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*The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.*

## **EBF RESPONSE TO THE EUROPEAN COMMISSION CALL FOR EVIDENCE ON THE INVESTOR COMPENSATION SCHEMES DIRECTIVE**

### **Key Points**

- The EBF supports the Commission's initiative to review the Investor Compensation Schemes Directive (ICSD) but underlines that this review should not solely be based on the current financial context nor lead to aligning the ICSD with the recently revised provisions of the Deposit Guarantee Schemes Directive. Key differences between depositors' protection and investors' protection need to be taken into account;
- The objective of the ICSD is to protect retail investors against losses of the investment firm holding the assets of the client. Ultimately, the scope of the ICSD should cover the same financial institutions throughout the European Union;
- Any potential increase of the level of coverage should be based on a thorough analysis of the need to raise the minimum level and, if so, to what maximum level, considering the importance of customer confidence in the financial system;
- Funding mechanisms currently vary across Member States, some being ex post, others ex ante and yet others a mix between both. Any amendment to harmonise the funding mechanism should only be proposed where a preliminary assessment has proven that benefits would exceed costs incurred;
- Given the rationale of the ICSD, provisional compensation is not necessary. Most important is a prudent process regarding the eligibility of the claim;
- Any investment losses in money market funds due to fund investments losing value should not be compensated for under the ICSD except in the event that UCITS safeguards on asset segregation and depositary oversight have failed.

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## General remarks

1. The EBF welcomes the opportunity to comment on the European Commission's call for evidence on the Investor Compensation Schemes Directive (Directive 1997/9/EC). It seems **appropriate to review the functioning of this Directive** given the length of time since the Directive was first introduced and the wider scope of the Markets in Financial Instruments Directive to cover new financial services.
2. The current financial climate alone should not lead to major changes in the scope, coverage level and funding of the Investor Compensation Schemes Directive (ICSD). **The purpose of the ICSD is to provide minimum protection to small retail investors in the event that an investment institution is unable to meet its obligations arising from investors' claims and has no early prospect of being able to do so due to reasons directly related to that institution's financial circumstances (e.g. bankruptcy or a moratorium of payment).** Therefore the ICSD should not be transformed into a vehicle to provide for protection of investors during financial crises<sup>1</sup>; it should maintain its original aim of providing for protection in a stable financial climate. Moreover, the ICSD should cover the same financial institutions and products throughout the European Union.
3. The EBF therefore understands to some extent the rationale behind the choice of issues raised by the Commission. The technical and legal aspects of these issues should however not be underestimated in the review process. **Any decision to amend the ICSD must be preceded and based on careful assessments of the appropriateness and impact of such modifications.**
4. The EBF would like to emphasize the **important difference between the protection of depositors on the one hand and the protection of investors on the other hand.** Unlike the depositor, the investor can fall back on a set of legal protection rules:
  - a. Unlike deposits on a deposit account, securities held in principle in a securities account fall outside the bankruptcy's estate in case of bankruptcy and the client (who remains the legal owner of the securities) will be able to reclaim them. It is only when securities are not included in a depot nor held by a bankruptcy remote vehicle, that the financial institution will not be able to restore financial instruments to their owner. In these cases compensation by the national investor protection scheme may be claimed.
  - b. Furthermore, the custody of financial instruments on behalf of clients is, since the implementation of the Markets in Financial Instruments Directive (MiFID), strictly regulated.
5. Consequently, **the ICSD provides for a backstop** in case other safeguarding measures, such as rules prescribing the segregation of clients' assets from the assets of the investment firm or investment bank, have failed. To prevent that safeguarding measures are not circumvented by the investment company, thorough supervision by the supervisors is a prerequisite.

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<sup>1</sup> See recital 23 of the ICSD which provides that the financing capacities, borne by investment firms, should not jeopardise the stability of the financial system of the Member State concerned.

## Responses to the Commission's questions

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

The technical nature of this question warrants further research and an impact assessment may be appropriate.

However, the primary objective of the ICSD is to provide minimum compensation to small retail investors against the risk of physical losses in case of the inability of an investment firm<sup>2</sup> to return assets held on behalf of the customer due to reasons directly related to its financial circumstances, e.g. where acts of fraud are committed.

The functioning of multilateral trading facilities (MTF) is a different issue as it is a trading platform. In general small retail customers are not likely to have access to MTF because of the criteria they have to meet to gain access as a participant (section 42 MiFID)<sup>3</sup>. The retail clients' investment firm or bank providing investment services will more likely trade at the MTF on the client's behalf. In the event of insolvency, the most that can happen is that orders will not be executed and price change risks will be realised; ownership rights will not, by contrast, be affected. **The client's assets, which are traded on a MTF, are consequently covered by the ICSD.**

For this reason, the EBF would advise that **MTF be excluded from the scope of the ICSD** and regulated separately in terms of provisions on liability.

### *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?*

No, it would not. As mentioned above the objective of the ICSD is to protect retail investors against losses of the investment firm holding the assets of the client. **The ICSD - financed by the investment firms sector - should not be kept liable for irregularities or illegal acts committed by entities which are not authorised to hold clients' assets.** An extension of the scope of application would also imply an unjustified and costly damage for conducting business.

The European Commission states (p.4) that an argument in favour of such an inclusion would be that clients do not perceive any limitations in authorisations and should consequently be compensated by the firm that does not hold clients assets. The EBF believes that it is unlikely that clients do not perceive limitations in authorisations since they must either open a securities account with a bank themselves or give their consent to an investment firm to open the bank account on their behalf. Appropriate information on whether the investment firm in question is covered or not by the ICSD would also be useful to ensure a high degree of investors' awareness.

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<sup>2</sup> Including credit institutions which also provide investment services

<sup>3</sup> They have to be fit and proper, have a sufficient level of trading ability and competence, have adequate organisational arrangements, have sufficient resources for the role they are to perform, taking into account the different financial arrangements that the regulated market may have established in order to guarantee the adequate settlement of transactions.

Only investment firms which hold any assets for third parties should adhere to the ICSD.

*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?*

In the current authorisation regime set out by MiFID, it is not possible to circumscribe the authorisation only to professional clients. Therefore, it would not in practice be feasible to exclude the investment firms providing services only to non-retail clients from the scope of the ICSD.

Nevertheless, the EBF would like to stress that professional investors are expected to conduct a survey on the manner in which investment firms make sure that they are able to return clients' assets and are expected to monitor the day-to-day business of their investment firm. Furthermore, **professional clients are less in need of protection than are retail clients**, which is why the protection of small investors is expressly mentioned in the ICSD recitals.

Consequently, the EBF believes that investment firms which provide their services only to institutional investors and professional investors should be excluded from the scope of the ICSD while retail clients should benefit from its protection.

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

No, they should not. Taking into consideration the objectives of the ICSD, it is not suited for compensation in these cases. **Compensation for failures at the level of third parties should, nevertheless, be based on existing separate national laws on non-contractual liability and laws on investment firms' use of third parties.**

*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?*

Investors in shares of UCITS should fully benefit from the guarantee provided that the management company and/or the UCITS financially contribute to the system. However, the EBF considers that the UCITS itself, as an institutional investor, should not be guaranteed.

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

No, they should not. **The ICSD does not aim at compensating investors for losses in case of violation of business rules.** Furthermore, the justification of a clients' claim on compensation in these cases depends on a complex submission of evidence before a court or board of appeal; if the bank in question were found liable to pay compensation, this **amount should be paid by the bankruptcy estate** as a preferential claim or concurrent claim depending on the jurisdiction. Joint and multiple liability for other banks' bad investment advice should not be introduced.

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

As noted in the general remarks, there are important legal differences between deposit protection and investor protection (§3 above). In addition, experience in Member States has so far shown no real problems at national level regarding investor protection schemes. Therefore, **any potential increase of the level of coverage should be based on a thorough analysis of the need to raise the minimum level and, if so, to what maximum level, considering the importance of customer confidence in the financial system.** Such analysis may very well prove that a smaller coverage level than that proposed in the revised Directive on Deposit Guarantee Schemes would suffice.

*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?*

No, the funding of the schemes should remain within the competence of the Member States. **Funding mechanisms currently vary across Member States, some being ex post, others ex ante and yet others a mix between both.** Moreover, in some Member States the Investor Compensation Scheme and the Deposit Guarantee Scheme are combined in one single fund, which implies that members pay one total contribution for both protection schemes together. In this situation, the funding mechanism of one scheme can hardly be discussed separately from the funding mechanism of the other and in any event, a revision of the ICSD should never result in the impossibility to combine DGS and ICS.

**Any amendment to harmonise the funding mechanism should only be proposed where a preliminary assessment has proven that benefits would exceed costs incurred.**

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

**No, it should not because the determination of the eligibility of the claim under the ICS is much more complex than it is under DGS.**

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

No, it should not. Most important is a careful and prudent investigation process regarding the eligibility of the claim. **Given the rationale of the ICSD, a provisional compensation is not necessary.** This does not mean that in case the prudent investigation shows that the client has a right for compensation such claim should not be paid out within a reasonable timeframe.

*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?*

No, they should not. **It is unclear what the additional value of such a ‘guarantee’ entails.** Compensations are only made after a careful and prudent investigation and compensation for rightful claims should be made within a reasonably period of time. In addition, it seems that such a ‘guarantee’ would only be suitable for an ex-ante fund but would have no value in case of ex post funding.

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

The EBF agrees with the Commission that investors in financial investments should not be protected from risks associated to their investments. **There should therefore not be any compensation from ICS for any investment losses in money market funds due to fund investments losing value.**

Since the purpose of the ICSD should not be to provide for guarantees in systemic crisis situations, the scope of the ICSD should not be extended to cover money market funds which would be deemed to be systemically relevant institutions. When a money market fund is systemically relevant, it (or the group of money market funds) has become too big to save by a guarantee scheme funded by other market participants.

As stated above, the ICSD provides for a backstop when other protection measures have failed. In the Federation’s view, investors in UCITS money markets funds should therefore **only be compensated under the ICSD in the event that UCITS safeguards on asset segregation and depositary oversight have failed.**

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