

**Existing Institutions and Legal Traditions
for the Enforcement of Financial
Information have Proven their
Effectiveness and Should be Respected**

ESMA's proposed Guidelines on enforcement tend to go too far in some important respects

1 Summary and General Remarks

Deutsches Aktieninstitut welcomes the opportunity to respond to ESMA's proposal for "Guidelines on enforcement of financial information" from 19 July 2013.

The enforcement of financial information is an important element of the regulatory architecture of the securities markets. Although it is not the only institutional safeguard to ensure that investors can trust in the financial information provided by issuers it serves as an "second check" of the financial statements and thus ensures preventively the compliance with accounting standards and/or EU legislation.

Though the case for enforcement institutions in general is clear, the case for a harmonised approach in Europe is, however, less clear given different legal traditions, different sizes of national capital markets and different institutional settings of the enforcement system.

Against this background we have the general feeling that the proposed guidelines tend to interfere too much with the existing institutional frameworks for the enforcement of financial information. This will lead likely to a number of "notes of non-compliance" from national enforcers according to Art. 16 (3) of the ESMA Regulation. As a consequence the false impression may be created that there is a general deficit in the enforcement of financial information or even that the financial information itself is flawed.

This is certainly not the case and it is also not the view of Deutsches Aktieninstitut: Financial information has been checked and certified by the accountants and issuers can be held liable for the correctness of the information. Also, most countries have implemented a national enforcer who ensures that there is "second line of defence" against serious malpractices.

For example the German system of enforcement has the specific institutional feature that it is two-staged. The examination work on the first stage is performed by the Deutsche Prüfstelle für Rechnungslegung (Financial Reporting Enforcement Panel (FREP)), which is a self-regulatory body equipped with examination power by national law. The German financial supervisory authority, the BaFin, will only be involved in the enforcement process if a company does not cooperate with the FREP. This institutional setting has gained a very high reputation among auditors, companies and other capital market participants, because it prevents serious malpractices in a cost-efficient and appropriate manner.

While we agree that enforcement needs to be effective we strongly believe that enforcement also needs to be efficient. All enforcement efforts for which the benefits do not clearly outweigh the costs need to be avoided. We strongly recommend that this principle is added to ESMA's enforcement guidelines.

Against this background Deutsches Aktieninstitut is sceptic with regard to some elements of the proposed guidelines which either materially go too far or will be not in line with the German two-stage system of enforcement.

In particular:

- We would oppose any extension of the **approval regime for prospectuses** in the direction of ex-ante enforcement of the financial statements included in the prospectuses since this would make the issuance of financial instruments much more costly and slow down the process of issuance without generating additional benefits to the investors. In contrast, ex-ante enforcement would reduce attractiveness of capital market finance.
- We are sceptic with regard to **common enforcement priorities** unless they will strictly be meant as a non-binding indicative list of possible enforcement issues. National enforcers should be free in setting own priorities and in taking into account the specific situation of the issuer under review and/or the national market (guideline 7).
- An enforcement related review activity should not contain "**full reviews**" as such full reviews are not efficient considering that the financial information has already been audited by an independent auditor. Instead, enforcement related review work should only be (a) very selective and (b) based on the findings of an analysis of the financial statements issued by the companies. We urge ESMA to drop the term "full review" or at least explain it better with respect to examination procedures as we fear that this term could result in the extension of the enforcement activities far beyond what is economically justified given the existing institutional safeguards for the correctness and reliability of financial information (guideline 8).
- We are concerned that ESMA's guidelines will pave the way towards additional **enforcement actions** that will be costly for listed companies without adding to investor protection or serving the objective of preventing malpractices better than the existing actions. This is particularly true for restatements of the accounts. Also, it is not clear whether ESMA's correction note goes beyond the German practice of making public "error findings". We also doubt that is necessary according

to or permitted by the EU legislation at all that ESMA “defines” enforcement actions. This task should rest with national legislator.

- We are strongly concerned that ESMA obviously envisages an **extended role for the European Enforcers Coordination Sessions (EECS)**: Making it more or less obligatory for national enforcers to discuss ex ante accounting issues in a number of cases will slow down decisions, make the process of enforcement generally more complex and creates the disincentive for countries with a rather less effective system of enforcement to free ride on the resources and capacities of other national enforcers.

2 Comments on the Proposed Guidelines and Specific Questions

Enforcement activities – approval of prospectuses

In the context of **guideline 6** ESMA seeks feedback whether we agree that in order to ensure investor protection, the measures included as part of a prospectus approval should be supplemented by additional measures of ex-ante enforcement in relation to financial information (Q 9, p. 29 as well as general part, p. 10).

Deutsches Aktieninstitut strictly opposes any extension of the approval regime for prospectuses in the direction of ex-ante enforcement of financial information.

This is neither necessary from an economic nor from a legal point of view. Prospectuses contain a huge amount of information which enables investors to make proper and informed investment decisions. In addition, the information contained in prospectuses is already now sufficiently and comprehensively checked for errors and misleading information by accountants, lawyers and other participants of the process of issuance of a financial instrument. Also, the issuer of a financial instrument (and other parties involved) can be held liable for the correctness of the information which creates strong incentives not to mislead the potential investors.

It is therefore right that the purpose of the “approval” of prospectuses is basically to check the completeness of the information as demanded by the Prospectus Directive and Regulation and to uncover obvious inconsistencies before prospectuses are issued to the market.

It is not and should not be the task of supervisory authorities and/or enforcers to scrutinise the financial information in the sense of reviewing the compliance with accounting standards. This has already to be done in the process of drafting the prospectus in the due interest of the person responsible for the prospectus for liability reasons. Any material extension of the enforcement of prospectuses would thus not only make the process of the issuance of financial instruments slower and much more costly. It would also be unnecessary from an economic point of view. In addition, it would create an additional disincentive to use open and regulated capital markets as a means of finance.

We therefore oppose any potential extension of the approval process or supplementation by ex-ante enforcement of financial information over the status quo in the German market. This should be made clear in the explanation to guideline 6 (p. 29) which is – by the way – the only guideline without any explanatory remarks so far.

Selection Methods

In the context of **guideline 7** ESMA also explains the role of the common enforcement priorities (no. 51 as well as Q 13, p. 30).

Deutsches Aktieninstitut does not fully understand the objective of the ESMA's common enforcement priorities because we do not understand what "taking into account" could, should or will mean in practice.

From our point of view the common enforcement priorities could at the most serve as a non-binding indicative list of possible accounting issues that may or may not be looked after by national enforcers on the basis of their free decision. National enforcers should be free in determining for their individual market and any individual issuer which aspects of the financial statement deserve a closer look.

For example, the German enforcer derives the enforcement priorities from "errors" that have occurred frequently in the past or from accounting issues that may likely play a key role in future. Different national markets may have different experiences or different critical accounting issues based on their specific economic situation or their structure of the economy. It is hard to imagine that a single set of common priorities will be adequate to cover all different enforcement needs. Therefore, national enforcers need to be free to adjust their key points of examination to national specifics.

In sum, we are sceptic with regard to a list of common enforcement priorities as they tend to limit the national enforcers' choice in setting their own priorities and adjusting them to the circumstances of the relevant market and/or the individual issuer.

We are thus concerned that the term "taking into account" will be connected to ESMA's (or the general public's) expectation (or even the obligation) that national enforcers follow the common enforcement priorities without any possibility to deviate from it. **It should therefore be made clearer that the legal nature of the common enforcement priorities is indicative and non-binding.**

Examination Procedures

Guideline 8 lays down what would be an appropriate examination procedure from ESMA's point of view. Deutsches Aktieninstitut agrees that it should be up to the enforcers to decide about the most effective way for the enforcement of financial information – under the restrictions defined by their legal framework.

However, we are concerned about the fact that enforcers should make “full reviews” or a combination of “full reviews and partial reviews” of the financial statements. In contrast, “only partial reviews” would not be considered as satisfactory for enforcement principles according to guideline 8 (no. 53.)

The term “full review” is defined as “a review of the issuer's financial statements that has covered all areas which are significant for that issuer under review” according to the definitions on p. 22.

We fear that this definition will open room for interpretation. In particular, “full review” could be misread in the sense that it is the objective of the enforcement to perform an in-depth-analysis of the financial statement, i.e. reviewing in detail any item of the accounts. This would clearly widen the scope of enforcement activities, would overstretch current resources of the European enforcers and the issuers whose financial statements will be reviewed and would result in enormous additional costs.

An enforcement related review activity should not contain "full reviews" as such full reviews are not efficient considering that the financial information has already been audited by an independent auditor. Instead, enforcement related review work should only be (a) very selective and (b) based on the findings of an analysis of the financial statements issued by the companies.

We therefore urge ESMA to drop the term “full review” as we fear that this term could result in the extension of the enforcement activities far beyond what is economically justified given the existing institutional safeguards for the correctness and reliability of financial information. **ESMA should make unambiguously clear that it is not aiming at extending the scope of enforcement activities in the direction of a second audit.** The term “full review” should therefore be substituted by a term that better reflects the rather limited scope of enforcement activities compared to the work of auditors. This should also be done because the term “full review” could create another “expectation gap” with regard to the accounts.

Also, we are concerned that the complete list of potential examination procedures (no. 54) could develop into obligatory legal rights of enforcers. This holds particularly true for the posing questions to auditors which should only be possible with agreement and participation of the issuer under examination. Anything else

would conflict with the confidentiality duties of auditors. In the same way we are sceptic whether it is really necessary that enforcers share information with other departments of the enforcer (f), because this could also create confidentiality problems.

Enforcement Actions

Guideline 9 describes which enforcement actions should be available from ESMA's point of view.

Deutsches Aktieninstitut is concerned about the content of the guideline for a number of reasons.

First, ESMA has obviously a far reaching interpretation of the content guidelines are allowed to have according to the ESMA Regulation. Guideline 9 determines the enforcement actions which with enforcers should be equipped in ESMA's view.

From our point of view, the issue of defining sanctions should solely rest with the national legislators. ESMA should not interfere with this core element of the legislators' tasks.

Second, besides this structural point we do not see the need that the enforcer should be equipped with all the enforcement actions listed in no. 57 sub a), b) and c). The German enforcement system is effective without having the full range of enforcement actions in place. It rests on the duty of issuers to publish a note on the "error finding" of the Deutsche Prüfstelle für Rechnungslegung and/or the BaFin and other more informal ways (such as described in no. 59 of the guidelines).

By the way ESMA's wording is not completely clear. What ESMA describes as a "restatement" (a) appears to be rather a "reissuance". In contrast, "the correction in future financial statements with adjustments of comparatives" (c) is what is a "restatement" under para. 42 of IAS 8. We believe that where the IFRS use a terminology in a specific manner ESMA should not use the same terminology in a different manner as such a different use is very likely to create confusion. Consequently, ESMA should use the term restatement in the same manner than IAS 8.

In addition to that, no. 58 also tends to go too far as it will oblige enforcers to demand correction, even if the departure from a standard is immaterial. From our point of view it should be the task of the enforcers to detect material departures from accounting standards. The correction of immaterial errors also contradicts IAS 8 which only requires the correction of material errors. We do not see any reason why and enforcer should request an error correction where IFRS does not require such an error correction.

Deutsches Aktieninstitut therefore is concerned that ESMA's guidelines will pave the way to additional enforcement actions that will prove costly for listed companies. This is particularly true for restatements of the accounts (a). Also, it is not clear whether ESMA's correction note goes beyond the German practice of making public "error findings".

Against this background Deutsches Aktieninstitut prefers that ESMA does not interfere with existing national systems of enforcement. At least, it should be clarified that existence of one of the enforcement actions (a) to (c) suffices to comply with the ESMA's standards. Also, it should be made clear that the German system of publication of "error findings" is in compliance with the issuance of correction notes (b).

Discussion of Emerging Issues

Guideline 14 describes in detail the role of the European Enforcers Coordination Sessions (EECS) for the envisaged harmonisation of enforcement in Europe. According to the guideline 14 and no. 77 national enforcers have to present (emerging) issues for discussion within the EECS before a decision will be taken in the specific case so that the national enforcer has to take into account the outcome of the EECS' discussion.

This proposal appears to go far beyond the current role of the EECS which is mainly limited to the ex-post discussion of enforcement issues of general interest and the publication of enforcement decisions in the enforcement data base.

Deutsches Aktieninstitut is therefore concerned that this extension of the role of the EECS will lead to a more complex, a more time-consuming and a less flexible enforcement of financial statements across Europe. **We do, indeed, see no need why the national enforcers should be obliged to gather ex-ante feedback from the EECS on enforcement decisions.** This would clearly slow down the enforcement and reduce the effectiveness and efficiency of the existing processes. Furthermore it might create a disincentive for countries with a less effective enforcement system to use the resources of other national enforcers for their enforcement duties.

Deutsches Aktieninstitut therefore strongly prefers that the role of the EECS is not widened to ex-ante control of enforcement decisions.

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