



Regulatory Impact Assessment

- Main Findings and Policy Recommendations -

Ordinance N. 38, 2007
Requirements to the activities
of investment intermediaries

-Chapter 8 –

Section II (Internal Control)

Financial Supervision Commission

Sofia

February 4, 2008

Working Group Composition

WG#1				
WG Coordinator	Bulgarian National Bank	Financial Supervision Commission	Financial Supervision Commission	Financial Supervision Commission
Financial Supervision Commission <i>Ms. Petya Nikiforova</i>	<i>Mr. Georgi Petkov</i>	<i>Ms. Broyana Dimitrova</i>	<i>Mr. Boyan Dombalov</i>	<i>Ms. Vesela Todorova</i>
Central Depository AD <i>Ms. Nadia Daskalova</i>	Bulgarian Association of Asset Management Companies <i>Mr. Evgeny Jichev</i>	Financial Supervision Commission <i>Mr. Nursen Murad</i>	Bulgarian National Bank <i>Mr. Lyubomir Mirchev</i>	Financial Supervision Commission <i>Mr. Zhelju Vasilev</i>

Facilitator

*Mr. Christian Winkler,
Senior Regulator,
UK Financial Services Authority*

Co-facilitator

*Mr. Riccardo Brogi,
Senior Regulatory Economist,
Convergence Program*

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1. Regulatory context

- Ordinance N. 38 implements MiFID Directive 2006/73/EC with detailed provisions about **Internal Control** on the following areas:
 - procedures;
 - profiles with specific tasks and responsibilities;
 - planning and ex-post reporting activities.
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2. Problem identification (1)

In the absence of intervention, it will be difficult for investment firms to monitor the compliance of its activities with regulatory requirements in a proper way. Investors would have been damaged accordingly.

The introduction of this regulation addresses the following:

- **Market failure**

- asymmetric information between consumers and investment firms;
 - negative externality (market reputation).
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2. Problem identification (2)

- **Regulatory failure**

Existing regulation is no longer appropriate for the current context (i.e. widened catalogue of the investment and ancillary services and activities requires the introduction of more demanding and detailed internal control requirements for investment firms)

3. Statutory goals at risk

The Working Group identified the following risks:

- **Protection of consumers**

Without adequate internal control mechanisms

- conflicts of interest between investment firms and customers (may occur in the process of providing different investment and ancillary services) can arise
- quality of services can be negatively affected.

- **Financial stability**

High and effective internal control standards are key for proper functioning of EU financial markets and financial stability.

4. Proposed regulatory action (1)

Ordinance N. 38 transposes Directive 2006/73/EC;

In doing so, a specific requirement for investment firms to have a dedicated and qualified compliance officer in each branch was introduced.

4. Proposed regulatory action (2)

If no intervention would have taken place, the market would have not corrected the failure by itself in the short term for the following reasons:

- ✓ Because of the complexity of the investment firms' activity, it would be difficult for them to ensure proper internal control mechanisms without further regulatory requirements for internal control;
 - ✓ Without internal control will be impossible to insure lawful performance of different services and activities with regards to different financial instruments by investment firms.
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5. Stakeholders consulted

- One Investment Firm;
 - Bulgarian Association of Asset Management Companies;
 - Central Depository AD.
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6. Feedback goals

- To what extent does the new regulation fit investment firm operational patterns?
 - Is the regulation aligned with market practice? Is there some super equivalence vs the EU Directive?
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7. Questions asked

First round consultation (to touch ground)

“Market and regulatory failures”

- Do you agree with us that the problem is as described before?

 - Do you agree with our analysis if no intervention or further intervention would have taken place?
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7. Questions asked

First round consultation (to touch ground)

“CBA on consumers”

- Do you agree with the analysis that we envisage about cost impacts? Please determine how the new regulatory approach would reflect costs to consumers and try to provide an estimate;
 - Do you agree with our analysis about benefit impacts? Please determine how the new regulatory approach would reflect benefits to consumers and try to provide a qualitative estimate
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7. Questions asked

First round consultation (to touch ground)

“CBA on regulator and regulated firms (1)”

- Estimate of the incremental direct costs that could arise from the regulation under review;
 - We have identified 7 different types of incremental compliance costs that could be incurred by regulated firms. Do you agree with our analysis? Please provide an estimate.
-

7. Questions asked

First round consultation (to touch ground)

“CBA on regulator and regulated firms (2)”

- Do you agree with our analysis about the benefit impact for regulated firms? Please provide a qualitative estimate;
 - Do you agree with our description of the regulatory impact of internal control in the following regards (quantity, quality and variety of products offered, efficiency of competition)?
-

7. Questions asked

Second round consultation (to deepen analysis)

“Market and regulatory failures”

- Do you think consumers were adequately protected by the previous regulation on internal control?
 - To what extent do you have already in place a mechanism similar to that set by the provisions (i.e. market-driven solutions)? Please give evidence.
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7. Questions asked

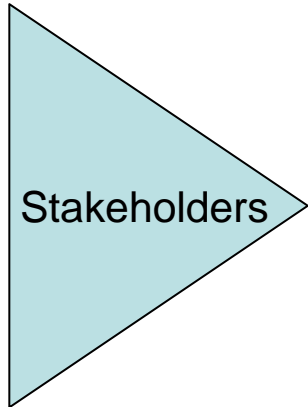
Second round consultation (to deepen analysis)

“What are the possible policy solutions?”

- In case the presence of internal control officers in each branch is eliminated, could you provide evidence of how the objectives of the Ordinance could be fulfilled? Which feasible alternative solutions do you propose?
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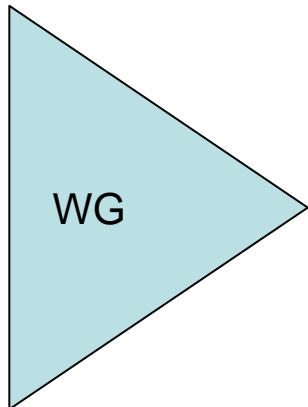
8. Overall feedback and Responses:

Problem identification



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.

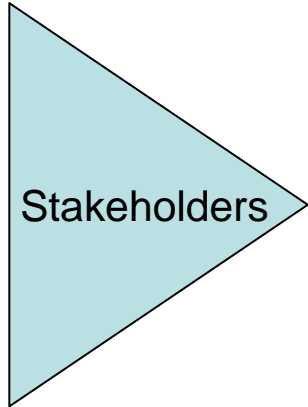
However, the new regulation requires a dedicated compliance officer (who deals and has to be in compliance with the new and stricter requirements) to be present in each branch or office of the firm where clients are admitted. This is considered as too costly for investment firms.



There is evidence from regulating investment firms that some of the firms are not willing to maintain proper internal control without particular regulatory requirements to do so.

In 2007, approximately 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.

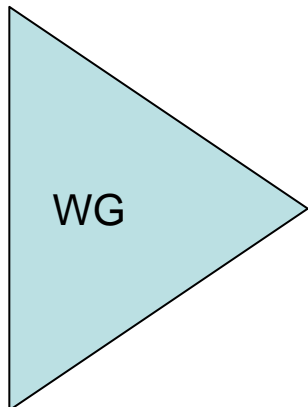
8. Overall feedback and Responses: Policy Options



In the stakeholders' view the new regulation is beneficial both for firms and for their clients, who are better protected.

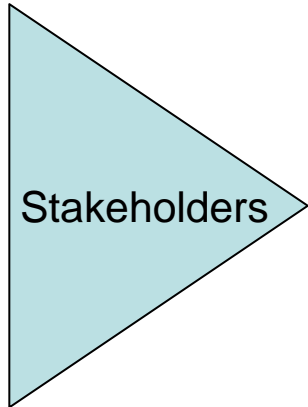
The requirement for the permanent presence of an internal control officer in each branch or office has been considered as too burdensome. Alternative suggestions are:

- an internal compliance officer responsible for several branches;
- a “mobile squad” responsible for several branches or a division of labor between the headquarters (periodical work) and the branches (day-to-day activity).



WG1 considers the suggestions for alternative solutions with respect to internal control function and the requirement mentioned above concerning the presence of qualified internal control officer in each branch and office.

8. Feedback and Responses: Cost-Benefit Analysis

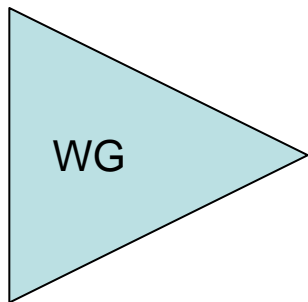


Participants considered that there will be one-off cost initially and on-going costs for internal control officers' salaries. These costs are part of the whole package of implementing Ordinance 38.

Those costs will be higher for small firms and for branches than for headquarters.

The requirement to have a qualified compliance officer in each branch of the investment firms is considered as very costly and overly burdensome.

All agree that this new regime will significantly reduce the risks of misconducts.



WG will look in more detail at the requirement mentioned above. Apart from that, we don't consider there is a need for changing the rules on internal compliance.

9. Policy Recommendations (1)

➤ The FSC monitors the status of implementation of the rules

The monitoring could include documentation and on-site inspections, monitoring of market behavior of investment intermediaries. In particular, the following monitoring actions are recommended:

i) The FSC monitors the number of complaints which relate to this regulation;

ii) The FSC monitors the capital market structure concerning investment intermediaries (i.e. how many firms go out of the market, how many firms enter the market).

➤ Dialogue with firms is necessary and it will be maintained

(e.g. public consultation initiatives, round tables, seminars)

9. Policy Recommendations (2)

➤ A “sunset mechanism” could be introduced

If following the aforesaid actions 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 qualified compliance officers in each branch. This could be achieved by applying the proposals raised during the consultation process with stakeholders.
