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## **BVI response to the Commission's Call for Evidence on Directive 1997/9/EC on Investor Compensation Schemes**

Dear Sir or Madam,

BVI<sup>1</sup> is grateful for the opportunity to participate in the call for evidence in relation to the review of Directive 1997/9/EC on investor compensation schemes ("ICSD"). We support the notion to gather information about the practical application ten years after the entry into force of the ICSD. Given the current financial markets conditions, we are in favour of an immediate revision of the ICSD.

First of all, the ICSD and the Deposit Guarantee Schemes Directive 94/19/EC ("DGSD") have different objectives. The DGSD protects depositors in the event of closure of an insolvent credit institution. In contrast, the ICSD provides protection against fraudulent misappropriation of clients' assets. For this reason, we strongly disagree with the idea that the rules of ICSD concerning e.g. the amount covered by the compensation claim should be adapted following the updating of the DGSD.

In accordance with the objective of the ICSD to provide for a harmonised minimum level of protection for small investors, we support the exemption of investment services to non-retail clients from the ICSD provisions. Furthermore, investment firms authorised to provide investment services but not to hold clients' assets should be kept outside the scope of the ICSD.

Last but not least, BVI members are clearly against the idea that money market funds shareholders should be subject to special treatment within the ICSD.

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<sup>1</sup> BVI Bundesverband Investment und Asset Management e. V. represent the interest of the German investment fund and asset management industry. Its 92 members manage currently assets in excess of EUR 1.6 trillion both in mutual funds and mandates. For more information, please visit [www.bvi.de](http://www.bvi.de). BVI is filed in the EU register of interest representatives (1575282143-01).

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## **I. Preliminary remarks: German scheme**

Germany does not have only one investor compensation scheme covering all investment firms that hold the single authorisation provided for in Directive 93/22/EEC ("ISD"). In fact, there are three legal schemes which do not cover losses of non-retail clients and which are principally in good working order:

- Deposit guarantee and investor compensation scheme for private credit institutions (Entschädigungseinrichtung deutscher Banken GmbH, „EdB“)
- Deposit guarantee and investor compensation scheme for public credit institutions (Entschädigungseinrichtung des Bundesverbandes Öffentlicher Banken Deutschlands GmbH, „EdÖ“)
- Investor compensation scheme for remaining investment firms (Entschädigungseinrichtung der Wertpapierhandelsunternehmen, „EdW“)

Furthermore, in accordance with Article 2 (1) of ICSD, Germany has exempted some credit institutions to which the ICSD applies from the obligation of membership to an investor compensation scheme (cf. Paragraph 12 of the German Act on deposit guarantee and investor compensation schemes).

Over one third of BVI members are investment firms required by Article 2 (1) of ICSD to belong to a investor compensation scheme. They render investment services covered by the ISD and the Directive 2004/39/EC ("MiFID") like portfolio management and investment advice mainly to non-retail clients. They are not authorised to hold clients' assets.

In this context, we would like to submit the following remarks:

## **II. Issues at stake**

1) Should the operation of multilateral trading facilities be excluded from the scope of the ICSD?
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In our view, the ICSD should not be adapted to all types of new services covered by MiFID and notably to the management of multilateral trading facilities (MTFs). MTFs are operated for a professional clientele, so that their membership in an investor compensation scheme is not required.

We also reject the suggested extension of the ICSD to the new MiFID activity of investment advice. Compensation for losses in client's assets resulting from fraudulent misappropriation on the part of the advisor are subject to national civil law and must be claimed before civil courts. The existing German investor compensation schemes do not provide protection in such cases.



In addition, investment advisors are generally not authorised to hold clients' assets. Compensation under the ICSD would only make sense in cases in which the advisor is authorised to hold client's' assets and misapplies the assets, thus causing losses to the client. Even though such cases should be rare in practice, any extension of the scope of the ICSD to investment advice should apply only to these.

2) Would it be appropriate to include in the scope of the ICSD all investment firms seeking authorisation to the provision of investment services, although their authorisation would not allow holding clients' assets?

BVI members are against extending the scope of application of the ICSD to all investment firms. For investment firms lacking authorisation to hold clients' assets, there is no need for additional protection under ICSD. If the assets are not held in the firm's name, they are held in the client's name or in a collective investment scheme. In either case they are segregated from the investment firm's assets and would not be affected by the firm's bankruptcy or default.

3) Would it be appropriate to include in the scope of the ICSD all investment firms seeking authorisation to the provision of investment services, although they provide their services only to non-retail clients?

Having regard to the objective of the ICSD to provide for a harmonised minimum level of protection for small investors, we reject this suggestion.

All German schemes do not cover losses incurred by non-retail clients. In fact, incidents by firms providing services solely to non-retail clients do not give rise to a claim against the scheme. A basic principle of MiFID is the assumption that a professional client has the necessary level of experience and knowledge in order to understand the risks involved in the transaction or in the management of his portfolio. Thus, it appears unjustified to extend the liability to contribution under the ICSD to investment firms the business of which is generally excluded from the corresponding compensation entitlement.

4a) Should investors be able to claim compensation in the case of default of the third party where their assets had been deposited?

4b) Should investors (such as UCITS or a UCITS unit holder) be able to claim compensation for loss of assets under the ICSD in those cases where the UCITS depositary or the institution which has been mandated to safe keep the assets, fail to perform its duty?

Initially, the ICSD covered the provision of the MiFiD non-core service of safekeeping and administration of securities. Therefore, in Germany investors are principally able to claim compensation in the case of default of a (German) investment firm which has been entrusted with safe-keeping of their assets. In line with the general concept of the ICSD, however, investors should also in this case be able to claim compensation only for loss of assets caused by fraudulent misappropriation (cf. Paragraph 4 (2) of the German Act on deposit-guarantee and investor-compensation schemes). Otherwise, in the event of closure of an investment firm pursuant to bankruptcy proceedings, the deposited assets are selected from the insolvency estate and investors are entitled to claim the restitution of assets against the liquidator of the insolvent firm.

However, the question is whether an investor should be able to claim compensation for losses of assets provoked by the third party entrusted with the safe-keeping function, even if he may not have a directive contractual relationship with that party. All German schemes do not cover losses of clients' assets arising from the default of third parties.

In our view, investors should not be able to claim compensation in such cases. Rather, the entitlement to compensation should be limited to losses of assets caused by fraudulent misappropriation in cases where the investor has a directive contractual relationship with the depositor. There is a sufficient investor protection in the event of closure of an insolvent investment firm. In cases where an investment firm transfers investors' funds to a third party which subsequently defaults on its duties, it is the task of regulatory authority to supervise and control these circumstances.

For these reasons, investors (such as UCITS or UCITS unit holders) should not be able to claim compensation for losses of assets under the ICSD in cases where the UCITS depositary or the institution which has been mandated to safe-keep the assets fail to perform its duty. At present all collective investment undertakings whether or not coordinated at Community level and the depositaries or manager of such undertakings are explicitly excluded from the scope of regulation under the ICSD and MiFiD, since they are subject to specific rules directly adapted to their activities.

The UCITS Directive clearly establishes the basic responsibilities and liabilities of the depositary. It clearly assigns responsibilities for safe-keeping of the fund assets to the depositary and imposes liability on the depositary in the event of wrongdoing or negligent performance of its duties. Determination of liability and its extent must be established in accordance with the relevant national civil law.

Otherwise, should the scope of the ICSD be extended to cover failures of third parties, we would suggest that the entitlement be granted to the management company of the damaged UCITS or, in the case of corporate funds, the UCITS itself who should be obliged to claim compensation on behalf of investors. Regarding the compensation amount, the claim should be assessed taking into account the number of investors in a fund. We are aware,



however, that in these cases it is quite difficult to identify the number and structure of shareholders after the relevant event.

5) Should loss events include also any losses suffered by (retail) investors as a consequence of the violation of conduct of business rules?

We are clearly against such extension as it implies a conceptual discontinuity in the ICSD which currently provides for compensation only in case of violation of principal contractual obligations such as restitution of assets under custody.

In contrast, breaches of conduct of business rules relate to ancillary obligations. Moreover, any claim for damages would need to be established on the basis of individual circumstances, mostly through legal proceedings before civil courts, which means obviously that the decision would depend upon the rules of national civil law. Also, the primary objective of ICSD is to cover unpredictable losses caused by punishable activities such as fraud, whereas compliance by an investment firm with conduct of business rules is subject to supervision and sanctions by the authorities as well as to regular controls by independent auditors.

6) Do you agree with the idea that the amount covered by the ICSD should be adapted following the updating of the DGSD?

BVI members strongly disagree with the idea that the amount covered by the ICSD should be adapted following the updating of the DGSD. This appears unjustified, especially as the ICSD provides for compensation only in case of fraud and thus, is in its scope limited in comparison to the DGSD which also covers general business failures of a company.

7) The ICSD does not harmonize the funding systems of the schemes. Should the ICSD provide for some general principles concerning the funding of the schemes?

BVI members support the idea that the ICSD should provide for some general principles concerning the funding of the schemes. This could be a feasible way to avoid unfair competition between European investment firms which render the same investment services.

In our view, the following issues should be harmonized:

- The moment contributions are due (We prefer the ex post-approach to scheme funding).
- Prudential criteria for the management of contributions collected ex ante (in the event that the ex post collected contributions are not enough to claim compensation)

- The way contributions are calculated (We think that due consideration should be given to the risk of an investment firm to prompt a case of compensation).
- The minimum level and the maximum limit on the amount that may be collected from firms in a given period and in case of collecting contributions ex ante.
- Liability of investment firms which are reassigned to the investor-compensation scheme after determination of a compensation case.

8a) Does the legislation of the Member State you know the best provide mechanisms aimed at limiting compensation schemes' obligations over time? If yes, how many clients saw their compensation unpaid as a result of such mechanisms?

8b) Should this kind of mechanisms be prohibited?

Germany does limit the cover to an investor's claim to 90 % with a cap of Euro 20.000 for each investor.

In our view, this kind of mechanism should not be prohibited. In order to encourage investors to take due care in their choice of investment firms, it appears reasonable to allow Member States to require investors to bear a small proportion of any loss. In accordance with the objective of the ICSD to provide protection against acts of fraud, it appears justified to proceed as previously done.

9a) Should the process of recognizing the eligibility of the claim be regulated for the purposes of the ICSD?

9b) Should, at least, a mechanism be introduced providing for provisional partial compensation based on a summary assessment of clients' positions?

9c) Irrespective of the harmonisation of their funding systems, should compensation schemes ensure that they have minimum reserve funds in order to comply rapidly with any immediate needs?

In our view, the process of recognizing the eligibility of the claim should not be regulated for the purposes of the ICSD. Currently, the recognition of eligibility takes place in accordance with national civil and insolvency law. Therefore, BVI members have doubts as to the feasibility of harmonising the relevant parts of insolvency law in order to establish common criteria for eligibility and the amount of the claim at EU level.

Irrespective of the harmonisation of funding systems under the ICSD, BVI members endorse the proposal to have minimum reserve funds in the compensation schemes.

### **III. Other issues to be discussed: Money market funds**

10) Do you think special attention should be given to money market funds?
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BVI members are clearly against the idea that money market funds shareholders should be given a special attention within the ICSD, since they are subject to specific rules directly adapted to their activities.

For that reason all collective investment undertakings, including money market funds, whether or not coordinated at Community level, are explicitly excluded from the scope of the ICSD. The legal documentation of money market funds and the funds' distributors should clearly explain the objectives of the fund in terms of capital preservation, liquidity and yield in order to enhance investor protection by proper disclosure of investment risks. These steps should be sufficient to achieve adequate perception of risks on the part of investors. There is no other reason to extend the scope of the ICSD to money market funds.

Furthermore, we do not think that stabilisation of money market funds can be achieved within the ICSD. First of all, compensations for losses in market value would mean a shift in paradigm of the current directive which grants compensation only for losses due to the institutional failure of an investment firm.

Moreover, in case of extending the scope of the ICSD to money market funds or the respective management companies, all other members to the compensation scheme must be expected to entail high membership fees to reflect the actual risk of value losses. This should pose a significant burden to the industry already suffering from high financial strains.

11) Based on the concrete application of the ICSD do you see further issues other than the ones mentioned in the present document that might be of relevance to this analysis?
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At the moment we do not see further issues that might be of relevance to the analysis.

We hope that our suggestions will help to devise a viable concept for the revision of ICSD. We would like to assure the Commission of our willingness to provide continuing assistance and to engage in further discussions on the subject at hand.

Yours sincerely

**BVI Bundesverband Investment und Asset Management e.V.**

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