



# FIN-USE

EXPERT FORUM OF  
FINANCIAL SERVICES USERS

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**FIN-USE RESPONSE TO CALL  
FOR EVIDENCE ON  
DIRECTIVE 1997/9/EC ON  
INVESTOR-COMPENSATION  
SCHEMES**

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FIN-USE notes with guarded satisfaction the Commission's call for evidence on investor compensation schemes ("ICS"). It is obvious for the expert group that the Commission's initiative is a direct consequence of the effect on people's savings following the financial havoc which came to a point during the last quarter of last year.

In 2005, the European Commission had commissioned Oxera to draw up a report on the implementation of the Investor Compensation Scheme Directive<sup>1</sup>. That report had made a comprehensive review of the state of implementation of the ICS Directive ("ICSD") across the member states (the "old" and "new"). But the Commission's website following this report is eerily silent as to any subsequent actions. It is highly likely that there were none. But perhaps the markets, at the time, were all working "to perfection", and therefore there was no sufficiently robust case to bring about any changes to the ICSD. And, as with the Commission's u-turn last year in respect of the depositor compensation scheme, here again, it had to be a financial mess which has triggered yet another consultation paper and scrambling towards patching a neglected aspect of investor protection. It's better late than never!

It is very disappointing that the Commission decided to put any developments and improvements to the ICS on the back-burner. The 2009 call for evidence states: *The purpose of this call for evidence is to obtain information from Member States, market participants and other stakeholders, in particular investors, about the application of the ICSD across Member States and about the need to modify it in order to take into account the changes of a regulatory or economic nature that have materialized in the EU financial markets. The information received will help the Commission services to focus on the real issues of concern for the review of the ICSD.* In 2005, much of the information was there. As the "business case" to justify changes at the time was not evident (even if, with hindsight, it was lurking in the background without getting noticed), it would seem that status quo was the preferred option.

So, even if the Commission's 2009 initiative can at best be described as "management by crisis" (excuse the pun), nevertheless we look forward to see how the Commission will exploit the opportunity to make amends in light of the dire consequences brought about by the financial crisis and thus bring about some important (and perhaps innovative) changes to the ICS directive.

We are enthusiastic but, at the same time, cautious for the simple fact that if one had to compare the Commission's October 2008 proposals on the depositor compensation schemes<sup>2</sup> with the final directive (Directive 2009/14), then it is evident that compromises between Member States may not only dilute but could also undermine any Commission initiative to enhance investor protection in the event of some maverick doing by a regulated entity.

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<sup>1</sup> 'Description and assessment of national investor compensation schemes established in accordance with Directive 97/9/EC', commissioned by the Internal Market Directorate-General of the European Commission - [http://ec.europa.eu/internal\\_market/securities/isd/investor\\_en.htm](http://ec.europa.eu/internal_market/securities/isd/investor_en.htm)

<sup>2</sup> Amendment of the Directive on Deposit Guarantee Schemes, 15 October 2009: [http://ec.europa.eu/internal\\_market/bank/docs/guarantee/dgs\\_proposal\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/guarantee/dgs_proposal_en.pdf)

We strongly feel that the Commission should dust-off the OXERA's 2005 report on the implementation of the ICSD and look again at the various assessments and recommendations it had made at the time. Its conclusions remain valid to this day.

But first, it is important to place the ICS in a proper framework. An ICS is one part of many layers of regulatory protection. In theory, a compensation scheme should be of secondary importance if there is a robust regulatory framework in place and where the regulators, the market and investors have full and unconditional access to information which they can assess of the various players in the financial system. However, in practice this is not the case. Markets are imperfect, regulators are over-burdened and under-resourced, and investors cannot be assumed that they are in a position to assess and interpret information. Moreover, the actual financial crisis has disclosed a lot of scandals in the aggressive marketing of financial products: based on the interested advice of the banks employees the costumers have frequently accepted high risks incompatible with their investor profile. In this sense, it could be stated that, when all other measures of a regulatory (like the MIFID Regulation, that has acted as a mere protector shield for the financial industry, failing in its real target and purpose, which is to give a robust and real protections for consumers) - and political nature, fail, a compensation scheme setup to protect those which are likely to suffer most from the failure of a firm – i.e. the investor or depositor - is triggered.

Oxera had this to say on this aspect: *Investor compensation schemes provide only one form of protection against the various risk exposures for retail investors. Other protection mechanisms are in place: these either are prescribed by regulation (eg, prudential regulation, segregation requirements, other conduct of business rules, supervision and enforcement), or emerge from institutional arrangements (eg, economic capital of investment firms, firm reputation, private insurance cover). The better the protection provided by the alternative protection mechanisms, the less the need and resource requirements for the statutory investor compensation schemes. However, past case experience suggests that there have been instances where the alternative mechanisms have failed and investors would have incurred significant losses, had it not been for the existence of a statutory scheme. The national investor compensation schemes established in the EU therefore play an important complementary role in providing last-resort protection for retail investors.*

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## REPLIES TO THE CALL FOR EVIDENCE

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### **1) Should the operation of multilateral trading facilities be excluded from the scope of the ICSD?**

FIN-USE believes that the operation of MTFs should not be excluded from protection under ICSD. From the normal consumer perspective the consumer will generally not have sufficient knowledge or information to know whether the product offered through the MTF platform is covered by ICSD, but will expect that protection would apply. Therefore, we recommend that ICSD cover is extended to protect all investment advice, product and services, so provided.

***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?***

All firms providing investment services, whether or not they are licensed to hold and control client funds and/or assets, should be required to come within the scope of the ICSD and participate in the compensation scheme for the same reasons that investors will not differentiate, or be in a position to differentiate, as to the scope of a firm's authorization.

***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?***

FIN-USE recommends that discretion be available to Member States to decide if investment firms seeking authorization to provide their services strictly to non-retail clients should be included in the scope of the ICSD or not.

That stated, FIN-USE recommends that an investment firm which is not a participant of an ICSD should specifically make such disclosure in its documentation to investors (mainly, but not exclusively, the terms of business letter). In addition, there might be a business case to be made in favour of increasing own capital limits for those firms which are not participants of an ICS.

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

Yes, investors should be able to claim compensation irrespective of where their funds are held. The investor has the client relationship with the investment firm with which he or she contracts, and it is of little concern to the client that a loss may occur as a result of a default of a third party. The client should be entitled to compensation in such circumstances.

***4(b) 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?***

Yes, the UCITS unit holder (the retail investor of a financial service) should be able to claim compensation for losses incurred where the UCITS depositary or institution fails in its duty of safe-keeping of the assets.

That stated, however, it would be reasonable to expect the Commission to back up its argument not only with the *modus operandum* as to how this aim

could be achieved, but also ensure that all such third parties are tightly and adequately regulated across the EU.

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

Client losses arising from violation of, or non-compliance with, ICSD advised best business rules/ practices, should be covered within the ICSD scope.

On this aspect, OXERA had this to say in 2005: *Retail investors are exposed to a range of risks when engaging an investment firm to carry out investment services on their behalf. Investor compensation schemes provide important protection against the risk that, in the event of default, an investment firm is not able to return to investors the monies or investment instruments belonging to them. The schemes therefore protect investors' assets against the risk of theft, embezzlement and other forms of fraudulent misappropriation. They may also provide protection where the loss of investor assets in the event of firm default has resulted from unintentional errors, negligence or breakdowns in the firms' systems and controls.*

*However, there is a range of other risks that do not qualify for compensation cover under the ICD and national laws, or where compensation is not certain. In particular, with the exception of the UK compensation scheme, there is no compensation for losses arising from bad investment advice. The UK experience suggests that bad advice may be the most significant risk for retail investors, in terms of both frequency of occurrence and potential impact. With the implementation of Directive 2004/39/EC on markets in financial instruments, investment advice will become a core investment service and, for the first time in many EU countries, a regulated activity. Combined with an expected growth in the market for independent financial advice in the EU, this could result in calls for greater regulatory protection. Even if investment advisers were required to participate in a compensation scheme (which they may following the implementation of the 2004 Directive), as is already the case in the UK, current compensation rules under the ICD and in all countries but the UK would not provide this protection. Bad advice is not compensated by schemes that focus on compensating physical losses of investor monies and securities.*

Oxera's observations remain true.

If the regulatory framework is coherent and robust, a MS should be in a position to sanction the firm for such breaches, for example, by limiting the services the firm may provide subsequent to a breach. It might be worth pondering a situation where penalties raised for breaches committed by an investment firm are paid into the ICSD. Many ICSs across the EU are pay-box schemes, that is their role is very much limited to paying investors in the event of a defaulting firm. Siphoning penalties into an ICSD could very well lead to firm being discouraged from engaging into further irregular / illegal activities, which could also lead to reducing moral hazard against the scheme.

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

Yes, FIN-USE agrees that the amount of compensation covered by the ICSD should mirror that of the DGSD. From a depositor/investor point of view, for reasons of confidence in this last-resort systems and juridical certainty, if the level of coverage is not at par for both schemes, it is likely that depositors/investors (at least those who are informed of the existence of the two schemes) would place savings in accounts/products covered by the DGSD rather than those covered by the ICSD. Depositors/investors would not enter into the merit of how and when either of the schemes is triggered – their ultimate pursuit is the level of coverage.

**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?**

While there may have been merit in the past in providing certain options to MSs in the funding of their ICSs, FIN-USE now leans towards the view that while it may not be possible under the ICSD to fully harmonize the funding of schemes in all Member States, there should be strong guidance and general principles prescribed for funding and compensation levels.

The challenge is that the EU has yet to agree on a “harmonized” approach to funding for such schemes. For instance, the depositor guarantee scheme directive is completely silent on funding and MS lost a golden opportunity during the course of discussing the proposal to amend the DGS directive to ensure that schemes are robustly funded by the very entities which caused the current financial mess in the first place.

The de Larosière Group<sup>3</sup> was unequivocal on this aspect: *Another important element to be taken into account is the way in which the DGSs are funded. In this respect, the Group is of the view that preference should be given to schemes which are pre-funded by the financial sector. Such schemes are better to foster confidence and help avoiding pro-cyclical effects resulting from banks having to pay into the schemes at a time where they are already in difficulty.* The Commission should be guided by this same principle in respect of ICS funding.

Now that there is a much greater awareness of these issues now among EU citizens, resulting from the financial crises and losses suffered by investors/consumers, it is extremely important that ICSs in Member States raise the profile of such schemes, and the adequate publication of their existence and compensation benefits. In this respect, we would argue in favour of any recommendation to amend the ICSD to reflect the new provisions of the DGS directive relating to the obligation of firms to make depositors aware of a scheme’s coverage and to what extent.

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<sup>3</sup> The High-Level Group on Financial Supervision in the EU:  
[http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf) . Downloaded on 10 April 2009.

*8(a) 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?*

In Ireland, a claimant has five months to make a claim following the determination that a valid basis for the activation of the ICS has been triggered. There does not appear to be any evidence that claimants have not received payment in respect of valid compensation claims because of this timeframe.

That stated, we would argue in favour of time limits for compensation reflecting those of the revised DGS directive.

*8(b) Should this kind of mechanisms be prohibited?*

However, FIN-USE believes that, irrespective of what reasons might be advanced in a Member State, there should not be an arbitrary time limit deployed to deny the obligation to compensate investors' valid claims, and that such delaying mechanism should not be allowed.

*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?*

The answer to 9a and 9b is: Yes, in order to avoid and prevent inordinate and sometimes vexatious delays, and the resultant frustration and hardship to injured investors, FIN-USE recommends that the ICSD stipulate the process by which claims for compensation are determined to be eligible or not, and that provisions be included to facilitate early and, if necessary, partial payouts to claimants.

*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?*

We agree that schemes should be required to arrange their funding mechanisms so that at any time the scheme has minimum sufficient liquid assets available to meet claims for compensation. The level of such assets might be prescribed for schemes as a percentage of participating firms' turnover or of firms' balance sheets, or such other appropriate measure so as to ensure that enough funding contributions have been pre-collected by the scheme to rapidly meet any claims for compensation.

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

Further attention should be given to money market funds, in the context of ICSD, so that to the greatest extent possible investors/ consumers interests are protected. However, FIN-USE appreciates that it is difficult to make a sustainable case to protect investors from losses arising from investment risk associated with their investment.

***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?***

We ask if ICSD adequately addresses and contemplates investments made online, and the e-investment market.

Furthermore, perhaps it would be opportune for the Commission to take a step back and look at the ICSD and DGS as one whole dossier (and perhaps one directive). There are divergences between the scope for which the two schemes are setup. But there are certainly a number of similarities. This is not a short term project, of course. However, now is the time to take action if the Commission wants to be at the forefront of innovative and functioning measures which favour enhanced investor protection.