

Magdalena Jagodzińska

ESME Member

Mr. Charlie McCreevy

European Commissioner for Internal Market and
Services

European Commission

April 8th, 2009

Re: Call for evidence in relation to the investor compensation schemes in the European Union

Dear Mr. McCreevy,

As a financial market practitioner I welcome the initiatives of the European Commission aiming at increasing confidence of investors in the financial markets and bringing improvement to solutions employed by the industry. At the same time I appreciate the opportunity we have been given to comment on the approach to the modification of investors' compensation schemes law.

Following the financial crisis and its impact on the situation of market participants and investors in different Member States it is indeed crucial that the governing authorities of the European Union should undertake measures to heal the situation. These measures should include the review of the existing legal framework as well as the effectiveness of the supervision over the financial markets and the quality of national laws adopted in Member States including the quality of transposition of the Community Directives. However, during this exercise, the potential (adverse) effect and impact of any actions executed at the European level on the markets and market players should always be identified, measured and adequately approached.

Solutions which would significantly increase the costs and bureaucracy within the industry without being visibly accompanied by an awaited improvement should be avoided. Principally, the measures taken should be directed at the enhancement of the common market qualities and the quality of supervision.

I am very skeptical about the current approach to make the legislation more stringent as without the efficient and well-organized supervision it can simply lead us to overregulation, and in consequence bring no added value for the industry and investors. Indisputably, after new rules introduced e.g. by MiFID as well as recent market developments, the in-depth review of the binding legislation and market practices is necessary. Nevertheless, such a review should primarily focus on finding and addressing the gaps in the legal framework, and not necessarily on strengthening the requirements.

It should be recognized that the existing European legal framework as such is quite comprehensive. The part which still requires attention is, however, uniform and timely transposition thereof in individual Member States. And this is the area where the role of the European Commission, as the guardian of

such common approach across the European Community, is paramount. The next matter to be considered is the supervision over the market to ensure that the market participants do observe the rules and principles as set forth by the legislation. Replacing such supervision with more strict legal provisions (e.g. compensation scheme for clients of companies which operate without a proper authorization, or do not observe MiFID requirements whereas such incidents should be in fact eliminated by effective supervision) will not bring the outcome which I believe is expected by the Commission. But it will surely increase the costs of the relevant market participants which will be eventually paid by the investors themselves.

Below I include the answers to the questions raised by the Commission in the Call for evidence.

Question 2)

Would it be appropriate to include in the scope of the ICSD all investment firms seeking authorization to the provision of investment services, although their authorization would not allow holding clients' assets?

This question has to be answered basing on the analysis of underlying residual risks. Let us assume that an investment firm, or UCITS management company, provides discretionary asset management services and does not safe-keep assets. The assets will have to be held by a third party upon an additional contract. The third party authorized to provide this kind of activity and participation in the compensation schemes (this should be a mandatory condition) will charge our investment firm (eventually the client) for the service. Moreover, it will have to participate in the compensation scheme; therefore the assets of clients of our investment firm are actually covered by the scheme. Therefore, we need to answer the following questions: what would be the purpose to include the investment firms which do not hold investors assets in the compensation scheme? And what are the risks for investors if these firms are exempted from the scheme? If the main risk addressed by the ICSD is that in case of a failure of an investment firm, the assets of client are protected by the compensation scheme, this condition is already met. Furthermore, the failure of the investment firm / UCITS management company which does not hold clients' assets should not influence the security of these assets as they will be safe-kept by another institution. Moreover, securities registered on the securities account maintained on behalf of client, in case of the failure of the entity holding the account, should be moved to another investment firm, therefore, the risk to be covered by the compensation scheme should regard the cash account with the insolvent entity.

Hence, it is not necessary to include in the scope of ICSD those investment firms / UCITS management companies authorized to provide discretionary asset management which do not hold clients' assets as it would be duplication of fees paid to the compensation scheme / deposit guarantee scheme in regard to the same assets and will not offer additional benefit (in a sense of protection of assets).

If there are Member States where similar coverage of investors is not guaranteed, the solution for me would be more standardized rules for compensation schemes with a limited leeway for national jurisdictions.

Question 3)

Would it be appropriate to include in the scope of the ICSD all investment firms seeking authorization to the provision of investment services, although they provide their services only to non-retail clients?

I would support the approach where the assets held on behalf of all types of clients are subject to the compensation scheme. It is difficult to see a reason why an investment firm should be exempted from participation in a compensation scheme in regard to the assets held on behalf of certain type of entities. However, I would recommend the cost-analysis of such solution.

Question 4a)

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

The situation discussed in the Call for evidence seems to relate to a few different situations:

- 1) Investment firm licensed to hold clients' assets decides to "outsource" this activity to a third party.

In this situation it seems that the assets of clients are actually covered in the compensation scheme, as the third party to which this service is "outsourced" should be duly licensed and should participate in the compensation schemes in regard to these assets. If this is not the case, and the investment firm chooses the third party who does not participate in the compensation framework, it should indeed pay fees in regard to the assets transferred (or it should be mandatory that the third company participates in the compensation schemes in regard to this assets). The idea should be that all clients' assets are covered by the scheme and it should clear from the legal perspective what rights the investor has and from which party he should claim the reimbursement.

When it has been identified by the Commission during the research that in the case described above the assets held on behalf of client are not covered by any compensation fees (neither of the parties to the outsourcing agreement participate in the investors compensation scheme in regard to these assets) it should be considered as an evident gap which needs legislative action.

- 2) Investment firm licensed to hold clients' assets maintains clients' cash account in the bank/ cash account in the third investment firm (for the purpose to settle transaction).

Discretionary portfolio management activity requires that there is a security account and a cash account held on behalf of a client. As long as the cash account is maintained by the bank, this account should fall under the scope of the deposit guarantee scheme. In case the cash account is maintained by the investment firm itself, it should be already covered by a compensation scheme.

Again, if a gap has been identified in this regard, the action on behalf of the Commission is required.

- 3) Investment firm licensed to hold clients' assets transfers financial means in order to settle the transaction made on behalf of the client.

The payment for purchase of securities (transaction) should usually take place at the date of settlement, which is different in respect to different types of financial instruments, markets or transactions (the exception may be initial offerings where the date and manner of payment is defined in the offering documents). However, I am not convinced whether it would be feasible and practical to create a compensation scheme which would cover this type of risk (money in transfer to cover the transaction pending settlement). Regarding the cash accounts maintained by an investment firm in another investment firm, the practical arrangements thereof should be analyzed.

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 fails to perform its duty?

- 4) Credit institution, or other entity, acting as a depositary holds clients' assets (assets of collective investment schemes, pension funds).

Beyond doubt assets held by a depositary for the account of collective investment vehicle (UCITS, other type of mutual funds, pension funds, unit-linked products) should receive some type of protection. If this is the case that in certain Member States this kind of assets are not subject to any protection (including any type of compensation scheme, deposit guaranty scheme, etc.) in case a custodian turns out to be insolvent this issue should be addressed. Therefore, it is vital that the assets of investment funds safe-kept by custodians be included in the adequate compensation system / deposit guaranty system. The Commission's document refers in this context to the possibility of the individual investor to claim compensation from the defaulting party. Hence, I would rather support the proposal to enable an investment vehicle as such (or an operator thereof in case of contractual investment vehicles which do not have legal personality) to request compensation of behalf of all clients of the investment vehicle.

Furthermore, all this must be considered bearing in mind significant differences in organization and functioning of market participants in different Member States, like: legal form of entities (e.g. UCITS), type of instruments issued by those entities (e.g. units in some investment vehicles are securities, and the other do not have such status; this differs not only according to the type of funds, but also within the UCITS products created in different jurisdictions), or the type of ownership rights (e.g. beneficial owner or lack of the recognition thereof in the national legislation) what also significantly influences the transactions' settlement process.

Question 5)

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

Like it has been already indicated in this response, no measures taken in regard to alter / improve compensation scheme model can replace the effective supervision. Incidents of violation of the law (here: MiFID) should be identified and adequately handled by the national regulator. And it should be the responsibility of those regulators to create proper regulatory framework (including timely

implementation of the Community Directives) and be able to execute obedience thereof. It is not reasonable to make market players (=investors) finance the compensation program aimed at reimbursing clients who suffered loss because a duly licensed entity did not carry out its business according to the law.

The goal of MiFID was to enhance protection of (retail) investor in the financial markets. It had a major impact on the way investment firms and other entities falling under the scope of this directive do their business. MiFID impacts the internal organization of investment firms, communication to (potential) clients, introduces the requirement to clearly define and communicate the risk connected with products offered. And naturally it translated into increase of costs of providing the financial services.

Despite the importance of MiFID's role for the investor protection, there are Member States which have not fully implemented the directive until today. Consequently, the investors in these countries cannot benefit from its provisions. And in case of those Member States who adopted the directive, the approach is not really consistent across the Community. I truly believe that those should be the top priorities for the European Commission – to ensure that the relevant directives are rolled out properly and in a uniform way in different jurisdictions. And the role of national regulators should be creating an effective system of supervision over financial markets.

Costly solutions which transfer the responsibility for ineffective market supervision to market players are not the response the industry and investors await, given the circumstances. Especially that these are the industry and investors who will bear the final costs of such measures.

Therefore, I would recommend rather revising MiFID in regard to certain solutions and the scope of entities / operations to which it should apply (e.g. including regulated investment vehicles in the scope) and diagnosing why it does not work in certain cases instead of introducing the proposed solution which can actually bring more harm than good to the industry.

Question 6)

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

If it was indeed the initial goal of the two directives that the levels of compensation schemes introduced by them should be consistent, I would support some alignment in this area. However, while reviewing ICSD in this regard the attention should be paid to the difference in the scope and size of operations carried out by different entities subject to these directives.

Question 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?

I believe the time has come when the effort should be made in order to obtain more harmonization and consistency among different jurisdictions of the European Union in this matter, as well as in the others. This is the only way that leads towards common European market and reaching the level playing field across the European Union.

For this reason any potential amendment to ICSD should include some general principles of the compensation schemes and address the most important areas which were identified to be significantly different among different Member States. The model of a compensation scheme should be standardized within the possible legal frameworks of different jurisdictions. This will ensure equal treatment of investors in all Member States as well as make it easier for the clients' of foreign branches to understand the relevant provisions which are applicable to their assets held by such a branch.

Question 10)

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

Including of any type of collective investment schemes in the investor compensation program should be definitely abandoned. Which purpose such solution will serve to?

When we take a look at the concept of an investment fund we can see that this is an institution created to invest the capital raised from the public in financial instruments and which operate on the principle of risk-spreading¹. Moreover, an investment fund (e.g. UCITS) is required to inform the investor about the investment limits, risk associated with the fund portfolio, information that the price of unit may be volatile depending on the valuation of instruments in the portfolio and all marketing materials should include information that the assets of an investment fund are priced according to the market value so an investor may withdraw less money than initially invested in the fund. Additionally, the UCITS Directive requires that upon request of the client, an investment fund should provide him with *"supplementary information relating to the quantitative limits that apply in the risk management of the UCITS, to the methods chosen to this end and to the recent evolution of the main instrument categories' risks and yields"*². To sum up, an investment fund (especially UCITS) is intended to be a safe product with diversified portfolio. The market risk, credit risk, counterparty risk, interest risk, etc. are closely connected to any investment in capital market and through the employed methods of risk management can be limited/controlled but not eliminated. For this reason, including of any types of collective investment schemes in the investors' compensation in the context of potential losses that may impact investors should not even be considered. Rather steps should be taken in order to educate the investor about the risk connected to investing in capital markets.

However, in order to handle this issue with adequate care (and bearing in mind that not all investment funds offered across European Union are licensed as UCITS) I think that the following steps might be considered by the Commission in this analysis:

- including of investment funds in the scope of MiFID requirements regarding product classification (level of risk), clients' classification, communication and disclosures to investors.

This is the practice in majority of cases anyway, as the distributors of units in collective investment schemes are subject to MiFID requirements in regard to all financial instruments they offer and this covers units of CIS. However, MiFID should be reviewed in such a sense

¹ Article 1, par. 2, first indent of the Council Directive 85/611/EEC

² Article 24a par. 4 of the Council Directive 85/611/EEC

that only those requirements which really influence the investors' awareness should apply to investment funds, like information about risk level and guarantee of proper information and due care of fund managers, as well as ensure that fund managers observe the conflict of interest principles, etc. Not all MiFID requirement should apply to investment funds.

- pan-European fund classification initiative

Adopting well-defined fund categories with clear allocation criteria and key principles of model portfolio will help investors to select the product which is optimal from the point of view of their risk profile. The initiative of EFAMA in this respect is worthwhile and should be further developed³. Nevertheless, I am not convinced this kind of "regulation" should be formalized in a form of Commission's directive. Either Commission's regulation (effective for all but with direct application without the need to make national transposition) or guidelines (less formal) should be the preferred option. Merging this with (partial) application of MiFID to investment funds should increase transparency in this field.

In this part I would like to directly relate to the suggestion of having a special approach to money market funds: if we manage to create a pan-European definition of a money market fund which would impact the structure of its portfolio, the (market) risk connected to this types of products should be coherent and not misleading practices should be observed. Money market funds as such due to the type of assets they invest in should be secure and liquid products.

- If in a given jurisdiction units of collective investment scheme are to be registered on the securities account and are held by an investment firm or any other authorized institution this account should be subject to compensation plan (this relates to money market funds). This must be, however, preceded by an analysis of the types of legal structures which can be used for an investment funds across Europe to see if the scale is large enough to be addressed in the Commission's regulation.

Question 11)

Based on the concrete application of the ICSD do you see further issues other than the ones mentioned on the present document that might be of relevance to this analysis?

- 1) Branches of foreign investment firms

The analysis should cover the manner the branches of foreign investment firms participate in the compensation schemes in the regard to the assets held on behalf of clients in the host countries. I refer to the practical approach of how (and to which authority) the clients of a branch should go in case of insolvency of such a firm, and how they will be compensated from the compensation scheme operating in the home country of the investment firm. It is valuable to check the efficiency of this system, and the awareness of investors about the way it works (are they informed about the rules by a branch?).

³ The European Fund Classification. An EFAMA Project to Facilitate the Comparison of Investment Funds: A Pan-European Approach (June 2008)

Of course, I am far from suggesting the approach that a branch should participate in the compensation scheme in the host country – the current solution should suffice. However, the practical functioning of the system should be verified.

2) Investment advice

The “Evaluation of the ICSD” mentioned the option to extend the compensation scheme to “bad” investment advice. At this point I would like to refer to my earlier comment regarding the goal of MiFID which introduces a set of principles to be observed by investment firms in order to ensure higher protection level of the investor. Implementation of MiFID as such is already a measure undertaken to protect the investor. The organizational framework of an investment firm including units of compliance, risk management and a separate internal audit team should guarantee the appropriate level of risk mitigation, whereas the reporting and information requirements towards the regulators and clients should ensure transparency.

Moreover, it is very difficult to define a “bad” investment advice in such a way which would ensure that this possibility is not abused by the investors acting in a bad faith. Any legal framework in this regard could not be completely free from the possibilities of abuse and frivolous, groundless litigations. Also there is the question of how such a compensation scheme should be financed and what be the impact of additional fees to be paid by investment firms subject to such scheme on the price the final investors will have to pay for their service?

I would advise not to include investment advice services in the compensation schemes but rather concentrate on carrying out the effective supervision over the entities which are in the scope of MiFID (maybe even extend the provisions of the directive onto additional entities now not in scope if this seems necessary).

Kind regards,

Magdalena Jagodzinska