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**Research Report**

## BaFin (in)dependence - a reform proposal

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# BaFin (in)dependence – A reform proposal

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# BaFin (In)Dependence – A Reform Proposal\*

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## *Abstract*

*In this paper we put forward a legal argument in favour of granting more independence to BaFin, the German securities market supervisor. Following the Wirecard scandal, our reform proposal aims at strengthening the impartiality and credibility of the German supervisor and, as a consequence, at restoring capital market integrity. In order to achieve the necessary degree of democratic legitimacy for giving BaFin more independence and disassociating it from the Ministry of Finance, the paper sets out the necessary steps for a legal reform that creates accountability of BaFin vis-à-vis the Parliament, subjecting it to strict disclosure and reporting obligations.*

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\* SAFE Policy Papers represent the authors' personal opinions and do not necessarily reflect the views of the Leibniz Institute for Financial Research SAFE or its staff.

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## Executive summary

The recent Wirecard scandal has highlighted a number of structural weaknesses and flaws in the institutional design of Germany's financial markets oversight. This paper focuses on one of these flaws, namely the hierarchical relationship between the Ministry of Finance and BaFin (*Bundesanstalt für Finanzdienstleistungsaufsicht*; Federal Financial Supervisory Authority), the German watchdog. Since BaFin is controlled by and accountable vis-à-vis the Federal Ministry of Finance in legal and in substantive matters, the so-called *Rechts- und Fachaufsicht*, major decisions in BaFin's supervisory process either need prior ministerial approval or can be altered by the Ministry retrospectively.

We suggest that the embeddedness of BaFin in the Ministry of Finance's line of reporting opens the possibility for the Ministry to superimpose its (short-term) political goals over "pure", as it were, law-enforcement in the framework of legal rules as defined by a legislative body. This openness to external political influence undermines the credibility of the supervisor as an impartial enforcer of existing law. The current architecture, blending rule enforcement and politically motivated decision making, cannot be reconciled with the intended role of the supervisory authority in a German model of *Ordnungspolitik*. This, however, is a prerequisite for capital markets to earn respect and trust by national and international investors. In light of international competition for investment capital, a trusted supervisory authority is a key institutional requirement. Abolishing the Ministry's right to issue instructions would put securities market supervision on an equal footing with banking supervision, which already operates independently in key areas.

The paper spells out critical legal changes that have to occur in order to accomplish the transition from the current to the desired supervisory architecture. Fundamentally, FinDAG should be amended in order to insulate BaFin from government instructions, concerning both individual cases and general instructions in the field of securities market supervision. The right of the government to oversee and direct securities market supervision by BaFin is abolished, and the ensuing loss of democratic legitimation that goes along with the guarantee of independence, will be compensated for in particular by (a) obliging BaFin to annually report directly to Parliament and to mandatorily answer questions from Members of Parliament on these reports, and by (b) including two international representatives of securities market supervisors in BaFin's Administrative Council.

The proposed transformation of BaFin into a more independent public authority, accountable vis-à-vis the parliament, can be implemented with comparatively little legislative effort, but is an important step towards enhancing the international standing of BaFin, and it is a significant contribution to the strengthening of Germany's and Europe's financial markets.

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## **I. Capital markets and the status of securities market supervision: Don't mistake Wirecard for a black swan!**

Capital markets act as an intermediary between investors and issuers, between capital providers and capital users, e.g. states or private firms. The allocation of resources within the economy is a key determinant of economic growth, and thus key to the formation of public and private wealth.

Among the fundamental prerequisites for well-functioning capital markets, the reliability and equal availability of information about market participants and their actions is of prime importance. Securities regulators and supervisors must therefore ensure that companies provide all relevant information in a timely and accurate manner, notably via accounting numbers and annual or quarterly statements. The disclosure of accounting information to investors and the broader public contributes to the integrity of capital markets and to investor protection. Since the provision of information is a public good, there is a demand for standardization and oversight pertaining to accounting numbers and processes. Thus, accounting standard setters, auditors and supervisory authorities play a critical role in strengthening the trust in markets, and lowering transaction costs.

There is an extensive literature on different facets of securities regulation, showing that stringent regulation *and* reliable enforcement of rules have positive effects on the functioning of capital markets. For instance, Hail and Leuz (2006) provide empirical evidence that investors respond favourably to more extensive disclosure requirements and stricter enforcement by lowering their required return. Pointing at the crucial role of enforcement authorities, Christensen et al. (2013) conclude that more stringent regulation will enhance market liquidity only if the regulator is willing to enforce the new rules properly. Similarly, Gipper et al. (2020) show that effective audit oversight can bring capital-market benefits by improving the credibility of financial reporting as perceived by investors.

By way of example, the Wirecard case has made it crystal clear what consequences the failure of a supervisory authority concerning accounting information may have for investors and, more generally, capital markets. Wirecard is of course an exceptional case in many respects. The criminal energy of management was certainly, if not unprecedented, then at least extraordinary. However, the case is not a “black swan” (Taleb, 2007), an outlier event from which little or nothing can be learned. On the contrary. The case throws a harsh spotlight on various peculiarities and structural weaknesses in balance sheet control and, more generally, securities market supervision in Germany and Europe.

A specificity of Germany’s regulatory architecture of securities markets has received some attention at the European and international level following the Wirecard case: BaFin’s lack of independence from the Federal Ministry of Finance in substantive matters (*sachlich-funktionale Unabhängigkeit*). In what follows, we will focus on the reasons for this and submit a proposition going forward.

Critics have highlighted Wirecard’s allure of the „German Fintech success story“, insinuating that the government had considerable incentives to look the other way where alleged financial reporting fraud considered its golden boy. ESMA’s peer review committee thus recommends limiting government influence, at least for ongoing investigations (ESMA, 2020, para. 275). And when calls are now made to Europeanize balance sheet control, the body to be responsible is regularly envisaged as an independent authority (e.g. AKB, 2020, p. 17 et seq.).

We are in no position to assess accusations raised against BaFin and the Federal Ministry of Finance in the Wirecard case or to investigate whether or what measures could or should have been taken at which point in time. Rather, we take Wirecard as an opportunity to discuss whether the ties between BaFin and the BMF can and should be loosened in the future and, in particular, whether it is possible and desirable to further insulate BaFin from supervision of the Ministry of Finance.

On a preliminary note, the independence of a supervisory authority can be justified in the context of market framework (*Ordnungspolitik*), in which the role of the supervisor is defined as a guarantor of a fair and indiscriminate application of the legal framework (Krahnen and Moretti, 2015; Dell’Ariccia and Marquez, 2006). While legal rules are discussed and defined in a political process, once a rule is defined, the parties concerned (individuals, households, companies, public authorities) should be able to trust in fair and unbiased application of the law. The freedom to act according to a well-defined set of rules, and not to behave opportunistically or in pursuit of an objective that is outside its mandate, is the privilege and the obligation of the supervisor. Investors will learn that rules become dependable and trustworthy, allowing them to allocate capital confidently for the longer term (Dell’Ariccia and Marquez, 2006).

The role of the government or a ministry is obviously much broader. They are an integral part of the democratic rule-making process. A sudden change of policies and decisions is an established feature of this democratic process. By contrast, once specific rules have been adopted by parliament, no such political discretion to make post-hoc changes to parliament's will is accorded to the executive branch. This is of particular importance where (short-term) incentives for the government or the competent ministry offer a temptation to do so, sacrificing parliament's will and the intended overall welfare to, for example, vested interests by politicians or lobbyists, leading to regulatory capture (Stigler, 1971; Carrigan and Coglianese, 2016).

Independence can make it more likely that a public authority is in a position to pursue its mandate single-mindedly, assuring reliable enforcement of rules. Given the core importance of trust in market stability and integrity, investors and issuers, the two most relevant parties involved in securities markets, will vote with their feet and engage on those markets which are, inter alia, respected for their fair and efficient market oversight. That said, the supervisor must of course not be entirely independent from any democratically legitimized institution. To give but one example, a ministry may handle the management nomination process as its major responsibility, adding legitimacy to the authority's daily operations. Summing up, a high degree of independence vis-à-vis the ministry can strengthen the former's role in capital markets without an undue sacrifice as to democratic principles.

## **II. Background: Dimensions of independence**

(In)Dependence can be achieved in different ways. (In)Dependence in substantive matters is only one of the at least three dimensions in which (in)dependence of a public authority may be conceptualized (e.g. Bredt, 2006, pp. 23 et seq.; Groenleer, 2009, pp. 29 et seq.; Groß, 2014, p. 198; Weißgärber, 2016, pp. 39 et seq.; Corrigan/Revesz, 2017; cf. Ruffert, 2008, pp. 447 et seq.).

### **1. Personal independence**

Whether and to what extent an authority is independent in terms of personnel is determined by the regulations governing the appointment and dismissal, the terms of office and the remuneration of its management personnel (Bredt, 2006, pp. 30 et seq.; Groß, 2014, p. 198; cf. Oertel, 2000, pp. 171 et seq.).

BaFin's Executive Board is nominated by the Government and appointed by the Federal President (§ 9 para. 1 FinDAG). The term of office is eight years, reappointment is possible, and the Federal President shall dismiss a member of the Executive Board only at his request or for good cause upon resolution of the Federal Government (§ 9 para. 2 FinDAG).



As an international point of comparison, we will in this paper use the SEC which is often described as the international flagship of securities regulators and the design of which has not least the goal of preventing party-political influence (cf. Masing, 2003, p. 586 et seq.; Ludwigs, 2011, p. 42 et seq.; Ruffert, 2011, p. 401 et seq.). As for the SEC, the President appoints the Commissioners, on advice and with the consent of the Senate (Cox et al., 2020, pp. 14 et seq.; Note, 2013, p. 785). It is a multi-member commission, where three members will be of the President's party and two of the opposition, the chair, of course, is appointed by the President and serves at his pleasure. Following general principles of administrative and constitutional law, the SEC chair can only be removed by the President "for cause", which is understood as inefficiency, neglect, malfeasance, or abuse of office (U.S. S.Ct., *Humphrey's Executor* [1935]; U.S. S.Ct. *Seila Law*, 2020; Note, 2013). Mostly, this is what U.S. scholarship has in mind when speaking of the SEC's independence: the impossibility of removing the Chair for political reasons, rather than for "cause" (U.S. S.Ct. *Seila Law*, 2020; Datla et al., 2013, pp. 784 et seq.; Note, 2013).

## 2. Financial Independence

Financial independence may be ensured, for example, by granting an institution the right to charge fees, thus not being dependent on external funding and namely not on grants from the general state budget (Groenleer, 2009, p. 32; Groß, 2014, p. 198; cf. Art. 30 SSM Regulation; Bredt, 2006, p. 34).

BaFin is a public authority with its own legal personality. It is not covered by the federal budget, but funded completely by the companies it supervises (§§ 14 et seq. FinDAG). Its budget is drawn up by the Executive Board and adopted by the Administrative Council.

By contrast, the SEC is dependent on the Congressional appropriations process. Interestingly, self-funding was proposed, but ultimately stricken from the Dodd-Frank Act (see: CFA Institute on SEC Funding<sup>2</sup>; more generally: Baling, 1994; Seligman, 2003-2004).

According to senior SEC staff, budget increases approved by Congress did not make up for the extended mandate under the Dodd-Frank Act (IMF, 2015, p. 50).<sup>3</sup> A budget squeeze may or may not reflect bad intentions by political decision-makers. The marginal political benefits are low; among the large variety of public goods provided by governments, enforcing securities law, which pleases the few rather than the majority, is quite unlikely to be a top priority. Nevertheless, the budget process has

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<sup>2</sup> See: <https://www.cfainstitute.org/en/advocacy/issues/sec-funding> (Last accessed: 20 March 2021)

<sup>3</sup> However, it is worth pointing out that bureaucrats have an incentive to exaggerate their financing needs, too; see Niskanen (1971) among others.

indeed been used to make sure that SEC bureaucrats toe the line without direct monitoring on a day-to-day basis (Weingast, 1984).

Above all, we learn from the SEC experience that budget-constrained enforcement authorities which need to fulfil output-based performance standards are inclined to devote their efforts to low-hanging fruits: SEC enforcement actions often target domestic companies, based in proximity and without much clout, and accounting areas in which it has built up expertise over the years to save scarce resources (Kedia and Rajgopal, 2011; Gadinis, 2012). Put another way, more complex multinational companies are less likely to be subject to enforcement actions, creating some sort of *home bias* in the SEC enforcement efforts (Langevoort, 2005).

### 3. Independence in substantive matters

In this paper, we focus on the third dimension of independence, i.e. independence in substantive matters. This feature very clearly distinguishes BaFin from other European and international securities market supervisors and it has been at the center of discussions about institutional reforms in the wake of the Wirecard scandal (cf. most recently e.g. Mülbert and Gurlit, 2021; Hennrichs, 2021, p. 4).

Independence in substantive matters has been defined as no other institution having any influence on the decisions of the authority (Bredt, 2006, pp. 32 et seq.; Groß, 2014, p. 198). Most importantly, the government is not allowed to issue instructions (*Weisungsunabhängigkeit* – instruction autonomy; see for this concept in detail e.g. Jestaedt, 1993, pp. 102 et seq.). An authority that enjoys substantive independence is bound only by the law, and its activities are controlled only by the courts.

As a securities supervisor, BaFin has not been substantively independent until now. Rather, it is subject to the supervision of the Federal Ministry of Finance, which controls both the legality and the appropriateness (*Recht- und Zweckmäßigkeit*) of BaFin's decisions (*Rechts- und Fachaufsicht*, § 2 FinDAG). BaFin is therefore obliged inter alia to regularly report to the Federal Ministry of Finance on important supervisory procedures and measures.

In the Wirecard case all steps taken by BaFin appear to have been closely coordinated with the Federal Ministry of Finance. According to information provided by the Ministry to the Finance Committee of the *Deutsche Bundestag*, BaFin reported to the Ministry on the Wirecard case and the measures to be taken more than 20 times between February 2019 and June 2020; in a number of cases, the Ministry had explicitly requested these reports (BMF, 2020). No details about the content of the reports have been published. However, it may be assumed that BaFin acted at least “in the shadow of the hierarchy” (Scharpf, 2000, p. 323: “im Schatten der Hierarchie”).

This exchange of information is in line with the “Principles governing the exercise of legal and technical supervision of BaFin by the Federal Ministry of Finance” issued by the Ministry ([https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Aufsichtsrecht/Satzung/aufsicht\\_bmf\\_bafin\\_en.html?nn=7859740](https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Aufsichtsrecht/Satzung/aufsicht_bmf_bafin_en.html?nn=7859740)). These principles quite impressively show that the Ministry at least intends to effectively monitor and control BaFin’s actions (Hermes, 2010, p. 80). Among other things, BaFin is required to report “on supervisory measures intended and already introduced that are of material importance” (Principles, III. 1.) and to notify changes in “its administrative practice in the application of particularly significant supervisory rules” (Principles, IV.1.c.). “In addition to the written reports, meetings take place on a flexible cycle”, in which e.g. “developments at systemically important undertakings under BaFin’s supervision that may lead to a crisis” are to be discussed (Principles, III.4.).

In contrast, the SEC is not overseen by any other institution and the government has no right to influence oversight processes or enforcement decisions. Any attempt to interfere would be understood as a violation of the principle of separation of powers (Strauss, 1984).

### III. Our reform proposal: Insulating BaFin from government instructions

In the following, we will show that there are convincing arguments under both, constitutional law (IV., V.) and international political economy (VI.) to abolish government oversight of BaFin’s work.

We propose to amend FinDAG so as to insulate BaFin from government instructions in the field of securities market supervision, both from instructions in individual cases and from general instructions,

- by **abolishing the government’s right to oversee and direct securities market supervision by BaFin,**

and to compensate the loss of democratic legitimation, that goes along with the guarantee of independence,

- by **obliging BaFin to annually report directly to the *Deutsche Bundestag* and to mandatorily answer questions from Members of Parliament on these reports,**
- and by **including two international representatives of securities market supervisors in BaFin’s Administrative Council.**

Our constitutional reasoning is illustrated in figure 1 (see below p. 11). In a nutshell, the argument goes as follows: The abolition of the right to issue instructions reduces an authority’s democratic legitimation in functional and substantive terms. This is legal only under two conditions, i.e. if the decrease in democratic legitimation is compensated for and if there is a special factual reason for

granting independence. A factual reason for independence can be assumed in particular if an authority insulated from government instructions is more likely to realize the goals underlying the law than an authority under government oversight. This is to be expected namely if the task at hand sets particular incentives and is, at the same time, particularly susceptible to being misused for the implementation of individual (political) interests or short-term political goals instead of the law's objectives.

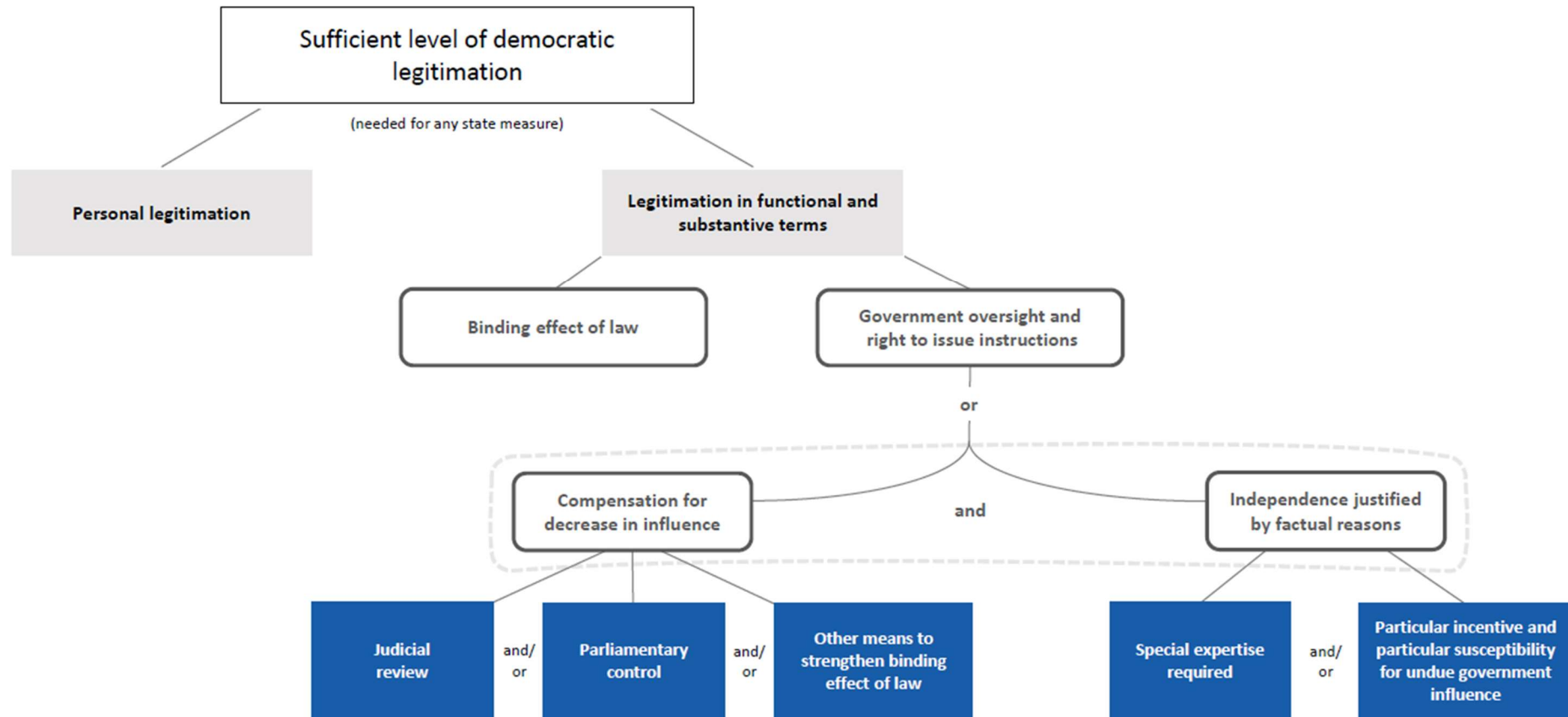
#### **IV. Constitutional requisites for granting independence from government instructions on law enforcement**

Independent authorities are still the rare exception in Germany today (for a short overview Jestaedt, 1993, p. 114 et seq.; Groß, 2014, p. 200 et seq.; in more detail e.g. Hermes, 2010; Masing, 2010, pp. 181 et seq.). In principle, administrative authorities are supervised by the government, and the government has the right to direct an authority's activities by issuing instructions. Until fairly recently, authorities in Germany were free from instructions only in those areas where independence was directly prescribed and legitimized by the constitution (cf. e.g. Hermes, 2010; Masing, 2010; Hoffmann-Riem, 2012, para. 53 et seq.), i.e. especially in the field of monetary policy.

Case law and literature in Germany have discussed, with varying intensity since the 1960s, whether and under what condition independent authorities are legal under the constitution (e.g. Oebbecke, 1986; Jestaedt, 1993; Böckenförde, 2004 para. 24; Schmidt-Aßmann, 2006, 5/36 et seq.; Bredt, 2006; Gärditz, 2010; Ludwigs, 2011). The central question as understood against the background of the German constitution is whether it is compatible with the principle of democracy to establish public authorities that are not bound by instructions issued by the Federal Government or the competent Minister.

As early as 1959, the Federal Constitutional Court ruled that – despite the concerns regarding the principle of democracy – the German constitution does not entirely rule out independent public authorities (BVerfGE 9, 268, 282). About ten years ago, requirements for independent regulatory and data protection authorities stemming from European Union law were the subject of intense debate in legal literature in Germany (as to independent regulatory authorities e.g. Gärditz, 2010; Ludwigs, 2011; as to data protection authorities e.g. Frenzel, 2010; Roßnagel, 2010; Spiecker genannt Döhmann, 2010). To date, it has not been conclusively settled whether the Federal Ministry of Economic Affairs and Energy is entitled to issue instructions to the Federal Network Agency (*Bundesnetzagentur*; Eifert, 2019, para. 140 et seq.; Ruffert, 2019, para. 27 et seq.).

Figure 1: Freedom from instructions (*Weisungsfreiheit*): Requisites of the *Grundgesetz* (Basic Law; German constitution)



Source: Own representation

Similarly, the Federal Competition Office (*Bundeskartellamt*) – even though it has been legally defined as an “independent higher federal authority” (§ 51 para. 1 Competition Act) – is still subject to general instructions given by the Federal Ministry for Economic Affairs and Energy (cf. § 52 Competition Act; the Ministry is obliged, though, to publish its general instructions). Whether instructions to the Federal Competition Office in individual cases are legal, is still being discussed (e.g. Stockmann, 2020, para. 7 et seq.); in any case, it is long-standing practice that the Ministry does not make use of this right (Kersten, 2010, p. 331 f.; Hermes, 2010, p. 74). It is in line with this tradition that the decision of the European Court of Justice, according to which State scrutiny over German data protection authorities is not consistent with the requirement of independence as defined in the relevant European directive (ECJ, C-518/07, ECR 2010, I-1885 para. 31 et seq.), was much criticized in Germany (e.g. Spiecker genannt Döhmann, 2010; Bull, 2010; Frenzel, 2010).

Most recently, the independence of the ECB and BaFin as banking supervisors within the Single Supervisory Mechanism (SSM) has been scrutinized by both, legal doctrine and the Federal Constitutional Court (BVerfGE 151, 202, 289 para 124 et seq., 324 para. 203 et seq.; from legal doctrine e.g. Ferran and Babis, 2013, pp. 270 et seq.; Moloney, 2014, p. 1637 et seq.; Groß, 2015, pp. 128 et seq.; Gentzsch and Brade, 2019, pp. 623 et seq.; Kaufhold 2021, para. 71 et seq.). The court has judged it to be “precarious in light of the principle of democracy”, but permissible by way of exception (BVerfGE 151, 202, 295 para. 138 and headnote No. 3 – Banking Union).

### **1. Ensuring a sufficient level of democratic legitimization: Personal and substantive legitimization of public authorities**

The conditions under which it is in line with the democratic principle of the German constitution to confer tasks and powers on independent public authorities are still unclear in detail. However, there is broad consensus on the basic principles (from the extensive literature and case law e.g. Oebbecke, 1986, pp. 23 et seq.; Jestaedt, 1993, pp. 265 et seq.; Böckenförde, 2004, para. 11 et seq.; Schmidt-Aßmann, 2006, 5/37; Bredt 2006; Grzeszick, 2010, para. 149 et seq.; Ludwigs 2011, pp. 46 et seq.; Trute 2012; BVerfGE 151, 202, 290 et seq., para. 127 et seq.):

- Public officials need to have *both personal* democratic legitimization *and* legitimization in *functional and substantive* terms.
- “Public officials have full *personal* democratic legitimization if they have been elected by the people or by Parliament, or if they have been appointed by or with the approval of another public official who in turn has personal legitimization.” (BVerfGE 151, 202, 291 para. 129 – Banking Union, emphasis

by authors; established case-law, cf. BVerfGE 47, 253, 275 f.; 68, 1, 88; 77, 1, 40; 83, 60, 73; 136, 194, 262 para. 168)

- “Legitimation in *functional and substantive* terms is achieved by the binding effect of law and by oversight and instructions provided by higher-ranking public authorities [...]” (BVerfGE 151, 202, 291 para. 129 – Banking Union, emphasis by authors; established case-law, cf. BVerfGE 83, 60, 71 ff.; 93, 37, 67; 107, 59, 89). If the government has the ability to issue instructions and thereby direct an authority, it is democratically accountable for the authority’s (in)action. Parliament can therefore hold the government or the respective minister responsible if the administration fails to fulfill its duties.
- The right to issue instructions is therefore understood as an important tool of democratic legitimation in *functional and substantive* terms. Yet, it is not the only one and it is not indispensable.
- “The form of democratic legitimation of state action is not decisive, but its effectiveness” (BVerfGE 151, 202, 291 para. 129 – Banking Union; established case-law, cf. BVerfGE 107, 59, 89; 135, 155, 233 para. 158; 136, 194, 261 et seq. para. 167 et seq.). What matters is whether a sufficient degree of personal and substantive democratic legitimacy has been achieved. When determining this, “the various forms of legitimation are not significant by themselves, but only in interaction” (BVerfGE 151, 202, 291 para. 120 – Banking Union; established case-law, cf. BVerfGE 107, 59, 87; 130 124, 128; 136, 194, 262 para. 168).

## **2. Constitutional preconditions for instruction autonomy: Compensation for the decrease in influence and specific justification**

Against this background, any suggestion to limit or abolish the Federal Government’s right to issue instructions, entails a loss in democratic legitimation of the – then independent – public authority. It is widely recognized that this is legal only if understood as an exception to the rule and only under two conditions (cf. e.g. Böckenförde, 2004, para. 24; Ludwigs, 2011, pp. 46 et seq.; Trute, 2012, para. 66; Hoffmann-Riem, 2012, para. 54; Schmidt-Aßmann, 2013, p. 162 et seq.; Ruffert, 2019, para. 31; more restrictive e.g. Jestaedt, 1993; Schmidt, 2007, pp. 276 et seq.; Kersten, 2010, p. 332 et seq.; Gärditz, 2010; sceptical Dreier, 2015, para. 123 et seq.):

- The decrease in influence (“*Einflussknicke*”, “*drops in influence*” – BVerfGE 151, 202, 290 et seq., 329 para. 126, 130 f., 212 and headnote No. 2) needs to be compensated by other means to ensure democratic accountability (BVerfG op. cit.); and

- granting independence needs to be “justified by factual reasons” (BVerfG 151, 202, 333 para. 219; s. also BVerfG 151, 202, 293 para. 134: “specific justification”).

Only if both conditions are met will the level of legitimacy be understood as sufficient and the decline of democratic accountability resulting from the instruction autonomy as justified.

However, it has not been conclusively clarified in the case law of the Federal Constitutional Court or in legal doctrine *by which means* a drop in democratic accountability can be *compensated* for (see below at a.) and *what constitutes* a justification “by *factual reasons*” (see below at b.).

#### **a. Mechanisms to compensate for a decrease in influence**

Both the ECJ and the Federal Constitutional Court have understood parliamentary and judicial control of administrative measures in particular as possible additional sources for democratic legitimation (ECJ, C-518/07, ECR 2010, I-1885 para. 42, 44 et seq.; BVerfGE 151, 202, 293, 334 et seq. para. 134, 224 et seq.; as to parliamentary control as a means for democratic legitimation in detail Schmidt, 2007). Parliamentary control can be strengthened, for example, by granting Parliament additional information rights and rights to ask questions (cf. BVerfGE 151, 202, 337 para. 230). Reporting and accountability obligations of the authorities provide another option (cf. BVerfGE 151, 202, 332 et seq. and 335 et seq., para. 218, 227). As a last resort, Parliament always has the possibility to amend or repeal the legal basis for administrative action (cf. BVerfGE 151, 202, 329 para. 211; Groß, 2012).

The expansion of administrative controls is limited above all by the principle of the separation of powers. Hence, it would, for example, be illegal from the outset to make administrative measures dependent on prior parliamentary approval (Ludwigs, 2011, p. 54).

Last not least, it can further contribute to stronger democratic legitimacy if national authorities are integrated into a European government agency network, whose members mutually control each other (Schmidt-Aßmann, 2013, p. 163; cf. Hoffmann-Riem, 2012, para. 54).

These forms of democratic legitimation are recognized by large parts of legal literature and by the case law of the Federal Constitutional Court. In contrast, it has been highly controversial whether state action can also be legitimized by its outcome ever since *Fritz Scharpf* (Scharpf, 1970) introduced the distinction between “input” and “output legitimation” into democratic theory in 1970 (e.g. from recent times Schliesky, 2004, pp. 656 et seq., pp. 715 et seq.; Möllers, 2005, pp. 33 et seq.; Unger 2008, pp. 80 et seq., pp. 278 et seq.; Classen, 2009, pp. 27 et seq.; Gärditz, 2010, p. 278 et seq.; Trute, 2012, para. 53 et seq.).



An *exclusively* result-oriented legitimization of all state action would certainly not be compatible with the Basic Law's conception of democracy, which in any case also calls for input legitimacy. But that is not up for debate anyway. Output is only in question as an *additional* source of legitimacy.

A central objection to output models of democratic legitimization points out that there simply cannot be an *a priori* correct or desirable outcome, since democratic legitimization procedures are designed precisely to produce political outcomes that are not and cannot be known in advance (e.g. Unger 2008, p. 278 et seq.; Gärditz, 2010, p. 278; Ludwigs, 2011, p. 49).

This is a justified objection as far as the legitimacy of *parliamentary* decisions is concerned. Parliament defines the common good and thus determines for itself what is „correct“. In contrast, the argument is much less convincing when the legitimization of the *administration* is at issue. The requirement of factual and substantive legitimization of the administration does not aim at enabling political results that are not known beforehand. On the contrary. The goal is to bind administrative measures to the will of the people, which is expressed in the law. The result of an administrative activity is “correct” if it implements the legal mandate. A task-adequate and functionally appropriate organization strengthens the democratic legitimacy of public authorities because it helps to ensure that Parliament's will – as enshrined in the law – is implemented (e.g. Schmidt-Aßmann, 2006, 5/35; Groß, 2007, p. 172; Trute, 2012, para. 53; cf. ECJ, C-518/07; Masing 2010, p. 214 et seq.).

As regards the democratic legitimization of independent authorities, this leads to the following conclusion: The fact, that a public authority is not subject to government oversight and is not bound by instructions issued by the government, triggers ambivalent effects. On the one hand, independence necessarily weakens democratic legitimization because the agency is not tied back to parliamentary will through the government. But on the other hand, it strengthens democratic legitimization if it can be expected that a task will be performed most effectively by an authority that is not subject to government directives. For in this case, freedom from instructions increases the probability that the result desired by Parliament will be achieved.

Hence, we submit that to ask for a “special factual justification” for the independence of public authorities is in essence a reference to this ambivalent democratic effect inherent in freedom from instructions when it contributes to the administration fulfilling its legal duties. Requiring a “special justification” is to be understood as an independent authority's potential to better fulfill its legally defined tasks if compared with an authority bound by instructions (cf. Schmidt-Aßmann, 2006, 5/37; Trute, 2012, para. 66).

Against this background we suggest that the two prerequisites for the constitutional admissibility of independent agencies are linked in the following way:

- The decrease in influence must be compensated for, so that a sufficient degree of democratic legitimacy is achieved; different mechanisms can be used for this purpose.
- Additionally, one specific compensatory source of legitimation is indispensable, to which the Constitutional Court refers by demanding a “factual reason”. It is the additional legitimation stemming from the fact, that an independent authority is significantly more likely to “correctly” apply the law than an agency bound by government instructions (see in more detail below at b.).

#### **b. Justification “by factual reasons”**

Granting independence from instructions to a public authority is then “justified by factual reasons”, if there is a better chance for an authority insulated from government instructions to realize the goals and policies underlying the law if compared to an authority controlled by the Federal Government or the competent Minister.

Two constellations, where “factual reasons” of this kind can be assumed in our opinion, stand out:

##### **aa. Special expertise**

Firstly, if *special expertise* is required to perform a task (cf. e.g. Groß, 2015, p. 110 et seq., p. 134, pp. 139 et seq.). This applies, for example, to examiners in all subject areas (see for a list of authorities, whose independence from instructions is traditionally accepted as being legal Jestaedt, 1993). Böckenförde (in his seminal article on democracy as a constitutional principle, Böckenförde, 2004, para. 24) already mentioned the examination system as an area in which government instructions were inappropriate and freedom from instructions can thus be granted to the responsible administrative bodies. It also applies to decisions made by collegial bodies or pluralistically constituted committees.

If the oversight body (namely the Federal Government) lacks the qualifications that the law requires of the decision-making body, then its right to issue instructions is either never used in practice (e.g. *Bundeskartellamt*), or, worse, its instructions risk introducing arguments into the decision-making process that run counter to the legislative goals.

##### **bb. Particular incentive and particular susceptibility for undue influence**

Secondly, “factual reasons” can be accepted to justify the establishment of an independent agency, if the task at hand *sets a particular incentive* and is, at the same time, *particularly apt* to be used for

implementing individual (political) interests or short-term political goals, running counter to the legislature's goals pursued by the relevant laws (cf. esp. Schmidt-Aßmann, 2006, 5/37; Masing, 2010, p. 189 et seq.; Trute, 2012, para. 68; crit. e.g. Jestaedt, 1993, p. 425 f., and Schmidt, 2007, pp. 276 et seq., assuming that only the constitution itself can justify independent authorities; Ludwigs, 2011, p. 48).

A paradigm example for this second type of "instruction-hostile" administrative tasks is monetary policy (e.g. Brosius-Gersdorf, 1997; Groß, 2015; Zilioli, 2016; BVerfGE 89, 155, 207 et seq.). Its primary objective is to maintain price stability. General economic objectives may only play a role if they do not compromise the objective of price stability (Art. 127 para. 1 TFEU). However, the incentives for a government to disregard this primary commitment to price stability are considerable. Obviously, interest rates control the volume of credit available on the market and, via available funding, inter alia a government's opportunities to implement its political program. Given that the design of monetary policy measures is always the result of complex evaluations with considerable discretion, a government would also have the possibility of attaching undue weight to short-term political interests. Accordingly, the Federal Constitutional Court justifies the independence of the ECB and, more generally, of central banks by pointing out that they are better suited to safeguarding price stability than sovereign bodies, which are dependent on the value of money for their ability to act (established case-law, cf. vgl. BVerfGE 89, 155, 207 et seq.; 142, 123, 220 et seq. para. 188 et seq.; 146, 216, 256 et seq. and 278 para. 59 et seq., 103; 151, 202, 293 et seq. para. 134).

But does this not qualify every administrative task as unsuitable by its nature for instructions from the government (for this objection and the counterarguments Masing, 2010, pp. 185 et seq.)? Even the approval for an industrial park or the third runway at an airport can be of great importance in terms of regional economic policy, and decisions often have to be made under considerable political pressure. It is one of the administration's basic tasks to make decisions in situations of political tension and to balance conflicting interests, and it is a classic task of the government to direct the administration in these situations. At any rate, this has not proven to generally result in undue influence (Masing, 2010, p. 188). Therefore, the right to issue instructions can only be categorized as dysfunctional if the administrative task at hand gives *particular* cause and *particular* opportunity to be instrumentalized for purposes outside the law (cf. Masing, 2010, pp. 190 et seq.)

Deciding when we are faced with such a situation will often be a contentious issue and a matter of degrees. Clues and arguments for when an administrative task is "instruction-hostile" can be gained by comparing administrative activities such as the regulation of network economies or monetary

policy, i.e. areas in which authorities are typically guaranteed more or less freedom from instructions, with classic areas of public trade law (cf. Masing, 2010, pp. 189 et seq.).

Starting from such a comparison, let us elaborate further on the *particular incentives* (see below at [1]) and the *particular openness* of an area of law to undue influence (see below at [2]).

(1) The independence of public agencies imposes itself whenever there are manifest conflicts of interest, triggering incentives for the government to superimpose political interests over the goals pursued by the applicable law. This is to be assumed in two constellations in particular (cf. e.g. Masing, 2010, pp. 189 et seq.):

For one thing, if a government has to decide directly on its own behalf. An illustrative case is the Federal Network Agency (*Bundesnetzagentur*) which was granted independence not least because the state is (or was) often co-owner of those privatized companies for which regulatory decisions have to be made (cf. Masing, 2010, pp. 197 et seq.).

Secondly, a concerning situation arises if the administrative measure at hand might directly impact the government's or a particular minister's political success. An incentive of this kind to hold back agency enforcement exist, for example, in competition law since stronger enforcement will curtail financially and fiscally strong companies and providers of a large number of jobs (Masing, 2010, pp. 190 et seq.)

In 2019, the Federal Constitutional Court recognized that there is a risk of undue political influence by the government in the area of banking supervision (BVerfGE 151, 202, 334 para. 223). The court did not elaborate on this aspect in detail. However, the experience of the last financial crisis, which led to the introduction of the SSM, makes the assessment understandable: The so-called *national or home bias*, i.e. the tendency to favor national champions when applying the law was identified as a major weakness of banking supervision and was a central argument for the establishment of a European-wide supervisor and for the independence of banking supervision (from the vast legal literature e.g. Ferran and Babis, 2013, p. 11; Binder, 2013, p. 300; Wymeersch, 2014, p. 8; Kaufhold, 2017, p. 23 et seq.).

By contrast, classic administrative measures under public trade law are not typically, and at any rate not by definition, addressed to particularly significant economic players. The application of e.g. the law relating to hotels and restaurants generally has at best a very indirect impact on the government's economic policy objectives.

(2) In order to qualify as "factual reasons" required under German constitutional law for accepting independent public agencies, in addition to an incentive for the government to influence enforcement, there has to be an avenue for the exercise of such power. Put differently, an administrative task needs

to be *particularly apt* to being misused for the implementation of individual (political) interests instead of the law's objectives in order to justify a guarantee of independence (cf. Masing, 2010, p. 192). This susceptibility may result in particular from the structure of the applicable regulations. The larger the discretion granted by legal rules, the more complex the evaluations to be made, the more numerous the factors to be weighted and set in relation to each other, when applying a statute, the broader the avenue for the government to influence enforcement.

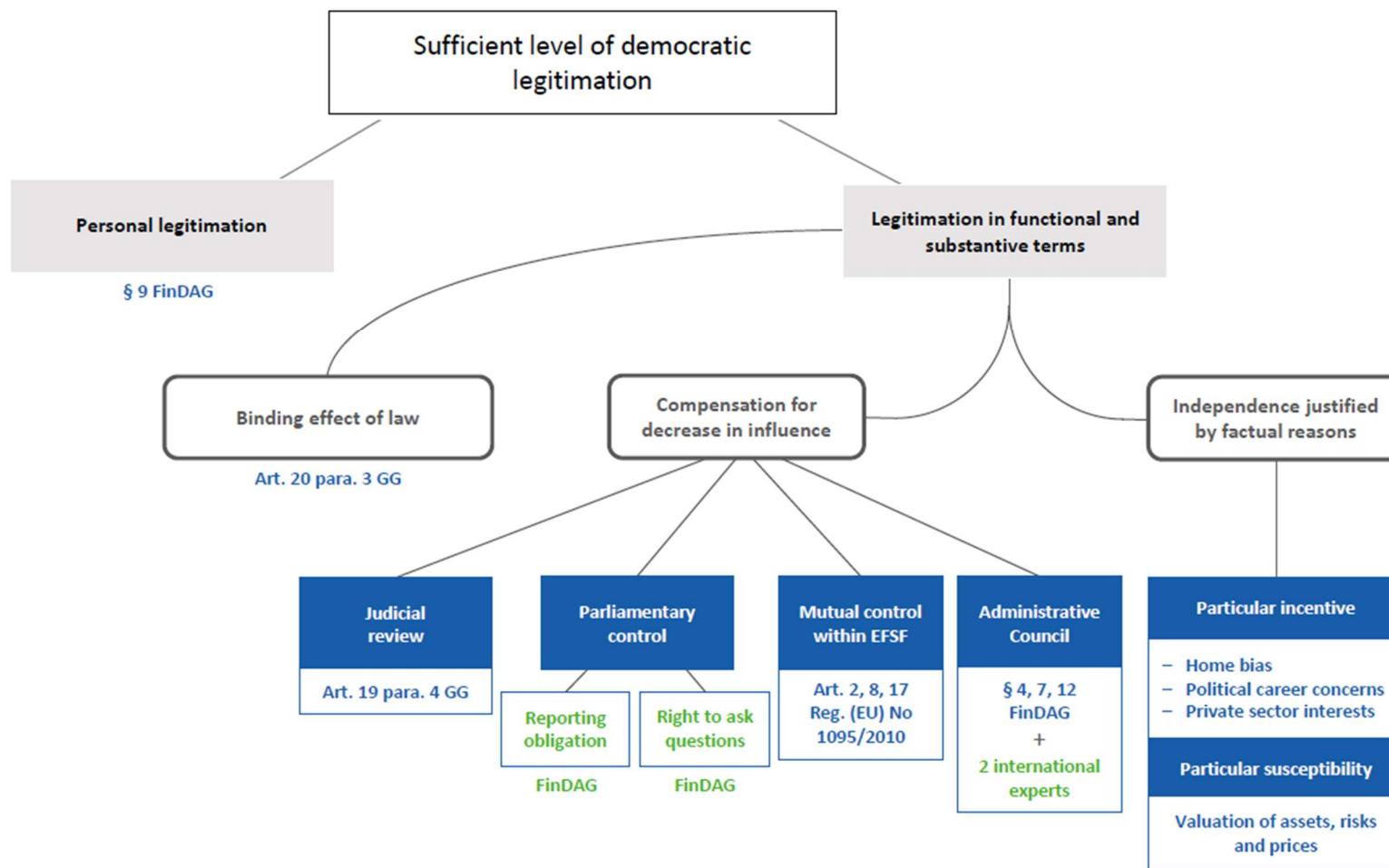
## **V. Constitutionality of BaFin independence from instructions as a securities market supervisor**

Given these constitutional premises: Would it be legal to insulate BaFin as a securities market supervisor from the Federal Government's instructions? If so, how can a sufficient level of democratic legitimation be ensured?

We argue that there is a specific justification for BaFin independence and we set out how to compensate for the loss of democratic legitimation resulting from the abolition of the Federal Ministry of Finance's right to issue instructions (see figure 2 below).

In a nutshell, this paper submits that the combination of an incentive to unduly step in and the opportunity to do so is what makes the factual reason justifying BaFin's independence. We argue that there are at least three kinds of incentives for undue influence from the government's side on securities market supervision (i.e. a home bias, political career concerns and private sector interests) and that capital markets and accounting law provide a number of avenues for influencing law-enforcement, in particular, when requiring the valuation of assets, risks and prices. The decrease in democratic legitimation resulting from instruction autonomy is partially compensated for by judicial review of BaFin measures, by the influence of the Administrative Council and by the mutual control of European securities supervisors within the ESFS. In addition, BaFin's democratic legitimation can and should be further strengthened by introducing an obligation to report to Parliament and to answer questions from Members of Parliament and by including two international experts on the Administrative Council.

Figure 2: Constitutionality of BaFin independence from instructions in the field of securities market supervision



Source: Own representation.

## **1. Personal legitimation**

BaFin has full personal democratic legitimation as defined by the Federal Constitutional Court (see above II.1.): It is managed by an Executive Board which consists of a President and five Executive Directors (§ 6 para. 1 FinDAG). All of them are nominated by the Government and appointed by the Federal President (§ 9 para. 1 FinDAG). Their term of office is eight years, reappointment is possible. The Federal President shall dismiss a member of the Executive Board at the request of such member or for good cause upon resolution of the Federal Government (§ 9 para. 2 FinDAG).

## **2. Legitimation in functional and substantive terms**

BaFin's administrative measures are also legitimized in functional and substantive terms by the fact that the agency is bound by law and its activities are subject to judicial review.

Whether it is constitutionally possible to abolish the Government's oversight and its right to issue instructions therefore depends crucially on whether the diminished level of influence is compensated for and whether there is a specific justification for granting independence to BaFin.

### **a. Compensation for the decrease in influence**

#### **aa. Mutual control of European securities market supervisors within the ESFS**

As to compensating for a loss in influence, we suggest to first take a glance at BaFin's embeddedness in the European System of Financial Supervision (ESFS), a network consisting of the national supervisory authorities and the European Supervisory Authorities (cf. Art. 2 para. 2 Regulation [EU] No. 1095/2010), including the European Securities and Market Authority (ESMA). One of the main objectives of the ESFS is "to ensure that the rules applicable to the financial sector are adequately implemented" (Art. 2 para. 2 Regulation [EU] No. 1095/2010). To this end, inter alia, peer reviews are carried out between national authorities (Art. 8 para. 1 lit. e, Art. 30 Regulation [EU] No. 1095/2010), and ESMA has been granted a right of self-intervention. In exceptional cases, it can adopt measures vis-à-vis financial market participants instead of a national authority (Art. 17 para. 4 Regulation [EU] No. 1095/2010). The ESFS thus contributes to the enforcement of the rule of law, of BaFin's obligation to obey the law and thereby its substantive democratic legitimation.

#### **bb. Strengthening BaFin's Administrative Council**

In addition, BaFin's Administrative Council (§ 7 FinDAG) is of importance as an additional means of democratic legitimation. It comprises 17 members, six representatives of the Federal Government, five members of parliament and six experts from the private sector and academia (§ 7 para. 3 FinDAG). The

Administrative Council oversees the management of BaFin and supports BaFin in fulfilling its tasks (§ 7 para. 1 s. 2 FinDAG), but it has no right to issue instructions or any other means to formally direct BaFin's administrative procedures.

However, that does not make the Administrative Council a toothless tiger: BaFin is funded by the companies it supervises. While the Executive Board prepares the budget plan, it is the Administrative Council who takes the final decision (§ 12 para. 2 s. 3 FinDAG). Furthermore, the members of the Executive Board have to regularly report to the Administrative Council (§ 7 para. 1 s. 3, 4 FinDAG), whose members, for their part, may at any time request information and debate from the Executive Board (§ 4 para. 2 s. 2 BaFin-Satzung [Statute of the Federal Financial Supervisory Authority]).

In this way, a balance is struck between the need for democratic accountability to parliament and the risk of undue influence in favor of national champions. The risk of a home bias in the Administrative Council's work could be further limited e.g. by involving representatives of foreign securities regulators and/or securities market supervisors as experts in the Council's work. We recommend that these international experts also be given voting rights.

#### **cc. Introducing a reporting obligation and information rights**

Additionally, it is worth to consider and we recommend requiring BaFin to annually report directly to the *Deutsche Bundestag* and to mandatorily answer questions from Members of Parliament on these reports.

We believe that the decrease in influence that goes along with the guarantee of independence will then be sufficiently compensated for by the combination and interaction of BaFin's integration into the ESFS, the control of the Administrative Council, the additional reporting obligation and the questioning rights for Members of Parliament.

#### **b. Specific justification**

Against that background, the question whether there is a "special justification" as required by the German Federal Constitutional Court, generally, for granting an authority independence from government instructions and, in particular, for BaFin independence from the Federal Ministry of Finance in the field of securities market supervision is at the core of the problem. We submit that for BaFin as a securities markets supervisor this justification may be delivered along the lines of a dangerous combination of an incentive to unduly step in and the opportunity to do so (cf. above III.2.b).

There are several *incentives* for the government to wield its influence in the enforcement of securities market supervision along the lines of political interests, disregarding that capital markets law aims at



ensuring market integrity and the protection of investors (see below at aa.). As to *avenues* for influencing enforcement in this way, for instance in the interest of national champions, capital markets and accounting law provides ample opportunities (see below at bb.).

#### **aa. Particular incentives in the field of securities market supervision**

Political economists, political scientists and legal scholars reveal a large variety of *incentives* for undue influence from the government's side on securities market supervisors. Precisely, we distinguish three cases:

- The incentives of the supervisor are aligned with the objectives of the government;
- members of government are captured by political career concerns;
- members of government are captured by private sector interests.

This section provides a non-exclusive list of well-documented incentives for political interference, each representing one of the above-mentioned categories.

First, a government (and, if bound by government instructions: the competent supervisory authority) has strong incentives to act with forbearance when enforcement actions jeopardize the competitive edge of national champions. The risk of *home bias*<sup>4</sup> is inherent in the European supervisory architecture (cf. Masing, 2010, pp. 214 et seq.): National authorities remain solely responsible for the supervision of their own (national) capital market. Yet, the customers of financial services, the beneficiaries of market supervision, are active on markets all around the globe. Since the provision of financial information has public-good character, national interests do not internalize the benefits of tighter enforcement for customers, resulting in an underprovision of or interferences with enforcement efforts against domestic firms. In this constellation, the government and a supervisory authority, that is subject to government control, pursue a national agenda. What is more, the government is unlikely to hold the supervisor to account for its failure to enforce international regulatory rules and standards.<sup>5</sup>

Framed in a different setting with very similar incentive structure, Besfamille (2004) predicts that local supervisors have greater incentives to collude with the supervisee if it brings benefits to their

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<sup>4</sup> This should not be confused with the term "home bias" as it is used in banking. There, it refers to the observation that banks are *home biased* in their asset allocation. Their excessive exposure to domestic sovereigns can trigger the so-called "doom loop" (Farhi and Tirole, 2018) or "diabolic loop" (Brunnermeier et al. 2016).

<sup>5</sup> Obviously, our argument is based on the specificities of the European supervisory architecture which fails to exploit the accountability gains of shared responsibility in a two-tiered system, see Laffont and Martimont (1999).

jurisdiction. Similar protective behaviour has been observed for banking supervision (see Quintyn and Taylor, 2003), for example, during the global financial crisis. Apparently, it is a very subtle form of political interference which does not necessarily rely on any pressure. There is some evidence to suggest that bureaucrats try to stay informed about the objectives and opinions of political decision-makers (Majone, 1993), which has been interpreted as political control through “self-imposed censorship” (Quintyn and Taylor, 2003).

Second, *political career concerns* may create incentives to deter enforcement efforts over the electoral cycle. Elections create implicit incentives for incumbent governments to stimulate the economy in the short term so as to maximize their re-election prospects. Their short-term incentives generate macroeconomic fluctuations which are undesirable from a social welfare perspective.

Initiated by Nordhaus (1975), there is a long track record of empirical evidence for politically motivated cycles in monetary policy: A monetary expansion prior to an election increases both output and employment, which is much appreciated by voters. Fortunately, the inflation response comes with delay; if the intervention is well timed, the bill arrives after the election day, giving policymakers the opportunity to counteract the inflationary pressure by a contractionary monetary stance. As a result, opportunistic behaviour by incumbent governments induces macroeconomic fluctuations over the electoral cycle, which makes out a strong case for politically independent central banks. For example, Vaubel (1997) provides empirical evidence to suggest that German central bankers provided the incumbent with a monetary surprise if the government had a partisan majority in the Bundesbank Council.<sup>6</sup>

A recent literature refers to the SEC, arguing that these incentives may extend to securities market supervisors: Mehta and Zhao (2020) have shown that SEC enforcement against financial misconduct translates into a lower probability of re-election for those incumbents who serve on the congressional committees that oversee SEC enforcement efforts. Put another way, voters hold them to account for losses from accounting fraud by companies based in their constituency. In order to optimize their re-election prospects, incumbents who hold an oversight position in Congress are therefore willing to deter enforcement actions against local companies prior to elections, thereby creating an electoral cycle in SEC investigations (Mehta and Zhao, 2020). Applying public choice theory, Heese (2019) shifts the focus to SEC enforcement efforts against large employers. Unemployment growth is a common performance standard for voters who engage in retrospective economic voting. Vigorous enforcement may involve heavy financial penalties which may cause undesirable employment effects. Again,

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<sup>6</sup> Alternatively, electoral cycles may be caused by partisan politics even if voters are rational (Kydland and Prescott, 1977).

politically appointed commissioners seem to be responsive to implicit electoral incentives: Prior to presidential elections, major employers in pivotal states are spared from SEC enforcement. If members of the Congressional oversight committees re-run for office, the SEC is less likely to challenge big employers whenever high unemployment is a major concern in their respective constituency (Heese, 2019).

These studies indicate that there are indeed material career concerns in the field of securities regulation. As a result, politicians might be tempted to (ab)use mechanisms of direct political control. Instructions by the executive branch should be regarded as a gateway to such political intervention. In our view, there is an obvious analogy with the political incentives in the case of monetary policy.

Admittedly, bureaucrats who envisage a career in the private sector might have similar forward-looking objectives. Stigler (1971) argues that bureaucrats are prone to act in the interest of well-organized lobby groups rather than public interest. However, when it comes to complex tasks such as monetary policy and, we believe, market supervision, bureaucrats seem to have higher stakes, thereby aligning private incentives with public interest (Alesina and Tabellini, 2007).

Third, it should not go without saying that particularly those in charge of supervisory authorities may be captured by *private sector interests*; in fact, vested interests may come as a disguised form of political influence. Holburn and Vanden Bergh (2004) argue that supervisees may find it more effective to capture those who are controlling the public authority, either a higher-ranked authority or political decision-makers themselves, rather than the supervisor. There is mixed empirical evidence to support the reasoning that politically connected companies have a lower incidence of enforcement actions. While Heese et al. (2017) find that the SEC is indeed more rather than less likely to issue comment letters to connected companies, lobbying activities seem to achieve a preferential treatment when stakes are high: companies with political ties are less likely to be subject to enforcement actions and, if they are prosecuted, the SEC charges lower penalties (Correia, 2014). On average, the SEC is less likely to detect fraud committed by well-connected companies. What is more, detection was delayed for months (Yu and Yu, 2011), at the expense of market integrity.

#### **bb. Particular susceptibility of capital markets and accounting law**

(Only) At first glance, one might doubt that capital market law and, in particular, accounting law are *particularly apt* to impose individual (political) interests over the goals pursued by the law. While it is true that these are not principle-based but rather detailed, rule-focused areas of law, the considerable discretion in applying these rules is implicit in the application of accounting standards and the intended evaluation of assets and liabilities these areas of the law require. Accounting law revolves around

evaluating assets, estimating cash flows and discount rates, thereby dealing with necessary discretion in applying the valuation methodology, relevant time-frames and risk models. Similarly, capital markets law rests on fundamentally vague legal terms such as “reasonable” investors, “artificial” prices or adequate levels of disclosure, to name just a few. Examples of discretionary aspects of valuation can be found in many areas, including accounting for goodwill, mergers and acquisition, provisions for credit losses, project risks and pension liabilities to name just a few.

## **VI. Organizing an independent securities market supervisor – an international perspective**

We submit that the loss of democratic legitimation that goes along with insulating BaFin from Government instructions is or can be compensated for by other democratic means and justified by the output expected from an independent authority. We therefore suggest that Parliament may choose to abolish the Government’s right to issue instructions to BaFin, bringing important elements of independence to this body.

Other countries have chosen different arrangements to balance the independence of their market supervisor by adequate measures of political accountability. A detailed overview on how legal status, independence in substantive matters and financial autonomy of competent authorities vary from one country to another is given in the appendix. There is one striking feature: A market supervisor under direct oversight of the executive branch – as it is in Germany – is unique in international comparison.

In other countries, it is the parliament that holds the market supervisor to account (AMF, CONSOB, FCA, FRC, SEC). While the French AMF reports directly, it is common that annual reports are submitted to the Treasury first, which is responsible for communications with the members of parliament (CONSOB, FCA). To the best of our knowledge, there are two cases in which oversight responsibilities involve a detailed assessment of the supervisory performance against the statutory mandate or politically approved enforcement priorities (FCA, SEC). In the US, two Congressional committees share the oversight responsibility over the SEC to which the supervisor reports annually. Detailed assessments are delegated to the Government Accountability Office, which is supposed to provide Congress with non-partisan information.

The Financial Reporting Council (FRC), which is among other tasks the UK counterpart of FREP, is undergoing a complete and radical overhaul, which deserves some attention. The Kingman Review (2018) has criticized, in particular, insufficient political accountability. While the parliament does not fulfil a formal oversight responsibility, the relevant parliamentary select committees are expected to hold the FRC to account. There are no periodic reporting obligations. Instead, the FRC will report at their invitation. According to Kingman, these select committees have exercised their oversight

authority only sporadically. A new regulator, the Audit, Reporting and Governance Authority (ARGA) is expected to replace the FRC in 2023. Its accountability measures will resemble the FCA arrangements. Above all, it will involve an annual reporting obligation vis-à-vis the parliament.

In the US only the OCC is under oversight of the Treasury comparable to “*Rechts-*” and “*Fachaufsicht*” in the German sense, since it is embedded in the Treasury in a way comparable to BaFin being embedded in the Ministry of Finance. If somebody from the executive branch tried to tell the SEC to pursue a certain action, it would be understood as violating administrative and constitutional norms. Different from the situation under German constitutional law, U.S. scholars see this as a separation of powers, not as a democratic principle issue.

Most oversight and accountability arrangements involve reporting and consultations on an annual basis. What is more, these submissions are often publicly available. This is why more direct parliamentary oversight improves transparency vis-à-vis the elected principal and the general public alike.

To come back to what was said above, we believe a word of warning is in order: Given that our analysis draws heavily on SEC evidence to uncover incentives for undue political intervention, it might come as a surprise that the SEC is introduced as a role model for highly effective market supervision. In our view, there are good reasons to consider the abundance of empirical research as a particular strength. To ensure market integrity, the interplay of (i) a supervisor with strong incentives to retain independence through its reputation, and (ii) market participants who challenge supervisory discretion and thereby contribute to the reputation, from which they benefit, matters. The reputation of the supervisory authority relies on its technical expertise and its deep understanding of market developments. If the supervisor acts transparently, monitoring by analysts and other observers, including academic researchers, will follow up on existing standards, and produce evidence for changes of those standards. Thus, the activities of supervisors and market research are intertwined, lifting supervisory standards and, eventually, the integrity of the market (Roychowdhury and Srinivasan, 2019).

## VII. Conclusion

This paper shows that it is constitutionally possible and desirable to free BaFin, the German securities market supervisor, from government instructions in order to ensure the functioning of capital markets and to protect investors.

We propose to amend FinDAG so as to abolish the Federal Ministry of Finance’s supervision of BaFin.

We submit that this would strengthen the credibility and impartiality of the German supervisor, and as a consequence, help to restore capital market integrity.

In order to compensate for the loss of democratic legitimation that goes along with insulating BaFin from Government instructions we suggest to (1) oblige BaFin, to annually report to the *Deutsche Bundestag* and to mandatorily answer questions from Members of Parliament on these reforms; and (2) to include two international representatives of securities market supervisors in BaFin's Administrative Council.

Setting up BaFin as a more independent body would send a clear signal to global capital markets, counteracting the enormous reputational loss after Wirecard and, more currently, Greensill.

## Appendix: Overview of legal status, independence and financial autonomy of competent authorities in different countries

	Germany	France	Italy	United Kingdom			United States
<i>Competent authority</i>	<b>BaFin</b>	<b>AMF</b>	<b>CONSOB</b>	<b>FCA</b>	<b>FRC</b>	<b>ARGA*</b>	<b>SEC</b>
<i>Legal status</i>	Independent public authority with its own legal personality	Independent public authority	Independent public authority with its own legal personality	Company limited by guarantee	Company limited by guarantee	tbd	Independent federal agency
<i>Independence in substantive matters</i>	Ministry of Finance controls both the legality and the appropriateness of BaFin's measures ( <i>Rechts- und Fachaufsicht</i> ); BaFin needs approval for some of its operational decisions.	Since AMF has far-reaching rule-setting competences, there are decisions that must be stamped by the Ministry of Finance. AMF is accountable to Parliament.	In specific cases, CONSOB must submit secondary regulation to the Ministry of Economy and Finance. CONSOB is accountable to Parliament and reports annually through the MEF.	FCA is accountable to the Treasury and Parliament. FCA reports to the Treasury through the annual report. Treasury reports to Parliament, weighing FCA's performance against its statutory objectives. FCA responds to requests for information by MPs.	FRC is accountable to the relevant parliamentary select committees at their invitation. Parliament plays no formal role.	ARGA will be accountable to Parliament and will report through the annual report.	SEC is accountable to Congress. SEC reports to two Congressional committees through the annual report. Government Accountability Office periodically scrutinizes SEC performance. Decisions related to rule-setting competences must be submitted to Congress.
<i>Financial independence</i>	Fully self-funded. Revenues derived from fees, reimbursements, and contributions for regulated entities.	Fully self-funded. Revenues derived from fees imposed on market participants. For legal reasons, the range of fees is fixed by the MoF.	Partially self-funded. Revenues derived from fees and appropriation from the State. CONSOB manages its budget autonomously.	Fully self-funded. Revenues derived from fees imposed on market participants.	Fully self-funded. Mixture of statutory, contractual, and voluntary levies paid by market participants.	Fully self-funded. Revenues derived from fees imposed on market participants.	Funding through an annual appropriation from Congress. Piece of the federal budget; SEC forwards its budget estimate to the Office of Management and Budget.

Source: Own representation, based on Krahn et al. (2020). | Notes: Audit, Reporting and Governance Authority (ARGA) expected to be fully implemented in 2023.

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