

Impact Assessment Analysis Document¹

Session 2

RIA Execution on FSC regulations

Working Group 2

WG Coordinator: Ms. Valentina Stefanova (FSC)

**Requirements to the activities of investment intermediaries,
Chapter 8 – Sections 3–4**

¹ Based on Draft Impact Assessment Guidelines prepared by CESR, CEBS, CEIOPS

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3L3 Impact Assessment Steps

1. Identification of the problem

1.1. Was there a significant market failure and/or regulatory failure and what was its nature?

Please state which potential market failures / regulatory failures MiFID and specifically the rules for internal audit and risk management address (see page 20/21 and 48-52 of the CESR Impact Assessment guide)

(The question about the significant market failure is connected with the problematical discussion, concerning the different aspects of the risk management and its reflections on the future development of the intermediaries. The principal scope of the Art.82 of the Bulgarian Ordinance № 38 is to oblige the participants in the investment intermediary business to define the frontiers of their actions, regarding the fulfilment of the accepted orders, taking into account the distinguishing between the big and small intermediaries and the grade of their capacity to support an eventual negative, resulted from successful market actions. We are of the opinion, that a new market must be protected not only in the state level, but also through the own initiative of the persons, interested in its increasing and in such way to give them possibility to create impediments for undertaking of imprudent risks in the portfolios management.) --> this does not answer the question

Regulatory failure

Common market – the absence of common rules has caused obstacles for the development of the common financial market. The introduction of the MiFid has solved this problem.

The Bulgarian Markets in Financial Instruments Act provides protection of the investors in financial instruments, which premises previous ensuring of the level of their knowledge about the nature of the financial instruments market;

The creation of prerequisites for the development of a fair, transparent and efficient financial instruments market;

The notion of the market failure includes asymmetric information to be on hand, as far as it regards investors' knowledge about the financial instruments market, which exercises an influence over the process of making individual decisions.

The intermediaries in the different Member states deliver different information as a content and scope.

Question 1: Do you agree with our statement about the regulatory and market failure solved by MiFID?

1.2. If no intervention or further intervention would have taken place, would the market have corrected the failure by itself in the short term?

The Bulgarian capital market is a new one, and this is the reason, that it could not be considered as experienced in the matter of solving the disruptive processes, as far as they concern the stability of the not professional clients and the dimensions of their eventual damages.

Especially with respect to the big (with full license) intermediaries, the irregular management of their internal processes and especially the false defining of the operational and market risks could conduce to damages for their financial status and to influence the market stability and confidence of the investors.

~~The absence of special rules in regard to the regulatory intervention would cause as consequence the further operation of the small (with limited license) intermediaries, because their existence couldn't be considered as a material systematic risk for the financial market in a case of failure and they wouldn't cause big disruption in the credence of the investors.~~

This is a dangerous statement. You effectively say that having small firms in the market is not efficient (which normally is not true).

The both problems mentioned above could not be solved by the intermediaries in a short time, without a regulatory intervention and only as a result of the competition and informational exchange between the associations of the intermediaries' firms.

Question 2 : Do you think that the regulatory and market failure caused before introducing of the MiFID regulation could not have been corrected by themselves without any intervention ?

1.3. What is the evidence that establishes that the market/regulatory failure is significant?

Please argue (on a general level) whether the market failures/regulatory failures identified in 1.1 are significant.

The rules, concerning the process of creating of prerequisites for a fair, transparent and efficient market of financial instruments are orientated to the harmonization of the operating requirements for all of the investment firms, which includes conduction of business rules and has as scope to provide a high-level protection for the investors.

(The aim of the norm in Ordinance № 38 is to prevent the appearance of market disruptions. The Bulgarian legislator has followed the content of the Directive, trying to implement their provisions in the Bulgarian law, having taken into account a bit of the own experience. We are persuaded that these rules are necessary and useful for the further development of the business of the investment intermediaries and the non banking financial market.)

--> This is not related to question 1.3, but actually is a good introduction for question 2.1,

1.4. Which objective – e.g. market integrity, market confidence, consumer protection, facilitating innovation, enhancing competition - is threatened by the failure?

The rules about the management of the operational, financial and market risks mentioned above, are of big importance for the consumer protection and for the increasing of the investors' confidence.

(In fact, the common rules are to be regarded as necessary for the enhancing competition too.) (you should only state that if you come to the conclusion below in 5.7 and 6.7 that the rules on internal audit and risk management have a positive effect on competition)

The introduction of the common rules, concerning the risk management and the internal audit results in the upholding of the integrity of the whole European Financial Market.

In regard of our market, these rules contribute for the facilitating innovation of the Bulgarian market.

2. Definition of policy goals

2.1. General goals²

The aim of the norm in Ordinance № 38 is to prevent the appearance of market disruptions. The Bulgarian legislator has followed the content of the Directive, trying to implement their provisions in the Bulgarian law, having taken into account a bit of the own experience. We are persuaded that these rules are necessary and useful for the further development of the business of the investment intermediaries and the non banking financial market.

The stability, the transparency and the credibility of the financial markets, as well the protection of the investors' interests and the insured persons are the principal objectives of the FSC strategy.

Please state which of these goals (and how) the rules on internal audit and risk management might help to achieve.

The risk management and the internal audit are the necessary conditions for the financial stability and the credibility of the financial markets.

Its scope is also to contribute for the economic growth and for reaching a high rate of employment on national level .

can internal audit and risk management rules really help to achieve that?

The enlargement of the existing business conduces to the employing of new workers and office – employees and to the emergence of new business activities in different areas. It corresponds to the principle “stable credence – bigger consumption – economical increasing”.

² Examples include a- financial stability, b- the proper functioning of markets, and c- consumer protection

2.2. Specific goals³

The specific goals are such type of aims, connected to or deriving from the principles, on which the market policy is built. They should be achieved in a cost-efficient manner, thus conserving the equilibrium between costs and benefits. ~~(to try to avoid the hyper indebtedness of the intermediaries).~~

The following four groups of goals are the most important:

- amelioration of the internal organization;
- defining of the personal responsibilities of the investors' employees;
- avoiding of conflicts of interests;
- giving a better definition of the risks and their reflection.

2.3. Operational goals⁴

- Establishing and introducing of common rules regarding the risk management and containing policy and procedures, which identify the risks relating to the investment intermediary's activities and including mechanisms for exercising control over the adequacy and efficiency of the policy procedures;

- Increasing of the investment intermediaries' risk management, creating internal audit department and creating a risk-management department – an internal unit or an external company to estimate customer and financial instruments related risks.

³ Examples (which link respectively to the general objective examples above) include a- capital adequacy provisions that align the economic and regulatory capital of banks and investment firms, b- disclosure regimes, and c- conduct of business rules.

⁴ Examples (which link respectively to the specific objective examples above) include a- specific rules relating to the use of credit evaluation models, b- rules on the publication of prospectuses, and c- rules setting out specific terms of business requirements

3. Development of “do nothing option”

3.1. Please illustrate how the option to “do nothing” would have looked like?

(In the hypothesis of the “do nothing” option, the absence of special rules in regard to the regulatory intervention would cause as consequence the further operation of the small intermediaries, because their existence couldn't be considered as a material systematic risk for the financial market in the case of failure and they wouldn't cause big disruption of the credence of the investors.)

--> This is a dangerous statement. You effectively say that having small firms in the market is not efficient and not a good thing (which generally is not true).

please describe here what the regulations on internal audit and risk management would have been without implementing MiFID.

The rule about the risk management has been implemented as a requirement of the Directive about the capital adequacy from 1.01.2007.

The internal audit contributes to the overview of the internal rules and procedures and gives ideas for the improvement of the market's functioning. Before the implementation of the MiFID in the Bulgarian legislation, this activity has been realized by the company's managing bodies and not on regulated basis.

In the case of "doing nothing", as far as it concerns the big intermediaries, the irregular management of their internal processes and especially the false defining of the operational and market risks could conduce to big damages for their financial status and for the market stability and confidence of the investors.

Question 3: Would the self regulation of the investment intermediaries be effective? And would it have solved the failure in short terms?

4. Development of alternative policy options

4.1. Please illustrate the option that has been implemented in the Regulation

Establishing and introducing of common rules regarding the risk management and containing policy and procedures, which identify the risks relating to the investment intermediary's activities and including mechanisms for exercising control over the adequacy and efficiency of the policy procedures.

Increasing the investment intermediaries' risk management, creating internal audit department and creating a risk-management division – an internal unit or an external company to estimate customer and financial instruments related risks.

4.2. In case that option(s) additional to that one implemented in the Regulation were considered, please illustrate the alternative policy option(s)

~~In certain cases the small intermediaries could not create departments for internal audit and risk management.~~

Not relevant here, as an EU directive is implemented.

It concerns the possibility to introduce either the internal audit, or the risk management.

5. Analysis of impacts (Users)⁵

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
5.1. Costs to consumers	If firms pass on higher costs of applying internal audit and risk management mechanisms, there would appear a risk of increasing of charges for the clients.	minor
5.2. Compliance costs	There are not any.	
5.3. Benefits	More investors and retail clients will purchase investment services as their trust in the investment intermediaries will rise. --> can you give an indication whether this will have significant or only minor impacts?	major high quality of the service
5.4. Quantity of the products	See 5.3 It won't reflect on the variety of the products, but it will concern the number of the offered services.	minor
5.5. Quality of the products offered	Portfolio management by investment intermediaries will become a more secure and widespread investment opportunity. (please explain why) --> this sits better under regulated firms Improving the quality of the products.	major
5.6. Variety of the products offered	The variety of the products offered would aggrandize on the applying of the MiFID basis. The market same and the free offering of diverse services, without the requirement to be occupied simultaneously of the both activities of the risk management and the internal audit would contribute to it.	minor

⁵ The table above is drawn from the UK Financial Services Authority

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
<p>5.7. Efficiency of competition</p>	<p>The common rules for all investment intermediaries will lead to the enhancing competition</p> <p>please explain why you think this is so</p> <p>The introduction of common rules and a single passport will allow investment intermediaries to provide their services on the single EU market. New intermediaries will appear on the home market in every EU country which lead to increasing the competition between Home member firms and other passporting EU firms.</p>	<p>major</p>

Question 4: Do you think that the new implemented provisions can bring additional expenses to the consumers?

Question 5: Do you think that there are some benefits for clients? Do the introduction of these rules will have impacts on the consumers' behaviour?

Question 6: Do you think that the new provisions will impact on quantity/number of sold services ?

6. Analysis of impacts (Regulated firms)⁶

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
<p>6.1. Compliance costs</p>	<p>- setting up a new risk management department (salary for employees, cost for the maintain working place, training for employees, fixed overheads, cost for buying and introducing a new electronic</p>	<p>Major for the big one with complex business</p>

⁶ The table above is drawn from the UK Financial Services Authority

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
	<p>system)</p> <ul style="list-style-type: none"> - setting up a new internal audit department (salary for employees, cost for the maintain working place, training for employees, fixed overheads) - appointing new staff in the above; - development of the policy and procedures under art. 82 (salary for employees, fixed overheads) - developing of the mechanisms for exercising control (salary for employees, fixed overheads) - creating internal rules for proceeding the risk management department (salary for employees, fixed overheads) - exercising the control in according with these mechanisms, preparing the monthly reports for department's activities (salary for employees, fixed overheads) - reviewing and assessing the rules for risk management by management body on a quarter basis (salary for management body and fixed overheads) - developing of the internal rules for proceeding the internal audit department (salary for employees, fixed overheads per person) - exercising the audit (a plan for auditing, preparing recommendations, preparing the monthly reports for department's activities (salary for employees, fixed overheads per person, training, preparing information system) - reviewing and assessing the proceeding of the internal audit department by management body on annual basis (salary for management body and fixed overheads) <p>Above mentioned costs depend on the nature, scale and complexity of the business</p>	

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
	of the investment intermediaries. Same costs they may decrease by using the developed common policy and procedures by association of the investment intermediaries for example.	
6.2. Direct costs	<p>If the association of the investment intermediaries decides to develop common rules for managing risks and internal audit – examining/considering these rules by the regulator, discussing with the association (salary for employees within the regulator, fixed overheads per person)</p> <ul style="list-style-type: none"> - developing a manual for ongoing and periodical supervision by the regulator (salary for employees, fixed overheads per person) - costs for compliance inspection (salary for employees, fixed overheads per person, costs for business trip if the investment intermediary has seat out of the capital) - costs for enforcement, investigation, sanction, administrative procedures (salary for employees, fixed overheads per person) 	
6.3. Benefits	<p>Better internal organization of the business can lead to a decrease of operational and market risks (what do you mean with market risks? Please explain) associating with activities of the investment intermediaries;</p> <p>--> can you give an indication whether this will have significant or only minor impacts?</p>	major
6.4. Quantity of the products offered		

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)
<p>6.5. Quality of the products offered</p>	<p>Portfolio management by investment intermediaries will become a more secure and widespread investment opportunity.</p> <p>(please explain why)</p> <p>The applying of the rules about the risk management as far as it concerns the own portfolio reflects on the financial stability of the intermediary. Through the optimizing of the operational risk will be realized the amelioration of the quality of the products offered.</p>	
<p>6.6. Variety of the products offered</p>		
<p>6.7. Efficiency of competition</p>	<p>The incremental costs associated with applying these new rules will affect a restriction to the business of the small intermediaries because of the high costs and will improve the environment for the pursuing of the activities of the other participants.</p> <p>(what does this mean? Does that mean that there are less firms in the market? This would be detrimental to competition!</p> <p>As a result of the market competition the incomes and also the price of the service will be minimized as a consequence of it. The conservation of the price and the increasing of the costs at the same time would result in the failure of the small market participants in a short period and in the diminishing of the number of the market participants as whole.</p>	

Benefits & Costs	Qualitative description	Quantitative description (e.g. major, minor)

Question 7 : Do you think that there are other benefits for investment intermediaries then the below mentioned which have not been considered? Please suggest!

Question 8: Do you think that provisions about risk management and internal audit will increase costs incurred by investment intermediaries? Please provide an approximate values of the below itemized cost categories!

Question 9: Are there any indirect costs to intermediaries in your opinion?

Impact Assessment Questionnaire is a consultation paper between us and the the investment intermediaries which are not credit institutions.

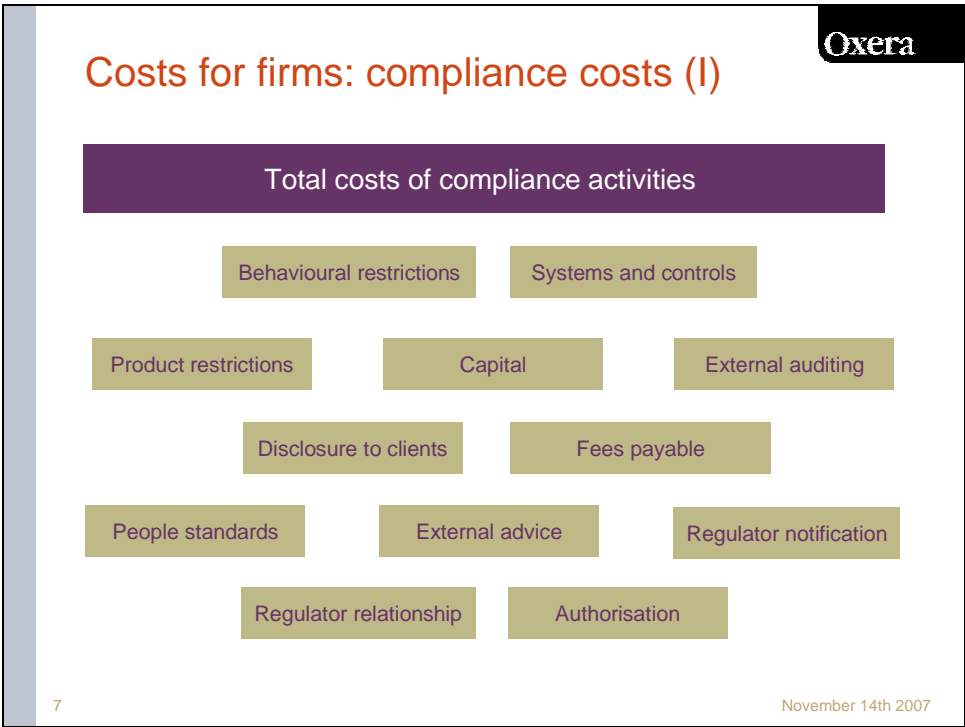
Annex – Methodological Section

- **Problem identification:**
Concepts are explained further in 3L3 Draft *Impact Assessment Guidelines*, at pp. 20-25, Appendix 2 p. 48.

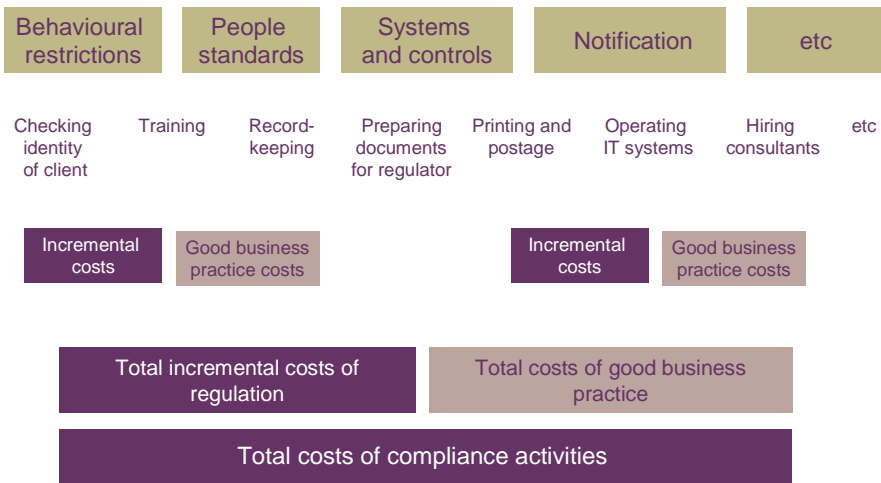
- **Definition of Policy Goals:**
Concepts are explained further in 3L3 Draft *Impact Assessment Guidelines*, at p. 27.

- **Cost and Benefit Analysis:**

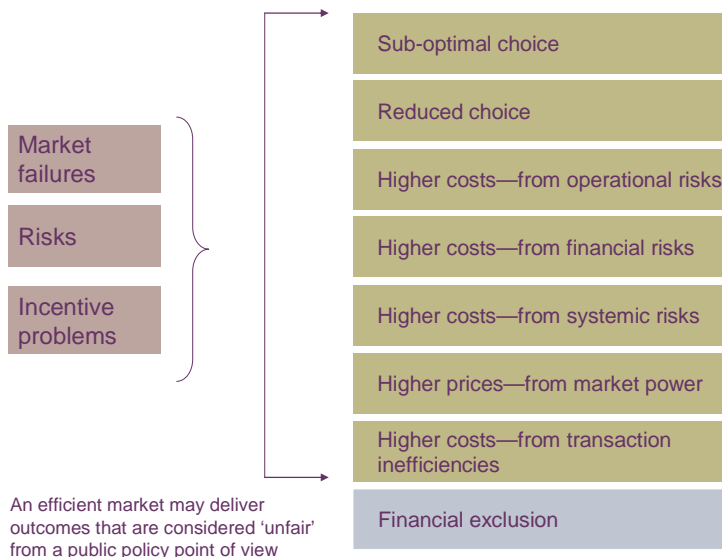
The following methodological excerpts by Oxera are also strongly suggested for an effective and systematic approach towards costs and benefits assessment.



Costs for firms: compliance costs (II)



Types of detrimental market outcomes for consumers



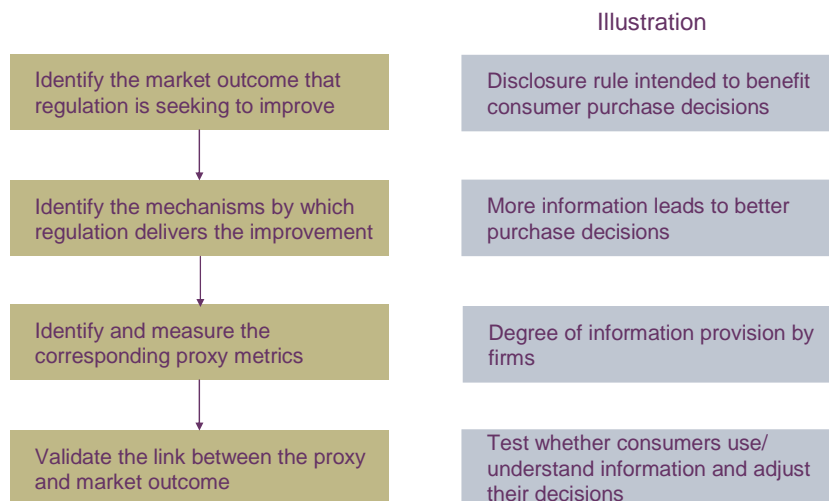
Direct measurement of consumer benefits

Type of detrimental market outcome that regulation may improve	Relevant measure of benefit is the value that consumers derive from ...
Sub-optimal choice	better choice (more optimal fit between what consumers buy and what they need)
Reduced choice	increased choice (wider availability of what consumers need)
Higher costs—operational risks	reduction of losses or other costs associated with operational failure
Higher costs—financial risks	reduction of losses or other costs associated with firm default
Higher costs—systemic risks	reduction of losses or other costs associated with systemic failure
Higher prices—market power	reduction in excessive prices
Higher costs—transaction inefficiencies	reduction in transaction costs, including search costs
Financial exclusion	improved access to financial services

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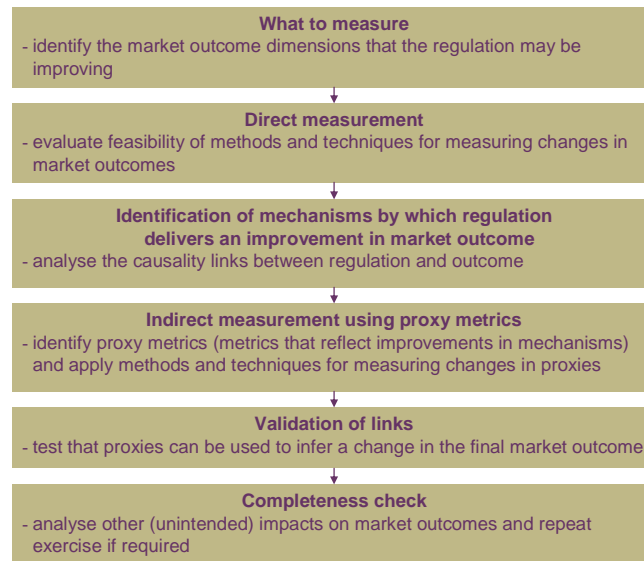
Indirect measurement of benefits (II)



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Summary of measurement framework



Concepts of cost/benefit assessment are also explained further in 3L3 Draft *Impact Assessment Guidelines*, at pp. 31-34 and in Appendixes 3-4.