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Banking in the crosshairs: Investigations by financial regulators and competition authorities in the banking industry – Libor, Forex, what next?

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National Report of Germany

Lars Schmidt

RITTERSHAUS Rechtsanwälte Partnerschaftsgesellschaft mbB
Mainzer Landstrasse 61
60329 Frankfurt, Germany
Tel. +49 69 274040-211
Email lars.schmidt@rittershaus.net

Lars Schmidt, RITTERSHAUS, Frankfurt, Germany

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Certain episodes of benchmark manipulation (Libor, Forex, etc.) have generated global doubt and concern with regards to the integrity of many benchmarks, undermining the integrity of the system and legal and commercial certainty, and resulting in major losses for investors.

1. **Have the authorities from your jurisdiction proposed or adopted any measures to ensure the necessary integrity of the market and of its benchmarks, guaranteeing that they are not distorted by any conflict of interest, that they reflect economic reality and that they are used correctly? (I.e.: measures to better protect investors, reinforce confidence, address unregulated areas, and/or ensure that supervisors are granted adequate powers to fulfil their tasks.)**

The manipulation of benchmarks has prompted a reaction, also in Germany and the European Union (EU), by the competent supervisory authorities and by the legislatures on the national and EU level. At both these levels, new laws have been discussed and some of them have already been adopted. At the national level, a question specifically debated was whether the legal regulations in place are sufficient to prevent and/or sanction this sort of manipulation of key benchmarks. This issue is important also because not all of the planned new regulations have been implemented yet, so that any manipulation of benchmarks that might be occurring currently would have to be dealt with under the existing laws.

a) Current legal regulations

Under the legal regulations in force in Germany until now, the manipulation of benchmarks is not explicitly or directly regulated and sanctioned.

The one thing that is in place is a general prohibition of market manipulation, but this does not address itself directly to benchmarks. At the European level, this prohibition is codified in Article 5 of the currently valid Market Abuse Directive (MAD) from the year 2003. The German legislature has transposed this prohibition against market manipulation into domestic law in Section 20a of the *Wertpapierhandelsgesetz* (WpHG, German Securities Trading Act). The legal norm applies to both natural and legal persons.

This said, the prohibition of market manipulation limits itself to financial instruments within the meaning of the Securities Trading Act (WpHG). These include only those financial instruments that have been admitted to trading on a German stock exchange, or included on the regulated market (*geregelter Markt*) or the regulated unofficial market (*Freiverkehr*). This means that benchmarks which are not traded themselves are not covered by the prohibition of market regulation under currently applicable law. Only if financial instruments traded on an exchange that are taken into account in the calculation of a given benchmark are manipulated, this could potentially constitute a breach of the currently valid prohibition against market manipulation. In effect, current German law on securities trading addresses and sanctions the manipulation of benchmarks only in exceptional cases. If market manipulation is found to have taken place, a fine of up EUR 1 million may be imposed. If intentional criminal activity is involved, the persons responsible could face monetary penalties or imprisonment for up to five years. It should be noted that German law does not provide for any criminal liability on the part of companies in this context.

b) Regulatory measures adopted in the wake of the LIBOR manipulation

aa) Measures taken at the national level

The *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin, Federal Financial Supervisory Authority), which is responsible for regulating banks, financial service providers as well as insurance companies in Germany, demanded in a circular letter of October 25th, 2013, that all financial institutions reinforce their internal control procedures with respect to their reporting on the determination of benchmark interest rates. In essence, the Federal Financial Supervisory Authority (BaFin) called upon the banks to implement the following measures:

- Application of the dual-control principle when reporting quotations

  The quotation amounts are to be counter-checked by an internal independent unit (e.g. Risk Controlling).

- Documentation of quotations

  The quotations and their underlying rationale are to be documented in a transparent manner.

- Clear definition of responsibilities and competences

Specific departments, teams and personally responsible persons must be designated for purposes of the quotation process.

- Setup of an escalation procedure

  The new working procedures to be introduced must include an appropriate escalation procedure serving to identify implausibilities.

- Setup of suitable, independent control processes

  The quotation amounts are to be verified on a regular basis.

With this deficiency letter, the Federal Financial Supervisory Authority (BaFin) concretize the minimum risk-management requirements derived from Section 25a of the *Kreditwesengesetz* (KWG, German Banking Act). This explicit tie-in with the German Banking Act (KWG) also allows the Federal Financial Supervisory Authority (BaFin) to take action under supervisory law with respect to specific quotation procedures.

bb) Measures taken at the European level

At the EU level, the Market Abuse Directive (MAD) and the Market Abuse Regulation (MAR) serve as the European legal framework for the prevention and sanctioning of market abuse. As far back as 2008, there were already plans to revise the MAD. By 2011, new draft versions of both the MAD as well as the MAR were presented for this purpose. But just as the legislative process was nearing the home stretch, the LIBOR scandal broke. In response, regulations governing previously unregulated benchmarks – particularly benchmark interest rates – were incorporated into the legislative process. As a result, the provisions of the MAD and the MAR will henceforth be expressly applicable to benchmarks as well.

Under Article 5 of the **MAD,** the EU Member States must take all measures required to ensure that market manipulation is treated as a criminal act, at least in grave cases of intentional conduct. This also expressly applies to the manipulation of benchmarks. Thus, Article 5 paragraph 2 lit. d) of the MAD defines the following as being liable to punishment: transmitting false or misleading information or providing false or misleading inputs or any other behavior which manipulates the calculation of a benchmark.

Pursuant to its Article 13, the MAD is to be transposed into national law by July 3rd, 2016.

The MAD is backed up by the **Market Abuse Regulation (MAR)** of April 16th, 2014. Given that the MAR is an EU Regulation, it will take immediate effect under the respective national legal systems once it enters into force. Pursuant to its Article 39, the MAR will also enter into force as of July 3rd, 2016. Under Article 12 paragraph 1 lit. d) of the MAR, transmitting false or misleading information or providing misleading inputs in relation to a benchmark also qualifies as market manipulation. Engaging or attempting to engage in such market manipulation is forbidden under Article 15 of the MAR. In addition, Article 16 of the MAR requires market operators and the financial institutions involved to adopt measures aimed at preventing and detecting market abuse.

In this way, the manipulation of benchmarks has for the first time been subsumed under the applicable scope of current regulations against market abuse. On the other hand, these regulations merely prohibit and sanction benchmark manipulation.

In order to limit the opportunities for manipulation to take place at all, it is planned to introduce a **Benchmark Regulation**. This is intended to improve the functions and administration of the benchmarks calculated and utilized within the EU and to ensure that these are not manipulated. The proposed Regulation harmonizes with the guiding principles agreed at the global level by the International Organization of Securities Commissions (IOSCO) in 2012 and 2013 and serves to implement these principles. A proposal for the Benchmark Regulation has already been formulated. The European Commission is working on the premise that final agreement can be reached on the Benchmark Regulation's wording by the late summer of 2015.

The current proposal for the Regulation applies not only to benchmark interest rates such as the LIBOR, but to commodity benchmarks as well. In fact, it covers all benchmarks which can be used as underlying reference values for financial instruments, such as energy/currency derivatives, which have been admitted to trading, or which are traded, on a regulated market.

The intention behind the proposal is to improve corporate governance and internal controls when it comes to benchmark processes. Accordingly, benchmarks are to be subject to supervision going forward and are to be provided only after having been granted corresponding regulatory approval. In the process, the administrators are to make every effort to avoid conflicts of interest.

In addition, the quality of the data-input methods used by the benchmark administrators is to be improved as well. Thus, the data relevant to a given benchmark are to be input in sufficient quantity so as to generate an accurate reflection of the economic realities prevailing on the market. The data used should be hard and reliable and drawn from dependable sources.

Those participating in a given benchmark should also be subject to appropriate controls. To this end, the administrator responsible for a given benchmark is to establish a code of conduct that precisely defines the tasks and obligations of those participating in the provision of benchmark input data. Finally, the continuous monitoring of critical benchmarks is to be assured. Thus, the benchmark administrators are to be monitored by the competent supervisory authorities.

2. Which authority monitors financial bodies in your jurisdiction?

Financial supervision in Germany is the remit of the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin, Federal Financial Supervisory Authority). The Federal Financial Supervisory Authority (BaFin) was set up in 2002 on the basis of the *Finanzdienstleistungsaufsichtsgesetz* (FinDaG, Act Establishing the Federal Financial Supervisory Authority).

Additionally, financial supervision in Germany, a Member State of the European Union, is increasingly being performed by European supervisory authorities, namely the European Banking Authority (EBA), which is based in London, as well as the European Security and Markets Authority (ESMA) and the European Central Bank (ECB).

3. [For EU and EFTA member states] Has your country completed the transposition of Directive 2014/65/EU of the European Parliament and of the Council on markets in financial instruments (also known as «MiFID II»)? If not, when will transposition be completed?

The Federal Republic of Germany has not yet completed the transposition of Directive 2014/65/EU (MiFID II) into domestic law. A proposed bill to transpose the Directive has yet to be introduced.

The stipulations of MiFID II are to be applied as of January 3rd, 2017. Given that the technical standards derived from the relevant consultation procedures will probably not be available until the end of 2015, a German law transposing the directive will likely not be in place before expiry of the transposition deadline in mid-2016.

On the other hand, the German legislator has already anticipated the transposition of Article 16 paragraph 3 of MiFID II by way of the *Kleinanlegerschutzgesetz* (Retail

Investors' Protection Act). The provisions of this Act apply to securities-related service providers who structure and/or distribute financial instruments, and obligate these companies to set up internal procedures for determining a corresponding target market when structuring and distributing financial instruments. Since some of the relevant technical standards to be derived from the consultation process are not yet available, it is quite conceivable that this advance transposition by the German legislator may have to be corrected again.

4. Have the authorities in your jurisdiction conducted any inquiry on leading banks or institutions in relation to anti-trust practices with regards to essential financial information and/or the clearing system?

Although the manipulation of benchmarks has thus far not been expressly prohibited under the law, Section 25a of the *Kreditwesengesetz* (KWG, German Banking Act) does obligate banks to comply with statutory regulations and to ensure that their business operations are properly organized. The manipulation of benchmarks is obviously not consistent with the proper organization of business. On this basis, the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin, Federal Financial Supervisory Authority) has already launched investigations against certain implicated banks, particularly Deutsche Bank AG, as well as against their respective boards of management. One of the focal points of these investigations by the Federal Financial Supervisory Authority (BaFin) is whether the banks' managers and BoM members were aware of the manipulation and possibly tolerated the practice. According to the most recent information provided by the Federal Financial Supervisory Authority (BaFin), these suspicions could not be hardened, however. The Federal Financial Supervisory Authority (BaFin) has yet to issue a final report on the matter.

In early December 2013, furthermore, the European commission imposed regulatory fines totaling EUR 1.7 billion against six international banking houses for colluding to manipulate the benchmark interest rates LIBOR, EURIBOR, and TIBOR in breach of anti-trust laws. The regulatory fine imposed on Deutsche Bank AG in this context amounted to EUR 725 million. The record-holder in terms of the largest penalty imposed was Swiss banking giant UBS, with a regulatory fine originally assessed at EUR 2.5 billion. However, the bank was fully released from paying this amount, as a result of the European Commission's stipulations regarding leniency granted to principal witnesses, given that UBS was the first bank to inform the European prosecutorial authorities about the infractions committed.

5. **Which new requirements have been established in order to reinforce governance and oversight and introduce measures sanctioning those responsible for LIBOR and other index manipulation?**

The legislative measures planned have already been described in Clause 1. The planned Benchmark Regulation is intended to reduce opportunities for manipulation, particularly at the EU level. Moreover, the European Market Abuse Directive (MAD) and the European Market Abuse Regulation (MAR) have been extended to cover the manipulation of benchmarks and to define the corresponding sanctions to be imposed. Finally, the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin, Federal Financial Supervisory Authority) has expanded the requirements for the proper management of business pursuant to Section 25a of the *Kreditwesengesetz* (KWG, German Banking Act) in such a way as to ensure that the quotation process for benchmarks is covered as well.

6. **Has any similar scandal/malpractice affected your jurisdiction? Have penalties been imposed and/or administrative or criminal sanctions? If not, which sanctions are foreseen in your jurisdiction for this type of misconduct?**

As far as we know, Germany has thus far not experienced any comparable manipulation of benchmark interest rates. On the other hand, investigations are ongoing in connection with anti-trust proceedings in response to the alleged manipulation of benchmarks used for various commodities (natural gas, crude oil, and biofuel) as well as for currencies.

Aside from the imposition of anti-trust fines for the manipulation of the LIBOR interest rate, these investigations under cartel law are not yet complete, so it is too early to tell whether additional sanctions will be imposed.

In principle, market manipulation on the basis of inside information constitutes an administrative offense (Section 39 paragraph 2 number 11 of the *Wertpapierhandelsgesetz* (WpHG, Securities Trading Act) and is punishable with a regulatory fine of up to EUR 1 million. The regulatory fine is imposed against the company committing the administrative offense.

Moreover, any person who intentionally engages in the above-described market manipulation as a member of a board of management or supervisory board will be liable to prosecution. The corresponding penalty is imprisonment for up to five years or a fine.

In addition to investigations into possible manipulations of benchmarks, there certainly have been attempts to manipulate the price of individual stocks. This is precisely what Porsche SE is currently being accused of: In the course of its attempted takeover of Volkswagen AG, Porsche SE is alleged to have intentionally manipulated the price of VW's ordinary shares by publishing inaccurate *ad hoc* notices. As things stand, criminal proceedings are pending against several former BoM members of Porsche SE on the grounds of market manipulation. Porsche SE itself is also being sued for damages by those VW shareholders and investors in derivatives on VW's ordinary shares who have suffered losses.

7. How are the potential conflicts of interest affecting banks or other financial institutions addressed in your jurisdiction? Which requirements are adopted to ensure that benchmarks reflect economic reality and that they are used correctly?

In order to prevent conflicts of interest and to protect market participants, Section 20a of the *Wertpapierhandelsgesetz* (WpHG, German Securities Trading Act) forbids market manipulation. The Market Abuse Directive (MAD) and the Market Abuse Regulation (MAR) extend the scope of this prohibition to also include benchmarks which were previously not expressly covered by the rules against market manipulation. Aside from this prohibition of market manipulation, credit institutions and financial service providers must also adhere to the compliance obligations defined in Section 25a paragraph 1 sentence 1 of the *Kreditwesengesetz* (KWG, German Banking Act). Thus, Section 25a paragraph 1 sentence 1 of the German Banking Act (KWG) requires that a proper business organization be in place in order to comply with statutory requirements. Section 33 of the German Securities Trading Act (WpHG) stipulates that companies providing securities-related services must meet these same organizational obligations. Furthermore, "Chinese walls" must be set up – insofar as necessary to prevent employees from exchanging information to the customer's detriment – pursuant to Section 33 paragraph 1 sentence 2 number 3 of the German Securities Trading Act (WpHG) in conjunction with Section 13 paragraph 3 sentence 2 number 1 of the *Wertpapierdienstleistungs-Verhaltens- und Organisationsverordnung* (WpDVerOV, Ordinance on the Conduct and Organization of Securities-Service Providers). Compliance with these requirements is monitored regularly by the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin, Federal Financial Supervisory Authority) and may be verified through special audits in certain cases. Deutsche Bank has been subjected to just such a special audit by the Federal Financial Supervisory Authority (BaFin) in connection with the LIBOR scandal. The investigation has not yet been concluded.

In addition, Section 33 paragraph 3 of the German Securities Trading Act (WpHG) requires companies providing securities-related services (which include banks) to avoid any conflicts of interest between individual employees or between the company and the customer, especially in connection with the distribution of securities. A breach of these regulations makes the party committing such breach guilty of an administrative offence or – under certain conditions – of a crime. Such a breach – particularly of the stipulations of Section 20a of the German Securities Trading Act (WpHG) regarding market manipulation – does not give rise to any liability claims under civil law, however. Instead, a customer having suffered losses may assert his claims against the bank or the company providing securities-related services only under general tort law.

8. Are any measures foreseen in your jurisdiction for the protection of "whistleblowers"?

A draft law to protect whistleblowers was introduced in the *Bundestag* (German Parliament) on November 4th, 2014. Its intended purpose is to improve transparency and provide protection for informants. It is also meant to create an exception to the principles of confidentiality under the laws governing the actions of officials, so that civil servants, too, will be permitted to report corruption offenses without being afraid of consequences under criminal law or under disciplinary law.

In the case of credit institutions, Section 25 paragraph 1 sentence 6 number 3 of the *Kreditwesengesetz* (KWG, German Banking Act) requires that, as of January 1st, 2014, such institutions must set up an in-house procedure which allows employees to report breaches of the principles of justice and the rule of law to appropriate units within the company while keeping their identity confidential.

9. Is there any measure in place in your jurisdiction to guarantee suitable and appropriate evaluation of benchmarks?

As of yet, there are no measures in place that can guarantee the appropriate and accurate calculation of benchmarks. On the other hand, the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin, Federal Financial Supervisory Authority) has issued an action plan that is intended to make benchmarks safer and more reliable until such time as the Benchmark Regulation comes into force (cf. Section 1 b) aa).

There have also been discussions as to whether alternative benchmark interest rates that are less vulnerable to manipulation might be available. However, as of now, no alternative benchmark interest rate has been regarded as the market standard.

10. Which requirements and/or transparency rules, if any, are undertaken in your jurisdiction in order to prevent distortions of competition resulting from divergences between other national laws and/or to provide more legal certainty for market participants? (I.e. to prevent or limit regulatory complexity and potential regulatory arbitrage.)

Along with the aforementioned *Kleinanlegerschutzgesetz* (Retail Investors' Protection Act), MiFID II will also be transposed into German law in the near term. In addition, the Market Abuse Regulation (MAR) as well as the Benchmark Regulation will take immediate legal effect once they come into force. No other legislative measures in this area are planned at the present time.

Since the planned Benchmark Regulation is geared towards the principles of the International Organization of Securities Commissions (IOSCO); it is also intended to ensure equal treatment and protection against manipulation at an international level.