Securities and Markets Stakeholder Group

15 February 2021
ESMA22-106-3194

# ADVICE TO ESMA

## Own initiative overview report on the Wirecard case

### Executive summary

The unprecedented case of Wirecard triggered the SMSG to present an own initiative report with constructive recommendations to ESMA and other European institutions. The magnitude of the case and its impact on a wide range of areas require forward-looking responses, embedded in a fully-fledged Capital Markets Union (CMU) where investor protection and market integrity are core objectives.

Following a documented examination of the case and building on the Fast Track Peer Review (FTPR) published by ESMA on 3 November 2020, the SMSG presents in a first part recommendations on priority topics which fall into ESMA´s remit, namely supervision/enforcement, market abuse and short selling. As a complement to this, the SMSG deemed relevant to also address auditing due to the importance of reliable statutory accounting for properly functioning capital markets. The second part of the report deals with general banking supervision, corporate governance and collective redress. Even though ESMA does not have direct competences in those areas, the SMSG is of the opinion that regulatory developments in those areas would mitigate the risk of such wrongdoings happening again.

The key recommendations of the SMSG's are the following (Annex 1 provides a full overview). First, in case more than one national authority oversees the supervision of accounting fraud, their respective competences should be clearly defined. The SMSG recommends that ESMA would develop guidelines to further harmonize how and when NCAs should use their investigative powers in case of possible accounting fraud. Further to a peer review on resources, the SMSG recommends that ESMA uses its supervisory convergence tools (i) to promote an NCA culture which avoids conflicts of interests, (ii) to standardise and make more transparent NCA's investigations and enforcement, and (iii) to foster exchange of information between different supervisors, criminal authorities, and also between supervisors and auditors. In the area of market abuse, the SMSG recommends that ESMA uses its supervisory convergence tools to improve several crucial aspects such as (i) the restriction of trading in financial instruments by NCA staff, (ii) effective scrutiny of allegations of market manipulation, and (iii) the publication of information about enforcement. With regards to short selling, the Wirecard case highlighted the limitations of the regime at national and EU levels. The SMSG is of the opinion that a fundamental reflection on the use of short selling bans is necessary. A dichotomy between a systemic short selling ban due to specific circumstances and a short selling ban applied to a specific share (the latter being disputable), may for instance be useful. The SMSG recommends that ESMA uses its supervisory convergence tools to clarify the circumstances under which a prohibition or a restriction can be enacted. The SMSG is not convinced of the usefulness of the opinion - a mere consistency check - which ESMA needs to issue in regard of any short selling restriction proposed by an NCA. The SMSG recommends that ESMA issues an own initiative report to the European Commission in order to pave the way for changes to the level 1 Short Selling Regulation.

Auditing is certainly one of the nexus of the Wirecard case which signals the need for a comprehensive reform of the EU audit rules. Therefore, the SMSG invites the European Commission to carry out a reflection on the mission of auditors, with the aim to clarify their duties to report on irregularities and to grant the corresponding powers, such as the rights for the auditors to access information, in particular from employees. In this context, forward-looking ideas may be inspirational (e.g. a rotation system in auditing teams, which is already required for ratings agencies, joint audits and appropriate liability caps for audit firms). Furthermore, the audit oversight system should be thoroughly examined, including the possibility of giving a role to ESMA in this respect, for instance in the form of direct supervision of big auditing firms.

In respect of the supervision of groups / financial holdings, the SMSG encourages the ESAs to use their supervisory convergence tools to strengthen (i) the supervision of complex groups, as well as (ii) the transparency and the efficiency of enforcement about outsourcing. More fundamentally, the SMSG sees a need for regulators to adapt regulation and supervision to the digital age, which implies a better understanding of new business models stemming from payments-related services and FinTechs. Another area where the SMSG deems relevant to draw lessons from the Wirecard case is corporate governance, inter alia on the following items: the need for (i) a mandatory robust compliance management system, (ii) access to critical information by the supervisory board, (iii) the establishment of an audit committee with a composition largely founded on independence, and (iv) penalties for a wrong “reporting oath” by the leadership of the company. Finally, the SMSG recommends that the EU institutions would reflect on the eligibility for collective redress of shareholders from the companies in which they have invested (for instance in case of misleading information).

This report has pointed to a number of serious problems in the supervision of Wirecard. However, in view of the SMSG’s limited resources and powers, this report is inconclusive on the question of whether there are grounds for ESMA to trigger a procedure against the relevant competent authority for non-compliance with EU law (so-called “breach of union law” procedure) under art. 17 ESMA Regulation. The SMSG therefore recommends that ESMA investigates in more detail whether there is ground to trigger an investigation under article 17 ESMA Regulation.

# I. Introduction

## I.1. About the report

1. Following the notification by Wirecard on 22 June 2020 that previously reported EUR 1.9bn on escrow accounts were missing, the European Commission tasked ESMA on 25 June 2020 to carry out a fact-finding work on the supervision of financial information. This exercise took the form of a Fast Track Peer Review (FTPR), a new supervisory convergence tool introduced in 2020. Based on the application of the 2014 Guidelines on the Enforcement of Financial Information (GLEFI) in relation to the Transparency Directive, the outcome of this FTPR was published on 3 November 2020. On this basis the Board of ESMA has been invited to carry out a reflection on ways of improving the supervision and enforcement of financial information in the EU.

2. In this context the ESMA SMSG has decided to set up a Working Group and to prepare an own initiative overview report. Its objective is not to substitute technical expert reports, but to deliver the SMSG's views on the regulatory and supervisory difficulties in respect of this case. The SMSG members are indeed interested witnesses due to the significant repercussions that this case will certainly have in their respective areas. This is why, mindful of the impact on financial markets and society as a whole, this report aims to present constructive recommendations which may serve as inspirational advice to ESMA and hopefully to other European institutions.

3. It has to be underlined that, although the circumstances which surround this case may legitimately trigger emotional reactions, this report intends to present balanced and forward-looking views, the leitmotiv of which is the need for integrity in financial markets and for a fully effective Capital Markets Union (CMU).

4. Animated by the willingness to make prevail a European approach respectful of the subsidiarity principle, this report is not limited to the items which fall into the remit of ESMA. The SMSG preferred to raise all relevant questions and take a holistic approach of the issues at stake. The pros and cons of the contemplated items were discussed at length, on the basis of which a number of recommendations have been made. It goes without saying that this report is conceived as a starting point and will deserve deeper technical analysis against the details of the financial regulation wherever appropriate.

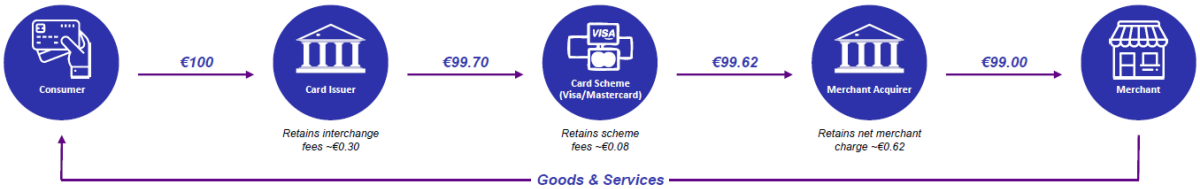
5. Before entering into the details of the case, the SMSG would like to underline its appreciation of the ESMA FTPR report, the findings and conclusions of which fuelled its reflection, as well as of the valuable information delivered by ESMA and other stakeholders close to the case.

6. As a last introductory word, this report is based on the information available at the date of this report, which may be incomplete. It can only be reiterated that the intention of this report is to trigger further analysis with a view to detailed and appropriate responses to this unprecedented case.

## I.2. General description of the case

7. Wirecard AG, located in Aschheim near Munich, established more than two dozen subsidiaries around the world. It described itself as a global technology group that facilitates electronic payments. It was classified neither as a payment institution nor as a financial holding, but as a technology company – and was therefore not subject to direct supervision of the German Federal Financial Supervisory Authority (BaFin).

8. The company was active in three segments: Payment Processing and Risk Management (PP&RM), Acquiring & Issuing (A&I) and Call Centre & Communication Services (CC&CS). A&I included credit card issuing and acquiring of credit card sales revenues and comprised activities from the subsidiary Wirecard Bank AG. CC&CS included after-sales services. In short, Wirecard was an intermediary that provided to its customers acquirer services for the acceptance of electronic payments from sales, and issuer services for the issuance of electronic payments cards. An illustrative chart of issuing and acquiring payment flows is provided below.




9. Wirecard also operated outside the EU. When the acquirer service was conducted outside the EU, Wirecard relied on third-party acquirers (TPAs) licensed to operate as acquirer in the non-EU country where Wirecard operated. As Wirecard had a direct control and obligations for the transactions processed through TPAs, all the fees paid to TPAs were recorded as Wirecard revenues and all the transactional fees attributable to TPAs were recorded as Wirecard cost of material. Wirecard was also responsible for indemnifying TPAs from financial losses incurred as a result of their intermediation with the final customer. A specific trustee-managed escrow account was dedicated to this task.

10. Among investors the company's growth sparked enthusiasm. Between 2010 and 2018 the revenues had risen from EUR 272 million to EUR 2 billion and the total assets from EUR 550 million to EUR 5.8 billion. Out of nothing, Wirecard was traded at the exchanges on an equal level with prestigious and almost century old companies such as Lufthansa. In October 2018 Wirecard entered Germany's DAX 30-index.

11. In April 2015 the Financial Times (FT) began its "House of Wirecard" series on the FT blog raising questions about the company's accounting. Several stories would follow in the following years. Other press articles, however, presented a more positive perspective. In 2016, "Zatarra Research and Investigation", a previously unknown entity, released a report containing allegations such as corruption, fraud and money laundering. Following the publication, Wirecard lost EUR 1,5 billion of market value.

12. In December 2014 the private body in charge of the first layer of financial enforcement in Germany, the Financial Reporting Enforcement Panel (FREP), had selected Wirecard's 2014 annual financial report for examination. Two years later FREP concluded there were no indications that the accounting was incorrect.
    Again in February 2019, FREP selected Wirecard 2018 annual financial report for examination with, in light of the FT allegations made in January 2019, an unlimited scope to address the

allegations raised. Based on these same FT allegations, BaFin requested from FREP a focused examination of the 2018 half year financial report. In parallel, BaFin launched in February 2019 investigations into market manipulation and, in April 2019, BaFin filed a criminal complaint with the Public Prosecutor's Office in Munich against market participants and two journalists on suspicion of market manipulation. The proceedings against Zatarra were closed in May 2020 (against monetary charge) and against the journalists in September 2020. Furthermore, BaFin issued on 18 February 2019 a short selling ban of Wirecard's shares for two months.

13. In October 2019, the FT made further allegations concerning the TPA business in Dubai and Ireland. At the end of October 2019, FREP, in collaboration from BaFin, decided to extend the scope of the focused examinations to include new indications of erroneous accounting. Wirecard's supervisory board appointed the auditor KPMG to conduct a forensic investigation, in parallel to the regular audit by Ernst and Young (EY). In June 2020, EY informed Wirecard that the company had submitted forged confirmations of holding EUR 1.9 billion on trust accounts. Wirecard publicly announced that there was a "prevailing likelihood" that the amount it had claimed to hold in the escrow accounts in the Philippines did not exist. On 25 June 2020 Wirecard filed for insolvency. Recently BaFin reported the suspicion of insider trading from one of its employees on 17 June 2020.

### I.3. Political and economic impact

14. Based on the above description the only sensible conclusion is that this case has to be regarded as one of the biggest accounting scandals in recent European history. The figures speak by themselves about the magnitude of the case: Wirecard´s highest market capitalization was more than EUR 20 bn, and the claims presented by banks, shareholders and clients amount to EUR 12.4 bn. Wirecard was presented as a national and EU champion, flagship of the FinTech industry: within 20 years, it claimed to have positioned itself on every continent serving more than 313 000 customers across 26 locations; in September 2018 it became part of the 30 companies that form the DAX 30 index, where it replaced Commerzbank. In other words Wirecard was seen as a rare German tech company able to challenge the giants of Silicon Valley.

15. The largest accounting fraud in German post war history leaves investors as well as citizens puzzled. Wirecard is the first member of Germany´s prestigious DAX index to file for insolvency. This in itself poses a fundamental question of trust towards the financial system. Shareholders and investors were also deceived and lost trust, not only because of this failing German FinTech growth company, but also more fundamentally due to the deficiencies in the financial system at several levels. It goes without saying that the 5000 employees of Wirecard, who were convinced to work for a flagship of the FinTech industry, also went through a bitter experience.

16. From a structural perspective, the Wirecard case has unveiled major weaknesses in corporate governance, auditing and supervision, aspects which matter for market integrity and investor protection. Three lines of defence exist to make sure that no breach is possible or that at least their detection is efficient and that an appropriate reaction is put in place, namely: the management/supervisory boards, the auditors, and the supervisors. In addition, the observed deficiencies in the system could trigger systemic risks due to the potential domino effects, for instance due to the lack of routing mechanisms to alternative providers.

17. This report will focus on the potential responses by the regulators and supervisors. The Wirecard case raises the question whether a broader reform of corporate governance and supervision in Europe is needed in the context of the CMU action plan. Although steps were already made in the right direction, room for improvement still exists. As a first step, the European Commission inserted in its renewed CMU action plan, published on 24 September 2020, that it "will carefully assess the implications of the Wirecard case for the regulation and supervision of EU capital markets and will act to address any shortcomings that are identified in the EU legal framework". Further to this commitment under the umbrella of the CMU, the European Commission has announced upcoming actions with regard to the national competent authorities´ (NCAs) coordination and EU supervision, the unregulated activities under the payment services directive (PSD), and auditing (more precisely with regard to the functioning of the EU audit system and the EU audit market rules). ESMA's past and upcoming actions will also be at the centre of this report.

18. At national level, the German jurisdiction is also in the process of responding to the Wirecard case. It is working on a new law on the integrity of financial markets (FISG – first draft submitted in October 2020, government draft in December 2020 and planned to pass in March 2021) and has set up a Bundestag Investigation Committee, the hearings of which are still ongoing. The measures which are currently being taken in Germany will be mentioned and summarised in the explanatory table in Annex 2 of this report.

19. In order to serve the aforementioned purposes, the report has been divided into two parts. A first part presents the priority topics of relevance to ESMA (leaving largely aside issues deriving from the Transparency Directive as the ESMA FTPR report had examined those in detail already). The second part of this report elaborates on other topics, which do not fall into ESMA´s competences. The SMSG felt it was necessary to also address this second category of topics, although in less detail, in order to meaningfully and holistically capture the dimensions and the impact of the case. The SMSG's recommendations are, however, more detailed in the first part.

## II. Priority topics of relevance to ESMA

20. The SMSG considers- the topics of supervision/enforcement, market abuse, and short selling as priority topics of relevance to ESMA, while auditing is included in this part as well, due to its relevance, although it is not at this stage part of ESMA´s competences.

### II.1. Supervision/enforcement at national and EU level

21. Although the supervisors are tackled first in this report due to the prime interest of ESMA in supervision, it should not be neglected that the management of the firm, namely the executive board and the supervisory board, is the first line of defence. The role of the auditors as contributing to an authorized and transparent accounting procedure of the firm will be addressed in a separate section. Further to these formal layers, all market players have a role to play (this includes - among others - investors, short sellers, or whistleblowers). It is not the subject of this report to address all these facets, but it is good to keep in mind that, while here the failures were in the first (governance) and second (audit and supervision) lines, the best defence against fraud is the awareness, the performance and the feeling of responsibility of all the components of the financial ecosystem.

22. When it comes to supervision and enforcement, the problems should be clearly identified before considering which form a reorganisation of the supervisory architecture could take. The circle to square consists of strengthening the oversight architecture in Europe, without unduly burdening markets and firms, nor undermining (on the contrary, ideally increasing) the attractiveness of EU capital markets for domestic and international investors and issuers or lowering investor protection rules. For this purpose, several theoretical approaches of supervision could be envisaged (e.g. systematic, principles v/ outcome-based). However, what will matter most in the end are clear definitions of competences and an efficient exchange of information between authorities.

### II.1.1. At national level

23. The dual supervision/enforcement of financial information certainly has attracted most attention in the context of the Wirecard case. This architecture, which has been adopted in Germany, is of a particular nature and revealed to bear both advantages and deficiencies.

The structure of supervision and enforcement

24. The control of financial statements in Germany follows a two-step enforcement structure which was introduced in 2005. The first layer consists of the German Financial Reporting Enforcement Panel (FREP) (Deutsche Prüfstelle für Rechnungslegung DPR e.V. (DPR)), an institution organised under private law, which examines financial statements on a random sampling basis but also if there are specific indications of an infringement of financial reporting requirements, or at the request of BaFin. The FREP procedure is based on cooperation with companies: it only examines financial statements if the company under examination is willing to cooperate with FREP. The second layer is constituted by the BaFin which steps in if a company refuses to cooperate in an FREP examination or does not agree with the result of the examination. It can also intervene in the enforcement process if there are serious doubts about the accuracy of the examination results or about whether the FREP has carried out the examination properly. It has to be emphasised that this architecture was designed for the supervision of law-abiding, cooperative companies. Structural weaknesses have been revealed, however, when the supervised companies engage in balance sheet manipulation and fraud: BaFin (which has more far-reaching powers when it comes to credit institutions) can only intervene if a company refuses to cooperate with FREP or if BaFin has strong doubts about the results of supervision by FREP. In this context BaFin informed ESMA that they do not comply with two of the Guidelines on the enforcement of financial information (ESMA/2014/1293 Rev) for legal reasons.

25. In the Wirecard case the dual enforcement design caused latency between FREP investigation and BaFin intervention, leading to a lack of clarity with regard to the responsibilities and accountability in the reaction to the Wirecard accounting fraud.

26. From a theoretical perspective, several options can be discussed regarding the supervisory/enforcement architecture and it is of utmost importance that those options are carefully scrutinized through the lens of the practice.

27. The current two-step system has its merits: the supervision of accounting has proven to be adequate in the large majority of cases. In addition, the private law solution promised more

flexibility and less bureaucracy. ESMA itself supported this structure in its peer review report in 2017, although it required adjustments. However, maintaining the current architecture would in any event imply a strict clarification of the competences and accountability of each authority, as well as the certainty that the necessary investigation powers are at the disposal of the authorities.

28. Another option would be to shift to a one-tier system, based on the assumption that the two-step enforcement structure is a misconception for criminal cases. There would be only one competent authority with the necessary powers and accountability, which could, however, delegate tasks to another entity. If this solution was adopted, it would be of utmost importance that adequate resources would be allocated to the single authority.

29. An intermediate and less drastic third option would be to create **a quick intervention/response force from the second step authority or from a task force with other authorities (e.g. federal criminal agency and prosecutors). This approach would allow for no latency,** and would heal the main flaws of the two steps enforcement structure without demolishing the entire architecture.

Definition of competences

30. **If more than one authority oversees supervision of accounting fraud, a clear definition of competences is in any event needed, with overlapping competences or gaps periodically examined and managed on a continuous basis**. The German draft law on integrity of financial markets (FISG - Finanzmarktintegritätsgesetz) seems to already follow those lines. The draft law sets forth a more centred procedure, where BaFin will be authorized to directly and immediately intervene in case of concrete suspicion of fraud. The two-tier financial reporting system was deemed to have come to its limit when confronted with a system of suspected fraudulent structures with an international dimension. In such cases the private enforcement is no longer seen as fit for purpose. If the draft law is adopted, it will in the future only be responsible for random inquiries, whereas BaFin will be empowered to act towards listed companies with sovereign enforcement rights. Inquiries based on concrete suspicion will from the start be the sole responsibility of BaFin, which will however not be entitled to launch random inquiries.

31. Further to the determination of the most appropriate institution to conduct investigations when suspicions are unveiled which was mentioned above, the scope and the use of these competences is of paramount importance. Indeed, the investigation powers of the relevant authority should be sufficiently strong in order to allow for an efficient financial reporting oversight. **It should be ensured that sufficient and clear investigation powers are at the disposal of the authority when suspicions are unveiled, with information rights towards third parties.** Mindful of the necessity to evolve in this direction, BaFin will be equipped with forensic capabilities in the draft German law FISG. A right to seizure and searching under the condition of a court decision requirement is to be established in case there are concrete indications of serious breaches against accounting regulation. A breach will be considered serious if it has relevance for the valuation of the company by capital market actors. The necessity to uncover cases of accounting fraud at an early stage is obvious, not only to protect investors and other stakeholders as well as the integrity of the financial markets but also to protect the credibility of financial centres. Whilst the US put in place since the 2002 Sarbanes Oxley Act a wide

range of proactive investigations, the EU legislation should further harmonise the use of those powers by the NCAs. Article 24 (4) of the Transparency Directive provides the principle that NCAs should have range of investigative powers for the exercise of their functions. **The SMSG recommends that ESMA would develop guidelines to further harmonize how and when to use those powers**.

32. The need to have consistent and effective enforcement of financial reporting across the EU has been underlined by the Wirecard case. High-quality financial reporting is indeed important for maintaining investors' trust in capital markets. The idea in this respect would not be for ESMA to take the charge of day to day supervision of financial reporting - ESMA would not be equipped for that, both in terms of competences or resources.

Treatment of information

33. An efficient enforcement system is also based on an adequate treatment of information. Already early on, the US developed whistleblower programs in this respect. **The SMSG recommends to ESMA to use its supervisory convergence tools in order to ensure an effective screening and handling of the warnings received**, inter alia from media and whistleblowers from inside and outside the institution.

34. Supervisors should pay close attention to the international press in particular. The existence of contradictory signals in the press, as was the case for Wirecard, should also be a signal for increased attention.

35. Whistleblowers, although less part of the continental culture, have become indispensable allies in the fight against financial fraud. They already benefit, through the 2019/1937 Whistleblower Protection Directive, from actual safeguards.

Resources

36. These different components of enforcement cannot be developed in an optimal way if the adequate resources (both quantitative and qualitative) cannot be allocated. **The SMSG recommends that ESMA carries out a peer review on the necessary for the resources to be proportionate to the supervisory authorities' mandate and adequate to its tasks**. Although BaFin had sufficient resources according to the 2017 ESMA peer review, its resources should be sufficient also in the future to fulfil a clarified and enlarged mandate.

Conflicts of interests

37. Another highly debated question is the management of conflicts of interest, internally and externally. A culture of avoiding or at least managing conflicts of interests should be developed, which ties up with the fundamental question of independence. **An adequate level of institutional independence should be required**. **The SMSG recommends that ESMA makes use of the supervisory convergence tools at its disposal to promote the development of a culture of avoiding conflicts of interest**.

Disclosure of enforcement

38. The right of the NCA to publicly announce the steps which it is taking in regard of financial reporting enforcement should be further examined. What could be of great help would be an

enforcement disclosure which should be more standardized. **The SMSG recommends that ESMA makes use of the supervisory convergence tools at its disposal to standardize when and how ongoing investigations and enforcement measures should be made transparent.**

Cooperation amongst authorities

39. None of the above considerations would deploy the full potential of the system in case the communication between authorities would not flow. **Efficient exchange of information is crucial, without the impediment of confidentiality agreements.** Such an information flow is indeed essential in order not to leave any void of which an ill-intended actor could take advantage. Although useful, the confidentiality agreements should not prevent authorities from sharing information. For this purpose, the draft German law FISG foresees that confidentiality obligations will no longer restrict BaFin in that respect. An enhanced openness between authorities should contribute to trigger the proper level of audit (e.g. a special audit at the Wirecard AG as the owner of Wirecard Bank. In order to adjust the confidentiality regime, EU legislation could, as recently mentioned in inter-institutional discussions, explicitly state that the exchange of information within and between NCAs does not constitute a breach of professional secrecy and could require the automatic exchange of relevant findings between securities supervisors, prudential supervisors and audit supervisors.

40. Another player of importance which whom collaboration should be close and efficient is the public state prosecutor who is taking over in some jurisdictions, such as Germany. The draft German law FISG clearly limits the competence of the NCA in favour of the state prosecutor as soon as criminal law is involved. This is why it is so important that the elements for the submission of the criminal complaint by the NCA are gathered in good time for the prosecutor to take over and act swiftly. This is particularly important in the area of anti-money laundering (Wirecard AG appeared to be involved in money laundering schemes entirely unrelated to the accounting fraud). **The exact competences of the NCA and the criminal authorities should be clarified, in case of any criminal offence, including market abuse and AML** in order not to leave any gap.

### II.1.2. At EU level

41. A potential mismatch between historically grown institutions and cultures and the introduction of a European regime could lead to an effect opposite to what is intended. The reconciliation of cultures and regimes at national and EU levels is key in order 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.

42. Following cases such as Wirecard, some could plead for a decisive shift of supervision towards the EU level. The need to strengthen powers of EU supervision was, for instance, mentioned in the European Parliament, based on the assessment that the national supervisors are not able to supervise cross-border companies or may be biased. In the study requested by the European Parliament entitled “What are the wider supervisory implications of the Wirecard case”, academics reflected on a proposal for a single, responsible market oversight institution at European level, the European Single Capital Market Supervisor (ESCMS), based on the ECB model for banking supervision. Such a configuration would, among other things, avoid or at least limit an excessive proximity between supervised financial entities and their respective supervisors.

43. Less radical than a centralized EU supervisor, is the idea of an integrated European supervisory network with the existing national agencies as branches, which would report to a centralized single capital market supervisor. Such architecture would have the merit of bringing an element of institutional independence to national agencies and strengthening supervisory convergence. The SMSG is of the opinion that **forward looking ideas such as integrated European supervisory network or EU-centralised supervision as well as the idea of a "28th regime" for some companies deserve attention and deeper analysis.**

44. However, it is likely that supervision at EU level may not be the silver bullet. ESMA has already the tools to increase supervisory convergence, and has used those tools successfully in the past. The SMSG is of the opinion that such a gradual path towards **supervisory convergence, also regarding the exchange of information between supervisors and auditors, should be fostered.** It has the merit of a supervision conducted at national level, with converging instruments. Instead of a drastic shift of supervision towards the EU level, an enhanced convergence allows to maintain the shared competences between the EU and the national level, while gradually raising the bar for the national supervisors and harmonizing their supervisory practices. **The SMSG encourages ESMA to continue to use its supervisory convergence tools to that effect, and should re-iterate its recommendation or issue an own initiative opinion to the Commission to take action,** especially in areas where the Wirecard case unveiled supervisory shortcomings.

## II.2. Market abuse

45. The Market Abuse Regulation of 16 April 2014, 596/2014 (repealing the Market Abuse Directive 2003/6/EC) aims to improve investor protection and preserve the integrity of markets, in particular addressing insider dealings and prohibiting market manipulation. These two dimensions deserve to be scrutinized in regard of the Wirecard case.

Insider dealing

46. Simply by supervising and engaging with regulated entities, the NCA's employees receive a multitude of information about the relevant entities that enables them to better assess risks and chances related to financial instruments related to these entities, than other investors. If employees use this information by making investment or de-investment decisions, there is not only a serious danger of reputation damage to the NCA, but also a threat to the functioning of the financial market and the confidence of market participants in effective supervision. Against this background, it is key that doubts regarding the integrity of the NCA are pre-empted from the outset and even alleged conflicts of interest are avoided.

47. Taking note of the activities of the employees of BaFin (with a pivotal role in gathering market intelligence on the identification of risks, as stated in the ESMA FTPR report) who traded securities related to Wirecard, it is, moreover, of the utmost importance that internal controls are put in place within the NCAs, allowing to efficiently detect the private financial transactions which are carried out on financial instruments relating to entities supervised by the NCAs. Equally important is the quality of these internal rules. These rules need to efficiently ensure that any employee, suspected of insider trading (even if they do not have direct access to inside information) cannot trade in related financial instruments and that, where necessary,

sanctions can be imposed. In particular the internal reporting IT system where employees should report their private financial transactions should allow for no delays.

48. Following these lines, the draft FISG in particular prohibits BaFin employees to trade in financial instruments that are admitted to trading on an organised market within the meaning of § 2 (11) of the Securities Trading Act in Germany or that are issued by an entity supervised by BaFin, or any group member of such entity. The SMSG is of the opinion that ESMA should ensure convergence between the Member States in this respect, so as not to allow such deficiencies to happen again.

49. **The SMSG recommends that ESMA uses the supervisory convergence tools at its disposal to ensure that the NCAs restrict trading by NCAs employees in financial instruments issued by supervised entities and group companies. Rules on insider trading should be adequately managed by the NCA (in line with the EU market abuse rules) and artificial intelligence should feed the analysis of suspicions reports.**

Market manipulation

50. The detection of market manipulation is certainly not easy. A market abuse examination is usually performed, at least in the beginning, in all directions, due to the numerous, and sometimes contradictory pieces of information received by the NCA. The information received from whistle-blowers and media, based on documented findings (e.g. in the Wirecard case, information on fake partner companies in Asia and on large shares of sales and EBIT with these partners) may be serious indications which should at least trigger a thorough investigation to establish the veracity of these allegations. In addition **the dissemination of misleading information should be identified quickly and should be appropriately sanctioned.**

51. In case of increased suspicions of market abuse, NCAs have a number of competences and powers. They can require documents, summon and question people or even search premises. Pursuant to Section 6 of the German Securities Trading Act, an investigation into Wirecard and the seizure of evidence such as files, electronic files and emails would have been possible. While legal implications in relation to the financial reporting enforcement rules have to be kept in mind, the BaFin approach in the Wirecard case shows that **allegations of market manipulations should be more deeply scrutinised before supervisory action is taken against the media and/or other whistleblowers. The SMSG recommends that ESMA uses its supervisory convergence tools in this respect.**

Enforcement of market abuse

52. The enforcement of rules against market abuse once again stresses the need for a clear allocation of competencies. In the Wirecard case, the market abuse rules should have been enforced more rapidly and thoroughly, through an intervention by BaFin already before the FREP finished its own examination and intervention. In such circumstances, it appears legitimate to challenge the argument of the *lex specialis* and to encourage the draft law which would ensure that **the competences to enforce market abuse rules are clearly established.**

53. As part of its competence to enforce, the NCA's competence to inform the public and the market is crucial. As a response to the Wirecard case, the German draft law FISG is putting in place a clear and wider competence for BaFin to inform the public about cases of financial reporting enforcement in an earlier stage of the enforcement process. The publication would

include the name of the company and be easily accessible on the website in view of the relevance of this information for the capital markets. For this purpose, confidentiality obligations will no longer restrict BaFin.

54. For sure, the publication of this information requires a weighing of the interests of the affected company and an assessment of the seriousness of the allegations. Such a mechanism would improve the correct valuation of the company and the transparency of the capital markets, as misleading or speculative information could be avoided. This should also discourage speculative trading to the detriment of the company, lenders and shareholders as well as other creditors such as bondholders. In order to maximise the efficiency of this mechanism, **the publication of information about enforcement should be timely. The SMSG recommends to ESMA to contribute to this by using the supervisory convergence tools at its disposal.**

### II.3. Short selling

55. Due to specific adverse situations or circumstances that constitute a serious threat to market confidence in appropriate price determination the German supervisory authority BaFin imposed a prohibition on short selling in respect of shares of the Wirecard AG on 18 February 2019, which lasted for two months.

Conditions of short selling prohibition

56. After the financial crisis, the activities of short sellers were popularly condemned. The EU Short Selling Regulation 236/2012 was published in March 2012 as a response to the global financial crisis of 2008-2009. The regulation puts a special focus on short selling activities and created regulatory tools to restrict short selling either in exceptional circumstances or in the case of a significant decrease in share price. Based on these new intervention powers for the NCAs, short sellers had faced restrictions. Now, a decade later, the public debate seems to rehabilitate short sellers, pushing the argument to the fore, that short sellers indicate with their investment decisions where the market suspects risks and wrongdoing by companies - thereby playing a vital role in financial markets.

57. Since the EU Short Selling Regulation entered into force, prohibitions and restrictions on short selling had only been imposed on struggling banks in Italy and Portugal for just a few trading days.
In the Wirecard case, the two months short selling prohibition was triggered in January 2019 after BaFin’s observation of negative press reports, a rise of net short positions and a price decline of Wirecard shares by 40 percent. According to article 20 of the EU Short Selling Regulation, a prohibition of short selling can only be issued provided that there are adverse events or developments which constitute a serious threat to financial stability or to market confidence. The reasoning of BaFin was that it wanted to avoid that the situation would escalate to a general market uncertainty and a loss of market confidence, given the company's importance for the economy. In BaFin's view, the prohibition was necessary to address the threat and did not have a detrimental effect on the efficiency of financial markets disproportionate to its benefits. However, from an investors’ perspective, the enacted prohibition could be perceived as a signal that Wirecard was under attack from shortsellers.

58. In addition, it seems to be debatable whether these requirements had been met in case of Wirecard. The Bundesbank, the German Central Bank, was sceptical of BaFin’s underlying assessment and decision at an early stage as its own analysis was that the uncertainty around

Wirecard for market participants actually did not cause any threat to market stability and (according to media information) the Bundesbank informed BaFin about their assessment.

59. The motivation of any short selling ban is of utmost importance in order to avoid that substantial doubts of market participants about the companies' (financial) credibility are ignored, and that companies which do not deserve so are illegitimately protected. In the NCA's assessment process, impartiality is of major importance. In particular, and as recently stressed by the German government, cultural background should not play any role in financial supervision in order to allow for an objective analysis of the situation. Only reasonably solid information about the activities and intention of short sellers (beyond their background) should be used as indications, combined with information from reliable and trustworthy sources. It should be noted that shortsellers, which in academic papers are often considered as "informed traders", play an important role, as they are critical voices to detect fraud (just as whistleblowers, journalists, other market participants, and investor and consumer representatives). They should be encouraged and heard to allow NCAs to discover any inaccurate information even more efficiently. Therefore, a short selling ban can only be imposed with the utmost care.

60. Also BaFin's choice of the short selling tool can be critically questioned. Instead of using the circuit breaker mechanism foreseen in article 23 of the EU Short Selling Regulation (with a pre-defined threshold (e.g. a fall in value of 10% or more in the case of a liquid share) and with a limited duration of two trading days), BaFin applied in the Wirecard case the empowerment foreseen in article 20 of the EU Short Selling Regulation. Article 20 allows to prohibit or impose conditions on short sales if there are adverse events or developments which constitute a serious threat to financial stability or to market confidence. On this basis, any measure can be enacted for a relatively long period of time of initially up to 3 month and, renewable for further periods not exceeding 3 months if the grounds for taking the measure continue to apply be extended. This legal basis requires a motivation that the short selling attack could have a global effect in one or more other Member States, which is going beyond the mere fact of being an international payment service provider.

61. In this context, it should be stressed that there is uncertainty about the interpretation of the conditions of article 20 of the EU Short Selling Regulation, for instance on the definition of "disorderly decline" in the price of the financial instrument. **The SMSG recommends that ESMA uses the supervisory convergence tools at its disposal in order to clarify the conditions for the prohibitions and restrictions of short selling, and more in particular the circumstances under which such a prohibition or restriction can be enacted as well as the procedures followed.**

Assessment of the current regime

62. The SMSG is of the opinion that an in-depth assessment of the short selling regime should be carried out at two levels. First, the scope and conditions of the existing tools offered by the EU Short Selling Regulation need to be debated, as described above. Second, on a more fundamental level, the overall effectiveness of such measures should be the subject of a thorough analysis, ideally based on quantitative research that covers a wide range of cases of short selling prohibitions. Some scientific research has already been undertaken, such as a preliminary study on short selling prohibitions in Europe during the Covid 19 pandemic, which analysed prohibitions imposed by Austria, Belgium, France, Greece, Italy and Spain on all stocks between March and May 2020. The study finds that prohibitions were actually detrimental for liquidity and failed to support prices. Also representative of this critical academic stance, is a study by Pagano and Berber (2013). This study assessed the short selling prohibitions imposed during the financial crisis between 2007 and 2009 and came to the conclusion that

prohibitions (i) were detrimental to liquidity, especially for stocks with small capitalization and no listed options, (ii) slowed price discovery, especially in bear markets, an (iii) failed to support prices, except possibly for US financial stocks. More recently a European study (published under the ESRB working paper n.68) investigating the impact of short selling ban on financial institutions has shown that, contrary to the regulators' intentions, financial institutions which stocks were banned experienced greater increases in the probability of default and volatility than unbanned ones, and these increases were larger for more vulnerable financial institutions.

63. Also on the supervisory side, short selling prohibitions and restrictions have been subject to a critical analysis. In the US, the Securities and Exchange Commission (SEC) admitted that temporary prohibitions on short selling during the 2008 financial crisis had had unintended market consequences and side effects, such as less liquidity in the markets. In the EU, an ESMA Technical Advice of 2017 assessed certain elements of the EU Short Selling Regulation, among which article 23 of the EU Short Selling Regulation. According to ESMA, empirical evidence showed that short-term bans seemed to have a limited effect on trading volumes and a small positive impact on returns of the shares under restriction, but did not seem to have a significant impact on price volatility. Also, the analysis suggested that temporary short selling restrictions do not have a statistically significant impact on share prices. Despite its limited effects ESMA did not reject the use by the NCAs of prohibitions and restrictions. ESMA added that the imposed constraints are relatively weak due to the temporary nature of the prohibitions and restrictions, the exemption for market making activities, and the ability to take short positions in securities covered by the prohibition using derivative instruments. Among other proposals, ESMA therefore suggested to extend the scope of short selling prohibitions and restrictions by NCAs to derivatives and OTC trading.

64. As a more radical proposal to adjust the short selling regime, **a dichotomy could be made between systemic short selling due to specific economic circumstances (e.g. pandemic crisis) and short selling applied to a specific share. Severe doubts may be legitimately expressed about the second category**, in particular where the prohibitions and restrictions are justified by a risk to the financial system. A short selling ban may not be an appropriate tool for risk management purposes. Cases such as Wirecard are a strong encouragement to reshape this regime. **The SMSG advises ESMA to issue guidelines or other level 3 tools in this respect.**

Role of ESMA

65. A further aspect of the short selling prohibition by BaFin is the role played by ESMA. Before imposing any restrictions, in particular under article 20 or article 23, an NCA needs to notify ESMA of the proposed measure. After receiving such a notification, ESMA should issue an opinion on whether it considers the measure or proposed measure necessary to address the exceptional circumstances. The opinion should state whether ESMA considers that adverse events or developments have arisen which constitute a serious threat to financial stability or to market confidence in one or more Member States, whether the measure or proposed measure is appropriate and proportionate to address the threat and whether the proposed duration of any such measure is justified. However, ESMA needs to issue its opinion within 24 hours, which explains why ESMA can in practice do hardly anything more than a consistency check, to ensure that the process has been complied with. The usefulness of this process can therefore be questioned. In the case of Wirecard ESMA's opinion was issued under the assumption that short selling activities against Wirecard could have an impact on the financial system in view of Wirecard's status as a payment service provider with a network of connections to customers in multiple economic sectors, among them the banking sector. The added value of such opinion can be questioned. It can even have the unintended effect to be seen as offering

confirmation of the NCA's analysis, in particular in terms of signal to the markets and to the investors. In other words, **the opinion issued by ESMA, conceived as a mere consistency check, is in practice not necessarily helpful. The SMSG recommends that ESMA issues an own initiative opinion to the European Commission to point to this problem and to request changes to the level 1 text.**

### II.4. Auditing

66. As stressed in the introduction of this report, auditing and financial reporting do not fall under the direct competences of ESMA. However, the SMSG still considers this to be a priority topic due to its crucial contribution to a proper functioning of the capital markets. Moreover, it cannot be seen in isolation, as effective and reliable statutory accounting is essential for the good internal and external conduct of a firm´s activities.

67. In 2018, the last year for which audited accounts are publicly available, Wirecard AG claimed to have processed EUR 125 billion worth of credit and debit card transactions, on which it generated EUR 2 billion of revenues. Already in 2015 inconsistencies in the accounting of Wirecard AG were pointed out by the media (in particular between sources of profit and the rise of intangibles on the balance sheet), followed in 2019 by whistleblower allegations of serious accounting fraud (in the form of a mismatch between the supposed scale of the partner businesses to which Wirecard entities have ascribed substantial revenue, and the modest reality on the ground in countries such as the Philippines). In the wake of these allegations KPMG was tasked by the company's supervisory board to perform a special investigation into the situation. Its report did not clarify all issues at stake. It did recognize though that "the results of our investigation cannot include an assessment of the accuracy of the published annual or consolidated financial statements as a whole" and referred to an annex containing a management letter relating to the escrow accounts (which is not publicly available).

68. The magnitude of the case (likelihood that EUR 1,9 billion was inexistent) and the reiteration of circumstances lead to the conclusion that a thorough reform of auditing may be needed. Indeed, Wirecard had been accused several times of accounting manipulation. For this reason a change of auditor happened in 2009 when EY replaced the small Munich auditor in charge of Wirecard's auditing since its creation. This followed an action before the Regional Court of Munich carried out by an investor protection association which triggered a comprehensive expert opinion performed by EY on alleged deficiencies in the financial statements in the fall of 2008.

69. In this context European Members of Parliament (MEPs) have asked the European Commission and the European competent authorities to assess to what extent this scandal can be attributed to deficiencies in the EU regulatory framework in the area of audit and supervision, and to look into ways of improving the functioning of the accounting sector, including through joint audits. The Liberals and Greens MEPs have launched a joint appeal to call for **a comprehensive reform of the EU audit rules through the review of the Statutory Audit Directive, e.g. with audit more focused on the detection of manipulation**, as accounting firms play a key role in a successful CMU. The EC is currently working on an upcoming second monitoring report on the statutory audit market of public interest entities. Moreover, an assessment of the current EU audit rules as avenues through which issues of relevance in the Wirecard case can be addressed has been launched.

70. The role of the auditor is to provide an opinion about the true and fair representation of the audited entity, according to current reporting standards. The role of the auditor is not to investigate and reveal ongoing frauds. Additionally, auditors generally assume that they receive accurate documents. However the importance of approaching received documents with professional scepticism is set as an objective by the International Auditing and Assurance Standards Board (IAASB). In addition, a fundamental principle of auditing is that auditors need to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement. It can be argued that this mission has not been conceived to track elaborated and sophisticated fraud involving multiple parties around the world in different institutions and with a deliberate aim of deception. Moreover, construction fraud is not easy to deal with. Nonetheless several ways exist to improve auditors' judgment, which would mitigate the risks of shortcomings as the ones which were observed in the Wirecard case. The law, and not only professional standards, should indeed contribute to make sure that professional scepticism and reasonable checks to uncover accounting manipulations and accounting fraud are an integral part of an external audit. The focus of the audit may be shifted more towards the detection of accounting manipulation, inter alia by empowering forensic investigation. **The SMSG would like to invite the European Commission to carry out a reflection with regards to the clarification of the duties of auditors to report discovered irregularities, both in terms of competences and timing (with public prosecutors informed in good time)**.

Financial information

71. The first element which guarantees that an auditor can properly exercise his role, is the access to the necessary information. A lack of information easily becomes a lack of control. In the Wirecard case it is obvious that auditors encountered issues in getting required information and data, including from third parties. KPMG underlined these difficulties in its special investigation report, published on 27 April 2020. This problem was in particular acute in regard of the list of customers and the access of a bank confirmation or account statement (the latter being mandatory to treat the escrow accounts as "cash or cash equivalents" on the consolidated balance sheet). The information which should have been extracted from these documents was of crucial importance - to ensure the right accounting treatment: depending on whether there is "control of customer relations", either gross or net accounting is applicable (IFRS 15 revenue recognition). The lack of clarity regarding the relation with customers led to EY not questioning the classification of Wirecard as a "principal" and the ensuing application of the gross treatment. However, it looks as if Wirecard was more of an agent in this business. The SMSG does not intend to enter into a detailed accounting debate, but to underline to which extent the quality of the information delivered to the auditors and their reliance on such information is crucial. In case of incompleteness or doubts, auditors should perform direct checks (for instance in respect of Singapore's OCBC Bank between 2016 and 2018 in order to confirm that the lender held large amounts of cash on behalf of Wirecard).

72. In order to help the auditors to fully exercise their mission, **auditors' right to information, in particular from employees, should be fostered and confidentiality agreements should be adapted. This aspect should be part of the reflection that the SMSG invites the European Commission to carry out on the exercise of the auditors' mission.** The judgment of the auditor is the nexus of the fight against fraud and all interested parties (including the press which used the term "fraud" regarding Wirecard for the first time in 2005) should commit to assist them in their search for the accounting truth. Complexity will always be the friend of the ones who are trying to hide an accounting fraud, which sometimes may go hand in hand with other allegations (such as money laundering in the Wirecard case). This should never make the auditor lose sight that his judgement is essential in case of suspicion of accounting

fraud and every tool and forensic capability should be granted to him in order to exercise it in the best conditions.

Duration of appointment

73. One of the recurring issues about auditing is the need for auditors' rotation and the time limit of their appointment. The Directive 2014/56/EU indeed allows Member States to extend the 10-year mandatory audit firm rotation for all EU public interest entities (which include listed companies, banks and insurance companies) once, for up to maximum 10 more years if a public tendering process is conducted (for a maximum of 20 years) or to maximum 14 more years where there is a joint audit arrangement (to a maximum term of 24 years).

74. The Wirecard case may plead at first glance for a restrictive approach of the extension of the duration of the auditors' appointment. In this spirit the German draft law FISG foresees an obligation for listed companies to make the auditors rotate every ten years. However, in the Wirecard case, EY had been auditor for 10 years exactly, so the rotation would not have solved the problem, unless it would be required after a shorter period of time.

75. In addition one may argue that companies lose knowledge and competence if they have to change auditor; rotation could also be counterproductive in case a company would like to deceive auditors and could take advantage of the fact that a new auditor needs to start from scratch. Studies show that frequent rotation can also have adverse effects, citing a higher probability of errors in early years.

76. Therefore, further to the **mandatory external rotation of auditors after a reasonable period of time, e.g. 10 years**, it seems to be reasonable to explore other avenues. **The rotation system in the rating agencies may be inspirational**: an internal rotation of analysts rating the entity is required which ensures a fresh look on the company.

Joint audit

77. Other more innovative ideas, such as **joint audits (4-eyes principle) may be worthwhile exploring**, to the extent a cost-benefit analysis reveals that they would be beneficial.

78. Before the EU audit rules reform of 2014, the possibility of having joint audit for large listed companies was already on the table. It is already mandatory in some Member States such as France. It could have several advantages, in particular in light of the Wirecard scandal: i) two audit firms have to agree on the audit work and conclusions; ii) it is more difficult for the company management or board to influence two audit firms than one, in particular when one is having a long-term relationship with the company; iii) the liability in case of wrongdoing is split into two, which would also improve (the ground for some claims being equal) the reparation prospects of the victims.

79. The European Parliament reiterated recently its call on the Commission to look into ways of improving the functioning of the accounting sector, including through joint audits on 8 December 2020. **The SMSG recommend assessing the relevance of requiring joint audits for large listed companies in the EU.**

Spectrum of services for auditors

80. Following the Enron-scandal in the US in 2001 the US-authorities, through the Sarbanes-Oxley-Act, forced auditors to abandon their advice services for the companies they audit. The UK Financial Reporting Council announced last year that it told the Big Four to separate their audit arms from their consultancy units by 2024 in a major shake-up of the sector. The Wirecard case may plead for the non-auditing services offered by auditors (advice, which generates the higher returns) to be reduced in order not to tangle them up in the companies´ interests. **The separation by audit companies of their audit arms from their consultancy units could indeed favour independence**. Opponents to this idea argue that this may make the search for auditors more complex and that the rules in the EU audit regulation are sufficient. In an attempt to strike the right balance, the German draft law FISG contemplates that auditors of companies of public interest will only be permitted to offer advice services on a smaller scale than before. Furthermore it will be possible for a qualified minority of shareholders to request the replacement of the auditor by court decision, if the auditing firm provides services prohibited under the regulation. A reflection to address the issue of the market concentration of audit services should also be undertaken.

Remuneration structure

81. Linked to the issue of independence, the auditor fee is paid directly by the audited entity. On top of that, as mentioned right before, the auditor might receive additional non-audit fees for consulting activities unrelated to the audit exercise. This remuneration structure may actually produce a conflict of interest driving the auditor to underperform in terms of scrutiny of the audited entity. If management misconduct is brought to light, the audit company may fear not only the loss of its fee but also a reputational damage. Hopefully the latter fear could also be *a contrario* an incentive for the auditor to perform well.

Liability of the auditor

82. The exercise of duties and responsibilities should be accompanied with accountability. In some EU Member States, however, such as Germany, a privilege exists for auditors in the form of a limitation of liability (to EUR 4 million). The Wirecard case puts the limitation of liability into question, in particular in cases of gross negligence. The German draft law FISG will tighten the liability in private law towards the audited company in order to create the necessary incentives for a diligent audit. The liability limit will be increased to EUR 16 million for listed companies, to EUR 4 million for non-listed companies and insurance companies and to EUR 1.5 million for other companies. As pointed out by the European Commission itself in its recent non paper, “This level of liability appears not to be commensurate with the cumulative audit fees paid to Wirecard’s statutory auditor over the tenure of its audit mandate, nor with the losses incurred by investors following a €20 billion reduction in Wirecard’s market capitalisation. Future legislative updates might consider eliminating or setting appropriate liability caps at EU level.” In case of proved negligence, there should be a possibility of triggering liability in a way that investors should be able to receive an appropriate compensation. Although the application of unlimited liability in cases of gross negligence looks logical at first sight, it is likely that this may lead to a further concentration on the market for private audit, which is against the intention of the EU regulation on auditing. Therefore **the SMSG recommends considering setting appropriate liability caps for audit firms at EU level.** In addition, **it would be useful to investigate the possibility of foreseeing criminal liability in case of intently or grossly negligent issuance of incorrect audit certificates by auditors.**

83. Auditors also have an important responsibility towards shareholders. As owners, who bear the economic risk, they do not have a direct relationship with the auditors in several European

Member States, including Germany. Following the Wirecard case, it appeared that **more transparency, comprehensibility** (and also accountability) **from auditors would be beneficial** and would strengthen the profile and the role of the auditor to address the expectation gap of the stakeholders towards what the auditors do. Transparent and comprehensive reporting from the auditors to shareholders at the general meeting of shareholders, with the possibility of answering their questions, could be useful legal developments.

Auditors public oversight body

84. On the occasion of the Wirecard case, one may wonder whether the deficiencies in the audit profession tie up with its system of oversight. The European Union has issued several regulations to promote a system of public oversight. A system of public oversight promotes greater audit quality than a system of peer review. However public oversight is not without limitations, because publicly appointed inspectors may have lower industry and technical knowledge, and may suffer from constraints in resources, regulatory capture, political pressure or inefficient bureaucracies. This means that scepticism remains as to whether public oversight systems have achieved their goals and are preferable to self-regulated oversight systems based on peer review.

85. The current organisation of public oversight of statutory auditors and audit firms in European Member States is fragmented and overly complex, characterized by limited responsiveness to red flags, and an apparent lack of communication among the POBSAs and with the other supervisors. The German Audit Oversight Body (APAS) is central and independent and can issue fines for misconduct and in extreme cases disbar auditors. In the Wirecard case it informed at a late stage the prosecutors that it found indications that legal due diligence and reporting obligations were not observed. It also sent an interim assessment late September 2020 to prosecutors in Berlin, requiring them to share their findings with criminal prosecutors in Munich. However the limited impact of these diligences may lead to reconsider if the oversight system is properly designed.

86. The US experience shows how a public oversight body can improve the accountability of a self-regulated regime of peer reviews. The 2002 Sarbanes Oxley Act established the Public Company Audit Oversight Board (“PCAOB”). The PCAOB (i) oversees auditors of public companies in order to ensure that the accounting quality meets specific standards, (ii) controls the registration process of audit firms and (iii) performs inspections. If violations are found, PCAOB imposes sanctions on the auditor (such as censure, monetary penalties and revocation of the registration). Academic studies suggest that PCAOB intervention increases the quality of audits. However, most of the improvement relates to small audit firms (Vanstraelen and Zou, 2020) releasing an opinion on financially distressed companies (Gramling et al., 2011). The effect of PCAOB on large audit firms is less visible, because the inspected firms do not show systemic deficiencies (Boone et al., 2019), or relates to specific areas of auditing, such as lower tolerance for earnings management (Carcello et al. (2011). In brief, the introduction of a public oversight body seems to improve the overall quality of audit. Unfortunately, there is no evidence that this improvement is strong enough to prevent the next accounting fraud. The public oversight body might play a role in addressing the conflict of interests between the duty of the auditor to detect and report fraud, and his interest in keeping a good relationship with the client who is paying for his services. However, conclusive evidence that auditors would act sub-optimally or would not disclose fraud, by negligence or intentionally, is challenging to achieve.

87. **The system of audit oversight would deserve a thorough analysis in order to avoid fragmentation.** As a minimum, **communication should be fostered among national public**

**oversight audit boards and with other supervisors.** Other measures could be explored including sanctions, such as a ban for audit firms for a set period of time to enter into public contracts (known as debarment) which is increasingly recognized globally as an effective tool to protect the integrity of public contracting and prevent corruption, money laundering, fraud and other misconduct. The audit oversight bodies could also be required to publish a summary of their inspection reports, which would create stronger incentives for auditors to enhance the quality of their audits, while providing audit committees with better information about incumbent auditors. Such reform of the national audit oversight bodies could be triggered by adjustments of the current EU audit legislation.

A role for ESMA?

88. The logical question which should be raised in view of the aforementioned insufficiencies, is whether ESMA should play a role in reconciling the surveillance of the auditors and the markets. Discussions about widening the scope of ESMA's competences to the oversight of auditing are legitimate. In this respect a parallel may be drawn with the auditing practices on market data. In order to appropriately regulate the latter, proposals have been made that ESMA (i) should develop audit standards to avoid conflict of interests and ensure appropriate confidentiality, and (ii) should consider whether auditors should be independent. A similar proposal could be made with regards to auditing where **ESMA might have a role to play e.g. with regards to the oversight of big auditors in the form of direct supervision.** By way of structural comparison, in the US the Public Company Accounting Oversight Board (PCAOB) oversees accounting professionals, and the SEC has oversight over the PCAOB.

89. This report has pointed to a number of serious problems in the supervision of Wirecard. However, in view of the SMSG's limited resources and powers, this report is inconclusive on the question of whether there are grounds for ESMA to trigger a procedure against the relevant competent authority for non-compliance with EU law (so-called "breach of union law" procedure) under art. 17 ESMA Regulation. **The SMSG therefore recommends that ESMA investigates in more detail whether there is ground to trigger an investigation under article 17 ESMA Regulation.**

## III. Other topics (generally outside the competence of ESMA)

### III.1. Supervision of groups / financial holdings

90. Wirecard's business was presented as a sophisticated one, worthy of the FinTech label, with a complex technological structure, with innovative and groundbreaking algorithms, able to provide superior margins to the company. The erroneous perception of Wirecard's business model by investors, supervisory authorities and the two audit companies, produced the equally erroneous conclusion that also the alleged fraud that was taking place was sophisticated. Wirecard was, however, only a middleman in the credit card business and the alleged fraud it perpetrated represents a straightforward old-style accounting fraud under a FinTech umbrella. Wirecard was consolidating revenues from third-parties although they were outside the consolidating perimeter. Wirecard's short-term assets and liabilities did not match for subsidiaries incorporated outside EU, as claimed by the FT since 2015. Wirecard showed an EBITDA margin of 28%, unconceivable for its industry (Barba Navaretti et al., 2020). Finally, when supervisory authorities forced Wirecard's hand, the company showed apparently bogus revenues and profits, that third party providers were figurehead, indirectly controlled by Wirecard's

management and forgery of clients' portfolio, as well as fake confirmation of holdings by the trustee regarding the previously mentioned EUR 1.90 billion.

91. New sectors and business models offer a relatively favourable setting to commit fraud. Wirecard's alleged misconduct presents similarities with the Enron case: a new sector where the company was able to thrive, a complex business model and creative accounting. New business models have, by definition, fewer experts in the field that can easily walk through the company's operations and point out what is wrong. Sufficient means in terms of staff and skills is crucial in order for the supervisory authorities to be able to apply adequately controls. A perception of complexity increases tolerance when one fails to understand the underlying activity and justifies ignorance when the fraud is unveiled. New business models require additional efforts from the supervisory authorities to frame the company into one of the already existing sectors and provide regulatory arbitrage opportunities. A lesson learned is that effective monitoring requires understanding the company's economics to its basics: "what do you sell, what do you buy and who is your customer".

Supervision of FinTechs

92. A business model such as the one developed by Wirecard, although attractive, is difficult to master, including for supervisors who are in the process of adapting to the digital age. Even when duly registered as financial intermediaries with the competent supervisory authorities, European FinTech companies are treated in many EU countries as technology companies rather than financial services providers. This is what happened in the case of Wirecard AG, which was classified as a technology company in Germany. FinTechs can be very complex companies. Therefore, there is a need for an approach combining the oversight of both entities and activities. The regulation and supervision of FinTechs are not fully mature and the regulators are still on a learning curve to get a full understanding of FinTechs' technologies and business models. The global scope of FinTechs' activities calls for convergence and coordination of rules and supervisory practices at the EU level and beyond. The ultimate goal should be that there is no regulatory arbitrage. The EU and Member States regulation and supervision should apply consistently to all providers engaging in a specific activity (payment services in this case) and creating the same risks, regardless of the provider category (bank or non-bank). **The SMSG encourages the ESAs to clarify the emerging related risks which are covered in their mandate and to pinpoint which ones would require further clarifications at level 1.**

Supervision of payment activities

93. In addition, Wirecard AG was not a payment institution within the meaning of the German Payment Services Supervision Act. Therefore it did not fall under the BaFin supervision from this perspective either. It only held an e-money license from the UK FCA, as a British e-money institute (Wirecard Card Solutions Limited) listed in the EBA register for payment and e-money institutions. It could thus operate in the entire EU by way of cross-border trade in services, while being supervised by the British FCA (so-called passporting, with no operational supervision by BaFin). Operating internationally, Wirecard AG was also licensed by Visa and Mastercard, meaning that it was able to both issue credit cards and handle money on behalf of merchants. Wirecard AG first focused its strategy on secure online payments, taking advantage of the global growth of e-commerce transactions. It then continued its evolution by focusing on online and contactless payments as well as (ironically) fraud prevention systems, while also facilitating online businesses with the requisite software and systems to remain plugged into the wider global financial system. Wirecard AG´s business model encompassed cashless payments across a vast network of credit card companies, retailers and banks. The fact that Wirecard AG was able to both process payments and issue credit cards resulted in

increasing the complexity of the flow of payments from customers, companies and banks. Based on this description it is hardly comprehensible that groups such as Wirecard AG do not fall under the supervision which is foreseen for payment services. This should encourage putting into place a wider supervision of payment processing technologies, to be clearly allocated between the NCA, the ESAs and, to a certain extent, the ECB.

94. In other words, the Wirecard case shows how urgent it is that regulators fully **understand the business model (in particular payments-related services and FinTechs) in order to adapt EU regulation (more coordinated) and supervision (more converging) to the digital age.**

Supervision of groups with a financial component

95. In groups where only one entity is part of the banking industry, it may be tempting for the supervisor to limit its supervision to the entity assigned to its authority. In the case of Wirecard AG, which was classified as a technology company rather than a financial services provider as mentioned above, only Wirecard Bank AG (integrated as a banking subsidiary with a full German banking license into the Wirecard Group in 2006) was under BaFin's supervision. The German authority had direct access only to Wirecard Bank AG and not to the entire group. There was no comprehensive and integrated oversight of Wirecard's activities, both in terms of lines of business and geography of its operations.

96. Wirecard AG was classified as a technology company and not as a financial holding group, in view of the focus of its activities and that of its subsidiaries following an audit performed jointly by BaFin and the Deutsche Bundesbank in 2017, with a later statement by the ECB. The Wirecard AG subsidiaries were not considered to be mainly financial institutions according to the applicable criteria, and therefore the group did not qualify as a financial holding. As a result, the classification of the group limited the enquiry. Probably if the entire group had been classified as a financial holding company, the accounting auditing would have been more rigorous and the alleged fraud might not have endured for so many years (Barba Navaretti et al., 2020).

Outsourcing

97. In addition, a significantly growing ecosystem where regulated entities, providing banking or financial services to clients, outsource services in regard of critical infrastructure or payments to service providers, brings further areas of concern into focus. In the Wirecard case, for instance, the payment processing of a Germany entity was handled by service providers in Philippines, Singapore and Dubai (who, in turn, pay a commission). This raises fundamental concerns on the definition of outsourcing, the assessment of materiality and criticality, affiliates, sub-contracting and outsourcing on a cross-border basis. In this respect stricter requirements have been imposed on banks and certain other providers of financial services, but cases such as Wirecard evidence that the guiding principle with regards to outsourcing should be "same activity/same risks = same regulation". **The SMSG recommends that the ESAs use the supervisory convergence tools at their disposal to foster transparency on outsourcing, increased control functions for the relevant NCAs in relation to outsourcing arrangements and, finally, a more effective enforcement of administrative measures against service providers, who outsource certain activities**. Dealing with existing inefficiencies, the fundamental precepts and principles of the EBA Guidelines on outsourcing arrangements (February 2019) and of the IOSCO guiding principles, in particular in its current consultation report (May 2020), should be brought to life.

98. In this respect, the German draft law FISG will attempt to make BaFin's supervisory powers more effective. It will introduce a general obligation for regulated entities to keep a register, evidencing all substantial, but also non-substantial outsourcing arrangements. Furthermore, an obligation of service providers located in a third country to appoint a process agent in Germany shall ensure that administrative measures against service providers could more effectively enforced.

Defying the complexity of groups

99. The complexity of groups (due either to the nature of the activity or the legal or geographical construction of the group) should not be an obstacle to an efficient supervision and should in itself trigger reinforced controls. There are several ways for supervisors to broaden their sometimes restrictive perimeter of supervision. For instance, a banking supervisor has the possibility to check the reliability of bank owners within the framework of a so-called owner control procedure. Furthermore, for the purpose of a supervision on a consolidated basis, the supervisory authority has the possibility to supervise the group´s subsidiaries that offered payment services abroad (even if they do not have a corresponding license in the EU), which would give comprehensive audit possibilities also over foreign business. This, in turn, could alter the assessment of the group as a whole as a financial holding and might open the door to a more extended supervision via for instance special audits on site.

100. An effective collaboration amongst authorities is crucial to master complex groups and track their operations. The different national and international authorities (at EU level, ESMA, EBA and ECB) gather complementary information which needs to be combined in order to get a full understanding and fact pattern. Good cooperation between these authorities will be key for the success of an efficient supervision of groups such as the Wirecard Group. Only a net of supervision, not only geographically but from different perspectives, combined with an efficient collaboration will allow to defy complexity and to leave no room for market participants with bad intentions.

101. **The SMSG recommends that ESMA (in conjunction with the other ESAs) issues an own initiative opinion to the European Commission in order to revise the criteria of supervision of groups (financial holdings).** In addition**, supervision of complex groups (in particular financial holdings) should be strengthened through supervisory convergence (which is currently foreseen as an outcome of ESMA's peer review on supervisory convergence planned this year).**

### III.2. Corporate governance

102. The way the lines of defence are organised internally and their interaction is at the core of a corporate governance system. Presented as the third leg in the "ESG" (environmental-social-governance) quest, it becomes of prime importance when it comes to situations such as the Wirecard case. This may give an impetus to reiterate how crucial corporate governance is due to its capacity to protect the system against external and internal deficiencies.

Internal controls

103. One of the most crucial aspects for a robust system of corporate governance is an efficient organisation of internal controls. The internal controls, which are composed of compliance (permanent control) and of internal audit (periodic controls), did not operate efficiently in the

Wirecard case. As far as the first aspect is concerned one could wonder why all publicly listed firms do not have an appropriate and effective internal control system. The accounting directive 2013/34/EU already requires companies to include in the management report a corporate governance report with a description of the main features of the undertaking's internal control and risk management systems in relation to the financial reporting process. Building on this, that the **SMSG recommends to introduce a mandatory compliance management system for publicly listed firms**. The compliance management system may also benefit from external auditing although this would entail further costs. The latter could take the form of an assessment by the external auditors not only of the existence of the declaration on corporate governance (which they already do) but of the effective implementation of this declaration. Germany being one of the jurisdictions where this does not exist yet, the new law FISG contemplates an obligation to put in place an "appropriate and effective" internal control system and risk management system within listed companies. The draft law does however not explicitly require firms to also establish a compliance management system.

Supervisory board

104. Due to the specificities of the dual system which is widely spread in Germany with the well-known debate about its pros and cons, the question arises whether the supervisory board could fully exercise its oversight role in this case. Further to the degree of professionalism of the supervisory board, which should not be neglected as the basis for a sound exercise of this function, the question which attracts more attention is the access to information by supervisory board members. Indeed the supervisory board members can properly exercise their function only if the critical (which should be understood as useful for the purpose of its function) information is available and shared with them, voluntarily or upon request. The access to this information should also be direct, i.e. without any intermediate level, which might distort its content or influence its understanding. In other words, **the supervisory board should be able to access critical information independently from management.** In addition, **the head of the internal control function** (the importance of which has been stressed in the previous paragraph) **should report to the supervisory board** (as external auditors already do).

Audit committees

105. The Wirecard case has also shed light on a need for more preparation of the oversight of the supervisory boards. This could take the form of an increased role for the audit committees. The audit committees are usually responsible for topics such as financial reporting, internal monitoring, risk management and internal revision. Article 39 of the Audit Directive requires that "Member States shall ensure that each public-interest entity has an audit committee. The audit committee shall be either a stand-alone committee or a committee of the administrative body or supervisory body of the audited entity. It shall be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity (…). At least one member of the audit committee shall have competence in accounting and/or auditing. The committee members as a whole shall have competence relevant to the sector in which the audited entity is operating. A majority of the members of the audit committee shall be independent of the audited entity."

106. However the Audit Directive includes derogations for certain types of companies and, although already recommended by corporate governance codes, the audit committees are not mandatory in every jurisdiction, as for instance in Germany. The Wirecard supervisory board would have certainly benefited from an earlier establishment of such an audit committee,

which should be informed by the head of the internal monitoring unit, the risk management unit and the internal revision unit on a regular basis, not only on special occasions. In addition the chairperson of the audit committee should be a financial expert who is independent from the company, the executive board and the controlling shareholder. The criteria for choosing the members of the audit committee as well as their independence matters very much. Independent members are desirable in order to avoid that they would feel to be bound by the actions of the management. In a nutshell **the requirement to establish audit committees should be consistent, with a composition largely founded on independence and benefitting from a regular information from the relevant staff.** By anticipation to this recommendation, the new German law FISG foresees that the supervisory board of listed companies of public interest will have to install an audit committee. Furthermore, information rights of the audit-committee's chairperson will be established, with the possibility of a direct exchange with the heads of the business units who work on issues concerning the audit committee. In order to reinforce the role of the audit committees, another welcome idea is being discussed at EU level to explicitly extend the tasks mentioned in the article 39 of the Audit Directive to cover also the systems of internal controls for risk of fraud and ongoing concerns.

Liability

107. Further to these structural adjustments in terms of corporate governance, the next logical step is to examine the two sides of the coin: responsibilities and liabilities. Responsibilities tie up with the duties in particular of the supervisory board members, in particular when they receive indications (for instance linked to the motivation of the resignation of other board members) which should be shared with the other members of the supervisory board. In this light **the duties of the supervisory board to disclose should be reviewed**, with a duty to disclose attached to information which is of significance for the proper functioning of the company.

108. Attached to this responsibility, there is by construction a consecutive liability which may legitimately appear as an essential component of increasing and strengthening the integrity of the financial markets. This leads to the question of translating the responsibility principle into a need for direct liability for the acting people, in particular the supervisory board and management board members. The latter, through their actions, are obviously in the forefront of the exercise of this responsibility and therefore should be irreproachable. In this spirit **penalties for wrong "reporting oath"** (so-called "responsibility statement" required from every management board member and which is published in the annual report) **for the leadership of the company should be foreseen.** It is the direction taken in Germany with the new law FISG, which foresees that a wrong "reporting-oath" of lawful representatives of a listed company will become a criminal offence, with a penalty lifted to 3 to 5 years prison term. The same penalty will be defined for cases where auditors issue a wrong audit certificate to a company of public interest and, in order to achieve a sufficient deterrence effect, also careless action will be punishable.

109. The liability regime of board members may also be adjusted with regards to the financial compensation requested in case board members´ failures would have been acknowledged. Cases such as Wirecard lead to wonder whether it is not time to open the door for instance to the reimbursement by the board members of the compensation paid by the company, or at least to the duplication of this compensation imposed on the board member and the company. The personal liability of board members is certainly one of the most difficult but needed adjustments to the liability regime, as it is the safeguard that the link between responsibility and liability is taken seriously and put in practice.

110. Another aspect of the liability regime is towards the shareholders. Although more daring, the idea of closing the gap which exists in some jurisdictions such as Germany (where supervisory board members and management board members of listed companies are liable to the company in the event of unlawful acts, but not directly towards the shareholders) is making its way. Cases such as Wirecard plead in favour of trying to correct what appears to be a significant deficit for European shareholders while constituting an essential building block for the integrity of the financial markets and investor protection. Practically this would enable investors to claim compensation from board members for insufficient or false information. **The Wirecard case invites policymakers to consider whether more emphasis should be put on the personal responsibility of board members.**

111. In cases of breaches of official duty, a liability of the competent NCA could also be taken into consideration. Having noted that there may be differences in the Member States in this respect the SMSG sees room for consideration at EU level.

### III.3. Collective redress for investors

112. Drawing up the conclusion that a binding European instrument regarding collective redress for consumer issues was needed, the co-legislators adopted in November 2020 the Directive on Representative Actions for the Protection of the Collective Interests of Consumers. Presented as part of the “New Deal for Consumers’ package”, this Directive establishes a collective redress mechanism for breaches of consumer rights which enables consumers across the EU to use representative actions to collectively demand compensation from companies that infringe their rights.

113. In spite of a priority recommendation from the High-Level Forum on capital markets union, the current EU Directive foresees that it would only apply to breaches of certain directives and regulations, such as MiFID II, UCITS or PRIIPs. An extension of the scope to the Market Abuse Directive (MAD2) and Regulation (MAR), as well as the PEPP Regulation, was not retained. Therefore, individual and small equity investors, employee shareowners or bond holders are not covered by the scope of the Directive (it is actually limited to other consumers and individual investors who buy packaged investment products such as funds and life-insurance).

114. Research has stressed that the vast majority of affected consumers in financial scandals are direct investors (shareholders, bondholders), who would not benefit from this mechanism in its current form. This leads to the question whether it should be relevant to launch **a reflection at EU level regarding the eligibility for collective redress of shareholders from the companies in which they have invested (for instance in case of misleading information).**

**Annex 1: Compendium of the recommendations**

*The recommendations provided by the SMSG to ESMA on issues related to its competences (as foreseen in Article 37 (5) of the ESMA Regulation) have been indicated in the table below with an asterisk.*

*As far as the other suggestions are concerned, in particular those regarding priority issues where ESMA has competences, they will hopefully serve as sources of inspiration for the EU institutions in the context of their mandate.*

| Recom-mendation number | |
|---|---|
| **Supervision/enforcement at national and EU levels** | |
| 1 | A quick intervention/response force from the second step authority or from a task force with other authorities (e.g. federal criminal agency and prosecutors) would allow for no latency. |
| 2 | If more than one authority oversees supervision of accounting fraud, a clear definition of competences is in any event needed, with overlapping competences or gaps periodically examined and managed on a continuous basis. |
| 3 | It should be ensured that sufficient and clear investigation powers are at the disposal of the authority when suspicions are unveiled, with information rights towards third parties. |
| 4 | The SMSG recommends that ESMA would develop guidelines to further harmonise how and when to use investigative powers.* |
| 5 | The SMSG recommends to ESMA to use its supervisory convergence tools in order to ensure an effective screening and handling of the warnings received.* |
| 6 | The SMSG recommends that ESMA carries out a peer review on the necessary for the resources to be proportionate to the supervisory authorities' mandate and adequate to its tasks.* |
| 7 | The SMSG recommends that ESMA makes use of the supervisory convergence tools at its disposal to promote the development of a culture of avoiding conflicts of interest.* |
| 8 | The SMSG recommends that ESMA makes use of the supervisory convergence tools at its disposal to standardize when and how ongoing investigations and enforcement measures should be made transparent.* |
| 9 | Efficient exchange of information is crucial, without the impediment of confidentiality agreements between authorities at national level. |
| 10 | The exact competences of the NCA and the criminal authorities should be clarified, in case of any criminal offence, including market abuse and AML in order not to leave any gap. |
| 11 | Forward looking ideas such as integrated European supervisory network or EU-centralised supervision as well as the idea of a "28$^{th}$ regime" for some companies deserve attention and deeper analysis. |
| 12 | Supervisory convergence, also regarding the exchange of information between supervisors and auditors, should be fostered at EU level. The SMSG encourages ESMA to continue to use its supervisory convergence tools to that effect, and should re-iterate its recommendation or issue an own initiative opinion to the Commission to take action.* |
| **Market Abuse** | |
| 13 | The SMSG recommends that ESMA uses the supervisory convergence tools at its disposal to ensure that the NCAs restrict trading by NCAs employees in financial instruments issued by supervised entities and group companies. Rules on insider trading should be adequately managed by the NCA (in line with the EU market abuse rules) and artificial intelligence should feed the analysis of suspicions reports.* |

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| 14 | The dissemination of misleading information shall be identified quickly and appropriately sanctioned. |
| 15 | Allegations of market manipulations should be more deeply scrutinised before supervisory action is taken against the media and/or other whistleblowers. The SMSG recommends that ESMA uses its supervisory convergence tools in this respect.* |
| 16 | The competencies to enforce market abuse rules should be clearly established. |
| 17 | The publication of information about enforcement should be timely. The SMSG recommends to ESMA to contribute to this by using the supervisory convergence tools at its disposal.* |
| | **Short selling** |
| 18 | The SMSG recommends that ESMA uses the supervisory convergence tools at its disposal in order to clarify the conditions for the prohibitions and restrictions of short selling, and more in particular the circumstances under which such a prohibition or restriction can be enacted as well as the procedures followed.* |
| 19 | A dichotomy could be made between a systemic short selling due to specific economic circumstances (e.g. pandemic crisis) and a short selling applied to a specific share; the need for the second category as a risk management tool is disputable. The SMSG advises ESMA to issue guidelines or other level 3 tools to adjust the short selling regime.* |
| 20 | The opinion issued by ESMA, conceived as a mere consistency check, is in practice not necessarily helpful. The SMSG recommends that ESMA issues an own initiative opinion to the European Commission to point to this problem and to request changes to the level 1 text.* |
| | **Auditing** |
| 21 | A comprehensive reform of EU audit rules may be undertaken through the review of the Statutory Audit Directive, e.g. with audit more focused on the detection of manipulation. |
| 22 | The SMSG would like to invite the European Commission to carry out a reflection with regards to the clarification of the duties of auditors to report discovered irregularities, both in terms of competences and timing (with public prosecutors informed in good time). |
| 23 | Auditors' right to information, in particular from employees, should be fostered and confidentiality agreements should be adapted. This aspect should be part of the reflection that the SMSG invites the European Commission to carry out on the exercise of the auditors' mission. |
| 24 | Mandatory external rotation of auditors after a reasonable period of time, e.g. 10 years. The rotation system in the rating agencies may be inspirational. |
| 25 | Joint audits (4-eyes principle) may be worthwhile exploring. The SMSG recommend assessing the relevance of requiring joint audits for large listed companies in the EU. |
| 26 | The separation by audit companies of their audit arms from their consultancy units could favour independence. |
| 27 | The SMSG recommends considering setting appropriate liability caps for audit firms at EU level. |
| 28 | It may be useful to investigate the possibility of foreseeing criminal liability in case of intently or grossly negligent issuance of incorrect audit certificates by auditors. |
| 29 | More transparency and comprehensibility would be of added value to shareholders. |
| 30 | The system of audit oversight would deserve a thorough analysis in order to avoid fragmentation. |
| 31 | Communication should be fostered among the national public oversight audit boards and with the other supervisors. |
| 32 | ESMA might have a role to play e.g. with regards to the oversight of big auditors in the form of direct supervision.* |
| 33 | The SMSG therefore recommends that ESMA investigates in more detail whether there is ground to trigger an investigation under article 17 ESMA Regulation. |

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| | **Supervision of groups / financial holdings** |
| 34 | The SMSG encourages the ESAs to clarify the emerging related risks which are covered in their mandate and to pinpoint which ones would require further clarifications at level 1.* |
| 35 | The understanding of the business model should be fostered (in particular payments-related services and FinTechs) in order to adapt regulation (more coordinated) and supervision (more converging) to the digital age at EU level and beyond. |
| 36 | The SMSG recommends that the ESAs use the supervisory convergence tools at their disposal to foster transparency on outsourcing, increased control functions for the relevant NCAs in relation to outsourcing arrangements and, finally, a more effective enforcement of administrative measures against service providers, who outsource certain activities.* |
| 37 | The SMSG recommends that ESMA (in conjunction with the other ESAs) issues an own initiative opinion to the European Commission in order to revise the criteria of supervision of groups (financial holdings).* |
| 38 | Supervision of complex groups should be strengthened through supervisory convergence (ESMA peer review foreseen in 2021).* |
| | **Corporate governance** |
| 39 | The SMSG recommends to introduce a mandatory compliance management system for publicly listed firms. |
| 40 | The supervisory board should be able to access critical information independently from management |
| 41 | The head of the internal control function should report to the supervisory board. |
| 42 | The requirement to establish audit committees should be consistent, with a composition largely founded on independence and benefitting from a regular information from the relevant staff. |
| 43 | The duties of the supervisory board to disclose should be reviewed. |
| 44 | Penalties for wrong “reporting oath” for the leadership of the company should be foreseen. |
| 45 | The Wirecard case invites policymakers to consider whether more emphasis should be put on the personal responsibility of board members. |
| | **Collective redress for investors** |
| 46 | A reflection at EU level regarding the eligibility for collective redress of shareholders from the companies in which they have invested (for instance in case of misleading information). |

**Annex 2: Summary of the German law on integrity of financial markets ("Finanzmarktintegritätsgesetz" / FISG)**

*Based on the cabinet draft (Regierungsentwurf) dated 16.12.2020*

| Amendment | Reason and Background |
|---|---|
| ***BaFin*** | |
| Reform of the two-tier financial reporting enforcement procedure towards a more state-centred procedure: BaFin will be authorized to directly and immediately intervene in cases of concrete suspicion of fraud | The two-tier financial reporting system has come to its limit when confronted with a suspected system of fraudulent structures coupled with an international dimension. In such cases the private FREP-enforcement has proven to be inadequate. Therefore it will be made possible that BaFin acts towards listed companies with sovereign enforcement-rights.<br>Private enforcement bodies like FREP will only be responsible for random inquiries (§ 107a Absatz 4 Satz 1 WpHG-E). With this amendment inquiries based on concrete suspicion (Anlassprüfungen) will be solely and from the start in the responsibility of BaFin which is however not entitled to launch random inquiries (§ 107 Absatz 2 WpHG). |
| Equipment of BaFin with forensic capabilities | There is a high common interest to uncover cases of accounting fraud at an early stage to protect the integrity of the financial market and the credibility of the German financial centre.<br>With the amended § 107 Absatz 7 WpHG-E a right to seizure and searching under the condition of a court-decision-requirement will be established. The right can be applied, if there are concrete indications for serious breaches against accounting-laws. Such a breach is "serious", if it has relevance for the valuation of the company by the capital- market-actors. In cases where criminal law is involved § 110 Absatz 1 WpHG-E limits the competence of BaFin in favour of the state prosecutor. |
| Equipment of BaFin with competence to inform the public earlier about cases of financial-reporting-enforcement | This amendment serves the valuation of a company and improves the transparency of the capital market, as lopsided information by the company or speculative report can be avoided. Possibly, also speculative trading on the cost of the company, lenders and shareholders can be avoided.<br>BaFin will be granted the competence to inform the public earlier and wider about accounting-issues, if there is a public interest (§ 107 Absatz 8 WpHG-E). Confidentiality obligations – as currently stated in § 21 WpHG – will no longer restrict BaFin. A publication requires a weighing of interests of the affected company and an assessment, if the correctness of the information |

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| | can be secured. The publication will include the name of the company and be accessible easily on the Website, because the information can be of relevance for the capital market. |
| Restriction of trade with financial instruments by staff of BaFin | Staff of BaFin traded with financial instruments linked to Wirecard and were in consequence exposed to the suspicion of insider trading.<br>Doubts regarding the integrity of BaFin have to be pre-empted from the start and conflicts of interest have to be avoided. Through their supervision the staff receives a multitude of information about the supervised companies that enables them to better assess risks and chances than other investors. In cases where staff uses this information in terms of investment decisions there is the danger of reputation damage to the supervisory authority and also a threat to the functioning of the capital market (§ 11a FinDAG-E).<br>BaFin staff members are therefore prohibited to trade financial instruments that are admitted to trading on an organised market within the meaning of § 2 (11) of the Securities Trading Act in Germany, are supervised by BaFin (even if only a subsidiary is supervised by BaFin) or which are considered as “financial corporations” (EU Regulation 549/2013). |
| ***Auditors*** | |
| Strengthening of auditor’s independence through a binding rotation after ten years | The auditors of Ernst & Young did not detect the accounting fraud for many years. Therefore doubts about the ability of private auditing have risen.<br>Measures to strengthen the independence of auditors are necessary to avoid auditing-failures and to strengthen the trust in the orderliness of auditing-documents in particular and the German financial market in general. Audit opinions (Testate) have to be a reliable foundation for investment decisions. Therefore an obligation for listed companies to rotate auditors after ten years will be established. (§ 317 Absatz 1a HGB-E) |
| Separation between auditing and advice-services will be extended where companies are of public interest | Auditors of companies of public interest will only be permitted to offer advice services on a smaller scale than before. This means a further – not total – convergence with the EU-Regulation on audit of public-interest entities (537/2014) (§ 143 Absatz 2 AktG-E). Furthermore it will be possible for a qualified minority of shareholders to request the replacement of the auditor by court decision, if services prohibited under the regulation are rendered (§ 318 Absatz 3 HGB-E). |
| Tightening of auditor’s liability towards the audited company in cases of neglect | The liability in private law towards the audited company will be tightened, in order to create the necessary incentives for a diligent auditing of the |

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| | accounting. The liability limit will be lifted to 16 million Euro in cases of capital-market-oriented companies, to 4 million Euro in cases of non-capital-market-oriented companies and insurance companies and to 1,5 million Euro in cases of other companies. There will be no limit anymore, if gross negligence is involved (§ 323 Absatz 2 Satz 1 HGB-E). |
| ***Criminal Law*** | |
| Penalty in cases of wrong „reporting-oaths“ by the company-leadership and in cases of issuance of incorrect audit-certificates by auditors | The wrong „reporting-oath“ (Bilanzeid) of lawful representatives of a listed company will become a criminal offence (§ 331a HGB-E) The penalty will be lifted to a frame of 3 to 5 years prison term. The same penalty will be defined for cases where auditors issue a wrong audit certificate to a company of public interest. In order to achieve a sufficient deterrence effect, also careless action will be punishable. |
| ***Companies*** | |
| Obligation to install „appropriate and effective“ internal control system and risk-management-system for listed companies | Strong internal supervisory-institutions are of fundamental importance. Doubts about Wirecard’s internal control system were raised in the supervisory board but did not lead to action. Therefore there will be an obligation to install an „appropriate and effective“ internal control system and risk-management-system within listed companies (§ 91 Abs. 3 AktG-E und § 22 Abs. 3 SE-AusführungsG-E). |
| Obligation to install an internal audit-committee for listed companies with public relevance | The supervisory board of listed companies of public interest will have to install an audit-committee (§ 107 Abs.4 AktG-E und § 7 PublG-E). Furthermore, information rights of the audit-committee’s chairperson will be established (§ 107 Abs. 4 AktG-E): a direct exchange with the heads of those business units that work on issues concerning the audit committee is now possible. |
| ***Stock Exchanges*** | |
| Exclusion of listed companies from the quality-segments of stock exchanges | The accounting fraud and subsequent insolvency of Wirecard has led to severe losses on the side of investors.<br>Amendments will ease the exclusion of companies that violate listing-conditions of stock exchanges (§ 42 BörsG-E). It will be secured that sanctions will be publicly announced (§ 50a Absatz 3 BörsG-E). The exchange of information between BaFin and the Exchange Supervisory Authority will be improved (§ 18 Absatz 1 Satz 6 WpHG-E). |

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