2ND QUARTER EDITION 2007

Q2/07
BaFinQuarterly

Issued by the Federal Financial Supervisory Authority

BaFin

Foreword

I am very pleased to be able to present today the second edition of our BaFin**Quarterly** and so provide you, as announced in our debut edition, with information on supervisory matters straight from the horse's mouth.

The Solvency II conference in Bonn was a major topic in the quarter just ended. For that reason in this edition we present a report on this event, which was organised by BaFin and was attended by well in excess of 340 representatives of the insurance industry.

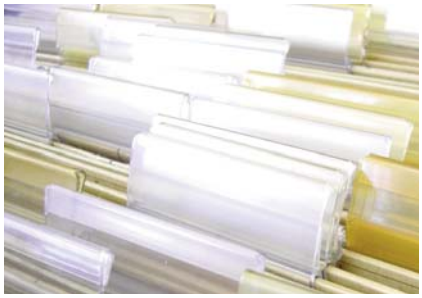
BaFin**Quarterly** also asked Dr. Thomas Steffen, BaFin's Chief Executive Director for insurance supervision, and Dr. Axel Wehling, a Director of the German Insurance Association, three questions about the new regulatory regime for insurers. You can read about what prospects and what difficulties the interviewees see for Solvency II in this edition on pages 14 to 16.

Among the other items also appearing in this edition are articles on what BaFin's cooperation agreement with the California Department of Insurance is all about, whether online credit intermediaries need a licence and how far Turkey has got with bringing its capital markets legislation into line with the EU.

I hope you find this edition of BaFin**Quarterly** interesting reading.

Sabine Reimer

Dr. Sabine Reimer
Head of Press and Public Relations



Current regulation

SUPERVISORY LAW

German REIT Act comes into force retrospectively

The Act relating to German Property Companies with Listed Shares (REIT Act) was promulgated in the Federal Law Gazette (Bundesgesetzblatt) on 1 June 2007. The REIT Act thus came into force with retrospective effect on 1 January 2007.

The Act introduces the real estate investment trust (REIT) – an internationally recognised and acknowledged vehicle for investing indirectly in property which has the benefit of a transparent taxation treatment – as a legal form for joint-stock companies in Germany. The objective behind the creation of REITs is to strengthen the role of Germany as a business centre, to enable the property business to become more professional and to create more equality of competition relative to other financial and property market centres.

A REIT is a property company which invests capital in buildings and real estate, manages them and attempts to generate a return on its investment through rental income and capital appreciation. The new Act provides for REITs in the form of quoted public limited companies. What distinguishes them from other companies is that tax is levied not on the profits at the company level but on the distributions in the hands of the investor.

However, REIT status, and thus the associated exemption from Corporation Tax and Trade Tax, are granted only if the companies meet extensive requirements. In particular, under sec. 13 of the Act they must distribute at least 90% of their earnings. In addition, under sec. 12 of the Act they must generate at least 75% of their income from property, whereby the ability to sell properties is limited.

Furthermore, at least 75% of their assets must be invested in property. Also for tax reasons, according to sec. 11 (4) of the Act any shareholder may have a direct interest of no more than 10% of the shares.

In order to ensure that REIT shares can continue to be traded at all times, sec. 11 (1) of the Act prescribes a minimum distribution of shares that must be permanently guaranteed: at least 15% of the shares must be held by shareholders each of whom is entitled to no more than 3% of the voting rights in the companies. At the time the companies are being admitted to listing on the stock exchange there must be a free float of at least 25%. BaFin is to assume responsibility for monitoring this initial minimum distribution ratio as part of the process of approving the prospectuses that have to be filed by REITs. For the purposes of monitoring the ongoing minimum distribution ratio, the disclosure requirements of secs. 22 et seqq. of the Securities Trading Act (Wertpapierhandelsgesetz - WpHG) relating to changes in voting rights percentages in listed companies are to be applied.

www.bafin.de » Aufsichtsrecht » Gesetze » REITG

SUPERVISORY PRACTICE

Californian supervisory authority CDI and BaFin agree closer cooperation

On 5 June 2007 BaFin signed a Memorandum of Understanding (MoU) with the California Department of Insurance (CDI). Under the terms of the MoU, the two supervisory authorities will exchange information on the insurance undertakings they each supervise and provide each other with mutual support.

The agreement between BaFin and the CDI is the first agreement of this kind that BaFin has concluded with a US supervisory authority in the insurance sector. It is at the same time the Californian supervisor's first international agreement altogether. The basis for this MoU was created by a transatlantic working group consisting of representatives of the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the National Association of Insurance Commissioners (NAIC) from the USA.

www.bafin.de » Internationales » Gemeinsame Standpunkte (MoU)

Internet "credit auctions" and the banking supervision law authorisation requirement for those involved

Ulf Mitschke
BaFin

"We need another 2,000 euros for our dream holiday" or: "I want to repay old debts". It is with words such as these that would-be borrowers might begin requests for loans aimed at potential lenders via the credit intermediation platforms that have been springing up with increasing frequency on the Internet of late. Prime examples of these Internet platforms, which are also pointedly referred to as "eBay for loans" or "Bank 2.0" are companies which have appeared in the UK and the USA in the last two years.

Manifestations of Internet credit intermediation

The basic principle underlying these up-and-coming credit intermediation platforms is that they bring private lenders and private borrowers together without the intervention of a credit institution (so-called "peer-to-peer" or "P2P" lending). Users who want to obtain a loan via the platform can specify the amount that they wish to borrow and the maximum interest rate that they are prepared to pay for the loan. Conversely, lenders can offer the amount that they would lend to other users and the minimum interest rate that they would like to be paid for this. If the terms are mutually favourable, lenders are paid a higher rate of interest for the loans that they extend to borrowers while borrowers pay less interest this way than either could obtain from their bank. It is also possible for borrowers to use the platform to obtain loans from private lenders that they would not have got from their bank for varying reasons.

There are big differences between the credit intermediation platforms operating on the market. Some facilities are based on extensive interaction between the users. Interested users are provided with a wealth of information to base their decisions on. For instance, lenders are allowed to examine the overall financial situation of the potential borrowers, including details of their employment and personal income, as well as the background to their loan requests and their previous payment records. Would-be borrowers may form themselves into groups the cohesion of which is based on, for example, religious or professional consensuses. They form themselves into groups in the hope that potential lenders will ascribe particular qualities to the members of the group in question which will lead them to conclude that the loan will be repaid without any problems or in the hope that lenders will regard the members of a particular group in their own right as already being particularly in need of and deserving of funding. In an ideal situation, the fact that the borrower is a member of a particular group results in the lender granting him a loan on especially favourable terms and encourages the borrower to fulfil his obligation to repay the loan because he fears that, otherwise, he will lose the respect of his group. The loan is disbursed and the borrower makes the interest and principal payments via the platform, which then deducts from the amounts due to both parties charges based on the amount of the loan and on the principal repayments respectively.

On the other hand, there are credit intermediation platforms that have commenced operations in the recent past on which interested lenders or borrowers can get themselves registered with upon payment of a fee. The platform first of all compares the profiles and then puts would-be lenders and borrowers in touch with possible counterparties. Thereafter, contracts are negotiated and drawn up, then concluded and executed solely between the contracting parties, outside the platform.

Other providers grade would-be borrowers into creditworthiness categories themselves. Consequently, in addition to the intended amount of the loan, the term of the loan and the desired interest rate, lenders can also specify the creditworthiness category of the would-be

counterparties. The provider then allocates the total loan amount being made available to up to 50 individual loans in the desired creditworthiness category. By allocating the loan amount to as many borrowers as possible, the lender's default risk of losing his money will in an ideal situation be reduced.

For all credit intermediation platforms have one thing in common: in peer-to-peer-lending the lender is still left with the risk that the borrower will default on repaying the loan. There is no guarantee or protection for the funds lent to borrowers via a credit intermediation platform, as there is with, say, a deposit insurance fund. Even if the individual counterparty default risk is distributed between a number of lenders, as provided for by some platforms, the individual lender can still lose all of the capital he has put up. Consumer protection associations point to the risks of lending between private individuals. In particular, the perception of the danger of losing one's capital may from time to time fade into the background, due to a certain "we-feeling" on the part of the platform users which is actually actively promoted by the marketing of some platform operators.

Legal situation in Germany

The Federal Republic also has various Internet portals offering credit intermediation between private lenders and private individuals or businesses in need of capital.

No banking authorisation is required in order to act purely as an intermediary between lenders and borrowers. In principle, credit intermediation platforms are not per se subject to supervision by BaFin. But BaFin does examine, on a case-by-case basis, whether the operators or users of credit intermediation platforms are creating an authorisation requirement under banking supervision law by the way in which they operate.

What BaFin looks at, regardless of the actual contractual wording of the individual business plan, is whether banking business is being conducted either by the users of the credit intermediation platform or by the platform operators themselves.

Authorisation requirement for users

By lending or, conversely, by accepting loan capital, platform users in particular may be conducting banking business requiring authorisation from BaFin within the meaning of the German Banking Act (Kreditwesengesetz - KWG). By extending monetary loans, lenders are conducting lending business. Similarly, by accepting loan capital from private lenders, borrowers may be conducting banking business and, by accepting outside funds as deposits or other unconditionally repayable funds from the public, may be conducting deposit-taking business.

Pursuant to sec. 32 (1), sentence 1, of the Act, these types of business may be conducted commercially, or on a scale which requires a commercially organised business undertaking, only with authorisation from BaFin.

There are standards limits for determining when BaFin's administrative practice will assume that a commercially organised business undertaking is required for the purposes of conducting lending business. There are set out in more detail in a BaFin Notice[1] on this subject.

The scale of the business is irrelevant if the business is to be conducted commercially. Banking business is conducted commercially if the operation is intended to run for some time and the operator is carrying it on with the intention of earning a profit. This shall be assumed to be the case as soon as one single transaction is concluded if the intention is to repeat it – even if only on an irregular basis. The intention of earning a profit shall also be deemed to exist, for example, if a transaction is intended to avoid having to pay higher interest at credit institutions, if it is proposed to repeatedly pay out the repayments of principal coming back in as new loans in accordance with the conditions of use or if the credit intermediation platform is to be used for the ongoing financing of small or medium-sized enterprises.

Authorisation requirement for operators

The operator of a credit intermediation platform may itself be conducting deposit-taking business requiring authorisation from BaFin. This is the case if, for example, it allows potential lenders to pay in the sums of money that these users may want to extend as loans via the credit intermediation platform before specific loan agreements are concluded (e.g. at the time the user/lender registers). Irrespective of the foregoing, the operators of a credit intermediation platform are implicated enterprises within the meaning of sec. 37 (1), sentence 4, of the Banking Act if one or more borrowers/lenders conduct or intend to conduct deposit-taking or lending business requiring authorisation from BaFin. In this case BaFin can also take action against the operator.

Action that can be taken by BaFin

If the operators or users of a credit intermediation platform are conducting banking business without the necessary authorisation, BaFin can intervene directly against them under sec. 37 of the Banking Act.

In addition to the foregoing, BaFin has the power under sec. 37 (1), sentence 4, of the Act to prohibit the operators of a credit intermediation platform, as implicated enterprises, from conducting their business and to order this business to be wound up. The condition for this is that, by operating the platform, the operators are implicated in the initiation, conclusion or processing of unauthorised banking business being carried out by the users. If a credit intermediation platform is intended to promote the initiation of unauthorised banking business, BaFin can also take action against it under the general danger-prevention provisions of sec. 37 of the Banking Act without hard evidence that the particular platform is being used for unauthorised banking purposes.

When would-be operators submit comments on intended business plans, BaFin insists on being provided with an account of the contractual and technological measures the operator intends to put in place in order to exclude any possibility of the platform being used to conduct unauthorised banking business by ensuring that users abide by the terms of the contract. If the plans do not provide convincing evidence of this, BaFin may resort to the investigatory powers granted by sec. 44c of the Banking Act in order to establish on a case-by-case basis whether users or the operator of the platform are conducting business requiring authorisation from BaFin.

[1] **www.bafin.de » Aufsichtspraxis » Merkblätter & Formulare**

International

ESSAY

International and European cooperation standards in securities regulation

Dr. Stefan L. Pankoke
BaFin

While securities trading and the services associated with it (e.g. investment advice and intermediation, execution of orders, portfolio and fund management, public offerings) have no trouble at all in leaping national boundaries, securities regulation is and remains in theory limited to its own territory: no administrative act, no investigatory measure by BaFin is enforceable in another country unless some special arrangement is in place. If this were in fact the case, the effective international prosecution of insider trading and market manipulation and the enforcement of legal provisions relating to corporate disclosure, transparency of trading and the organisation and conduct of players requiring authorisation to operate would remain an illusion. The International Organization of Securities Commissions (IOSCO), clearly recognised this problem when it was created in 1983 and has been working on solutions to it ever since by defining internationally recognised standards. EU legislation has consistently adopted these IOSCO standards and, by building on the foundations of the fundamental of the EC Treaty and the greater homogeneity of the EEA member states relative to the global level, has been able to take new routes – routes which could in turn inspire global standard-setting in the long term.

International cooperation standards as an institutional framework

IOSCO is recognised world-wide as the international standard setter for the regulation of securities and derivatives markets. It currently comprises 120 regulatory authorities which regulate well in excess of 90% of the world's financial markets and which, as the IOSCO Presidents' Committee, can adopt standards unanimously. Most authorities belong

either to the Emerging Markets Committee or the Technical Committee. The latter brings together the regulators of the developed countries' securities markets, including BaFin, and exercises by far the greatest influence on IOSCO standards.

As far as IOSCO is concerned, the term "international standard" can be defined in two ways:

1. Depending on the committee that supports it, a distinction can be drawn between Technical Committee standards and Presidents' Committee standards; the latter are those of IOSCO as a whole, since they have the support of all 120 IOSCO regulatory authority members.

2. Depending on the intended degree of bindingness, a distinction is drawn between principles, which tend to be generally observed, standards und recommendations. In addition, the Technical Committee also adopts descriptive reports that have no normative content.

IOSCO's international cooperation standards

The cross-border investigation of insider trading, market manipulation and investment fraud was identified as an urgent problem in cooperation between regulatory authorities. Consequently, most of the IOSCO standards concentrate on the exchange of confidential information by way of administrative assistance, i.e. between regulatory authorities. The international law and other legal rules governing international legal assistance applied in this area, on the other hand, appeared inadequate. Firstly, they are frequently not applicable, since many offences in the field of securities regulation are not punishable as a criminal offence or by administrative fine, or are not so in all countries. And secondly, the time-consuming legal assistance procedure hardly meets the requirements of efficient international securities regulation.

The model that has established itself is a two-track system of national legal bases for the exchange of information on the one hand and informal Memoranda of Understanding between regulatory authorities on the other. IOSCO has been the pioneer in this field: its "Principles of Memoranda of Understanding" of 1991[1] have also served as a model for the development of numerous bilateral MoUs.[2] Furthermore, key elements of these principles were incorporated in IOSCO's "Objectives and Principles of Securities Regulation"[3], which since 2003 have been recognised as one of twelve standards by the Financial Stability Forum[4] and have therefore become a core component of the assessments of national financial markets conducted by the International Monetary Fund since then[5]. In October 2003 IOSCO adopted a methodology for the consistent implementation of such assessments[6] which further refines the "Objectives and Principles" and contains criteria for measuring the conformity of national regulatory systems with these objectives and principles. In addition, the "Principles of Memoranda of Understanding" are also the basis of the Multilateral Memorandum of Understanding on the exchange of information and monitoring of securities trading adopted by the Federation of European Securities Commissions (FESCO) in 1999 and continued by what has now become the Committee of European Securities Regulators (CESR) (CESR MMoU)[7]. EEA members who have implemented the relevant EU Directives are also automatically signatories to the CESR MMoU.

In terms of content, the CESR MMoU lays down the conditions under which authorities have to render each other mutual administrative assistance. In addition to the framing of requests for administrative assistance, these cover in particular the confidential treatment of information received and the possibility of it being used without restriction for criminal prosecution purposes. The authorities must, of course, also be able to employ their own enforcement powers in response to requests for assistance in order to obtain the information requested . Banks and investment services providers must also fulfil certain information-recording obligations, similar to those stipulated by money-laundering regulations.

Following the shock of 11 September 2001, in May 2002 IOSCO also adopted what has by now become an international yardstick: the IOSCO Multilateral Memorandum of Understanding concerning Consultation, Cooperation and the Exchange of Information (IOSCO MMoU), which currently has 41 signatories. Three years later the Presidents' Committee declared it the "international benchmark for enforcement-related cooperation"[8], thereby de facto elevating it to the status of a standard. All the securities regulators brought together within IOSCO have thus given a political undertaking to file an application to sign the IOSCO MMoU by 31 December 2009 at the latest. If it should prove not to be possible to sign by then because national law still does not allow administrative assistance, as required by the IOSCO MMoU, or because the confidential treatment of information received does not appear guaranteed, members undertake to dismantle the barriers to signing that still exist in

the medium term and to continue to work towards signing. Under German law[9] BaFin can in theory exchange confidential information with all signatories to the IOSCO MMoU. In practice, however, cooperation is required only with a minority of them.

In addition to the instruments designed to make it easier to exchange information of relevance to investigations, IOSCO also devotes its attention to individual aspects of the sanctions system, albeit to little practical effect so far. Cooperation and coordination on offences being investigated is also of enormous importance in cross-border cases. One has only to think of, say, sanctions for inaccurate disclosure by a company traded on the stock exchange of more than one country or the cross-border seizure of illegally acquired assets for the purpose of assistance in the recovery of those assets. As far as the last point is concerned, IOSCO members declared their belief in improved cooperation on the cross-border freezing of assets, especially bank accounts, as far back as a 1993 Presidents' Committee Resolution.[10] After it had been established in 2003 that inadequate progress had been made on this front since then, IOSCO put the subject back on the agenda and in June 2006 adopted a new resolution on the subject – the Presidents' Committee Resolution on Cross-border Cooperation to Freeze Assets Derived from Securities and Derivatives Violations.[11]

European cooperation standards

In EU legislation, what is meant by standards is the instruments for the harmonisation and unification of EU law: Directives and Regulations. As an agreement, the CESR MMoU merely puts flesh on the bones of the EU legislation on the exchange of information laid down in the Market Abuse, Takeover and Prospectus Directives and the Markets in Financial Instruments Directive (MiFID).[12]

As in the international arena on the basis of IOSCO standards, European cooperation obligations can also be divided into investigation-related and sanctions-related obligations. In the investigation procedure the EU Directives implement the IOSCO standards on the exchange of information wholesale. Joint on-site inspections by more than one authority are expressly provided for only in EU law[13], but de facto they also take place with authorities from third countries on an ad hoc basis. However, in the case of sanctions-related cooperation obligations EU law goes considerably beyond the international standards of IOSCO. In addition to the IOSCO Resolution of June 2006 on the freezing of illegally acquired assets for the purpose of assistance in the recovery of those assets, which has its European counterpart in the Market Abuse Directive[14] and MiFID[15], the EU Directives also provide for a series of further powers which may also be used in the context of cross-border administrative assistance. Examples include the prohibition of a professional activity[16], the suspension of trading in a financial instrument[17] and the serving of documents.[18]

Beyond European capital markets legislation, legal instruments from the field of general judicial cooperation also help to make national borders more porous for securities regulators' legal acts. This applies in particular to the mutual recognition and enforcement of criminal or administrative fines.[19]

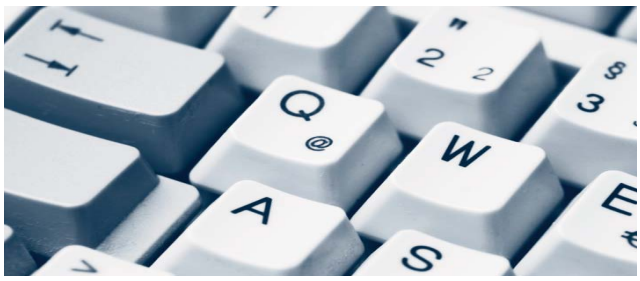
Global securities regulation unthinkable without close cooperation

Securities regulation of globalised financial markets has become unthinkable without a close-knit network of cooperation relationships between national regulatory authorities. IOSCO is therefore making a significant contribution to the establishment of internationally accepted cooperation standards, which have in practice proved a great success. IOSCO has managed to achieve a lasting effect in the field of investigation-related cooperation, especially the exchange of information. Standard-setting is proving more difficult in sanctions-related cooperation. EU legislation has copied the IOSCO cooperation standards wholesale and has gone far beyond them in key areas. At the same time, the cooperation provisions of capital markets legislation are flanked by the legal instruments of general judicial cooperation. It is perhaps not surprising that international standard-setting in this area is having to contend with much greater difficulties, given experiences in the field of cross-border confiscation of illegally acquired assets. Success can be achieved more rapidly through

bilateral agreements. The German legislation has also created the conditions for this[20] by in principle making no distinction in cross-border cooperation between EEA member states and third countries.

[1] **www.iosco.org » Library » IOSCO Public Documents » 1991**
[2] **www.iosco.org » Library » IOSCO MOU » IOSCO Multilateral MOU**
[3] **www.iosco.org » Library » IOSCO Public Documents » 1998**
[4] **www.fsforum.org » Compendium of Standards**
[5] **www.imf.org » What the IMF Does » FSAP**
[6] **www.iosco.org » Library » IOSCO Public Documents » 2003**
[7] **www.cesr.eu**
[8] **www.iosco.org » Library » IOSCO Public Documents » 2005**
[10] **www.iosco.org » Library » IOSCO Public Documents » 1993**
[11] **www.iosco.org » Library » IOSCO Public Documents » 2006**

[9] Legal bases are secs. 7 & 23 of the Securities Trading Act, sec. 19 of the Investment Act and sec. 8 of the Securities Acquisition and Takeover Act.
[12] See e.g. Art. 16 of the Market Abuse Directive (2003/6/EC); Art. 56 (1) of the Market in Financial Instruments Directive (2004/39/EC, MiFID); Art. 4 (4) sentence 1 of the Takeover Directive (2004/25/EC); Art. 22 (2) of the Prospectus Directive (2003/71/EC); Art. 50 (3) of the UCITS Directive (85/6001/EC).
[13] E.g. in Art. 16 (4) of the Market Abuse Directive; Art. 57 of MiFID.
[14] Art. 12 (2) (g) in conj. with Art. 16 (1) sentence 1 of the Market Abuse Directive (MAD).
[15] Art. 50 (2) (f) in conj. with Art. 56 (1) sentence 1 of MiFID.
[16] Art. 12 (2) (h) in conj. with Art. 16 (1) sentence 1 of the Market Abuse Directive; Art. 50 (2) (g) in conj. with Art. 56 (1) sentence 1 of MiFID.
[17] Art. 12 (2) (f) in conj. with Art. 16 (1) sentence 1 of the Market Abuse Directive; Art. 50 (2) (j) in conj. with Art. 56 (1) sentence 1 of MiFID.
[18] Art. 4 (4) sentence 3 of the Takeover Directive.
[19] Council Framework Decision 2005/214/JHA of 24 February 2005 on the application of the principle of mutual recognition of financial penalties (EU OJ L 76 of 22.03.2005, p. 16).
[20] See sec. 7 (7) sentence 1 of the Securities Trading Act.



REPORT

EU Twinning Project: Conference in Istanbul

The Turkish financial supervisory authority, the Capital Markets Board of Turkey (CMB), held a European Union (EU) Twinning Project Conference at the Hilton Hotel in Istanbul on 6 June 2007. Speakers from BaFin, together with members of staff of the CMB, introduced key EU capital market legislation und presented to the 250 or so participants from the world of business, supervision and the law proposals for their possible transposition into Turkish law. Those attending the conference included not only the Turkish Deputy Prime Minister, the Counsellor of the Delegation of the European Commission in Turkey and high-ranking representatives of the Capital Markets Board of Turkey but also BaFin President Jochen Sanio.

"Birlikten kuvvet doğar, together we're strong." Those are the words with which Sanio launched his opening remarks at the beginning of the Istanbul Conference. "That our project is such a success is, of course, also due to the fact that the cooperation between our Turkish colleagues and ourselves is working so well", said the President of BaFin; at the same time he also praised the know-how of his CMB counterparts: "What they contribute in the way of technical expertise is international state of the art."

The EU Twinning Project, "Assisting the Capital Markets Board of Turkey (CMB) to comply fully with European Union capital markets standards", has been running since January 2006 and is intended to prepare the Turkish capital market and the Turkish capital market supervisory authority for possible EU accession. Those involved in the project from the German side are staff members of the Federal Finance Ministry, BaFin and the Deutsche Bundesbank. The task they have been asked to complete by November 2007 is to familiarise their Turkish counterparts with the relevant 31 EU capital markets Directives and Regulations and to support them in transposing them into Turkish law.

Sanio said he was pleased that BaFin had earned the confidence that Turkey and the CMB had placed in it: "After all, we on the German side are providing the lion's share of the input to the twinning project. Over the course of the last 17 months, more than 50 experts have contributed to the project, of which 41 have been from BaFin."

The Deputy Prime Minister of Turkey, Prof. Dr. Abdüllatif Şener (AKP), and the Chairman of the CMB, Dr. Turan Erol, stressed that the twinning project was of major importance not only for any future accession to the EU; the joint project had already improved Turkey's economic cooperation with the EU and Germany.

The main focus of the Conference was on the Market Abuse, Prospectus, Investor Compensation and UCITS Directives. Discussions included, for example, the definition of insider trading and market manipulation, the scope of the Prospectus Directive, the procedure for dealing with compensation cases and approval issues regarding investment funds that meet the requirements of the Directive.

No cherry-picking

The 31 Directives and Regulations that are having to be implemented into Turkish law also include the Capital Adequacy and Takeover Directives as well as the Directive on Markets in Financial Instruments (MiFID). In view of this mountain of material, it was likely that the staff of the CMB, too, had already been overcome by a feeling which people in Germany knew only too well – and which Internal Market Commissioner Charlie McCreevy aptly described as "regulatory fatigue", Sanio surmised. And yet, he continued, he was strongly in favour of the European single market in financial services and therefore strongly in favour of common European – and even internationally recognised – regulatory standards. However painful it might be, "we can´t just cherry pick". For despite all its blemishes, "if we look at the Financial Services Action Plan, then we can see", said Sanio, "that this picture, taken as a whole, has meaning."

The Turkish financial industry feels well forearmed for the challenges ahead. At least, that was the unanimous opinion of the members of the closing panel, which included representatives of Deutsche Bank Turkey and Merrill Lynch Turkey.

www.spk.gov.tr » Twinning

Capital Markets Board of Turkey (CMB)

The Capital Markets Board of Turkey (Sermaye Piyasası Kurulu – SPK) has been regulating and supervising the Turkish securities markets and their institutions since 1982. The CMB consists of ten main departments which deal with, for example, matters of market regulation and surveillance, enforcement, institutional investors and intermediaries. The CMB is managed by an Executive Board, the CEO of which is Dr. Turan Erol as Chairman. The CMB has around 460 employees, most of whom work in Ankara; some work in the Istanbul regional office.

BaFin promotes European Passport Network

In September representatives of European banking, securities and insurance regulators will be coming together for a meeting of the EU Passport Network in Paris. The experts meeting will be the fourth of its kind since the Network was established in 2004. The objective of this annual meeting of regulators is to exchange practical experiences and everyday problems with the regulations, Directives and laws relating to the European passport.

The so-called "EU passport" allows banks, financial services providers, insurers and investment firms to operate on a cross-border basis within the European Union (EU) and within the European Economic Area (EEA) without having to apply for separate authorisation in the host country. For example, if a French financial services provider wants to provide services in Germany for which it already has the French authorisation, it only has to notify its French home country regulator. The latter then forwards the application, the so-called notification letter, to BaFin. "Although the EU passport is not a real passport like one you'd use for foreign travel, it does allow a company -like a passport- to operate commercially in the EU and EEA", said Jörg Willems, who is in charge of the Network secretariat. The EU passport is therefore the basis for a single EU financial market. "It is the EU passport that provides national companies with discrimination-free access to the

markets of all member states." However the passport does not apply for Switzerland, Willems added.

For regulators this means a continuous exchange of information. The experts network had already been created by BaFin at the beginning of the 2004 expansion of the EU. But when the EU expanded from 15 member states to 25, the project speeded up. The EU expansion has made it possible for banks, insurers and investment firms to offer their products or to establish local branches in the new member states as well. In order to discuss cooperation in connection with the EU passport, BaFin was seeking to make contact with the supervisory authorities of the 10 new EU accession countries as early as 2003. First training programmes for the supervisory authorities followed e.g. in Estonia, Latvia and Malta, on the basis of which the EU Passport Network was finally established. As the initiator of the Network, BaFin therefore provides the Network secretariat, which prepares the experts meetings and coordinates the exchange of information between authorities. The target of the EU passport experts meeting is to bring together as many as possible of the officials of each regulatory authority actually responsible for dealing with these matters; this ensures that the everyday problems of cooperation in particular can be discussed.

At the invitation of BaFin, the first two meetings of the EU passport experts took place in Bonn in 2004 and 2005. in 2006 the experts met for the first time outside BaFin in London. This year's meeting will also be attended for the first time by representatives from the latest EU accession countries, Bulgaria and Romania. The fifth EU passport experts' meeting, in the autumn of 2008, is scheduled to be held in Bonn or Frankfurt am Main. The fact that by now always at least 20 country representatives attend the experts meetings shows how much they are valued and the growing importance of the exchange of information between European regulators and of cross border financial services activities in general.

www.bafin.de » Aufsichtspraxis » Merkblätter & Formulare » Merkblatt

BaFin sets up microinsurance Round Table

Stephanie Siering
BaFin

The fight against poverty has become a subject of increasing attention from supervisory authorities too in the past couple of years. In addition to microcredits, microinsurance for the poorest sections of the population[1] has recently come to figure high on the agenda of the development policy debate. Against this background, in April BaFin[2] invited high-ranking representatives from the industry, government institutions and welfare organisations[3] to an international round-table meeting on microinsurance in Bonn. The aim of the Round Table is to develop generally accepted international framework guidelines for the supervision of microinsurance providers. The meeting was the second of this kind that BaFin has organised. "Internationally, therefore, it deserves the honour and privilege of being the first supervisory authority of a country with a developed financial system to take in interest in this subject and to actively promote the exchange of ideas with other players", said Dr. Bernd Balkenhol, who attended the meeting on behalf of the International Labour Organisation.

Microinsurance is insurance aimed specifically at households with very low incomes. It provides cover against elementary risks such as ill-health, flooding or death. The premiums are very low by western standards, frequently only a few cents a month; and the one-off insurance payouts rarely exceed a few hundred US dollars either. But even so, these products are making a valuable contribution to sustainable economies and the conservation of resources in developing countries.[4]

The number of potential customers for microinsurance world-wide is put at around one billion people, of whom only 3% currently have access to insurance. In India alone the potential customers are estimated to number 200 million.[5] The next five years will set the course for tapping this new market. India, Peru, the Philippines, Brazil and South Africa have already responded to the demand for microinsurance and developed new approaches to supervising microinsurance providers. The international insurance industry has also recognised that the poorer people in the new mega-markets such as Brazil, India or China are the biggest target group in the world and has already begun to get involved in the microfinance segment.

Up to now state and private insurance systems have often not been accessible to the poor and those working in the informal (or "grey") economy.[6] To date, this gap has been partially filled only by providers of "informal insurance".[7] These are often private individuals or groups of people pooling insurance risks without any legal authorisation. One such example is the burial societies of South Africa: these societies cover the costs incurred in a burial. And yet they are subject to no sort of supervision or registration requirement, which is a major challenge for policy, since they are competing directly with the regulated sector. The difficulty for all those involved lies in the transition of these businesses from the regulated (informal) to the regulated (formal) sector.

Microinsurance not regulated up to now
In most countries the regulatory framework is not designed to cope with microinsurance, even though this form of insurance is complex not only from the perspective of supervisory bodies. In view of the rapidly growing number of customers and providers it is essential to think about the optimal form and depth of supervision and regulation of this important financial instrument for combating poverty and providing cover against risks as soon as possible. For this reason the regulatory barriers to and opportunities for encouraging the spread of microinsurance are currently being examined at the international level. The International Association of Insurance Supervisors (IAIS) has analysed various microinsurance concepts intended to help those concerned to escape the "uninsurability" dilemma.

Consumer protection a prime concern in any possible regulation

The subjects discussed at particular length by those participating in the Round Table therefore included the proportionality of supervision, adequate consumer protection and risk-based supervision. There was consensus in Bonn that microinsurance was a challenge for the supervisory authorities. In addition to encouraging the development of the market, for example by relaxing supervisory requirements, the prime concern was protection of the consumer. The regulators and supervisors brought together in the IAIS were faced with the problem of developing a supervisory framework for the many "informal insurers" without destroying the existing structures.

In order to establish microinsurance businesses, certain national structures have to be in place, such as, for example, a generally accepted legal framework. All those present affirmed most strongly

Microinsurance

The key distinguishing features of what is known as microinsurance:

- Small premiums and phased premium payment methods;
- Few but clearly defined and simple rules and conditions;
- Simple claims settlement and rapid benefit payouts;
- Geared towards covering risks of low-income households; and
- Relatively low benefits.

What is special about microinsurance is that it is tailored to local market conditions and the products are designed with the customers' needs in mind, unlike "one size fits all" products. The biggest problem for providers is identifying what is and what is not insurable or marketable. Due to the lack of market data on such things as mortality, incomes and ill-health, providers are forced to go down alternative routes, for example when defining insurance cover and calculating risks. In India pre existing medical conditions are therefore co insured en bloc. By taking out group policies the individual risk for the provider is reduced.

that microinsurance also needed to be suitably regulated and supervised on the basis of international standards. In that context they attached particular importance to the role of actuaries and reinsurers. But those attending the meeting also thought that behind the existing supervisory framework for conventional insurers (e.g. capital requirements, intermediary regulations or separation of different lines of business) lay barriers to their application for microinsurance purposes.[8]

Marketing costs a key issue in microinsurance

As far as the insurance providers are concerned, it is essential to take due heed of the interests of their customers and to respect their cultural peculiarities. In addition, they will also have to develop their own marketing, premium, claims settlement and funding formats in order to adapt to the particular markets in question. From its experience to date, the industry has come to realise that reducing transaction costs is a much greater key issue with microinsurance than it is with conventional insurance products. This is driving the search for innovative solutions in the insurance industry business process. For example, because premiums are so small, it is essential to employ innovative and efficient marketing channels. For marketing purposes, companies that are already operating are employing, for example, private individuals from the local community such as teachers or local authorities. But cooperative banks, microfinance institutions, non-government organisations and other agents such as shopkeepers or mobile phone companies are also putting themselves forward as marketing channels. Such alternative marketing channels are efficient, since not only do they make the information-flow easier but they also make negative risk selection (adverse selection)[10] and asymmetrical information (moral hazard)[11] more difficult. In addition, they also help to spread knowledge of and trust in insurance. In order to be able to develop the microinsurance market it is necessary to further expand awareness of microinsurance and to establish the offers and an insurance culture in general among target group.

Microinsurance has great potential

Microinsurance is only just beginning to spread and is probably the biggest untapped global insurance market. It is also an important addition to other, better known microfinance products such as savings and microcredits, which have already established themselves as a major weapon in the fight against poverty. Consequently, providers of microinsurance can make a significant contribution to the creation of social safety nets in developing countries.

So that this objective can be achieved, the regulatory authorities will also be continuing their work. BaFin is also heavily involved in drawing up the international framework guidelines and will actively contribute the knowledge it has acquired. The Round Table will be continued in 2008.

[1] The definition of "poorest sections of the population" differs from country to country. But, generally speaking, a person is deemed to be poor if they have an average daily income of 2 US dollars a day per caput or less.
[2] Together with the Gesellschaft für Technische Zusammenarbeit (GTZ) on behalf of the Bundesministerium für Entwicklung und Zusammenarbeit (BMZ), the Gesamtverband der deutschen Versicherungswirtschaft (GDV) and the Münchener Rück Stiftung (Munich Re Foundation).
[3] Including the Gesellschaft für Technische Zusammenarbeit (GTZ), the MicroInsurance Centre, the International Labour Organisation (ILO), the International Cooperative and Mutual Insurance Federation (ICMIF) and the Fin Mark Trust.
[4] Cf. Krech, Dr. Rüdiger: Gesellschaft für Technische Zusammenarbeit (GTZ).
[5] Cf. Roth, Jim; McCord, Michael J.; Liber, Dominic: The Landscape of Microinsurance in the World's 100 Poorest Countries; The Microinsurance Centre, LLC; April 2007.
[6] Cf. Krech, Dr. Rüdiger: Gesellschaft für Technische Zusammenarbeit (GTZ).
[7] Cf. IAIS (Pub.): Draft Issues in Regulation and Supervision of Microinsurance, 2007.
[8] Cf. Wiedmaier-Pfister, Martina: Gesellschaft für Technische Zusammenarbeit (GTZ).
[9] „"Negative risk selection" is also known in the life assurance sector as "anti-selection". Good and bad risks are insured according to a scale of identical insurance premiums. For good risks the insurance premium is too high, and to cover the cost of bad risks the premium ought to be increased. The situation could be rectified by introducing excesses or supplementary insurance for bad risks in order not to lose the good risks, for which the rates would otherwise be too high.
[10] One side of the market cannot observe the actions of the other side of the market once the contract has been concluded. What is known as a moral hazard problem arises when asymmetrical information (information held by only one side of the market) does not come to light until after the contract has been concluded, either because the actions of one side of the market are not observable or verifiable (undisclosed action) or because only one of the two sides of the market comes into possession of information after the contract has been concluded and that one side of the market can make its action dependent upon that information, so influencing the outcome (undisclosed information).
[11] Cf. Klein, Dr. Brigitte Klein: Gesellschaft für Technische Zusammenarbeit (GTZ).

Solvency II

ESSAY

More than 340 attend BaFin conference on Solvency II - Next stage in the implementation under the spotlight

On 10 July 2007 the European Commission presented its draft Solvency II Framework Directive. In order to discuss the challenges that undertakings and supervisors will be faced with as a result of the future supervisory rulebook, BaFin invited representatives of the German insurance industry to a conference in Bonn on 20 June 2007. More than 340 insurance undertaking representatives attended the BaFin conference, which was held in Bonn.

BaFin President Jochen Sanio said right at the beginning that the conference was meant to promote the dialogue with insurance undertakings: "In our eyes, the undertakings that we supervise are not supervisees but customers and partners." But that also meant that undertakings had to play their part in developing the law. For that reason Sanio was especially pleased about the great response that the conference had generated. He pointed out in his opening remarks that Solvency II offered undertakings incentives: for instance, undertakings that used their own internal models, instead of the standard model, in order to calculate their solvency requirements could hope to reduce their capital requirements. That could be read as a "deal" with the regulator that no-one could really argue with: "Insurers who use internal models have more up-to-date and more detailed information and can manage their business in a way that is more commensurate to their risks", the BaFin President said.

Dr. Karsten Hoppenstedt, a member of the European Parliament, in his address to the conference, stressed the importance of the tightness of the timetable for parliamentary discussion. The objective was supposed to be for the European Parliament to adopt the Solvency II Framework Directive by May 2009. If this deadline were to be missed, there would be a serious delay in implementation, since there were to be new elections to the EU Parliament in June 2009.

Solvency II will mean major changes for the market

Those attending the conference were particularly interested in what BaFin's future supervisory practice will look like under Solvency II. The main focus of interest was therefore on both the quantitative and the qualitative requirements and on the requirements that BaFin will set for undertakings' internal models. For each of the sets of topics there was a separate panel discussion which involved a lively exchange between BaFin staff members, representatives of the German Insurance Association, the European Commission, the UK Financial Services Authority and insurance undertaking representatives.

A representative of one undertaking said that he thought Solvency II was a "a giant step forward" from the existing solvency system, since it measured risks realistically. The change of system to Solvency II would change insurers' business policies, so that in five to ten years the business would look completely different from what it had been up to now and the changes in the market that would take place would therefore be bigger than after the deregulation of 1994.

Capital requirements to be calculated on the basis of risk-based principles in future

The first panel dealt with the quantitative requirements that undertakings would have to meet. BaFin representatives explained to participants that capital requirements would in future be calculated on the basis of across-the-board risk-based principles

containing a pre-set probability of ruin. This would be done either by way of a standard formula that would have to be calculable for all undertakings or by means of more complex internal models. The capital that undertakings would have to have in future would be determined on the basis of an "economic" balance sheet, based on market values.

The topics discussed during the course of the panel included, for example, the proposed methodology for calculating minimum solvency capital (or the Minimum Capital Requirement – MCR), which is the absolute lowest capital limit for conducting business. In the opinion of some participants the calculation formula currently being tested in the third Solvency II quantitative impact study (QIS 3) should preferably make way for a fixed ratio to the Solvency Capital Requirements (SCR), since in exceptional cases the MCR could be higher than the SCR. This would penalise insurers with good internal models. The reply to this argument was that for supervisors the MCR fulfilled an important safety function, which would be essential at least for a transitional period after the introduction of the new solvency regime.

Insurance undertaking representatives were also critical of the fact that capital was being divided into different qualities: this was unnecessarily complicated and in actual fact even superfluous, since it was based too heavily on the banking supervision calculation system.

Principle of proportionality central to the Solvency II Directive

The topics discussed by the second panel were the qualitative requirements that regulators will impose on insurers under Solvency II. These include undertakings' supervisory reporting and disclosure requirements. It became clear in the discussion between the panel members that, while a reasonable package had been put together so far, further discussion was needed on individual issues. When it came to the further shaping of the qualitative requirements it was important that BaFin only set minimum standards and did not impose maximum requirements. Furthermore, when it came to implementing the second pillar of Solvency II, which covers undertakings' risk management and controlling, it was essential to adhere to the principle of proportionality. Accordingly, the new rules and regulations should always be applied in such a way that the nature and scale of the business being conducted and the complexity of the individual

THREE QUESTIONS FOR

Dr. Thomas Steffen, BaFin´s Chief Executive Director Insurance Supervison

Solvency II – What are the prospects, in your opinion?
Dr. Steffen: Solvency II offers the prospect of developing a comprehensive and risk-based solvency and supervision system. In the areas of risk measurement, risk management and risk limitation in particular the new regulatory framework will mean a quantum leap. With Solvency II we shall be setting a standard which may set new yardsticks beyond the borders of Europe. In addition, even though a number of issues are still unresolved, the design of the new group supervision system has a great deal of potential for other financial sectors as well.

Where do you see problems?
Dr. Steffen: The regulatory burden on small and medium-sized insurance undertakings in particular must not be excessive. We must therefore seek to ensure that regulatory requirements and the closeness of supervision are duly proportionate to the size, business activities and risk profile of the undertaking in each case. In particular, the standard formula for measuring capital must not become too complex.

What will change for consumers?
Dr. Steffen: One clear objective of Solvency II is to improve consumer protection. Solvency II is meant to create a single level playing-field that harmonises the competition conditions for insurers throughout Europe. This will lead to more competition, more choice for customers and therefore to lower prices over time as well.

THREE QUESTIONS FOR

Dr. Axel Wehling, Cross-Sectoral Issues Director, German Insurance Association

Solvency II – What are the prospects, in your opinion?

Dr. Wehling: The new solvency system is meant to create more security and confidence for consumers and for the insurance industry and to increase the competitiveness of European insurers. In addition to reforming the capital requirements, the aim of Solvency II is to establish comprehensive and high quality internal risk management and efficient allocation of capital. The new regulatory system offers the insurance industry new growth opportunities from which both consumers and investors will benefit.

Where do you see problems?

Dr. Wehling: Problems will arise where the regulatory requirements deviate from economic principles. Despite the tight timetable for the Solvency II project, the new regulations should be properly tested. It is important for small and medium-sized undertakings in particular that the bureaucratic burden of Solvency II is not unnecessarily high. Solvency II rules must not be allowed to interfere with the market process or circumscribe undertakings' freedom of action by rigid quantitative restrictions. A flexible, principles-based regulatory system that can be adapted to take account of the latest market developments in good time is crucial for the success of Solvency II.

What will change for consumers?

Dr. Wehling: Under Solvency II good risk management will become an important competitive factor. So consumers will benefit from even more transparency, a greater choice of products and cheaper premiums. So for the consumer Solvency II will become a quality seal for insurance products that will play an important role as a decision-making criterion when taking out insurance.

insurance undertaking were taken into account. A representative of the EU Commission added that transition periods for the introduction of Solvency II had also been proposed which were intended to make the transition to the new system easier for undertakings. Furthermore, the principle of proportionality would be enshrined in a prominent position in the Solvency II Directive. Representatives of BaFin also stressed that Solvency II must not impose too great a burden on small insurers.

Undertakings intend to use internal models

In Panel 3 the participants had a vigorous discussion about internal models and the future group supervision. One particular industry concern was that proper account should be taken of diversification effects in large groups. As a result of mutually offsetting risk effects large companies could achieve a 25% lower solvency capital requirement at the group level compared to individual valuation of the risks at the subsidiary company level. Towards the end of the panel session company representatives were asked to indicate by a show of hands whether they will be using internal models instead of the standard model. A surprisingly large number of the company representatives present intimated that they were planning to do so. Since BaFin would be having to vet these models, Dr. Thomas Steffen, Chief Executive Director responsible for insurance supervision at BaFin, expressed concern that BaFin's limited resources could lead to a backlog of applications building up. He therefore hoped that the applications would be spread over quite a long period. But on the other hand, Dr. Steffen was also pleased with the commitment being shown, since developing internal models would help undertakings to understand their risks better and promote the dialogue with the Supervisory Authority generally.

www.bafin.de » Internationales » Themenschwerpunkte » Solvency II » Konferenz am 20.06.2007

Financial Market Directive

ESSAY

The Financial Market Directive Implementing Act

Hans-Georg Carny
Martin Neusüß
both BaFin

The Financial Market Directive Implementing Act (FMDIA; Finanzmarktrichtlinie-Umsetzungsgesetz – FRUG)[1] cleared its last Parliamentary hurdle on 11 May 2007. The Bundesrat voted not to convene the Mediation Committee, thereby clearing the way for the transposition of Financial Market Directive 2004/39/EC[2] into national law. The Directive, generally referred to by its English abbreviation MiFID[3], is the most important European regulatory rule-book for the capital market in recent years. It replaces the ISD (Investment Services Directive)[4] and represents a comprehensive further harmonisation of the conditions governing securities trading throughout Europe. MiFID is also intended to improve investor protection, by introducing new business conduct and transparency obligations, and to promote competition between trading platforms. The following figures give some idea of the regulatory density of the new European rules: MiFID alone runs to 71 Articles; the accompanying implementing measures add just under 100 further Articles.[5]

Hans-Georg Carny

As an "omnibus" act, the German Act implementing MiFID, the FMDIA, amends a number of different German capital market Acts. The Act most heavily affected is the Securities Trading Act (Wertpapierhandelsgesetz – WpHG). But the Banking Act (Kreditwesengesetz – KWG) and Stock Exchanges Act (Börsengesetz – BörsG) are also being considerably amended. Articles 4 to 13c of the FMDIA make minor consequential changes to other Acts and Ordinances, such as the Stock Exchange Admissions Ordinance, for example.

The Federal Finance Ministry and BaFin will shortly be issuing a number of more detailed ordinances having the force of law to supplement the FMDIA. One of particular importance will be the Ordinance on the Detailed Specification of Conduct of Business Rules and Organisational Requirements for Investment Firms, which will transpose the MiFID Implementing Directive. In addition, existing ordinances such as, for example , the Financial Analysis Ordinance and the Securities Trading Reporting Ordinance, will also be brought into line with the new requirements of MiFID and the FMDIA.

As specified by MiFID, virtually all of the amendments being brought in under the FMDIA will come into force on 1 November 2007. The financial industry therefore has very little time left to complete the extensive adaptation work lying ahead of it. However, the German legislative machinery could not deviate from this deadline for liability reasons. In addition, compared to the rest of Europe, Germany has a good record on the implementation of MiFID – despite the sheer scale of the new rules and regulations.

Upon closer inspection, it also turns out that many of the supposed reforms have long been taken for granted, at least by the major firms. Other regulations, such as those prescribing concrete expressions of what have hitherto legally been very abstract concepts of good conduct obligations vis-à-vis users of investment firm services, are already familiar from BaFin's administrative guidelines and interpretation practice and are now merely being elevated to a higher level of bindingness. BaFin will also take account of the time pressure

that institutions are under when it monitors whether they are complying with the new FMDIA rules.

The most important changes in the field of securities trading are:

- An expanded list of the securities investment services requiring authorisation
- Reporting system
- Conduct of business and organisational rules
- Pre- and post-trade transparency
- Systematic internalisation
- Cross-border activities
- Closer cooperation within the EU

List of the securities investment services requiring authorisation expanded

The FMDIA expands the list of securities investment services for which authorisation is required: in future anyone providing investment advice or operating a multilateral trading system will also require official authorisation.

Investment advice

Investment advice had previously been an ancillary investment service and, as such, did not require authorisation. In future, authorisation from BaFin will generally be required, although investment advisers will be able to use the European "passport" and also offer their services throughout Europe. Investment advice is deemed to exclude general investment tipping, financial analysis and advertising and to cover only personal recommendation(s) tailored to the individual situation of the client or represented as such by the institution. BaFin, together with the Deutsche Bundesbank, will also shortly be publishing an Information Notice on the new legal status of investment advice.

In principle, investment intermediation and investment advice relating to investment fund units continue to fall outside the remit of BaFin supervision. The relevant Land supervisory authority remains responsible for supervising such activities under the Trade, Commerce and Industry Regulation Act (Gewerbeordnung) because there was no wish to create a greater regulatory burden than was absolutely necessary. If firms that are providing investment intermediation or investment advice services relating to investment fund units, and are thus per se exempt from BaFin supervision, are interested in operating across Europe, they may, however, submit voluntarily to the strict supervision of BaFin in accordance with the MiFID standard (opt in) and so use the European "passport". That way it would be quite simple for them to engage in cross border activities as well.

Operation of a multilateral trading system


Martin Neusüß

Operating a multilateral trading system (referred to in MiFID as a "multilateral trading facility" – MTF) is an investment service which is a special instance of the general business of investment intermediation. The facility is a platform which brings together multiple third-party buying and selling interests in financial instruments within a system in a way that results in a contract. An MTF can be operated by a market operator or by an investment firm. This gives the latter an opportunity to compete with the regulated markets. A number of major banks have already announced their intention of taking advantage of this opportunity for institutional trading at least.

The operators of MTFs and of regulated markets are governed by largely identical rules which are all intended to ensure that trading proceeds in an orderly fashion. There are differences in the requirements for the admission to listing of financial instruments and in the follow-up admission to listing obligations for issuers under the Securities Trading Act. These apply only to financial instruments which are admitted to listing on a regulated market within the meaning of MiFID. In Germany these are the stock exchanges' official market and regulated market, which will in future be designated under the single title of regulated market.

Additional investment services requiring authorisation

For the first time ever, services involving unusual derivatives based on e.g. freight rates, the weather or any indices are to be supervised as investment services requiring authorisation in future. Financial analysis becomes an ancillary investment service – and as a result it will be covered by the conduct of business and organisational obligations at institutions subject to supervision.

Own-account trading will no longer, as hitherto, be covered only when it constitutes a service for third parties; it will also be covered when it takes the form of proprietary trading, i.e. when it involves nothing but the management of the institution's own assets. Definitions of exceptions will, however,

ensure that the only undertakings to be affected by this arrangement will be those that provide other financial services and are therefore also already subject to authorisation now.

Even though BaFin is having to adapt its supervisory processes to take account of the expanded authorisation requirement, most of the firms affected are probably already on the list of institutions subject to authorisation now because of their other business activities; consequently the number of new additions to the list will be relatively limited.

Tied agents

MiFID also governs further details on the use of tied agents. These will in future also be allowed to practice the new investment service of investment advice. On the other hand, though, they must restrict themselves to being tied to only one institution, which assumes liability for their actions. In order to create the simplest possible procedures the Banking Act also leaves to the liable institution the task of conducting the fitness test called for by MiFID and the administrative duties in connection with the registration of agents. All that BaFin has to do, therefore, is to make the register of tied agents available to the public; in addition, it can also restrict its activities to indirect supervision of tied agents as part of its inspections of individual institutions.

Reporting system

The reporting system provided for by sec. 9 of the Securities Trading Act forms the basis for many of BaFin's monitoring activities. These include, for example, the tracking down of insider dealing and market manipulation. Here, too, the FMDIA involves a number of changes. In rigorous application of the home country principle enshrined in MiFID, investment firms will in future only have to report their transactions to the competent authority in their home country. If necessary, the latter will in turn pass on the transaction data to the authority of the market which is the most liquid for the financial instrument concerned. For those institutions which have to file reports, this model has the advantage that they only have to do so with one supervisory authority, irrespective of where the transaction was effected. But the increasing dependence on an exchange of data within Europe is also causing problems. Despite great efforts, as things stand at present it is unlikely that the Europe-wide exchange of reports will function smoothly, technically speaking, right from the start – which is supposed to be 1 November 2007.

By shaping the reporting system in the Securities Trading Reporting Ordinance in the way it has, BaFin is aiming to ensure that the technical infrastructure already existing in the reporting system in Germany can in principle also continue to be used in future. The objective is thus to keep the adjustment expenditure limited to what is absolutely necessary both for those required to file the reports and for BaFin. Conduct of business and organisational rules Institutions that provide investment services requiring authorisation must comply with organisational and conduct of business provisions; these are ultimately intended to protect investors. As far as the conduct of business obligations are concerned, for the moment the basic rule continues to apply: investment services must be provided in the interest of the client, with professional expertise, due care and attention and conscientiousness.

Inducements

The acceptance or granting of financial or other inducements outside the immediate client relationship is now expressly prohibited unless they are disclosed to the client and are intended to improve the quality of the service. While the first requirement is clear and hardly controversial, it is proving very difficult to define criteria for assuming an improvement in quality that work equally well for both practitioners and investors. Marketing models that are based on, say, kick-back payments will in any event need to be examined more closely.

Avoiding conflicts of interest

If institutions provide investment services for clients, conflicts of interest may arise between the firm and the client or between clients. When it comes to

managing conflicts of interests the prime concern of institutions must be to take effective steps to bring such conflicts of interest to light and to render them harmless for their clients. If organisational measures are not sufficient to adequately prevent the interests of clients from being prejudiced, institutions must disclose the conflicts of interest to clients in a non-specific manner.

Clients and professional clients

In comparison with the legal position prevailing to date, the FMDIA and its accompanying Detailed Specification Ordinance allow different rules to apply to disclosure and reporting requirements, obtaining client details and the processing of client orders in the best interests of the client, with a distinction being drawn according to the nature of the contracting party: in relation to the separately defined categories of professional clients and qualified counterparties lower conduct of business requirements apply than vis à vis retail clients. A priori, all institutions, insurance companies and investment companies, major corporations and (supra-)national organisations are deemed to be professionals. In certain circumstances, clients may be re-classified. For instance, especially experienced or wealthy individuals may waive some of the protection to which they are per se entitled. Of course, institutions still have the option of limiting themselves to business with clients of a particular category.

In order to enable clients to take decisions on their own responsibility, institutions must provide them with readily understandable and, if need be, standardised information on the firm and its services, on the nature of the financial instruments under consideration and the risks they entail, on pertinent execution venues and on the costs that they might expect to incur. These details and all promotional and other information that an institution makes available to its clients are subject to a clarity and honesty imperative.

Investment advisers and portfolio managers are obliged to obtain details of the knowledge and experience of their clients, their investment objectives and financial circumstances in order to be able to verify whether a particular financial instrument or investment service is suitable for these clients (suitability test). This personal information is indispensable, because without it the asset manager cannot take discretionary decisions and cannot present the client with a serious investment suggestion tailored specifically to the latter's needs. If the client refuses to provide the information, the institution must give up the idea of providing the financial service.

For investment services other than investment advice and portfolio management, only information regarding the knowledge and experience of clients needs to be sought in order to be able to assess whether the financial instruments and/or services in question are by their nature appropriate for the client (appropriateness test). If clients fail to provide the information or the assessment is negative, they must merely be warned; they may, nevertheless, still be provided with the service if they so insist. Further relaxations of the rules apply if the service relates to so-called "non-complex" securities such as listed shares, debt instruments with no derivative elements or investment fund units which the client asks about on his own initiative.

For all details provided by the client the service provider may assume that they are correct and complete, provided that it has not encouraged the client to withhold information or it is not grossly negligent in failing to recognise the incorrect nature of it. The service provider does not, therefore, have to develop the zeal of a detective. A similar concession applies for institutions that receive client orders via other investment firms, such as investment brokers, for example; these institutions may also rely on the original institution having acted in accordance with the law and on the information supplied being correct.

Best execution

One conduct of business rule which should be highlighted in particular is the obligation to execute orders on the most favourable terms for the client (best execution). Accordingly, when it comes to the execution of client orders or passing them on to third parties by way of commission business, own-account trading, investment or contract broking or portfolio management, institutions have to take all appropriate measures in order to achieve the best

possible result for their clientele. The relevant criteria here are the particular features and prices of the financial instruments, the client himself and the costs, speed and probability of the order being

executed and settled. For retail clients the price of the security and the execution costs should be the determining factors. A firm must not "manage" the outcome of the favourability test by arbitrarily distinguishing between the possible execution venues, such as organised markets, multilateral trading systems, systematic internalisers or market-makers, when it comes to its own charges. The precedence given to stock exchanges under sec. 22 of the Stock Exchanges Act will be repealed. If the client has given specific instructions regarding the nature or place of execution, then these will obviously have to be observed. In order to ensure the best possible execution, firms are obliged to draw up appropriate internal principles, which they have to inform clients of. Although the optimum does not actually have to be been achieved in each individual case, institutions must be able to prove that they have consistently abided by their own execution principles.

Establishment of independent controls

The organisational blanket clause whereby an institution must take all measures necessary to always be able to provide investment services in a fit and proper manner is already well-known. In addition to management of conflict of interests, these measures also include, as a matter of principle, control mechanisms that are independent of the operational side of the business; these are to be divided into Compliance, Risk Control and Internal Audit and their reports must be regularly scrutinised by senior management and supervisory bodies. By calibrating them according to the nature, scale and complexity of their business, it is intended to be possible to simplify the rules for smaller institutions by allowing the same person to hold more than one job, by restricting the independence requirement or by doing without some functions.

Transactions by individual staff members and other staff conduct must be subject to controls in order to see whether they are compatible with insider legislation and the firm's own obligations. The new legislation will also require effective and transparent management of retail client complaints. These must be dealt with without delay, and every case must be documented.

Other organisational arrangements

More detailed organisational regulations on internal decision-making and process structures, staff qualifications, data protection, measures to deal with system failures and other business disruptions and interruptions, risk management in the narrower sense and the avoidance of outsourcing risks are set out in the Minimum Requirements for Risk Management (MRRM). Special organisational arrangements are demanded when it comes to preventing conflicts of interest in the production of financial analyses. Rules governing this are being incorporated in Financial Analysis Ordinance. But firms still have the option not to take these measures if they clearly designate their financial analyses as advertising material. Consequently, any recommendations may in this case also be biased. Detailed provisions govern the protection of clients' assets, which investment firms cannot dispose of without a banking licence. Unlike in the past, omnibus client accounts are also allowed now, provided that the accounts remain segregated from the institution's own assets. Strict accounting provisions apply to these accounts, however. Client funds must be paid into accounts with credit institutions or – with the client's consent – into eligible money market funds. In special circumstances financial instruments forming part of the client's assets may in future be used for own-account transactions financed through securities.

Record-keeping obligations

In order that BaFin and the external auditors may monitor institutions' business activities efficiently for the purposes of their examinations under sec. 36 of the Securities Trading Act, institutions are obliged to keep informative records that they can use, in particular, to reproducibly prove that they have complied with conduct of business rules. The Implementing Regulation specifies which data for client orders or portfolio manager decisions and for transactions have to be recorded. The Conduct of Business Rules and Organisational Requirements Ordinance lays down further detailed specifications, some of which already take account of the recommendations of the Committee of European Securities Regulators (CESR). BaFin will also be providing a list of all record-keeping obligations for market practitioners on its website, incidentally. However, in view of the great variety of institutions and business models it is not possible to provide

definitive detailed rules governing documentation requirements.

Pre- and post-trade transparency

One of the primary objectives of MiFID is to make securities trading, and especially share trading, more

transparent. For that reason the Directive and therefore also the FMDIA introduce extensive disclosure obligations for regulated markets and MTFs. Pre trade, investment firms and MTFs must make public the range of current bid and offer quotes and the depth of trading interest at those prices on a continuous basis. In order to promote post-trade transparency, regulated markets and MTFs must make public the price and volume of the transactions executed via their respective trading platforms, and as close to real-time as possible. While such transparency rules have to a large extent applied to stock exchanges already, the regulations for MTFs have now been enshrined in a new sec. 31g of the Securities Trading Act. The EU Implementing Regulation sets out the transparency obligations in more detail; subject to certain conditions, it also allows exceptions, depending on the trading system and the volume of trading. It should be underlined that under German law these obligations apply only to trading in shares and certificates representing shares that are admitted to trading on a regulated market. The EU Commission is currently looking into whether these obligations should be extended to other financial instruments.

Share trading is also becoming more transparent as a result of investment firms now being required make public the transactions that they effect outside regulated markets and MTFs as well. They must declare the time, price and volume of these transactions, which will enable others to have a complete overview of what is happening on the market. This obligation, which has now been incorporated into a new sec. 31h of the Securities Trading Act, also applies only to trading in shares and certificates representing shares that are admitted to trading on a regulated market. In order to prevent the fragmentation of published notices of transactions concluded, in addition to other details the EU Implementing Regulation also stipulates that the data must be easy to consolidate. There will be providers who will collect and collate the many individual notices published in order to provide a better market overview.

Systematic internalisation

Systematic internalisers are firms which, on a frequent, regular, organised and systematic basis, deal on own account by executing client orders outside a regulated market or MTF (cf. sec. 2 (10) of the revised Securities Trading Act). Secs. 32 to 32d of the Act reflect the high requirements that MiFID sets for this internal type of execution. Among other things, the provider is as a matter of principle obliged to publish binding quotes on a continuous basis and to grant clients discrimination-free access to those prices. However, the enhanced obligations for internalisers apply only to client orders in shares or certificates representing shares that are admitted to trading on a regulated market. In addition, it is not sufficient for the execution of orders to be internalised only an occasional basis, such as by way of fixed-price transactions offered on an ad hoc basis against the firm's own portfolio. Internalisation must in fact be systematic and play a significant role in the provider's business model.

Cross-border activities

If firms avail themselves of the European "passport" and provide investment services on a cross-border basis, they are subject only to the regulations and supervision of their home country; all that they need to do is to submit business plans to their regulatory authority stating which target countries they would like to provide which investment and ancillary services in. This information is necessary for the notification system between the home country and host country authorities. Firms may operate on a cross-border basis not only by remote communication but also through contractually tied agents, provided they have also notified the authorities of this. Moreover, multilateral trading system operators may provide facilities in any other Member State in order to ensure cross-border access to their systems.

Regarding the establishment of branches in another Member State, the host country will in future monitor whether the branches are complying with the conduct of business rules in the stricter sense. All other provisions, including those relating to the

organisational measures to be taken to protect clients, fall within the remit of the home country.

Closer cooperation within the EU

It is not only the firms being supervised that are having to prepare – sometimes at great expense – for the entry into force of the reforms on 1 November 2007. BaFin, too, is faced with great challenges. It is having to put flesh on the bones of the new arrangements in consultation with market participants and to work towards a proper practical implementation. BaFin is part of a network of European supervisory authorities. It is now having to build even more strongly than before on cooperation with its partners in the other Member States. MiFID demands that national supervisors collaborate very closely on a cross-border basis in order to ensure that they monitor the single market in financial instruments effectively. They must provide each other with immediate mutual support in clarifying facts and prosecuting offences and may refuse to do so only in a few exceptional circumstances.

The change-over to the new MiFID regulations is costing both sides, not only investment firms but also BaFin as well, a great deal of time and effort, which will hopefully soon pay off by investors having even more confidence in the capital market. Firms should also take advantage of the reforms to test long-standing structures for their fitness for purpose and to exploit the opportunities opening up to innovative and competitive institutions and trading platforms on the harmonised single European market.

[1] **www.bundestag.de » Dokumente » Drucksachen » Drucksache 247/07**

[2] 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 (EU OJ No. L 145/1, 2005 No. L 45/18), amended by Directive 2006/31/EC of the European Parliament and of the Council of 5 April 2006 amending Directive 2004/39/EEC on markets in financial instruments having regard to certain deadlines (EU OJ No. L 114/60).
[3] Markets in Financial Instruments Directive.
[4] Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (OJ L 35/1 of 11.2.2003).
[5] Directive 2006/73/EC of 10.8.2006, EU OJ No. L 241/26, and Regulation 1287/2006/EC of 10.8.2006, EU OJ No. L 241/1.

Agenda

DIARY

28.07.2007	CEBS: Bureau Meeting, London
11.-14.09.2007	Meeting of the German speaking Supervisory Authorities, Luxembourg
11.-12.10.2007	IWCFC-Meeting, Frankfurt
16.-19.10.2007	IAIS: Annual Conference 2007, Fort Lauderdale
20.11.2007	CEIOPS: Conference 2007, Frankfurt

Imprint

Publisher
Federal Financial Supervisory Authority (BaFin)
Press and Public Relations Department
Graurheindorfer Straße 108, 53117 Bonn
Lurgiallee 12, 60439 Frankfurt, Germany

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Photos
Own pictures, Photocase.com, Footolia.de, GDV, Pixelio.de, Digitalstock.de

Journal Design
Discodoener
Agentur für Design & Kommunikation
Stiftstraße 1, 70173 Stuttgart, Germany

Subscription
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