

## **Benchmark Paper: The Financial Market Promotion Plan 2006**

On 25 February 2003, the Federal Government presented its 10-Point Programme on improving enterprise integrity and investor protection (Federal Ministry of Finance(FMF) / Federal Ministry of Justice(FMJ)). The elements of the Programme under the responsibility of the FMF (holding members of corporate bodies directly liable for incorrect ad-hoc disclosures, enforcement body, stock exchange reform/supervision legislation, grey capital market, analysts / rating) are simultaneously part of the Financial Market Promotion Plan 2006 (FMPP).

The chief issues dealt with in the FMPP are:

- The Investment Law 2003 / Investment Tax Law
- Hedge funds / Alternative investments
- Securitisations market / Asset-backed securities
- FMF elements of the 10-Point Programme

### **Current situation**

On balance, the results of the financial market promotion measures introduced to date in Germany are something to be proud of. Using benchmark data provided in a financial market promotion plan, we are going to waste no time in introducing the steps necessary to further improve the regulatory framework for the financial centre Germany. We plan to release the strengths which are undoubtedly at hand to fortify our financial centre.

By introducing a package of measures from the various parts of the market spectrum, this plan aims to further improve investor protection and strengthen the German capital market – both in its own right and in relation to its international competitors.

### **Investment Law 2003**

This law will eliminate competitive disadvantages which the German funds industry has repeatedly complained about over the past few years. It will level out advantages enjoyed by locations such as Ireland or Luxembourg.

Within the framework of the up-coming implementation of the so-called UCITS Directive (UCITS = undertakings for collective investment in transferable securities), the environment for issuing and managing investment funds in Germany will be subjected to critical scrutiny by my Ministry. The goal here is to rid the law of any redundancies and to expand the room for manoeuvre.

The possibilities of how investment funds may be structured will enjoy richer variety thanks to the guidelines contained in the Directive, as fund types which previously were determined by law are being discarded. Thus, it will be possible for funds to adopt innovative structures such as purely derivative funds which will also be able to engage in cross-border transactions.

The Investment Law also envisages more efficient supervision of investment funds in Germany. Approval procedures connected to the issuing of new funds are to be streamlined, the duration of the approval procedure to be appreciably shortened. As a result, the Federal Financial Supervisory Authority will be able to concentrate more on the truly critical cases. This, in turn, allows us to contribute to a reduction in bureaucracy.

The legal framework is being made more flexible by allowing for various areas to be dealt with by legal ordinances. This ensures that, for example in the area dealing with regulations on derivatives for funds, the legislator issuing the ordinance can respond early to new market developments. The result of this will be an increase in the legal certainty relating to fund investment in Germany.

The investor will also profit from increased transparency in fund investment, particularly as regards cost arrangements and information on the funds. A so called simple sales prospectus will enable the investor to see at a glance all the important information relating to a particular investment fund.

We support the idea of an EU-wide standard for these prospectuses. The investor is thus granted a better opportunity to compare funds offered by foreign sources with those available in Germany.

Germany supports the EU Commission in its efforts to ensure that the content of the Directive is interpreted, implemented and applied on a unitary basis, as this is the only way in which fair competition between EU financial centres may be guaranteed in this sector.

The taxation aspects of fund investment will be regulated in a separate investment tax law which also envisages reviewing taxation of revenue derived from foreign investment funds. Domestic and foreign funds will enjoy the same non-discriminatory access to the German capital market.

### **Hedge funds**

The Investment Law 2003 will also contain its own section providing rules on hedge funds, thus enabling us to keep up with developments in areas of alternative investments, which are particularly advanced in the Anglo-American financial market.

With the introduction of the Investment Law 2003, a legal framework will be provided for the first time for those who offer shares in hedge funds. Arduous, roundabout routes such as those involved in the sale of structured products like hedge fund certificates, will become superfluous with the introduction of the new legislation. The investor will be handed a clearly defined product.

The Investment Law 2003 will, in principle, enable both domestic and foreign hedge funds to sell shares to institutional and private investors in the same way.

Corresponding provisions in the Investment Tax Law will ensure that hedge funds will also not be disadvantaged from a taxation point of view when compared with conventional funds. The restructuring of the fiscal framework conditions is essential in bolstering the attractive conditions offered by the financial centre Germany for hedge funds, an undertaking which will also aid in the development of capital-market-specific know-how in Germany.

The German Financial Supervisory Authority will ensure a clear and simple authorisation procedure. Basically, with the exception of the general principle of risk diversification, there will be no special legal requirements as regards investment decisions. The unlimited use of credit instruments and short-selling will also be permitted.

The use of these instruments plays an important role in the investment strategies of hedge fund managers. We expect large willingness on their part to meet the necessary measures relating to risk management and transparency in order to keep risks for the financial centre Germany at a minimum. In particular, in the interests of greater transparency, we are planning to impose a reporting obligation in situations where securities are sold short.

Great importance will be also attached to investor protection, particularly where private investors are concerned, when availing themselves of alternative investment opportunities. The new regulation will not only contain provisions relating to product information in the sales prospectus and terms of contract but will also ensure that private investors will only be permitted to invest in holding funds when these offer a wide diversification of risk. Moreover, we seek to ensure that the investor is made aware of the risk of losing all of his or her invested capital by an explicit warning note such as that which has proved its worth in Switzerland.

### **Securitisation / Asset-backed securities**

We are also pursuing new ways by developing the market for asset-backed securities, a market which is growing in importance. We will create the conditions for the sustainable improvement of the legal and economic framework for issuing asset-backed securities in Germany. We will also take this into consideration in the Basel II negotiations.

It is to be made easier for credit institutions to securitise credit claims and risks from lending operations in Germany and to refinance these on the capital market. Thus, special-purpose firms which take over credit claims from the credit institutions and organise their securitisation are to be treated in the same way as the banking industry for trade tax purposes. Traditionally, other European financial markets, especially the British market, have enjoyed advantages in this area. Germany, however, is now catching up.

In Germany, from now on the credit institutions will be able to bundle their credit claims and risks in these special-purpose firms, thus allowing them to issue a series of liquid securities on the capital market. This new securities segment will provide the financial centre Germany with an important stimulus.

Securitising credit risks provides more leeway for the credit institutions to issue further credit as it reduces risk, relieves pressure on equity, and improves refinancing. The more efficient

and broader capital allocation and risk diversification resulting from securitisation can also contribute to a general reduction of interest rate levels for corporate borrowing. We are currently reviewing whether further legal or prudential rules are necessary as far as securitisation is concerned.

### **Measures to regain the confidence of investors (10-Point Programme)**

In order to successfully promote the financial market, it is essential to win back investor confidence. The number of shareholders and investors in funds has stabilised in the last six months. This is linked to measures we have hitherto adopted such as the creation of the German Financial Supervisory Authority, the implementation of a corporate governance code and the numerous improvements introduced in the Fourth Financial Market Promotion Law.

The so-called 10-Point Programme follows in this tradition. When drafting this programme, special care was consciously given to focusing on needs of investor protection. The decisive aspects are:

#### **Enforcement**

A crucial element in regaining investor confidence is to ensure the reliability of corporate financial statements and clarity and accuracy of balance sheets. We will achieve this by establishing a so-called enforcement body.

A review body of auditors organised along private law lines and under state supervision will have a powerful partner on its side in the form of the German Financial Supervisory Authority which can summon the whole palette of public law instruments to implement enforcement measures when necessary.

The establishment of a national enforcement body can also be seen in a European light. The goal is to take further steps to create a European enforcement structure. This is crucial in a single European financial market, which we will have in 2005 following the implementation of the EU Financial Services Action Plan. Europe must speak with one voice on this topic.

#### **Liability of corporate bodies**

We also hope to give investor confidence a boost by increasing the personal responsibility of managers. In future, directors' boards and top-level executives are also to answer with their private assets for incorrect ad-hoc disclosures. Thus, the contradiction in the current

regulation whereby shareholders have to reach into their own pockets, as it were, when filing suit can be eliminated. It also appears to be worth reflecting on whether or not the area to which the current directive applies should be extended to cover the dissemination of other information relevant to the capital market, such as in speeches or interviews, for example.

### **Grey capital market**

Every year, billions of euros worth of investors' money disappear on the grey capital market, a loss which is fatal to the efforts to regain investor confidence. We are hoping for substantial improvements here by making it obligatory to publish an issuing prospectus for investments being publicly offered on the grey capital market. This will lead to investors being better informed and increase the liability of the issuer.

### **Analysts/Rating**

Trust is also an issue of importance when dealing with those actors on the financial markets whose judgements can influence the behaviour of millions of investors - the financial analysts and rating agencies. With both these groups, it is also our declared goal to avoid conflicts of interest and to increase the level of independence of analyses and credit standing assessments.

Since the introduction of the Fourth Financial Market Promotion Law, the conduct of business rules set out in the Securities Trading Law also apply to financial analysts in the investment services sector. These rules are currently being made more concrete by the German Financial Supervisory Authority. However, we want to further increase the independence of these analysts. It is worth considering whether it should still be possible in the future to make the income the analysts earn dependent upon the economic success of trading activities or commissions from investment banking.

We are paying great attention to developments in the SEC, which has evidently decided on a strict divide between the analysis and investment banking sectors.

As regards possibly introducing regulations for rating agencies, we are closely watching the reactions to the report published at the end of January by the SEC relating to the function of rating agencies in the securities markets. It is precisely against the background of the significance of these rating judgements coupled with Basel II that the independence of the agencies and the avoidance of conflicts of interests is of particular importance.

The huge significance accorded to rating by the international financial community is shown by the rigorous discussions on rating independence within the G7 meetings. Germany plans to participate intensively in these discussions.

### **European inclusion/ Financial Services Action Plan**

Many points link the Financial Market Promotion Plan 2006 and the creation of a single European financial market envisaged by the EU's Financial Services Action Plan. More than 80% of the capital market regulations owe their origins to decisions of the European judiciary.

Since Germany is the EU's largest financial services market for the private investor, it is important that appropriate weight is lent to her voice.