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AMENDING DIRECTIVE 97/9/EC ON INVESTOR COMPENSATION SCHEMES (ICS): SAFEGUARDING INVESTORS' INTERESTS BY ENSURING SOUND FINANCING OF ICS

Compilation of Briefing Notes

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POLICY DEPARTMENT A: ECONOMIC AND SCIENTIFIC POLICIES

ECONOMIC AND MONETARY AFFAIRS

AMENDING DIRECTIVE 97/9/EC ON INVESTOR COMPENSATION SCHEMES (ICS): SAFEGUARDING INVESTORS' INTERESTS BY ENSURING SOUND FINANCING OF ICS

COMPILATION OF BRIEFING NOTES

Abstract

This compilation of briefing papers deals with two specific issues in relation to the Commission Proposal to amend Directive 97/9/EC on Investor Compensation Schemes (ICS), more specifically on how to safeguard investors' interests by ensuring sound financing of ICS. The first two notes discuss the proposed borrowing mechanism (namely questions such as: Is the proposed compulsory borrowing mechanism an adequate solution which does not lead to moral hazard? Which alternatives to the mutual borrowing mechanism could be taken into account? Are there other sources for funding than the proposed borrowing mechanism with a view to avoid moral hazard?) and explore interim solutions in view of the proposed 10-year transition period to build up the final level of ex-ante funding. In this regard, the notes cover approaches to protect investors within this 10-year period and possible alternatives, e.g. in terms of building up the target level and in terms of timing. The third and fourth note relate to funding principles and mechanisms. They evaluate in particular whether the proposed (ex-ante) target fund level of 0.5% is adequate in view of the products covered, the coverage level, and in view to the risk covered occurring in investment firms and UCITS. Furthermore, it is examined if the ex-ante funding as such is an adequate solution to finance the schemes.

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ENSURING SOUND FINANCING OF ICS: REMARKS ON THE COMMISSION'S PROPOSAL AMENDING DIRECTIVE 97/9/EC ON INVESTOR COMPENSATION SCHEMES

NOTE

by Marco LAMANDINI

Abstract

The Committee requested an opinion on the Commission's proposal amending Directive 97/9/EC (ICSD), focussing on the funding of investor compensation schemes (ICS) and in particular on their borrowing mechanism and the interim solutions in view of the proposed 10 year transitory period. The opinion should clarify whether the proposed compulsory borrowing mechanism is an adequate solution, which does not lead to moral hazards; which alternatives to the mutual borrowing could be taken into account and if there are other sources of funding preferable to the proposed borrowing mechanism, in order to avoid moral hazards; considering the 10 year transitory period envisaged in the proposal, how can investors be protected in the meantime and what could be the alternatives. This note endeavours to offer a view on these complex issues. Part 1 is an introduction on the funding and borrowing mechanisms foreseen in Article 4a and 4b of the proposal. Part 2 illustrates the rationale for harmonising the funding and coverage of ICS and for introducing a pan-European principle of solidarity among national ICSs. Part 3 comments on the reasons militating against the limited harmonization envisaged in the proposal and casting doubts on the opportunity of the provisions on a harmonized funding regime, with a very long transitory period of 10 years and on a compulsory lending mechanism among national ICS without the provision of any monitoring and governance tools to the lending ICSs. Part 4 draws some conclusions.

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EXECUTIVE SUMMARY

The Committee requested an opinion on the Commission's proposal amending Directive 97/9/EC (ICSD), focussing on the funding of investor compensation schemes (ICS) and in particular on: a) their borrowing mechanism and b) the interim solutions in view of the proposed 10 year transitory period. The Commission specified that the opinion should clarify: a) whether the proposed compulsory borrowing mechanism is an adequate solution, which does not lead to moral hazards; b) which alternatives to the mutual borrowing could be taken into account and if there are other sources of funding preferable to the proposed borrowing mechanism, in order to avoid moral hazards; c) considering the 10 year transitory period envisaged in the proposal, how can investors be protected in the meantime and what could be the alternatives. This note endeavours to offer a view on these complex issues. Part 1 is an introduction on the funding and borrowing mechanisms foreseen in Article 4a and 4b of the proposal. Part 2 illustrates the rationale for harmonising the funding and coverage of ICS and for introducing a pan-European principle of solidarity among national ICSs. Part 3 comments on the reasons militating against the limited harmonization envisaged in the proposal and casting doubts on the opportunity of the provisions on a harmonized funding regime, with a very long transitory period of 10 years and on a compulsory lending mechanism among national ICS without the provision of any monitoring and governance tools to the lending ICSs. Part 4 draws some conclusions.

1. THE FUNDING AND BORROWING MECHANISMS FORESEEN IN THE PROPOSAL

The Commission proposal of 12 July 2010 (COM(2010)371 final) for a directive amending Directive 97/9/EC of the European Parliament and of the Council on investor compensation schemes, relying extensively on a thorough report prepared by Oxera[1] and a following wide consultation process, provides for the insertion of two new Articles, 4a and 4b, in the ICSD.

Firstly, Article 4a sets an ex ante funding mechanism for each national scheme, whereby "Member States shall ensure that each scheme establishes a target fund level of at least of 0.5% of the value of the monies and financial instruments held, administered or managed by the investment firms or UCITS that are covered by the protection of the investor compensation scheme". Such target level can be eventually modified by the Commission by means of delegated acts "taking account of the development of financial markets". Under paragraph 3 of the same Article 4a "the target fund level shall be financed prior to and irrespective of the occurrence of any event" triggering the protection of the scheme, but Member States "shall ensure that the level of funding for each scheme is reached within a ten year period after the entry into force of this Directive and that each scheme adopts and complies with an appropriate planning in order to fulfil this objective".

Secondly, Article 4b introduces a statutory right for each scheme to borrow from all other national schemes, provided that the conditions set in paragraph 1 of the same Article are cumulatively met (essentially, that the borrowing scheme is not able to fulfil its obligations and is not delinquent in respect of previous loans extended by another scheme). All other schemes (one for each Member State) are then to act as lending schemes, it being however provided that:

(i) the total amounts of the funds available at Union level for lending shall be equal to 10% of the ex ante funding amount of the overall schemes;

(ii) the total amount lent to each borrowing scheme shall not exceed 20% of the total amount of the funds available at Union level for lending;

(iii) each scheme shall lend in proportion to the amount of covered monies and financial instruments;

(iv) the borrowing scheme shall repay the loan at the latest after 5 years; annual instalments may be agreed upon, but interest shall be due only at the time of repayment;

(v) the interest rate shall be equivalent to the marginal lending facility rate of the ECB during the credit period.

Under paragraph 8 of the same article "Member States shall ensure that the contributions levied by the borrowing scheme are sufficient to reimburse the amount borrowed and re-establish the target level fund as soon as possible and at the latest within a ten year period after the reception of the loan".

[1] Oxera, *Description and assessment of the national ICS established in accordance with Directive 97/9/EC*, Report prepared for the European Commission (Internal Market DG) and Appendices, January 2005, *passim*; compare also Oxera, *Funding of the Financial Services Compensation Scheme*, Report prepared for the FSA, March 2006, *passim*.

2. THE RATIONALE FOR HARMONISING THE FUNDING AND COVERAGE OF ICS AND FOR INTRODUCING A PAN EUROPEAN PRINCIPLE OF SOLIDARITY: A) THE CASE FOR

It is quite apparent that, in broad terms, both provisions are aimed at fostering investor protection in Europe, on the one hand, by harmonizing the requirements on the funds immediately available to each ICS to fulfil its obligations and, on the other hand, by introducing a pan European principle of solidarity among European investment firms.

In so doing, the proposal seeks to bring about a level playing field regarding the degree of security offered in each Member State by the safety net represented by the national ICS, so as to prevent differences in the funding and coverage of the national schemes (as the significant ones currently existing, which the proposal aims at harmonising at EUR 50,000[2]) from converting into competitive advantages or disadvantages for the respective national investment firms.

In turn, the cross-border extension of solidarity among investment firms and their ICS relies on the implied assumptions that

(i) within the Single financial market all European investment firms derive benefits from investor confidence (and should therefore contribute to the building up of such confidence, also by taking part to the ICSs' funding necessary for their intervention) and, at the same time,

(ii) such confidence must be restored, in case of market disruptions, drawing from private monies, first of all at national level (according to a principle of proximity) but, if the national scheme concerned is not robust enough, through an individually limited, but significant, in aggregate, recourse to a pan-European support of other schemes.

Public intervention must remain in the backstage as the very last resort, available only when there is a clear systemic risk and all other strategies to cope with it impinging on private monies proved ineffective.

In fact, the rationale for the establishment of a network of national ICS seems to be grounded on the implied assumption that market confidence, within the Single European financial market, is no longer solely a national good (or interest).

The traditional argument used to justify ICS is two-fold:

(i) from a market failure micro perspective, it is argued that small investors are unlikely to be in a position to assess the soundness and probity of an investment firm, much less to monitor it[3]; they deserve, therefore, some form of institutional response to their informational weaknesses and collective action problems. What is more, this is nowadays true not only at national level but, also, throughout the entire Single Market (indeed, informational asymmetries are particularly acute in respect of investment firms established abroad);

[2] Compare Article 4, paragraph 1, as amended by Article 1(4) of the proposal.
[3] N. Moloney, *EC Securities Law*, Oxford University Press, 2nd edition, 2009, p. 728.

(ii) from a macro perspective, it is contended that even if investment firms do not pose the same systemic risk as banks, investors' losses derived from operational and financial failures could affect market confidence. Due to the current integration of the European financial market, spill over effects are likely to occur, disseminating also cross border any disrepute and other negative effect on market confidence originated at national level.

Based upon these reasons and the finding that, within the Single Market, investor protection is no longer a matter pertaining to one single Member State (the one exerting home country control), but it is, by now, a European concern, the Commission believes that the ICS national regimes deserve a more harmonised regulatory response. If the investment firm benefiting of the European passport carries on a pan-European cross border activity, its client base shall reflect, in principle, its pan-European activity and clients based in different Member State should, on the one hand, count on the very same protection irrespective of the national ICS called to intervene, depending on the home Member State of the investment firm and, on the other hand, such clients should rely on some degree of contribution of the entire European financial industry to cope with a failure which could threaten confidence in the European financial market as a whole. This, in turn, would prevent regulatory competition from distorting the competitive process in the field.

3. THE RATIONALE FOR HARMONISING THE COVERAGE AND INTRODUCING A PAN EUROPEAN PRINCIPLE OF SOLIDARITY: B) THE CASE AGAINST

There are, however, arguments also against the adoption of Articles 4, 4a and 4b as proposed by the Commission.

a) As to the harmonisation of coverage and soundness of national ICSs, evidentiary experience[4] shows that, up to now, retail investors did not pay much attention to the coverage and soundness (or, at least, funding arrangements) of the relevant ICS when choosing the investment firm to which they entrusted their savings: a finding that in fact weakens the alleged competitive role of ICS coverage in the pan-European market of investment firms, casting doubts on the appropriateness of a costly harmonization effort in this domain. Moreover, a "one size fits all" rule (setting at the same level of EUR 50,000 the coverage) does not necessarily reflect the real interests at stake: since it is well known that the median clients' investment in securities varies significantly throughout Europe, a uniform amount could easily prove either under-compensating or overcompensating retail investors, depending on their nationality. For instance, the median Bulgarian investor would be fully compensated whilst the Italian or Dutch investor could be compensated for only a fraction of their investment. Such inequalities could be considered a necessary evil in adopting a single European ICS, but they are hardly convincing in a reform simply increasing the interconnection between ICS which, however, remain fully national.

The same holds true also in respect of the funding arrangements envisaged in Article 4a of the proposal. Indeed, in the frame of a single European ICS (a policy option considered by the Commission in its impact assessment but postponed as a longer term option[5]), the ex ante funding requirements now set in Article 4a would be fully justified, because it would certainly be up to the European regulators to design the structure and functioning of a brand new European scheme and, in this context, to set the amount of the fixed endowment and that of the calls for additional contributions deemed sufficient for the European scheme to cope, in a timely manner, with its compensation obligations. On the contrary, having discarded for the time being such a (more ambitious) policy option, it is arguable that the European institutions can impose, under the subsidiarity principle, uniform funding arrangements to schemes which, on one side, remain fully national and, on the other side, have chosen so far very different funding arrangements delivering *nonetheless similar results*[6]. In other words, there is no compelling evidence that ex ante funding is superior to ex post funding, since, for example, Italian and British ICS performed fairly well so far under the latter funding system whereas schemes adopting the ex ante funding failed to respond to the market needs. Both systems proved empirically workable so far and in light of the existing experience it seems awkward to express a preference for either one of the two.

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[4] FSA Consultation Paper 24, *Consumer Compensation: A Further Consultation* (1999), p. 16.

[5] Commission staff working document, *Impact assessment accompanying document to the proposal for a directive of the European Parliament and of the Council amending Directive 1997/9/EC on investor compensation schemes*, SEC (2010) 845, Brussels 12 July 2010, p. 36.

[6] This is acknowledged also by the DG Internal Market and Services, *Evaluation of the Investment Compensation Scheme Directive, Executive Summary and Recommendations*, p. 7 ("in relation to past compensation events, none of the compensation schemes in the EU 15 reported any funding shortfalls that resulted in compensation payment being delayed or not being made).

Moreover, since ICS (differently from banks' resolution funds like the ones envisaged in the Commission Communication on crisis management in the financial sector[7]) do not display any liquidity function nor do they ensure the bail in of ailing firms as a going concern but are "simply" called to compensate ex post the damages already suffered by retail investors, it remains to be demonstrated why ICS should establish an ongoing fund of at least 0.5% of the monies and financial instruments held, administered or managed, if it can be shown that the industry can respond in a timely manner to call for contributions when these are effectively needed.

b) In a way, this argument seems to be acknowledged also by the Commission itself when it concedes that there is room for the application of a very long transitory period: this seems to demonstrate indeed that there is no urgent and compelling need for such a reform, if the Commission can afford to wait 10 years to see it in place. This is even more so if we consider that the Commission characterises as a longer term policy option that of setting up a single European ICS. Since, in my view, "longer term" can hardly be more than 10 years, the act of establishing the European ICS should likely be the right venue to set these rules. The introduction, by now, of these provisions would certainly simplify, in due course, the adoption of a common European scheme, because, if and once all national schemes were more harmonised, national objections to the introduction of a European ICS would likely fade. I doubt however that this evolutionary process fits in this specific domain where, based upon the concept of the integrated European financial market, I would see a clear European interest (and a proper legal basis) in setting up by now a European ICS but I hardly see a proper justification (other than political pragmatism, based upon a very weak legal basis though) for a compromise solution departing from both single market and subsidiarity principles.[8]

Moreover, when considering the appropriateness of the 10 year transitory period and the possible interim alternatives to the mutual borrowing that could be taken into account, one should consider that national ICSs could not find, so far, insurers willing to insure their risks[9] and that the proposal already requires that other credit facilities at market conditions be in place with the banking system to be triggered before the compulsory borrowing mechanism (Article 4a, paragraph 5). This indicates, to my mind, that other sources of funding, additional to such borrowing facilities, are hardly conceivable. For example, lacking any function of the national of ICS of systemic risk aversion, the ECB should not be called to any direct or indirect intervention. It remains, however, difficult to understand, for me at least, why – outside the frame of a, as yet un-adopted, common European ICS, which would unify the last resort safety net for investors throughout the whole European market – national ICS should be legally required to extend last resort loans where commercial banks refrain from doing so having - it is to be assumed - negatively assessed the creditworthiness of the borrower.

[7] Commission Communication, *An EU Framework for Crisis Management in the Financial Sector*, Brussels, 20 October 2010, COM (2010)579 final, p. 14.

[8] There might be some merit, therefore, in the complaints under the subsidiarity principle advanced by the Swedish and British parliaments: compare Riksdag, statement by the Committee on Finance, 2009/10:FiU43 (calling for a possibility to inter-schemes lending instead of the mandatory lending); UK Parliament, European Committee B (Bayley Committee), 21 October 2010.

[9] ICCL, The Investor Compensation Company Limited, *Consultation Paper in relation to the funding of the scheme*, 9 October 2009, p. 13 ("The ICCL has regularly explored in detail the option of purchasing insurance to cover compensation events as one method of capping the exposure of participants in the scheme. To date, however, it has not been feasible for the ICCL to obtain insurance cover").

Can a directive impose to the ICSs' directors a duty to deviate from their due diligence in managing their schemes' assets for solidarity reasons not grounded in any stability concern? It could be argued that, under article 4b, paragraph 4 ("Member States shall ensure that the contributions levied by the borrowing scheme are sufficient to reimburse the amount borrowed […] as soon as possible and at the latest within a ten year period after the reception of the loan"), these loans will be repaid and therefore the ICS managers would not "buy risk". But if the provision of Article 4b, paragraph 4 were enough to guarantee the lender, why should we need such a compulsory lending? Should it not be enough to rely on assistance from commercial banks, negotiated between the national ICS and its banks under the umbrella of a similar provision of State intervention?

c) In my view, the introduction of a principle of pan European solidarity, if not counter-balanced by appropriate governance and monitoring tools, currently not foreseen in the proposal, could be deeply fraught with moral hazard, because the lending ICS, albeit called to a mandatory lending, are not granted any ex ante and ex post governance or monitoring right into the way the borrowing ICS is managed. As already noted, despite the provision of Article 4b, paragraph 4, these loans could easily prove quite risky. Suffice to think of the Amis and Phoenix cases[10] and the cost implied for the relevant national ICS. Not surprisingly, the Commission itself acknowledged that "the supply of commercial credit may be limited, particularly in larger failures where the lender has no certainty about the capacity of the scheme and its participating firms to repay borrowed funds in the future"[11], adding also that "this raises the question of whether a guarantee form the state of other forms of state funding may be required in these cases". A finding that, in fact, on the one hand, casts doubts on the real possibility for national schemes to draw only from private monies if they must rely on last resort state guarantees or other public funding and, on the other, correlates national ICS to fiscal responsibility: two outcomes which, to my mind, could and should be avoided simply adopting a European scheme capable of spreading more widely, to the whole European financial industry, the risk associated with the functioning of the compensation scheme.

[10] For a brief description, compare Commission staff working document, *Impact assessment,* p. 118.

[11] DG Internal Market and Services, *Evaluation of the Investment Compensation Scheme Directive, Executive Summary and Recommendations*, p. 8.

A FEW CONCLUSIONS

Thus, to my mind, the Commission proposal is either too timid or too intrusive.
Too timid, because, whilst acknowledging that in the frame of the European integrated financial market, market confidence is no longer a purely national good, it does not target directly the establishment of a European ICS, and in particular a brand new European system partly decentralised as it would have been obviously possible along the lines of the System of European Central Banks.
Too intrusive because, albeit departing from the idea of setting up a European scheme, the proposal:

a) seems to transplant in this field ideas which are fit in the banking sector in the frame of the banks' resolution fund called to cope with systemic stability and liquidity risks[12] but are beyond the scope of the limited ex post investor protection granted by investment firms' ICS;

and above all,
b) it fails to vest (i) into the national schemes in respect to the investment firms covered and (ii) into all lending national schemes in respect to the borrowing scheme (and through it in respect of the investment firms covered by the same) governance and monitoring tools aimed at monitoring on an ongoing basis and taking corrective actions in respect to the risks insured. In so doing, the solidarity principle is in practice dissociating risk and control and, imposing a standard funding mechanism which is not risk weighted, encourages moral hazard.

[12] Compare Commission Communication, *An EU Framework for Crisis Management in the Financial Sector*, Brussels, 20 October 2010, COM (2010)579 final, *passim*.

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SAFEGUARDING INVESTORS' INTERESTS BY ENSURING SOUND FINANCING OF AN INVESTOR COMPENSATION SCHEME

NOTE

by Kern ALEXANDER

Abstract

Recent European financial market developments demonstrate gaps and shortcomings in retail investor compensation schemes (ICS). The European Commission engaged in a review that showed significant disparities in the application of the Investor Compensation Scheme Directive (ICSD) and the need for further supervisory convergence in regulating Member States' schemes in order to enhance investor protection and reduce arbitrage between Member States. The Commission has proposed amendments to the ICSD that would harmonise the level of compensation available to investors across Member States at 50,000 euros per investor. Further, it requires ex ante funding measures for ICS that are capable of compensating investors in a short period of time and a borrowing mechanism that would allow under-funded schemes to borrow from other schemes to cover eligible investor claims. Although the ICSD enhances the level playing field by harmonising the regulation of ICS in key areas and increasing investor compensation, it may ultimately undermine investor protection by increasing the risk of moral hazard among retail investors and in the provision of investment services by financial firms. The Commission should examine these proposals closely as discussed in this Note.

Contents

INTRODUCTION

Investor compensation schemes have become well-established regulatory mechanisms in many developed financial markets to protect investors and their assets against investment firm failure. In the European Union, the Investor Compensation Schemes Directive 1997 (ICSD) [13] was designed to protect investors and clients who entrust their funds or financial instruments to EU investment services firms by providing compensation in cases where the investment firm cannot return the funds or instruments to the investor. ICSD was intended to complement the regulatory safeguards that had been introduced by the Investment Services Directive 1993, which was replaced in 2007 by the Markets in Financial Instruments Directive (MiFID). Although MiFID provides a comprehensive *ex ante* regulatory regime to protect investors, it does not create an *ex post* compensation scheme for investors or clients who incur losses at investment firms because of operational problems or fraud.

The present ICSD requires Member States to establish compensation schemes that will pay at least a minimum of 20,000 euros to investors who lost funds or instruments because of investment firm fraud, negligence, or operational problems. However, compensation is not to be provided where investors lost money because of economic or market risks. Although the ICSD has led to 39 compensation schemes being established by the EU's 27 Member States, the schemes provide significantly different degrees of investor protection along with varying levels of funding. These discrepancies have resulted in unequal degrees of investor protection across Member States thus leading to arbitrage by some investment firms and inefficiencies which are obstacles to the development of the internal market.
The Commission engaged in a review of the Directive in 2009 and proposed amendments in 2010 to the ICSD to address these weaknesses. The review revealed significant disparities in the application of the ICSD which suggests the need for increased convergence in Member State supervisory practices to reduce the risk of arbitrage and enhance efficiency in the internal market. Although the home country control principle of supervision provided appropriate supervision in the early stages of the ICSD, the changing structure of financial markets – including increased cross-border offerings of retail financial service products - and the growing risk of insolvency and fraud which was exposed in the Madoff scandal and the Lehman Brothers collapse, suggest the need for a more harmonised investor compensation regime at the EU level with higher compensation levels and increased convergence in supervision among Member States. This Note examines these issues in the context of the Commission's proposed amendments to the ICSD. Part 1 reviews the rationale for investor compensation schemes and shows how they present different risks from deposit guarantee schemes and therefore should be subject to different types of safeguards and levels of protection. Part 2 analyses the proposed borrowing facility between Member States' schemes and what risks it may pose to the effective functioning of compensation schemes and examines some of the implications of the 10 year phase-in period and the risks of moral hazard in creating investor compensation schemes.

[13] Directive 97/9/EC on investor compensation schemes, OJ L 84, 26 March 1997, p. 22.

1. THE RATIONALE FOR INVESTOR COMPENSATION SCHEMES

This section argues that the rationale of investor compensation schemes – investor protection in capital markets - is different from that of deposit guarantee schemes – to protect bank depositors and prevent bank runs which can create systemic risk – thereby justifying different regulatory treatment for the different types of risks they face.

1.1. The difference with deposit guarantee schemes

The main objective of investor compensation schemes is to protect investors who have entrusted their funds to financial intermediaries or investment firms from the insolvency of these firms. Although investor compensation schemes resemble deposit guarantees with banks or credit institutions, there are important differences with their regulatory objectives and with the risks they pose to society. Deposit guarantee schemes are deemed to be necessary not only to protect individual bank depositors, but also to protect financial stability in the banking sector. Banks generally have leveraged balance sheets with illiquid assets that are generally invested over the medium to longer term, and short-term liquid liabilities – mainly to depositors and other short-term creditors - which can be realised on short notice. This maturity mismatch between illiquid longer term assets and liquid short-term liabilities creates a fragile, leveraged funding structure for banks which requires depositor confidence so that they can fulfil their intermediary role of borrowing short-term and lending longer term, thereby generating positive externalities for the broader economy.[14] Deposit guarantee schemes are considered necessary to maintain depositor confidence in the banking sector so that a bank run does not lead to banks selling illiquid longer term assets at a 'fire sale' price in order to pay their short-term liabilities, resulting in significant economic losses for the broader economy.[15] Moreover, market failure can occur in the banking sector based on asymmetric information between depositors and banks regarding the amount of information and expertise available to depositors to assess the riskiness of the bank's balance sheet. The potential negative externalities caused by a bank run for the broader economy justifies both *ex ante* prudential regulation and *ex post* bail-out mechanisms for depositors such as deposit guarantees.[16]

By contrast, investor compensation schemes are designed for investment firms who generally do not pose systemic risk for the financial sector because their balance sheets do not generally consist of a maturity mismatch between illiquid assets and liquid liabilities because most of their assets are invested in liquid short-term investments in the capital markets which can be liquidated quickly and sold for fair market value to repay liabilities to the firm's clients. Moreover, *ex ante* prudential regulation ordinarily requires investment firms (unlike banks) to segregate the funds of their client investors in designated accounts that can be accessed by the firm on short notice to compensate its clients when required and to insulate the investors' funds against creditors of the investment firm. The funds that are managed by investment firms are usually invested in speculative securities and other financial instruments.

[14] See Diamond and Dybvig (1983), 'Bank Runs, Deposit Insurance, and Liquidity', *Journal of Political Economy* 91, p. 401.

[15] Garcia and Prast (2003), 'Depositor and Investor Protection in the EU and the Netherlands: A Brief History', De Nederlandsche Bank.

[16] Also, the negative externality of bank failure sometimes justifies the central bank to provide 'lender of last resort' support to ailing deposit institutions which are illiquid but solvent and which can provide the central bank good collateral for the value of the central bank's liquidity support. See Goodhart, Hartmann, Llewellyn, Rojas-Suarez, and Weisbrod (1998), 'Financial Regulation: Why, How, and Where Now?', London, Routledge.

Investors who entrust their money with investment firms, however, are vulnerable to firm failure, even though the failure of the investment firm will almost always not be of systemic significance to the broader financial system.

Unlike bank deposits, the amounts held with investment firms will often be in excess of the amounts held on deposit with banks. Under these circumstances, policymakers have considered a degree of protection or a 'safety net' for retail investors to be justified and appropriate to meet the risk that an investment firm could become insolvent through operational failure (i.e., fraud) and unable to repay the funds in its clients' accounts.

Investment firms acquire custody and control over retail investor funds in a number of ways. For example, a firm may hold the funds of its client investors through the receipt of the proceeds of the sale of securities, or through dividend and interest payments on securities investments. Investors may make cash deposits with investment firms before they place an order to purchase or sell securities, and investors may entrust the custody of securities with a firm for safe-keeping. Moreover, investment firms often enable their clients to purchase securities on margin by advancing part of the purchase price of the securities and then holding the securities as collateral for the loans. They also can repledge the securities to a third party lender to secure the firm's future borrowings from that lender. As indicated above, investor funds and securities should be held in segregated accounts in order to comply with asset protection and own-account trading rules, which protect the funds from the creditors of the investment firm if it becomes insolvent. In a Madoff-type situation, funds can be fraudulently misappropriated which may result in a failure to segregate clients' money and record their assets, in which case the investor will simply have a claim in the insolvency of the firm for a pro-rata portion of its surplus assets. In these cases where investors' claims are pooled with other creditors of a failed investment firm because of fraud or operational failure, compensation schemes are designed to short-circuit bankruptcy proceedings, which can be lengthy and create much uncertainty regarding the eventual payout to investors.

Reducing the impact of insolvency or fraud risk in order to protect investors has been the main objective of many investor compensation schemes established by developed countries with advanced financial markets.[17] These schemes are based on the notion that a small retail investor is unlikely to be in a position to assess the likelihood of fraud, insolvency or operational failure at an investment firm. Although information regarding the firm's operations and financial condition may be in the public domain, such information can be complex and difficult for the ordinary investor to interpret. Similarly, the integrity and good governance of the firm will not be easily discernible to the investor and general public.

Moreover, policy makers have considered compensation schemes to be important for achieving broader investor confidence objectives that can affect financial stability, even though the failure of investment firms does not pose the same degree of systemic risk, if any at all, as does the failure of bank deposit institutions. In certain countries, such as the United Kingdom, however, where there is mass retail participation in financial markets, any loss of confidence that has widespread effect can potentially create system-wide problems in the financial sector and in particular in the securities markets. It is often contended therefore that investment compensation schemes can achieve regulatory objectives by enhancing overall investor confidence that results in investors investing more funds than they would have in the absence of such schemes.[18] Nevertheless, the potential loss of retail investor confidence in the securities markets as a result of an inadequate investor compensation scheme would pose much less systemic risk than a similar loss of confidence by depositors in

[17] Indeed, as discussed below, this was the main rationale for EU Member States in adopting investor compensation schemes as required by the EU Investor Compensation Directive of 1997.
[18] See discussion in Moloney, EC Securities Regulation, Oxford University Press, p. 730.

credit institutions. Because of their fragile funding structure, a bank failure poses much greater systemic risk than the failure of an investment firm.

This means that the protections granted to retail investors and bank depositors have different objectives: deposit guarantee schemes aim to reduce the potential systemic risk of bank runs which can arise because of weak depositor protection, while a compensation scheme for retail securities investors has investor protection as its primary objective, which is important at the micro-level of the individual investor but has little, if any, implication for systemic risk and financial stability.

Each scheme addresses different risks and costs to the financial sector and therefore the level of coverage should be calculated according to these risks and costs and not merely because they should be equivalent to one another to avoid the arbitrage problem.

1.2. The Investor Compensation Scheme Directive 1997

The ICD provided a harmonised minimum level of protection for 'the small investor in the event of an investment firm being unable to meet its obligations to its investor clients.'[19] ICSD requires all Member States to comply with certain minimum standards in establishing investor compensation schemes for investors[20] who entrust assets or funds with investment firms with operations in the EU.[21] It provides that clients who receive investment services from investment firms (including credit institutions in some circumstances) be compensated when the firm is unable to return the money or financial instruments that it holds on behalf of its client. The ICSD is addressed specifically to retail investors and not to institutional investors and other professional investors because of their greater financial resources and ability to diversify their holdings, thereby allowing them to reduce their exposure to any one investment firm. Moreover, by restricting the scheme to retail investors, it was intended to limit the potential costs of compensation claims against the scheme by retail investors, as compared with the larger potential claims of institutional investors (i.e. insurance companies and pension funds).

Article 2 (1) provides that each Member State must ensure that one or more investor compensation schemes are established and recognised and that they provide a minimum level of coverage of EUR 20,000 per investor per firm. To reinforce the ICSD, the Market in Financial Instruments Directive (MiFID)[22] requires that all authorised investment firms participate in an investor compensation scheme in the Member State where they are established or incorporated. Article 2(1) also allows Member States to exempt certain credit institutions or deposit banks from the obligation to join an investor compensation scheme if they are already exempt under Article 3 (1) of the Directive on Deposit Guarantee Schemes (DGS),[23] but they must inform the Commission thereof.[24]

The Treaty basis for the Directive is Article 53 (1) TFEU which provides for the adoption of measures for the coordination of provisions laid down by law, regulation, or administrative action in Member States concerning the taking up and pursuit of activities as self-employed

[19] Recital, para. 4.

[20] Article 1 defines an investor as 'any person who has entrusted money or instruments to an investment firm in connection with investment business'.

[21] The Market in Financial Instruments Directive (MiFID) defines investment firm as 'any legal person the regular occupation or business of which is the provision of investment services for third parties on a professional basis'.

[22] Directive 2004/39/EC, *OJ* L 145, 30 April 2004, p. 1.

[23] See Directive 94/19/EC of the European Parliament and Council of 30 May 1994 on deposit guarantee schemes, OJ L 135, 31 May 1994, p. 5 and Explanatory Memorandum COM (94)585.

[24] To qualify for the exemption, the credit institution must provide the same protection and information for investors as provided to depositors, and investors must have at least equivalent protection to that offered to depositors.

persons and the removal of any regulatory barriers to the cross-border movement of these persons and capital.

ICSD adheres to the supervisory principle of home country control based on mutual recognition and minimum harmonisation.[25] Under ICSD, the home Member State control principle holds that an investor compensation scheme recognised in one Member State would also protect investors at branches established in other Member States by investment firms belonging to that compensation scheme. This provides an incentive for the home regulator to exercise effective oversight of the investment firm's cross-border operations because its failure could result in the home Member State's investment scheme incurring substantial costs.

Although the home country control principle was deemed to have provided effective regulatory oversight for investors who entrust funds to the cross-border EU operations of investment firms, the further liberalisation of EU financial markets – including the rise of electronic trading and multilateral trading facilities - and the growing willingness of retail investors to purchase financial products and investments from cross-border offerings has imposed considerable strains on the home country supervision system. This has led to proposed amendments to the ICSD that would result in further harmonisation in the regulation of investor compensation schemes and a minimum level of coverage of EUR 50,000 per investor per firm.[26] It appears that one of the rationales for increasing the coverage of the investor compensation scheme from EUR 20,000 to EUR 50,000[27] is that the increase in investor coverage under the proposed Directive should be similar to the increase in coverage under the EU deposit guarantee schemes Directive, which went from EUR 50,000 to EUR 100,000.[28] If investor compensation remained capped at EUR 20,000, financial institutions would have the incentive to arbitrage these requirements by designing financial products accordingly that would attract the most favourable regulatory treatment and the most protection. Although this argument has some validity, it does not address the more serious concern that the risk to a retail investor that its investment firm will fail does not generally pose a systemic risk to the financial system, while a loss of confidence by depositors in their banks could create systemic risks for the entire financial system. This is one reason why bank depositors merit more protection in deposit guarantee schemes than retail investors in securities markets who entrust their money or financial instruments to a financial intermediary which fails because of operational problems or fraud: the negative externality generated from the operational failure of the retail investment services firm will almost always be negligible and absorbed in an insolvency proceeding.

[25] Article 7 (1) recognises the principle of home control based on mutual recognition.

[26] See COM(2010)371 final, Proposal for a Directive of the European Parliament and of the Council amending Directive 97/9/EC of the European Parliament and of the Council on investor compensation schemes, 12.7.2010.

[27] See Proposed Article 4 (a) (1) of the amended Directive which requires Member States to 'ensure that schemes provide for coverage of EUR 50 000 for each investor in respect of the claims referred to in Article 2 (2a) or (2c).' Member States which were providing in excess of EUR 50 000 at the time of the adoption of new Directive will be allowed to maintain that higher level of coverage for no more than 3 years from the date of the Directive's transposition. Ibid.

[28] Proposed Directive, Recital (4) states that '[a]t the time of its adoption, Directive 97/9/EC took into account the coverage and the functioning of deposit guarantee schemes as regulated under Directive 94/19/EC'. 'Consequently, it is appropriate to continue taking into account any modifications of Directive 94/19/EC. Moreover, Recital (8), states in relevant part that '[a]s the compensation coverage under Directive 94/19/EC is now higher than the one under this Directive, it is necessary to provide the highest protection to investors in cases where both Directives 94/19/EC and 97/9/EC could cover assets held by banks.'

Moreover, it should also be pointed out that as a matter of legal doctrine the depositor merits more protection under a deposit guarantee scheme than the investor does under a compensation scheme because the depositor's legal claim is more precarious than the investor's claim: the depositor's claim is only an unsecured personal claim against the bank to repay the deposit, whereas the investor's claim against the failed investment services firm is a proprietary claim that attaches to the property – the monies or the financial instruments – that was entrusted to the investment firm to invest on behalf of the investor. In a world without deposit insurance or investor compensation schemes, the investor under private law would have a priority claim that attaches to the money it entrusted to the investment firm, whereas the depositor only has an unsecured contractual claim personally against the bank with whom it deposited the money which does not attach to the proceeds of the deposit itself. The more precarious position of the depositor's claim justifies stronger regulatory protections such as prudential regulation and deposit guarantee schemes, whereas retail investors in securities markets ordinarily merit conduct of business standards for those who have been entrusted with their funds. In drafting the ICSD, it is not clear whether or not the Commission has considered these important legal differences between the depositor's claim and the investor's claim and their implications for the design of the regulatory regime.

1.3. The need to amend the ICSD

Ten years after the ICSD entered into force, the Commission began a review of the functioning of the ICSD and its effectiveness in protecting investors and clients of investment service firms. Although the Commission acknowledges that there is no evidence to suggest that the financial crisis caused an increase in compensation claims, it received many complaints from investors about the application of the ICSD mainly related to the scope of coverage, inadequate funding of compensation schemes, and delays in obtaining compensation.[29] The Commission assessed various reform proposals against the following policy criteria: investor protection and confidence, a level playing field in the amount of protection and the cost effectiveness of various funding mechanisms for such coverage, and whether it promotes the efficient operation of securities markets, including reducing moral hazard among market participants.[30] The Commission's proposals set forth sweeping reforms that aim to harmonise most of the requirements of investor compensation schemes across Member States. Significantly, the maximum level of compensation for investors who lose financial instruments or money because of frauds, administrative malpractice, or operational failures at investment service firms would be EUR 50,000.[31] Further, the schemes which shall provide such compensation must be funded *ex ante* and will have to provide a minimum target fund level of 0.5% of the value of assets held or controlled by investment firms on behalf of their clients. In addition, Member States' schemes which exhaust their fund to compensate investors will be allowed to borrow certain funds from the schemes of other Member States. Member States would be required to implement these amendments to their schemes' funding arrangements over a ten year period.

[29] Proposal COM(2010) 371 final, Explanatory Note, p. 2. The proposal forms part of a broader review on compensation and guarantee schemes comprising the proposals to amend the DGS and ICSD and a White Paper on insurance compensation schemes. The review was also motivated by several major failures of investment services firms in which investors lost substantial amounts: in particular the AMIS case in Austria and the Phoenix case in Germany led to substantial investor losses and near insolvency of the German and Austrian investor compensation schemes. See European Commission, 'Commission Staff Working Document', *Impact Assessment*, accompanying the Proposal for a Directive of the European Parliament and of the Council amending Directive 1997/9/EC on investor compensation schemes, pp 11-12.
[30] Ibid., p. 3,
[31] Proposed Art 4 (1).

In addition, the proposed amendments contribute to further convergence in the supervisory oversight of investor compensation schemes and therefore logically fit into the broader institutional developments involving the creation of the European Supervisory Authorities (ESAs) and the recent efforts by the Commission, Parliament and Council to enhance convergence in Member State supervisory practices through the ESAs and in particular through the European Securities and Markets Authority (ESMA) with respect to investor compensation schemes.[32]

[32] These supervisory initiatives are also part of the broader institutional restructuring of EU financial regulation which involves the creation of three new European Supervisory Authorities which assume their regulatory powers in January 2011.

2. THE BORROWING MECHANISM

As discussed below, the proposed borrowing mechanism creates an innovative and effective way for underfunded schemes to borrow from other Member State schemes while adhering to conditions and requirements that should prevent moral hazard from becoming too much of a risk.

2.1 Is the proposed compulsory borrowing mechanism an adequate solution?

It is recognised that investment compensation schemes may from time to time exhaust their funds through covering the liabilities of the scheme. In such a case, the proposed Directive would permit the scheme to borrow from other Member State compensation schemes. It is important to emphasise that such borrowing will be a last resort measure to obtain the necessary funds to cover liabilities to investors in the scheme. Presently, the funding mechanisms for Member States' schemes varies as some Member States have opted for different types of schemes: some are funded *ex ante* – that is, a levy is imposed in regard to the eligible assets of investment firms prior to an event that would allow an investor to file a compensation claim against the scheme. In contrast, other schemes use *ex post* funding measures that do not levy funds from participating firms until after a claim has been filed in the scheme for losses incurred by a failed firm. The proposed directive would introduce far greater uniformity in the funding structure by requiring Member States' schemes to establish an *ex ante* funding mechanism that would levy contributions to reach a target level of 0.5% of the value of the 'monies and financial instruments held, administered or managed by the investment firms' on behalf of its clients.[33] Member states are required to ensure that the target level of 0.5% is reached within a ten-year period after the entry into force of the Directive and that each scheme implements an appropriate programme to achieve this objective.[34]

Furthermore, the new funding mechanism would be based on cooperative arrangements amongst Member States' that would establish borrowing facilities between Member States schemes so that countries with deficits in their schemes could borrow from other Member State schemes to cover funding shortfalls through compensating claims.[35] The borrowing mechanism, based on the principle of solidarity, provides schemes with a 'back-up source of funding' that is temporary and subject to specified conditions.[36] Such borrowing facilities can facilitate enhanced coordination between national compensation schemes and lead to more harmonised practices and procedures in administering compensation schemes.

Specifically, proposed article 4b provides that if a Member State's scheme has insufficient funds to cover its immediate needs, it would have the right to borrow from other Member States' schemes. Member State schemes would be required to set aside a designated portion of their *ex ante* funding to be made available for lending to other schemes.[37]

[33] Proposed Art 4a (2).

[34] Proposed Art 4a (3).

[35] Proposed Art 4b.

[36] Proposal COM(2010) 372, Explanatory Note, p. 10.

[37] Proposed Art 4a (8) states that: 'Member States shall ensure that 10% of the ex-ante funding amount of the schemes referred to in Article 4a (2) is available for lending to other schemes under the conditions established in Article 4c.' It goes on to say that '[t]he Commission may amend [...] the percentage of the ex-ante funding amount to be made available for lending to other schemes, taking into account the developments in financial markets.' Ibid.

The European Securities and Markets Authority (ESMA) would be responsible for receiving any borrowing requests and for determining whether the requirements for such a borrowing request have been met and to receive and transmit the relevant funds once these conditions are met. The scheme borrowing the funds will have at the most five years to repay the loan beginning from the time when the loan request was made.

2.2 The problem of moral hazard

Much criticism, however, has been levelled against investor compensation schemes for contributing to moral hazard among investors because they can undermine the incentive of investors to exercise due diligence in considering the various risks which financial instruments and the firms which offer them can pose.[38] Moral hazard is a concept often referred to in the economics literature to explain the risk that an insured party will act less carefully in its behaviour to prevent an insured event from occurring.[39] If retail investors were not compensated for their losses by an investor compensation scheme, they would, it is argued, take more care in assessing the risks to which their investments are exposed and in monitoring the firms responsible for managing their assets. The risk to which investors are exposed is inherent in financial markets and furthermore investors are not required to invest in securities markets. Moreover, an extensive regime of prudential and conduct of business regulations (i.e., MiFID) already governs in most developed market jurisdictions the risk-taking and operations of investment service firms in order to protect investors from fraud, insolvency or mismanagement. It is not unreasonable therefore to expect that investors – the beneficiaries of an elaborate system of existing *ex ante* regulatory controls - take more care in monitoring and assessing the risks of their investments and accept responsibility for their choice of investment firm. However, this mutuality of obligations between investors and their investment firms can be distorted in favour of investment firms because of hard-to-detect operational failures and sophisticated financial frauds in violation of conduct of business regulation.

Although moral hazard will always exist in financial markets where there is asymmetric information and misaligned incentives between the owner of assets (the principal) and the manager of those assets (the agent), *ex ante* regulation can play an important role in reducing moral hazard by aligning the economic incentives of the investment firm with those of the investor, and by providing more information for the investor to monitor the operations and behaviour of the investment firm as well. Nevertheless, moral hazard will always be a significant problem in securities markets where the investment compensation scheme provides a 100% guarantee against risk, in effect serving as an indemnity against all losses.[40] As investors' understanding of risk and regulation, however, becomes more sophisticated, the problem of moral hazard is becoming increasingly a factor in the design of investor protection schemes.

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[38] See FSA Consultation Paper 24, 'Consumer Compensation: A Further Consultation (1999).

[39] See generally Goodhart (1989), *Money, Information and Uncertainty*, p. 210.

[40] Indeed, the UK Financial Services Authority concluded in 1997 that a 100% guarantee would 'undermine the encouragement which we would otherwise wish to give to individuals to enter into transactions in financial services only after proper consideration, to the best of their ability, of the balance of risk and reward'. See FSA (UK Financial Services Authority), Consultation Paper 5 Consumer Compensation 6 (1997). Empirical evidence from the UK Financial Services Authority however has also suggested that consumers' general awareness of compensation schemes across all financial sectors is very low and that it is not a factor to which consumers attach much influence. See FSA Consultation Paper 24, 'Consumer Compensation: A Further Consultation (1999) 16.

This has led to some compensation schemes being limited to a maximum value which is intended to incentivise investors to take more responsibility in assessing the risks not only of their investments but also of the firms to whom they entrust their funds to make investments on their behalf. However, the amendments to ICSD would raise a moral hazard concern by allowing states to provide full 100% coverage for investor losses up to a maximum of EUR 50,000.

Investor compensation schemes also raise competition concerns in so far as their mandatory nature may undermine investor protection by reducing the incentive for firms to compete in terms of providing investor security.[41] Competition may be further undermined by requiring the investment services industry to be subject to an industry levy or 'quasi-tax' which might result in prudently managed firms subsidising a fund that is used to compensate investors who lost money with firms which were imprudently or recklessly managed. Without such a fund, it is argued, the poorly managed firms would attract fewer investors and would have to pay higher returns and reduce services for those investors they do attract. Moreover, an industry-wide levy with a uniform amount that is not risk-based could operate as a barrier to entry, especially for smaller investment firms with stricter risk management controls; these firms would pose much less risk to the system than larger firms whose failure would create disproportionate costs to the investment scheme. Therefore, the calculation of the assessment should not be uniform across the industry and instead should be adjusted to reflect the different risks which investment firms of different sizes and risk management systems pose to investors and to the broader financial system. In addition, another type of moral hazard could be created where the investment firm paying into the compensation scheme might have the incentive to take less care or act recklessly based on its knowledge that the scheme would compensate investors for any losses and therefore it could take more risks from an operational perspective. This supply side moral hazard problem, however, could be reduced significantly by having in place an effective regime of prudential controls on investment firms to prevent operational risk, but could be exacerbated by having an overly generous compensation scheme or a scheme which requires an *ex ante* charge that is not based on the soundness and quality of the individual investment firm's risk management practices and anti-fraud measures.[42]

Based on the above theories of moral hazard, the proposed borrowing mechanism presents an obvious moral hazard risk. Indeed, there is the risk that the under-funded scheme will seek rents or subsidies from the adequately-funded schemes. This is because the borrowing facility network created by the Directive would enhance the ability of under-funded schemes to borrow the necessary funds from other Member State schemes in surplus to meet the target level of 0.5% of the money and financial instruments held, administered or managed by investment firms. Moreover, a major financial failure in a Member State in which losses far exceed the amount available in the compensation scheme as in the *Phoenix* case could cause a scheme in one state to tap the surplus assets of schemes in other Member States, which could create an incentive for weak regulation of scheme risk controls.

[41] For a general study of these competition concerns, see Page and Ferguson (1992) *Investor Protection* 71.

[42] Indeed, the control and reduction of operational risk is a major objective of the Capital Requirements Directive which incentivises banks to improve their risk management for credit, market and operational risk (and now with Basel III liquidity risk) by allowing them to hold lower levels of regulatory capital if they can demonstrate sound risk management practices. Operational risk is defined broadly to include institutional failure because of non-market related organisational breakdown, fraud and financial crime and all types of legal risks. See Capital Requirements Directives, 2006/48EC, and 2006/49/EC. See CRD consolidated version http://eur-lex.europa.eu/LexUriServ/LexuriServ.do?uri=CONSLEG:2006L0049:20091207:EN:PDF (applying operational risk regulatory requirements to credit institutions and investment services firms as defined under MIFID).

The ICSD amendments, however, address the moral hazard problem by establishing a more harmonised regulation of schemes across Member States and importantly adopt a set of principles to reduce moral hazard and specify payment obligations and conditions which the borrowing scheme must comply with during the term of the loan. For example, Article 4b attempts to address the risk of moral hazard through a number of detailed requirements and incentive-compatible conditions. Given these safeguards, it appears that the moral hazard risk has been limited significantly in the proposed borrowing mechanism.

CONCLUSION

The ICSD was designed as a last resort 'safety net' to protect investors against investment firm insolvency because of operational and regulatory failures by requiring Member States to establish a compensation mechanism to reimburse investors for some of their lost assets. The ICD is reactive, rather than preventative, and therefore does not establish a prudential regulatory regime to protect investor assets because it addresses the need to provide investors with compensation for their losses once a investment firm or regulatory failure occurs. Although investor confidence can be prejudiced to such an extent that it could significantly reduce the willingness of retail investors to invest in the securities markets, the possibility of systemic risk in retail securities market is remote at best. In contrast, deposit guarantee schemes address the problem of systemic risk directly by promoting depositor confidence in the banking sector in order to avoid bank runs which can cause systemic risk. Moreover, the depositor's private law claim against a bank for the proceeds of its deposit suffers a disadvantage in comparison with the claim of an investor for the return of its money or instruments entrusted to an investment services firm to be invested in the markets in so far as the depositors is personal against the bank whilst the investor's claim is proprietary and can attach to the specific property in question. These differences in the economic risks and the nature of the legal claims confronted by bank depositors and retail securities investors justify different levels of *ex ante* regulation and *ex post* protection schemes to compensate them for their respective losses. The ICSD proposal therefore should not consider the safeguards for investor compensation schemes to be equivalent in an economic sense to deposit guarantees. Moreover, the ICSD increases moral hazard by substantially increasing the compensation to EUR 50,000 for eligible investors who lose their funds or instruments because of investment firm operational failure and/or fraud. Although the ICSD does not protect against economic or market risk, it reduces the incentive for retail investors to monitor the operations of investment firms and under certain circumstances disincentives investment firms to invest in enhanced operational risk management. The borrowing facility also raises moral hazard concerns because it enhances the ability of under-funded schemes to borrow the necessary funds from other Member State schemes in surplus to meet the fund target level and to obtain emergency funding when the schemes of a Member State are exhausted. Also, the ten-year phase-in period does not pose a significant problem for Member States to raise the needed funding to reach the target level because national schemes can borrow from other Member State schemes during the phase-in period. Although the conditions imposed on the schemes for using the borrowing facilities reduces the moral hazard problem, the high level of protection required for the schemes and the lack of a risk-based pricing model for determining how much firms contribute to the scheme raises serious moral hazard questions which the Commission and the Parliament should examine more closely.

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SAFEGUARDING INVESTORS' INTERESTS BY ENSURING SOUND FINANCING OF ICS:

FUNDING PRINCIPLES AND MECHANISMS

NOTE

by Achim KASSOW

Abstract

This briefing paper addresses the funding principles and mechanisms of the Proposal of 12 July 2010 amending Directive 97/9/EC on investor-compensation schemes (ICSD). Based on the contributions provided by market participants and the Impact Assessment, the paper concludes that the ICSD-Proposal reveals shortcomings which warrant further empirical investigation and collection of data on the appropriateness of the level of funding. Moreover, the funding principles and mechanisms of the ICSD-Proposal should be reassessed against the ICSD's main objectives, its fitting in the current and upcoming regulatory environment on the protection of clients'/UCITS assets and its costs and benefits on products and services for retail clients.

The paper further argues that the ICSD-Proposal target fund level of 0.5% is inappropriate in view of the products covered, the coverage level, and as to the risk covered occurring in investment firms and UCITS. However, it recognises that an appropriate level of ex-ante funding as such is an adequate solution to finance compensation schemes.

Contents

EXECUTIVE SUMMARY

This briefing paper addresses the funding principles and mechanisms of the Proposal of 12 July 2010 for a Directive of the European Parliament and of the Council amending Directive 97/9/EC of the European Parliament and of the Council on investor-compensation, COM(2010)371 ("ICSD-Proposal") schemes ("ICSD"). It will evaluate in particular whether the proposed ex-ante target fund level of 0.5% is adequate

- in view to the products covered;
- in view to the coverage level, and
- in view to the risk covered occurring in investment firms and undertakings for collective investments in transferable securities (UCITS).

Furthermore, it will be examined if the ex-ante funding *as such* is an adequate solution to finance the compensation schemes.

Based on the contributions provided by market participants and the Impact Assessment ("Impact Assessment"), *i.e.* the accompanying document to the ICSD-Proposal, the ICSD-Proposal reveals shortcomings which warrant further empirical investigation and collection of data on the appropriateness of the level of funding. Moreover, the funding principles and mechanisms of the ICSD-Proposal should be reassessed (and ultimately amended) against (i) the ICSD's main objectives, (ii) its fitting in the current and upcoming regulatory environment on the protection of clients'/UCITS assets and (iii) its costs and benefits on products and services for retail clients.

Against this background, this paper will conclude that the ICSD-Proposal target fund level of 0.5% is inappropriate

- in view of the products covered
- in view of the coverage level, and
- in view to the risk covered occurring in investment firms and UCITS.

Notwithstanding the foregoing, an appropriate level of ex-ante funding *as such* is an adequate solution to finance compensation schemes.

1. SUMMARY OF THE ICSD-PROPOSAL

Currently, the ICSD protects clients when they entrust money or financial instruments to an investment firm. Clients must be compensated by schemes in two situations derived from reasons directly related to the financial circumstances of the firm:

- - if a firm is unable to repay money owed or belonging to a client and held on the client's behalf in connection with investment services; or
- - if a firm is unable to return to a client a financial instrument belonging to the client and held, administered or managed on the client's behalf.

In the future, the ICSD-Proposal shall also cover a potential failure of a custodian with whom an investment firm has deposited assets of a client. In addition, as unit holders in collective investment schemes, such as UCITS, are currently not entitled to compensation if a depositary or sub-custodian fails to return assets, the ICSD proposal will extend the scope of coverage under the Directive to allow investors in UCITS to claim in such situations. A new compensation level for claimants in the amount of EUR 50,000 is foreseen and the target fund level should represent at least 0.5% of the value of the assets covered by the protection of the schemes.

2. OBJECTIVES OR FINDINGS OF THE ICSD, THE IMPACT ASSESSMENT AND THE ICSD-PROPOSAL

Bearing in mind that no system of supervision can provide complete protection, particularly where acts of fraud are committed, the ICSD merely required each Member State to have an investor-compensation scheme that guaranteed a harmonized minimum level of protection at least for the small investor in the event of an investment firm being unable to meet its obligations to its investor clients. The financing *capacities* (but not the funding) of the schemes had to be *in proportion* to their liabilities (ICSD, Recitals 3, 4 and 23).

The Impact Assessment re-affirmed that compensation schemes only provide a last resort safety net for clients of investment firms if other important safeguards fail. Compensation schemes cannot be the principal means of protecting investors but are a last resort measure that applies when all of the main protections fail (Impact Assessment, p. 5). Other types of compensation schemes (such as banking and insurance schemes) also provide a certain level of investor protection but have different underlying objectives compared to investor compensation schemes under the ICSD-Proposal (Impact Assessment, p. 5).

While it alleges that there is no evidence to suggest that the financial crisis contributed to more compensation claims from schemes under the ICSD, DG Markt had, prior to the financial crises, received investor complaints about the application of the ICSD in a number of important cases involving large investor losses in the recent years. It therefore concluded that harmonisation on how schemes should be funded would result in higher consumer protection and would lead to greater confidence when investors use investment services (Impact Assessment, p. 34). It admitted however, that the appropriate level of ex-ante funding is inherently difficult to determine, as the potential claims/losses are highly volatile and difficult to predict (Impact Assessment, p. 10).

In contrast to some of the findings of the Impact Assessment, the ICSD-Proposal aims at, inter alia, ensuring that recent amendments to the DGSD[43] (upon which the ICSD allegedly was initially modelled) do not result in unjustified differences in the protection provided to depositors and investors using investment firms. This level is increased to EUR 50,000 in order to take into account developments in the financial markets and in the Union's legislative framework. This amount takes into account the effects of inflation in the Union and the need to better align the level of compensation with the average value of investments held by retail clients in the Member States (ICSD-Proposal, Recital 12).

3. GENERAL OBSERVATIONS

Investor Compensation Schemes are fundamentally different from Deposit Guarantee Schemes (DGS) and any alignment between the both is subject to potential error. By ensuring that depositors are reimbursed for the loss of their funds held with a bank that goes bankrupt, the DGS does not only fulfil a central role of client protection, but also plays an essential role in promoting financial stability. Accordingly, the ICSD very rightly argued that the cost to credit institutions of participating in a guarantee scheme bears no relation to the cost that would result from a massive withdrawal of bank deposits not only from a credit institution in difficulties but also from healthy institutions following a loss of depositor confidence in the soundness of the banking system (ICSD, Recitals).

However, money and other assets, notably securities, differ as to the risk which results from the legal relationship when such assets are held with another person. Monies are held as deposits, the bank is a creditor to its client. In the case of bankruptcy, the client has – in the absence of a specific trust arrangement - a proportionate claim on the remaining monies.

To the contrary, securities are held by the firm in a safe keeping manner and national property laws generally treat securities to be ring-fenced from the insolvency estate of the safe-keeper, a conclusion which can be drawn from a comparative survey[44] prepared for the Legal Certainty Group, an advisory group made up of 36 legal experts from the post-trading industry, legal practice, academia and competent authorities mandated by the Commission in 2005.

It is therefore not surprising that evidence suggests that the financial crisis did not contribute to more compensation claims from schemes under the ICSD (Impact Assessment, p 6). It follows that retail claimants' rights to *return* securities in the insolvency of failing credit institutions or investment firms were not significantly effected by the financial crisis.

In addition, the ICSD-Proposal should have devoted more attention to the fact that several investment firms are also deposit taking institutions and are therefore covered by the DGS as far as claims for money resulting from an investment service are concerned. Regarding claims against a bank for the return of securities, the occurrence of an insolvency situation where the securities to be restituted are subject to a shortfall due to a fraudulent behaviour of employees or directors of the bank, this scenario is almost always very unlikely due to the higher level of regulation of fully licensed banks opposed to smaller investment firms.

[43] Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19 EC on deposit guarantee schemes OJ L68 of 13 March 2009, p. 3; and Commission Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes [recast], COM(2010)368 final (12.7.2010).

[44] Of 24 April 2006, seehttp://ec.europa.eu/internal_market/financial-markets/docs/certainty/background/comparative_survey_en.pdf.

In addition, the proper role of the ICSD as one, amongst many others, elements of the regulatory regime on retail investor protection must be highlighted. At the very forefront of this regulatory framework stands the Directive 2004/39/EG on Markets in Financial Instruments (MiFID)[45] as well as the Directive 2009/65/EG on Undertakings for Collective Investments in Transferable Securities[46] replacing the Directive 85/611/EEC (UCITS IV). In short, MiFID provides rules to safeguard clients and on how client assets must be held by an investment firm (see Art. 13 (7) and Art. 13 (8) MiFID as well as Art. 16 *et seq* of Commission Directive 2006/73/EC[47]). UCITS IV provides for rules on the proper functioning of custodians of UCITS funds as well as their liability (see Art. 32 et seq UCITS IV).

Consequently, if already at the time of coming into force, the regime of the ICSD was to provide a last resort safety net, the ICSD is now embedded into a new regulatory framework and any changes to the ICSD would have to take such new, assumingly better, legal environment into account. This holds all the more true if the MiFID and UCITS IV regulatory regime is currently under way of being amended or new regulation will be established. Notably, European legislation will most likely further govern the liability of custodians to the UCITS fund or its unit holder (the upcoming so called UCITS V Directive) to align with the regulation on custodian liability for Alternative Investment Funds (AIFM-Directive[48]). Moreover, the Commission Services are currently preparing a draft Directive on legal certainty of securities holding and transactions (Securities Law Directive – "SLD"). The SLD is expected to address two issues: the legal framework of holding and disposition of securities held in securities accounts with an account provider, covering, inter alia, the protection of account-held securities in the insolvency of the account provider as well as the submission of any activity of safekeeping and administration of securities under an appropriate supervisory regime.

Thus, these regulatory developments will directly affect and improve investor protection for securities depositors and unit holders of UCITS funds. Consequently, if the level of protection of clients' and UCITS assets is, as a result of the upcoming future legal framework, in flux, and the protection of such assets therefore to be further improved, the ICSD-proposal appears, in its current form, premature.

[45] of 21 April 2004, OJ L 145 of 30 April 2004, p. 1.
[46] Of 13 July 2009, OJ L 302 of 17 November 2009, p. 32.
[47] MiFID Implementing Directive of 10 August 2006, OJ L 241 of 2 September 2006, p. 26.
[48] Directive on Alternative Investment Funds Managers (AIFM); proposal COM(2009)207; adopted, but not yet published.

4. SPECIFIC OBSERVATION - ADEQUACY OF THE PROPOSED TARGET FUND LEVEL OF 0.5% IN VIEW OF THE PRODUCTS COVERED

It must be acknowledged that the ICSD's proposal "*covers*" product and services in multiple ways:

Regarding the assets it deems to protect, the ICSD-Proposal applies to a situation where an investment firm or a third party custodian does not return (i) cash, (ii) financial instruments (i.e. securities) or UCITS fund assets (ICSD-Proposal, Art. 2 (a), 2 (b) and 2 (c)).

As regards financial instruments held, administered or managed by investment firms, it is extremely rare that financial instruments are lost as investors have a direct right of property on them. In reality, cases where securities are not returned will almost certainly involve fraudulent behaviour on behalf of the firm/custodian. As mentioned, the Securities Law Directive will shortly – for sake of clarity - harmonize the existing legal framework on the vindication of securities from the insolvency estate of the insolvent investment firm or third party custodian. Consequently, the (ex-ante) target funding level of 0.5% in respect of financial instruments should therefore be smaller.

Similarly, for the reason mentioned above, the inclusion of UCITS unit holders being able to claim the loss in value of their UCITS unit due to the inability of a depositary or a third party to whom the assets of the UCITS have been entrusted to return these assets, is inappropriate. An ex-ante target funding level of 0.5% of the financial instrument "held" therefore appears overly high and disproportionate.

The UCITS Directive already provides a high degree of protection of unit-holders through the requirements it imposes on depositaries' activities. In addition, a review of the UCITS Directive will shortly be launched to further clarify and harmonise depositaries' liabilities, including more, stringent rules on depositaries' supervisory duties and the due diligence requirements to appoint sub-custodians. The revision will also identify the circumstances where depositaries will have an obligation of asset restitution, notably in the case of sub-custodian failure. Rare cases of failure of (probably inadequately chosen) custodians will remain. It is therefore doubtful that the protection of these rather rare cases under the ICSD is justified from a cost-benefit point of view.

Otherwise, the current Commission proposal would ultimately impose on investors' additional costs for an insurance that they might not want and worse, that might be irrelevant for their type of investment (European Banking Federation, Position Paper[49], 27.10.2010, p 5). Moreover, applying a fully harmonized "one size fits all" target fund level, based on assets of each and any type of UCITS regardless of their risk profile and the location of the depository or third party to which the UCITS has entrusted the assets, appears disproportionate.

[49] Investor Compensation Schemes - Position on the European Commission's Proposal to amend Directive 97/9/EC on Investor Compensation Schemes, European Banking Federation, 27/10/2010, http://www.ebf-fbe.eu/index.php?page=financial-markets-and-securities.

Moreover, it must be highlighted, that the impact assessment does not contain any analysis of the impact of these rules concerning the funding of the schemes on the cost structure of securities custody or UCITS. Industry figures as at end of June 2010 suggest that the total assets under management in UCITS are of approximately 5.49 trillion Euros. Setting the target level at 0.5% would require a total contribution of approximately 27 billion Euros potentially taken out of UCITS assets over a 10 year period (if depositaries are not required to contribute to the funding of the schemes, or if they “pass on” these costs to the UCITS through an increase of the depositary fees). In comparison, the total loss for UCITS in the wake of the Madoff scandal was of approximately 1.7 billion Euros. This represents a considerable cost that UCITS unit holders would have to bear in order to benefit from the coverage of the ICSD. These additional costs appear to be disproportionate in comparison of the benefits that UCITS unit holders would enjoy in terms of increased protection.

Similarly, the cost of custody might increase significantly if the securities held in custody would be subject to a charge of the custodian to contribute to the funding by 0.5% of the security value. One must keep in mind that custody fees might only amount to around 0.1% or less of the value of the assets held in custody.

5. SPECIFIC OBSERVATION - ADEQUACY OF THE PROPOSED TARGET FUND LEVEL OF 0.5% IN VIEW OF THE COVERAGE LEVEL

The proposed coverage level of EUR 50,000 presents a significant increase of 150% as compared to the current level (of EUR 20,000). The ICSD-Proposal however, does not provide compelling evidence to conclude that such choice is sufficiently supported by data on retail client investments.

The statistical data of the average of amounts of monies and securities held by investment firms on behalf of retail investors included data from six Member States, out of which five are “EU-12 Member States” (including Poland, Latvia, Hungary). The Commission concluded that the statistical data is insufficient and instead relied on the study commissioned by the European Commission on “the EU market for consumer long-term retail savings vehicle”. However, this report draws on the Eurostat data in 1999-2005 and a survey of investor attitudes in eight (sic!) Member States, which, according to the Commission ”only provides estimates and therefore needs to be treated with care” (Impact Assessment, p 23).

Consequently, it can not be excluded that the coverage level of 50,00 EUR has *not* been adequately assessed against the - little - data available. Moreover, as noted above, the ICSD is *not* comparable to the DGSD and the argument that an increase in covered deposits should be accompanied by an increase in assets covered under the ICSD-Proposal should be reconsidered.

Finally, it must be noted that the significant increase of the coverage level would take place against the backdrop of the deletion of a system of co-insurance as foreseen by the ICSD. Under the ICSD, the Member States where allowed to limit the compensation equal to or exceeding 90% of the coverage level to encourage investors to take adequate care in selecting an investment firm.

6. SPECIFIC OBSERVATION - ADEQUACY OF THE PROPOSED TARGET FUND LEVEL OF 0.5% IN VIEW OF THE RISK COVERED OCCURRING IN INVESTMENT FIRMS AND UCITS

Reference is made to the general and specific observations on the adequacy of the proposed target fund level in view of the specific risk of securities and of UCITS funds (see above points 3. – 5.). In addition to such observations, it must be underlined that some of the investment *services*, by their definition, do not entail the acceptance of money or securities of retail investors (and pose no risk to clients' assets). Consequently, it must further analysed in which way multilateral trading firms which usually service professional clients or eligible counterparties should contribute to a national compensation scheme.

7. SPECIFIC OBSERVATION - ADEQUACY OF AN EX-ANTE FUNDING *AS SUCH*

Again, reference is made to the general and specific observations on the adequacy of the proposed target fund level in view of the specific risk of securities and of UCITS funds made above. Subject to these observations, an (appropriate) ex-ante funding as such would be an adequate solution to finance the schemes but should have the possibility to request exceptional/surplus contributions if the assets held by the investor-compensation scheme are not sufficient to cover the payment of the claims. It must be emphasized that the use of an ex-ante funding system all the more requires a very careful assessment of the adequacy of the amount of ex-ante funding.

According to the Impact Assessment, compensation schemes are principally financed by contributions levied from participating firms. These contributions can either be collected to build a reserve in anticipation of future losses (ex-ante funding) or when needed to cover compensation costs of failures that have occurred (ex-post funding). A majority of the investor-compensation schemes are pre-funded.

Several reasons supporting the ex-ante funding of compensation schemes exist. Chief among such reasons is the one that the ex-ante funding might put the compensation scheme in a better position to compensate investors in a more efficient manner, i.e. it would ease the administrative, and probably timely burden, to raise the necessary funding in the critical time when investors seek for compensation. Moreover, the investment firm (or third party depository) giving rise to a compensation claim would itself have contributed to the scheme which is used to provide compensation.

8. CONCLUDING REMARKS

The primary difficulty in establishing whether the 0.5% target fund level for compensation schemes is adequate occurs in the non-availability of empirical statistics as to the quantum of the assets held on behalf of investors by firms conducting investment services within the scope of the Directive. The Commission's own Impact Assessment states in Annex V "there is very limited data available at the national investor compensation schemes about he average amount held by investment firms on behalf of retail investors". The use of the proxy estimate of average household holdings of securities within the scope of the directive is understandable but does not provide a satisfactory basis for assessing the adequacy of the target.

Employing *reductio ad absurdam*, the proposed directive envisages that the compensation schemes would be able to compensate each investor up to EUR 50,000 in case of a firm's failure and that 0.5% of the value of all covered investments should be set aside for this purpose.

Given that the average and median figures per household used as the proxy for investment services under the scope of the directive are considerably below EUR 50,000 (EU-15: EUR 30,730 and EUR 21,451 respectively, see Annex V), this would suggest that the target of 0.5% of assets in scope is itself by extrapolation excessive for the purpose.

In these circumstances and given that the commercial impacts of any levy being direcly or indirectly passed on to investors, it would obviously be adequate to satisfy industry practitioners that this level was proportionate to win their support. A systematic establishment of a mechanism for calculating the ongoing quantum of assets under the scope of the directive is required to draw conclusion on adequacy.

In addition to the target fund level of 0.5% not having an empirical reference point to establish adequacy, further issues arise from the nature of investment itself. The type of investments, market evolution and retail investor capacity make the quantum of assets in scope extremely volatile. The proposed Directive remains silent on many details of the running of the compensation schemes in scope, which in themselves are or become pertinent in the evolution of an adequate harmonised target for compensation schemes across the Union. The proposed Directive does not establish standards for the frequency of measurement of schemes against target levels; details of how the compensation schemes themselves will be maintained including investment principles; risk adjustments for concentration in perceived riskier product segmentation; and the treatment of surplus and deficits including appropriate sanctions.

The underlying objective of the proposed Directive to establish harmonised compensation arrangements for investment services across the Single Market is in itself not contentious. In achieving this objective, there is a necessity for empirical measurement of the scope in addition to that of the Impact Assessment already completed. The objective also requires the establishment of mechanisms that are flexible enough to accommodate the existing differences that occur across the Member States and through a phased transition establish a fit-for-purpose Union-wide reserve for compensation.

REFERENCES

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SAFEGUARDING INVESTORS' INTERESTS BY ENSURING SOUND FINANCING OF ICS: FUNDING PRINCIPLES AND MECHANISMS

NOTE
by István FARKAS

Abstract

The Commission introduced a Proposal for amending Directive 97/9/EC on investment compensation schemes. The Proposal addresses a series of issues of investor compensation, i.a. on coverage, funding, and cooperation. This briefing mainly examines three broad issues related to ICS: (i) the advantages of the ex ante funding mechanism, (ii) the need and limits of the extension of ICS and (iii) considerations in relation to the determination of the coverage level of ICS.

The briefing concludes that the pre-funded (ex ante) mechanism is more suitable for ICS than the post-funded (ex post) one; that the extension of ICS to third party custodians is a logical step forward, but that the involvement of UCITS requires more cautious approaches (and should therefore be postponed); and that the target level may be lowered to 10 basis points of the funds and instruments held by investment firms and third party custodians on behalf of retail (non-professional) clients.

Contents

EXECUTIVE SUMMARY

On the basis of the "Proposal for a Directive of the European Parliament and the Council amending Directive 97/9/EC of the European Parliament and the Council on investment compensation schemes", COM(2010) 371 of 12 July 2010, three main issues were analysed (i) the funding mechanism, (ii) coverage issues (services, clients and risks) and (iii) the target level of investment compensation schemes ("ICS").

As far as the funding mechanism is concerned at least from the point of view of macro and micro economic approaches as well as the psychological effect of the funding mechanism, the pre-funded (ex ante) system is considered to be the most suitable for ICS.

The extension of ICS coverage to all the services under the so-called MiFID[50] regardless whether the services provider currently holds clients' assets or not (due to his business policy, license etc.) seems to be useful. Therefore ICS would cover the potential damages involved in the mismanagement of clients' assets, in order to create a level playing field for future compensation. The cost, however, would be borne by those service providers which manage client assets at the time the contribution is due.

The involvement of third party depositories has been approached from the point of the ultimate effect on the client. Following this logic it was found that ICS would not analyse the reason the failure of an investment firm, the third party failure in this case could be treated as for mismanagement of the service provider. The involvement of undertakings for collective investments in transferable securities ("UCITS"[51]) would be useful, however it seems to be advisable to take this step later harmonised with other investment services (e.g. unit linked insurance, other collective investments).

The target level of ICS was calculated on the basis of the number of potential claims and their maximum amount. Accordingly, a lower amount (10 basis points) might be sufficient. Some additional arguments (such as the alternative funding arrangements, borrowing mechanisms and the fact that ICS should be in the position to reclaim the paid amount during the course of liquidation process) and the possibility to increase the acceptability of the proposal are also mentioned.

[50] Directive 2004/39/EC of 21 April 2004 on Markets in Financial Instruments, OJ no. L 145 of 30 April 2004, p. 1.
[51] see Directive 2009/65/EC (recast) of 13 July 2009, OJ no. L 302 of 17 November 2998, p. 32.

1. BACKGROUND

Investors' interests are protected on the basis of EU legislation: Directive 97/9/EC on Investor-Compensation Schemes ("ICSD"). The current Directive provides compensation for clients of investment service providers in case of inability of such investment service providers to repay funds or return assets to the clients held on behalf of the clients.

During the period from 1997 (when the ICSD was adopted) to date, some experiences were observed (like the divergence of the implementation of ICS across the Member States due to the minimum harmonisation nature of the Directive), the legal environment has been radically changed in the securities field (inter alia, but the most relevant legislative change being that Directive 2004/39/EC on markets in financial instruments, MiFID, has replaced the former Investment Services Directive). Last but not least, the financial crisis has turned the focus towards the need for a level playing field in case of customer protection in order to bolster safety of retail clients. One remarkable step in this direction was the amendment of the Deposit Guarantee Schemes Directive[52] ("DGSD") which has impacted on the compensation systems of the securities market as well.

The Commission submitted a proposal amending the ICSD. In this document "Proposal for a Directive of the European Parliament and the Council amending Directive 97/9/EC of the European Parliament and the Council on investment compensation schemes" the main issues addressed are as follows:

- all investment services and activities covered under MiFID should be subject to the ICSD;
- alignment of the classification of clients in the ICSD with the MiFID definition of clients to be considered as professional;
- extending compensation to investors for claims relating to the failure of a firm to return financial instruments due to the failure of a third party custodian and failure of a UCITS depositary;
- exclusion of claims involving market abuse;
- increasing the level of compensation to a fixed amount of EUR 50 000;
- setting up funding principles (ex-ante funding, minimum coverage, target level);
- borrowing as a last resort mechanism between national schemes;
- partial compensation mechanism.

This Briefing Paper focuses on safeguarding investors' interests by ensuring sound financing of investment compensation schemes (ICS): funding principles and mechanisms. Special attention is given to the questions related to: (i) the adequate funding system (ex ante and ex post mechanisms);(ii) the products covered;(iii) the risks covered and;(iv) the coverage level (the target level).

[52] Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19 EC on deposit guarantee schemes OJ L68 of 13 March 2009, p. 3.

2. INTRODUCTION

A consequence of the current financial crisis is that the general public, especially the small (retail) investors may lose their confidence in the financial intermediaries. The rebuilding of investors' confidence is a complex and involved task. In addition to the harmonised regulation and a well functioning European supervisory framework, a sound and robust financial sector is the most important aim in this process. Regulation and supervision has to cover areas (such as credit rating agencies, derivative products) which in the past have been in the shadows.

Besides regulation and supervision, financial infrastructure (in a broader sense) has to be strengthened. Undoubtedly, for settlement systems (cash and securities), risk reduction through the use of central counterparties is part of the broader infrastructural network. From the point of view of retail costumer confidence, however, the guarantee schemes (for investors, depositors and insurance policy holders) are the key factors.

The High-Level Expert Group (chaired by Jacques de Larosière) stated clearly in paragraphs 133-135 and Recommendation 14 of its report the most important elements of these schemes[53]:

"Recommendation 14: Deposit Guarantee Schemes (DGS) in the EU should be harmonised and preferably be pre-funded by the private sector (in exceptional cases topped up by theState) and provide high, equal protection to all bank customers throughout the EU.

The principle of high, equal protection of all customers should also be implemented in the insurance and investment sectors."

The proposed amendment to the ICSD (the "Proposal") is an important step in this direction. It must be stated however, that without similar regulation in other financial services, especially in case of insurance policy holders, the consumers' confidence will not be fully recovered. Financial products by nature have a lot of similarities (like unit-linked insurance products and investments in derivative instruments or in collective investment products); and there is a growing share of combined products (deposits and capital market investments, insurance and capital market products etc.) in the market which requires harmonised investor protection schemes in case of different services. Moreover the retail client is a complex entity, meaning that a feeling of uncertainty with respect to one investment product will be projected to others, irrespective of that financial product's protection level.

[53] N.B. It is worth mentioning that the group was focussing on the deposit guarantee schemes, but the requirements set up are valid for all the other costumers' compensation schemes.

3. THE FUNDING MECHANISM

There is a fundamental issue that has to be clarified: who is the beneficiary and who is the bearer of the Investor Compensation Scheme? The obvious answer is that the beneficiaries are the retail investors. Retail investors (investors who are not qualified professional investors under MiFID) will enjoy protection against losses incurred due to inability of their investment firm to repay cash deposited with the investment firm, or to return the assets (instruments) held.

3.1 The insurance approach

According to this approach, the investor compensation scheme is a special insurance for the retail investors against the failure of the investment firms. The cost of this insurance is payable by the investment firms, as the proposal stated: "*no investment firm authorised in that Member State or UCITS authorised in that Member State may carry on investment business or carry on activities as a UCITS unless it belongs to such scheme*" (Article 2 paragraph (a) Section 1 of the Proposal), and "*Member States shall ensure that cost of financing schemes is ultimately borne in relation to investment business by investment firms or third party custodians covered by the scheme and in relation to UCITS activities by UCITS or their depositories or third parties who are covered by the schemes. Regular contributions by members shall be raised annually*." (Article 4a, paragraph 6. of the Proposal).

This means that the ICS will be funded by the contributions of its members, i.e. yearly contributions paid by the service providers. It is clear that the contribution payable will be part of the costs of the service providers and will be reflected in the price of the services provided. Obviously it will not be an automatic price increase (the price of this business is a market phenomenon, therefore competition, i.e. demand and supply as well as the general economic environment would influence the effective price level); however from the economic point of view one can say that the cost of the ICS, or the insurance premium will finally be borne by the investors. As a consequence, a retail investor buying services from an investment firm which is member of an ICS will buy at the same time insurance against the failure of that investment firm.

From this point of view, the funding system must be a pre-funded mechanism in order to cover risks. The logic of an insurance is risk sharing. In case of failure, the post-funding mechanism will create an uneven risk sharing: the investment firm which is unable to pay back the cash or to return the assets to its customers would not be in a position to contribute to the scheme; therefore others ("the innocents") would have to cover the cost of the failure of that member.

3.2 The macroeconomic approach

The chosen funding mechanism will be related to cost allocation in time. The pre-funded system means that parallel with the starting of the activity (or from the time when the regulation will come into force) the service providers will pay a certain amount to the ICS, regardless of any investor's claim. In this way, the pre-funded system creates equivalent approaches for investors and service providers, i.e. in the sunny days; they prepare themselves for the rainy days. The pre-funded mechanism is a system where the participants of the investment business (investors and service providers) prepare themselves – by undertaking to pay costs now – for potential losses in the future.

By virtue of this described above nature, the pre-funded system is neutral from the point of view of the economic situation. As the proposed amendment of the ICSD will be effective after the peak of the current financial crisis, and due to the effect of the more cautious service providers' activity, the general awareness of the regulators and the public as a whole, the pre-funded system can be seen as an anti-cyclical tool as well.

As far as the macroeconomic concept is concerned, the pre-funded system has no negative impact on the economic cycles, contrary to a post-funded system where the contribution has to be paid by the investment firms (and ultimately by their clients) in a period when the market circumstances are deemed to be difficult. If the failure of the investment firm is due to financial difficulties, it is very probable that the market as a whole suffered.

3.3 The microeconomic and psychological approach

From the microeconomic point of view, the pre funded system can reduce the overall costs of the ICS. As the contributions are paid annually, the collected amount can be invested, and the return of such investments will be part of the risk coverage. The Proposal in Article 4a section 3 stated: "*Contributions collected to reach the target fund level shall only be invested in cash deposits and low risk assets...*".

Finally, there is an argument for the pre-funded ICS related to the starting point: namely the intent to increase retail investors' confidence. We should take into consideration that rebuilding confidence of the costumers contains psychological and emotional elements as well. Whatever the professional rationale of a funded mechanism would be, the confidence of the retail investors will be assured by the fact that there is a fund which has a reported volume of cash or cash equivalent assets which can be used for compensation in case of need.

4. THE COVERAGE

The proposed amendment intends to harmonise the text and the concept of ICS with MiFID, in terms of services/products covered as well as the eligible customers. This is an essential step to create transparent and harmonised approach for the investment business in the Single Market.

4.1 The services covered

In general terms, the proposed amendment's intention is to cover all investment services listed in the Annex I of MiFID. The concept behind this is that any investment services which might have a possibility to hold directly or indirectly cash or instruments - mentioned in Section C of that Annex I – of the clients must be part of the ICS.

Should one accept this approach, it is irrelevant whether an investment service provider (like an operator of a Multilateral Trading Facility - MTF) is currently managing clients' assets or not; the proposal intends to involve all the potential managers. It is important to note that the contribution is connected to the actual position of the service providers and the clients' assets held, therefore the cost of funding for the investment firms is in line with the value of such assets at risk. From this point of view the calculation methodology of the contribution – whether it is purely based upon the value of the clients' asset held, or the contribution base is modified by the number of the retail customers' accounts, and/or by the weighted risks of them – is irrelevant.

A 'headache' item of the proposal (as it seems from the reactions in the public consultation) is the extension of the coverage to third party custodians (depositories) and especially to UCITS. The best way to assess the rationale of these steps is to set up the logical chain of the ICS. The starting point is that the ICS will compensate the eligible clients (up to the amount set) in case of (Proposal Article 2 paragraph 2):

"*A scheme shall provide coverage for investors in relation to investment business in accordance with the Article 4 where one of the following conditions is met first:*

(a) *the competent authorities have determined that an investment firm, appears for the time being, for reasons directly related to the financial circumstances of the investment firm or the financial circumstances of any third party with whom financial instruments have been deposited by the investment firm, to be unable to meet its obligations arising out of investor's claims and has no early prospect of being able to do so,*

(b) *a judicial authority has made ruling for reasons directly related to the financial circumstances of the investment firm or the financial circumstances of any third party with whom financial instruments have been deposited by the investment firm, which has the effect of suspending investors' ability to make claims against the firm or the firm's ability to make claims against the third party.*"

The investor which has a contract with the investment firm submits a claim to return his instruments to him. Should the investment firm be unable to do so (regardless of the reason which may have caused this financial circumstance), the scheme will compensate the eligible clients. The Proposal when extending the coverage to third party depositories therefore might read as follows: "…*if the failure of the investment firm is due to the failure of a third party not providing strategies to compensate the client, the investment firm's liability also covers those parts.*".

The key is that the ICS will not analyse the reason of the financial difficulties. It might be a misconduct of internal procedures, breaches of internal rules or legal provisions, (set up for instance by MiFID in Article 13), operational difficulties etc. Once the inability is proven, the compensation mechanism will commence. In this way, the inability of the third party (the depository, or custodian contracted by the investment firm to safeguard the client's asset on behalf of the investment firm) could be treated as a mismanagement of the investment firm (the duty of such firm is to carefully select, and control the contracted third party in order to ensure to keep its ability vis-à-vis the client of the investment firm). Following this logic, if the failure is due to the inability of the third party, the cost of the compensation of it lies with that third party. This is reflected in Article 4a, paragraph 6 of the Proposal:

"*Member State shall ensure that the cost of financing schemes is ultimately borne in relation to investment business by the investment firms or third party custodians covered by the scheme...*".

The involvement of UCITS, however, is not that simple. The unit holder (the investor) does not have a direct claim for certain assets, but the benefit of a collective investment scheme. This means that the investors may run the operational risk of the collective investment scheme (i.e. UCITS, pension fund, insurance firm providing unit-linked products) and the operational risk of the third party. However, the client of that third party is a professional investor (i.e. UCITS, pension fund, insurance firm providing unit-linked products). Therefore, the unit holder will not be the first who is facing the failure of the third party (depository, custodian) but the UCITS itself. There is no reason to say that the unit holder would not be eligible for the investment protection, similar to the client of an investment firm.

However, it would be advisable to extend the investors compensation schemes to unit holders when all the other investment related products (like unit-linked insurance products, pension funds other collective investment products) and services will be covered by a similar protection. It would ensure a level playing field and make regulatory arbitrage avoidable.

4.2 The eligible customers

Limiting ICS coverage to non-professional (basically retail) investors is a correct and convincing solution. The ICS (like in case of DGS) intends to eliminate the losses that may incur in a contracted relationship in which one contracting party (the non-professional client) has an information and influence disadvantage (information and market power gap).

MiFID determines the professional investors, from the point of view of risk taking capacity:

"*When providing investment advice or portfolio management the investment firm shall obtain the necessary information regarding the client's or potential client's knowledge and experience in investment field relevant to the specific type of product or service, his financial situation and his investment objectives so as to enable the firm to recommend to the client or potential client the investment services and financial instruments that are suitable for him*." (Article 19 paragraph 4 MiFID)

This concept is a special "Know-Your-Customer" procedure, in which the investment firm categorises its clients as "professional" or "non professional." The proposal – modifying the Annex of the prevailing ICSD – intends to exclude the professional clients as it is stated in the Annex II of MiFID.

In terms of eligibility, the involvement of UCITS in the ICS could create difficulties. The classification of MiFID regarding professional/non-professional investors does not apply directly to the unit holders. Should all the unit holders qualify as a non-professional investors, UCITSs have to bear an uneven burden in funding ICS. This is another argument to postpone extending ICS to UCITS for now.

4.3 Risks covered

The investor compensation is related to the risks stemming from the failure of service providers. Using the categories of the Capital Requirements Directive[54] (CRD), ICS liability would not contain market risks (i.e. changing the market value of assets, investment products or in case of UCITS the market value of units). Similarly the credit risks in case of such instruments (such as debt securities) are excluded. The risks covered are typically operational risks. These risks however have been addressed by different means.

Firstly, the legal requirements on investment services, (under MiFID or the Directive on UCITS) clearly states conditions, i.e. requirements that are necessary to be met in order to run a sound and prudent activity. According to those criteria, investment service providers have to comply with inter alia the licensing procedure containing the checking of the sound financial base, and the existence of rigorous internal governance, control mechanisms and rules handling conflicts of interests.

Secondly, the legal framework requires external controls, like independent auditors.

Thirdly, the infrastructure around the investment service providers, such as the clearing and settlement system, e.g. the concept of central counterparties, also provide protection against those risks.

Finally, the investment firms and UCITS are subject to supervision which has power to ensure that firms comply with these criteria.

Although the risks mentioned are mitigated by these means, it cannot be assured that all potential failures would be avoided by them. Therefore, the ICS would be the final protection in case of operational failures. The risks covered by ICS however are limited in two ways:

(1) not all but only the non-professional investors enjoy compensation, and further excluded are those which are related to criminal or market abuse activity;

(2) the other limitation is the cap on the compensation. The proposed amount of EUR 50,000 means that claims exceeding this amount will not be compensated.

[54] See Article 75 of the Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), OJ L 177 of 30 June 2006, p. 1.

5. COVERAGE (TARGET) LEVEL

There is a fundamental difficulty regarding the qualification of the satisfactory level of coverage. A comprehensive data base of the number of clients, the breakdown of customers (professional and non-professional) and the average holdings of the clients could not be identified. The OXERA report is rather outdated (the latest figure therein dates from 2003) and by its mandate, it is dealing only with the experienced cases. However the target level might be judged on the basis of these cases and logical assumptions.

The issues mentioned above predict that the potential usage of ICS is limited. That all of the instruments and cash handled by investment services providers on behalf of customers are divided according to professional and non-professional clients, and just the latter enjoy protection, is one element to be taken into account. The other item is that the probability of such failures in view of the available information is rather low (we have no evidence that even during the current crises Europe has experienced a significant increase of these cases). Most importantly, the compensation is a limited one: according to Article 3 Paragraph 4 of the Proposal "*Member States shall ensure that schemes provide for coverage of EUR 50 000 for each investor in respect of the claims referred to in Article 2(2a) or (2c).*"

When one calculates a target level for such compensation schemes, the trade-off between the cost and the safety has to be considered. It is rather clear that a 100% protection (which would mean that the scheme has a target level equal to the number of protected customers multiplied by EUR 50,000) is extremely costly and unnecessary. It must be added, that the compensation amount is a maximum one, i.e. the average size of the "non-professional" clients' assets is more than likely to be less than EUR 50,000.

5.1 Basis of calculation

The target level could be approached in such a way that the sufficient available fund of ICS has to cover a certain number of non-professional clients, with maximum claims. According to the OXERA report, the total number of claims was around 61,000 between 1999 and 2003 in the EU-15. The average size of claims did not exceed EUR 20,000. Applying this as a guidance, we can say that the ICS target level should be treated as sufficient where it covers around 200,000 cases, each of them valued at EUR 50,000. 200,000 claims would represent 1-3 large (medium sized) investment firms' failure(s) or a several small companies in trouble. On the basis of that estimate, the target level would be EUR 10 billion.

Although the calculation of the 0.5 % of the covered assets as a coverage level is not very clear, using a rough estimation and the reactions of the contributions of market participants to the Call for Evidence[55], it might be around EUR 50 billion, i.e. at least five times higher. In light of the issues mentioned above, the coverage level of 10 basis points of the assets managed by investment firms on behalf of eligible clients should be seen as sufficient. It is important to note that the target level is determined as a percentage of the assets held by the ICS's member. Therefore, in case of extension or a growing value of the assets, the target level amount will increase automatically.

This amount provides a sound financial basis for the ICS, and due to its pre-funded nature would convince retail customers that the system is able to ensure sufficient safeguards against the operational failure of the service providers.

[55] See Commission Press Release IP/09/230 of 9 February 2009.

5.2 Additional reasons of lowering the target level

It should be noted that the system contains two additional funding alternatives. On one hand, the proposed borrowing mechanism can mitigate the risks when an ICS in one Member State has to pay out more than the target level of that scheme, then the claims could be covered by the money borrowed from other Member States' schemes. On the other hand, the proposal requires definite steps to be made in order for the schemes to have the opportunity to make additional calls to its members, and have in place adequate alternative funding arrangements (Article 4a paragraph 4 and 5 of the Proposal).

In any event, the obligation of ICS to compensate eligible clients would be temporary by nature. When the schemes transfer the funds to the client, they do so on behalf of the investment firms, therefore the scheme "shall have the right of subrogation to the rights of those investors in liquidation proceedings for amount equal to their payments" (Proposal Article 19 paragraph 2).

There are some additional considerations to be mentioned:

The lower target level (and in parallel with it during the 10 years transition period, the lower contribution level) would decrease the financial burden of the participating investment firms and third party custodians (and, in case of extension to UCITS, and other collective investment products). This would ease acceptance of the Proposal.

Following the implementation of the ICSD of 1997, there are existing investor compensation schemes in all Member States. However, the calculation methodology (which varies in Member States as the Oxera report shows) may influence the breakdown of the burden amongst the participants according to the number of eligible clients, and the risk associated with them. Some of these schemes are of a prefunded nature, so for them the cost burden associated with achieving the target level should be lower as they can take into account the amount of existing funds.

The target level by nature is an indecisive one. The size of the business and the market value of the instruments held might influence the coverage level. It is important to state that, should the calculated target level exceed the amount of funds of ICS, it is not entitled to pay back contributions. Moreover, the benefit of the investments of the ICS will increase the funds of ICS irrespectively of the fact that the target level has already been reached.

CONCLUSION

The pre-funded (ex ante) mechanism is more suitable for ICS than the post-funded (ex post) one.

Extension of ICS to third party custodians is a logical step forward; however, the involvement of UCITS requires more cautious approaches. It would be advisable to postpone the coverage until other investment related business will be subject to similar compensations.

The target level may be lowered to 10 basis points of the funds and instruments held by investment firms and third party custodians on behalf of retail (non-professional) clients.

REFERENCES

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