

More bite for BaFin 2.0?

German Federal Finance Ministry publishes reform proposals to supervisory framework.

APRIL 2021

QuickTake

The Wirecard scandal exposed a number of operational and cultural weaknesses in Germany's national competent authority (**NCA**), the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht* – **BaFin**).

In response, the German Federal Finance Ministry, as legislative policymaker, has had to answer to the German legislator, and it has published a number of proposals on how to make BaFin better at what it does – in short, BaFin 2.0 should have “*mehr Biss*” or more bite and do so through legislative and institutional reform, an area long earmarked for action. The question remains whether it will be enough to prevent Wirecard 2.0?¹ Since Wirecard, trouble has been brewing in Bremen and over in Britain in respect to Greensill. A number of firms with similar operating models, along with financial institutions that share the same auditors, are likely to be under increased scrutiny, whether by the supervisors or otherwise, as the reforms at EU and national level look to remedy identified shortcomings and/or prevent a repeat. BaFin is in the process of revisiting its supervisory approach for complex groups, which may serve as a first indicator of the regulatory tone in the future.

In the most recent reform proposal that was announced on February 2, 2020, this included seven reform areas and three overarching principles that can be summarized in the form of the outcomes below (the **Scholz Seven-Point Plan**). These in turn build off the efforts being advanced in the form of the German draft Financial Market Strengthening Act (**FiSG Draft Act**) – in summary, more power, more people, more rigor and more efficiency for a reformed BaFin 2.0:

1. The German Federal Finance Ministry's overarching goals are to:
2. Strengthen the impact of supervisory and auditing activities;

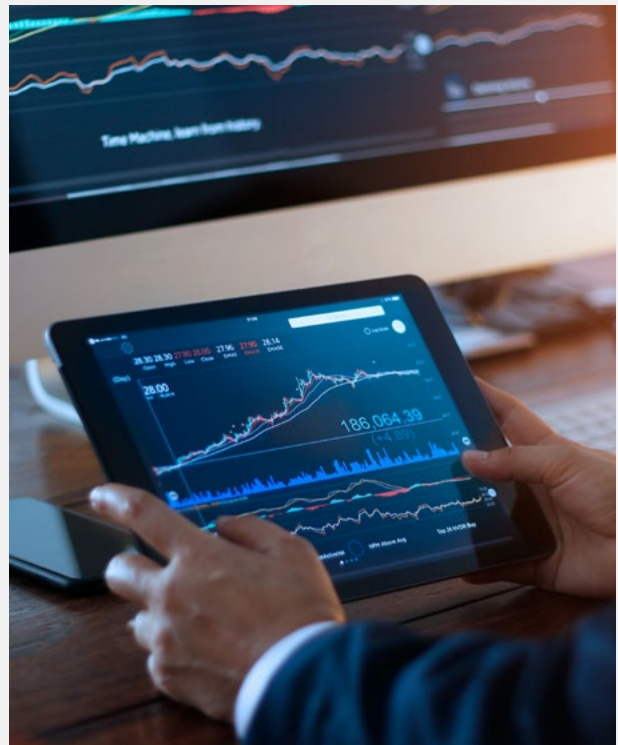
3. Streamline internal structures and processes, assigning responsibilities more clearly;
4. Supervise the financial market more effectively with state-of-the-art technology.
5. A new unit will be created for the supervision of complex companies, which will cover all business areas and “supervise companies ever more closely than before” – allowing for a more rapid response.
6. A new “forensically trained” task force at BaFin will be created to conduct ad hoc and special audits on its own initiative and in cooperation with the public prosecutor.
7. The balance sheet control procedure will be fundamentally reformed. BaFin will receive significantly strengthened access rights and more competent personnel, in particular auditors, to better review financial statements. With its extended access rights, BaFin will be able to carry out forensic audits on a sovereign basis – at least at the level of intervention that led to the discovery of balance sheet fraud in the Wirecard case.
8. The exchange of information with market participants is to be intensified and the findings of whistleblowers are to be systematically recorded and evaluated. Information from the market and from whistleblowers is particularly valuable for BaFin's work. Optimization of the processing procedures should increase the knowledge gained, introduce monitoring of processing and make it easier to identify anomalies.
9. Regular and intensive exchanges of information are to be sought with consumer and investor advocates; the findings are to be incorporated into the supervisory work. BaFin's powers to act will be strengthened and the instruments for proactive investor and consumer protection will be expanded.

¹ This is not the first time BaFin was reformed and senior management have been in the spotlight – its first president Jochen Sanio was investigated until 2015. The last major overhaul of the organization took place following allegations of fraud and gross mismanagement at the regulator from 2004 to 2006, which culminated in reforms in 2008 and the dismissal of its first president in 2012. Elke König took over the helm prior to her move to the Single Resolution Board (**SRB**), created as part of Banking Union reforms.

10. The position of the future BaFin president will be strengthened. He/she will be given more responsibility in matters relating to the central management of BaFin. This will enable decision-making processes at management level to be more efficient and effective. In addition to modernizing BaFin, the new powers of the BaFin president will also coordinate the two new units, Task Force and Focus Supervision. In addition to the new powers, Mark Branson, a British-Swiss dual national, will take over the helm of the BaFin and may set a new tone from the top.

11. A central Data Intelligence Unit (**DIU**) and a digital supervisor cockpit are to form the backbone of IT-driven supervision of the financial sector.

This Client Alert assesses these reform efforts, the emerging issues and domestic criticisms (notably that the reforms do not go far enough and/or little evidence of blue-sky thinking) and how they compare with the findings and recommendations of the European Securities and Markets Authority (**ESMA**) (including the March 3, 2021, ESMA proposals to the European Commission to improve the EU’s Transparency Directive²), before looking at what BaFin 2.0 might mean for supervised entities, as well as BaFin’s interaction in the European System of Financial Supervision (**ESFS**), notably in the wake of Wirecard and more recently Greensill. All of this has reopened a debate on the need for further Europeanization of financial services regulation and supervision generally. Such a further acceleration of Europeanization would also lend support to the EU’s efforts on completing both the Capital Markets Union and reforming the Banking Union’s operation.



A separate Client Alert in this dedicated series on the “Future of Financial Services Supervision – post FISG” assesses the impact of proposed changes to BaFin’s rules on outsourcing and the impact on domestic and EU-27 financial services firms. That Client Alert also considers the interplay of the proposed German rules with those existing EU-level rules, which are set by the EBA, ESMA and EIOPA, (each subject to amendments and reforms – an issue commented on by the European Central Bank (**ECB**) in its Opinion on FISG, which was published on February 26, 2021³), ahead of the EU’s wider-reaching efforts on harmonizing EU (and by extension national rules) on outsourcing arrangements in the financial services space, including in light of the EU’s proposed Regulation in a Digital Operational Resilience Act (**DORA**).⁴

2 Available [here](#).

3 Available [here](#).

4 See dedicated coverage from our Eurozone Hub on this development available here:

- **1st Alert** in our series of deep dives on the EU’s Digital Operational Resilience Act (**DORA**)
- **2nd Alert** in our deep dives on DORA
- **3rd Alert** in our deep dives on DORA and the ESAs’ response to policymakers

Where are we now, following Wirecard?

A number of fundamental shortcomings have been identified following the review by German legislative policymakers and the first of its kind fast-track peer review (**FTPR**)⁵ by the European Securities and Markets Authority (**ESMA**), at a request by the European Commission on June 25, 2020⁶. The reviews covered the operations of Germany's Federal Financial Services Supervisory Authority (**BaFin**) in respect of Wirecard Bank, supervised by BaFin, which ended in insolvency of the group company Wirecard AG, which BaFin did not supervise, following a globally orchestrated accounting fraud.

Wirecard AG was founded as a fintech in 1999. In 2005, it was admitted to the regulated market of the Frankfurt Stock Exchange (**FWB**) by way of a reverse listing (i.e. by merging into an already listed company and thus without going through the regulatory scrutiny associated with an IPO). One year later, Wirecard joined the "Tech DAX", the FWB's technology index. In 2018, it joined the DAX 30, the FWB's index of the 30 largest and most liquid German domiciled firms. Since being admitted to trading, Wirecard has been the subject of media scrutiny.

Following allegations made at the start of 2019 and subsequently in October 2019, Wirecard commissioned KPMG to perform a forensic investigation. KPMG published its findings in April 2020, revealing a series of issues the firm had not been able to fully investigate. As a result, the publication of Wirecard's 2019 annual statement was delayed as EY, the appointed auditor, refused to give the audit certificate (*Bestätigungsvermerk*) to the financial statement. In June 2020 Wirecard admitted that €1.9 billion accounted for in their 2019 annual financial statements did not exist. The prosecutor's office issued arrest orders for various Wirecard executives, including the former CEO and former

COO on the suspicion of organized and professional fraud (*gewerbsmäßiger Bandenbetrug*). The criminal investigations are still ongoing to date.

Importantly, the Wirecard group as a whole was not under the supervision of BaFin or the ECB in its supervisory capacity in the Banking Union (**ECB-SSM**), due to it falling outside the then applicable definition of a "financial holding group" as defined by the CRR/CRD IV as interpreted by BaFin. Consequently, only Wirecard Bank AG was supervised by BaFin. In addition, as a company listed on a regulated market i.e. the FWB, Wirecard was subject to market supervision by the stock exchange, as well as enforcement procedures, the competences over which were shared between BaFin and the Financial Reporting Enforcement Panel (*Deutsche Prüfstelle für Rechnungslegung* – **FREP**). Finally, Wirecard's financial statements were subject to mandatory auditing with auditors being supervised *inter alia* by the APAS. With Wirecard admitting that €1.9 billion accounted for in their 2019 annual financial statements would not exist, regulators both in Germany and in Europe aim to determine and remedy the shortcomings of the current supervisory system.

5 This is a regulatory tool that was introduced in 2020 through the Peer Review Methodology following the revised ESMA Regulation. Such peer review is conducted by a peer review committee composed of experts from National Competent Authorities (**NCA**s) and ESMA and chaired by ESMA.

6 ESMA's report was prepared in response to a request received from the European Commission that it conduct a fact-finding analysis of the events leading up to the collapse of Wirecard AG. This is the first peer review carried out by ESMA under the revised ESMA Regulation and the new peer review methodology, in the form of a fast track procedure and focusing on only one jurisdiction and one issuer. The peer review was conducted by a committee (**PRC**) composed of experts from NCAs and ESMA staff and chaired by a senior ESMA staff member. The PRC sent a questionnaire to both BaFin and FREP, engaged with them through additional questions and through on-site visits which took place by way of video conferencing. The PRC also engaged with the APAS (see below) and with academics. Facts and analysis in the report were checked for accuracy with both FREP and BaFin and both ESMA's Corporate Reporting Standing Committee and its Management Board were consulted on the draft report. The final version was submitted to and approved by ESMA's Board of Supervisors representing the EU-27's NCA within ESMA's mandate and the report was adopted in its final form on November 2, 2020, and published a day later.

Initial domestic responses⁷ turned to Germany's regulatory periodic disclosure framework and the division of tasks between BaFin and the FREP as the competent regulatory authorities. Later, there was also criticism of the role of auditors, stock exchanges and the supervisory board (*Aufsichtsrat*). As a result of the ongoing discussion, the German Bundestag on October 10, 2020, formed an investigative committee.⁸

On October 26, 2020, the German Treasury published its FISG Draft Act. Simultaneously, at the EU-level, ESMA launched its FTPR and published its findings on November 3, 2020.⁹ It remains to be seen to what extent the FISG Draft Act will be further aligned to the findings of the 2020 Peer Review during the legislative process. Since then, ESMA has on March 3, 2021, published its own recommendations to the European Commission on how to improve the Transparency Directive (see discussion that follows).

Meanwhile shortcomings and ultimately supervisory intervention has followed in respect of the Greensill Group and the German-based Greensill Bank AG (see discussion below).

Much of what happened at Wirecard and now separately at Greensill and its auditors is still subject to ongoing investigation and civil claims, including under collective action legislation that was recently introduced by way of an EU regulation.¹⁰ BaFin has come under fire for its handling of critical investors and journalists and failing to raise questions regarding Wirecard, and for having failed to act with respect to information provided by tip-offs and whistleblowers.¹¹

Moreover and perhaps more fundamentally, irrespective of the remediation and reform efforts, the German Federal Finance Ministry has itself been subject to a number of criticisms. These range from the inadequate oversight of BaFin, FREP and

7 The following table summarizes the main developments and policy proposals issued as a result of the Wirecard case:

June 25, 2020	The European Commission requests ESMA to conduct a FTPR on Germany's transposition of the Transparency Directive as supplemented by the GLEFI.
June 30, 2020	The German Ministries of Justice and Consumer Protection and Finance terminated the recognition agreement with the FREP – which formed the basis of the two-step enforcement process. The termination will come into effect on December, 31, 2021. As of the time of writing, no new recognized body has been appointed.
July 15, 2020	ESMA launched its first fast track peer review at the request of the European Commission.
July 23, 2020	German Federal Minister of Finance Scholz published a 16-point action plan to strengthen the supervision of complex multi-jurisdictional groups and audits.
October 6, 2020	The German Federal Finance Ministry and the German Ministry of Justice and Consumer Protection jointly propose an "action plan to combat balance sheet fraud and to strengthen and supervise capital and financial markets", which forms the foundation of the FISG Draft.
October 10, 2020	The German Parliament, the Bundestag, formed an investigative committee <i>inter alia</i> on political involvements in Wirecard and its supervision by BaFin. The investigative committee is still ongoing and currently hearing witnesses.
October 26, 2020	The German Federal Finance Ministry published the ministerial draft of the FISG.
November, 3 2020	ESMA publishes its findings of its FTPR. In short, ESMA finds that FREP and BaFin fully or partially meet ESMA's expectations. ESMA concluded with recommendations to: strengthen the independence of BaFin from supervised entities as well as the Federal Finance Ministry; enhance coordination and exchange of information between competent authorities; improve market monitoring (whistleblower, international media); and upgrade internal conflicts of interest policies at BaFin.
December 14, 2020	APAS' chief executive admitted under questioning in the investigative committee to trading of Wirecard shares and was subsequently released from his position.
December, 16, 2020	The German cabinet endorses a revised Draft FISG and proposed the Act to the German Parliament, the Bundestag.
January, 20, 2021	The press reports that BaFin intends to revisit the qualification of groups with bank subsidiaries that do not qualify as financial holding companies (see below for assessment).
January 28, 2021	The press reports on leave of absence and criminal charges being filed against a BaFin employee for alleged insider trading.
January, 29, 2021	The BaFin announced that Felix Hufeld, President of BaFin for eight years, will make way for new leadership. Mark Branson, the Chief Executive of the Swiss financial services regulator FINMA, who has held that position since 2014, is appointed.
February, 2, 2021	German Federal Minister of Finance Scholz publishes action plan for internal reorganization of BaFin.

8 Committee of Enquiry 19/22240, 19/22996.

9 See Report [here](#) and Press Release [here](#).

10 For further information on the EU's Collective Action Directive see [here](#).

11 Which also now benefits from EU-wide regulation in the form of the Whistleblowing Directive – see the first edition in our dedicated series on this development and its impact on financial services firms available [here](#).



APAS to the lack of independence of BaFin from issuers and government. This is a point that ESMA critiqued heavily and which the Scholz Seven-Point Plan does not address. Specifically, concern has been expressed about the insufficient supervisory scrutiny by the German Federal Finance Ministry over BaFin in its interactions with various market participants as well as BaFin's own supervisory staff's personal account dealings in Wirecard's publically listed securities or derivatives.¹² A number of staff members who engaged in such dealings have already been subject to investigation and disciplinary action including dismissal. Senior-level resignations have also been tendered. Further action may be forthcoming from both ESMA and EU-level authorities, yet those plans may go beyond what is being proposed in Berlin in respect of BaFin and its staff in Bonn and Frankfurt, given criticism that some of the recommendations in ESMA's report have yet to be reflected in full.

In the interim and very much in response to the domestic criticisms and blame being attributed to failures of the present system of supervision of accounting and financial services, the German Finance Minister, Olaf Scholz¹³ issued a 16-point plan in the summer of 2020. On February 2, 2021, a further seven-point plan and three overarching principles (the **Scholz Seven-Point Plan** – as detailed in the QuickTake above), based also on proposals from consulting firm Roland Berger, KPMG Legal (separate to the team working on Wirecard) and Sopra Steria, was published. The Scholz Seven-Point Plan sets out the target objectives of a more robust and capable BaFin but does not set out a definitive roadmap on how these reforms should be fully implemented. Separately a number of staffing changes have been proposed or are being advanced.¹⁴

In addition to shortcomings at BaFin, the German federal government cancelled the contract with the private sector body FREP in June 2020, given that the self-regulatory organization of the auditing industry was seen to not be serving its intended purpose. Meanwhile the governmental Auditor Oversight Body (*Abschlussprüferaufsichtsstelle*) (**APAS**), which is a body in the German Federal Office for Economic Affairs and Export Control (**BAFA**), is set to be significantly strengthened, giving it power to impose tougher sanctions on rule violations and companies will be required to replace auditors every 10 years. Following such changes, the Big 4 auditing firms would also be required to establish a greater separation between auditing and consulting services – a move that is being echoed across certain EU-27 jurisdictions and also in the UK in light of similar shortcomings. APAS' chief executive was under investigation and subsequently dismissed in December 2020 due to his buying and selling shares in Wirecard while APAS itself was investigating Wirecard's auditor.

Several auditors of financial services firms and fintech firms are either on notice, or in the case of Wirecard's auditor, subject to investigation and/or pending legal action due to various failings and the absence of required or appropriately implemented systems and controls. Some auditors' mandates have been suspended or terminated by financial services firms or by BaFin, notably following developments concerning Greensill.

In addition to the above, BaFin had already communicated in January 2021 that it would employ greater supervisory scrutiny in respect of the German Stock Exchange – Deutsche Börse, as well as firms with a similar perceived risk profile as Wirecard. The developments at Greensill have been

¹² The review of transactions between January 2019 and September 2020 yielded more than 500 personal account dealing transactions by BaFin supervisory staff in Wirecard's publically listed securities and derivatives.

¹³ Who is equally expected to stand for as the lead candidate of the Social Democrat Party (SPD) in Germany's September 2021 elections and if successful would be set to become Chancellor of Germany, thus replacing Angela Merkel.

¹⁴ The most recent version of this plan is available (in German) [here](#) and in a corresponding speech [here](#).

an opportunity for BaFin to put that commitment into practice. Independent of this most recent development, a number of fintech firms had, already since the start of 2021, been informed of a change in their regulatory categorization, including that their group is a financial holding company. Such changes in categorization mean that such firms are subject to greater on-going compliance and reporting requirements. Furthermore and in a wider-reaching change across financial markets, a number of departures of analysts covering Wirecard and other peers for financial services firms has already been set in motion.

In summary, while BaFin had previously only been responsible for supervising Wirecard Bank as opposed to the entire group, this is set to change. One of the reform areas proposed is for BaFin to also supervise complex groups. This includes financial holding companies and mixed financial holding companies, which are themselves now subject to increased scrutiny as well as Banking Union supervision courtesy of CRD V changes that were announced in 2019 and which come into force in June 2021.¹⁵ A new reformed “BaFin 2.0” is being pushed by the German Federal Finance Ministry as being able to operate on a par with or even be the pinnacle of the world’s best supervisory authorities. That being said, until BaFin has been fixed and further staffed, other key changes, such as the extension of its remit to take over the direct supervision of the approximately 37,000 plus independent financial advisors into its remit, have been put on hold.¹⁶

This type of development may not be new in a number of jurisdictions, including across Europe, but it is comparably new for Germany in the extent of what went wrong. Similar issues emerged over the border in Austria not only in light of Wirecard’s Austrian connections but also in respect of the Austrian NCAs’ similar issues with Commerzialbank Mattersburg, which came to light in an equally complex accounting scam, and which has since ended in insolvency. Austria’s financial services regulatory and supervisory authorities have not been investigated for their own failings by ESMA, even if domestically investigations and hearings are underway.

15 See coverage from our Eurozone Hub available [here](#).

16 Please see coverage from our Eurozone Hub on the proposed extension of remit as originally planned, available [here](#).





The German regulatory framework on periodic transparency of listed companies

Before exploring the findings of ESMA and the regulatory responses, it is worth recapping the complex multi-layered compliance framework of listed financial firms in Germany so as to understand why FISG is pressing for reforms in this area, as is ESMA, notably in its letter to the European Commission on proposals to improve the EU's Transparency Directive (as discussed below).¹⁷

At its core, periodic disclosure by single corporate entities is governed by the German Trade Code (*Handelsgesetzbuch* – **HGB**), which transposes the EU Accounting Directive into German law and sets out the general principles of accounting in proportion to the size of a company. Companies listed on a stock exchange (*kapitalmarktorientierte Kapitalgesellschaften*) are thereby deemed to be large entities and as such subject to the most extensive set of rules, requiring

such firms to set up an annual report, a profit and loss account, an annex and management report, which has to be confirmed by a responsibility statement (*Bilanzeid*) of the board of directors. The same applies to financial institutions.¹⁸ Annual accounts as well as management reports are subject to auditing and publishing.¹⁹ This set of rules is complemented by Germany's implementation of the Transparency Directive²⁰ and the ESMA Guidelines on the Enforcement of Financial Information (**GLEFI**)²¹ in Germany's Securities Trading Act (*Wertpapierhandelsgesetzbuch* – **WpHG**). The periodic transparency rules in the WpHG apply to domestic issuers (*Inlandsemittenten*). They mirror the HGB framework²² and, furthermore, require domestic issuers to prepare half-yearly reports, i.a. abridged financial statements and abridged management reports, which

17 Details of which are available [here](#).

18 Section 340k HGB.

19 For credit institutions see Section 340l HGB.

20 Directive 2004/109/EC as amended notably by Directive 2013/50/EU.

21 ESMA Guidelines on enforcement of financial information, ESMA/2014/1293 as of 28 October 2014.

22 Section 114 WpHG for annual accounts.



are not subject to mandatory auditing.²³ In respect to the accounting method for individual accounts, firms may choose between German, i.e. HGB based accounting, and accounting according to international standards (**IFAS**).²⁴ Stock exchanges, and the FWB in particular, require firms listed on premium segments, such as the Prime Standard, to use IFAS accounting.

For listed companies, annual and semi-annual periodic disclosures are subject to the enforcement procedure,²⁵ which aims to ensure compliance of financial accounting with legal requirements, including financial accounting standards, whether IFAS or HGB.²⁶ The responsibilities in this enforcement procedure are shared between BaFin and the FREP. The FREP is a private organisation certified by the Ministry of Justice as an “inspection body” (*Prüfstelle*).²⁷ It conducts random and incident-related “inspections” on periodic disclosure. The latter may only be initiated upon request of BaFin, and the FREP will report back to BaFin on its findings. Under the current framework, BaFin may only engage in such inspection itself in case the inspected entity refuses cooperation with the FREP or in case of significant doubts as to the findings in

FREP’s report. In the event that FREP reports errors in the financial statement, the BaFin as a public authority will then formally determine the error, decide on its publication and on notices to other public authorities, including the prosecutor’s office.

On the corporate governance side, German listed entities are typically organized as companies limited by shares (*Aktiengesellschaft – AG*) and therefore organised in a two-tier board system consisting of a management and a supervisory board. Under corporate law at least one member of the supervisory board of a listed company is required to be proficient in financial accounting or a separate audit committee (*Prüfungsausschuss*)²⁸ has to be appointed.

23 Section 115 WpHG.

24 We note that the latter does not fully liberate firms from the obligation to prepare HGB accounts for other purposes.

25 Section 106 et seqq WpHG.

26 Section 106 WpHG.

27 See Section 342b HGB.

28 Section 340k HGB.

ESMA's peer review of Germany's implementation of the Transparency Directive

Following a request by the European Commission²⁹, ESMA was the first to respond to the collapse of Wirecard by launching the FTPR on July, 15, 2020 on the topic of the supervisory responses of BaFin and FREP and the events leading to the collapse of Wirecard (**2020 Peer Review**). The FTPR is an innovative regulatory tool that allows a Peer Review Committee (**PRC**) to conduct an expedited assessment of the compliance of national competent authorities (**NCA**) with EU law. In summary, ESMA's FTPR in 2020 assessed the application by BaFin and FREP of the GLEFI and on legal and procedural impediments to the effectiveness of the German two-tier supervisory system for financial reporting.³⁰ The review assessed the standards as they existed

at BaFin and FREP prior to (2015-2018) and following the Wirecard scandal (2019-2020). Importantly, the FTPR was limited and did not assess the accounting methods used but rather concentrated on evaluating the regulatory oversight aspects of the Wirecard collapse.

It is worth noting that in 2017, ESMA already conducted a peer review into Germany's implementation of the Transparency Directive in respect to the GLEFI guidelines 2, 5 and 6 (**2017 Peer Review**).³¹ Such a periodic peer review is conducted by an Assessment Group (**AG**), which assesses compliance of multiple NCAs. The following table sets out and compares the results of both reviews:

	2017 Peer Review	2020 Peer Review (Wirecard)
Guideline 2 – human and financial resources	<ul style="list-style-type: none"> The AG acknowledges that BaFin and FREP staff are highly skilled and highly experienced. The AG suggests extending the contracts for Panel Members in FREP, which could ease the management of conflicts of interests. 	<ul style="list-style-type: none"> BaFin and FREP fully meet ESMA's expectation on resources. Contracts for Panel Members in FREP should be extended. Simultaneous examinations should be subject to prioritization.
Guideline 3 – independence <i>How do competent authorities manage conflicts of interests?</i>	n/a	<ul style="list-style-type: none"> FREP fully meets ESMA's expectations regarding Wirecard, on a general matter it may consider restrictions on access to information, trading and holding of securities, and supervisory board seats of Presidential Board members. BaFin partially meets the expectations. The PRC identified "severe" deficiencies in BaFin's internal control system which lacks information on staff securities holdings; also it identified a risk of government influence from the Treasury in handling the Wirecard investigation.

29 Request dated 25 June 2020.

30 In Germany, the enforcement of financial information is performed in a two-tier system. FREP is responsible for examining in the first tier whether the information referred to in the EU's Transparency Directive is drawn up in accordance with the relevant reporting framework. BaFin is the central competent authority responsible for examinations in the second tier and for taking appropriate measures in case of infringements.

31 Such Peer Review was conducted in seven Member States, including Germany (in relation to the 2014 annual financial statements and 2015 semi-annual statements, 2015 annual financial statements).

<p>Guideline 5- selection method</p> <p><i>How are companies selected for the enforcement procedure?</i></p>	<ul style="list-style-type: none"> • The AG praises FREP’s change in its selection model. By applying a mixed model combining risk, rotation and random approaches, the AG believes that companies that are at a high risk of misstatements are selected. Entities with higher capitalization and higher impact on financial markets are exposed to greater attention from the media and are thus more likely to be selected based on abstract risk than smaller issuers. The rotation approach ensures that companies in the main indices are reviewed every 4/5 years. • AG asserts that most risk factors identified by FREP are based on media information. FREP should enhance procedures to identify abstract risks based on other sources (databases, equity research reports etc). • The interaction between BaFin and FREP in selecting the issuers for examination should be enforced. BaFin should share information with FREP on market abuse and grounded complaints. 	<ul style="list-style-type: none"> • FREP’s risk based approach fulfils the expectations. It should improve its review of the (international) press and other sources. BaFin should not solely rely on FREPs review of media but should perform its own assessment. <p>Wirecard: 2014-2018</p> <ul style="list-style-type: none"> • FREP partially meets the expectations. It failed to take into account the allegations in the Financial Times and in Germany’s “Manager Magazin” as well as information from whistleblowers and did not select Wirecard in 2015, 2016 or 2017 based on concrete risk nor included it in the abstract risk pool during these years. • BaFin largely met the expectations between 2015 and 2018. It did not request an examination itself. <p>Wirecard: 2019/2020</p> <ul style="list-style-type: none"> • FREP and BaFin met the expectations in 2019 and 2020 when selecting Wirecard’s 2018 reports based on risk.
<p>Guideline 6 – effective way of enforcement</p> <p><i>How effective are the enforcement procedures?</i></p>	<ul style="list-style-type: none"> • BaFin appears to take a comparably “legalistic approach” on accounting issues compared to other NCAs. Because the IFAS are principle-based, the AG opines that in most cases enforcers should give more weight to economic substance than legal form. • The FREP database should be improved to include information about most relevant issues. • The content, timing and means of dissemination of infringements to the market could be improved. • FREP should be independent in appearance (not only in substance). Policies should be implemented especially in regard to relationships to inspected entities and auditors. • FREP’s selection model could be enhanced and synergies improved if BaFin would exchange information with FREP. 	<p>Wirecard: Enforcement procedure of 2014 annual statement</p> <ul style="list-style-type: none"> • FREP has partially met the expectations. Severe deficiencies and some material risks were left unaddressed; delays in the examination by FREP were caused by competing examinations. • BaFin was not involved as no errors were identified by FREP. <p>Wirecard: Enforcement procedure of 2018 semi-annual statement</p> <ul style="list-style-type: none"> • FREP largely meets the expectations, the shortcoming neither impaired the overall effectiveness not left material risks unaddressed as these were addressed, albeit at a later stage; the timeliness of the scope expansion was slow. • BaFin s involvement was limited to checking the examination, it could have expanded the scope earlier.

The results in the table above should however be read in the context of a summary of recommendations that ESMA included in its FTPR on BaFin and FREP, thus making BaFin's comprehensive reform not only unavoidable but also an EU priority as opposed to just a national one. In terms of shortcomings, ESMA identified the additional overarching issues that the Scholz Seven Point Plan picks up but perhaps only in part:

1. BaFin should have independence from issuers and government, but there was a lack of information about BaFin's employees' personal account dealing, thus raising doubts on the robustness of the BaFin's internal control system regarding conflicts of interest as well as a heightened risk of influence by the German Federal Government, notably through the Federal Ministry of Finance, given the frequency and detail of BaFin's reporting, sometimes following actions taken. Equally, BaFin should be independent of and not have an overreliance on FREP and its staff – which going forward will no longer be an issue. It was also recommended that the AOB can inform BaFin about violations of audit regulations, including their nature and severity, in order to enable an assessment regarding the risk that the financial statements of an issuer may be erroneous.
2. Market monitoring (including in relation to the international media signals) by both BaFin and FREP was inadequate. Notably the non-selection or non-timely selection of Wirecard's financial reports for examination based on risks during the period between 2016 and 2018 was a failing.
3. FREP's examination procedures for Wirecard's financial reports were insufficient in that the scope of the examinations did not appropriately address areas material to the business of Wirecard, nor the media and whistle-blowing allegations against Wirecard. Moreover, the analyses performed (level of professional skepticism, timeliness of examination procedures, assessment of disclosures) and their documentation were insufficient.
4. Further failings were present more broadly in the effectiveness of the supervisory system in the area of financial reporting. Notably this includes the operations and the respective roles of BaFin and FREP in the case of (indications of) fraud in financial reporting. BaFin and FREP are not aligned in the perception of each other's role and the limitations and possibilities that both have in the context of the two-tier system. More specifically, BaFin was not put in the position to thoroughly assess FREP's examinations of Wirecard, which would have enabled BaFin to determine whether it should take over the examinations from FREP. Specifically, the strong confidentiality regime, by which both institutions are bound, may have hindered the exchange of relevant information between them and with other relevant bodies, including timely escalation to the public prosecutor. In a more wide-reaching criticism, ESMA concluded that there was widespread evidence of a lack of coordination and inefficiency in exchange of information between relevant teams in BaFin.
5. Improving oversight of conduct of supervisory staff joining from supervised entities or from issuers with securities admitted to trading on regulated markets (or those who audited or counselled issuers as part of their previous employment) with regards to (i) cooling-off periods; and (ii) the additional notice to them regarding obligations to disclose any conflict of interest.

Other responses – a push for more Europeanization of financial services beyond the Banking Union?

Consequently, given the conclusions reached by ESMA and the German domestic policymaker response, a number of domestic but also EU-level commentators and policymakers have claimed that it might be the right time to press ahead with reforms that would otherwise have been sidelined by NCAs and national policymakers protecting what may have been considered “national champions”. These proposals on the reform of BaFin may have wider-reaching consequences beyond reforming BaFin and instead serve to shape EU policymaking and the pace of further Europeanization of oversight generally and the roles of respective levels in the current ESFS, especially given the calls for a single Capital Markets Union supervisor.

Influential think tanks such as the Leibniz Institute for Financial Research SAFE (Sustainable Architecture for Finance in Europe) at Goethe University Frankfurt have published extensively on the lessons and policy options for the EU following Wirecard. More recently, Professors Dr. Jan Pieter Krahn and Dr. Katja Langenbucher (and others) have gone so far as to (sensibly) call for a European Single Markets Supervisor (**ESMS**) that would build upon and effectively supercharge ESMA’s mandate but based on principles now well established in the Banking Union i.e., direct EU-level and indirect NCA-level supervision.³² ESMA would be a frontrunner to which such an ESMS upgrade could be applied, as echoed by Ignazio Angeloni,³³ who stated that the EU’s Banking Union should act as a model for empowering ESMA following Wirecard.³⁴

ESMS would harmonize supervisory standards and practices across EU Member States, effectively substituting for established national practice. The enforcement following the EU’s Single Rulebook could also, as advocated by Krahn & Langenbucher, be restricted to a subset of all firms, such as (i) all listed firms, or (ii) all listed firms in a particular size class, or (iii) all firms included in an index, in which case established national practice vis-à-vis smaller firms is left unaffected.

Whether that happens will be decided in Brussels as opposed to Berlin, Bonn or Frankfurt but it does echo calls of other EU policymakers, including those issued by the European Supervisory Authorities, such as ESMA, as well as the European Central Bank and Single Resolution Board in their Banking Union supervisory roles. In short, Krahn & Langenbucher’s proposals suggest the European Commission and EU legislative policymakers might consider the following points regardless of any ESMS:

- **“Suggestion 1 (Information flow: whistleblowing):** To start investigations in a timely manner, early providers of information (whistleblowers) must be heard by the relevant parties and be taken seriously. We recommend developing a supervisory strategy allowing for an effective screening of the many voices raised and encouraging whistleblowing from within or outside publicly listed firms. Such a strategy may include substantial financial incentives for whistleblowers.” This proposal to pay rewards to whistleblowers, while borrowing from experiences in the United States, has long been debated and subsequently dismissed by EU-level policymakers as the wrong form of incentive.

32 See SAFE Policy Letter No. 88 July 2020 available [here](#) and a Study (SAFE White Paper No. 74) requested by the influential ECON Committee of the European Parliament “What are the wider supervisory implications of the Wirecard case” available [here](#).

33 Ignazio Angeloni, prior to taking up fellowships at SAFE and at the Mossavar-Rahmani Center for Business and Government at the Harvard Kennedy School, was a member of the supervisory board of the ECB and head of the Financial Stability and Macroeconomic Policy Department of the ECB that led the preparation of the establishment of the Banking Union’s Single Supervisory Mechanism in the ECB. Prior to joining the ECB, Angeloni held leading positions at Italy’s Ministry of Finance, the Bank of Italy and the International Monetary Fund. He regularly publishes extensively on economics, finance, banking and European integration.

34 See publication [here](#).

- **“Suggestion 2 (Information flow: short selling):** A short sale ban is an asymmetric intervention that prevents critical information being reflected in the price. As prices are also important signals to market participants, management, and supervisors, having such information in the price is important. Therefore, we recommend making the conditions under which supervisors may enact short sale prohibitions significantly more restrictive.” Such a proposed change would go against much of the established principles that were put in place by the EU legislative policymakers in the EU’s Short Selling Regulation, itself a response to the 2010-2012 sovereign debt crisis, so widespread action here is unlikely.
- **“Suggestion 3 (External audits):** We suggest a reform of external audits to strengthen auditor accountability. It is not that Wirecard is different, or a special case, but that there is a common refrain to accounting scandals. Therefore, the law, not just professional standards, should unmistakably state that auditors’ professional skepticism and reasonable checks to uncover accounting manipulations and accounting fraud are an integral part of an external audit. The market supervisor and the audit oversight body also need to spell out their expectations for auditors that certify financial statements as providing a true and fair view. To strengthen auditor incentives as well as penalties for weak audits, auditor liability should be raised considerably. Finally, we recommend reviewing the effectiveness of existing public audit oversight bodies. At a minimum, these bodies should publicly disclose summary metrics about their inspection findings for individual audit firms, as this would provide valuable information about auditor quality to clients and investors.” This is an area that is earmarked for reform by both EU and national policymakers.
- **“Suggestion 4 (Internal controls and supervisory board oversight):** The Wirecard experience suggests strengthening companies’ internal controls and the oversight role of supervisory boards. At a minimum, the law should require that publicly listed firms have an appropriate and effective internal control system. External auditing of this control system should be considered. A mandate would reinforce our Suggestion 3 as it would clarify the role of auditors in detecting accounting fraud. Supervisory boards need access to critical information independent from management. Therefore, the head of the internal control function should report to the supervisory board (as external auditors already do). To strengthen supervisory board oversight of external audits, publicly listed companies should be required to have a dedicated audit committee. The chair of this committee needs to be independent and a financial expert. In addition, the majority of the audit committee members need to be independent.” Most of this suggestion is either specific to dual-board company structures, which do not exist in all EU-27 jurisdictions, or applies existing EU financial regulatory principles to non-financial corporates.
- **“Suggestion 5 (Enforcement of financial reporting):** The legal framework for enforcement [in the context of BaFin] is shaped by EU law but includes German specificities. While general market oversight is entrusted to BaFin, the Wirecard case shows that its investigative powers are too limited as far as financial reporting oversight is concerned. Additionally, a Germany-specific two-step enforcement structure has made the system prone to latency and created unclear responsibilities and accountability in cases of accounting fraud. We suggest reforming the two-step enforcement procedure, making BaFin the only competent authority. BaFin can enlist the help of bodies like FREP for the enforcement of financial reporting, if they wish so, but the powers and accountability remain entirely with BaFin. As to the European framework, we suggest strengthening the mandatory competencies granted to supervisory authorities under the Transparency Directive. They should have investigative and enforcement powers modelled on the strictest standards available under Market Abuse Regulation.” This suggestion generally follows the conclusions set out in ESMA’s FTPR.

- **“Suggestion 6 (Overarching market oversight mandate):** More generally, the Wirecard case shows that BaFin, as the responsible agency, did not or could not live up to its overarching mandate to protect investors and market integrity. Along with strengthening its powers, we propose to clearly establish the supervisory agency’s accountability for fulfilling this overarching oversight mandate in substance. This accountability requires an appropriate level of institutional independence as well as sufficient resources to fulfil its tasks.” This suggestion generally follows the conclusions set out in ESMA’s FTPR.
- **“Suggestion 7 (Market oversight agency):** The Wirecard experience offers lessons beyond the failure of internal controls, auditors and the market supervisor. We read it also as an illustration of a mismatch between national Member State’s historically grown institutions (and cultures) and the introduction of a European regime. Reaping the benefits of a truly unified European CMU will require addressing such mismatches. We propose to create a single, responsible market oversight institution at the European level, which may be called the European Single Capital Market Supervisor (**ESCMS**). Such an institution would address ripple effects to other countries within the same European capital market that scandals like Wirecard create. In addition, it would help to overcome regulatory fragmentation, conflicts of interest due to national competition in the markets for goods and services as well as regulatory arbitrage and capture.” This suggestion basically echoes the ESMS concept above (see also comments below).
- **“Suggestion 8 (European market oversight):** A Europe-wide market oversight system will require the expertise of national markets, with their idiosyncrasies in corporate law, insolvency law and more. We propose to build the European oversight architecture with the existing national agencies as branches of an integrated European supervisory network. The ESCMS serves as the apex layer in the network, to which all national agencies are reporting. A hub-and-spoke architecture of this type will also introduce an element of institutional independence into national agencies.” This would effectively echo the core institutional set-up of the Banking Union’s Single Supervisory Mechanism and the ECB and NCA’s role therein.

In terms of the ESMS’s set-up, a number of the principles proposed by Krahn & Langenbacher had already been proposed by and assessed by other academic and practitioner commentators, and their approach states:

- NCAs’ national market supervisory agencies/ departments should be integrated into ESMS. As to governance, the ESMS would be independent from the Member States, but also from the EU Commission. A core issue is to provide the apex institution with the necessary staff to carry out its role as supervisor. Taking Germany as an example, Krahn & Langenbacher suggest that the market supervisor currently is a department within the BaFin. It would have to be integrated as the German branch of the ESMS.
- Under this approach all aspects of market integrity would be covered, including from tradeable securities and other financial instruments (including OTC derivatives), thereby protecting investors and allowing for fair and transparent pricing of such financial instruments. The competences of ESMS could comprise all features covered by current market conduct NCAs, including prospectus audit, market abuse, insider trading, as well as the oversight as to price formation, disclosure and market infrastructure.
- ESMS could be institutionally set up on a hub and spoke model similar to the mechanics that have been applied in the Banking Union. ESMS would headquarter all back end and central services with a network of national branches carrying out the day-to-day supervisory work on the ground. To the extent that today’s supervisory agencies become part of, or collaborate with, the new ESMS system, the personnel is contracted by, and reports to the ESMS.

The above is just an experiment in hypothetical policymaking and not a proposal. It is therefore worth turning to an assessment of ESMA’s findings and contrasting these with the Scholz Seven-Point Plan, prior to looking at the latter’s impact on BaFin supervised financial services firms as an ESMS or such a similar new body will still be a long way off, regardless of the Europeanization of financial services rulemaking and supervision, which is set to gather pace in 2021 and beyond.

ESMA expresses its own recommendations to the European Commission on the Transparency Directive

On March 3, 2021, ESMA published the proposals it had sent to the European Commission on how to improve the EU's Transparency Directive (TD) following Wirecard.³⁵ It focuses on the enforcement of financial information generally and specifies that ESMA should modify the TD to meet four aims:

1. Enhance cooperation between authorities across the EU via:

- Eliminating confidentiality impediments that prevent an efficient and effective exchange of information between TD competent authorities (i.e. NCAs) and MAR/Prospectus NCAs, audit oversight bodies, prudential supervisors, and Anti-Money Laundering (AML) supervisory authorities;³⁶ and
- Developing RTS on cooperation and information exchange between accounting enforcers and audit oversight bodies, prudential supervisors as well as, where relevant, with AML supervisors.

2. Enhance coordination and governance on a national level via:

- Requiring that national transposition measures clarify the responsibilities, reporting obligations and roles when delegation or designation models concerning enforcement of financial information are implemented; and
- Including regular review clauses to ensure that delegation and designation models are fit for purpose.

3. Strengthen independence of the NCAs via:

- Not allowing the outsourcing of the task of regular examinations of financial information to audit firms; and
- Modifying the TD to ensure that the central competent authority, designated authorities and/or delegated entities and their staff are independent from market participants and they perform their duties and act independently from governments.

4. Strengthen harmonized supervision of information across the EU via:

- Modifying the TD, to ensure that the powers of accounting enforcers are harmonized across the EU. Notably, to ensure that all accounting enforcers, including the delegated entities and designated authorities, have the binding powers to request information and to require corrective information;
- Supplementing the powers of NCAs to, amongst others, require an independent second audit or forensic examination and carry out joint on-site inspections or investigations;
- Reinforcing ESMA's role in financial reporting by including the IAS Regulation into Article 1 (2) of the ESMA Regulation; and
- Strengthening consistent application and enforcement of disclosures related to "alternative performance measures".

The proposed modifications to the TD are based on ESMA's experience gained while coordinating the enforcement of financial information in Europe, notably, when preparing reports, discussing supervisory cases or preparing statements and opinions. In addition, the letter addresses some of the deficiencies encountered when conducting the ESMA Peer Reviews on the application of Guidelines on Enforcement of financial information in 2017 and in the context of the Wirecard case."

³⁵ Details of which are available [here](#).

³⁶ It should be noted that the inclusion of the cross-reference to AML authorities aims to support the EU's overall efforts to create a more uniform AML and financial crime prevention framework.

Impact on BaFin supervised financial services firms and outlook

Financial services firms that are supervised by BaFin or are looking at becoming supervised will likely have to contend with a sharper tone in supervisory scrutiny from BaFin. One thing is certain is that, aside from receiving a broader toolkit and enhanced supervisory powers, BaFin will likely be recruiting many more supervisory staff, including auditors, given that BaFin only employed five full-time employees as auditors and instead relied on the work of auditing firms – which may have led to overreliance.

The replacement of key senior management personnel (including its president and deputy president/chief executive director of securities supervision/asset management) is likely to shape the tone of BaFin's supervisory scrutiny in its reformed set-up. The German state secretary in the Federal Ministry of Finance has communicated that any new president of the BaFin, while needing to speak German, should have an international background as well as a track-record of independent analytical and leadership expertise and does not need to be a German citizen. The appointment of Mark Branson, a British-Swiss national who has acted as chief executive at FINMA, the Swiss regulator, since 2014, certainly seems to fit the bill in terms of setting a new tone from the top. That being said, Branson is faced with the not so easy task of repairing BaFin's reputation and fulfilling the Scholz Seven-Point Plan.

Looking beyond the new management appointments, improving and increasing the amount of supervisors (with a better organizational culture) is an immediate solution in need of applicants. Regardless of the timely and welcome reforms being rolled-out at BaFin, further steps in the Europeanization of rulemaking and filling the gaps in supervision that have been exposed by both Wirecard and Greensill are set to dominate the remainder of 2021 and well through to the end of the 2022 supervisory cycle.³⁷

The issue for supervised institutions (regardless of business model) will be that all of these domestic changes, while timely, welcome and necessary, may in turn translate into higher supervisory costs. Some domestic market participants have stated they are unlikely to be wanting to pay domestic costs if EU-level supervision is being driven forward. This is a consideration for EU and domestic policymakers across the EU-27 in how to balance the right type of EU-led supervision that works hand in hand with domestic expertise while at the same time ensuring that increased costs are not passed on by supervised institutions to their counterparties and perhaps more importantly not to end-customers and thus consumers.

If you would like to discuss how any of the developments discussed above may affect your business as well as the present opportunities for you or your clients more generally, please contact our [Eurozone Hub](#) or our key contacts.



³⁷ It should be noted that the JURI and ECON Committees of the European Parliament on March 23, 2021, held a further public hearing on Wirecard. For more details on that, please click [here](#). Further hearings on Greensill and other recent developments that have attracted supervisory scrutiny are likely to follow.

Key contacts:



Dr. Michael Huertas

Partner, Co-Head Financial
Institutions Regulatory Europe
D +49 69 45 00 12 330
M +49 162 2997 674
michael.huertas@dentons.com



ABOUT DENTONS

Dentons is the world's largest law firm, connecting talent to the world's challenges and opportunities in more than 75 countries. Dentons' legal and business solutions benefit from deep roots in our communities and award-winning advancements in client service, including Nextlaw, Dentons' innovation and strategic advisory services. Dentons' polycentric and purpose-driven approach, commitment to inclusion and diversity, and world-class talent challenge the status quo to advance client and community interests in the New Dynamic.

dentons.com