

# THE INVESTORS' COMPENSATION FUND

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## **CALL FOR EVIDENCE ON THE REVIEW OF THE INVESTOR COMPENSATION SCHEMES DIRECTIVE**

The Finnish Investors' Compensation Fund (ICF) welcomes the opportunity to comment on the European Commission's call for evidence on the Investor Compensation Schemes Directive (Directive 1997/9/EC) ("ICSD"). 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 (Directive 2004/39/EC) ("MiFID") to cover new financial services.

### **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 to return client assets due to reasons directly related to its financial circumstances, e.g. where acts of fraud are committed.

As the Commission states, a multilateral trading facility (MTF) is essentially a trading platform and including MTFs to the scope of the ICSD would seem artificial. In general, small retail customers are not likely to have access to an MTF because of the criteria they have to meet to gain access as a participant (section 42 MiFID). 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 traded on an MTF, are consequently covered by the ICSD.

For this reason, the ICF would advise that MTFs would 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.

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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 inclusion would be that clients do not perceive any limitations in authorisations and should consequently be compensated by the firm which does not hold clients assets. The ICF 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 shall 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 ICS would also be useful to ensure a high degree of investors' awareness.

### **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?**

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 ICF believes that the scope of the ICSD should not be broadened to professional investors.

However, in the current authorisation regime set out by MiFID, it is not possible to circumscribe the authorisation only to professional clients. Therefore, it would be impossible to exclude from the scope of the ICSD the investment firms providing services only to professional clients. A client also has, under MiFID, a right to ask to be treated as professional investor, even though he or she was, in fact, a retail client.

### **4) Failure of third parties**

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

#### **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?**

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.

### **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 investment firm in question were found liable to pay

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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 investment firms' bad investment advice should not be introduced.

There are also other means to redress the investor for the losses suffered as a consequence of violation of conduct of business rules, such as financial ombudsman or a securities complaint board.

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

There are important legal differences between deposit protection and investor protection. 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 DGSD would suffice.

However, the ICF deems that the covered amounts should be converged - if not aligned - in order to avoid distortion between different investment or savings products. The distortion may become more apparent if the minimum level of deposit guarantee is raised to 100.000 euros and the minimum level of the investor compensation remains at 20.000 euros.

## **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 (ICS) and the Deposit Guarantee Scheme (DGS) 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 ICS and DGS.

Any amendment to harmonise the funding mechanism should only be proposed where a preliminary assessment has proven that benefits would exceed costs incurred. It is essential to guarantee that incoherent funding systems do not jeopardize a level playing field for the participating banks and investment firms within the EU.

## **8) Restrictions on carryover of the reimbursement debts**

### **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?**

No. Carryover of the reimbursement debts is not applicable to Finland.

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## **b) Should this kind of mechanism be prohibited?**

Since the ICF is not familiar with the mechanism and it is not applicable to Finland, we do not have comments on this question.

## **9) Reduction of payout delay**

### **a) 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 ICSD is much more complex than it is under DGSD.

### **b) 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.

### **c) Irrespective of the harmonization 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 'guarantee' entails. Compensations are only made after a careful and prudent investigation and compensation for rightful claims should be made within a reasonable period of time. In addition, it seems that such '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 ICF agrees with the Commission that investors in financial instruments 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, albeit money market funds have been considered equal to client funds in MiFID (Level 2 Directive, article 16.1(e)).

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 ICF'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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**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?**

## **Abolishing the co-insurance**

Given that co-insurance is abolished in the DGS regime, the Commission should consider abolishing it also from the ICSD. The Northern Rock case in the UK proved that the depositors, as well as investors, are as worried to lose a percentage of their savings or investments as they are to lose all of it.

## **Topping up and supervision**

The problems of supervision and topping-up should also be assessed. If the investment firm seeking to top up is a major business, it will very likely pose a risk of insufficient supervision. The ICF suggests, that the investor compensation, as well as deposit guarantee, should be borne completely on the home state schemes, aligned with the home/host supervision principle. We acknowledge that this is part of a wider supervision issue that is currently being tackled by the *de Larosière* Group and the Commission.

Sincerely yours,

**THE FINNISH INVESTORS' COMPENSATION FUND**

Board of Directors