

Response to the European Commission's Call for Evidence on Directive 1997/9/EC on Investor-Compensation Schemes

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General Comments

The current economic and financial crisis has also led to a loss of confidence in the existing compulsory investor compensation schemes. This has various reasons: many investors fear that the funds held by investor compensation schemes may not be sufficient to effectively cover all cases of investment-losses. Additionally, many market-participants criticise the fact that assets with a deposit-like structure (shares of money-market funds, etc.) are not covered by any compensation-system. Furthermore, the amount guaranteed by statutory compensation is seen as insufficient especially by many private investors.

Due to these circumstances, governments and general public seem to be increasingly concerned that the lack of investors' confidence in the statutory compensation schemes could further destabilize the financial system. This already led to the introduction of implicit investor guarantees by numerous European governments.

Therefore a profound debate on the basic principles of investor-compensation is strongly necessary. However, Deutsches Aktieninstitut¹ objects to the core-proposals of the European Commission as they will not significantly improve investor-compensation but may even change the situation for the worse.

The Commission's call for evidence mainly focuses on two components, an increase of compensation sums and a significant enlargement of the range of financial products that should be covered by the compensations schemes. Deutsches Aktieninstitut views these components critically, as their implementation would result in a significant increase of the membership-fees payable by investment firms to the respective compensation-system which they are part of. In Germany, the present compensation system already proved in-

¹ Deutsches Aktieninstitut e.V. is the association of German exchange-listed stock corporations and other companies and institutions which are engaged in the capital markets development.

sufficient, as in the case of „*Phönix Kapitaldienst GmbH*“ the volume of compensation claims raised (about 200 million Euros) surpassed the funds held by the respective compensation-institution, the „*Entschädigungseinrichtung der Wertpapierhandelsbanken (EdW)*“, which amounted only to about 5 – 7 million Euros by far. The closure of the remaining gap would thus mean an exorbitant raise of the membership-fees to the compensation institution, which in the present situation amount to up to 10 percent of the yearly profit already. Such an increase might not only seriously threaten the existence of many financial enterprises but could also lead to insolvencies and in the worst case trigger further compensation-cases.

The „*Phönix*“-case clearly shows that even the existing compensation rules are not equipped to cover the insolvency of a “big player”. Against the background of the severe existing global economic and financial crisis Deutsches Aktieninstitut believes that an increase of compensation sums and an expansion of the range of compensation-covered financial products at the same time cannot be financed unless the government takes its role as „lender of last resort“. For investors this would result in nothing else than in an illusion of safety: the investor relies on the compensation institution while at the same time finances his own compensation claim with his taxes paid.

Responses to selected questions

Question 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?

No. Institutional Investors have previously been excluded from investor-compensation schemes for good reasons. This status quo has to be maintained. Unlike private investors, institutional investors are usually capable of thoroughly reviewing and assessing the integrity and creditworthiness of the investment firms they rely on. If deposits of institutional investors were covered by statutory compensation schemes, they would not be encouraged enough to monitor investment firms on a frequent basis.

Additionally, the membership-fees for compensation institutions would need to be raised significantly. This would hence lead to liquidity-problems, as stated above and clearly suspend an important element of market control.

Question 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?

No. According to German law an investment firm has to keep clients' assets strictly separate from its own estate. This ensures the protection of the clients'

assets if insolvency occurs. UCITS (shares of investment funds) are to be separated strictly from the investment firm's assets in a depositary bank. In the case of insolvency even of the depositary bank, either the national supervision authority (BaFin) or the depositary bank itself will arrange for a transfer of the investor's assets to another depositary bank. The insolvency of the depositary bank is not linked to a decline of the value of the separated assets; this makes investor compensation definitely unnecessary.

Question 6:

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

According to the financing problems described in the "General Comments" Deutsches Aktieninstitut sees the proposed increase of compensation amounts very critically.

An increase of the compensation amount simultaneously to the abolishment of the investor's own contribution (10 percent of his deposit) will reduce the investor's incentives to reasonably inform himself about the chances and risks of his investment.

Similar trends will be observed with regards to financial consultants who are likely to recommend products with a higher risk, as they might feel their responsibility to be reduced by their reliance on statutory investor-compensation. Additionally, an imbalance of financial advice is to be expected, as consultants will strongly focus on yield-aspects or may exclusively advise products covered by compensation schemes irrespective of whether they are useful to their clients or not. This might also distort competition between financial products that are covered by the compensation schemes and those that are not.

A broad basis of thorough information and transparency for investors is essential. During the current economic and financial crisis, it has been observed that a lot of investors bought financial products which they did not entirely understand and which risks they were unable to assess. Instead of increasing the compensation sums which will promote nothing else but an illusion of safety, Deutsches Aktieninstitut proposes to improve the financial education of the general public. Besides necessary campaigns of public institutions in order to improve the general knowledge about financial matters, one of the most important steps to achieve this aim would be the introduction of a compulsory subject "economics" in all general schools.

Question 10:

Do you think special attention should be given to money market funds?

No. The coverage of money market funds under statutory compensation schemes is not necessary. As already mentioned in the answer to question 4b), investment funds are obliged to keep client-assets strictly separate from

their own assets. Clients are therefore not affected by the insolvency of the supplier of the fund.

Deutsches Aktieninstitut opposes the idea of a compensation for investment losses of money market funds, as it leads to a decline of the investor's encouragement to thoroughly evaluate the chances and risks of his investment. (Reference is made to the answer of questions 6). As the funds-management sometimes takes risks in connection with foreign currency investments or asset-backed securities, the investor would benefit from possible profits exceeding an average yield while on the other hand would not be obliged to take losses. This could be problematic as many investment firms would hence increase the risks of their products dramatically.