the court must deem an opt-in structure to be unfit for the action at hand. If the conditions are met, then the Administration of Justice Act Section 254 e, subsection 8 grants the possibility of using the opt-out mechanism. The legislative history indicates that the number of opt-out cases was expected to be very limited, and practice to date in Denmark has also shown this prediction to be correct. The major case, against Bank Trelleborg Sagerne 356/2010 og 28/2011 (online version in Danish is available here:

(the Consumer Ombudsman) can take opt-out cases to court.⁵² In the light of these statements, it is argued that the EU-style collective redress should be formed on the opt-out basis or at least on the hybrid of opt-out/opt-in, while the pure opt-in measure should be avoided.

1. *Legal Framework for Opt-Out Collective Redress in Antitrust*

Bearing in mind the diversity of national antitrust rules, opt-out (or hybrid of opt-out/opt-in) collective actions should apply at national level that follow the same basic principles throughout the EU, taking into account the legal traditions of the Member States and safeguarding against abuse. Contrary to the Recommendation on collective redress, this paper argues that a sector-specific measure should be adopted for collective redress in antitrust. A sector-specific measure ensures better uniformity among the Member States in relation to Articles 101 and 102 TFEU. The critical idea underlying the horizontal initiative is that this mechanism requires further sector-specific implementation in national jurisdictions (in antitrust matters, for example, access to evidence, passing on and interaction between public and private enforcement of EU antitrust rules). With reference to a collective redress mechanism, a more suitable legislative act for a sector-specific initiative in EU competition law would be a directive rather than a regulation. A sector-specific mechanism laid down in a directive would comply with the principles of subsidiarity and proportionality and it would be more respectful for national procedural autonomy. A directive, furthermore, would be a flexible instrument for introducing a minimum standard in any area of national law and avoid intervention in domestic provisions. This is of particular importance for the functioning of damages actions, ensuring common minimum guarantees all across the EU while leaving to the Member States the choice of the most appropriate tools to do so.⁵³ In view of the chosen instrument for the Directive on damages actions, it would be more appropriate to stick to the same form of instrument towards a coherent European approach to collective redress. Furthermore, given the fact that collective redress is a highly debatable and sensitive topic at the EU and national

<http://www.domstol.dk/hojesteret/nyheder/Afgorelser/Pages/DomibankTrelleborg-gruppessmlet.aspx>) failed in the Supreme Court after several years. It was thus emphasized that it must be clear that the claims would not otherwise be pursued, and they must be of modest size, as noted, less than 2,000 kroner.

⁵² Cf. Section 28(1) of the Marketing Practices Act, under which, if a majority of consumers have the same claim for compensation in connection with a breach of the Marketing Practices Act, the consumer ombudsman can, on request, group the claims under one. Section 28(2) provides that the ombudsman can be appointed group representative in a class action lawsuit (cf. Ch. 23a of the Administration of Justice Act).

⁵³ Lear Study (n 36); Buccirosi and Carpagnano (n 25) 8-9.

level, a regulation seems one step too far, because it might interfere with domestic systems. From a technical point of view, the Article 103 TFEU appears to be the most suitable Treaty provision with the CJEU case law in antitrust that requires that every legislative act should be based on one single legal basis.⁵⁴ Also a legislative initiative under Article 103 TFEU (besides antitrust specificities) would pave the legal background for both cross-border and national litigation, while the positive effects would also extend to both SMEs and consumers. Needless to say, a dual legal basis consisting of Articles 103 and 114 TFEU could also be an alternative in antitrust collective redress. On deeper consideration, however, the interface between these provisions might be incompatible between the ordinary legislative procedure provided for by Article 114 TFEU and the special legislative procedure provided for by Article 103 TFEU.

V. COLLECTIVE REDRESS AS A POTENTIAL REMEDY TO MITIGATE DEFICIENCIES OF EU COMPETITION LAW ENFORCEMENT

In the following section, it is demonstrated that collective redress is a potential remedy to mitigate deficiencies of competition law enforcement, including but not limited to: i) access to justice; ii) proving causation; and iii) insufficient public enforcement of EU competition law.

First, the availability of collective actions in national legal systems may facilitate access to justice by creating measures which simplify and help access to the courts. Collective actions would ensure a fundamental right for victims, namely in that legal representation is provided for a group of victims in order to ensure equality of arms.⁵⁵ This is notably because of the potential to reduce the organizational costs and to handle the financial risks attached to private litigation. The costs of the lawsuit decrease because the financial risk is spread over a group of injured persons participating in the collective procedure. It means that plaintiffs no longer run the risk of having to bear extensive costs of the lawsuit. Furthermore, the probability of winning the case increases since multiple plaintiffs have larger financial means to pay for experienced and highly competent lawyers in the relevant fields of law, while individual consumers may not be able to afford on representatives with such a level of expertise.⁵⁶

⁵⁴ See for instance, Case C- 242/87 *Commission v. Council (ERASMUS)* [1989] ECR I425.

⁵⁵ See, for instance, Case C-305/05 *Ordre des barreaux francophones et germanophone and others v Conseil des ministres* [2007] ECR I-5305, [31]. The European Court of Justice ruled that the right to be represented by a lawyer is indispensable for a fair civil proceeding according to Article 6 of the European Human Rights Convention.

⁵⁶ R Van den Bergh and L Visscher, 'The Preventive Function of Collective Actions' (2008) 1 *Erasmus L Rev* 2, 19.

Second, collective redress provides an attractive ability to bundle multiple individual claims and thus to gain efficiencies by tackling common legal, factual and economic issues collectively (and giving the claimants more clout against the defendants). In cases where an authorized consumer association files a claim on behalf of its members, it might reverse the insurmountable burden of proof from the plaintiff to their own hands.⁵⁷ It is clear that consumer associations have larger financial means to start and develop antitrust cases, for example, to cover legal fees and potential expert fees. Furthermore, the availability of representative actions could greatly solve, or at least diminish, information asymmetry, meaning that plaintiffs are in a better position to provide proof with sufficiently high probability. Therefore, representative action by a consumer association may have the informational advantages of the applicable laws in comparison with individual consumers, such that designated bodies are able to assess better whether certain behaviour of firms constitutes an infringement.⁵⁸ In addition, it is argued that consumer associations may facilitate the analysis of the but-for test. In order to conduct such an analysis, the claimant has to have thorough understanding of the relationship between prices and their determinants, including the potential impact of the antitrust violation.⁵⁹ It is clear that the complexity of methods and models for assessing the but-for test might be too complicated for private parties, especially for consumers. As such, collective actions are attractive alternative to determine the real damage value as closely as possible which that is embedded in the full-compensation principle.

Third, collective redress is a potential tool to mitigate dysfunctional compensatory mechanisms of EU competition law. It should be observed that public authorities alone are not able to enforce competition law effectively because they lack resources and competence to secure compensations for victims. As mentioned before, truly effective compensation by the way of private enforcement is limited, because private parties face significant obstacles in bringing damages actions. In such circumstances, the collective redress mechanism seems a useful aid to antitrust enforcement through creating the enlarged group of enforcers able to claim their rights granted under EU law. Moreover, if a collective redress mechanism is established, then it has to increase the part played by national competition authorities and national courts in implementing EU and national competition law while guaranteeing its effective and

⁵⁷ Abele, Kodek, Schaefer (n 19), 851.

⁵⁸ Van den Bergh and Visscher (n 56), 19.

⁵⁹ Abele, Kodek, Schaefer (n 19), 854.

uniform application. Finally, the collective redress approach also involves the matter of antitrust enforcement between the Member States. The common collective redress would facilitate inter-European antitrust enforcement in three different ways:

1. Claimants in one Member State are able to access redress mechanisms in other Member States when they have suffered a detriment.
2. Claimants are provided with clear and predictable means of recognizing and enforcing judgments from other Member States.
3. Likewise, representative bodies based in one Member State are able to take or facilitate action on behalf of affected claimants in another Member State.

This envisages the consumer protection against rogue traders across the borders since consumer bodies and national enforcement authorities would be built upon judicial cooperation between different Member States.⁶⁰ If such a system were to be developed, the cases with cross border elements would be easier resolved.

VI. CONCLUSION

The current orientation of public antitrust authorities is to stress deterrence when imposing cartel fines. Even at their unprecedented high level, current antitrust fines against cartels seem to be insufficient to ensure deterrence. First, the increasing number of discovered cartels and increasing fines show that the existing fines may not be enough to persuade cartelists to abide the law. Second, recent law and economics literature estimates that the gain from collusion outweighs the expected punishments, even given the upper limits of a possible fine and the probability of detection in calculating the deterrence of antitrust fines. As such, it was argued that current fine levels should be complemented with other measures to enhance deterrence, in particular a more deterrence-oriented private enforcement. However, in as much as private enforcement framed upon competition law, it serves primarily a compensation function while deterrence is viewed as a welcome side-effect. From this perspective, this paper observed three main obstacles facing victims of competition law infringements in bringing damages actions: (i) cost and (legal) uncertainty;

⁶⁰ The Law Society of England and Wales, 'Towards a Coherent European Approach to Collective Redress' (2011) ETI Registration number: 24118193117-34, 13; 'Cooperation between Member States for Consumer Protection' (*Europa Website*) <http://europa.eu/legislation_summaries/consumers/protection_of_consumers/l32047_en.htm> accessed 15 April 2014.

(ii) complexity of causality; and (iii) disclosure rules. Collective redress mechanisms appeared to be an attractive alternative to solve, or at least diminish, the inefficiencies of antitrust enforcement: sub-optimal deterrence and ineffective damages claims. Nevertheless, the effectiveness of collective claim depends on the type of collective actions introduced and whether it provides sufficient incentives to bring collective action and possibilities for funding.

First, it was observed that opt-in collective actions are practically not workable in national jurisdictions. In such circumstances, this paper argued that an opt-out nature of collective action is better suited to tackle the issues related with low participation rates, lack of funding and sub-optimal deterrence. However, opt-out proceedings, at least in the Commission's expectations, might jeopardize the right of access to the courts under Article 6 of the ECHR and might increase the number of unmeritorious claims. In the light of these statements, it was argued that the EU-style collective redress should be based primarily on the opt-out basis or at least on the hybrid of opt-out/opt-in, while the pure opt-in measure should be avoided.

Second, as regards the deficiencies of private enforcement by individual parties, it was demonstrated that collective actions in national legal systems may therefore facilitate access to justice by creating measures which simplify and help access to the courts. Furthermore, collective redress provides an attractive vehicle to deal with a wide range of legal and economic methods for proving causation. In cases where an authorized consumer association files a claim on behalf of its members, it might reverse the insurmountable burden of proof from the plaintiff to their own hands. Finally, collective redress is an effective tool to mitigate dysfunctional enforcement by public authorities. This is remarkably because the collective redress mechanism is a useful aid to public enforcement through creating the enlarged group of enforcers able to claim their rights granted under EU law.

Given the possible attractiveness of opt-out collective actions, the binding collective redress procedures in antitrust has to be included in the legal framework of EU competition law. Opt-out collective actions applying at national levels should follow the same basic principles throughout the EU for the sake of consistency across the EU. Contrary to the Recommendation on collective redress, this paper argues that a sector-specific measure should be adopted for collective redress in antitrust. From this perspective, a more effective legislative act for a sector-specific initiative in EU competition law would be a regulation rather than a directive. From a technical point of view, Article 103 TFEU, which

requires that every legislative act should be based on one single legal basis, appears to be the Treaty provision that is most compatible with the CJEU case law in the field of antitrust. According to the plan of a package on private damages actions, the Member States have to put in place the principles set out in the Recommendation by June 2015. After that, the Commission will assess the impact of its Recommendation, and based on the results of this, decide whether further measures are necessary. The binding measure on collective redress is expected in 2017. For these reasons, it will be interesting to follow the recent developments in the UK, where a limited opt-out provision into the collective action regime is going to be introduced together with the Consumer Rights Bill in 2014. If it can work effectively without abusive litigation, this approach could inspire the Commission for a more assertive approach on collective redress.

TRANSPARENCY IN THE STAFF SELECTION PROCEDURE OF THE EU INSTITUTIONS: COMMENTS ON THE PACHTITIS CASE

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As one of the key principles governing the activities of the civil service of the European Union, transparency has become more and more important in the decision-making process, activities of the institutions, budget and staff-selecting process. The European Personnel Selection Process (EPSO) -the body in charge of organising the competitions to become EU staff- must ensure it in the selection procedures for the future employees. As a result of the efforts of the EU to apply that principle, candidates of the competitions have been able to get access to information on their performance in those exams. Furthermore, the Court of Justice of the EU has recognised such transparency of the EU administration towards the candidates in competition selection procedures. In 2007, a candidate in a staff selection process appealed the decision of EPSO to exclude him from the competition and alleged, amongst other grounds, a failure to comply with the EU principle of transparency. Despite the fact that there have been judgments and decisions, the issue has not been entirely addressed by both the Court of Justice of the EU and the European Ombudsman. The purpose of this paper is to assess that possible breach of the principle of transparency in the particular Pachtitis case.

Keywords: CJEU, EPSO, EU Administration, EU Law, EU Institutions, Staff Selection, Transparency.

TABLE OF CONTENTS

I. INTRODUCTION	141
II. THE EPSO AND TRANSPARENCY IN THE COMPETITIONS TO BECOME AN EU OFFICIAL	144
1. What is the European Personnel Selection Office (EPSO)?	145
2. How Are the Competitions Performed and How Is Transparency Ensured?	146
III. ORIGINS OF THE CONTROVERSY BETWEEN MR PACHTITIS AND EPSO	148
1. Background to the Dispute	149
2. The Controversy Before the Court of Justice of the EU (CJEU)....	152

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a.	Case F-35/08 Pachitis v Commission, Judgment of the European Union Civil Service Tribunal of 15 June 2010.....	153
b.	Case T-361/10 P Commission v Pachitis, Judgement of the General Court of 14 December 2011.....	154
c.	Case T-374/07 Pachitis v Commission, Order of the General Court of 20 April 2012 and Case F-49/12 Pachitis v Commission, Order of the EU Civil Service Tribunal of 2 December 2013.....	156
3.	The Opinion of the European Ombudsman on the Issue.....	158
a.	The Ombudsman's Own-Initiative Inquiry OI/4/2007/(ID)MHZ	158
b.	Inquiry After Mr Pachitis' Complaint 1150/2008/(ID)(BU)CK159	
IV.	IS THERE A BREACH OF THE EU PRINCIPLE OF TRANSPARENCY?	162
1.	Analysis of the Potential Breach Under the Scope of Regulation 1049/2001.....	163
2.	Assessing the Possible Infringement of the European Code of Good Administrative Behaviour	167
3.	The Consideration of the Principle of Transparency by the Court of Justice of the EU (CJEU).....	168
V.	CONCLUSION	171

I. INTRODUCTION

Subject delineation. Transparency is one of the key principles governing the activities of the civil service of the European Union (EU).¹ From the Treaty of Maastricht to the Lisbon Treaty, transparency has become more and more important for an EU whose fight against opacity in the decision-making process has reinforced its democratic character and enhanced the public confidence towards it². All the European institutions, bodies, offices and agencies have to work in the most open way possible and enable

¹ European Ombudsman, 'Public Service Principles for the EU Civil Service' (*European Ombudsman website*, 2012)

<www.ombudsman.europa.eu/en/resources/publicserviceprinciples.faces> accessed 6 June 2014.

² For the European Ombudsman, 'transparency has been the subject of growing recognition in Europe, starting with Declaration No 17 on the right of access to information annexed to the Final Act of the Treaty on European Union, which was signed in Maastricht on 7 February 1992, and culminating in the adoption and solemn proclamation of the Charter of Fundamental Rights'. European Ombudsman, Decision of 9 March 2009 on own-initiative inquiry, OI/4/2007/(ID)MHZ, [32].

citizens, residents and legal entities in the EU to exercise the right to access to their documents under certain principles and conditions³. Moreover, the Financial Regulation also foresees the principle of transparency when establishing and implementing the EU budget.⁴

However, not only must the principle of transparency be applied to the EU institutions' activities, decision-making process or budget but also to its staff selection process.⁵ In this sense, the European Personnel Selection Office (EPSO) – the body in charge of organising the competitions to become a member of the EU staff – must ensure transparency in the selection procedures for future officials.⁶ As a result of the efforts of the EU to apply that principle, candidates have been able to get access to information on their performance in the competition tests.⁷ Furthermore, European case law has recognised such transparency of the EU administration towards candidates in competition selection procedures.⁸

Problems. In 2007, a candidate appealed the decision of EPSO to exclude him from the competition. That candidate, Mr Dimitrios Pachitis, followed a series of legal and administrative actions before the European institutions and bodies to challenge this decision and alleged, amongst other grounds, a failure to comply with the EU principle of transparency. EPSO is an EU inter-institutional body which plays a key role in the organization of transparent competition exams to become a member of the EU staff. The candidate requested a review of the decision as well as a copy of his questions and answers in those tests, together with a copy of the sheet of correct answers and he also asked to be informed about which questions had been annulled later.

Despite insisting, all that Mr Pachitis managed to get was a statement several months later with the number of questions, the letters corresponding to his answers and those corresponding to the correct

³ Article 15 of the Treaty on the Functioning of the European Union [2012] OJ C 326/47.

⁴ European Commission, Commission Regulation (No 2342/2002 of 23 December 2002 laying down detailed rules for the implementation of Council Regulation (EC, Euratom) No 1605/2002 on the Financial Regulation applicable to the general budget of the European Communities (Financial Regulation) [2002] OJ L357/1.

⁵ Regulation No 31 (EEC), 11 (EAEC), laying down the Staff Regulations of Officials and the Conditions of Employment of Other Servants of the European Economic Community and the European Atomic Energy Community (Staff Regulations) [1962] OJ L 45/1385, arts 3.5 and 12.3.

⁶ *ibid.*

⁷ European Ombudsman, Decision of 9 March 2009 (n 2), [33].

⁸ Case T-72/01 *Pyres v Commission* [2003] ECR-SC-IA-169 and II-86I, [70]; Case T-371/03 *Le Voici v Council* [2003] ECR SC-IA-209, [126].

answers as well as the assurance that his tests did not include any of the annulled questions. Moreover, so far a series of circumstances have prevented a correct assessment and consideration of the potential breach of the principle of transparency. The fact that EPSO apparently seems to fall outside the scope of the EU rules on transparency (Regulation 1049/2001) has been one of the reasons. There have also been problems of competences between the different courts of the Court of Justice of the EU (CJEU or the Court). Furthermore, the body in charge of watching over the good administration of the EU institutions and bodies (the European Ombudsman) has had to refrain due to the fact that the principle of transparency was under judicial review before the CJEU and both the Treaty on the Functioning of the EU (TFEU) and the Ombudsman's own Statute prevent it from acting in those situations. The purpose of this paper is to assess the possible breach of the principle of transparency in the particular *Pachtitis* case.

Structure. The main question addressed in this paper is the application of the principle of transparency in the EU staff selection process by analysing the *Pachtitis* case. This study has been divided into four parts. The paper begins with the establishment, administration and tasks of EPSO as well as giving a brief overview of the staff selection procedure and how the principle of transparency is ensured in it. It will then go on to review the controversy through: the facts of the *Pachtitis* case; the three times that the CJEU considered the case; and the opinion of the European Ombudsman, as guardian of good administration in the EU institutions, through inquiries on this case and others related. The third section analyses the possible failure to comply with the principle of transparency from three points of view: Regulation 1049/2001 on the access to European Parliament, Council and Commission documents; the European Code of Good Administrative Behaviour; and the relevant case-law of the CJEU. Finally, the fourth section provides the conclusions.

Method followed and materials used. A case study approach was chosen to analyse the application of the EU principle of transparency in the staff selection procedure. The methodology to carry out this study has obviously included bibliographic research and document review through a series of EU primary and secondary legislation, case-law and websites. A major problem in analysing the breach arose because all the facts from the case were obtained after examining the relevant judgments and decisions of the CJEU and the European Ombudsman respectively. In this sense, further collection of information is required to corroborate the facts and evaluate exactly the content of the correspondence exchanged between EPSO and Mr Pachtitis.

Originality. The EU staff selection procedure must be transparent in order to be consistent with democracy and the principle of good administration as well as the strengthening of public confidence on the EU.⁹ If the principle is not adhered to, it risks undermining public confidence in the EU institutions and dissuading potential candidates to participate in the selection processes.¹⁰ When discussing the EU staff recruitment procedure, the *Pachtitis* case has been a hot topic in the last few years due to the many times that the CJEU had to deal with the controversy.¹¹ The judgments of the CJEU in favour of Mr Pachtitis led to a decision adopted by EPSO allowing those candidates excluded after the first stage of the 2010 competition to retake their exams. Since EPSO decided not to open new annual competitions but to allow those unsuccessful candidates to retake the exam instead, this had effect on the thousands of applicants who decide every year to participate in the competition with the hope of becoming EU officials.¹² A lot has been said about the lack of authority of EPSO to exclude Mr Pachtitis from the process¹³, but this author is not aware of any publication analysing the possible failure to comply with the principle of transparency despite the fact that it was one of the grounds alleged by Mr Pachtitis. Furthermore, neither the CJEU nor the European Ombudsman have managed so far to address the issue entirely, mainly because of problems related to the competences of each body.¹⁴ In this sense, this study seeks to analyse the case from the point of view of the legal aspects of the principle of transparency.

II. THE EPSO AND TRANSPARENCY IN THE COMPETITIONS TO BECOME AN EU OFFICIAL

The European institutions select their permanent staff through competitions composed of several exams and open to any EU citizen who meets the preconditions needed. The aim of the competitions is not to fill positions but to provide a list of candidates for the institutions to choose from for future positions. Thus, a successful candidate does not immediately become a member of the EU staff. The competitions are

⁹ European Ombudsman, Decision of 9 March 2009 (n 2), [32].

¹⁰ *ibid.*, [32-34].

¹¹ 'Summaries of the Rulings of the Court of Justice of the EU on the *Pachtitis* case' (*Europa website*, 21 December 2012) <http://europa.eu/epso/doc/news_en.pdf> accessed 17 May 2013.

¹² 'EPSO statement' (*Europa website*)

<http://europa.eu/epso/doc/statement_en.pdf> accessed 7 May 2013.

¹³ Case F-35/08 *Pachtitis v Commission* [2010] (Civil Service Tribunal, 15 June 2010); Case T-361/10 *P Commission v Pachtitis* [2011] ECR II-08225; European Ombudsman, Decision of 9 March 2009 (n 2).

¹⁴ *ibid.*

organised by EPSO but there is a selection board which is appointed to select the candidates on the basis of their performance and the requirements set by the competition notice.¹⁵ Such a process must be governed by the principle of transparency as laid out by the relevant EU primary and secondary legislation and case-law.

I. *What is the European Personnel Selection Office (EPSO)?*

On 25th July 2002 EPSO was created by Decision 2002/620/EC.¹⁶ Moreover, Decision 2002/621 of 25 July 2002 regulates its organisation and operation.¹⁷ EPSO's aim is to provide a list of candidates from which all the European institutions and bodies can recruit staff. It is important to note that EPSO was created in the context of the EU enlargement in 2004 and thus the main priority at its establishment was to organise open competitions for citizens of the new Member States.¹⁸ EPSO became operational as of 1st January 2003 and since then it has organised more than 700 open competitions and selected over 20,000 qualified candidates who have been placed on reserve lists, out of which more than 15,000 have been recruited by the European Institutions.¹⁹

There are several categories of staff at the EU institutions.²⁰ A distinction must be made between permanent employees (officials) and temporary ones. Permanent employees are either administrators (AD) or assistants (AST), which are all selected through a competition organised by EPSO.

Amongst the temporary staff there are contractual agents, temporary

¹⁵ European Personnel Selection Office (EPSO), Guide to open competitions [2012] OJ C270 A/1, p 3.

¹⁶ Decision 2002/620/EC of the European Parliament, the Council, the Commission, the Court of Justice, the Court of Auditors, the Economic and Social Committee, the Committee of the Regions and the European Ombudsman of 25 July 2002 establishing a European Communities Personnel Selection Office [2002] OJ L 197/53.

¹⁷ Decision 2002/621/EC of the Secretaries-General of the European Parliament, the Council and the Commission, the Registrar of the Court of Justice, the Secretaries-General of the Court of Auditors, the Economic and Social Committee and the Committee of the Regions, and the Representative of the European Ombudsman of 25 July 2002 on the organisation and operation of the European Communities Personnel Selection Office [2002] OJ L197/56.

¹⁸ 'About EPSO' (*EPSO website*) <<http://europa.eu/epso/about/>> accessed 29 May 2013.

¹⁹ European Personnel Selection Office (EPSO) & European School of Administration (EUSA), 2012 Annual Activity Report <http://ec.europa.eu/atwork/synthesis/aar/doc/epso_eusa_aar_2012.pdf> accessed 25 May 2013.

²⁰ 'Types of employment' (*EPSO website*) <http://europa.eu/epso/discover/types_employment/index_en.htm> accessed 2 May 2013.

agents, interim staff, seconded national experts and trainees. Contractual agents are employed for a contract between one and three to five years whereas temporary agents are hired for a maximum period of six years. Interim staff are signed up on a very short term and temporary basis (up to 6 months), through temping agencies. Seconded national experts are supported by the Member States' public administrations for a certain period of time up to four years. Trainees can be either paid (blue book stagiaires) or unpaid (stagiaires 'atypiques').²¹ From all the categories of temporary staff, EPSO only organises the selection for contractual agents. Thus, EPSO is only responsible for the competitions to become permanent staff and contractual agents. When doing so, EPSO is obliged to ensure the transparency of the process.²²

2. *How Are the Competitions Performed and How Is Transparency Ensured?*

In order to participate in the competition exams, candidates must register online and submit their application files. The competitions for permanent staff consist of at least two stages: the first has a series of tests which may vary depending on the competition and leads to the second stage, which is the assessment centre to which only the most successful candidates of the first stage are admitted.²³ The selection board appointed for the competition assesses the performance of the candidates and selects those who finally end up in the reserve list. The competitions for contractual agents include a first stage and afterwards there is a competency test.²⁴ The successful candidates in both processes only become EU staff if the services of the institutions select them.²⁵

Before 2005, the competition exams included pre-selection tests, both written and oral²⁶. In those pre-selection tests, the candidates were allowed to leave the examination room with the paper containing the questions of the exam.²⁷ They were also allowed to request and receive detailed information about their answers (ie which questions they had answered correctly or incorrectly).²⁸ However, in 2005, EPSO decided to alter the exams and the pre-selection tests were replaced by multiple choice computer based tests (CBTs).²⁹ These CBTs allow each participant to take

²¹ To check all the different types of employment please read EPSO website, *ibid*.

²² Staff Regulations (n 5).

²³ EPSO Guide to Open Competitions (n 15).

²⁴ This varies depending on whether it is a specific or general contract agent selection process, *ibid*.

²⁵ *ibid*.

²⁶ European Ombudsman, Decision of 9 March 2009 (n 2), [2].

²⁷ *ibid*, [1].

²⁸ *ibid*.

²⁹ EPSO, Annual Activity Report 2005

the exam in a special centre prepared to carry out such tests on a date chosen by the participant and within a specific and defined period of the year.³⁰ For that reason, EPSO carried out a call for tender to contract an operator of the CBT system which has prepared the tests ever since.³¹

Article 15 TFEU establishes the duty for all European institutions, bodies and offices and agencies to work in the most open manner possible. More specifically, the EU Staff Regulations require EPSO to carry out the procedure in a transparent manner.³² Furthermore, there have been a series of cases where the CJEU has shaped the jurisprudence on the application of transparency in the selection procedure.³³ In addition, a series of EU secondary legislation governs the right of citizens to have access to the documents of all European institutions and bodies or certain ones in particular (Commission, Parliament and Council).³⁴

EPSO also acknowledges the right of candidates to access information when they are directly and individually concerned.³⁵ However, it refuses to grant access to anything else but the results of the CBTs and, in the event of candidates making it to the second stage, their overall marks for each competency assessed and their competency passport, unless candidates failed to complete the tests.³⁶ Thus, EPSO publicly states that, when granting access to the results of the CBT tests, '(t)hese will not show the wording of the questions or of the answers, but merely the reference

<http://ec.europa.eu/atwork/synthesis/aar/aar2005/doc/epso_aar.pdf> accessed 21 May 2013.

³⁰ European Ombudsman, Decision of 9 March 2009 (n 2), [2].

³¹ *ibid.*

³² Staff Regulations (n 5).

³³ C-23/64 *Vandevyvere v Parliament* [1965] ECR 157, [164]; Case T-189/99 *Gerochristos v Commission* [2001] ECR-SC I-A-11 and II-53; Cases T-167/99 and T-174/99 *Giulietti v Commission* [2001] ECR-SC I-A-93 and II-441; Case T-72/01 *Pyres v Commission* (n 8); Case T-72/01 *Pyres v Commission* [2003] ECR-SC I-A-169 and II-861; Case T-371/03 *Le Voici v Council* [2003] ECR-IA-209; Case T-33/00 *Martínez Páramo v Commission* [2003] ECR-SC I-A-105 and II-541; Case C-160/03 *Spain v Eurojust* [2005] ECR I-2077; Case F-2/07 *Martins v Commission* [2010] (unpublished); Case F-7/07 *Angioi v Commission* [2011] (Civil Service Tribunal, 29 June 2011).

³⁴ Article 23 of the European Parliament resolution on the European Ombudsman's special report to the European Parliament following the own-initiative inquiry into the existence and the public accessibility, in the different Community institutions and bodies, of a Code of Good Administrative Behaviour ('European Code of Good Administrative Behaviour') (C5-0438/2000 – 2000/2212 (COS)), [2002] OJ C72/331; and Regulation (EC) No 1049/2001 of the European Parliament and of the Council of 30 May 2001 regarding public access to European Parliament, Council and Commission documents [2001] OJ L145/43.

³⁵ EPSO Guide to Open Competitions (n 15), point 6.2.

³⁶ *ibid.*, point 6.2.

number/letter of the answers you chose and of the correct answers.³⁷

The questions of the CBTs may be cancelled by the selection board if an error is detected after the tests have taken place. In this case, the points initially attributed to that question are redistributed amongst the remaining questions.³⁸ EPSO allows candidates who consider that one or more questions had errors to ask for their annulment and it also enables them to request a review of the process under certain conditions.³⁹ In addition, candidates also have administrative and judicial appeal procedures to challenge the actions or failures to comply with the rules and obligations. Judicial appeals are submitted to the EU Civil Service Tribunal of the CJEU whereas administrative appeals are lodged before the EPSO and the European Ombudsman.

In spite of all the aforementioned, there are still some concerns about the application of the principle of transparency by EPSO. In this sense, it must be remembered that according to data released by the European Ombudsman in 2012, EPSO only scored a 69% compliance rate with the Ombudsman's suggestions in 2011.⁴⁰ Moreover, the Ombudsman also found a case of non-satisfactory response to its suggestions concerning a lack of transparency in an EPSO competition.⁴¹ In addition, EPSO's way of carrying out the recruitment procedures has been recently affected by the judgments of the Court of Justice of the EU in favour of a candidate who challenged the process. After being rejected in an EPSO competition exam in 2007, Mr Dimitrios Pachtitis denounced a series of errors and failures to comply with several principles (transparency amongst them) before the Court of Justice of the EU and the European Ombudsman.

III. ORIGINS OF THE CONTROVERSY BETWEEN MR PACHTITIS AND EPSO

As outlined above, Dimitrios Pachtitis followed a series of legal and

³⁷ *ibid*, point 6.2.I.

³⁸ *ibid*, point 6.3.

³⁹ *ibid*, point 6.4.

⁴⁰ European Ombudsman, 'EU Institutions Comply with 82% of Ombudsman Suggestions' Press Release EO/12/18 of 3 December 2012 <http://europa.eu/rapid/press-release_EO-12-18_en.htm> accessed 19 May 2013.

⁴¹ In Case 2586/2010/(ML)TN (European Ombudsman, 30 April 2013) the complainant alleged that EPSO misused resources by organising a two-field competition with a single reserve list; and refused to provide the contestant with the name of the external examiner assisting the selection board. The Ombudsman found that the grounds for rejection were very inadequate and, in some respects, blatantly incorrect.

administrative actions before the European institutions and bodies to challenge EPSO's decision to exclude him from a competition in 2007. The aim of this chapter is to provide the reader with the background to the dispute as well as to examine both the judgments of the Court of Justice of the EU and the inquiries of the European Ombudsman on this issue.

1. *Background to the Dispute*

Dimitrios Pachtitis is a Greek national who participated in an administrators' competition organised by EPSO in 2006/2007 to establish a reserve list of Greek translators to work as permanent staff for the EU institutions.⁴² The competition was published on 15 November 2006 and the selection procedure consisted of three different stages.⁴³

The first stage had two multiple-choice tests each containing 30 questions; one of them aimed to evaluate the general knowledge of the participants about the EU whereas the other one was to evaluate the candidates' abilities (ie verbal and numerical reasoning skills).⁴⁴ The first stage tests were carried out by computer and the questions were different for each candidate since they were randomly selected from a database provided to EPSO by an external contractor.⁴⁵ Only the 110 candidates who obtained the best mark in the admission tests would be invited to the second stage of the competition.⁴⁶ The second stage would consist of written tests and the third stage would be an oral test.⁴⁷ The selection board of the competition was involved only after the admission tests and therefore only at the stage of the written and oral tests.⁴⁸

On 31st May 2007, EPSO notified Mr Pachtitis that he had not passed the first phase of the selection process because his results did not allow him to be within the short-listed 110 candidates who would go to the next phase.⁴⁹ In fact, Mr Pachtitis scored 18.334 out of 30 points, whereas the 110 successful candidates had obtained at least 21.333 out of 30 points.⁵⁰ He then wrote a letter to EPSO on 4th June 2007 requesting copies of his

⁴² Case F-35/08 *Pachtitis v Commission* (n 13), [16].

⁴³ *ibid*, paras 16 and 18.

⁴⁴ *ibid*, para 18.

⁴⁵ *ibid*, para 20.

⁴⁶ *ibid*, para 18.

⁴⁷ *ibid*.

⁴⁸ *ibid*, para 20.

⁴⁹ *ibid*, para 21.

⁵⁰ Mr Pachtitis scored 23 out of 30 points in the test about the EU and 16 out of 30 points in the test about personal abilities, *ibid*.

questions, his answers and a sheet with the correct answers⁵¹. However, EPSO refused to provide him with such information on 27th June 2007 and did not justify such refusal.⁵²

Then, on 10th July 2007 Mr Pachtitis submitted a complaint, under Article 90(2) of the Staff Regulations of the Officials of the European Union (from now on the Staff Regulations)⁵³ and Regulation (EC) 1049/2001 regarding public access to documents of the EU institutions⁵⁴, contesting the validity and content of EPSO's decision of 31st May 2007 and requesting copies of his exam's own answers and all the correct answers.⁵⁵ On the one hand, Mr Pachtitis alleged the failure to comply with the principles of equal treatment, objectivity and transparency, as well as the infringement of the obligation to motivate the decision of 31st May 2007. On the other hand, Mr Pachtitis also denounced that there had been errors detected by the selection board of the admission tests' when correcting the exams.⁵⁶ Those errors consisted in a series of questions which were proved to be incorrect and later cancelled by an advisory board to the procedure.⁵⁷ Consequently, he asked EPSO to revise its decision of 31st May 2007 by re-examining his exams and informing him about those errors found by the selection board.⁵⁸

On 20th July 2007, EPSO replied to him by saying that he had to address the complaint to the Secretariat-General of the European Commission in order to request access to the documents.⁵⁹ Mr Pachtitis did so one day later.⁶⁰ By 22nd September of that year he had not received any reply, so he decided to bring an action before the former Court of First Instance and current General Court of the CJEU against the refusal to provide him with the copies.⁶¹ However, the General Court would not rule until 20th April 2012 by declaring itself incompetent and referring the case to the EU Civil

⁵¹ *ibid*, para 22.

⁵² *ibid*, paras 23-24.

⁵³ Staff Regulations (n 5).

⁵⁴ Regulation (EC) No 1049/2001 of the European Parliament and of the Council of 30 May 2001 regarding public access to European Parliament, Council and Commission documents [2001] OJ L145/43

⁵⁵ Case F-35/08 *Pachtitis v Commission* (n 13), [24].

⁵⁶ *ibid*.

⁵⁷ *ibid*, para 26.

⁵⁸ *ibid*, para 24.

⁵⁹ Decision of the European Ombudsman of 26 March 2009 closing his inquiry into complaint 1150/2008/(ID)(BU)CK against the European Personnel Selection Office (EPSO), [3].

⁶⁰ *ibid*, [4].

⁶¹ As it will be seen later, the Tribunal avowed itself to have no competence on the issue and referred it to the EU Civil Service Tribunal, *ibid*, [5].

Service Tribunal.⁶²

EPSO notified Mr Pachtitis that ‘*the number of multiple choice questions set, the letters corresponding to the applicant’s answers and those corresponding to the correct answers*’ by email on 26th November 2007.⁶³ Finally, EPSO rejected his complaint by a Decision of 6th December 2007 and claimed to have re-examined his file and the consequences of cancelling certain questions for his results.⁶⁴ Apparently, Mr Pachtitis’ tests did not include any of the seven questions that were cancelled by an ‘advisory committee’ which was responsible for the quality control of questions inserted in the database.⁶⁵

Apologising for the delay, the Secretariat-General of the European Commission replied negatively to Mr Pachtitis’ request for documents on 17th January 2008.⁶⁶ On 14th March 2008, he brought proceedings for annulment before the EU Civil Service Tribunal against EPSO’s decisions of 31st May and 6th December 2007 and all related measures.⁶⁷ That was the second time he was denouncing EPSO before the CJEU.⁶⁸ Besides this, on 14th April 2008 Mr Pachtitis lodged a complaint with the European Ombudsman because of EPSO’s failure to transfer his request for documents on 10th July 2007 to the Secretariat-General of the European Commission.⁶⁹ The Ombudsman decided to open an inquiry on 5th June 2008.⁷⁰ However, it closed the inquiry on 26th March 2009 without acknowledging Mr Pachtitis to be right.⁷¹

On 15 June 2010, the EU Civil Service Tribunal ruled in favour of Mr Pachtitis and annulled both EPSO decisions of 31 May and 6 December 2007.⁷² On 25 August 2010, the European Commission brought an appeal against the ruling of the EU Civil Service Tribunal.⁷³ However, on 14

⁶² Case T-374/07 *Pachtitis v Commission* [2012] OJ C 174/22. In any case, the EU Civil Service Tribunal ruled on December 2013 by stating that there was no further need to adjudicate on the action. This was held on the grounds that Mr Pachtitis did not have any more a personal interest to seek the annulment of the decision because it would not bring him any benefit: Case F-49/12 *Pachtitis v Commission* [2013] (Civil Service Tribunal, 2 December 2013), [28], [30-31] and [33].

⁶³ Case F-35/08 *Pachtitis v Commission* (n 13), [25].

⁶⁴ *ibid*, [26].

⁶⁵ *ibid*.

⁶⁶ European Ombudsman, Decision of 26 March 2009 (n 59), [6].

⁶⁷ Case F-35/08 *Pachtitis v Commission* (n 13), [1].

⁶⁸ The first time was Case T-374/07 *Pachtitis v Commission* (n 62).

⁶⁹ European Ombudsman, Decision of 26 March 2009 (n 59).

⁷⁰ *ibid*.

⁷¹ *ibid*.

⁷² Case F-35/08 *Pachtitis v Commission* (n 13).

⁷³ Case T-361/10 *P Commission v Pachitis* (n 13), [8].

December 2011 the General Court dismissed the appeal.⁷⁴

The case had consequences for the EPSO competitions' applicants in the years 2010 and 2013. The judgments made EPSO decide to repeat the following competitions which had already taken place in 2010: EPSO/AD/177/10 (European Public Administration, Law, Economics, Audit and ICT⁷⁵), EPSO/AD/178/10 (Librarians) and EPSO/AD/179/10 (Audiovisual).⁷⁶ Because of that, EPSO decided not to organise competitions in 2013 for the respective categories but to allow participants of 2010 to retake the exams.⁷⁷

In a public statement, EPSO announced the amendment of the procedures for future competitions in order to take into account the rulings and explained that it had decided to repeat the competitions with the aim of preventing past candidates from lodging further complaints on the same basis as Mr Pachtitis.⁷⁸

On 21 March 2013, corrigenda to the notices of competitions EPSO/AD/177/10-Administrators (AD 5) and EPSO/AD/178-Librarians and EPSO/AD/179/10 (Audiovisual) were published in the Official Journal of the European Union.⁷⁹ In those corrigenda, EPSO clarified who could retake the exams.⁸⁰ According to it, only those participants in the 2010 competitions who were excluded after the CBTs because they did not meet the minimum result or the result was not sufficiently high enough to be invited for the next phase. Consequently, no European citizen was able to take part in the exams in 2013 except for those who did participate in 2010 but were excluded after the first phase.

2. *The Controversy Before the Court of Justice of the EU (CJEU)*

The CJEU has dealt four times with the *Pachtitis* issue so far, more

⁷⁴ *ibid.*

⁷⁵ The number of candidates who validated their application in the competition EPSO/AD/177/10-Administrators (AD 5) was 51639 (European Public Administration: 29104; Law: 7331; Economics: 6391; Audit: 2941, and; ICT: 5872) <http://web.archive.org/web/20100526135300/http://europa.eu/epso/apply/on_going_compet/adm/index_en.htm> accessed 21 May 2013.

⁷⁶ Corrigendum to notice of open competitions EPSO/AD/177/10 [2013] OJ C82 A/5 and EPSO/AD/178-179/10 [2013] OJ C82 A/6.

⁷⁷ However only those candidates who did the CBT and did not make it to the second stage can retake the exam, *ibid.*

⁷⁸ 'EPSO statement' (*Europa website*)

<http://europa.eu/epso/doc/statement_en.pdf> accessed 7 May 2013.

⁷⁹ See (n 76).

⁸⁰ *ibid.*

specifically the EU Civil Service Tribunal and the General Court. Nevertheless, the breach of the principle of transparency has not been considered in any of those judgements. In this subsection, all those judgments are analysed together.

a. Case F-35/08 *Pachtitis v Commission*, Judgment of the European Union Civil Service Tribunal of 15 June 2010

On 14 March 2008 Mr Pachtitis brought proceedings for annulment before the European Union Civil Service Tribunal against EPSO's decisions of 31st May and 6th December 2007 and all related measures.⁸¹ He alleged absence of justification for the reasons for which he was refused access to the documents requested in those two decisions by EPSO, a lack of authority to exclude him from the competition, breaches of several important principles (equal treatment, proportionality and objectivity) and errors in the process.⁸² The Tribunal annulled both decisions and set aside any related measure.⁸³ Nevertheless, the ruling of the Tribunal did not consider at all the possible breach of the principle of transparency but it is important to note that Mr Pachtitis did not allege it in his appeal either.

In this sense, the EU Civil Service Tribunal ruled in favour of Mr Pachtitis and annulled both EPSO decisions. This was justified because 'the applicant was excluded from the second stage of the competition at issue by a procedure conducted by an authority lacking power to do so and by a decision taken by that same authority'.⁸⁴ For the Tribunal, neither EPSO nor the advisory committee, which had invalidated seven questions of the tests, were to be considered as a 'selection board' in the meaning which is provided by the Staff Regulations.⁸⁵

It argued that EPSO had insufficient authority to carry out the tasks assigned to the selection board by the Staff Regulations⁸⁶, and more specifically those tasks that

affect the determination of the content of the tests and their correction, including tests comprising multiple-choice questions to assess verbal and numerical reasoning ability and/or general knowledge and knowledge of the European Union, even if those tests are presented as tests for 'admission' of candidates to the

⁸¹ Case F-35/08 *Pachtitis v Commission* (n 13), [1].

⁸² *ibid*, [44].

⁸³ *ibid*.

⁸⁴ *ibid*, [65].

⁸⁵ *ibid*, [66].

⁸⁶ *ibid*, [70].

competition's written and oral tests.⁸⁷

With this ruling, the EU Civil Service Tribunal rejected the authority of EPSO to act as a selection board unless the Staff Regulations are amended to grant powers to EPSO allowing it to perform that function. It is important to bear in mind that the Tribunal based its judgment on EPSO's lack of authority to reject candidates.⁸⁸ Thus, the other three allegations made by Mr Pachtitis were not addressed. Nevertheless, the European Commission appealed against the judgment before the General Court of the Court of Justice of the EU.⁸⁹

b. Case T-361/10 P *Commission v Pachtitis*, Judgement of the General Court of 14 December 2011

On 25 August 2010 the European Commission appealed against the judgment of the EU Civil Service Tribunal before the General Court of the CJEU since it considered that EPSO was competent to exclude Mr Pachtitis from the second stage of the competition.⁹⁰ However, the General Court did not accept the arguments provided by the Commission and, on 14th December 2011 it issued a ruling confirming the previous judgment in favour of Mr Pachtitis, without considering the possible breach of the principle of transparency.⁹¹ That non-consideration can be explained because the appeal by the Commission did not call for it, nor did the original complaint by Mr Pachtitis. The previous ruling had not taken it into account either. Thus, for the General Court, Mr Pachtitis had been excluded from the second stage of the competition through a decision from an authority lacking the power to do so.⁹² In this manner, the General Court sided with the judgment of the EU Civil Service Tribunal and rejected point by point the arguments raised by the Commission.

The European Commission claimed that the EU Civil Service Tribunal had failed to comply with the obligation to state the grounds of the judgment because it did not explain why a competition could not be done in two stages, it did not indicate any provision preventing EPSO from organising the first of the two stages of the competition, and it also made a mistake by not considering all the powers conferred to EPSO by Decisions 2002/620 on the creation of EPSO and 2002/621 on EPSO's organization and functioning and by Articles 1(1)(e) and 7(1) and (2) of annex III of the

⁸⁷ *ibid.*

⁸⁸ *ibid.*, [48-72].

⁸⁹ Case T-361/10 P *Commission v Pachtitis* (n 13).

⁹⁰ *ibid.*, [22].

⁹¹ *ibid.*

⁹² *ibid.*, [58].

Staff Regulations.⁹³

The General Court rejected all the allegations and argued that the obligation to state the grounds does not carry an obligation of a point-by-point reply to all the arguments of the litigants.⁹⁴ Moreover, it denied that the EU Civil Service Tribunal had said that a competition could not be done in two stages and that EPSO was not competent for organizing the first stage. It explained that the Tribunal had simply shown that EPSO had no competences to choose and assess the subject of the questions of the competition and it could not replace the selection board.⁹⁵ The General Court argued that the Tribunal did not call into question EPSO's competence to organize a two-stage competition but wanted to clarify whether the first stage of the competition could be organised and exclusively performed by EPSO without any involvement of the selection board.⁹⁶ Furthermore, the General Court agreed with the views of the Tribunal on the fact that the first stage of the competition was indeed a competition itself and not a merely formal element of the procedure as the Commission was pointing out.⁹⁷

The General Court also held that the Tribunal did not fail to consider Decisions 2002/620 and 2002/621 because they have a lower rank than the provisions of the Staff Regulations about which it had already made conclusions.⁹⁸ In addition, the General Court acknowledged the Tribunal to be totally right when considering that EPSO's establishment in 2002 and particularly article 7 of annex III of the Staff Regulations and Decisions 2002/620 and 2002/621 did not affect the allocation of powers between the appointing authority and the selection board.⁹⁹ In this sense and according to the General Court, the EU Civil Service Tribunal had explained that under article 30 of the Staff Regulations, a selection board designated by the appointing authority has to draw up a list of suitable candidates and the procedure for competitions laid down in Annex III to the Staff Regulations.¹⁰⁰

As a consequence of this judgment confirming the previous one by the EU Civil Service Tribunal, EPSO decided to take several measures with the

⁹³ *ibid*, [24] and [30].

⁹⁴ *ibid*, [25].

⁹⁵ *ibid*, [26-27].

⁹⁶ *ibid*, [31].

⁹⁷ *ibid*, [34].

⁹⁸ *ibid*, [28].

⁹⁹ *ibid*, [55].

¹⁰⁰ *ibid*, [43].

aim of preventing the situation from repeating.¹⁰¹ Thus, it amended the procedures for the competitions and since then, the pre-selection tests of the competition's first stage are no longer held by EPSO but they are the responsibility of the Selection Board.¹⁰² Also, EPSO decided to repeat those competitions already held but where the same mistakes in the distribution of tasks detected by the judgments were found.¹⁰³ For example, this last measure meant that no new general competition for administrators was carried out in 2013 except for repeating the administrators' competition in 2010.¹⁰⁴

- c. Case T-374/07 *Pachtitis v Commission*, Order of the General Court of 20 April 2012 and Case F-49/12 *Pachtitis v Commission*, Order of the EU Civil Service Tribunal of 2 December 2013

In case T-374/07 the General Court gave judgment on the issue on 20th April 2012.¹⁰⁵ In fact, this was the first proceeding for annulment introduced by Mr Pachtitis before the CJEU on 22nd September 2007 against EPSO's decision of 27th June 2007 refusing to grant him access to a copy of his questions and answers in the first stage of the competition and against EPSO's implicit rejection on 20th July 2007 to his complaint issued on 10th July 2007.¹⁰⁶ This is the proceeding that Mr Pachtitis started while waiting for the reply of the European Commission's Secretariat-General and it is also the same proceeding alleged by EPSO during a European Ombudsman's investigation and which was closed since the issue of the

¹⁰¹ See EPSO's statement (n 78).

¹⁰² *ibid.*

¹⁰³ Corrigendum to notice of open competitions EPSO/AD/177/10 [2013] OJ C 82 A/5 and EPSO/AD/178-179/10 [2013] OJ C82 A/6.

¹⁰⁴ Since only candidates of the Administrators competition in 2010 who took the exam and did not make it to the second stage are allowed to participate in the repetition of the exam, only 20,994 people (12,542 in Public Administration, 2,774 in Law, 2,186 in Economics, 1,173 in Audit and 2,319 in ICT) out of the 51671 candidates in 2010 (29,118 in Public Administration, 7,337 in Law, 6,397 in Economics, 2,994 in Audit and 5,865 in ICT) have confirmed taking the exam again. See: <http://www.eutrainig.eu/eu_news_details/chances_of_getting_an_eu_job_are_now_tripled#> accessed 13 May 2013.

¹⁰⁵ Case T-374/07 *Pachtitis v Commission* (n 62).

¹⁰⁶ Mr Pachtitis had requested access on 4th June 2007 and ESPO replied on 27th June 2007 by refusing him the access to the documents requested. On 10th July 2007 Mr Pachtitis had submitted a complaint, under Article 90(2) of the Staff Regulations of the Officials of the European Union and Regulation (EC) 1049/2001 contesting the validity and content of the EPSO decision of 31st May 2007 and requesting copies of his exam's own answers and all the correct answers. EPSO replied on 20th July 2007 telling him to readdress his complaint to the Secretariat-General of the European Commission. European Ombudsman, Decision of 26 March 2009 (n 59), [2-5].

principle of transparency was already before the Court.¹⁰⁷

Contrary to the other appeal by Mr Pachtitis, this one did stress the failure to comply with the principle of transparency. Nevertheless, the General Court did not consider it. This was due to the fact that the General Court found itself at a crossroads since the issue covered both the Staff Regulations and Regulation 1049/2001. The General Court would be competent to deal with Regulation 1049/2001 but not for the Staff Regulations, which are under the responsibility of the EU Civil Service Tribunal.¹⁰⁸ After assessing the grounds of the proceeding, the General Court considered that it was not competent to deal with it and forwarded it to the EU Civil Service Tribunal.¹⁰⁹ The General Court deliberated that the decision which Mr Pachtitis wanted to annul was not an act adversely affecting Regulation 1049/2001 but articles 90 and 91 of the Staff Regulations.¹¹⁰ Moreover, relevant case-law of the CJEU had considered that article 91 of the Staff Regulations relating to the conditions for appeals of EU staff before the Court is applicable also for candidates of EU competition exams.¹¹¹ As Mr Pachtitis was a candidate of the competition exams for working at the European institutions, the General Court argued that he was subject to the Staff Regulations¹¹² and as such, the issue should be dealt by the EU Civil Service Tribunal.¹¹³

Consequently, the Court addressed the issue again on case F-49/12 OF 2 December 2013.¹¹⁴ However, the EU Civil Service Tribunal did not tackle the issue from the point of view of Regulation 1049/2001. Thus, it did not pronounce itself about the possible breach of the principle of transparency. In fact, the Tribunal decided not to adjudicate on the action because Mr Pachtitis did not have yet a personal interest to seek the

¹⁰⁷ European Ombudsman, Decision of 9 March 2009 (n 2), [29].

¹⁰⁸ Case T-374/07 *Pachtitis v Commission* (n 62), [13] and [17].

¹⁰⁹ *ibid*, [18].

¹¹⁰ *ibid*, [13].

¹¹¹ Case 23/64 *Vandevyvere v Parliament* [1965] ECR 157 and 164; Case C-160/03 *Spain v Eurojust* [2005] ECR I-2077, [18].

¹¹² Case T-374/07 *Pachtitis v Commission* (n 62), [15].

¹¹³ Protocol (No 3) on the Statute of the Court of Justice of the European Union, annexed to the Treaties, as amended by Regulation (EU, Euratom) No 741/2012 of the European Parliament and of the Council of 11 August 2012 (Statute of the Court of Justice of the European Union) [2012] OJ L228/1. According to article 8.2 of Annex I of the Statute of the Court of Justice of the EU, if the Court of Justice or the General Court note that an appeal falls under the jurisdiction of the European Union Civil Service Tribunal, then they will forward it to that Tribunal; Case T-374/07 *Pachtitis v Commission* (n 62), [17].

¹¹⁴ Case F-49/12 *Pachtitis v Commission* (n 62).

annulment of a decision which is not going to benefit him.¹¹⁵

3. *The Opinion of the European Ombudsman on the Issue*

The European Ombudsman is the guardian of the European administration and it has dealt twice with the *Pachtitis*' issue: one own-initiative general inquiry concerning EPSO's refusal to provide candidates with access to their questions and answers and a more specific one lodged by Mr Pachtitis himself.¹¹⁶

a. The Ombudsman's Own-Initiative Inquiry OI/4/2007/(ID)MHZ

Following several complaints received by the European Ombudsman against EPSO for refusing candidates' access to their questions and answers in the multiple choice computer based tests of the first stage of the competitions organised, it decided to open an own-initiative inquiry against EPSO on 20th November 2007.¹¹⁷ This inquiry concerned not only the particular *Pachtitis* case but also many other different cases.

For the Ombudsman, EPSO's refusals neglected the right of candidates to request and obtain a copy of their test papers and constituted '*an instance of maladministration*'¹¹⁸ because it did not justify adequately the refusals. Since the questions were reused for different exams, EPSO alleged financial arguments as the reason for not granting the candidates' access to their copies.¹¹⁹ EPSO maintained that providing candidates with their copies would oblige it to replace those questions from the database containing all of them.¹²⁰ Apparently, those questions were provided by an external service provider and the replacement of each question costs several hundreds of Euros.¹²¹ Thus, EPSO would incur more costs to replace the revealed questions.¹²² In its defence, EPSO also argued that candidates could receive an information sheet concerning their performance at the tests and which contained the question numbers, the answers given, the corresponding correct answer and the time needed to answer each of them.¹²³ Furthermore, EPSO did not refuse to give access to those questions challenged by a candidate when a court needs to exercise control

¹¹⁵ *ibid*, [28], [30], [31] and [33].

¹¹⁶ European Ombudsman, Decision of 9 March 2009 (n 2); European Ombudsman, Decision of 26 March 2009 (n 59).

¹¹⁷ European Ombudsman, Decision of 9 March 2009 (n 2), [3-6].

¹¹⁸ *ibid*, [12] and [13].

¹¹⁹ *ibid*, [19-23].

¹²⁰ *ibid*, [21].

¹²¹ *ibid*, [22].

¹²² *ibid*.

¹²³ *ibid*, [18].

over them.¹²⁴

In order not to neglect the principle of transparency, the European Ombudsman seemed very reluctant to accept the financial arguments alleged by EPSO and was not convinced at all about the administrative and financial burdens for EPSO that would result from the disclosure of the questions.¹²⁵ The Ombudsman acknowledged that the computer based tests had led to better and more efficient examinations but that could not be at the expense of the transparency of the selection process.¹²⁶

Nevertheless, the Ombudsman decided not to continue its own-initiative inquiry.¹²⁷ EPSO had pointed out that some cases, such as the previously analysed case *Pachtitis v Commission and EPSO* (T-374/07) concerning the disclosure of the questions and challenging EPSO's refusal to do so on the basis of Regulation 1049/2001, were pending before the CJEU.¹²⁸ The European Ombudsman cannot open inquiries when the alleged facts are or have been the subject of legal proceedings and it must prevent itself from intervening in cases which question the soundness of a court's ruling.¹²⁹ Thus, it decided to close the inquiry on 9th March 2009.¹³⁰ In fact, at that time there were two other similar cases pending before the Court besides the *Pachtitis* case, namely *Angioi v Commission* (F-7/07)¹³¹ and *Martins v Commission* (F-2/07).¹³²

b. Inquiry After Mr Pachtitis' Complaint 1150/2008/(ID)(BU)CK

On 14th April 2008 Mr Pachtitis issued a complaint to the European Ombudsman against EPSO.¹³³ That complaint was lodged some months after the Ombudsman decided to open the own-initiative inquiry previously analysed. In this case, Mr Pachtitis' accusation had nothing to do with the refusal of access to the questions and answers. In fact, Mr Pachtitis' complaint was about EPSO's failure to transfer his submission of a compliant on 10th July 2007 to the European Commission. As seen before, EPSO replied by 20th July asking Mr Pachtitis to re-address his

¹²⁴ *ibid*, [19].

¹²⁵ *ibid*, [34].

¹²⁶ *ibid*, [31].

¹²⁷ *ibid*, [29].

¹²⁸ *ibid*, [14].

¹²⁹ Art 228 of the Treaty of the Functioning of the EU (TFEU) and art 1(3) of the European Ombudsman's Statute.

¹³⁰ European Ombudsman, Decision of 9 March 2009 (n 2).

¹³¹ Case F-7/07 *Angioi v Commission* (n 33).

¹³² Case F-2/07 *Martins v Commission* decision of 15 April 2010 (not yet reported).

¹³³ European Ombudsman, Decision of 26 March 2009 (n 59).

complaint to the European Commission's Secretariat General.¹³⁴ Consequently, Mr Pachtitis invoked the principle of good administration under the European Code of Good Administrative Behaviour¹³⁵, which obliges the transfer to the competent service of the Institution of those letters or complaints which are received by a service which is not competent to deal with it.¹³⁶

That code is applied 'to all officials and other servants to whom the Staff Regulations and the Conditions of employment of other servants apply, in their relations with the public'.¹³⁷ By following the code, the institutions and their administration should do everything necessary to apply this code to other persons working for them, and who are not officials or other servants (ie persons employed under private law contracts, national experts and even trainees).¹³⁸ There is also an obligation to transfer to the competent service of the EU institution any letter or complaint received by a Directorate General, Directorate or Unit which has no competence to deal with it.¹³⁹ Thus, Pachtitis argued that EPSO should have transferred his complaint to the European Commission.¹⁴⁰

On 5th June 2008 the European Ombudsman decided to open an inquiry.¹⁴¹ It is important to remember that, on 22nd September 2007, Mr Pachtitis lodged a proceeding for annulment against EPSO's decision refusing to provide him with the questions and answers¹⁴² and, in March 2008, he lodged another similar proceeding against EPSO's decision to exclude him from the competition.¹⁴³ Since the subject matter of his complaint to the Ombudsman had nothing to do with the two previous proceedings for annulment¹⁴⁴, the European Ombudsman was indeed able to open the inquiry.¹⁴⁵

¹³⁴ The Secretariat General of the European Commission did not reply until 17 January 2008. *ibid*, [3].

¹³⁵ European Parliament resolution on the European Ombudsman's special report to the European Parliament following the own-initiative inquiry into the existence and the public accessibility, in the different Community institutions and bodies, of a European Code of Good Administrative Behaviour (n 33), art 15.

¹³⁶ *ibid*, art 15.

¹³⁷ *ibid*, art 1.1.

¹³⁸ *ibid*, art 1.2.

¹³⁹ *ibid*, art 15.

¹⁴⁰ European Ombudsman, Decision of 26 March 2009 (n 59), [8-9].

¹⁴¹ *ibid*.

¹⁴² Case T-374/07 *Pachtitis v Commission* (n 62).

¹⁴³ Case F-35/08 *Pachtitis v Commission* (n 13).

¹⁴⁴ European Ombudsman, Decision of 26 March 2009 (n 59), [12].

¹⁴⁵ Art 228 of the TFEU prevents the European Ombudsman from opening inquiries when the alleged facts are or have been the subject of legal proceedings. Moreover,

On the arguments presented to the Ombudsman, EPSO acknowledged that the European Code of Good Administrative Behaviour's article 15 on the obligation to transfer to the competent service was a principle to follow generally.¹⁴⁶ Furthermore, EPSO also informed the Ombudsman that it had cooperated with the European Commission in the handling of applications for public access to documents.¹⁴⁷ According to such cooperation, EPSO was responding to direct and indirect requests transferred by the Commission and it was also informing those applicants whose requests for access were refused that they were able to lodge an application to the European Commission on the grounds of Regulation 1049/2001.¹⁴⁸ This was done on the basis of article 4 of the Commission Decision 2001/937/EC of 5 December 2001 amending its rules of procedure.¹⁴⁹ That Decision annexed the rules for the application of Regulation (EC) No 1049/2001 to the Commission's Rules of Procedure.

The European Ombudsman had some doubts about EPSO being under the duty to transfer the complaint to the Commission under the principle enshrined in article 15 of the Code.¹⁵⁰ Furthermore, the Ombudsman first noticed that EPSO was not mentioned in either Regulation 1049/2001 or Decision 2001/937 and realised later that Decision 2002/621/EC setting up the body does not regulate public access to documents held by EPSO.¹⁵¹ On top of that, the Ombudsman was of the opinion that, even if the Commission had some documents of EPSO, not all documents held by EPSO fell within the sphere of responsibility of the European Commission.¹⁵² The Ombudsman's reasoning followed article 3(a) of Regulation 1049/2001 which applies to documents 'concerning a matter relating to the policies, activities and decisions falling within the institution's sphere of responsibility'.¹⁵³ Hence, the European Ombudsman also rejected the competence of the Commission to issue decisions on confirmatory applications made against EPSO's rejection of initial

art 1(3) of the European Ombudsman's Statute impedes its intervention in cases which are either before courts or which question a court's ruling.

¹⁴⁶ European Ombudsman, Decision of 26 March 2009 (n 59), [14].

¹⁴⁷ *ibid*, [15].

¹⁴⁸ *ibid*.

¹⁴⁹ Commission Decision of 17 October 2000 amending its Rules of Procedure (European Commission Code of Good Administrative Behaviour) [2000] OJ L267/63.

¹⁵⁰ European Ombudsman, Decision of 26 March 2009 (n 59), [17].

¹⁵¹ *ibid*, [18].

¹⁵² *ibid*, [21].

¹⁵³ Regulation (EC) No 1049/2001 (n 54), art 3(a).

applications.¹⁵⁴ Consequently, the European Ombudsman decided to close his inquiry on 26th March 2009.

From both inquiries, it is clear that the Ombudsman found grounds to consider that EPSO failed to comply with some principles when dealing with the *Pachtitis* case. Whereas the own-initiative inquiry covered the possible breach of the principle of transparency, the complaint lodged by Mr Pachtitis only dealt with the principle of good administration. Nevertheless, the Ombudsman had to refrain because the principle was already under judicial review by the CJEU.¹⁵⁵

IV. IS THERE A BREACH OF THE EU PRINCIPLE OF TRANSPARENCY?

The degree of transparency varies across the public administration of the different EU countries.¹⁵⁶ However, it is a structural and essential principle for an accountable and legitimate legal system as well as for the exercise of the rule of law.¹⁵⁷ Transparency is very useful in order to have a more adequate control over the legality of public action and refers to ‘a minimal openness of process, access to documents and publication of official measures’.¹⁵⁸ As such, it is an underlying requirement for proper administration in the EU which caters ‘for an effective relationship of political control between the democratic sovereign – EU citizens – and the responsible public institutions’.¹⁵⁹ Since it is the EU legislature’s duty to publish all legislative measures and decisions¹⁶⁰, the principle of transparency interacts with important precepts such as legal and institutional responsibility, accessibility, and publication.¹⁶¹

Criticisms on the level of transparency have led to measures being taken to improve the openness of the EU institutions.¹⁶² Therefore, the quest for increased openness and transparency in the decision-making process has always been at the very heart of the debate about the future direction of

¹⁵⁴ European Ombudsman, Decision of 26 March 2009 (n 59), [21].

¹⁵⁵ European Ombudsman, Decision of 9 March 2009 (n 2), [29].

¹⁵⁶ Svein S Andersen and Kjell A Eliassen, *The European Union: How Democratic Is It?* (Sage publications 1998), 2.

¹⁵⁷ Herwig CH Hofmann, Gerard C. Rowe and Alexander H Türk, *Administrative Law and Policy of the European Union* (Oxford 2011), 170.

¹⁵⁸ *ibid.*, 170-171.

¹⁵⁹ *ibid.*

¹⁶⁰ As required expressly in Article 297 TFEU. *ibid.*, 172.

¹⁶¹ *ibid.*

¹⁶² Andersen and Eliassen (n 156), 159.

the EU.¹⁶³ Transparency is one of the principles which guide the European Union's civil service.¹⁶⁴ According to that principle, 'civil servants should be willing to explain their activities and to give reasons for their actions' and they should also 'keep proper records and welcome public scrutiny of their conduct, including their compliance with these public service principles'.¹⁶⁵

Even though it is not a new principle, it represents existing expectations of citizens and civil servants.¹⁶⁶ Besides, it also helps 'civil servants to understand and apply rules correctly, and guide them towards the right decision in situations where they should exercise judgment'.¹⁶⁷ As a high-level distillation of the ethical standards for EU civil servants, the principle of transparency constitutes a vital component of the service culture to which the European public administration adheres. It also helps to generate and focus an on-going, constructive dialogue among civil servants, and between civil servants and the public.¹⁶⁸ Such a dialogue is vital in order to consolidate and deepen 'a shared understanding of the ethical values of public service among civil servants and citizens with different cultural backgrounds'.¹⁶⁹

In order to consider the possible breach of the principle of transparency, this section analyses the issue from the point of view of Regulation 1049/2001 on the access to documents of the European Parliament, Council and Commission, the European Code of Good Administrative Behaviour, and the relevant case law of the CJEU.

1. *Analysis of the Potential Breach Under the Scope of Regulation 1049/2001*

Regulation 1049/2001 lays out the conditions for public access to the documents of the European Parliament, European Commission and Council of the EU.¹⁷⁰ The Regulation is applicable to all the documents elaborated or received by those three EU institutions.¹⁷¹ Any EU citizen as well as any individual or legal entity that lives or has its registered office in

¹⁶³ Dimitris Chrysoschoou, *Democracy in the European Union* (IB Tauris & Co 2000), 9.

¹⁶⁴ European Ombudsman (n 1).

¹⁶⁵ *ibid*, 6.

¹⁶⁶ *ibid*, 1 (Introduction).

¹⁶⁷ *ibid*.

¹⁶⁸ *Ibid*, 2 (Introduction).

¹⁶⁹ *Ibid*, 4 (Introduction).

¹⁷⁰ Regulation (EC) No 1049/2001 (n 54).

¹⁷¹ *ibid*, art 2.3.

a Member State has the right to have access to such documents.¹⁷² As Mr Pachtitis is a Greek national and thus he is an EU citizen, it is clear that this Regulation applies.

Article 3 of the Regulation provides a very broad definition of the term ‘document’. According to that article, a document means any content, whatever its medium is¹⁷³, concerning issues under the competences of the corresponding EU institution. In this sense, Mr Pachtitis requested EPSO to provide him with an exact copy of the questions that he got and the answers, both the ones that he provided and the correct ones, in the two tests of the first stage of the competition in which he participated.¹⁷⁴ Since the definition of ‘document’ in Regulation 1049/2001 is very broad, it could be argued that it seems that the information requested by Mr Pachtitis to EPSO falls under the Regulation’s definition of ‘document’. However, it brings us to the question of whether EPSO is covered by this Regulation.

In fact, the title of the Regulation expressly mentions public access to the documents of the European Parliament, Council and Commission. Article 1 of the Regulation specifies that the aim of the Regulation is ‘to define the principles, conditions and limits on grounds of public or private interest governing the right of access to European Parliament, Council and Commission [...] documents [...] in such a way as to ensure the widest possible access to documents.’¹⁷⁵

EPSO is not part of the three mentioned EU institutions. Actually, EPSO is an inter-institutional body of the European Union, such as the Publications Office of the European Union¹⁷⁶, the European School of Administration¹⁷⁷ and the Computer Emergency Response Team¹⁷⁸. The Regulation specifically foresees its application to the public access of documents of the three main institutions involved in EU legislation.

¹⁷² *ibid*, art 2.1. Besides, art 2.2 allows the EU institutions to grant access to those documents to any individual or legal entity who does not live or have its registered office in a Member State.

¹⁷³ *ibid*, art 3, which sets out that the format may be written on paper or stored in electronic form or as a sound, visual or audiovisual recording.

¹⁷⁴ Case F-35/08 *Pachtitis v Commission* (n 13), [22].

¹⁷⁵ Regulation (EC) No 1049/2001 [54], art 1.

¹⁷⁶ Inter-institutional body whose task is to publish the publications of the institutions of the European Union.

¹⁷⁷ Inter-institutional body set up on 10th February 2005 to provide training in specific areas for members of EU staff.

¹⁷⁸ Inter-institutional body set up on 1st June 2011 to help manage threats to EU institutions’ computer systems.

However, article 15 (3) of the TFEU lays down the access to documents, whatever their medium, of the European institutions, bodies, offices and agencies for any citizen of the EU, and any natural or legal person residing or having its registered office in a Member State. Besides, it also stipulates that 'each institution, body, office or agency shall ensure that its proceedings are transparent and shall elaborate in its own Rules of Procedure specific provisions regarding access to its documents'. By reading that article, it is clear that an EU citizen such as Mr Pachtitis should be allowed to have access to the documents of an EU inter-institutional body such as EPSO. Nevertheless, it should not be forgotten that the wording of article 15 (3) TFEU came after the amendments introduced by the Lisbon Treaty to both TFEU and the Treaty of the EU (TEU). In this sense, it has to be borne in mind that the Lisbon Treaty entered into force on 1st December 2009 and Mr Pachtitis had already lodged his complaint before that date. Hence, it would be difficult to argue that the dispositions of TFEU apply to a past situation which happened before they became applicable. The European Ombudsman has already shared the same concerns about whether EPSO is covered or not by Regulation 1049/2001 and his decision hints that it is not¹⁷⁹. In any case, the duties of the Ombudsman do not include the interpretation of EU law but the uncovering of maladministration in the activities of the institutions.¹⁸⁰

In order to adapt the Regulation to the changes introduced in the EU Treaties following the entry into force of the Treaty of Lisbon on 1 December 2009, on 21st March 2011 the European Commission tabled a proposal whose aim is to extend the scope of the Regulation to all the EU institutions, bodies, offices and agencies.¹⁸¹ Nevertheless, the proposal's approval is still pending. Thus, it cannot be used for the purposes of this study.

However, it should not be forgotten that on 21st July 2007 Mr Pachtitis wrote to the European Commission requesting the documents (ie his exam

¹⁷⁹ European Ombudsman, Decision of 26 March 2009 (n 59), [18-20].

¹⁸⁰ Art 2 of Decision 2008/587/EC, Euratom of the European Parliament of 18 June 2008, amending Decision 94/262/ECSC, EC, Euratom on the regulations and general conditions governing the performance of the Ombudsman's duties (European Ombudsman's Statute) [2008] OJ L189/25.

¹⁸¹ The Commission had already tabled another proposal on 30 April 2008, whose approval is still pending. The 2011 proposal, which was tabled to adapt the Regulation to the provisions of TFEU, also foresees some restrictions for the public access to documents of the European Court of Justice, the European Central Bank and the European Investment Bank.

questions and answers).¹⁸² He did so as EPSO had told him on 20th July 2007 to readdress the request to the Commission.¹⁸³ The Commission replied negatively on 17th January 2008, clearly infringing the duty to reply within due time¹⁸⁴ and posing some doubts concerning the obligation to motivate the refusal.¹⁸⁵ On the Commission's defence it could be argued that it does not own EPSO's documents.¹⁸⁶ Nevertheless, since EPSO told Mr Pachitis to forward the complaint to the Commission¹⁸⁷, it could be assumed that the documents were indeed under its possession and thus, Regulation 1049/2001 would be applicable.

Furthermore, article 4 of Regulation 1049/2001 contains the grounds of justification that the EU institutions may use to reject a request for access to their documents. Those exceptions allow the Commission, Parliament and Council to refuse access to a document whose disclosure would undermine the protection of public interest¹⁸⁸, the privacy and the integrity of an individual¹⁸⁹, the commercial interests of a natural person or legal entity, court or tribunal proceedings and legal advice, and inspections, investigations and audits. Moreover, the EU institutional triangle can refuse access to internal documents or documents received which concern an issue pending decision as long as the disclosure undermines the institution's decision-making process.¹⁹⁰ In the case of internal documents which contain opinions for internal use, even if the decision is adopted, the institutions may refuse the access unless the disclosure has a superior public interest.¹⁹¹ Last not but least, in the case of documents which concern third parties, the EU institutions have to consult them before disclosing any document.¹⁹²

¹⁸² European Ombudsman, Decision of 26 March 2009 (n 59), [4].

¹⁸³ *ibid*, [3].

¹⁸⁴ Replies must be sent within fifteen working days according to the European Commission's own Code of Behaviour for staff of the European Commission in their relations with the public. Commission Decision of 17 October 2000 amending its rules of procedure (2000/633/EC, ECSC, Euratom) OJ L267/63.

¹⁸⁵ European Ombudsman, Decision of 9 March 2009 (n 2), [13].

¹⁸⁶ European Ombudsman, Decision of 26 March 2009 (n 59), [21].

¹⁸⁷ *ibid*, [3].

¹⁸⁸ Regulation (EC) No 1049/2001 (n 54). Article 4.1.a clarifies that the protection of the public interest must be regarding public security, defence, international relations, and the financial, monetary or economic policy of the EU or a Member State.

¹⁸⁹ *ibid*. Art 4.1.b points out that the protection of privacy and the integrity of an individual must be in accordance with the EU legislation regarding the protection of personal data.

¹⁹⁰ *ibid*. However, art 4.3 also provides an exception to the exception by stating that this provision shall not apply if the disclosure has an upper public interest.

¹⁹¹ *ibid*, art 4.3.

¹⁹² *ibid*, art 4.4.

When reading article 4, it does not seem that Mr Pachtitis's request fits any of the grounds for exception. In fact, he was asking for his own documents and there was no risk to undermine any third party nor his intimacy and integrity. Furthermore, he was requesting copies of the questions and answers of the exam. None of those documents contained any opinion for internal use since the exam was a multiple-choice test corrected by a computer. Thus, there should be no grounds to refuse Mr Pachtitis' request in principle.

Article 7 of Regulation 1049/2001 also foresees a motivation in the case that there is a total or partial refusal. It seems that neither EPSO nor the Commission motivated their refusals. However, the CJEU has ruled that providing the results of the CBTs is more than enough to motivate the refusal.¹⁹³ Additionally, EPSO publicly rejects to send anything but the information sheet with the results to those candidates in the first stage.¹⁹⁴ That argument seems weak and will be later analysed in the section dealing with the case-law of the CJEU.

Therefore, from all the aforementioned facts, it can be concluded that there is no breach of this Regulation by EPSO because it falls outside its scope of application. If that were not the case and EPSO was covered by this Regulation, there would have been an infringement of this particular law. On the contrary, the Commission could be considered as not having complied with the Regulation as long as the documents are in its possession and since any of the grounds of exception provided by article 4 seem to apply.

2. *Assessing the Possible Infringement of the European Code of Good Administrative Behaviour*

The European Code of Good Administrative Behaviour is a non-legislative EU act contained in a resolution of the European Parliament of 6 September 2001.¹⁹⁵ The code aims to lay out a series of rules and principles that the EU institutions and bodies as well as their staff are bound to respect when dealing with the public.¹⁹⁶ The code applies to any EU

¹⁹³ Case F-7/07 *Angioi v Commission* (n 33), [67]; Case T-33/00 *Martínez Páramo v Commission* (n 33), [43].

¹⁹⁴ EPSO Guide to Open Competitions (n 13), point 6.2.

¹⁹⁵ European Parliament resolution on the European Ombudsman's special report to the European Parliament following the own-initiative inquiry into the existence and the public accessibility, in the different Community institutions and bodies, of a European Code of Good Administrative Behaviour (n 33).

¹⁹⁶ *ibid.*

institution and body, such as EPSO, and to their staff.¹⁹⁷

Transparency is one of the principles which appears in that code. In this sense, the code establishes the obligation for the EU staff to ‘deal with requests for access to documents in accordance with the rules adopted by the Institution and in accordance with the general principles and limits laid down in Regulation (EC) No 1049/2001’.¹⁹⁸ Since EPSO is covered by this Code and the previous section has analysed the issue from the point of view of Regulation 1049/2001, a consideration of the rules regarding transparency adopted by EPSO is needed in order to see whether there has been a failure to comply with the principle of transparency in the *Pachtitis* case.

In this sense, Mr Pachtitis only participated in the first stage of the competition and EPSO considers that it is only obliged to provide those candidates of that stage with their test results.¹⁹⁹ This is argued for financial reasons since questions are re-used for future competitions and replacing them is expensive according to EPSO.²⁰⁰ Moreover, it is also done in order to avoid commercial practices with the questions.²⁰¹ Thus, EPSO expressly refuses to grant access to ‘the wording of the questions or of the answers’ and will only provide with ‘the reference number/letter of the answers’ chosen by the candidate ‘and of the correct answers’.²⁰² However, the CJEU has specified those conditions more in detail.

3. *The Consideration of the Principle of Transparency by the Court of Justice of the EU (CJEU)*

The CJEU has stressed the need for transparency in the EU staff selection process several times. As seen in Case T-374/07 *Pachtitis v Commission*, candidates of competition exams are considered to be covered by the Staff Regulations.²⁰³ Thus, the Court confirms that, under the second paragraph of article 25 of the Staff Regulations, ‘any decision relating to a specific individual who is taken under the Staff Regulations and adversely affecting him must state the grounds on which it is based’.²⁰⁴ Besides, it has acknowledged that candidates are allowed to be provided with the general criteria for correcting the exams as well as copies of their corrected exams

¹⁹⁷ *ibid*, art 2.

¹⁹⁸ *ibid*, art 23.

¹⁹⁹ EPSO Guide to Open Competitions (n 13), point 6.2.

²⁰⁰ European Ombudsman, Decision of 9 March 2009 (n 2), [22].

²⁰¹ *ibid*, [20] and [21].

²⁰² EPSO Guide to Open Competitions (n 13), point 6.2.1.

²⁰³ Case T-374/07 *Pachtitis v Commission* (n 62), [18].

²⁰⁴ Case F-7/07 *Angioi v Commission* (n 33), [136].

if they request them.²⁰⁵ However, the Court has also ruled that the candidates are only allowed to have access to their own written exams²⁰⁶ and in the case that the candidates took part in a multiple choice test, the relevant EU institution fulfils the obligation to justify a refusal of access to the documents requested by communicating the results of the tests and informing about the annulment of certain questions.²⁰⁷

However, the argument of complying with the obligation to justify by simply communicating the results and informing about the annulment of questions seems weak. By only providing the results, the candidate cannot either check the accuracy of the answers or identify errors. Thus, the candidate has to rely on what EPSO says. Since the CBT questions are re-used in later competitions, EPSO has justified this refusal to access the answers and questions on the basis of economic reasons and to avoid commercial businesses with the questions.²⁰⁸ In this sense, the competitions where candidates were allowed to have access to their written exams seemed to be more transparent than the current ones.²⁰⁹

Notwithstanding, the CJEU has also admitted that a candidate has the right of access to the questions when he challenges the relevance of certain questions or the validity of the answer adopted as correct and provided that the difference between his results and the pass threshold is such that, assuming that his objection is well founded (...) he could be among the candidates who passed the tests in question.²¹⁰

Unless that happens, the institution can refuse the access and by providing the results of the exams, it obeys to the obligation to justify such refusal.²¹¹ In the *Pachtitis* case, the claimant wanted access to his own exam's questions and answers but also to the questions of all the exams due to the fact that he was aware that seven questions had been annulled.²¹² Furthermore, his results were somehow close to the results of the 110 successful candidates who made it to the second stage of the process. Pachtitis obtained 18.334/30 points, whereas the 110 successful candidates

²⁰⁵ Case T-72/01 *Pyres v Commission* (n 8), [70].

²⁰⁶ Case T-33/00 *Martínez Páramo v Commission* (n 33).

²⁰⁷ Case F-7/07 *Angioi v Commission* (n 33), [137]; Case T-189/99 *Gerochristos v Commission* (n 33), [34]; T-167/99 and T-174/99 *Giulietti v Commission* (n 33), [81-82].

²⁰⁸ European Ombudsman, Decision of 9 March 2009 (n 2), [18-22].

²⁰⁹ T-33/00 *Martínez Páramo v Commission* (n 33).

²¹⁰ Case F-7/07 *Angioi v Commission* (n 33), [138].

²¹¹ *ibid*, [139-140].

²¹² Case F-35/08 *Pachtitis v Commission* (n 13), [22] and [24].

had obtained at least 21.333/30 points.²¹³ It seems clear that the checking of the annulled questions is needed so that the candidate may recognise whether he/she took those questions or not.

Thus, Mr Pachtitis was challenging seven annulled questions and his results were close to the minimum grade point average required to go for the second stage of the competition.²¹⁴ Even though none of the seven questions annulled were present in Mr Pachtitis' exam, it looks like EPSO should have provided him with at least those seven questions as well as his questions and answers.

Concerning Mr Pachtitis' first letter to EPSO on 4th June 2007 requesting access to his tests' questions and answers²¹⁵, EPSO might have breached the principle of transparency. EPSO replied on 4th June 2007 refusing access but did not provide any reason for such refusal since it reserved 'the right to include its explanations in a future 'Guide for Applicants'.²¹⁶ On the question of the lack of justification, it could be argued that EPSO had already provided him with the results and informed him about the seven questions that were annulled, which is enough reason to justify the refusal of access to questions and answers in multiple-choice tests in accordance with the relevant European case-law.²¹⁷ Nevertheless, by reading the facts of the case it is implied that EPSO did not inform him about the seven annulled questions.²¹⁸ This is proven by the fact that on his complaint of 10 July 2007, Mr Pachtitis denounced errors in the exam and asked EPSO to 'inform him which, if any, of the questions in the admission tests had been 'cancelled' by the selection board'.²¹⁹

For considering the possible breaching of the principle, it is essential to know whether EPSO had informed him or not about the existence of such errors. If EPSO did, there should be no lack of compliance. On the contrary, the breach of the principle could be argued if EPSO did not inform him. Finally, on 26 November 2007 EPSO provided him with 'a statement showing the number of multiple choice questions set, the letters corresponding to the applicant's answers and those corresponding to the

²¹³ *ibid*, [21].

²¹⁴ *ibid*, [21], [22] and [24].

²¹⁵ *ibid*, [22].

²¹⁶ *ibid*, [23].

²¹⁷ Case F-7/07 *Angioi v Commission* (n 33), para 137; Case T-189/99 *Gerochristos v Commission* (n 33), [34]; Cases T-167/99 and T-174/99 *Giulietti v Commission* (n 33), [81-82].

²¹⁸ Case F-35/08 *Pachtitis v Commission* (n 13), [24] and [26].

²¹⁹ *ibid*, [24].

correct answers'.²²⁰ Nevertheless, given that Mr Pachtitis finally obtained that information does not invalidate the fact that there might have been a breach of the principle if EPSO did not inform him on its reply of 4 June 2007 about those annulled questions.

V. CONCLUSION

Transparency has proven to be very important for the European Union and both primary and secondary legislations have provided for this in respect of the activities of the European institutions, bodies, offices and agencies. Article 15 TFEU establishes an obligation for all of them to work in the most open way possible. Regulation 1049/2001 on access to the documents of the EU institutional triangle gives citizens, residents and legal entities the right to have access to them. In addition, the European Code of Good Administrative Behaviour has laid out a series of rules for the institutions and bodies to follow when dealing with the public. Furthermore, EPSO has developed its own rules to ensure transparency in the selection procedure. But the question is whether all this is enough.

EU case law has ruled that first stage candidates may only be given access to the information sheets with their results in the computer based tests (CBTs).²²¹ However, the CJEU admits the right of access to questions when a candidate challenges the relevance and/or validity of the questions and their results were close to the minimum score needed to enter into the second stage.²²² Before the use of CBTs, there were pre-selection, written and oral tests. Then, candidates were allowed to have access to their written tests.²²³ Thus, it seemed to have been more transparent. Nowadays candidates must rely on the results provided by EPSO and since they cannot see the questions and answers, they cannot check whether there have been mistakes or not that they did not realise at the time of the exam.

EPSO has justified the refusal to the questions and answers on the basis that they are reused and if they are disclosed, they must be replaced.²²⁴ According to EPSO, the replacement of questions is very expensive.²²⁵ Furthermore, EPSO also exculpates itself in order not to foster business activities with the questions.²²⁶ It is true that CBTs have led to a series of improvements which modernise and make the selection process more

²²⁰ *ibid*, [25].

²²¹ Case F-7/07 *Angioi v Commission* (n 33), [137].

²²² *ibid*, [138].

²²³ Case T-33/00 *Martínez Páramo v Commission* (n 33).

²²⁴ European Ombudsman, Decision of 9 March 2009 (n 2), [19].

²²⁵ *ibid*, [22].

²²⁶ *ibid*, [20].

flexible for the benefit of candidates.²²⁷ Nevertheless, the use of CBTs must not entail less transparency.²²⁸

In this sense, it must be borne in mind that the CJEU has neither considered so far the failure to comply with transparency nor put into question the use of CBTs in the *Pachtitis* case. It has simply ruled that EPSO did not have legal powers to act like it did in the case.²²⁹ Moreover, EPSO could not be subject to Regulation 1049/2001. Only the institutional triangle falls under the scope of the Regulation. For this reason and in order to adapt to article 15 TFEU, it would be desirable to amend the Regulation including the rest of the institutions and bodies under its scope. This is not easy because the Commission has already tabled two proposals which are still pending approval by the EU co-legislators.²³⁰ Notwithstanding, EPSO is indeed covered by both the European Code of Good Administrative Behaviour and article 15 TFEU²³¹, which guarantee the access to documents and require transparency in the activities of EU bodies such as EPSO. Nevertheless, the European Commission is certainly under the scope of Regulation 1049/2001 and it neither granted Mr Pachtitis access to the documents nor stated reasons for the refusal.²³² It remains to be seen whether the Commission had those documents requested by Mr Pachtitis, although it could be argued that it seems it had them since EPSO told him to forward the complaint.²³³

In any case, allowing CBT candidates the access to anything but the information sheet with the results unless they challenge the validity and relevance of the questions is not enough to determine that the selection procedure is transparent. Furthermore, the reasons explaining the refusal to anything but that information sheet are purely economic ones. On top of that, it must be remembered that Mr Pachtitis did challenge the validity of the questions since he was aware of the existence of errors.²³⁴ If the candidate cannot see the questions, how can he know whether there have

²²⁷ *ibid*, [25] and [31].

²²⁸ *ibid*, [31].

²²⁹ Case F-35/08 *Pachtitis v Commission* (n 13); Case T-361/10 *P Commission v Pachtitis* (n 13).

²³⁰ Proposal for a Regulation of the European Parliament and of the Council of 30 April 2008 regarding public access to European Parliament, Council and Commission documents [COM(2008) 229 final]; Proposal for a Regulation of the European Parliament and of the Council of 21 March 2011 amending Regulation (EC) No 1049/2001 regarding public access to European Parliament, Council and Commission documents COM (2011) 137 final.

²³¹ However, the TFEU was not in force at the time of the *Pachtitis* case.

²³² Case F-35/08 *Pachtitis v Commission* (n 13), [22-26].

²³³ European Ombudsman, Decision of 26 March 2009 (n 59), [3].

²³⁴ Case F-35/08 *Pachtitis v Commission* (n 13), [24].

been mistakes or not?

Finally, in the particular case of *Pachtitis* there have been some problems related to competences amongst institutions and within them. Thus, for example, the Ombudsman is not allowed by the TFEU and its own statute to intervene if the issue is under judicial review.²³⁵ This happened with the ruling of the General Court in case T-374/07²³⁶ which made the Ombudsman close its inquiries.²³⁷ Nevertheless, that judgment does not tackle the breach of the principle of transparency because the General Court understands that, Mr Pachtitis being a candidate of the EPSO competition, the issue at stake has more to do with the Staff Regulations rather than with Regulation 1049/2001.²³⁸ The General Court forwarded the case to the EU Civil Service Tribunal, which liaised with it from the point of view of the Staff Regulations. Bearing in mind that the appeal was lodged on 22nd September 2007 and the judgment was ruled on 20th April 2012, this seems too much time to wait for a simply referring to another different court.²³⁹ It should not be forgotten that the review of this appeal made the Ombudsman refrain.²⁴⁰ Therefore, it would be desirable that such an important principle guiding the EU Civil Service was not discriminated and underestimated by the own bureaucracy of the EU institutions.

For all the arguments raised before, it cannot be concluded that the EU staff selection procedure is entirely transparent since candidates have no access to their questions and answers and must totally rely on what EPSO claims as fact to be the truth.

²³⁵ Art 228 of the Treaty of the Functioning of the EU (TFEU) and art 1(3) of the European Ombudsman's Statute. European Ombudsman, Decision of 9 March 2009 (n 2), [29].

²³⁶ Case T-374/07 *Pachtitis v Commission* (n 62).

²³⁷ European Ombudsman, Decision of 9 March 2009 (n 2), [29].

²³⁸ Case T-374/07 *Pachtitis v Commission* (n 62), [13], [15], [16] and [18].

²³⁹ *ibid*, [1] and [18].

²⁴⁰ European Ombudsman, Decision of 9 March 2009 (n2), [29].

BOOK REVIEW:

‘PUTTING INTELLECTUAL PROPERTY IN ITS PLACE: RIGHTS DISCOURSES, CREATIVE LABOR, AND THE EVERYDAY’ BY LAURA J MURRAY, STINA PIPER AND KIRSTY ROBERTSON

(OXFORD UP 2014) ISBN: 9780199336265. 62 GBP

Emma Linklater*

This short but confident book considers intellectual property ‘law’ in the most distanced sense. In essence, the book seeks to contextualize IP, the different roles it has to play and the contours it can take. Recognizing that there are multiple factors that influence creators, the authors explain the dissociation between the written law of IP and its conception and application in the ‘everyday’. The contribution of the book is therefore to set the social and historical context to IP law as we know it, rather than commenting on the state of law or its enforcement.

For those familiar with the subject, it is worth noting by way of compliment that both in tone and topic the book rings distinctly of Rosemary Coombe’s 1998 ‘The Cultural Life of Intellectual Properties’. This book is, however, an interdisciplinary effort by three Canadian scholars; an IP law specialist (Piper), an English and cultural studies Professor (Murray) and an historian of visual culture (Robertson). The combination of these backgrounds means that the book is accessible to a wide reach of readers, all the more so for its use of contemporary, unique and accessible case studies. Each chapter picks up a different theme, and the diversity of these themes is worth reflecting on (who would have knitting circles could cause so much of a furore?). In their given order, the chapter subjects cover: the difficulties of cross-border ‘translation’ of IP law and norms (chapter 2); the evolving roles and perceptions of IP in hand crafts, in patenting plant hormones, in newspaper editing, in the legal profession, and in small locally based arts communities (chapters 3-7); and finally the dynamics of the city of Dafen in China, renowned for its output of hand-painted replica paintings.

You, like I did, probably eyed the chapter topics above with some

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suspicion, and began wondering what exactly this might have to do with law: real law? From a lawyer's viewpoint, the text has a distinctly more historical and social focus than most of us are probably used to; the pages are filled with names, dates, subjects questioned and excerpts of their sometimes frustratingly imprecise and subjective responses. However, the law is undoubtedly there and it is in attempting to remedy our law-centric view of IP that this work finds its biggest challenge. The authors take care to pinpoint where, from a legal perspective, their respondents are clearly in the wrong and, more to the point, where our everyday conception of 'IP law' is, for want of a better word, befuddled. As lawyers, with our statutes, case law, textbooks and commentaries close at hand, we tend to think of IP for the most part in these black-letter terms. Instead, throughout the case studies examined in the book, IP is framed as a community built and community supported recognition of certain ethical or professional norms, rather than a law-based infliction of rights and duties. The law, it seems, is on the back-burner.

An interesting aspect that the case studies underline is the point that, as lawyers, we tend to see only one side of IP – the side that portrays the interactions between creators and 'outsiders'; it is in these situations that recourse to law is most prevalent. However, there exists a distinctly separate side to IP, enforced through common norms shared by a community (which may equally exist online as in more traditional contexts). Where practices that are 'illegal' from a community IP perspective are adopted *within* the community by a member against the 'common interest' of members, recourse is most often to social action rather than legal action. Even writing the above sentence, it was necessary to employ the use of scare quotes because, particularly for online community norms, it seems that the 'common interest' may be in fact decided by a relative few, and that the concept of 'illegality' according to the community norms may have little to do with *actual legality according to the law*. This is perhaps best demonstrated in Chapter 3, which looks at the intrigues of IP norms in online crafting communities. Entitled 'No One Would Murder for a Pattern' (if that doesn't pique your interest perhaps nothing will), it essentially underlines that the norms – which often are based on vague conceptions, or more often misconceptions – about copyright, trademark and patent law enforced by communities online are often stricter than those developed offline (eg within knitting groups or at craft fairs) and stricter even than the law itself. For example, while instructions for a pattern cannot be copyrighted (only surrounding texts that constitute 'works' can be), even copying the pattern alone and disseminating it within the community is considered as 'illegal' by the community itself.

The stand-off approach to the actual nitty-gritty of the law allows us to step back and better understand the extent of the complexity of IP dynamics between creators, creative communities, legal minds and outsiders. However, if you wish to read about the critical need for strong, accessible and effective law for creators, then you should go elsewhere. If anything this book serves to disprove this assertion that is by now commonplace in IP discourse, particularly insofar as copyright is concerned. In this sense, the limited notions of IP law held by the creators that make up the case studies can be seen to trivialize the efforts of actors on all sides of IP debate (from 'copy-left' activists through to rightholders) who seek to attain changes in behaviour through changes to statutes:

We hold that IP law is nothing like an on-off switch with determinable and direct effects. Yes, some realms of corporate cultural production may be saturated enough with lawyers that statutes and case law may be an especially prominent driver of behaviour. But more generally, we contend that in seeking a full understanding of what IP law is, statutes and cases are the last thing we should look at, not the first. (p 1-2)

The authors instead assert that local norms and customs are, and should be, the starting point; legal codes can supplement these not the other way around. They revere that the essence of IP 'law' is more than just stubbornly worded codified laws and legal judgments. It is a collection of interactions that make up an altogether more fluid arrangement; 'IP law in our view is not so much the day in court as the many other days IP law is experienced and imagined in the various contexts in which it is invoked.' (p 2)

A last word remains to be said about the unity of the chapters in their approach and their tone. Although each was penned by a single scholar, the writing is not easily identifiable with the discipline of the author. For example, Piper (the lawyer of the trio) writes chapter 4 on plant hormone research and patents, however the content stays well away from the legal intricacies and reads convincingly (to this lawyer at least) like the chronologically and historically accurate work of a full out historian. Equally Robertson (an historian) writes chapter 3 on IP in online knitting and craft circles - focussing on social analysis of online chat room interactions, questionnaire responses and inserting in a good amount of legal correction, her discipline by no means betrays her. As is clarified in the Afterword, this work can therefore truly fall into the category of interdisciplinary and collaborative scholarship. Finally, while it is noted that the book is written by three distinguished female academics, who in the afterword confess the project originally started out to be a principally

feminist work, to the present author a discreet feminist tone is present but is by no means prevalent. For example, this can be pinpointed distinctly in Chapter 2 insofar as it explicitly addresses the absence of female voices in what is referred to as 'free culture discourse' (think Larry Lessig), but for the rest it remains as an undertone.

In short, if you are looking for a legal commentary or the historical background to the body of law we now call 'intellectual property' this is not the place to come. If you are instead going for something by way of escape from more typically black-letter approaches, without feeling the guilt of stepping outside the intellect-zone entirely (it is, after all, not quite August yet) then this is a good basis for a more long-term reflection. To top it all, no doubt you'll gain some crafty coffee-break material from these well-researched yet unexpected case studies which previously you may never have thought to ponder.