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from: Secretary-General of the European Commission,  
signed by Mr Jordi AYET PUIGARNAU, Director

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to: Mr Pierre de BOISSIEU, Secretary-General of the Council of the European  
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Subject: COMMISSION STAFF WORKING DOCUMENT  
SUMMARY OF THE 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

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Delegations will find attached Commission document SEC(2010) 846.

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EUROPEAN COMMISSION

Brussels, 12.7.2010  
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**COMMISSION STAFF WORKING DOCUMENT**

**SUMMARY OF THE 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**

{COM(2010) 371}

{SEC(2010) 845}

## **1. PROBLEM DEFINITION**

Recently there has been evidence of issues which if not addressed could be detrimental to investor compensation in the EU and to confidence in the use of investment firms. The problems identified can broadly be divided in three groups:

### **1.1. Problems experienced in the functioning of the Investor Compensation Schemes Directive (ICSD)**

*1.1.1. Funding of schemes:* Funding of schemes is currently left to national law. Only recital 23 of the ICSD sets some basic principles stating that the cost of financing schemes must be borne by investment firms themselves. The financing capacities of such schemes must be in proportion to their liabilities, although that must not jeopardize the stability of the financial system of the Member State concerned.

*1.1.2. Payout delays:* Article 9(2) of the ICSD establishes a strict deadline for reimbursement (as soon as possible and at the latest within three months). But, this deadline only runs once the "eligibility and the amount of the claim" have been established.

*1.1.3. Lack of investor awareness about the scope and coverage of schemes:* Article 10 of the ICSD requires Member States to ensure that investment firms make available to actual and potential investors information about the relevant investor compensation scheme including the amount and scope of cover. However, there are concerns that investors are not adequately informed about the potential coverage of the investor-compensation scheme.

*1.1.4. Technical issues about firm coverage and exclusion of claims involving market abuse:* Article 9(3) of the ICSD excludes claims where a criminal conviction has been obtained for money laundering but not claims by investors who have engaged in market abuse.

### **1.2. Inadequacy of the ICSD due to subsequent changes in the financial services industry and the EU regulatory landscape**

*1.2.1. Non-coverage of civil claims for breach of conduct of business obligations:* The ICSD currently only requires compensation to be paid for losses if an investment firm fails to repay money or return financial instruments held on a client's behalf. Other losses, due for example to a decline in the value of the investment or negligent investment advice by the firm, are not compensated under the ICSD.

*1.2.2. No coverage for non-retail clients:* The ICSD focuses on protecting "small investors". Non-retail clients can be excluded from coverage, unless the national scheme decides to cover losses of such clients.

### **1.3. Gaps in the regulatory system**

*1.3.1. Failure of a third party custodian:* Investors may be exposed to the failure of the firm, but also the potential failure of a custodian. In a case where a third party custodian is not able to return the financial instruments to its client, the client will not

be able to benefit from any compensation payment by the compensation scheme established under the ICSD.

1.3.2. *Non coverage of UCITS investors for the loss of the assets of a UCITS fund in case of bankruptcy of the UCITS depositary (or bankruptcy of a sub-custodian):* The management of a UCITS is not a service under the Markets in Financial Instruments Directive (MiFID). As a result, the ICSD does not cover UCITS and their units' holders in case a UCITS, via its depositary, loses its assets.

1.3.3. *Money market funds:* During the financial crisis, some money market funds in the EU and the US experienced difficulties leading to concerns about the risks associated with them and a rapid increase in investor redemption requests. The ICSD does not cover investment losses arising from financial instruments, including money market funds.

## **1.4. Reducing disparities between the protection of clients of investment firms and banking depositors**

1.4.1. *Minimum level of compensation:* Article 4 of the ICSD harmonizes the minimum level of compensation (€20 000) for each investor. The compensation limit of €20 000 was never adjusted to reflect inflation or the increased exposure of European investors to financial instruments since the ICSD commenced. Furthermore, the Deposit Guarantee Schemes Directive (DGSD) was recently amended to provide for at least €50 000 per investor per investment firm, increasing to a fixed level of €100 000.

1.4.2. *Co-insurance:* Article 4(4) of the ICSD allows Member States to limit the coverage of the compensation to a specified percentage (equal to or exceeding 90%) of an investor's claim. This means that a client can be required to bear a proportion of the loss (within the compensation limit) aiming at encouraging investors to take some care in choosing investment firms.

## **2. THE BASELINE SCENARIO, SUBSIDIARITY AND PROPORTIONALITY**

The problems detected in section 1 cannot be efficiently addressed at Member States level as they stem from existing EU legislation and can only be addressed through changes in EU legislation. The European Commission considers that the solutions proposed respect the principles of subsidiarity and proportionality.

## **3. OBJECTIVES**

The review of the ICSD aims at (i) improving the functioning of the ICSD to ensure that it provides sufficient investor protection for clients of firms and confidence in the use of investment services; (ii) updating the ICSD in areas where it has become inadequate due to changes in the financial services industry and in the regulatory landscape; (iii) reducing gaps in the regulatory system and (iv) ensuring that recent amendments to the DGSD (upon which the ICSD was initially modelled) do not result in unjustified differences in the protection provided to depositors and investors using investment firms.

## 4. POLICY OPTIONS

With the intention to meet the objectives set out in the previous section, the Commission services have analysed different policy options:

### 4.1. Policy options for improving the functioning of the ICSD.

4.1.1. *Policy options relating to funding of investor-compensation schemes:* (i) No action at EU level on this issue; (ii) Harmonise how schemes should be funded; (iii) Introduce a solidarity principle between the national schemes; (v) Create a pan-European scheme.

4.1.2. *Policy options relating to reducing payout delays:* (i) No action at EU level; (ii) Link the deadline for payouts to the trigger events; (iii) Introduce an obligation for schemes to provisionally pay partial compensation if the payout delay exceeds a given time period.

4.1.3. *Policy options relating to lack of awareness by investors about the scope of the ICSD:* (i) No action at EU level; (ii) Amend the ICSD to require firms to disclose to investors in clear and simple terms what is covered and what is not covered by schemes (e.g. investment risk is not usually covered).

4.1.4. *Policy options relating to coverage of firms operating MTFs and firms acting outside their permission:* (i) No action at EU level; (ii) Clarify that firms which are not authorised to hold clients assets are not covered under the ICSD; (iii) Clarify that if firms do in fact hold client assets (irrespective of restrictions on their permission or the nature of their investment service) then clients should be entitled to compensation under the ICSD if the firm defaults.

4.1.5. *Policy options relating to excluding claims involving market abuse:* (i) No action at EU level; (ii) Amend the ICSD to expressly exclude claims for compensation by persons who have engaged in market abuse; (iii) Leave it to Member States to decide whether transactions where market abuse was involved are to be excluded from compensation.

### 4.2. Policy options in areas where the ICSD is no longer adequate due to changes in the financial services industry or in the regulatory landscape

4.2.1. *Policy options relating to coverage for claims where there has been a breach of conduct of business obligations:* (i) No action at EU level; (ii) Extend compensation to cover unpaid claims for any breach of conduct of business requirements against a firm that defaults; (iii) Extend compensation to cover unpaid claims for a limited set of breach of conduct of business requirements.

4.2.2. *Policy options relating to coverage for non-retail clients:* (i) No action at EU level; (ii) Extend compensation to claims relating to non-retail clients; (iii) Extend compensation to certain non-retail clients (e.g. local authorities or large corporates).

4.2.3. *Policy options relating to aligning the classification of clients with the MiFID definitions:* (i) No action at EU level; (ii) Introduce a new classification of clients

under the ICSD based on pure quantitative criteria; (iii) Align the ICSD with the MiFID as to the classification of clients.

#### **4.3. Policy options for reducing gaps in the regulatory system**

4.3.1. *Policy options relating to non-coverage for failure of a third party custodian:* (i) No action at EU level; (ii) Provide in MiFID that firms should be strictly liable to a client for any failure of a custodian they appoint; (iii) Extend compensation to investors for claims relating to the failure of a firm to return financial instruments due to failure of a third party custodian.

4.3.2. *Policy options relating for the loss of the assets of a UCITS fund in case of bankruptcy of the UCITS depositary (or bankruptcy of a sub-custodian):* (i) No action at EU level; (ii) Extend compensation within ICSD to UCITS funds for assets that have been lost by a depositary (or sub-custodian); (iii) Amend UCITS directive to strengthen safeguards that apply to depositaries and sub-custodians; (iv) Extend compensation to UCITS holders where their investments have lost their initial value as a result of the loss of assets by a UCITS depositary or its sub-custodian.

4.3.3. *Policy options relating to non-coverage of money market funds:* (i) No action at EU level; (ii) Introduce new requirements in the UCITS directive to define "money market funds" and strengthen requirements for such funds; (iii) Extend compensation under the ICSD to loss of value of units of "MiFID qualifying money market funds".

#### **4.4. Policy options for maintain some alignment between the ICSD and the DGSD.**

4.4.1. *Policy options relating to the minimum level of compensation under the directive:* (i) No action at EU level; (ii) Amend the ICSD and replicate the coverage adopted under the DGSD; (iii) Amend the ICSD to increase the minimum level of compensation to €50 000, but allow individual Member States to specify a higher limit; (iv) Amend the ICSD to increase the level of compensation to €50 000 and require all Member States to apply this fixed level of compensation (maximum harmonisation of the coverage level with a grandfathering clause for the Member States with a higher limit).

4.4.2. *Policy options relating to the co-insurance principle:* (i) No action at EU level; (ii) Modify the co-insurance principle; (iii) Remove the possibility of co-insurance.

### **5. ASSESSMENT AND COMPARISON OF THE OPTIONS**

The different policy options are tested against the criteria of investor protection and confidence, level playing field and cost-effectiveness. In view of the conclusions reached in the impact assessment, the European Commission considers appropriate to present a proposal amending the Investor Compensation Schemes Directive in order to address the following issues:

- Modify the Directive to provide for more detailed harmonisation of funding and for a borrowing mechanism between national compensation schemes.

- Article 9 should be amended to provide for a provisional payout of partial compensation to investors within a specified period if final payment has not been made within that period.
- Article 10 should be amended to require firms to provide clear information about what is covered and what is not covered under the scheme (e.g. that investment risk is not covered).
- Article 4(2) and Annex I should be amended in order to align the definition of retail investors in the ICSD with the definition in MiFID.
- A new provision should be included to clarify that firms are covered under the Directive if they in fact hold client funds irrespective of the type of investment service they provide or whether they are doing so in breach of a requirement on their authorisation.
- Article 3 should be amended to exclude claims for compensation by a person who has engaged in market abuse.
- Article 4(1) should be amended to increase the compensation level to €50 000.
- Article 4(4) should be amended to remove the co-insurance principle.
- Various articles should be amended to provide that compensation should be payable if a retail investor suffers loss due to the failure of a third party custodian appointed by the firm to hold financial instruments for the client.
- Various articles should be amended to provide that compensation should be payable to a unit holder of a UCITS scheme if the retail unit holder suffers loss due to the failure of a depositary or sub-custodian of the scheme.

In addition the Commission is currently analysing the possibility to:

- amend UCITS to strengthen safeguards that apply to depositaries and sub-custodians
- take action to strengthen requirements applying to Money Market funds.

## **6. IMPACTS OF THE PREFERRED OPTIONS**

The impact of the changes comprising the preferred policy options in relation to the main stakeholders are the following:

- a) *Harmonise how schemes should be funded.* Investor protection and confidence will be reinforced as these principles and rules will reduce the risk of a scheme having insufficient funding to meet its obligations. There will also lead to an increased harmonisation of the level of investor protection between Member States. Investment firms will be required to provide more contributions ex ante which would increase the funding costs; however, the increased harmonisation of the funding rules will improve the proper functioning of the single market by reducing discrepancies affecting the treatment of investment firms between Member States.

- b) *Introduce a solidarity principle in the context of the European system of national schemes.* Investor protection and confidence will be reinforced through borrowing possibilities among national schemes.
- c) *Require provisional payout of partial compensation if payout delay exceeds a given time period.* Investors will be confident that they will receive part of the compensation amount after a given time period.
- d) *Require firms to disclose to investors what is covered and what is not covered by ICSD schemes.* It will increase investor awareness of the level and scope of coverage.
- e) *Compensate investors under the ICSD for claims relating to failure of a firm to return financial instruments due to failure of a third party custodian.* It will increase protection for investors and increased funding will be required.
- f) *Extend compensation to UCITS unit holders where their investments have lost their initial value due to the loss of assets by a UCITS depositary or a sub-custodian.* It will increase investor protection and confidence. New contributions will be required from UCITS.
- g) *Clarify that if firms do in fact hold client assets the clients should be entitled to compensation if the firm defaults.* It will increase investor protection and confidence.
- h) *Exclude coverage of claims when market abuse was involved.* It will improve investor confidence and market integrity.
- i) *Increase the level of compensation to a fixed amount of €50 000.* It will increase harmonisation of the level of investor protection between Member States. Contributions required from investment firms will be increased. The higher compensation limit for investments will reduce the competition distortion between investing in deposits and investment products.
- j) *Remove the possibility of co-insurance.* Investors will receive consistent treatment across Member States. Contributions required from investment firms will be slightly increased.

## **7. MONITORING AND EVALUATION**

The Commission is the guardian of the Treaty and therefore will monitor how Member States have implemented the changes of the ICSD. Where needed, the Commission services will offer assistance to Member States for the implementation of the legislative changes in the form of transposition workshops with all the Member States or bilateral meetings at the request of any of them. When necessary, the Commission will pursue the procedure set out in Article 258 of the TFEU in case any Member State fails to respect its duties concerning the implementation and application of Community Law.

As the number of investment firm failures leading to their inability to return the securities and monies held on behalf of retail investors are unpredictable, the functioning of the ICSD cannot be regularly monitored on the basis of how investment firm failures are handled. Nevertheless an evaluation of the consequences of the application of the legislative measure

could take place three years after the transposition deadline of the legislative measure. Such review could be performed jointly by the European Commission and by ESMA. This review should include an analysis of: (i) the possible complaints received by the European Commission, (ii) how concrete cases have been handled, and (iii) how national ICS do comply with the new requirements in terms of funding and disclosure of information. The review should be disclosed to the Council and the European Parliament.