



Policy Recommendations

Working Group 1

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**Requirements to the activities of investment intermediaries,
Chapter 8
Section II (Internal Control)**

EXECUTIVE SUMMARY

The World Bank administered Convergence Program has organized in 2007/2008 in Bulgaria a knowledge transfer and capacity building program, designed to help participants from various regulation and supervision authorities to get acquainted with the basics of Regulatory Impact Assessment (RIA).

After an introductory session, where presentations were made by experienced speakers from EU authorities and their consultants, participants joined in Working Groups (WG) and they took part in a training exercise, designed to develop basic skills in undertaking a RIA.

Working Group 1, consisting of representatives from (pls insert) has chosen to set up an ex-post RIA on an existing piece of legislation, **Ordinance No. 38 on the requirements to the activities of investment intermediaries, Chapter 8, Section II (Internal Control)**. The group identified categories of key stakeholders that are affected by this regulation, then they were contacted and a consultation was organized (written questionnaire and face-to face interviews.)

Under the guidance of experts from the World Bank Convergence Programme and facilitators, the WG performed the main steps recommended by the Impact Assessment Guidelines for EU Level 3 Committees jointly issued by CESR, CEBS and CEIOPS in May 2007, drafting the suitable documents related to each step.

These documents included:

- a consultation document;
- a summary of consultation feedback; and finally
- a policy recommendations document.

The present document is a summary of all the activities described, and it ends with policy recommendations based on the Impact Assessment.

PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

This document is the outcome of an Impact Assessment (IA) knowledge transfer and capacity building program organized by the World Bank administered Convergence Program. The participants of the Working Group are representatives of Bulgarian authorities involved in regulation of financial markets issues (pls insert).

The IA training exercise was undertaking a retrospective IA – ex-post RIA - on an existing piece of legislation, **Ordinance No. 38 on the requirements to the activities of investment intermediaries, Chapter 8, Section II (Internal Control)**. After discussions some categories of key stakeholders were identified as being affected by this piece of legislation.

Consultation with stakeholders is a key part of the IA process, because it promotes public accountability and provides stakeholders with the opportunity to contribute to the evidence base that should underpin the policy making process. The Working Group has conducted a stakeholder consultation. They have designed an explanatory cover letter and a questionnaire, which were sent to a set of selected stakeholders.

The questionnaire was designed to provide evidence relating to:

- a) the nature of the problem that the regulation was seeking to address, and
- b) the costs and benefits of the regulation and of two alternative policy options that in theory could have been chosen instead of it, thus recognizing the fact that in a "live" IA exercise different policy responses could be considered to address the same policy problem.

Stakeholders were also asked to help after the questionnaire-answering phase was completed by attending a face-to-face meeting to quality check all stakeholder responses and enhance the WG's understanding of their answers.

After reception of answers from stakeholders, a summary of questionnaire results was drafted, then these were processed into a consultation document. The consultation document, including more in-depth issues that were raised during the meeting with stakeholders, became the basis for drafting a summary of consultation feedback, which was used in its turn as the underlying evidence for this report, summarizing all findings gathered during the process.

PROBLEM IDENTIFICATION

Investment firms should conduct their business in a way that protects the interest of consumers and fosters the integrity and efficient operation of the markets. Compliance with the regulatory framework is clearly central to meeting this goal.

In our view, the problem being addressed by this regulation is that in the absence of regulatory intervention, it will be difficult for investment firm to monitor the compliance of its

activities with regulatory requirements in a proper way. This would be detrimental to consumers, as there is asymmetric information between consumers and investment firms. It could also have negative impacts on market confidence, as the misbehaviour of individual firms could also damage the reputation of the market as a whole (negative externality).

In addition, we believe that this is also a case of regulatory failure because the existing regulatory regime is no longer appropriate for the realities - the widened catalogue of the investment and ancillary services and activities requires the introduction of more demanding and detailed internal control requirements for investment firms. The effectiveness of the internal organization is crucial for the proper functioning of an investment firm. Internal control mechanisms are an important part of that.

Stakeholders were asked to provide answers to the following questions:

Question 1: Do you agree with us that the problem is as described above and with the analyzes provided? Please explain your answer, including evidence (or suggesting the type of evidence that would be relevant) where at all possible. For example, what evidence do you think would demonstrate or in fact does demonstrate that there was significant regulatory failure? Do you agree that if the internal control wouldn't be designed as it is proposed, regulatory failure as described above would remain?

Question 1.1: Do you think consumers were adequately protected by the previous regulation on internal control? In what way the new regulation is better than the previous version

Question 1.2: do you think the new regulation is clear about the duties of firms regarding internal control?

Question 2: If no intervention or further intervention would take place, would the market have corrected the failure by itself in the short terms?

Question 3: to what extent did you have already in place an internal control mechanism similar to that set by the provisions (i.e. market-driven solutions)? Please give evidence.

Feedback from consulted stakeholders: Consulted stakeholders believe that there is market failure, but part of them consider that the market would be able to correct this itself in the future. Due to the previous regulatory regime all the firms already had internal control departments. With respect to small firms all the stakeholders agreed that those firms will not be able to regulate themselves. One shareholder believes that the new regime is a step forward compared with the previous one as the duties of compliance officers are defined more clearly. However, the new regulation requires a dedicated compliance officer in each branch of the intermediary, which is very costly.

Our response: In our point of view we should adopt this new regulation because it concerns the interest of the clients and we have evidence from regulating investment firms that that some of the firms are not willing to maintain proper internal control without particular regulatory requirements to do so. In 2007, 90 penalties to investment firms have been imposed concerning breaches of the requirements of Ordinance N 1 on the requirements to the

activities of investment intermediaries and 10 complaints have been made by clients or potential clients against investment intermediaries.

Furthermore the rules should be equivalent for all the participants in the market, so there should be a comprehensive internal control regime for all the investment firms. The new rules address the specific situation of small firms.

We will address the comment on the costs of having compliance officers in each branch in the cost and benefit section of this document.

OBJECTIVES / GOALS

General objectives

- **protection of consumers** – Amending internal control mechanisms should help to improve consumer protection in two ways: it should help to avoid conflicts of interests, that may occur in the process of providing different services and should help to ensure compliance with other legislative requirements. As a result the quality of services provided should be improved.
- **Proper functioning of financial markets / financial stability** – high and effective internal control standards are important for proper functioning of EU financial markets and for financial stability

Specific / Operational objectives

- **Introducing internal procedures for proper functioning of the internal control** – We identified the following requirements for staff involved in this controlling process to achieve this objective: to be independent from the activity/services it controls; to review regularly (for example at least once a week) the particular activity; regular reporting of its activities to senior management.
- **Tailor-made internal control mechanism to the specific characteristics of the investment firm** – Due to the huge variety of investment firms and their businesses the internal control mechanism should be in accordance to the volume of firms' business (e.g. with respect to the specific activities and services, the financial instruments that it deals with, and the structure of the financial group it belongs to)

POLICY OPTIONS

The Ordinance N 38 introduces into Bulgarian legislation requirements of Directive 2006/ 73 EK, implementing MiFID, so we are obliged to adopt such a regulation and in this case “do nothing option” is not applicable.

In our questionnaire we asked stakeholders about their views on the implementation of internal control procedures in Ordinance 38. Stakeholders seemed to have a problem with the requirement to have a dedicated compliance officer in each branch. We followed this up in our stakeholder consultation meeting.

Question 1: How do you assess consumer protection is addressed with the new set of provisions?

Question 2: In case the presence of internal control officers in each branch is eliminated, could you provide evidence of how the Ordinance objectives could be fulfilled? Which feasible alternative solutions do you propose?

Feedback from consulted stakeholders: Stakeholders appreciated that the new regulatory regime is beneficial both for firms and for their clients, who are better protected. On the other hand they consider that the requirement for permanent presence in each branch or office of internal control officer is too burdensome and suggested alternative mechanisms aimed at ensure the fulfillment of all the requirements of the Ordinance concerning the activity of the investment firm and the responsibility of internal control function. Alternative mechanisms could include a internal compliance officer responsible for several branches or having a “mobile squad” responsible for several branches. One stakeholder also suggested a division of labor between the headquarters (periodical work) and the branches (day-to-day activity).

Our response: We accept the suggestions for alternative solutions with respect to internal control function and the requirement mentioned above concerning the presence of internal control officer in each branch and office.

ANALYSIS OF QUALITATIVE AND QUANTITATIVE IMPACT

Costs

Costs to the regulator – direct costs

The direct costs will consist of:

- Preparation and adoption of new regulatory internal control policy;
- monitoring whether investment firms comply with internal control requirements;
- Additional reporting provided by firms has to be analyzed

We expect these costs to be of minor significance.

Costs to regulated firms – compliance costs

We identified the following categories of compliance costs related to internal control procedures:

One-off costs:

- Costs for analyses on how to implement the rules on internal control, e.g. development of policy and procedures, communication of the rules, management time (staff-time/salaries)
- Costs for hiring staff with appropriate experience and knowledge (one-off cost for the hiring process)
- Training costs for the employees on the new rules

- Costs new IT systems and other office equipment (if applicable)

Ongoing costs:

- Salary for employees
- Other ongoing costs for the operation of the department (e.g. software license, office material, etc.)
- Time other departments have to spend to deal with internal control issues
- Management time – Time for dealing with internal control issues on an ongoing basis as well as costs for reviewing and assessing the rules for internal compliance

Stakeholders were asked the following questions concerning costs due to internal control mechanisms by WG1:

Question 1: Do you agree with the costs categories for investment firms?

Question 2: Can you give cost estimates? In many firms internal control departments were already established (due to previous regulation). Could you please define precisely which additional costs (and their magnitude) are due to the **new** regulation on internal control (e.g. internal control officer per branch, hiring other staff, training costs, IT costs, etc.)?

Feedback from consulted stakeholders: Participants considered that there will be mainly one-off cost initially and on-going costs for internal control officers' salaries. Those costs will be higher for small firms and higher for branches than for headquarters. Generally, the additional burdens for firms with respect to new regime have been considered as not significant. However, there is one specific issue: The requirement to have a dedicated compliance officer in each branch of the investment firms. This is considered as very costly and overly burdensome.

Stakeholders agreed that his new regime will significantly reduce the risks of misconducts. It was noticed that is still early to be made observance over clients' claims.

Our response: Apart from the costs due to the requirement of dedicated compliance officers in each branch, we think that he costs that firms will face are not significant. Compared to benefits they are worth to be made.

We will look in more detail at the requirement of dedicated compliance officers for each branch. Apart from that, we don't consider there is need for change for the rules on internal compliance.

Costs to consumers

Consumers potentially face the risk that firms pass on higher costs for internal control mechanisms to them. Stakeholders said, that apart from the requirement on compliance officers for each branch, additional costs are not significant. This also limits the risk of higher prices/commissions for consumers.

Benefits

WG1 asked stakeholders about the potential impact of the new rules on internal control on the variety, quality and quantity of products offered. Concerning the quality of the service, we also analyzed whether the number of customer complaints has decreased since the regulation was enacted.

Feedback from consulted stakeholders relating to quantity, quality and variety of products:

There is a general sense that the regulations are beneficial (increased trust, confidence, possibly more demand for higher-risk investment products, etc.). However, it is difficult to assess which part of this is due to the regulations on internal control, internal audit and risk management or if this is due to the implementation of MiFID as a whole.

One stakeholder specifically commented that in their opinion for investment intermediaries 95% of the change is market driven issue, only 5% are driven by MiFID/Ordinance 38.

Our response:

Feedback from stakeholders confirmed the regulation suggested as beneficial. We cannot draw any conclusions on the customer complaints at the moment, as the time since the implementation of Ordinance 38 is too short.

At this stage we consider here is no need to change our policy with this respect. In the future we will continue to observe the impact of the regulation and if necessary will make some amendments.

Efficiency of competition:

We asked the stakeholders the following question concerning efficiency of competition

Question 1: How many firms do you think will close down because of this regulation? How many firms will need to get restructured to face the cumbersome compliance rule requiring one internal control officer per branch?

Feedback from consulted stakeholders: It was suggested that in the future the new regulatory regime will cause restructuring of the market. A small number of firms is likely to be forced out of the market. A significant number of firms (possibly 20 %) of the firms will have to restructure their business due to the requirement of having an internal control officer in each branch.

Our response: On this stage we consider here is no need to change our policy with respect to competition issues. In the future we will continue to observe the impact of the regulation and if necessary will make some amendments.

COMPARISON OF THE OPTIONS

This is an ex-post Regulatory Impact Assessment and deals with the implementation of an EU directive. Therefore we didn't compare different regulatory options.

POLICY RECOMMENDATIONS

The working group identified one particular issue in the implementation of internal control mechanisms: the requirement of having a dedicated internal control officer in each branch of an investment intermediary. Stakeholders described this requirement as very costly and overly burdensome.

Based on this observation, our **general policy recommendations** with respect to internal control mechanisms are as follows:

1. The FSC monitors the status of implementation of the rules (looking specifically at the identified problem: compliance officers for each branch). The monitoring could include documentary and on-site inspections, monitoring of market behaviour of investment intermediaries. Dialogue with firms is necessary and it will be maintained by public consultation initiatives, round tables, seminars and other.
2. The FSC monitors the number of complaints which relate to this regulation.
3. The FSC monitors the market structure of the investment intermediaries market (i.e. how many firms go out of the market, how many firms enter the market)
4. If the FSC thinks after a certain period (e.g. 1 year) that the implementation is not going smoothly, the FSC could suggest to:
 - Alleviate the burden related to the requirement of compliance officers in each branch. This could be achieved by either allowing firms to use e.g. “mobile squads” of compliance officers or to have one compliance officer who is responsible for several branches.
 - This could be done either via FSC guidance or via revision of Art. 76(4) of Ordinance 38.
 - It is important to consult with market participants in this process.