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Jan Krahnen | Katja Langenbucher

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policy_center@safe-frankfurt.de | www.safe-frankfurt.de

The Wirecard lessons: A reform proposal for the supervision of securities markets in Europe*

Jan Krahnen, Goethe University Frankfurt and SAFE
Katja Langenbucher, Goethe University Frankfurt and SAFE[1]

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Abstract

The Wirecard scandal is a wake-up call alerting German politics to the importance of securities market integrity. The role of market supervision is to ensure the smooth functioning of capital markets and their integrity, creating trust among and acceptance by investors locally and globally. The existing patchwork of national supervisory practice in Europe is under discussion today, in the wake of Brexit that will end the role of London as a de-facto lead supervisor in stock and bond markets. A fundamental overhaul of a fragmented securities markets supervisory regime in Europe would offer the potential to lead to the establishment of an independent European Single Market Supervisor (ESMS). Endowed with strong enforcement powers, and supported by the existing national agencies, the ESMS would be entrusted with ensuring a uniform market standard as to transparency and other issues of market integrity across Europe. This would not rule out maintaining a variety of market organization structures at the national level. The ESMS would need executive powers in the world of markets (i.e. securities and trading), much like the SSM in the world of banking. To fill this new role, ESMS would have to be established as a new, independent institution, including an enormously scaled up staff if compared, e.g., to ESMA.

1. Background: The Wirecard case is a wake-up call, but not specific to the extant institutional set-up

The past few days have exposed the German supervisory agency Bafin to a series of allegations, questioning its role as a trusted authority that ensures the integrity of the securities markets in Germany. In hindsight, Bafin is accused of having neglected early warnings of misconduct by Wirecard,

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when such claims had been raised by FT journalists as early as 2015, culminating in FT reports in early 2019. Suggesting the opposite, namely a manipulative short sale attack on Wirecard (ab)using FT journalists, Munich prosecutors had opened an investigation in 2019. Following up on this prosecution and extreme volatility in markets, Bafin intervened in February 2019, issuing a short sale ban of Wirecard shares for two months.[2] While a prohibition of this type has to do with market volatility, not with the veracity of the information, small and household investors, who accounted for a large part of Wirecard's investors, may still have interpreted the restriction as a sign of support for Wirecard management, hence possibly influencing expectation formation as well as pricing.

Could Bafin have intervened earlier? While Wirecard Bank AG, a subsidiary of Wirecard AG, is under direct Bafin supervision but had not run into trouble, things are more complicated as to Wirecard AG. That parent company, a payment processor and financial services provider, and typical "FinTech" had been considered a technology company, hence a non-bank. As such, while qualifying for general market oversight of listed companies, it did not fall under Bafin's direct regulatory supervision, because – despite wholly owning Wirecard Bank AG – it was not considered a financial holding company. For that reason, investigating accounting malpractice required Bafin to follow a two-step enforcement procedure provided for by German law. The first step involved the "Deutsche Prüfstelle für Rechnungslegung" (DPR), a private sector, self-regulatory body, findings of which enjoyed legal privilege. Only the second step allows for Bafin enforcement but opinions are mixed on whether and when Bafin could have triggered that second step enforcement procedure.[3]

The Wirecard case is not unique to Germany. The US market supervisor, the Securities and Exchange Commission (SEC), had to acknowledge omissions and failures with respect to accounting and disclosure of relevant information to the market in the past. Cases like Enron, WorldCom or Bernard Madoff come readily to mind, and the damage done in terms of dollars in these cases was often considerably larger than in the Wirecard case.

Still, the damage done in terms of reputation loss in the Wirecard case will be considerable. It comes at a moment in time when Brexit leads to the most distinguished European financial market leaves the Union, when the COVID-19 crisis accounts for volatility and loss on financial markets and when Germany takes over the presidency of the EU council.

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[2] https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Meldung/2019/meldung_190218_Allg_Vfg_Wirecard_Verbot_Leerverkaufspositionen.html. Note in addition, that ESMA signed off the short sell-decision of Bafin in a short declaration on its website, alluding to "threats to market confidence" and "threats to the German financial market" without offering further explanations; see https://www.esma.europa.eu/press-news/esma-news/esma-issues-positive-opinion-short-selling-ban-bafin.

[3] On methods of accounting control, see https://www.bafin.de/DE/Aufsicht/BoersenMaerkte/Transparenz/Bilanzkontrolle/bilanzkontrolle_node.html

Of course, the presidency will offer chances to make things right. The role of self-regulatory bodies like the DPR along with auditing firms will have to be re-evaluated. The proper regulation and supervision of FinTech companies will have to be discussed. Investor protection will have to be accorded a prominent place, coupled with quicker and more efficient enforcement action, with collective redress schemes and possibly rules on securities exchange indices. The lack of a clear investor protection mandate is not specific to Germany – it is a common issue for many European capital markets. Additionally, while important steps have been reached in defining a uniform securities law, which is good, and akin to the status in the US, much remains to be done. Lastly, enforcement remains largely a national issue – a situation which differs sharply from the US. The lack of common enforcement standards risks regulatory capture, facilitating unduly close relationships between supervisor and supervisee, particularly if the supervisee is in competition with firms supervised elsewhere. Too tempting (and incentive-aligned) may be supervisory forbearance in country A if this helps the supervisee in A to thrive when under pressure from a competitor that is supervised in country B.

It seems quite natural that regulatory capture is particularly relevant if many regulators compete in a relatively small geographic region. Thus, in the EU minus UK, there are 27 market regulators – and one might expect rules designed to protect investors to be squeezed and bend. In fact, international investors may discount the laxity or forbearance expected in a market with many geographically separated markets, like the EU market, and raise the required return on capital for firms across the board (see Hail and Leuz, 2006, on the extent to which cost of capital for firms rise in response to weak regulatory enforcement).

To sum up, the Wirecard scandal, while not genuinely a reason for lifting market supervision at the European level, signals fundamental weaknesses of both, regulation and enforcement at the EU level.

A final point on why we may need to shift to a system with stronger investor protection now rather than later: the current double challenge of dealing with the pandemic macro shock and a large investment program, Europe's envisaged Green deal simultaneously, will require a much larger and much better managed European capital market than the cluster of smaller markets we have now. We are convinced that a full harmonization of enforcement policy will be able to give enhanced credibility to Europe's securities law. And credibility, in turn, will be required to manage the huge amounts of debt, both private and public, that are needed to manage the transition through the current crisis, towards a public investment policy that respects a Green deal.

2. Where to go - reform objectives: Ensuring market integrity

The role of the market supervisor may be defined by the term market integrity, as in Austin (2017). This term involves typically three characteristics, the elimination of market abuse activities, fair and

equal common access to the market as well as transparent and accurate corporate information about prices and issuers. Market integrity allows investors, small or large – local or international, to trade with one another on the basis of the same rules and information. That way, market integrity enables trading to be fair.

For a long time, market integrity and its ingredients, fair and homogenous accounting and trading rules, well defined access rules, and strict enforcement of those rules, have been defined as the centerpiece of investor protection against unfair trade. Research has shown that if these criteria are met, the cost of capital for companies tends to be lower (see Hail and Leuz, 2006). In a similar way, a stricter oversight over auditing practice also lowers cost of capital, suggesting that investors take the incentives of auditors to carry out their work in an impartial way into consideration.

A strict market regime, as it is supervised by the agency, may help firms to raise capital from external sources (see Valiante, 2016, p. 213ff).

Market integrity is the main objective of the securities market supervisor, and enforcement is the key condition to make the system work properly. By ensuring prices to be fair, i.e. to reflect in principle all publicly available information, and access to trading venues leveled for all market participants, the market becomes attractive as a trading venue for investors. It also becomes attractive as a place to issue stocks, i.e. to bring securities to the market and to allow investors to share risks and returns.

Since an effective supervisory process can benefit firms and shareholders, it is also an instrument to strengthen the role of capital market financing in a bank-dominated financial system. As of now, the relative importance of capital markets in Europe has remained limited. The market capitalization of the German DAX, the index comprising the 30 largest listed corporations in the largest economy of Europe, is eclipsed by the market cap of any one of the three digital leaders in the US market, Amazon, Apple and Microsoft.

3. How to get there: Options for establishing uniform rule enforcement in Europe's capital market(s)

The establishment of an integrated supervisory process covering the 27 national financial markets could be an important step towards an efficient, deep and resilient capital market in Europe. The difficult question is how to reconcile the idea of one capital market with the given architecture of an only partially harmonized securities law, no central enforcement institution and insufficiently harmonized corporate law, even where corporate actions of immediate impact on the functioning of capital markets are concerned. This is in stark contrast to the US, where not only securities law is mostly federal law. Additionally, Delaware and a small number of other states are key corporate law

players, leading to a de-facto harmonization of corporate law. Where corporate law matters impact on securities trading, the SEC "under the guise of regulating external corporate action - say, disclosure to securities markets - effectively assume control over the underlying governance structure of the corporation, the very internal affairs that state law is said to govern" (Roe, 2003).

A possible route for a unified markets supervision would harmonize supervisory standards and practice across member states, effectively substituting for established national practice. The enforcement following the European rule book may be restricted to a subset of all firms, such (i) as 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.

The key institutional innovation recommended in the Letter is to create a supervisory apex institution with enforcement rights at all levels of the market. Within the sphere of its competences, such key institution would replace the existing national agencies. Parts or all of existing national market supervisory agencies may be integrated into the new supervisory agency, the "European Single Market Supervisor" (ESMS). As to governance, the ESMS would be independent from the member states, but also from the EU COM. 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, the market supervisor currently is a department within the Bafin. It would have to be integrated as the German branch of the ESMS group.4

Under this approach, ESMS has a clear mandate to preserve the integrity of all markets for 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 the new agency comprise all features covered by today's market conduct authorities, including prospectus audit, market abuse, insider trading, as well as the oversight as to price formation, disclosure and market infrastructure. Today, the latter includes all types of exchanges, crossing networks and internalizers, such as banks and large institutional investors.

As to institutional set-up, ESMS consists of a headquarter with all backend and central services, and 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.

Obviously, institutional set-up and competences depend on how the new agency is structured under European law. We can see two tested ways how to establish an agency of this type, either by a

[4] The logic of market operations would suggest CCPs to be part of the market infrastructure and, hence, be supervised by the ESMS, rather than by ESMA.

regulation ("Verordnung"), or by a simplified Treaty revision procedure, Art. 48 para. 1, 6 TEU, decided primarily at the European Council level.

As to the former, the regulation, a potential new agency could follow the model of the Regulation of the European Parliament and the Council, establishing ESMA. While this would offer a somewhat swift and quick procedure to establish the agency, its executive powers would be rather limited, as is suggested by the ruling of the European Court of Justice on ESMA short sale bans.

Alternatively, the new agency could be created through a simplified Treaty revision procedure, following the model of the ESM in 2012. In that case, a ratification by national parliaments is required, however, it will usually be simplified due to the ex-ante consent by heads of state in the course of a simplified Treaty revision procedure.

How to think about ESMS and ESMA

An important organizational question concerns the relationship between ESMS and the European Securities and Markets Authority (ESMA). Three options (perhaps more than 3) are available.

One option is integration: ESMS could be envisaged as part of ESMA. However, the broad supervisory and enforcement jurisdiction we envisage for the ESMS would then not be feasible, given that ESMA's direct powers are tailored to well-defined special situations, such as supervising the rating agencies. It is doubtful how powers of this type could be conferred to the whole set of market supervisory activities without embarking on a Treaty change.

A more promising option is complementarity: ESMA coexists with ESMS, implying a clear separation of the tasks of regulation and supervision/enforcement in the sphere of ESMS's competences, as it is successfully practiced in banking, where EBA and SSM form a tandem much like ESMA and ESMS in our case. Note that despite all similarity to the SSM, the ESMS cannot easily be treated in a similar way, as part of the ECB. The reason is that Art. 127 para. 6 TFEU with the SSM Regulation, the basis for the SSM integration in the ECB, does not mention explicitly markets as the realm of potential ECB supervisory activities, thereby potentially ruling out a close ECB collaboration.

Let us close on a note of urgency. In earlier years, the UK's FCA together with the Bank of England and HM Treasury, to which it belongs, served as the de-facto market supervisor for large parts of Europe. The staffing and expertise of the UK market watchdog was widely seen as being better prepared for dealing with financial innovations in products and trading, and international investors. Its analyses are highly respected and often define the frontline of regulatory action globally. There is certainly a lesson to be learned from the relatively strong performance of London's financial market, in terms of investor protection and market performance, over the years.

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