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signed by Mr Jordi AYET PUIGARNAU, Director

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Subject: COMMISSION STAFF WORKING DOCUMENT  
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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EUROPEAN COMMISSION

Brussels, 12.7.2010  
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**COMMISSION STAFF WORKING DOCUMENT**

**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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## 1. INTRODUCTION

The Directive 97/9/EC on Investor-Compensation Schemes (ICSD<sup>1</sup>) was adopted in 1997 to complement the Investment Services Directive<sup>2</sup> (ISD). The ISD has since been replaced by the Markets in Financial Instruments Directive (MiFID).<sup>3</sup> The ICSD provides for clients receiving investment services from investment firms (including credit institutions) to be compensated in specific circumstances where the firm is unable to return money or financial instruments that it holds on the client's behalf. The Directive applies to intermediaries providing investment services. It does not apply to insurance undertakings, pension funds or other types of funds.

### 1.1. Objective of the Directive

The ICSD's main objective is to assist the proper functioning of a single market for investment services and encourage the use of investment services across the EU. By providing for a minimum level of harmonisation of compensation schemes, it aims to eliminate competitive distortions that could arise and prejudice the operation of the internal market if Member States were to impose their own compensation scheme requirements on passporting firms<sup>4</sup>. The investor protection it provides also encourages retail clients to use investment services across the EU with confidence that they will receive a certain minimum level of protection.<sup>5</sup>

The ICSD only contains the minimum harmonisation necessary to achieve its objectives. Many topics, such as the legal form, the organisation and scheme funding, are currently left to the discretion of the Member States.

### 1.2. Situations in which the Directive provides for compensation

The ICSD protects clients when they entrust money or financial instruments to an investment firm. Clients must be compensated by schemes in two limited situations derived from reasons directly related to the financial circumstances of the firm:

- 1) if a firm is unable to repay money owed or belonging to a client and held on the client's behalf in connection with investment services; or
- 2) if a firm is unable to return to a client a financial instrument belonging to the client and held, administered or managed on the client's behalf.<sup>6</sup>

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<sup>1</sup> Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes, OJ L 084, 26/03/1997 P. 0022 - 0031

<sup>2</sup> Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field; OJ L 197, 6.8.1993

<sup>3</sup> Directive 2004/39/EC, OJ L 145, 30.4.2004

<sup>4</sup> Investment firms are able to use the MiFID passport to provide services to customers in other EU member states. These services are regulated by the home Member State.

<sup>5</sup> Recitals 4 and 5 of the ICSD.

<sup>6</sup> MiFID investment services where an investment firm may hold client money or financial instruments for a client include where it is executing client orders, receiving and transmitting orders for

Claims under the Directive will typically arise due to fraud or other administrative malpractice within the firm or due to firm default derived from errors, negligence or problems in the firms' systems and controls.

### **1.3. The Directive does not compensate for losses due to investment risk**

The ICSD does not compensate investors for "investment risk" (the risk that an investment will result in a loss) e.g. if a share or unit declines in value or there is default in payment of a bond. A variety of potential risks are inherent in any investment decision. An investment may suffer loss due to the underlying assets falling in value, the market falling, a counterparty or depository failure, problems with the business of a company or entity that issued the investment or for any number of other reasons.

Investing in financial instruments by its nature involves investment risk. It is not appropriate for investors to be compensated for this risk or to try to legislate to eliminate the risk. Compensating investors for losses due to investment risk would create moral hazard issues and involve significant cost. Further, it is difficult to justify compensating for one type of investment or risk without setting a precedent that should be extended to all other types of investments or risks.

While it is not appropriate due to the expense and for moral hazard reasons to compensate investors for losses due to investment risk, various other Directives include protective measures designed to ensure that investors understand the risks involved in an investment and receive advice or portfolio management services that match their individual risk appetite. For example:

- the prospectus and the summary in the prospectus must identify and warn investors of the risks associated with an investment;<sup>7</sup>
- when providing investment advice or portfolio management services, investment firms are required under MiFID to ensure that investments recommended are suitable for the client;<sup>8</sup>
- investment firms must ensure that appropriate information is provided to clients so that they are reasonably able to understand the nature and risk of any investment being offered and can take an investment decision on an informed basis.<sup>9</sup>

But it is important to note that these measures are not designed to eliminate investment risk or compensate investors for this risk.

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a client, providing discretionary portfolio management services or in connection with providing investment advice.

<sup>7</sup> Article 5 of Directive 2003/71/EC

<sup>8</sup> Article 19.4 of Commission Directive 2004/39/EC

<sup>9</sup> Article 19.3 of Commission Directive 2004/39/EC

#### **1.4. Safety net**

Compensation schemes only provide a last resort safety net for clients of investment firms if other important safeguards fail. Compensation schemes cannot be the principal means of protecting investors but a last resort measure that applies when all of the main protections fail.

MiFID is the principal means by which clients receiving investment services are protected against risks arising from the firm holding their assets. For example, it imposes detailed requirements on investment firms relating to their systems and controls and the holding of money and financial instruments for clients (segregation of assets, who may hold client funds, use of custodians etc)<sup>10</sup>. These are the principal regulatory protections intended to protect clients against the risk of their assets being lost or stolen or being claimed by creditors in the event of the firm's insolvency. In theory, if firms always complied with the detailed MiFID requirements then the need for compensation should rarely arise. But the ICSD (like the other compensation directives) recognises that in practice full compliance with regulatory requirements cannot always be guaranteed.

#### **1.5. Retail investor focus**

The ICSD focuses on compensating retail investors. There are references throughout the Directive to protecting "small investors"<sup>11</sup> and also the amount of compensation (currently € 20,000) is targeted to their situations. This is consistent with principles underlying the MiFID<sup>12</sup> (and before that the ISD) which provide the highest level of protection to retail investors. Professional investors are presumed to have greater knowledge and resources and therefore to be better able to understand the nature of the investment services they receive, to bargain to protect their own interests and if necessary to take action to enforce their rights.<sup>13</sup>

#### **1.6. Different objectives of deposit and insurance compensation schemes**

Other types of compensation schemes (such as banking and insurance schemes) also provide a certain level of investor protection but have different underlying objectives to investor compensation schemes under the ICSD.

The Deposit-guarantee schemes directive (DGSD)<sup>14</sup>, setting up the deposit-guarantee schemes, has an important banking stability objective. It provides for depositors to be compensated up to a specified limit if the bank is not in a position to pay back the

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<sup>10</sup> Article 18 of Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (OJ L 241, 2.9.2006, p. 26)

<sup>11</sup> Recitals 4, 5 and 11 and Article 4 of Commission Directive 97/9/EC  
<sup>12</sup> Article 19 of MiFID

<sup>13</sup> A review of MiFID is scheduled to take place in 2010. During that review if necessary issues relating to protection of non-retail investors will be considered, in particular at the level of distribution channels and conduct of business rules.

<sup>14</sup> Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes, OJ L 135 , 31/05/1994 P. 0005 - 0014

money. It does so because banks are susceptible to the risk of a run if depositors believe that their deposits are not safe and try to withdraw deposits at the same time. It aims to prevent bank runs and protect the stability of the financial system.

Insurance schemes provide last resort protection to consumers when insurers are unable to fulfil their contractual commitment, offering protection against the risk that claims will not be met in the event of a failure of an insurer. Apart from protecting policy holders from losses, the schemes address concerns about the wider market impacts (e.g. policyholders losing confidence in the insurance market as a whole).

## **1.7. Reasons for the review**

Ten years after the ICSD entered into force, and immediately after the financial crisis, it is the right time to review the functioning of the ICSD. There is no evidence to suggest that the financial crisis contributed to more compensation claims from schemes under the ICSD. However, in recent years, DG MARKT has received investor complaints about the application of the ICSD in a number of important cases involving large investor losses.<sup>15</sup> The complaints are principally related to the coverage and funding of schemes and delays in obtaining compensation. The review of the ICSD is also an important element, together with the review of the DGSD<sup>16</sup> and the examination of protection for insurance policy holders, of the Commission's policy to strengthen the EU regulatory framework for financial services as set out in the Communication on "Driving European recovery"<sup>17</sup> in response to the recent financial crisis. It also considers the objective set at G-20 level of addressing any loopholes in the regulatory and supervisory system and the objective of restoring investor confidence in the financial system.

The Commission has reviewed the ICSD and is putting forward proposals aimed at improving its application, increasing its efficiency and enhancing investor protection. This document is the impact assessment accompanying the proposal for the review of the ICSD; it does not pre-judge the final form of any decision to be taken by the European Commission.

## **2. PROCEDURE**

The ICSD review and its impact assessment have been prepared in accordance with the Commission's approach to applying the better regulation principles. The initiative is the result of an extensive and continuous dialogue and consultation with all major stakeholders, including securities regulators, market participants, national investor compensation-schemes and consumers. The analysis will follow the principle of proportionality and will offer an in-depth qualitative and, where possible, a quantitative assessment of the impacts. The impact assessment work will then draw on:

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<sup>15</sup> See for example Annex V and VI which set out details of the Amis case in Austria and the Phoenix case in Germany which involved claims totalling €145 million and €674 million respectively.

<sup>16</sup> [http://ec.europa.eu/internal\\_market/bank/guarantee/index\\_en.htm](http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm)

<sup>17</sup> Commission Communication for the Spring European Council "Driving European recovery" COM(2009) 114 final of 4.3.2009

- analysis of contributions submitted during a call for evidence launched from 9<sup>th</sup> February to 8<sup>th</sup> April 2009<sup>18</sup> (a brief summary of the responses received is set out in Annex 1);
- analysis of the answers to the questionnaire sent to industry and European Securities Markets Expert Group (ESME)<sup>19</sup> and discussion at an ESME meeting;
- analysis of the answers to the questionnaires<sup>20</sup> sent to the national Investor-Compensation Schemes;
- internal research (including dialogues with stakeholders, examination of other relevant EU directives, further analysis based on published studies, articles and relevant literature, close monitoring of market developments);
- views from industry and investor associations expressed at a targeted hearing on 3<sup>rd</sup> September 2009 organised by the Commission services in order to allow a number of EU industry and investor associations to express their views on the review of the ICSD (see Annex IV for a summary of the discussion);
- regular or ad hoc meetings and discussions with the European Securities Committee (ESC)<sup>21</sup> and market participants;
- a meeting with national investor compensation schemes on 9<sup>th</sup> February 2010 (see Annex IX for a summary of the meeting);
- findings of a study by OXERA which was commissioned in order to evaluate the application of the Directive. The study, titled "Description and assessment of the national investor compensation schemes established in accordance with Directive 1997/9/EC" (February 2005)<sup>22</sup> was commissioned by the European Commission. It examines the impact of certain aspects of the ICSD on EU financial markets.

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<sup>18</sup> The Commission services received 70 contributions. The non-confidential contributions can be consulted in the Commission website.

[http://ec.europa.eu/internal\\_market/consultations/2009/investor\\_compensation\\_en.htm](http://ec.europa.eu/internal_market/consultations/2009/investor_compensation_en.htm)

<sup>19</sup> ESME is an advisory body to the Commission, composed of securities markets practitioners and experts. It was established by the Commission in April 2006 and operates on the basis of the Commission Decision 2006/288/EC of 30 March 2006 setting up a European Securities Markets Expert Group to provide legal and economic advice on the application of the EU Securities Directives (OJ L 106, 19.4.2006, p14-17).

<sup>20</sup> See Annex II.

<sup>21</sup> The European Securities Committee (ESC) fulfils both comitology and advisory functions in the securities field. It is composed of high level representatives from the Member States and is chaired by a representative of the Commission. Discussions were held at meetings of the ESC on 14 November 2008, 11 February 2009 and 15 July 2009.

<sup>22</sup> The study is available at [http://ec.europa.eu/dgs/internal\\_market/docs/evaluation/national-investor-rep2005.pdf](http://ec.europa.eu/dgs/internal_market/docs/evaluation/national-investor-rep2005.pdf). The opinions expressed in the Study by OXERA do not necessarily reflect the position of the European Commission. OXERA is a private firm that was contracted by the European Commission to undertake the study. The statements and opinions expressed in the study are the responsibility of the firm. The European Commission does not endorse the OXERA report, but uses it as a source of information for the review of the Investor-compensation schemes Directive.

## **2.1. Steering Group**

The Steering Group for this Impact Assessment was formed by representatives of a number of services of the European Commission, namely the Directorate General Internal Market and Services, the Directorate General Economic and Financial Affairs, the Directorate General for Health and Consumers, the Legal Service and the Secretariat General. This Group met four times, on 29 June, 29 July, 11 September and 21 January 2010. The members' contributions have been taken into account in the content and shape of this impact assessment<sup>23</sup>.

## **2.2. Impact Assessment Board**

DG MARKT services met the Impact Assessment Board on 10 March 2010. The Board analysed this Impact Assessment and delivered its opinion on 12 March 2010. During this meeting the Board members provided DG MARKT services with comments to improve the content of the Impact Assessment that led to some modifications of this final draft. These are the most relevant ones:

- to better substantiate the various problems arising from insufficient harmonisation of the operation, coverage and the level of protection offered by investor compensation schemes and explaining why those issues cannot be sufficiently addressed at Member States level;
- to provide more detailed assessment of the cost of the proposed measures, how they would be distributed by Member States and firms and how many investors would benefit from the changes; and
- to provide more detailed justification as to why the proposed measures are proportionate and assess whether non-legislative action could address the problems sufficiently.

After considering the improved draft, the Impact Assessment Board delivered its final opinion on 3 June 2010. This Impact Assessment was updated to take into account the additional comments from the Board, notably:

- to clarify the costs of the proposed measures, and how many investors would benefit from the proposed changes;
- to justify better why the proposed measures regarding the funding and the cross-border solidarity principle are considered to be proportionate and to present clearly the positions of Member States on each of the preferred options, and
- to justify better the durations of the proposed transition periods for the preferred options concerned.

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<sup>23</sup> In accordance with the rules for the elaboration of impact assessments the minutes of the last meeting of the steering group have been submitted to the Impact Assessment Board together with this impact assessment.

### 3. 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.

It is important to stress that the number of firm failures that have triggered the operation of investor compensation schemes has been relatively low. Of the EU-15 Member States, 9 of them experienced firm failures between 1999 and 2004<sup>24</sup>. The total number of failures excluding the UK<sup>25</sup> over that period amounted to 37, with most of the cases generating a small number of claims (See Annex III for further details concerning the operation of compensation schemes). Of the EU-10 new Member States only the Czech Republic and Hungary had experienced compensation cases over this period, with respectively 6 and 13 cases. Since 2004, there are ten schemes which have dealt with compensation cases, the most important case being the "Phoenix case" in Germany and the "AMIS case" in Austria.<sup>26</sup>

There is no evidence to suggest that the financial crisis contributed to more compensation cases in the EU. Investor confidence however is important for well functioning markets. Despite the low number of compensation cases, investor compensation schemes and their effective functioning is essential in order to maintain investor confidence in the use of investment firms.

First, the efficiency of the compensation schemes and the certainty of the conditions for compensation might need to be improved to match up to investors' expectations of being quickly compensated for losses arising from the provision of investment services. Second, the current level of discretion given to Member States needs to be considered from the perspective of the objective of creating a single market and a level playing field for investment services throughout the EU. Third, to reduce potential gaps in the regulatory system it is necessary to consider whether custodians, UCITS depositaries and money market funds should be covered by a compensation/guarantee scheme following a number of recent events that have highlighted investor protection concerns in these areas. Finally, changes in the regulatory framework of the DGSD are to be assessed to take into account some of its elements in this review.

Therefore, the impact assessment report will examine different options aiming at addressing the concerns expressed by investors and other stakeholders and improving effectiveness of the operation of the ICSD. The problems identified can broadly be divided in four groups: (i) problems experienced in the functioning of the ICSD, (ii) inadequacy of the ICSD due to changes in the financial services industry or regulatory landscape since the ICSD is applied (this includes MiFID replacing the ISD and the emergence of new investment services), (iii) reducing gaps in the regulatory system and (iv) reducing disparities between the protection of clients of

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<sup>24</sup> The period covered by the Oxera study.

<sup>25</sup> The high number of cases in the UK can be attributed to the significantly broader scope of the UK scheme which covers unpaid claims by a retail investor against an investment firm for negligent investment advice and poor investment management.

<sup>26</sup> For a summary of these cases see Annex VI.

investment firms and banking depositors (e.g. a deposit with a bank will be protected for an amount up to €100 000, but client monies held by an investment firm will only be protected for up to €20 000).

These four groups of problems have been tackled in this impact assessment bearing in mind the importance of enhancing investor protection, particularly in the context of the current financial crisis. The problem tree is to be found in Annex VII.

### **3.1. Problems experienced in the functioning of the ICSD**

There are situations where there is evidence that in practice the ICSD is not operating efficiently in fulfilling its objectives.

#### *3.1.1. Funding of schemes*

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

Although compensation schemes are generally funded by way of contributions from participating firms, there are important differences regarding:

- the moment contributions are collected (*ex ante* or *ex post*, in respect of the occurrence of any loss events),
- the management of the schemes (including the existence of any “prudential” criteria for the management of contributions collected *ex ante*),
- the degree to which funds are pooled across participating firms,
- the way contributions are calculated,
- whether there are any limits on the amount that may be collected from firms in a given period, and
- the existence of different funding arrangements (such as borrowing power, any State contributions, the use of fines imposed on firms).

The firm's contributions can either be collected to build a reserve in anticipation of future losses (*ex-ante* funding) or when needed to cover compensation costs of failures that have occurred (*ex-post* funding). Pre-funding helps to smooth contributions over time and makes sure future insolvent firms would contribute to the funding of the claims they would generate. It also contributes to rapid and smooth payment of compensation costs by building up a reserve of readily available funds to compensate investors. Although *ex-ante* funding helps to smoothen out the contributions over time and enables funds to compensate investors rapidly, to determine the appropriate level of *ex-ante* funding is inherently difficult as the potential claims/losses are highly volatile and difficult to predict (practical difficulties in operating a system of pre-funding). As a result, the fund will always be in a situation of surplus or deficit. This also means a lost cost of opportunity for investment firms as they have to lock funds in a fund for future compensation costs.

As demonstrated in Annex III, even between schemes which are ex ante funded the coverage ratio, i.e. the ratio between the ex ante funding and the total monies and securities held by investment firms on behalf of retail investors, can vary significantly. Based on the data provided by the schemes, we were able to assess the coverage ratio for six of them (see table page 83-84 "Funds available"). The coverage based on the total monies and securities ranged from 0.02% for Poland to 0.32% for Slovakia. The coverage ratio based on the total covered monies and securities<sup>27</sup> could be assessed for 8 schemes and ranged from 0.14% for Hungary to 2.01% for Slovakia.

The ICSD thus leaves too much flexibility to Member States concerning the actual level of funding of the schemes: there is no clear method to identify what should be the level of ex-ante funding. There are no provisions to adequately mitigate the risk of a scheme not being able to meet its obligations.

Sound funding arrangements are critical to the effectiveness of compensation schemes in achieving the ICSD's objectives. Funding can affect the ability of schemes to meet their obligations under the ICSD, how rapidly clients can be compensated, and the contributions required from firms in the event of losses. As currently only few schemes are funded adequately with a rigorous methodology to assess the funds needed to compensate for a given amount of losses<sup>28</sup>, investor confidence in a scheme or in investment firms in a Member State can be compromised after firm failures.

A good illustration of these funding difficulties is the Irish scheme which experienced a large compensation case in 2001. The size of the compensation claims was such that it exceeded the scheme's available funds. The scheme managed to raise additional contributions spread over several years. If it had levied these contributions in a single year it might have been problematic for some of the participating firms. In the light of the substantial claims arising from this and other compensation cases, the Irish scheme ("ICCL"<sup>29</sup>) reviewed twice (in 2004 and in 2007) its funding arrangements. Both reviews were carried out because the scheme funding levels were assessed to be inadequate.

There is more recent evidence that in some States, due to problems of funding, the national investor-compensation scheme was close to being insolvent. For example, following the Phoenix case<sup>30</sup> in Germany, which involved claims up to € 674 million,

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<sup>27</sup> Amount of securities and monies up to the maximum compensation limit.

<sup>28</sup> The OXERA study noted at pages 89 and 90 that:

*"...although funding difficulties have been reported in some instances, to date no compensation scheme has experienced a significant shortfall of funds that would have prevented it from making payments to investors. However, this does not necessarily imply that scheme funding can be considered adequate going forward. Few EU compensation schemes have undertaken a rigorous assessment of the adequacy of their funding arrangements in light of potential loss exposures. ... For example, schemes that operate an ex ante funding system indicated that they had either set ex ante premia on an ad hoc basis or had used simple rules of thumb to determine a target size for their standing funds. Similarly most ex post schemes had not analysed their potential exposures to firm defaults or the implications of these exposures for required firm contributions."* □ □

<sup>29</sup> Investor Compensation Company Limited, <http://www.investorcompensation.ie/index.php>

<sup>30</sup> See Annex VI for a summary of the case.

an urgent measure of last resort giving public funds to the national investor-compensation scheme was introduced in order to avoid the fund being unable to payout partial compensation payments after the affiliated firms contested the legality of special contributions and refused payments<sup>31</sup>. The Phoenix case was an extreme case relating to the failure of a large investment firm but similar extreme cases could again occur in the future. Another example is Austria where the scheme funds would be insufficient to cover the claims arising from the AMIS case (around € 145 million).<sup>32</sup> The AMIS case was not an extreme one-off case. It was caused by the failure of a mid-sized investment firm. In light of these events the Austrian legislation was recently amended to improve the funding of the scheme. The ex-post funding mechanism was replaced by ex ante funding supplemented by surplus contributions if necessary. In addition the fund can call upon a State guarantee if needed.

The broad discretion under the ICSD about how to fund schemes and differences in the way funding is organised by individual Member States creates a number of potential problems. It can undermine investor protection and investor confidence in the use of investment firms (if investors are not confident that there will be adequate funding in place to pay their claims if there is a default). It can also affect the proper functioning of the internal market if the likelihood of investor protection, and the contributions required from firms, vary significantly across Member States depending on the adequacy of individual funding arrangements. It also increases the risk of regulatory arbitrage. Investors might decide to invest via investment firms located in Member States where compensation schemes have the highest level of ex ante funding. Annex III describes the current position regarding funding of the different schemes in Member States.

Moreover, if investor confidence is to be nurtured and financial markets are to thrive to offer citizens alternative ways to invest their savings to be used in the future, it is necessary to create a robust legal and regulatory framework, including a healthy system of investor compensation schemes.

### 3.1.2. *Payout delays*

The trigger for the payment of compensation under the Directive is where either:

- 1) the relevant competent authority determines that an investment firm appears, for the time being, for reasons directly related to its financial circumstances, to be unable to meet its obligations arising out of investors' claims and has no early prospect of being able to do so; or
- 2) a judicial authority makes a ruling, for reasons directly related to an investment firm's financial circumstances, which has the effect of suspending investors' ability to make claims against it.<sup>33</sup>

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<sup>31</sup> [Press release to be found in: http://www.e-d-w.de/en/Phoenix-Stand.html](http://www.e-d-w.de/en/Phoenix-Stand.html)

<sup>32</sup> See Annex VI for a summary of the case

<sup>33</sup> Article 2(2) of the ICSD

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. That is, it is not linked to the date of the trigger events set out above.

The deadlines for establishing the "eligibility and the amount of the claim" are determined by national law. In practice, responsibility for checking the eligibility of each claim and its amount usually lies with either the liquidator of the insolvent firm or the insolvency Court or the scheme itself.

The Oxera study noted that processing claims can take considerably longer than the limits set. Payouts can potentially take several years, especially if insolvency is prolonged through court proceedings in which the conclusions of the insolvency administrator are contested.<sup>34</sup> For example, in Germany, the compensation scheme determined in March 2005 that the Phoenix investment firm was unable to pay out investor's claims. Four years later the scheme was not yet able to establish the amount and eligibility of the individual claims because of various court proceedings. To start compensating investors, the scheme initiated partial compensation payments in February 2009 (4 years after the occurrence of the failure). The disbursement of these partial compensation payments is expected to be completed in two and a half years.

So in practice there can be a considerable delay before an investor receives any compensation. This undermines investor protection and investor confidence. It also might discourage investors to place money in investments which would have a negative impact on the efficient flow of capital in the financial system.

### 3.1.3. *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. Information must be made available in a readily comprehensible manner. It also provides that Member States should lay down rules limiting the use of such information in advertising. In addition, the Directive Implementing MiFID also requires investment firms holding clients' assets to provide clients with summary details of any relevant investor compensation or deposit guarantee scheme which applies to the firm<sup>35</sup>.

Responses to the call for evidence and comments received during the public hearing indicate concerns that investors are not adequately informed about the potential coverage of the investor-compensation scheme. For example, investors are not necessarily aware that the ICSD does not compensate losses if an investment declines in value or becomes worthless due to the failure of a fund or issuer, or due to a decline in the stock market or the value of underlying investments or other investment risks. Also, concerns were raised about lack of awareness by investors about how the ICSD applies in cross border situations. Moreover, a specific case in

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<sup>34</sup> Oxera study pages 47 to 62

<sup>35</sup> Article 30(1)(g) of directive 2006/73/EC.

Portugal<sup>36</sup> made evident that investors are not always aware of the level of protection they could receive when investing in a specific product (i.e. whether it is covered by the DGS or the ICS).

The Austrian AMIS case highlighted the problem of lack of investor awareness about the scope and coverage of schemes. Following the AMIS case, Austrian legislation<sup>37</sup> was amended to include additional disclosure obligations. Austrian investment firms must now expressly inform investors that they are prohibited from holding client assets.

#### 3.1.4. *Technical issues about firm coverage and exclusion of claims involving market abuse*

A number of technical issues have arisen about whether firms that have limited authorisations are covered under the ICSD. The first is the case of a firm being only authorised to provide the MiFID investment service of operating a multilateral trading facility (MTF)<sup>38</sup>. The second situation is the case of an authorisation which prohibits a firm from holding client assets or dealing with retail clients.

The AMIS case in Austria clearly illustrates the latter case. The firms in that case were not allowed to hold clients assets and/or money and were not members of the investor compensation scheme. Following their insolvency the Austrian ICS denied compensation to investors. The scheme position was challenged before an Austrian Court which obliged the scheme to compensate investors. The Austrian scheme has appealed against this judgment.

Concerning the first case, MTFs rarely hold client assets and their clients (i.e. the users of the market) would rarely be retail clients, so this problem is rather theoretical. But the review provides a chance to clarify the application of the ICSD to MTFs and other investment services under MiFID. This review is also an opportunity to clarify the position of an investor dealing with a firm whose activities are limited by the detailed terms of its authorisation.

A further technical issue is whether the ICSD should explicitly exclude any claim for compensation where the investor has engaged in market abuse. Article 9(3) of the ICSD excludes claims where a criminal conviction has been obtained for money laundering<sup>39</sup> but not claims by investors who have engaged in market abuse.

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

Changes in financial markets (e.g. investment advice becoming a more important investment service, greater use of custodians, the emergence of multilateral trading facilities) and changes in the EU regulatory landscape (e.g. MiFID replacing the ISD,

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<sup>36</sup> Case concerning the distribution of some investment products by the Banco Privado Portugues

<sup>37</sup> Bundesgesetz über die Beaufsichtigung von Wertpapierdienstleistungen (Wertpapieraufsichtsgesetz 2007 – WAG 2007), §75-78

<sup>38</sup> An MTF is a trading platform that brings together multiple buying and selling interests. Operating an MTF is an investment service under Annex I of MiFID.

<sup>39</sup> Money laundering is defined in Article 1 of Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering. □

problems that arose during the financial crisis concerning the treatment of custodians and money market funds) have raised issues about whether the ICSD's coverage is too narrow and whether greater clarity is required in certain areas.

### 3.2.1. *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.<sup>40</sup> 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.

Investors may have a civil claim against a firm for damages that arise from a breach of statutory or fiduciary duties. For example, if an investment firm gives poor investment advice or is involved in misselling an investment to a client, the client may be able to bring a civil claim against the firm for a breach of MiFID conduct of business requirements.<sup>41</sup> But, even if the investor has established such a claim for damages, the investor may still suffer loss if the investment firm fails before the claim is paid and does not have adequate assets to pay the claim. The ICSD does not cover such an outstanding investor claim in the event of the firm's insolvency.

The UK has extended its scheme to cover outstanding investor claims for breach of conduct of business requirements against a firm that becomes insolvent. As a consequence the UK scheme has a significantly higher number of claims than other schemes. Most of those claims relate to a failure by an investment firm that has given unsuitable investment advice<sup>42</sup>.

Since the ICSD commenced, investment advice has become an investment service under MiFID<sup>43</sup>. MiFID sets out detailed new requirements designed to prevent inappropriate investment advice. As investment advice becomes a more important and widespread investment service in the EU there is an increased risk of civil claims by investors against firms for misselling of investments or poor advice. Compensating investors for such claims is only an issue if the firm defaults and it is unable to pay the claims. Annex VII sets out figures on complaints about investment advice in certain Member States.

The ICSD is a minimum harmonisation Directive so Member States can choose to cover cases other than those required under the Directive.<sup>44</sup> The issue is whether coverage for claims relating to investment advice should remain optional in order to

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<sup>40</sup> Recital 8 and Article 2(2) of the ICSD.

<sup>41</sup> Article 19 of MiFID

<sup>42</sup> For example the Oxera study at page 94 sets out a table showing that between 1999 and January 2005 there had been just over 1600 failures covered by the UK scheme (almost all arising from claims for negligent advice) while there had only been 36 in total in the remainder of the EU schemes (from fraud, mismanagement or third party default)

<sup>43</sup> Annex I.A of MiFID

<sup>44</sup> The Stock Exchange Guarantee Scheme in Portugal covers losses beyond what is required in the ICSD. The relevant Scheme covers any losses suffered by a non-qualified investor that arise from the non-compliance by the members of the regulated market operated by Euronext Lisbon of its duties as a financial intermediary with capacity to trade in said market. It also covers losses suffered by non qualified investors as a result of the breach of the duties of the participants of the settlement system operated by Interbolsa. No compensation has been paid as of today.

take into account specificities in market structures or whether the ICSD should be amended to make it mandatory.

### 3.2.2. *No coverage for non-retail clients*

The ICSD focuses on protecting "small investors"<sup>45</sup>. Non-retail clients<sup>46</sup> can be excluded from coverage, unless the national scheme decides to cover losses of such clients<sup>47</sup>. Several schemes have elected to cover some non-retail clients.<sup>48</sup> In a few recent high profile cases, local authorities, charities and high net worth individuals have suffered losses related to deposits in failed banks or investments in failed funds.<sup>49 50</sup> While the facts of these cases would not in any case have come within the scope of the ICSD, they do raise the broader issue of whether it is appropriate from an investor protection and confidence perspective to limit the scope of the ICSD to compensating small investors. As mentioned in section 1.5, under the MiFID review we will assess whether any further protection is necessary for institutional investors under conduct of business requirements.

A related issue is whether for the purposes of consistency with other Directives the definition of "retail client" in the ICSD should be aligned with the current MiFID definition of "retail client".<sup>51</sup> The MiFID definition also covers a broader range of SMEs than the current ICSD definition.<sup>52</sup>

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

### 3.3.1. *Failure of a third party custodian*

Under MiFID, financial instruments can be held in two different ways:

§ By the investment firm itself holding financial instruments for a client<sup>53</sup>. In that situation, if the financial instruments are kept "in connection with investment business" provided by the investment firm and cannot be returned by the investment firm to its client, then the client is protected under the ICSD and can recover his loss through the compensation scheme.

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<sup>45</sup> See for example the reference to small investors in recital 4 of the ICSD.

<sup>46</sup> A list of such investors is set out in Annex 1 of the ICSD.

<sup>47</sup> Recital 17, Article 4 (2) and Annex I of the ICSD. The list of non-retail clients who can be excluded includes professional and institutional investors, regional authorities and large companies.

<sup>48</sup> For example, Austria, the Czech Republic, Denmark, Finland, France, Germany, Hungary, Italy, Lithuania, Poland, Portugal, Spain, Sweden and the UK extend coverage to some degree to certain non-retail investors, although the extent of this extra coverage and who is covered varies significantly between Member States.

<sup>49</sup> For example, in the UK it is estimated that 123 local authorities had deposited an estimated £919.6 million in Icelandic Banks and 48 charities lost a combined total of £86.6 million in deposits with Icelandic Banks. See Part 4 of the fifth report of the UK Treasury Select Committee prepared on 4 April 2009.

<sup>50</sup> A number of high net worth individuals and charities suffered losses directly or indirectly through exposure to investments in funds controlled by Bernard Madoff.

<sup>51</sup> The term "retail client" is defined in Article 4.1(12) of MiFID.

<sup>52</sup> Annex II paragraph 1.2 of MiFID is the relevant provision that defines which SME's may be professional or retail clients for the purposes of MiFID.

<sup>53</sup> Ancillary services pursuant to Annex I of MiFID

§ By the financial instruments being held by a custodian (a "third party custodian") usually selected by the firm<sup>54</sup>. The third party custodian used by the investment firm may either be another entity in the same group<sup>55</sup> or a third party service provider<sup>56</sup>. Alternatively, the client in certain Member States may himself select a third party custodian to keep his financial instruments<sup>57</sup>.

Investors may therefore not only be exposed to the failure of the firm, but also the potential failure of a custodian<sup>58</sup>. In a case where a third party custodian<sup>59</sup> 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. This is because under the current scope of the ICSD, compensation schemes are only available to investors whose financial instruments have been lost by (the) investment firm "for reasons directly related to an investment firm's financial circumstances"<sup>60</sup>.

MiFID addresses this risk in part by providing that where financial instruments are to be held for a retail investor by a third party, the firm must inform the client of the responsibility of the firm under applicable laws for the acts or omissions of the third party and of the consequences for the client if the third party becomes insolvent. Further, the firm must provide the retail client with a prominent warning of the risks.<sup>61</sup> Still, there is under the ICSD a difference in the level of protection provided for investors who have purchased a financial instrument, depending on whether the firm itself or a third party custodian holds their assets.

The use of third party custodians is relatively common (for example, as investors increasingly look to take advantage of investment opportunities outside the EU). Also, sometimes investment services groups are organised in a way where investment services, such as brokerage and custody services are handled by two separate entities.

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<sup>54</sup> Article 17 MiFID implementing Directive places conditions upon which such custodian may be selected  
<sup>55</sup> This is more typically the case in continental Europe where often the group member is a credit institution.

<sup>56</sup> The third party may or may not be an authorised investment firm. Typically if it is based in Europe it will be regulated, but in certain overseas jurisdictions when holding assets in that jurisdiction, the third party may be unregulated.

<sup>57</sup> This is the case when the client himself deposits his assets with a third party and authorises the investment firm to operate on his behalf the account held with such third party (e.g. the commonly used model for portfolio management in Germany, "proxy" model vs. "trust" model).

<sup>58</sup> The Oxera study at page 98 noted that, in research carried out for the UK FSA in 2001/2 that financial risks associated with defaults can lead to potentially large client money losses but these occur infrequently. It then went on to state that the default of a third party is therefore the risk with the largest potential impact – larger than the default of the investment firm itself. Most client money balances are held with UK banks, and the risk of these banks defaulting is small. The risk of default of non-bank third parties, in particular those based overseas, was evaluated as being more likely to occur.

<sup>59</sup> It should be noted that third party custodians do not necessarily need to be authorised under MiFID and even if they are MiFID investment firms this would not usually affect the position under the ICSD as there is not a direct client relationship between the custodian and the investor.

<sup>60</sup> Article 2(2) of the ICSD

<sup>61</sup> Article 32 of Commission Directive 2006/73/EC

The situation is even more complex as different civil law regimes apply in different Member States. In some Member States investment firms are responsible for the assets entrusted to them, irrespective of their diligence in selecting custodians. In other Member States, investment firms are not responsible towards clients if they can demonstrate they adopted due care in selecting custodians.

3.3.2. *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 UCITS Directive specifies requirements relating to collective investment funds (UCITS) and their management companies<sup>62</sup>. Specifically, it requires the fund's assets to be safe kept by a custodian separate from the fund manager (the so-called 'depositary').<sup>63</sup>

The management of a UCITS is not a MiFID service. As result, the ICSD does not cover UCITS and their units' holders in case a UCITS, via its depositary, loses its assets. This is due to the following reasons:

- The ICSD was originally intended to complement the ISD and enhance the single market for investment services only. These do not include UCITS management.
- The ICSD only protects investors against the custody risk, where a firm is not able to return the financial instruments to its client. If UCITS assets are lost, the value of the shares or units of the UCITS will become worthless or diminish but will not be lost. The investors will lose the value of their investment in the UCITS but the shares and units will still exist. The ICSD does not intend to cover investors' losses due to investment risk which results in the value of shares or units becoming worthless.

Issues related to the loss of UCITS assets (partially due to a sub custodian default) have recently arisen in the Madoff fraud.<sup>64</sup> Apart from investing funds in the Madoff scheme, some UCITS had also transferred all their assets on sub custody through Madoff entities. When these sub-custodian entities defaulted, the UCITS were not able to recover their assets. As a result, the UCITS units and shares lost their value. UCITS investors suffered because the value of their units and shares had become worthless, not because these shares and units had been lost<sup>65</sup>.

However, it may be argued that the issue is of a similar nature to the problem presented under point 3.2.3 and that any solution adopted for failure of a third party custodian in the case of investment firms providing investment services (e.g. individual portfolio management) should also be extended to cover a UCITS unit

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<sup>62</sup> Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities

<sup>63</sup> Articles 7 to 10 of Directive 85/611/EEC.

<sup>64</sup> A UCITS fund must have a depositary to hold fund assets. The depositary can either hold the assets itself or use a sub-custodian.

<sup>65</sup> The Madoff case has revealed an important gap between the protection offered to UCITs compared to MiFID investors, because the ICSD does not cover losses suffered by a UCITs unit holder caused by a loss of UCITs assets subsequent to the default of a depositor or its sub custodians.

holder in the case of loss of assets subsequent to the default of a depositary or its sub-custodian.

This situation can be highly detrimental to UCITS investors and the confidence they may place in the UCIT label, in particular if they feel that a direct investment in financial instruments provides a higher degree of protection than an indirect investment in the same financial instruments through a UCITS fund<sup>66</sup>.

According to EFAMA<sup>67</sup>, total assets under management by European investment funds amounted to €7 trillion as of end 2009. The UCITS funds accounted for 75% of the European fund market with €5 trillion assets under management. In 2008 EFAMA assessed the proportion of retail participation in all investment funds, including UCITS funds, to 37%. This means that circa €2 trillion of UCITS assets are in the hands of retail investors.

This is in line with the study commissioned by the Commission on "the EU market for consumer long-term retail savings vehicle"<sup>68</sup>. This study pinpointed investment funds, both UCITS and non-UCITS, as the third long term saving vehicle in order of importance for European households after life and pension funds, and other deposits. Investment funds represented 16% of the total savings of Europeans in 1999 (€1.8 trillion) and 13% in 2005 (€1.9 trillion).

Based on EFAMA data as of end 2008, there are around 35 500 UCITS funds in Europe. Based on the assumptions that there are 2 000 unit holders per UCITS fund<sup>69</sup> and that 37% of these unit holders are retail investors, the estimated amount invested per retail unit holder is circa €72 000<sup>70</sup>.

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<sup>66</sup> To address the vulnerabilities that have emerged from the depositary sector, the Commission recently consulted on issues relating to role of the UCITS depositaries, also in the light of the Madoff fraud. It is likely that this will result in specific amendments to the UCITS framework to strengthen the existing legislation in order to clarify what their duties and liability are. The public consultation, closed on 15 September 2009, is part of a comprehensive review of the existing European regulatory principles which are applicable to UCITS depositaries.

<sup>67</sup> European Fund and Asset Management Association: [http://www.efama.org/images/stories/efama\\_quarterly\\_statistical\\_release\\_q4\\_20091.pdf](http://www.efama.org/images/stories/efama_quarterly_statistical_release_q4_20091.pdf)

<sup>68</sup> BME Consulting, the EU market for consumer long-term retail savings vehicle, 15 November 2007: [http://ec.europa.eu/internal\\_market/finances/docs/cross-sector/study\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/cross-sector/study_en.pdf)

<sup>69</sup> Based on EFAMA statistics, some Member States (DK, DE, ES and SLO) report the number of unit-holders in all investment funds domiciled in their countries. Estimated number of UCITS unit-holders in these countries was calculated taking into account the proportion of UCITS funds to all investment funds in these countries. Based on these estimates, it was possible to calculate potential average number of unit-holders per UCITS fund in these countries. Taken together, the average number of UCITS investors per UCITS fund is approximately 2.000 investors. It needs to be highlighted however that this figure is most likely an upper estimate since it could be reasonably expected that UCITS funds will have a much higher number of investors on average than 2.000.

<sup>70</sup> It needs to be highlighted however that €72.000 is most likely an upper estimate since it could be reasonably expected that UCITS funds will have a much higher number of investors on average than 2.000. If we were to double the average number of unit-holders per UCITS to 4.000, then the estimated average amount held by a unit-holder would be around €40.000.

There are 560 UCITS depositaries in Europe based on data collected by the Commission in 2004<sup>71</sup>.

### 3.3.3. Money market funds

A "money market fund" is a fund that markets itself as highly liquid and invests in short term debt instruments.<sup>72</sup>

Information from industry associations suggests that a large majority of investors in money market funds are institutional investors (e.g. 90% in France) and most of the remainder are high net worth individuals. So retail investors are not significant in terms of being the overall holders of units in these funds.<sup>73</sup> Money market funds are popular with institutional and some retail investors who view them as being relatively low risk investments and almost as safe as bank deposits.<sup>74</sup> This perception is reinforced to some extent by Article 18 of implementing Directive 2006/73/EC which allows investment firms to place clients' funds into an account opened, *inter alia*, with a "qualifying money market fund" as defined in the MIFID implementing Directive.<sup>75</sup>

During the financial crisis, some money market funds in the EU and the US<sup>76</sup> experienced difficulties leading to concerns about the risks associated with them and a rapid increase in investor redemption requests.<sup>77</sup> It became clear that some of these funds may have involved higher risk than the "money market" label might have suggested, for example, by investing in instruments with longer term maturity, due to a lack of harmonised approach and definition of what a money market fund is across the EU.<sup>78</sup> As a consequence, many money market funds were faced with a sharp decrease in their portfolio value, and were not able to reimburse investors with the initial value of their investment.

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<sup>71</sup> COM(2004) 207 final – Regulation of UCITS depositaries in the Member States: review and possible developments

<sup>72</sup> Short term debt instruments include, for example, certificates of deposits, time deposits, commercial paper, asset-backed securities, repos and floating rate securities.

<sup>73</sup> Based on information provided by the European Fund and Asset Management Association in a letter dated 15 July 2009.

<sup>74</sup> At the end of 2008, European money market funds had €1,350 Billion under management.

<sup>75</sup> Article 18(2) of Directive 2006/73/EC mentions the conditions to be fulfilled to be a "qualifying money market fund".

<sup>76</sup> The Reserve Primary Fund was the first money-market fund to expose investors to losses in 14 years. The fund had to write down its exposure to Lehman commercial paper which forced the net value of its assets below \$1 a share. Money market fund shares traditionally trade at \$ 1 a share (stable share price). This led to a run on other money market funds with investors asking for early redemptions of their holdings. As a result the US government via the US Treasury had to guarantee the shares of investors in money market funds.

<sup>77</sup> During the week of September 15, 2008, investors withdrew approximately \$300 billion from US prime (taxable) money market funds, or 14 percent of the assets held in those funds. In Europe €70 billion of the funds under management were redeemed in a few weeks following the bankruptcy of Lehman Brothers (EFAMA Annual Report 2008-2009 pg 9; [http://www.efama.org/index.php?option=com\\_docman&task=cat\\_view&gid=86&Itemid=-99](http://www.efama.org/index.php?option=com_docman&task=cat_view&gid=86&Itemid=-99) ). In the fall of 2008, 4 funds were closed and 12 temporarily suspended redemptions for a short period.

<sup>78</sup> The risks associated with money market funds can vary significantly from fund to fund. "Enhanced" money market funds seek higher yields than the more "conservative" money market funds and invest in longer-dated instruments and more volatile instruments such as asset-backed securities and derivatives.

Various initiatives have been undertaken to address the problem. For instance, in the US, federal authorities created a temporary guarantee program to support the value of the U.S. money market funds units<sup>79</sup> and ensure those funds could access enough liquidity to reimburse their unit holders at par.<sup>80</sup> This program closed in September 2009 without having to compensate for any losses. More recently, the SEC has launched a consultation to strengthen its rules and define the instruments which are eligible in a US money market funds portfolio.<sup>81</sup>

Similar initiatives have been undertaken in the EU. In October 2008, the ECB broadened the scope of eligible collateral in liquidity lending transactions to ease liquidity tensions on the short term money markets. In July 2009, the EFAMA and IMMFA came forward with a new proposal for a European classification and definition for money market funds.<sup>82</sup> CESR is consulting on a common definition of a money market fund in Europe.<sup>83</sup> It is possible that this may result in a strengthening of the requirements under the UCITS Directive that apply to money market funds.

Consistently with the overarching principle that investment risk has to be borne by investors, the ICSD does not cover investment losses arising from financial instruments, including money market funds. However, it has been suggested that, in the light of the specificities of these funds, in addition to the described initiatives, it may also be appropriate to widen the scope of the ICSD to compensate retail investors in money market funds for any investment losses they may incur.

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

#### *3.4.1. Minimum level of compensation*

Article 4 of the ICSD harmonizes the minimum level of compensation (€20 000) for each investor.<sup>84</sup> When the ICSD was introduced, it was considered sufficient to align this level with the one set under the Deposit Guarantee Scheme Directive (€20 000 at the time).

There are now concerns that the level might be too low. 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

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<sup>79</sup> Press release to be found in: <http://www.treasury.gov/offices/domestic-finance/key-initiatives/money-market-fund.shtml>

<sup>80</sup> In September 2008 the US Federal Reserve set up a liquidity facility to help restore liquidity to the ABCP markets and thereby to allow money market funds to sell their illiquid assets to release them from liquidity pressure they faced from unit holder's redemption requests. See <http://www.frbdiscountwindow.org/mmmf.cfm?hdrID=14#f1>

<sup>81</sup> Press release to be found in: <http://www.sec.gov/rules/proposed/2009/ic-28807.pdf>

<sup>82</sup> Proposal for a definition of money market funds by EFAMA to be found in: [http://www.efama.org/images/stories/09-4056\\_european\\_mmf\\_definition\\_paper\\_version\\_9\\_july.pdf](http://www.efama.org/images/stories/09-4056_european_mmf_definition_paper_version_9_july.pdf)

<sup>83</sup> CESR Consultation Paper – A common definition of European Money Market Funds (20<sup>th</sup> October 2009)

<sup>84</sup> Although Member States can opt to restrict the compensation amount to 90% of the claim, on the principle that the investor should bear a proportion of the loss (the "co-insurance" principle).

000.<sup>85</sup> These measures were taken because the different level of coverage of the schemes in the Member States led to distortion of competition and to regulatory arbitrage by investors, who were in some cases moving their deposits from one Member State to another. The same could happen for Investor Compensation Schemes. However it should be mentioned that the level of regulatory arbitrage by investors in securities may be less likely than for depositors as the risks addressed by the ICSD (i.e. failure by a firm due to fraud or systems problems to return assets to a client) are quite difficult to anticipate. Also it is possible that investment firms could consider it more reasonable to establish themselves in Member States where the level of protection is higher, as they could provide better confidence to potential investors who are subject to such a regime.

Although the ICSD and the DGSD address different risks, the discrepancy between them may create a number of problems. Firstly, where cash is held by a bank, it can in some cases be difficult to distinguish between cash held for investment purposes and cash held as deposits. The ICSD<sup>86</sup> allows Member States to determine whether such claims should be regarded as investment claims (and therefore fall under the ICSD with a €20 000 limit) or as deposits (and fall under the DGSD with a €100 000 limit).

A significant discrepancy between the thresholds could create a competitive distortion by encouraging investors to invest in deposits (with the higher protection under the DGSD) rather than in investments using an investment firm. This was one of the reasons why in Spain the compensation levels both under the ICSD and the DGSD were aligned.

The low minimum level of compensation under the ICSD also creates the risk of cross border discrepancies. For example, some Member States have introduced much higher limits (e.g. Spain €100 000, the UK £50,000 and France €70 000) while many others still maintain the minimum level of €20 000. The differences may encourage clients to seek out firms operating cross border from Member States with a higher level of protection. As an example investors might move their securities within their home country from a national investment firm to the branch of an investment firm from another Member State where the compensation limit is higher. Investors might also move their securities from one Member State to another Member State where higher compensation limits are in place. Although such behaviour was not experienced during the crisis, this situation potentially undermines the purpose of the ICSD which was to ensure the proper functioning of a single market for investment services and to eliminate competitive distortions.

Finally, if evidence shows that investors typically hold in excess of €20 000 in investment accounts, then the current limit may compromise investor protection and undermine investor confidence in the use of investment services under MiFID.

There is very limited data available at the national investor compensation schemes about the average amount held by investment firms on behalf of retail clients. Most

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<sup>85</sup> See Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay.

<sup>86</sup> Article 2.3 of the ICSD

of the schemes do not have any information about the number of securities accounts held by retail clients or the number of retail clients as highlighted in table "Estimate of securities and monies held by investment firms" of Annex III. Average securities and monies held per retail securities account were available for 6 Member States, 5 of them being new EU-12 Member States and Portugal. Among the 5 new EU-12 Member States, Poland had the highest average with an amount of €43 000 while the other 4 new EU Member States had significantly lower averages ranging from €8 000 in Latvia to €26 000 in Hungary. Portugal's average of €44 000 was very close to the Polish average. It should be noted that the countries for which data are available are among the 10 countries with the lowest Gross Domestic Product (GDP)<sup>87</sup> per capita among the EU-27

As the average amount of financial instruments held per investor or securities account is most of the time not available at the national scheme level, we calculated the average amount of securities held per household based on the household's financial accounts published by Eurostat. This data only provides an estimate and therefore needs to be treated with some care. The average amount of securities held per household across all EU countries amounts to €21 000. The average for EU-15 countries amounts to €31 000. The median<sup>88</sup> being very close to respectively €28 000 for EU-15 and €21 000 for EU-27.

The study commissioned by the Commission on "the EU market for consumer long-term retail savings vehicle"<sup>89</sup> also sheds some light on the amount and type of securities held by retail investors. This report draws on the Eurostat data in 1999-2005 and a survey of investor attitudes in 8 Member States<sup>90</sup>. The importance of direct and indirect savings in securities by households has generally increased in developed countries although this trend is mitigated for the EU countries and varies by type of securities. It should be noted that savings behaviour varies enormously between Member States, and that the % of households investing in securities is still sometimes limited depending on the Member State and the type of securities (bonds, quoted shares, investment funds).

Retail bonds holdings grew at a 4% annual rate over the period 1999-2005 although according to their consumer survey, fixed income products are the least well-known long term savings products to European households. Only 48% of retail investors are familiar with them and a mere 7% actually hold them. An important aspect of retail bond investments is the fact that the average balances held by consumers are quite substantial. According to the consumer survey, the average amount invested in bonds per consumer is €173 000 in the Netherlands, €106 000 euro in France, over €87 000 in Italy, €43 000 in Germany, €29 000 in Spain, €19 000 in Sweden and €18 000 in the UK. With respect to equities, they only took into account the category "quoted

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<sup>87</sup> Source: Eurostat, GDP per capita in Purchasing Power Standards (PPS) (EU-27 = 100), year 2008

<sup>88</sup> The median is the middle value in a distribution, above and below which lie an equal number of values. In certain cases, the median can be a good way to determine an approximate average, especially when dealing with a set of numbers that could otherwise be skewed by outliers,

<sup>89</sup> BME Consulting, the EU market for consumer long-term retail savings vehicle, 15 November 2007: [http://ec.europa.eu/internal\\_market/finances/docs/cross-sector/study\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/cross-sector/study_en.pdf)

<sup>90</sup> The survey drew on a representative sample of 1 000 respondents in the selected 8 Member States (UK, Germany, Italy, France, Spain, the Netherlands, Sweden, Poland). The interviews were conducted in the summer of 2007.

shares" from Eurostat data. The value of quoted stocks in the hands of European households experienced a significant decline of 18% over the period 1999-2005. This can be explained by the significant decline in share prices between 1999 and 2002 and a partial disinterest of retail investors reflecting a higher risk sensitivity (the share of households with share ownership in 1999 was 16.3% as compared to a 14.2% in 2005). Investment funds are a popular investment vehicle with retail investors but were also adversely affected by the stock market downturn of 2001-2002 with a cumulative average growth rate of 1.17% over the period 1999-2005. According to the results of their consumer survey, the popularity of investment funds varies significantly between Member States: 29% of households in Germany have them in their portfolios. By contrast, the corresponding figure in France and the UK is only 6 and 4%. Based on data from the consumer survey households in the countries where investment funds are most popular tend to invest between €30 000 and €50 000 while their French and UK counterparts invest over €120 000.

#### 3.4.2. *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). The option is commonly referred to as a "co-insurance principle". The reason for this option in the ICSD is to encourage investors to take some care in choosing investment firms.<sup>91</sup>

The option of imposing the co-insurance principle arguably reduces the level of investor protection provided under the ICSD and increases the differences between the thresholds in different Member States. The DGSD included a co-insurance principle but it was recently abolished as part of the amendment increasing the coverage level.

Only a minority of Member States (Finland, Germany, Hungary, Ireland, Latvia, Malta and Poland) have adopted and/or maintained the co-insurance principle and cover 90% of the claim up to €20 000. The UK scheme removed the co-insurance principle at the beginning of 2009.

The issue is whether it is appropriate to retain in the Directive the option for Member States to impose a co-insurance principle, as the application of this principle reduces investor protection and investors cannot reasonably be expected to be able to distinguish and choose between good and bad investment firms.

#### 4. THE BASELINE SCENARIO, SUBSIDIARITY AND PROPORTIONALITY

If no action is taken at EU level, that is, under a dynamic baseline scenario, the problems defined in section 3 would remain without a response. Market based financing is playing an important role in the financing of European large and medium sized enterprises and in the allocation of European savings. Orderly, transparent and effectively regulated financial markets can serve as an important motor for wealth-

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<sup>91</sup> See recital 13 of the Directive.

creation. Investors need to feel that there are enough guarantees in the securities markets to invest their savings in financial instruments instead of in a bank deposit. In Europe, corporate borrowers have turned to financial markets as an alternative source of finance to bank-lending. Increased supply is matched by a ready demand as investors turn to market-based investments as a means of bolstering risk-adjusted returns on savings and making provision for their retirement.

MiFID has facilitated the integration across the EU of markets in financial instruments. However, in order to allow for effective cross-border interaction of all potential buy and sell interests it is necessary to create the necessary safeguards for investors to maintain confidence in these markets. A robust legal and regulatory framework is crucial if investor confidence and liquidity are to be nurtured and financial markets are to thrive. Financial markets can survive periodic bouts of volatility, cyclical corrections or underperformance of individual stocks. They will not survive the erosion of investor confidence if intermediaries/investment firms fail to discharge their fiduciary obligations to the end-investor or if in the case of failure due to fraud of an investment firm they cannot recover their investments. It is necessary to create the appropriate guarantees for an equal level of investor protection throughout the EU. To avoid divergences/fragmentation of investor protection and any potential distortion of competition, the level of protection should be harmonised as much as possible at EU level.

Investor confidence across Europe: imbalances in the way consumers and investors see the EU financial market have broader implications in terms of financial stability, monetary policy (e.g. difficulties in Greece affect the Euro and create tensions among EU Member States because trust in the Euro is being damaged) and on the real economy in general (e.g. if people lose their savings or their investments there is no sufficient consumption to boost the real economy).

If there is no action at EU level, not all Member States will modify their investor compensation arrangements; as we have seen, only those Member States which have suffered a real problem with the funding of the schemes in a specific case have introduced changes to reinforce the schemes. To take action only after major firm failure is not good enough to protect investors. A major firm failure implies a huge loss of confidence on the markets by investors. If there is no real safety net to protect investors, they will have no incentives at all to invest in securities markets. Therefore, we consider that simply relying on the response of a Member State after a major problem with a national compensation scheme is not an adequate way to create investor confidence in markets.

For instance, the regulation exclusively at national level of the funding of schemes and payout delays would continue to result in differences in the ability of national schemes to react to firm defaults both in terms of rapidity and extent of compensation; the lack of clarity about the coverage under the compensation schemes would cause unjustified differences in the treatment of investors in different Member States; the absence of a common and effective regime for providing information to investors about scheme coverage might lead to a different understanding of coverage conditions among investors; the full harmonisation in the coverage of Deposit Guarantee Schemes at EU level without a parallel assessment

concerning the Investor Compensation Schemes would not appear justifiable, especially in the light of the initial alignment of the two Directives.

Therefore, the problems detected in section 3 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.

At EU level we should try to avoid as much as possible the recurrence of extreme situations which have triggered changes in national legislation. The review of the ICSD aims at improving the proper functioning of a single market for investment services, increasing investor protection and investor confidence in the EU. Further, it is necessary to take into account the objective set at G-20 level of addressing any loopholes in the regulatory and supervisory system

In recent years, the harmonisation of the regulatory framework in the securities sector has significantly increased. Under this harmonised framework for investment services, it is not justifiable from an investor perspective that investment firms are treated differently in different member States when they fail to return clients assets.

Further, the measures adopted at EU level in the banking sector (and notably the increase of coverage of the Deposit Guarantee Schemes) have created differences in the level of protection provided to investors to whom investment services are provided and banking depositors. These levels were initially aligned. A consistent approach is important to avoid competitive distortion in the various markets.

The amendment of the ICSD proposed by the European Commission respects the principle of subsidiarity and proportionality. There are issues such as the calculation of the contributions to the schemes by firms and the management of the schemes which have not been the source of identified problems; therefore, they should be left to the Member States. Moreover, the exchange of best practices between the schemes might be a good tool to support the application of the new principles to be introduced in the Directive. The current impact assessment will examine the possibility for ESMA to produce technical standards for some specific application issues.

All solutions have been drafted bearing in mind cost-efficiency; the calculations and estimates that are brought forward in section 8 and Annex V advocate that the objectives in terms of investor protection are fully respected. The analysis of the impact of the solutions on stakeholders presented in section 8 shows that the changes proposed by the European Commission are likely to have positive impact on investors and intermediaries.

## **5. OBJECTIVES**

The general objectives of the review of the ICSD are:

- a) to ensure the ICSD provides a sufficient level of investor protection to clients using investment firms;
- b) to improve the proper functioning of the ICSD and of a single market for investment services across the EU in a cost-effective way;

c) to renew investor confidence in the use of investment firms, especially in a context in which confidence might be affected by the financial crisis;

d) to ensure there are no gaps in the regulatory system;

e) to ensure that changes to compensation/guarantee schemes Directives do not lead to unjustifiable differences in the protection provided for different types of investments or services in the EU.

With these objectives in mind, the review of the ICSD aims more specifically 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.

### **5.1. Ensuring that the functioning of the ICSD provides sufficient investor protection**

This general objective can be specified in the following operational objectives:

- Establishing detailed criteria or principles for ensuring that investor-compensation schemes are properly funded, in order to ensure that different funding arrangements do not become a factor that alters competition between firms established in different Member States and to improve the ability of schemes to fulfil fully and rapidly their obligations to investors;
- Put in place appropriate payout modalities aiming at reducing the payout delays to allow investors to be compensated promptly;
- Improving investor awareness of the scope and coverage of schemes by informing existing and potential investors of the investor compensation scheme conditions;
- Improving investor protection by clarifying that the right to compensation is not dependent on whether an investment firm is complying with detailed terms of its authorisation so that investors dealing with a firm are protected irrespective of any technicalities relating to the firm's authorisation;
- Excluding claims for compensation under the Directive by persons who have engaged in market abuse in order to promote investor confidence and market integrity.

### **5.2. Update the ICSD in areas where it has become inadequate due to changes in the financial services industry and in the regulatory landscape to ensure appropriate coverage and increase efficiency of protection**

The following operational objectives should be fulfilled:

- To protect investors from negligent investment advice by considering whether the scope of the ICSD should be extended to failure by a firm to pay claims by a client for breach of conduct of business obligations;
- Considering whether to increase the protection of non-retail investors by extending the scope of the ICSD to provide for compensation to be payable to non-retail clients;
- To ensure the protection of SME's as investors is consistent within the financial markets legislation by aligning the ICSD with the MiFID of retail investors which covers a broader range of SMEs;
- Clarifying when the ICSD should apply to new MiFID services such as operating a multilateral trading facility (MTF) or to firms that are not authorised to hold client assets or to deal with retail clients, in order to avoid different application in Member States that may result in different levels of investor protection and different treatment of firms operating in the EU;

### **5.3. Reducing gaps in the regulatory system**

In particular, the following operational objectives should be fulfilled:

- Improving investor protection by assessing what is the most suitable means to protect investors from the failure of a third party custodian appointed by the firm to hold client assets (i.e. where the default of a third party results in the firm not being able to return assets to the client);
- Improving investor protection by assessing what is the most suitable means to protect UCITS unit holders from the failure of a UCITS depository or sub-custodian;
- Improving investor protection by assessing what is the most suitable means of protecting money market unit holders from a loss of value of units in such a fund;

### **5.4. Ensuring that recent amendments to the Deposit Guarantee Scheme Directive do not result in unjustified differences in protection for investors**

In particular, the following operational objectives should be fulfilled:

- Increasing the minimum level of compensation payable under the ICSD so that it approaches or is aligned with the level of compensation for bank deposits under the DGSD in order to improve investor protection by fixing an appropriate compensation amount and to provide for a more level playing field between banking and investment products;
- Improving investor protection and confidence by deleting the option of Member States being able to introduce a co-insurance principle (that is, the principle that clients be required to bear a proportion of any loss) so that clients receive full coverage within the compensation limit.

## 6. POLICY OPTIONS

With the intention to meet the objectives set out in the previous section, the Commission services have analysed different policy options. The first section reflects the most relevant policy options that have been considered in relation to improvement of the functioning of the ICSD. The second section contains the list of policy options that have been analysed in relation to the update of the ICSD in areas where it has become inadequate or no longer provides sufficient investor protection. The third section contains the list of options examined to reduce gaps in the regulatory system. The fourth section reflects the most relevant policy options that have been considered in relation to the alignment between the ICSD and the DGSD.

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

#### 6.1.1. *Policy options relating to funding of investor-compensation schemes*

- (1) **Option 1 – No action at EU level on this issue.**
- (2) **Option 2 – Harmonise how schemes should be funded..**
- (3) **Option 3 – Introduce a solidarity principle between the national schemes.**
- (4) **Option 4 – Create a pan-European scheme.**

#### 6.1.2. *Policy options relating to reducing payout delays*

- (1) **Option 1 – No action at EU level.**
- (2) **Option 2 – Link the deadline for payouts to the trigger events.**
- (3) **Option 3 – Introduce an obligation for schemes to provisionally pay partial compensation if the payout delay exceeds a specified time period.**

#### 6.1.3. *Policy options relating to lack of awareness by investors about the scope of the ICSD*

- (1) **Option 1 – No action at EU level.**
- (2) **Option 2 – Amend the MiFID and any other sectoral directives in order to introduce a further level of disclosure.**
- (3) **Option 3 – 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).**

#### 6.1.4. *Policy options relating to coverage of firms operating MTFs and firms acting outside their permission*

- (1) **Option 1 – No action at EU level.**
- (2) **Option 2 - Clarify that firms which are not authorised to hold clients assets are not covered under the ICSD.**

- (3) **Option 3 – 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.**

6.1.5. *Policy options relating to excluding claims involving market abuse*

- (1) **Option 1 – No action at EU level.**
- (2) **Option 2 – Amend the ICSD to expressly exclude claims for compensation by persons who have engaged in market abuse.**
- (3) **Option 3 – Leave it to Member States to decide whether transactions where market abuse was involved are to be excluded from compensation.**

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

6.2.1. *Policy options relating to coverage for claims where there has been a breach of conduct of business obligations.*

- (1) **Option 1 – No action at EU level.**
- (2) **Option 2 – Extend compensation to cover unpaid claims for any breach of conduct of business requirements against a firm that defaults.**
- (3) **Option 3 – Extend compensation to cover unpaid claims for a limited set of breach of conduct of business requirements.**

6.2.2. *Policy options relating to coverage for non-retail clients*

- (1) **Option 1 – No action at EU level.**
- (2) **Option 2 – Extend compensation to claims relating to non-retail clients.**
- (3) **Option 3 – Extend compensation to certain non-retail clients (e.g. local authorities or large corporates).**

6.2.3. *Policy options relating to aligning the classification of clients with the MiFID definitions*

- (1) **Option 1 - No action at EU level.**
- (2) **Option 2 - Introduce a new classification of clients under the ICSD based on pure quantitative criteria**
- (3) **Option 3 – Align the ICSD with the MiFID as to the classification of clients.**

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

#### *6.3.1. Policy options relating to non-coverage for failure of a third party custodian*

- (1) Option 1 – No action at EU level.**
- (2) Option 2 – Provide in MiFID that firms should be strictly liable to a client for any failure of a custodian they appoint.**
- (3) Option 3 – 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.**

#### *6.3.2. 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).*

- (1) Option 1 – No action at EU level.**
- (2) Options 2 – Extend compensation within ICSD to UCITS funds for assets that have been lost by a depositary (or sub-custodian).**
- (3) Option 3 – Amend UCITS directive to strengthen safeguards that apply to depositaries and sub-custodians.**
- (4) Option 4 – 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.**

#### *6.3.3. Policy options relating to non-coverage of money market funds*

- (1) Option 1 – No action at EU level.**
- (2) Option 2 – Introduce new requirements in the UCITS directive to define "money market funds" and strengthen requirements for such funds.**
- (3) Option 3 - Extend compensation under the ICSD to loss of value of units of "MiFID qualifying money market funds".**

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

#### *6.4.1. Policy options relating to the minimum level of compensation under the directive*

- (1) Option 1 – No action at EU level.**
- (2) Option 2 – Amend the ICSD and replicate the coverage adopted under the DGSD.**
- (3) Option 3 – Amend the ICSD to increase the minimum level of compensation to €50 000, but allow individual Member States to specify a higher limit (minimum harmonisation of the coverage level).**

- (4) **Option 4 - 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).**

#### 6.4.2. *Policy options relating to the co-insurance principle*

- (1) **Option 1 – No action at EU level.**
- (2) **Option 2 - Modify the co-insurance principle**
- (3) **Option 3 – Remove the possibility of co-insurance.**

## 7. **COMPARING THE OPTIONS**

This section discusses the advantages and disadvantages of the different policy options against the following criteria:

- Investor protection and confidence: the option proposed should maintain and, when necessary, enhance the level of investor protection achieved by the ICSD and the level of investor confidence in the use of investment services.
- Level playing field: the extent to which the option reduces unjustified differences in the protection provided for different types of investments or services in the EU.<sup>92</sup>
- Cost-Effectiveness: the extent to which the option achieves the sought objectives and facilitates the operation of EU securities markets in a cost effective way.

The options are measured against the above-mentioned pre-defined criteria in the tables below. Each scenario is rated between "---" (very negative), 0 (neutral) and "+++" (very positive). In some cases not all criteria are applicable to the issues under analysis. The assessment highlights, also graphically, the policy option which is best placed to reach the objectives outlined in section 5 and therefore the preferred one.

### 7.1. **Policy options for improving the functioning of the ICSD.**

#### 7.1.1. *Policy options in relation to funding of investor-compensation schemes*

- (1) **Option 1 – No action at EU level on this issue.** Retaining the status quo would mean that individual Member States schemes would retain complete discretion as to how to fund their investor-compensation schemes. This would have the consequences set out in section 3.1.1 regarding investor protection (i.e. if funding is not adequate in a Member State it can undermine investor protection and investor confidence in investment services). It could also affect the proper functioning of the single market for investment services if different

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<sup>92</sup> The subsequent comparative tables of policy options will identify the context of level playing field with regard to each policy option group.

approaches to funding result in significant differences in the likelihood of a scheme being able to meet its obligations. The timing and level of contributions by firms would also continue to vary between Member States depending on the extent to which an individual scheme requires pre-funding or contributions after a default. So this option is not likely to be effective.

- (2) **Option 2 – Harmonise how schemes should be funded.** This option should result in more harmonisation of funding of schemes. This policy option would require the introduction of principles and some more prescriptive rules for the funding of investor-compensation schemes.

A prescriptive model (if based on sound methodology) might significantly reduce the risk of any scheme having inadequate funding to meet its directive obligations in the event of a default. So it would improve investor protection and investor confidence in investment services. It would also provide a greater degree of harmonisation than principles which is a pre-requisite to the proposal to introduce a solidarity principle between the national schemes (see Option 3).

The model would include the following: compensation schemes should have in place adequate systems to determine the potential liabilities of schemes; schemes should be adequately financed in proportion to their liabilities; a target fund level should be established by each scheme to meet the potential liabilities, being a percentage of the size of the activities covered by the members of the scheme and should be adequately pre-funded; adequate alternative funding arrangements, including borrowing facilities from commercial banks or public institutions if based on commercial grounds, should be in place; the cost of financing schemes should be ultimately borne in relation to investment business by the investment firms or third party custodians covered by the scheme and to a similar extent in relation to UCITS activities, by UCITS or their depositaries or third parties who are covered by the scheme. The target fund level should be reached within a transitional period of 10 years to take into account the current differences at national level and allow ex post funded schemes (eight Member States have ex post funded schemes and 4 Member States have schemes with a mix of ex ante and ex post funding – See Annex III) to build up progressively their ex ante funding level without jeopardising the financial health of their contributing firms.

It would not be possible to achieve the same outcome through non-binding instruments, such as a recommendation by the Commission, as different schemes could adopt different funding principles and the same level of funding of the schemes would not be guaranteed in all Member States.

Contributions to the call for evidence and the views of industry and investor associations supported the introduction of general principles leaving the details to Member States. Also some compensation schemes are in favour of the introduction of pre-funding and more transparent systems.

A detailed prescriptive approach to funding would not allow as much flexibility to adapt to differences in markets in different Member States. Also

the range of investment services and firms covered by the Directive may make it less amenable to detailed prescription compared with for example the DGSD (which covers a specific type of investment offered by a specific type of institution).

Although this option would result in a heavier burden for compensation schemes and firms than a purely principle-based approach, this more detailed approach would lead to much greater degree of harmonisation of schemes and would also reduce the risks of a scheme having inadequate funding. As a consequence, it would result in higher consumer protection and would lead to greater confidence when investors use investment services. The future European authority (ESMA) – to be set up under the framework of the new European supervisory infrastructure<sup>93</sup> –, will be entitled to produce binding standards to be endorsed by the Commission in some areas in order to ensure a coherent application of the Directive.

This option is considered to be more effective than taking no action at EU level. Based on the answers received from a limited number of Member States to the call for evidence<sup>94</sup>, some of them were not convinced about the need to introduce general funding principles<sup>95</sup>.

**(3) Option 3 – Introduce a solidarity principle between the national schemes.**

This policy option could be in addition to option 2. It might emphasize the role of a European system of national schemes by providing that, as a last resort, funds from schemes in other Member States could be lent to a scheme that has insufficient funds to meet its responsibilities under the ICSD. This would be a measure that provides schemes with an alternative back up source of funding (although only on a temporary basis). Indeed compensation schemes might have a temporary liquidity problem in the case of the failure of a very large investment firm. The ex ante target fund level will be built up to cope with a mid-size failure, but not with a one-off extreme case. The proposed cross-border solidarity principle would be a cost effective way to address these temporary and rather exceptional liquidity problems, while at the same time ensuring the industry will contribute to the compensation costs.

This would provide greater protection to investors and promote investor confidence in investment services as they would know that funds for compensation might as a last resort be provided from a network of compensation schemes in other Member States if an individual scheme had insufficient funding.

Together with the establishment of consistent funding principles and rules between Member States (option 2), it might facilitate a closer relationship and better on-going coordination between national schemes and would act as

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<sup>93</sup> Legislative proposals adopted by the Commission on 23.9.2009: COM(2009) 499 final, COM(2009) 500 final, COM(2009) 501 final, COM(2009) 502 final and COM(2009) 503 final.

<sup>94</sup> Eight Member States contributed to the call for evidence: Czech Republic, Estonia, Finland, France, Germany, Hungary, Netherlands, United Kingdom.

<sup>95</sup> France, Hungary, Netherlands, United Kingdom were not in favour of such a measure.

an incentive to develop more harmonised practices and working procedures. In the meantime it would limit a possible risk of moral hazard between undersized and better funded schemes on the basis of the necessary repayment (mid-term) obligation. In any case, a level of technical detail should ensure that each scheme must ring fence and have available for lending a certain amount, established on the basis of common criteria.

For investment firms, the borrowing power of the schemes would give more flexibility in the collection of funds in the case of huge loss events, allowing a more balanced distribution during the time. Indeed, without proper borrowing arrangements, the scheme in need would be obliged to collect the necessary funds from its member firms in a relatively short period of time.

The borrowing power would be limited to the loss-events covered by the ICSD and would not extend to any further coverage granted at national level.

Within the pre-funded portion of scheme funding it would be necessary to specify the amount ("common pot") that must be available under the solidarity principle for lending to other schemes to prevent the lending scheme from endangering its financial capability.

Such a network of national schemes would be only possible if required by a binding Community instrument. Moreover, the development of the system of national schemes would be consistent with the proposed system of European supervision, in particular with the creation of the European Securities Markets Authority. Because of its political implications, at this stage this option is considered as the preferred one in combination with option 2 above, as option 2 is a prerequisite to option 3. These options would also be consistent with a gradual approach towards option 4 (creation of a pan-European scheme).

- (4) **Option 4 – Creation of a pan-European scheme.** This policy option implies the setting up of a single Community scheme, to administer a fund and pay out compensation to investors under the ICSD.

This option would add to investor protection and confidence in terms of the funding of the single scheme (as there would be confidence that there was a larger pool of funding). It would improve the functioning of the single market for investment services (by removing current differences between schemes in different Member States). It would also be a cost-effective solution due to the economies of scale generated by the operation of a single scheme.

But such a proposal is unlikely at this point in time to be realistic. The ICSD only sets minimum standards and there are still significant differences between Member States on issues such as coverage, the level of compensation, the process for determining the eligibility of claims and funding of schemes. Setting a pan-EU scheme would require a new regulatory framework, which would involve political and economic

challenges, including the assessment of impacts on national fiscal policies, going beyond the ordinary review of the current ICSD.

This option may be a longer term option but in the short term a greater degree of harmonisation and elimination of national differences is necessary. The proposed combination of options 2 and 3 would in any case be a step in paving the way towards this longer term option.

	Investor protection and confidence	Level playing field	Cost-Effectiveness
No action at EU level	0	0	0
<b>Harmonise how schemes should be funded</b>	+++	++	-
<b>Introduce a solidarity principle between the national schemes</b>	+++	+	+
Creation of a pan-European fund	+++	++	--

### 7.1.2. Policy options relating to reducing payout delays

- (1) **Option 1 – No action at EU level.** Under this option, the current situation would remain unchanged. That is, the time limit could be taken as applying from when the claim has been processed and the amount of the claim has been established (not when the firm is declared in default). This would mean potentially long delays in the payment of compensation, depending on national administrative and insolvency laws. This has the serious consequences for investor protection and confidence in investment services set out in section 3.1.2. It also would leave existing discrepancies between payout times across Member States. Compensation schemes have expressed views in favour of this option.
- (2) **Option 2 – Link the deadline for payouts to the trigger events.** This policy option would require the time limit (e.g. of three months) to apply from the date on which the firm is declared to be in default (rather than when the claim is established). This option would not interfere with but would operate in parallel with national insolvency laws.

Under this option the result to be achieved would be specified (i.e. a claim must be paid out within a specified period after the trigger event) but it would be left to Member States to determine how this outcome is best achieved<sup>96</sup>.

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There are a few Member States where the time limit of 3 to 6 months starts to run from the date the financial regulator has ascertained the scheme's payment obligation (Finland, France), from when an investor has submitted a compensation claim (Netherlands), or from the date the inaccessibility of the funds has been ascertained (Slovakia).

This option would be beneficial in terms of investor protection and confidence in investment services as investors would have greater confidence that a claim must be processed within a specified period from the trigger event. It would also reduce significant differences in payout times between Member States.

A potential difficulty is that there may be cases where due to fraud or system problems within a firm, records are missing or are incomplete. In such cases it may be difficult to accurately verify the eligibility and amount of a claim within the specified period.

- (3) Option 3 – Introduce obligation for schemes to provisionally pay partial compensation if payout delay exceeds a specified time period.** This policy option would entitle investors to receive a partial compensation from a scheme if the payout delay exceeds a given time period. This time period would be amended to start running from the date on which the firm is declared to be in default (as under option 2). But, if the scheme is not able to make a full pay out during this period, it will be required to make provisional partial payment based on an initial assessment of the claim. The level of the partial payment would need to be prescribed. The balance would be paid out later once the claim had been fully verified.

This option combines the approach under option 2 but allows the scheme to make a partial payment where it cannot make a final determination of the claim within the specified period. It would increase investor protection and investor confidence as investors would at least receive part of their claim promptly. It would also reduce differences between Member States in payout times.

Arguments might arise as for option 2 about the difficulty for the scheme in verifying a claim if there are no records. Schemes would also need the ability to recover amounts provisionally paid out if it was subsequently discovered that the claim was not in fact valid. But these difficulties are outweighed by the need for investors to receive full or partial compensation within a reasonable period. Failure to provide such payouts within a reasonable period risks undermining the objectives set by the Directive. This solution is to be included in a binding instrument in order to make it effective and guarantee the rights of investors and of the schemes. Investor associations have expressed clear views in favour of this option. The schemes' main concern with this option is that in case of too large partial compensation payments, reclaiming money from investors is a very sensitive and expensive process. A number of Member States<sup>97</sup> having responded to the call for evidence have also expressed implementation concerns about this option – at least as long as details are not known.

	Investor protection and confidence	Level playing field	Cost-Effectiveness
No action at EU level	0	0	0

<sup>97</sup> Czech Republic, Estonia, France, Germany, Hungary, Netherlands, and the United Kingdom

Link the deadline for payouts to the trigger events	+++	+	0
<b>Require provisional payout of partial compensation</b>	+++	+	+

7.1.3. *Policy options relating to lack of investor awareness about the scope and coverage of the ICSD*

- (1) **Option 1 – No action at EU level.** Under this policy option, no further action would be taken. Reliance would be placed on the adequacy of existing requirements in the ICSD and MiFID (for clients to be informed about the amount and scope of cover under the ICSD) and on how they are being implemented. The consequences in section 3.1.3 would remain. That is, despite the existing requirements, there are concerns that retail investors are not sufficiently aware of the existence of the ICSD, what it covers and does not cover and how it applies in cross border situations. There is therefore a risk that the ICSD does not provide the necessary investor protection and the level of investor confidence in investment services that it was intended to provide.
- (2) **Option 2 – Amend the MiFID and any other sectoral directives in order to introduce a further level of disclosure.** Under this option, a further level of detail would be added in the sectoral directives where the coverage under the ICSD applies. In the case of investment services and activities, the MiFID would be the relevant sectoral directive. In the case of UCITS, the UCITS directive would be modified. This approach is not the most efficient because it would fragment in different legal texts the disclosure requirement.
- (3) **Option 3 – 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).** Under this policy option the existing obligation for investment firms to provide information about compensation schemes to new clients would be supplemented by requiring further detail to be provided about what is and is not compensated under the ICSD and how it applies in cross border situations. Specifically it would require them to explain that certain losses (e.g. due to investment risks) are not subject to the payment of compensation under the ICSD.

This option would seem to be the most effective provided that disclosure is clear and easy for the investor to understand. Moreover, there is a large consensus between industry, investor associations and compensation schemes about the fact that disclosure requirements should be strengthened. For the sake of consistency, the ICSD seems the most suitable directive to provide further details about the coverage. The reinforcement of the legal requirements could be accompanied by non-binding actions such as the development of best practices by the firms.

	Investor protection and confidence	Level playing field	Cost-Effectiveness
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No action at EU level	0	0	0
Provide further detail in the sectoral directives (such as MiFID)	+	+	+
<b>Provide further detail in the ICSD</b>	+	+	++

7.1.4. *Policy options relating to coverage of firms operating an MTF and firms acting contrary to the terms of their authorisation*

- (1) **Option 1 – No action at EU level.** This policy option would maintain the current uncertainty and potential lack of coverage for investors. It may also result in different approaches in individual Member States.

For example in a situation where a firm does in fact hold client assets or deals with retail investors (despite the terms of its authorisation) and the assets are lost, for example through fraud by an employee of the firm, the investor may not be entitled to any compensation in some States. This would compromise investor protection and investor confidence. It is also arguably unrealistic to expect retail investors to be aware of the precise terms of a firm's authorisation and whether or not they are being breached by the firm. Further, it is unfair that the retail investor should be deprived of investor protection under the ICSD where it is the firm that has not complied with detailed conditions of its authorisation.

Issues relating to whether operation of an MTF should be covered by the ICSD are probably less important and more theoretical, given that MTFs usually do not hold client assets and MTF users are unlikely to be retail clients.

This option would result in a continued lack of clarity and perhaps some legal uncertainty.

- (2) **Option 2 – Clarify that firms which are not authorised to hold clients assets are not covered under the ICSD.** This policy option would involve establishing that some investment services providers, although subject to an authorisation and supervisory regime, are not covered under the ICSD. The rationale for this option would be that since, in legal terms, some intermediaries cannot find themselves in the situation covered by the ICSD, they should not be covered under the directive. This option would leave to investors the burden of checking the legal terms of the firms' authorisation; in addition they would leave them exposed to the risk that - de facto and in violation of the firm's authorisation – it could hold clients assets or deal with a retail client without being covered by the ICSD.
- (3) **Option 3 – Clarify that if firms do in fact hold client assets (irrespective of restrictions on their authorisation or the nature of their investment service) then clients should be entitled to compensation under the ICSD if the firm defaults.** This policy option would involve clarifying in the ICSD

that a claim for compensation can be made by a client if in fact the investment firm holds moneys or financial instruments on behalf of a retail client and fails to return them. This would be irrespective of whether the firm is doing so in contravention of any limitation on the firm's authorisation (e.g. preventing it from holding client assets or from dealing with retail clients) and irrespective of the legal nature of the investment service it provides (e.g. if it is operating a MTF). This option would provide greater clarity and legal certainty and provide some increase in investor protection and investor confidence. It would enable retail investors to assume that they are covered by the ICSD without checking detailed conditions on a firm's authorisation. The issue of whether contributions are required from such firms would be left to the discretion of each individual scheme (as it is currently the case).

This option would provide greater clarity and promote confidence in the use of investment services. It would also result in more consistency across Member States in the application of the ICSD which would assist the proper functioning of the ICSD and the passport; for this to happen the extension of the coverage by the schemes is to be introduced in a binding instrument to ensure the level playing field in the EU. This option was generally supported by many stakeholders in the contributions to the call for evidence. Among the Member States having contributed to the call for evidence, a minority of them were against<sup>98</sup>.

	Investor protection and confidence	Level playing field	Cost-Effectiveness
No action at EU level	0	0	0
Clarify that firms which are not authorised to hold clients assets are not covered under the ICSD	--	0	-
<b>Clarify that if firms do in fact hold client assets then clients should be entitled to compensation if the firm defaults</b>	++	++	+

#### 7.1.5. Policy options relating to coverage for claims involving market abuse

- (1) **Option 1 – No action at EU level.** Under the status quo, claims involving conduct that is market abuse could in theory still be eligible for compensation under the ICSD. This is a largely theoretical issue and is unlikely to occur in practice (i.e. that a person who has engaged in market abuse would claim against the scheme). But leaving open the possibility is inconsistent with the general objective of prohibiting market abuse and promoting market integrity in financial markets.
- (2) **Option 2 – Amend the ICSD to expressly exclude claims for compensation by persons who have engaged in market abuse.** This policy option would

<sup>98</sup> Member States against were Finland, Estonia, and Hungary.

exclude any claim for compensation where a person has engaged in market abuse. It would promote investor confidence and market integrity by removing this theoretical loophole. The loophole is inconsistent with the objective of financial services directives to prohibit market abuse and promote market integrity. It is necessary to introduce this exclusion in a binding legal instrument, as it should be binding for all schemes within the EU.

- (3) **Option 3 – Leave it to Member States to decide whether transactions where market abuse was involved are to be excluded from compensation.** This policy option would introduce an option in the ICSD allowing Member States to exclude claims for compensation involving market abuse. This is not a credible option from an investor confidence or market integrity perspective; as such an amendment would imply that individual Member States would be free to choose to permit claims for compensation involving market abuse.

	Investor protection and confidence	Level playing field	Cost-Effectiveness
No action at EU level	0	0	0
<b>Exclude coverage of claims where market abuse was involved</b>	+	+	+
Leave it to Member States to decide	--	-	0

## 7.2. Policy options for updating the ICSD in areas where it is no longer adequate due to changes in the financial services industry or in related directives

### 7.2.1. Policy options relating to the non-coverage of claims for breach of conduct of business obligations

- (1) **Option 1 – No action at EU level.** Under this policy option, the scope of mandatory coverage would not be expanded to include civil claims for breach of conduct of business rules against a firm that becomes insolvent. It would remain optional for Member States to extend the scope of claims covered by their schemes based on the characteristics of their specific market (e.g. the frequency of breaches of conduct of business requirements by firms in that market, the extent to which civil claims are made and the likelihood of firms failing with unpaid claims against them).

Leaving discretion to individual Member States would mean that Member States can take into account market differences and the risks in their particular market when deciding whether to extend the coverage of their schemes to cover this situation. The risk set out in section 3.2.1 would remain (i.e. that individual Member States fail to recognise that negligent advice becomes an increased source of risk and, if firms fail, investors with civil claims against the firms are left without adequate compensation). If this risk materialises it could have a detrimental effect on investor protection and confidence in the use of investment firms. But it might also be argued that there may be other more effective means to deal with this risk, e.g. closer supervision of such

firms, requiring firms to take out professional liability insurance or enhancing civil liability by intermediaries. All these options will need to be considered in the forthcoming MiFID review – which is the most appropriate instrument in order to deal with issues related to the activity of investment firms and their relationship with their clients. For these reasons taking no action in the context of the ICSD is our preferred option. Nearly all the Member States<sup>99</sup> having answered the call for evidence were in favour of keeping the status quo, except the United Kingdom where any breach of conduct of business rules is already covered.

- (2) **Option 2 – Extend compensation to cover unpaid claims for any breach of conduct of business requirements against a firm that defaults.** This policy option would require the schemes to extend their coverage under the ICSD to compensate investors for unpaid claims against a firm for breach of MiFID conduct of business rules where the firm has defaulted. This option could cover the breach of a wide number of conduct of business rules for all investment services (e.g.: information requirements, know your customer obligation; suitability requirements; conflict of interest rules<sup>100</sup>).

This would be a significant extension of the scope of the ICSD and would significantly increase investor protection and investor confidence in the use of investment services. There is currently only one Member State (the UK) which covers such claims.

There may be an issue about the necessity of such a measure in different markets. For example, in some Member States typically retail investment services are more likely to be provided by firms belonging to large banking or insurance groups while in other Member States, there are a larger number of smaller firms providing investment advice<sup>101</sup>. While the risk of poor investment advice might not necessarily be higher for a small independent firm, the risk of default might be perceived to be higher. A small independent firm normally has less financial resources to pay out large amounts of compensation claims.

There is not yet clear evidence of an EU wide problem of small investment firms that are subject to civil claims defaulting with unpaid claims. Moreover, most of the respondents to the call for evidence expressed that this option would be legally and administratively very complicated and even unworkable, including that it would imply an increase in costs for the financial system.

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<sup>99</sup> Member States in favour of the status quo were Czech Republic, Estonia, France, Germany, Hungary, and the Netherlands.

<sup>100</sup> Article 19 (2), (3), (4) and (5) of MiFID and Article 18 of MiFID.

<sup>101</sup> See Oxera report pages 105-106 for further details on market structure.

A related complexity for this option is that Member States have the choice under MiFID to not apply that Directive to investment firms that are only allowed to provide investment advice and are not allowed to hold client assets.<sup>102</sup> This option has been exercised in a number of Member States. Therefore the conduct of business obligations that apply to many smaller investment advisers across Europe may vary and depend on the national legislation in each Member State. The appropriateness of this optional exemption is an issue that will be reviewed as part of the 2010 MiFID review.

A more cost effective option may be as part of the MiFID review to review the continued appropriateness of the optional exemption and also to consider whether other requirements could be imposed to ensure that firms providing investment advice have sufficient capital, appropriate insurance to pay out any outstanding civil claims for breaches of conduct of business requirements or enhance the liability borne by investment firms. Pending the issue being considered as part of the MiFID review, extending compensation under the ICSD would remain optional.

- (3) Option 3 – Extend compensation to cover unpaid claims for a limited set of breach of conduct of business requirements.** As the previous one, this policy option would require the schemes to extend their coverage under the ICSD to compensate investors for unpaid claims against a defaulted firm. However, under this option a more narrow set of conduct of business rules would be covered (e.g.: only violations in the provision of investment advice or even only breach of the suitability rule for investment advice<sup>103</sup>).

Although the extension of the scope of the Directive under this option would be less broad than in the previous one, it still faces the same issues. In addition, it would require a complex graduation of services and conduct of business rules in order to establish the ones which would be covered under the ICSD and the ones which wouldn't. This could add uncertainty as to the actual coverage and client protection.

	Investor protection and confidence	Level playing field	Cost-Effectiveness
<b>No action at EU level</b>	<b>0</b>	<b>0</b>	<b>0</b>
Extend compensation to claims relating to any breach of conduct of business requirements	+	0	--
Extend compensation to claims relating to a limited set of breaches of conduct of business requirements	+	-	--

<sup>102</sup>

Article 3 (1) of MiFID

<sup>103</sup>

Article 19 (5) of MiFID.

7.2.2. *Policy options relating to coverage for non-retail clients*

- (1) **Option 1 – No action at EU level.** Under this policy option, Member States would maintain the possibility to include non-retail clients, if they elect to do so. Member States would retain flexibility depending on the characteristics of their own market. This approach is consistent with the initial focus under the ICSD and under MiFID of protecting small investors.

In practice a few Member States cover non-retail clients under the compensation schemes. There is no evidence that failure by other Member States to cover non-retail clients has caused significant or widespread problems under the ICSD and therefore retaining the current option appears appropriate. Most stakeholders supported this option.

- (2) **Option 2 – Extend compensation to claims relating to non-retail clients.** This policy option would extend compensation to all types of clients of investment firms.

In reality this would not provide much further investor protection for larger non-retail investors. Relative to the value of investments held by non-retail investments the compensation payable under the ICSD (even if increased) is relatively low. For example, if a local authority had hundreds of thousands of Euros of cash or financial instruments held by an investment firm that then defaulted, it would only currently be entitled to receive €20 000 from most schemes.

Such an extension would add to the cost for firms without really providing much protection to this category of clients, due to the limited amount of the compensation, which is tailored to small investors' situations. As set out above in option 1, there is no clear evidence suggesting that the scope of the ICSD should be extended to cover non-retail investors. Further, compensating professional and/or institutional investors may create moral hazard issues, as it may discourage such investors from doing adequate due diligence on firms they propose to use. In this respect non-retail investors are in a much better position to be able to assess the soundness of a firm.

So this option does not appear to be cost effective and would not significantly enhance investor protection.

- (3) **Option 3 – Extend compensation to certain non-retail clients (e.g. local authorities or large corporates).** Under this option, coverage would be extended only to specific non-retail clients (e.g. local authorities or large corporates), leaving the option to Member States to also extend coverage to other non-retail clients.

The same arguments as set out for option 2 would apply (i.e. this option provides only limited additional investor protection and potentially creates moral hazard issues). Therefore this option is also not a preferred one.

	Investor protection and confidence	Level playing field	Cost-Effectiveness
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<b>No action at EU level</b>	<b>0</b>	<b>0</b>	<b>0</b>
Extend compensation to claims relating to non-retail clients	0	+	---
Extend compensation to certain non-retail clients	0	0	--

### 7.2.3. Policy options relating to aligning the classification of clients with the MiFID definitions

- (1) **Option 1 – No action at EU level.** Under this policy option, the slight differences between the definition of some "professional and institutional investors" in the ICSD<sup>104</sup> and the definition of "professional clients" in MiFID<sup>105</sup> would remain. This would result in some inconsistency.
- (2) **Option 2 – Introduce a new classification of clients under the ICSD based on pure quantitative criteria.** Under this policy option, a new classification could be introduced under the ICSD in order to take into account the dimension of clients' assets involved in the provision of investment services independently of their professional qualification or their formal classification between professional or retail clients (for instance only clients with assets below a certain threshold would be covered). This solution would have the advantage of providing coverage where it may be useful in the light of the limited amount covered by the directive (currently, EUR 20.000). On the other hand, it would introduce an additional criterion of client categorization in the context of investment services and activities that could create uncertainty and make the classification of clients more complex.
- (3) **Option 3 – Align the classification of clients in the ICSD with the MiFID definition.** This option would provide greater consistency and clarity and simplify the position for compensation schemes and investors. It would also be consistent with the intent of the ICSD, i.e. to complement the ISD (now replaced by MiFID).

Further adopting the MiFID definition could cover a broader range of small and medium enterprises (SMEs) than the current ICSD definition<sup>106</sup>.

<sup>104</sup> Annex I of the ICSD and notably n. 1, 2, 3 and 8.

<sup>105</sup> Annex II.I of the MiFID.

<sup>106</sup> Currently firms which meet at least two of the following criteria are always able to claim compensation under the ICSD: Balance sheet total ≤ €4 400 000, net turnover ≤ €8 800 000, average number of employees ≤ €50. Under MiFID, only the bigger firms meeting at least two of the following criteria may be classified as professional clients *per se*: Balance sheet total < €20 000 000, net turnover < €40 000 000, own funds < €2 000 000. As a result, the adoption of the MiFID definitions would narrow the scope of firms that may be excluded under the ICSD.

This option, which can be implemented only through the amendment of the existing Directive, also has the advantage that, if under the MiFID review it were considered appropriate to extend the scope of protection of the retail client category to include other classes of clients, those clients would then automatically be covered under the ICSD, as the scope of coverage of the ICSD is linked to the scope of MiFID. For these reasons this is the preferred option. The alignment of the definitions under the two directives was generally supported by stakeholders.

	Investor protection and confidence	Level playing field	Cost-Effectiveness
No action at EU level	0	0	0
Introduce a new classification of clients under the ICSD	0	-	-
<b>Align the definition of a clients in the ICSD with the MiFID definition</b>	+	++	+

### 7.3. Policy options relating to reducing gaps in the regulatory system

#### 7.3.1. Policy options relating to non-coverage for failure of a third party custodian

- (1) **Option 1 – No action at EU level.** Under this option, the coverage of the failure of a "third party custodian" would not be guaranteed at EU level. Member States would still retain the possibility of extending at national level, the coverage of their national investor-compensation schemes to cover such cases. MiFID imposes specific requirements on firms who use third party custodians. It also requires the firm to provide a prominent warning to retail investors about the risks where third party custodians are used. Still, retail investors might not fully appreciate the different coverage under the ICSD if there is failure of a third party custodian. It also means that protection of retail investors will be quite different under the ICSD depending on whether their assets (i.e. financial instruments) are held by the firm itself or a third party custodian. Further, different positions taken in different Member States regarding extending coverage and different national laws about the liability of firms for custodians would mean that in the event of a failure of a custodian the position of investors could vary considerably from Member State to Member State. So taking no action is not considered to be the best option.
- (2) **Option 2 – Provide in MiFID that firms should be strictly liable to a client for any failure of a custodian they appoint.** Under this option, if an investment firm appoints a custodian and the custodian fails to return the financial instruments, the client would still have a legal claim against the firm for the return of financial instruments held by the custodian. That is, the firm could not avoid liability by arguing that it complied with all of its MiFID obligations and exercised all due diligence in the appointment of a custodian. This would potentially increase the protection provided to the client but the ability of the client to be compensated by the firm for any civil claim would

still depend on the firm having sufficient assets and capital to pay for the client's loss. Further, in an extreme situation imposing such liability could result in the failure of the firm itself (even though it has exercised all due diligence in selecting and monitoring the custodian). As MiFID already specifies relatively detailed requirements relating to the use of third party custodians it does not seem appropriate in this context to extend liability to a firm for failure of a third party custodian where the firm has complied with the MiFID requirements. We also note that the jurisdictions that currently impose strict liability regimes tend to be those jurisdictions where firms normally use a custodian within the same group rather than independent third party custodians. For these reasons this is not the preferred option.

- (3) **Option 3 – 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.** This policy option would give investors the right to be compensated by the investor-compensation scheme in case of failure of a third party custodian that results in the firm not being able to return the client's financial instruments.

This option would increase investor protection and investor confidence in investment services by dealing with the potential gap that would arise if a custodian were to default. Further it would do so without intervening, in this context, on the broader issue of the liability of firms in the case of default by a third party custodian. The extension of the coverage of compensation is to be included in a binding instrument, i.e. the ICSD, as it is necessary to provide for legal certainty both to the investors and to the market participants. This option will have cost implications for investment firms and entities providing custody services in terms of the contributions that need to be paid to schemes. But this is outweighed by the increase in the investor protection provided by the extension of coverage. This is the preferred option based on cost effectiveness and investor protection and confidence. A majority of Member States<sup>107</sup> having contributed to the call for evidence were against this option.

	Investor protection and confidence	Level playing field	Cost-Effectiveness
No action at EU level	0	0	0
Provide in MiFID that firms should be strictly liable to a client for any failure of a custodian they appoint	++	+	---
<b>Extend direct compensation to investors for claims relating to the failure of a custodian</b>	+++	+	+

<sup>107</sup> Member States against were Czech Republic, Finland, France, Netherlands, and the United Kingdom.

7.3.2. *Policy options relating to non-coverage for the default of a depositary or sub-custodian of a UCITS fund*

- (1) **Option 1 – No action at EU level.** Under this option, the coverage of the default of a depositary or sub-custodian of a UCITS would not be guaranteed at EU level. UCITS holders would still be unable to claim for compensation under the ICSD because due to failure of a depositary or sub-custodian and a loss of assets, their units or shares have lost value. Member States would be allowed to extend the coverage of their national investor-compensation schemes to these cases. This might have the potential consequences set out in section 3.3.2.
- (2) **Option 2 – Extend compensation to UCITS where assets have been lost subsequent to the default of its depositary or its sub-custodian.** This policy option would give UCITS (i.e. the fund itself) the right to be compensated by the investor-compensation scheme if the assets cannot be returned to it, because its depositary or a sub-custodian is insolvent.

This option would however only result in limited protection for UCITS investors as the level of UCITS losses that could be claimed by the UCITS fund through the ICSD (i.e. currently 20 000 Euros) would be very marginal compared with the average value of a UCITS portfolio (a few million euros<sup>108</sup>). Therefore this option would not seem to result in any significant increase of investor protection

- (3) **Option 3 – Amend UCITS Directive to strengthen the safeguards applying to depositaries and sub-custodians.** This option involves amending the UCITS Directive to strengthen the requirements that apply in relation to depositaries and the use of sub-custodians and to clarify the UCITS depositary liability. This option contributes to increasing the UCITS investor protection and the level of confidence in investment in UCITS schemes.

This option would seem effective and proportionate as arguably there has been a lack of clarity in the UCITS requirements relating to depositaries and the use of sub-custodians and a lack of consistency in applying those requirements. In this respect, the Commission has recently consulted on depositary issues to gather views and evidence on the need to adjust the current UCITS framework. It is likely that this will result in specific amendments to the UCITS framework to strengthen the existing legislation in order to clarify what their duties and liability are. This will constitute a separate work stream in the UCITS context.

- (4) **Option 4 – Extend ICSD compensation to UCITS holders where assets have been lost subsequent to the default of a UCITS depositary or its sub-custodian.** This policy option would give UCITS holders the right to be compensated by the investor-compensation scheme if the assets cannot be returned to the UCITS, because the UCITS depositary or any sub-custodian is insolvent. UCITS investors could claim for compensation under the ICSD, because their units or shares have lost their initial value due to a loss suffered

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<sup>108</sup> UCITS funds AuM amounts to 167 millions Euros in average - *Source EFAMA fact book 2008*

by the UCITS subsequent to the default of the UCITS depositary or its sub-custodian.

This option would increase investor protection and confidence in investment in UCITS schemes. In addition, in the light of the choice made under point 7.3.1, it is reasonable that the risk of losing assets because of problems with third party custodians under MiFID is addressed in similar terms in the case of problems with depositaries or sub-custodians of the UCITS.

Compared with option 2, the level of compensation offered through the ICSD seems proportionate for unit holders and covers the average amount that investors invest in a UCITS<sup>109</sup>.

This option could be complementary to option 3. Coverage of UCITS would of course be a significant extension of the scope of the ICSD beyond investment firms providing investment services. Also, the cost of this extension in coverage would logically be expected to be provided by UCITS or UCITS depositaries or sub custodians rather than investment firms. Moreover, strengthening the requirements for UCITS depositaries by its own could not efficiently address the problem. Nowadays, the ICSD is a safety net on top of the requirements on firms imposed by MiFID; a similar system should be built for UCITS. On balance this option along with option 3 would be the best options to protect investors and promote investor confidence in UCITS. The Member States<sup>110</sup> being opposed to extend the coverage to failure of a third party custodian were also against this option.

	Investor protection and confidence	Level playing field	Cost-Effectiveness
No action at EU level	0	0	0
Extend compensation to UCITS funds for assets that have been lost by a depositary (or sub-custodian).	+	0	--
Amend UCITS to strengthen safeguards that apply to depositaries	++	0	+
<b>Extend compensation to UCITS holders where assets have been lost by a depositary or sub-custodian</b>	+++	<b>0</b>	+

<sup>109</sup> According to estimation based on data provided in the EFAMA Fact book Euro household invest an average of 10.000 euros in collective investment funds.

<sup>110</sup> Member States against were Czech Republic, Finland, France, Netherlands, and the United Kingdom.

### 7.3.3. Policy options relating to non-coverage of money market funds

- (1) **Option 1 – No action at EU level.** Under this policy option, loss arising from investment in money market funds would continue not to be compensated under the ICSD. This would be consistent with the general principle underlying financial regulation in the EU, that investors in financial investments should not be protected from investment risk associated with their investments (e.g. if the value of the underlying assets or the value of the market declines). It would also mean that the ICSD is not extended to cover an entirely different set of participants from investment firms (i.e. operators of money market funds). The majority of contributors to the call for evidence, including all Member States, considered that money markets should not be covered by the ICSD.
- (2) **Option 2 – Introduce new requirements in the UCITS directive to define "money market funds" and strengthen requirements for such funds.** Under this policy option, requirements relating to money market funds would be strengthened. For example, by setting specific criteria for what can be described as a money market fund and prescribing specific regulatory requirements that apply to the operation of such funds. This initiative has been undertaken by CESR in order to create a European money market fund label. Equivalent initiatives have also been undertaken in the US, where the SEC is currently developing some proposals to strengthen the current definition of the US money market funds. Defining money market funds would help create a homogenous class of assets in the EU. It would be an essential first step should any further alternative solution need to be developed by authorities in order to avoid another liquidity crisis. This option would imply the amendment of the UCITS Directive, for which a new impact assessment would be developed assessing appropriate options. This is the preferred option from the perspective of increasing investor protection and being the most cost effective.
- (3) **Option 3 – Extend compensation under the ICSD to loss of value of units of "MiFID qualifying money market funds".** This option would provide for investors to be compensated in the event of a specific loss of value of their units in money market funds. It would apply to the safest money market funds based on the MiFID definition of a qualifying money market fund.

It would increase investor protection and investor confidence in qualifying MiFID money market funds. However this might not be significant as only the safest funds, those theoretically posing the least risk to investors would be covered.

Any proposal to compensate unit holders would need to consider why compensation should be payable for "investment risk" on such an investment, which is not a risk covered by the ICSD or other Directives. It would also be necessary to identify which types of money market funds are considered to be low risk, and why other similar "low risk" funds or products should not also be guaranteed. Singling out only one class of investment (money market funds) for special treatment would also seem to create a competitive advantage to money market funds over other analogous funds and products.

Investment risk is inherent in all financial decisions in investment products such as money market funds and is rarely the subject of regulation. The only exception is bank deposits, which due to their universal use, unique characteristics and systemic importance are treated as requiring special treatment (due to the risk of bank runs). But money market funds are not the same as bank deposits. They are popular with retail investors in certain Member States but are not universally used in the same way as bank accounts. They are an investment product with investment risk and the investment risk can vary significantly from fund to fund.

There would clearly be a cost to this option in terms of funding the scheme. It is assumed that this would be borne by money market fund operators rather than investment firms (as investment firms are a distinct and separate population). This appears to be a less cost efficient option than other options.

An alternative solution would be to apply coverage to all money market funds (not just the safest funds). But this would highlight even more starkly the issue of why money market funds that invest in higher risk instruments should be protected under the ICSD while other types of funds or investments are not protected. It might also raise moral hazard issues.

On the assumption that the issue will be dealt with through a strengthening of the requirements under UCITS that apply to money market funds (option 2), that option would appear to be the most effective means of dealing with issues relating to money market funds.

This option is therefore considered not to be justifiable or cost effective.

	Investor protection and confidence	Level playing field	Cost-Effectiveness
No action at EU level	0	0	0
<b>Take action to strengthen requirements applying to Money Market Funds</b>	++	<b>0</b>	+
Extend of compensation under the ICSD to loss of value of the safest money market funds	++	--	-

#### 7.4. Policy options to maintain some alignment between the ICSD and the DGSD.

##### 7.4.1. Policy options relating to the minimum level of compensation under the ICSD

- (1) **Option 1 – No action at EU level.** Under this option, Member States would continue to be free to increase their compensation levels, but the minimum compensation level would remain unchanged. The potential consequences set out in section 3.3.1 would remain, especially regarding distortion of the internal market and compromising investor protection and confidence in investment services. It would also leave significant differences between the

level of compensation payable for investments and deposits (where the level is now significantly higher since the DGSD has been amended).

So this option is not considered credible either from an investor protection viewpoint (as the minimum level of compensation would remain comparatively low) or from the perspective of maintaining a level playing field between investments and deposits and between the levels of compensation provided for in different Member States.

- (2) **Option 2 – Amend the ICSD and replicate the coverage adopted under the DGSD.** This policy option would re-introduce the level playing field between the ICSD and the DGSD. It would introduce a maximum compensation level, so that Member States would not be able to set different amounts.

This option would be significant in terms of investor protection. Especially in those limited situations where cash is held by a bank and it is difficult to determine if it is a deposit or is being held in connection with an investment service. In such cases the investor would receive the same level of compensation irrespective of how the cash is classified.

But it is unclear that it would necessarily result in a significant increase in confidence in investment services. For example, if on average investors have cash or investments worth €30 000 held by investment firms, increasing the level to €100 000 would arguably not provide much further investor confidence than increasing the level to €50 000.<sup>111</sup>

Therefore while it would promote a level playing field between investments and deposits and between the protections provided for in different Member States, this option is not considered to be cost effective.

- (3) **Option 3 – Amend the ICSD and increase the minimum level of compensation to €50 000, but allow Member States to specify a higher limit (minimum harmonisation approach).** This policy option would increase the minimum compensation level by fixing it at a level which is more closely related to the average value of investments held by retail clients, while allowing Member States to apply higher compensation levels.<sup>112</sup> Most industry associations expressed the view that there should not be an automatic alignment with the DGSD; although investor representatives supported the alignment of the compensation level. Investor compensation schemes have expressed mitigated views. The Commission's view is that this option is a fair compromise between on the one hand increasing investor protection and investor confidence in investment services, and on the other hand reducing the risk of a level playing field issue between deposits and investment products.

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<sup>111</sup> Please refer to Annex IV for the average amount held by investment firms on behalf of retail investors  
<sup>112</sup> Put customers first – European survey on people's approach to savings, Fidelity International, April 2010: "Around half of those surveyed think they have good or reasonable knowledge of financial products while around half admit to having a poor level of knowledge. There are significant differences between countries. The UK stands out as the country with the highest level of claimed knowledge, which may reflect more independent advice and a more sophisticated financial press."

This option is to be introduced by a change in the ICSD as it should have binding effects to ensure a minimum level of protection to investors in all Member States.

It would potentially require further funding depending on the average level that would be established (especially if further pre-funding was required). But it would ensure that the level of costs would be calibrated to a realistic level of investments held by investors. Indeed the target fund level will be calculated taking into account the amount of securities and monies held by the members of the scheme on behalf of retail investors. As a result national schemes of Member States where the average amount of securities held by retail investors is lower than the minimum compensation limit will require lower level of contributions from their participating firms.

As the national schemes do not, as a general rule, have any data on the distribution of the amount of monies and securities among retail investors, they could not provide us neither with the average and median of securities held by retail investors neither with an assessment of the impact on contributions from participating firms if the minimum compensation limit would be increased (see question 13 in the second set of questions sent to the national schemes).

In terms of data on the amount of monies and securities held by investment firms on behalf of retail investors, only 6 Member States, 5 of them being new EU-12 Member States and Portugal, could provide us with average data. As explained under paragraph 3.4.1., among the 5 new EU-12 Member States, Poland had the highest average with an amount of €43 000 very close to the Portugal's average of €44 000. As a reminder these two countries are ranked in the lowest 10 EU-27 countries in terms of GDP per inhabitant. For a more representative sample of data we used the study commissioned by the Commission on "the EU market for consumer long-term retail savings vehicle". It should be noted that savings behaviours vary enormously between Member States. Based on their customer survey (see paragraph 3.4.1.), retail investors can invest significant amounts in bonds and in investment funds<sup>113</sup>, even exceeding €50 000 in several Member States. The third source of data we used was Eurostat. As the average amount of financial instruments held per investor or securities account is most of the time not available at the national scheme level, we calculated the average amount of securities held per household based on the household's financial accounts published by Eurostat. These data are only rough estimates and should be analysed with care. The average amount of securities held per household across all EU countries amounts to €21 000. The average for EU-15 countries amounts to €31 000. As you will notice the data from the different sources are not easily comparable and give a wide range of estimations. If you compare the amounts per consumer from the consumer survey carried out by BME Consulting with the

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<sup>113</sup> Based on data from their consumer survey, the average amount invested in bonds per consumer is €173 000 in the Netherlands, €106 000 euro in France, over €87 000 in Italy, €43 000 in Germany, €29 000 in Spain, €19 000 in Sweden and €18 000 in the UK. Households in the countries where investment funds are most popular tend to invest between €30 000 and €50 000 while their French and UK counterparts invest over €120 000.

Eurostat data per household, the main conclusion we can draw is that the number of retail investors should be lower than the number of households. As a result the new minimum compensation amount should be higher than the average amount calculated per household based on Eurostat data.

Only three schemes (Germany, Ireland, and Italy) were able to provide us with an impact assessment in terms of compensation amounts to be paid and investors' coverage based on a concrete compensation case (except for Italy). Indeed when a compensation case is triggered, the scheme will receive the distribution of the monies and securities held by the defaulted firm for each of its retail client. Two additional schemes (Portugal and Bulgaria) were able to provide an assessment in terms of investors' coverage. It should be stressed that it is difficult to assess to what extent these 5 examples might be representative of the other 22 Member States in view of the different investment patterns by retail investors between the different Member States.

Based on the Phoenix case in Germany, an increase of the compensation limit to € 50 000 would result in the compensation costs rising by 23% and would benefit approximately 4.0% of the investors. An increase to € 100 000 would result in the compensation costs rising by 37% and would benefit approximately 5.5% (4.0% + an additional 1.5%) of the investors. The number of investors having filed a claim in the Phoenix case amounted to 30 000 investors out of which approximately 90% had invested less than € 20 000. As a result 10% of the investors remained unprotected (for the amount above €20 000). The number of additional investors that would have benefited from an increase of the limit to € 50 000 or € 100 000 would have been respectively 1 200 or 1 650 additional investors out of the 3 000 unprotected investors.

Based on data collected by the Irish scheme in relation to the W&R Morrogh case, an increase of the compensation limit to € 50 000 would result in the compensation costs rising between 15% and 31% and would benefit approximately 2.9% of the 2 605 investors having filed a claim (or 78 claimants). An increase to € 100 000 would result in the compensation costs rising between 46% and 73% and would benefit 4.4% (2.9% + an additional 1.5%) of the investors (or 117 claimants).

In the case of Italy, with the current level of compensation of €20 000, 70% of the investors are covered. An increase to €50 000 would mean that 90% of the investors would be covered at a costs increase of 50%.

According to the Portuguese scheme, with the current level of coverage € 25 000, in average, 82.6% of covered investors would be fully compensated if the ICS was triggered. The increase in the level of coverage to € 50 000 and to €100 000 would lead to an increase in the proportion of investors that would be fully compensated to respectively 91.4% and 96.1%. If we use as a proxy the number of securities accounts (circa 2.3 million) to assess the number of investors, the increase of the limit would benefit respectively circa 205 000 (8.8% of the investors) and 315 000 investors (13.5% of the investors).

In the case of Bulgaria, 95% of the investors are covered with the current compensation limit of €20 000.

The optimal level of coverage is likely to be less than that adopted under the DGSD. But to deal with situations where it is unclear if assets held by banks are covered by the ICSD or the DGSD, the ICSD could be amended to specify that the investor is to be compensated under the directive providing the highest level of coverage (i.e. the DGSD); the current option to Member States under Article 2(3) of the ICSD should be modified accordingly. This would protect investors, reduce level playing field concerns and provide an incentive to banks to clearly specify the character of an account (i.e. whether a deposit or a securities account).

Although this option would contribute to increased investor protection and a fair level playing field between investment products and deposits, there is still the risk of arbitrage between Member States since they would still be allowed to apply higher compensation levels. In some Member States the current compensation limits are already higher than the proposed compensation level of €50 000 (e.g. Spain €100 000, the UK £50,000 and France €70 000). As a result investors might move their securities within their home country from a national investment firm to the branch of an investment firm from another Member State where the compensation limit is higher. Investors might also move their securities from one Member State to another Member State where higher compensation limits are in place. Although such behaviour was not experienced during the crisis, this situation potentially undermines the purpose of the ICSD which was to ensure the proper functioning of a single market for investment services and to eliminate competitive distortions.

- (4) Option 4 \_ 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).**

The approach of maximum harmonisation would require a fixed level of compensation of €50 000 in all Member States. This new compensation limit of €50 000 will be close to the limit in place in the UK (£50 000) where retail investors are more acquainted with investment products. If in the UK, where there is a high number of investment firms active the authorities have considered that this limit is adequate, being a more dynamic and developed market in terms of investment products, it could also be adequate for the EU. To allow for a smooth transition in Member States with a higher compensation limit than €50 000 (e.g. Spain €100 000, the UK £50,000 and France €70 000), the existing higher compensation amount could continue to apply in these Member States for a period of 3 years from the date of transposition of the revised ICSD. The UK compensation limit being relatively close to the proposed level of compensation of €50 000, the transition may be possible more quickly. In the case of Spain and France, the difference being greater, a decrease of their compensation limits might justify a longer transition period.

In summary the transitional period of 3 years seems to be reasonable as the funding needs of these schemes should be impacted in a positive way. This option would present the same advantages as Option 3 in terms of investor protection while in addition reducing the risk of cross border discrepancies. Nonetheless we have to acknowledge that the decrease of the compensation limit in the two Member States with an existing significantly higher limit (i.e. Spain and France) might create competitive distortions between investment products and deposits. But the Commission is of the view that this risk is lower than the risk of arbitrage between Member States with different compensation limits. This option is therefore the preferred option. Views expressed by Member States in the call for evidence about an increase of the compensation limit were divided. Half of them were in favour of an increase, but not always necessarily to the level of coverage under the DGSD<sup>114</sup>.

	Investor protection and confidence	Level playing field	Cost-Effectiveness
No action at EU level	0	0	0
Amend the ICSD and replicate the coverage adopted under the Deposit Guarantee Scheme Directive	++	+	-
Amend the ICSD and increase the minimum level of compensation to a minimum level of €50 000	++	+	0
<b>Amend the ICSD and increase the level of compensation to a fixed amount of €50 000</b>	++	++	0

#### 7.4.2. Policy options relating to the co-insurance principle

- (1) **Option 1 – No action at EU level.** Under this policy option, Member States would continue to have the option of limiting the compensation for an investor's claim to 90% or more of the claim. That is, Member States could require investors to bear a proportion of any loss ("the co-insurance principle"). This option would mean that the consequences set out in section 3.4.2 would remain.
- (3) **Option 2 – Modify the co-insurance principle.** Under this policy option, the co-insurance principle would be modified in order to require a qualitative element i.e. the assessment of whether the client could have become aware of problems in the holding of assets by the investment firm. The option would further strengthen the rationale of the co-insurance principle (that is to encourage investors to take some care in choosing and maintaining the investment firms). On the other hand, it would add complexity and delay in the management of ICSD cases.

<sup>114</sup> Member States in favour of an increase were Estonia and France, as well as Finland and the United Kingdom but in these two cases not necessarily to the level of coverage under the DGSD.

- (3) **Option 3 – Remove the possibility of co-insurance.** This policy option would eliminate the option for Member States to require investors to bear a proportion of any loss.

The co-insurance principle diminishes the compensation that clients can claim. Eliminating this option would provide increased investor protection under the ICSD and would also improve investor confidence in investment firms, as clients would no longer have to bear part of the loss if there is fraud at a firm or other problems with the firm's systems or controls. The elimination of the co-insurance principle would be done through amendment of the ICSD to ensure the same level of investor protection in all Member States. A non-binding solution would not be able to achieve the same purpose.

The rationale for this option was expressed in the ICSD to be to encourage investors to take due care in their choice of investment firms.<sup>115</sup> It addressed an element of moral hazard risk (i.e. that the introduction of the ICSD may encourage investors not to take care in their selection of investment firms). But arguably it is unrealistic to expect retail investors to be able to identify which firms are more or less likely to be affected by fraud or systems failures (unless a firm is making claims about a service that are clearly unrealistic). Contributors to the call for evidence, industry and investor associations have expressed a great consensus on removing the co-insurance principle.

Therefore this option is the preferred option based on investor protection and confidence and ensuring a level playing field between investments and deposits and across Member States.

	Investor protection and confidence	Level playing field	Cost-Effectiveness
No action at EU level	0	0	0
Modify the co-insurance principle	0	0	--
<b>Remove the possibility of co-insurance</b>	++	+	<b>0</b>

## 8. ANALYSIS OF IMPACTS

### 8.1. Impact on stakeholders

The following table shows the impact of the changes comprising the preferred policy options in relation to the main stakeholders.

Impact on stakeholders	Investors	Compensation schemes	Investment firms	Supervisors	Other stakeholders
Scenario					

<sup>115</sup> See recital 13 of the Directive.

Impact on stakeholders Scenario	Investors	Compensation schemes	Investment firms	Supervisors	Other stakeholders
Harmonise how schemes should be funded	Investor protection and confidence would be reinforced as these principles and rules would reduce the risk of a scheme having insufficient funding to meet its obligations. There would also lead to an increased harmonisation of the level of investor protection between Member States.	Compensation schemes would benefit from common and clearer funding requirements.	Investment firms would be required to provide more contributions ex ante which would increase the funding costs (1).  The increased harmonisation of the funding rules would improve the proper functioning of the single market by reducing discrepancies affecting the treatment of investment firms between Member States.	Supervisors would have common and clearer rules in order to assess the adequacy of the funding of the scheme.	No impact
Introduce a solidarity principle in the context of the European system of national schemes	Investor protection and confidence would be reinforced through borrowing possibilities among national schemes. They would be confident to be compensated within a reasonable period of time even in the case of the failure of a very large investment firm.	National schemes would benefit from the development of common network leading to problem- and solution-sharing. This solidarity principle would be a cost-effective way to cope with liquidity problems that might arise from the failure of a large investment firm.	This option would provide more flexibility in the collection of contributions from investment firms, with the possibility to distribute overtime any important losses. This solidarity principle would be a cost-effective way to cope with the failure of a major investment firm, while ensuring the industry will contribute to such a failure.	This solution would be consistent with the current common framework of supervisors and with the forthcoming EU system of supervisory authorities	No impact
Require provisional payout of partial compensation if payout delay exceeds a given time period	Investor protection and confidence would be reinforced as investors would be confident that they would receive part of the compensation amount after a given time period.	Schemes would need more resources to verify the eligibility and the provisional amount of the claim within the specified time period.	The earlier payment of claims could have an impact on the funding levels required from the investment firms.	No impact	No impact

Impact on stakeholders	Investors	Compensation schemes	Investment firms	Supervisors	Other stakeholders
Scenario					
Require firms to disclose to investors what is covered and what is not covered by ICSD schemes	This option would increase investor awareness of the level and scope of coverage and result in greater investor confidence.	Schemes would receive fewer invalid claims if the scope of coverage is clearer to investors.	Investment firms would have to improve their existing disclosure procedures.	Supervisors would have clearer rules against which to assess the compliance by investment firms with the disclosure requirements.	No impact
No action at EU level: Do not expand the scope of mandatory coverage to breach of conduct of business obligations	Investor protection in the event of the failure of a firm giving poor investment advice may vary between Member States depending on whether coverage in that State is extended to cover such situations.	No impact	No impact	No impact	No impact
Align the definition of clients in the ICSD with the MiFID definition	It would provide greater certainty and clarity leading to improved investor confidence. More medium-sized companies would fall under the scope of the ICSD.	The identification of investors eligible to the coverage of the scheme would be easier as it would correspond to the MiFID classification implemented by the investment firm.	There would be a common categorisation of retail investors in the two directives avoiding any duplication of categories.	No impact	No impact
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	Increased protection for investors in situations where there was failure of a third party custodian.	Potentially more claims will need to be processed if there is default of a third party custodian.	Increased funding will be required from firms to cover the extension in scope of the Directive.	No impact.	Third party custodians may also be required to contribute to funding the extra coverage.
Amend UCITS to strengthen safeguards that apply to depositaries and sub-custodians	Increased investor protection and confidence when investing in UCITS schemes	No impact	No impact	Improved supervision of UCITS funds and their depositaries and sub-custodians	UCITS funds would have to comply with stronger requirements in relation to depositaries and sub-custodians whose liability would be clarified.

Impact on stakeholders Scenario	Investors	Compensation schemes	Investment firms	Supervisors	Other stakeholders
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	Increased investor protection and confidence when investing in UCITS schemes	A wider range of claims will need to be processed by schemes as a result of the extended scope of scheme coverage.	No impact (on the assumption that the cost of funding the extra coverage is borne by UCITS funds and/or depositaries and not by investment firms).	No impact	UCITS funds and/or depositaries are likely to be required to provide funding to cover the extension of coverage under the Directive.
Take action to define "money market funds" in the UCITS directive and to strengthen requirements applying to such funds	Increased investor protection and confidence resulting from the clarity of having a common definition of Money Market Funds and specific regulatory requirements in terms of types of investments and risk management.	No impact. Compensation schemes would not cover investment risk.	No impact	Improved supervision of Money Market funds	Money Market Funds would have to comply with new regulatory requirements.
Clarify that if firms do in fact hold client assets the clients should be entitled to compensation if the firm defaults	Investor protection and confidence would be increased as investors could claim irrespective of the investment's authorisation and of the nature of the investment service provided.	This option would bring clarity to the scope of the scheme and avoid any situation like the AMIS case where investors and the scheme do not agree on the scope of the coverage.	In Member States where such claims are not currently permitted, firms may have to provide funding where previously they were not required to do so.	No impact	No impact
Exclude coverage of claims when market abuse was involved	It would improve investor confidence and market integrity by removing this loophole.	No impact	No impact	No impact	It would increase market integrity by removing this loophole.

Impact on stakeholders Scenario	Investors	Compensation schemes	Investment firms	Supervisors	Other stakeholders
Amend the ICSD and increase the level of compensation to a fixed amount of €50 000	The compensation level would be aligned with the average amount of investment held by investors leading to increased protection and confidence in many Member States. This would also increase harmonisation of the level of investor protection between Member States.	No impact	Contributions required from investment firms would be increased (especially if greater ex ante funding is required).  Harmonisation of compensation levels between Member States ensuring a level playing field between firms in different States.  The higher compensation limit for investments would reduce the competition distortion between investing in deposits and investment products.	No impact	No impact
Remove the possibility of co-insurance	The compensation amount would slightly be increased resulting in increased investor protection and confidence.  Investors would receive consistent treatment across Member States as there would no longer be discretion for individual States to impose co-insurance.	No impact.	Contributions required from investment firms would be slightly increased <sup>116</sup> .	No impact	No impact

<sup>116</sup> The UK FSA conducted a detailed cost benefit analysis in October 2008 before deciding to remove the co-insurance principle for investment products: "If co-insurance had not been applied to the compensation payments made during the period December 2001 to December 2007, claimants would have, as a group, benefited from payments being approximately 1.4% higher."; [http://www.fsa.gov.uk/pages/Library/Policy/CP/2008/08\\_15.shtml](http://www.fsa.gov.uk/pages/Library/Policy/CP/2008/08_15.shtml)

(1) The IA Board has called for an assessment of the one-off and ongoing costs for the relevant stakeholders. To assess the costs impact upon investment firms of the introduction of harmonised funding rules is hypothetical at this stage as these funding rules will be defined based on a number of variables that will need to be determined on a State by State basis and as there is a lack of data at the national schemes level which makes the calibration of an appropriate target fund level very difficult. As a result the following figures should be looked at very carefully and in no case are these claimed to be representative.

We have made our simulation based on the amount of covered securities and monies which is the most appropriate calculation base to calculate the amount of the target fund level. But it should be noted that the amounts of the covered securities and monies communicated by the schemes are based on the existing compensation limit (in most cases €20 000) whereas we propose to increase the compensation limit to €50 000. It is also worth noting that these simulations do not take into account the extension of the coverage to firms providing custody services or UCITS depositaries<sup>117</sup>. Nonetheless two scenarios have been developed which gives a rough estimate of the potential costs impact upon investment firms in a limited number of Member States (10 schemes). In the first scenario, where the target fund level has been set at 0.50% of the covered securities and monies held by investment firms on behalf of retail investors with an ex ante funding proportion of 100%, there would be 4 schemes with a deficit of funding and 6 schemes with an excess of funding. Portugal which is currently ex post funded would be the most severely impacted scheme with an average increase of funding of circa € 1.2 million per participating firm (it should be taken into account however that big firms will have to contribute more than smaller ones in proportion to their business size and there would be a transition period of 10 years to reach the target fund level).. Hungary would have the second highest deficit in funding with an average of circa €400 000 per participating firm. Luxembourg and Netherlands would incur a deficit of respectively circa €40 000 and €20 000 per investment firm<sup>118</sup>. The six schemes with an excess of funding are Bulgaria, Cyprus, Denmark, Romania, Slovakia, and Spain (Fogain). In the second scenario the target fund level has been set at 1.00% of the covered securities and monies held by investment firms on behalf of retail investors with the same ex ante funding proportion of 100%. The proportion of schemes with a deficit of funding and schemes with an excess of funding would remain the same. The Portuguese scheme would still have the highest deficit with about € 2.4 million per participating firm. Hungary would rank second with circa €1 million per participating firm. Luxembourg (ex post funded scheme) and Netherland would have a similar level of deficit with around €70 000 per participating firm<sup>119</sup>. The six schemes left with an excess of funding are Bulgaria, Cyprus, Denmark, Romania, Slovakia, and Spain (Fogain).

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<sup>117</sup> The number of retail investors in UCITS funds in Europe is significant. Based on EFAMA data as of end 2008 (see page 19), there are around 35 500 UCITS funds in Europe. Based on the assumptions that there are 2 000 unit holders per UCITS fund and that 37% of these unit holders are retail investors, the estimated number of retail investors in Europe is approximately 26 millions.

<sup>118</sup> With respect to the Netherlands, these data relate to non-bank investment firms (i.e. data from the scheme covering bank investment firms were not available).

<sup>119</sup> With respect to the Netherlands, these data relate to non-bank investment firms (i.e. data from the scheme covering bank investment firms were not available).

The additional costs calculated per firm will be (partially) passed on to retail investors. Taking the assumption that 100% of the costs would be pass on to retail investors, this would mean a one-off costs increase (to be spread over a transitional period of 10 years) per retail investor in the first scenario of between €25 and €40 and in the second scenario of between €65 and €135 for the countries with a deficit of funding for which the number of securities accounts were available<sup>120</sup>.

## 8.2. Other impacts

### 8.2.1. *Impacts on the environment, employment and third countries*

It is not expected that the changes in the ICSD are going to have any impact on the natural environment or on the gender policy of the EU.

Concerning the social impact of the amendments to be introduced in the ICSD, it is not possible to assess the direct impact, however as the amendments to the ICSD are introduced in order to enhance investor protection and investor protection is essential in maintaining a social order, social welfare, prosperity etc., the overall impact will be positive for the society. Consumers will be better protected and thus have more confidence in the system, that they will trust to, for instance, finance their pensions through alternative investments and not simply rely on national social security budgets – which have become very tight through the crisis. Moreover, the enhancement of investor protection (buy side) will facilitate the access of SMEs (sell side) to alternative financing mechanisms. As a consequence, SMEs will have more financing to create further jobs, thus it will create a positive impact on the employment.

As regards investment firms of third country origin, as in order to operate in the EU under the MiFID framework they have to become EU investment firms and be established in the EU, they will not be impacted in a different way as EU firms. Investors of third countries will be protected in the same way as EU investors; therefore their level protection will also be enhanced.

### 8.2.2. *Impacts on small and medium size enterprises*

"Small" companies<sup>121</sup> are covered by the ICSD, but "medium sized companies"<sup>122</sup> were excluded from the scope of the ICSD.<sup>123</sup> The alignment of definition of retail

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<sup>120</sup> These estimates are only based on the four Member States out of the 10 Member States which could also provide us with the number of securities accounts held for retail clients by investment firms. These four Member States are: Hungary, Netherlands, Portugal and Hungary. All of these four schemes have a deficit of funding in our two simulations except Romania which in the first scenario has a slight surplus.

<sup>121</sup> See Article 4(2) and Annex I Category (8) of the ICSD; Companies which are of such a size that they are permitted to draw up abridged balance sheets under Article 11 of the Fourth Council Directive 78/660/EC are covered by the ICSD.

<sup>122</sup> As per the definition of the Fourth Accounting Directive 78/660/EC, "medium-sized" companies are companies which, on their balance sheet dates, do not exceed the limits of two of the following three criteria::

- balance sheet total: EUR 17 500 000;
- net turnover: EUR 35 000 000;
- number of employees: 250.

investors under the ICSD with MiFID would bring more "medium sized" companies under the scope of the ICSD.<sup>124</sup> Therefore, SMEs will be better protected, as they will have the right to claim compensation in case of failure of an investment firm. Currently, there is no level playing field at EU level on the coverage of SMEs by compensation schemes.

The changes envisaged to improve the functioning of the ICSD (principles about funding, provisional payout of partial compensation, more detailed information about compensation scheme coverage) would lead to a better protection of the retail investors including the "small" and "medium sized" companies. The increase of the minimum level of compensation and the removal of the co-insurance principle would also enhance retail investor protection and confidence.

Concerning investment firms, as their contributions to the compensation schemes is likely to be proportionate to the size of their business, compliance costs may not be as significant as for larger firms. A direct effect of the amendments to the ICSD will be that as investor protection is enhanced, investors will have more incentives to invest in securities markets and thus the scope for business of investment firms will be extended, including for SMEs.

### **8.3. Estimation of reduction or increase in administrative burden**

No additional administrative burden is foreseen for investment firms, as supervisory authorities have already the necessary information to be transmitted to the national compensation schemes to calculate the amount that every firm will have to contribute - in compliance with MiFID, investment firms have to report all the relevant information to the supervisory authorities.

Concerning UCITS depositaries and sub-custodians, the extension of the coverage of the investor compensation scheme to the UCITS unit holders in case of loss of the assets by a UCITS depositary or a sub-custodian will involve additional reporting by the depositaries and sub-custodians to the relevant authorities.

There will be increased disclosure obligations upon investment firms, UCITS and the national schemes. The existing disclosure obligations upon investment firms will need to be reinforced by requiring firms to disclose in clear and simple terms what is covered and what is not covered by the schemes. The full set of disclosure obligations upon investment firms will be extended to UCITS which were currently not covered by the ICSD. National investor compensation schemes will have to publish annually information about their level of funding and the target funding level.

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<sup>123</sup> As per the definition of the Fourth Accounting Directive 78/660/EC, "small" companies are companies which, on their balance sheet dates, do not exceed the limits of two of the following three criteria:

- balance sheet total: EUR 4 400 000;
- net turnover: EUR 8 800 000;
- number of employees: 50.

<sup>124</sup> Article 4 (11) & (12) and Annex II of MiFID: Professional investors are defined in Annex II of MiFID and includes large undertakings. Article 4(12) of MiFID defines retail investors as investors not being professional investors.

Based on the calculations presented in Annex XII, we estimate that there will be approximately €1 500 000 of one-off administrative burden on investment firms and credit institutions providing investment services. There will not be any measurable on-going costs imposed by the planned amendment on these firms.

The on-going administrative burden on UCITS is estimated at € 9 400 000, and the on-off costs on UCITS are estimated at €240 000.

For the compensation schemes we estimate a recurring administrative burden between €15 000 and €30 000 per year overall in the EU 27.

#### **8.4. Summary of the final outcome**

In view of the conclusions reached in this impact assessment, the European Commission considers appropriate to present a proposal amending the Investor Compensation Scheme Directive. The fulfilment of the policy objectives described in section 5 is to be achieved through a legislative solution, as it is necessary to harmonise the details for the funding of investor compensation schemes, the coverage of the schemes, the minimum compensation limit and the compensation payout periods in order to create a level playing field for investors' compensation in the European Union. A Directive is the proposed instrument, as it will ensure a common framework while leaving some margin of discretion to the Member States when implementing it, since national compensation schemes operate in very different ways due to differences in national markets. The issuance of a recommendation by the Commission on the issues covered by this review would not be enough, as it would not create the necessary legally binding obligations to ensure a level playing field for investor protection within the EU. The exchange of best practices between the schemes might be a good tool to support the application of the new principles to be introduced in the Directive.

However, as a legislative measure should be principles based and, to the extent possible, avoid unnecessary technical details, it is necessary to recognize a role for the forthcoming European Securities and Markets Authority (ESMA) – set up in a proposal for a Regulation adopted by the European Commission in September 2009 and currently under negotiation through the co-decision procedure – in elaborating technical standards with regard to the highly technical functioning of the compensation schemes.

The proposal should aim at solving the problems identified in this impact assessment:

- 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 assets for retail clients 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.

## **9. 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.

## ANNEX I – OUTCOME OF THE CALL FOR EVIDENCE

The European Commission received 70 contributions: 9 from compensation schemes, 4 from investors or investor groups, 45 from industry bodies, professional bodies and firms and 12 from Member States (securities regulators and finance ministries).

Contributions received from stakeholders varied in detail. There was a large amount of consensus on a number of technical issues. Also, there was consensus against extending the scope of the directive in a number of areas (especially from industry rather than investor groups). On issues relating to the structure and funding of schemes, opinion was divided. A summary of the main comments received is presented in the following:

- § **Should Multilateral Trading Facilities be covered by the directive?** – There was general consensus that in practice MTFs do not hold clients assets so it is unlikely that investors may suffer losses as a direct consequence of the operation of an MTF. Other emphasised that, still, the directive should cover this possibility (even if remote) and that this should also apply to regulated markets that operate an MTF in order to ensure a level playing field.
- § **Should investment firms be covered even if their permission does not entitle them to hold client assets?** – The principle was generally supported. Some respondents argued that the coverage should be consistent with any limits in the authorisation. Others underlined that investors should be protected under the directive even if a firm was not entitled under its permission to hold funds. It is reasonable that a client's protection should not depend on a factor (the precise terms of a firm's permission) that client's cannot be expected to be aware of.
- § **Should investment firms be covered if they provide services only to non-retail clients?** – In line with the reasoning developed in the previous point, some respondent emphasised that, since retail customers may not be aware of the precise terms of a firm's permission, firms should be covered under the ICSD if they do in fact provide services to a retail customer (although their contribution to the fund should reflect the limitation in their authorisation). Under a different point of view, some respondents were also open to the idea of extending coverage to professional clients; most responses, however, opposed extending coverage under the directive beyond retail clients to, for example, local authorities, professional or institutional investors.
- § **Should investors be compensated for default of a third party where assets have been deposited? Should UCITS and UCITS unit holders be able to claim for the failure of a UCITS depositary or sub-custodian?** – Many responses opposed such perspectives as being a significant and unjustified extension of the scope of the directive. There is generally no contractual relationship between investors and depositaries and it is more appropriate that clear responsibilities should be placed on an investment firm or UCITS regarding the appointment and monitoring of a depositary or sub-custodian. If a depositary or sub-custodian fails it should be for the investment firm or the UCITS to recover monies by civil action. Further, some responses suggested that, due to the differences between investment services and collective portfolio management, tools other than the ICSD would address more appropriately the issue of UCITS unit holders' compensation (e.g. a separate and specially designed UCITS compensation scheme was mentioned).

- § **Should the directive cover any breach of conduct of business rules?** There was a divergence of views. Especially in the UK, where the scheme already covers any breach of conduct of business rules, respondents were prudently supportive. Most other respondents thought that this would be legally and administratively complicated and unworkable as it would be very difficult for schemes to judge if there was a valid claim in the event of a default by a firm. The issue of the significant increase in costs for the financial system was also raised.
- § **Should the level of compensation under the directive be aligned with the level under the deposit guarantee scheme directive?** There were a number of respondents who thought that the levels should be aligned. Many suggested, however, that the nature of the investments and risks addressed is quite different. Further, it was claimed a lack of evidence that existing levels under the ICSD were inadequate. For example, very few claims resulted from the financial crisis. Various respondents suggested that any increase should be subject to a thorough cost benefit analysis. In some cases, there was support for a level playing field as to maximum levels.
- § **Should general principles about how schemes should be funded be introduced?** The majority of respondents supported details of funding being left to individual Member States. Others thought that at least some funding principles would be useful. Some respondents took an explicit position in favour of pre funding. The issue of ensuring consistency between the ICSD and Deposit Guarantee Schemes Directive was mentioned, also in the light of the joint operation of the two schemes in some countries. Access to liquidity by such schemes (such as lending facilities) would also need to be addressed.
- § **Should the process of recognizing the eligibility of the claim be regulated?** Most responses thought that the process should not be regulated at Community level as it would be much more complicated than for claims by depositors. The issue of existing huge differences between national laws and judiciary systems was underlined.
- § **Should provisional partial compensation be introduced?** There were mixed responses. Some believing it was desirable and others that it was not feasible as it would be difficult to quickly verify a claim and then complicated to recover amounts that were later found to have been unduly paid out.
- § **Should compensation schemes have minimum reserve funds?** Responses were divided. Many underlined that the need of compensation is not the same as for deposit guarantees, where funding is required more urgently, and that reserve funds would add complexity to the funding and to the management of the resulting funds.
- § **Should special attention be given to money market funds?** Most thought that they should not be covered as the rationale was entirely different (i.e. to encourage investment in money market funds for a public policy purpose) and that it would be compensating for 'investment risk' a risk that should not be covered by compensation funds. Other underlined that possible liquidity problems should be addressed through measures other than the ICSD, which has a completely different purpose.

#### **Other issues**

- § Some respondents felt that, especially in cross borders situations, there needs to be clear disclosure to investors about the scope and coverage of schemes.
- § It was also suggested that more co-operation between member states should be provided for in the directive.

- § In general, the need for more alignment between the ICSD and the Deposit Guarantee Schemes Directive was also mentioned (for example, cancelling the co-insurance principle i.e. that a portion of losses should be borne by the investor).
- § Another point is that there is no exclusion of coverage for claims involving a transaction where market abuse has been involved (an exemption currently only applies to money laundering).

## ANNEX II – QUESTIONS SENT TO INVESTOR COMPENSATION SCHEMES

### First set of questions sent in June 2009

#### **1. Funding arrangements**

1.1. How is the compensation scheme funded? By pre- and/or post-funding? Up to what percentage?

1.2. In the case of pre-funding, how is the on-going management of collected funds regulated or supervised?

1.3. Are funds pooled/differentiated across industry sectors and types of investment business?

1.4. On what basis are contributions calculated (e.g. investment and cash balances, number of clients, revenues or incomes, number of employees, capital, deposits of credit institutions, mix of fixed and variable contributions)?

1.5. Are there limits on contributions? If yes, what limits?

1.6. Are contributions annual or based on a different timeframe?

1.7. Does the compensation scheme have power to borrow funds?

1.8. If there are different compensation schemes, can they borrow between schemes?

1.9. Is State funding envisaged? If yes, in which way?

1.10. Is the compensation scheme allowed to take out insurance to meet their funding requirements?

1.11. Is the compensation scheme able to recover some of the compensation costs after liquidation of firms in default?

1.12. How many compensation cases has the compensation scheme dealt with since 2004?

1.13. Are there any funding agreements with third countries?

#### **2. Structure of compensation schemes**

2.1. How is the compensation scheme structured? What is the ownership?

2.2. How many firms are participating in the compensation scheme? How many EEA branches are participating?

### **3. Rules on depositaries**

3.1. Are failures of a depositary appointed by an investment firm or of any sub-depositary used by the depositary covered by the compensation scheme?

### **4. Compensation limit/ claims / partial compensation**

4.1. What is the maximum amount of compensation?

4.2. What is the time limit on making claims?

4.3. What is the time limit on compensation payment?

4.4. Are there preliminary partial compensations allowed? If yes, under which conditions?

4.5. Are there any "carryover mechanisms" allowed – that is mechanisms aimed at preventing schemes from carrying their compensation debts over a certain period of time?

4.6. Based on any available information, what is the average amount invested by retail investors in your Member State?

### **5. Eligible claims and claimants**

5.1. Is the compensation scheme covering sources of loss beyond what is required in the ICSD (e.g. investment advice, conduct of business?) If yes, under what conditions? How many cases of claims due to breaches of conduct of business obligations have you received?

5.2. Is the compensation scheme covering claimants included in Annex I of the ICSD? If yes, which ones?

### **6. Exemption from the obligation to belong to a ICSD scheme**

6.1. Has any Member State exempt investment firms from the obligation to belong to an Investor Compensation Scheme (cfr Recital 10 & Article 2 (1))? If yes, what alternative arrangements have been put in place?

### **Second set of questions sent in November 2009**

## Method of funding

1. If your Investor Compensation Scheme (ICS) is ex-ante funded, do you have any ex ante target fund level? If yes, what is the level?

€ million	2006	2007	2008
Fund size			

How was this target fund level determined?

If you have ex-ante funding but this is not based on any target fund level, please explain your methodology to assess the appropriateness of the level of ex ante funding.

2. Have you recently increased, or considering increasing, the proportion of ex ante funding versus ex post funding for your ICS? If yes, do you have any estimates of the cost to investment firms of increasing the percentage of ex ante funding? Please briefly explain the conclusions regarding the level of the proposed increase and the projected cost to firms.
3. If, on top of ex ante funding, there is the possibility to ask for exceptional/ex post contributions, what is the proportion of ex post funding versus ex ante funding?

## Coverage of SME's

4. Does your ICS cover securities and monies held on behalf of Small and Medium size Enterprises (SME's) beyond what is specified in Annex I (8) of the Directive?

If so, could you please specify how SMEs are defined in your country for the purposes of the application of the investor compensation scheme?

## Compensation cases

5. Following our first questionnaire you kindly provided us with the number of compensation cases your scheme had to deal with since 2004. Could you in addition provide us with the following details for each of the cases?

Name of failed investment firm	Year	Total number of claims	Total payout (€ million)

## Estimate of securities and monies held by investment firms

6. What is the total amount of securities and monies held by investment firms on behalf of retail investors? If you do not have detailed figures please provide an estimate.
7. What is the total amount of covered securities and monies held by investment firms on behalf of retail investors (i.e. amount of securities and monies up to the maximum compensation limit)? If you do not have detailed figures please provide an estimate.

Total amount (€ millions)	2006	2007	2008
Securities and monies held on behalf of retail investors			
Covered securities and monies held on behalf of retail investors			
Please specify the level of coverage applied for calculations of covered securities and monies			

8. Could you please list the top 10 ICS members with respect to respectively (i) the amount of securities and monies held on behalf of retail investors as of end 2008 and (ii) the amount of covered securities and monies held by investment firms on behalf of retail investors as of end 2008?

	Name of DGS member (*)	Securities and monies	Covered securities and monies
1			
2			
3			
4			
6			
6			
7			
8			
9			
10			

(\*) If you can not report the name of the DGS member (e.g. confidentiality reasons), please replace the name by X1, X2, X3, ...

If you are providing data on covered securities, please specify the level of coverage you are using:

9. What is the total number of securities accounts held for retail clients in your Member State?

## Funds available

10. For ex ante funded schemes, what is the total amount of readily available funds as of end 2008? Could you please provide us with the accumulated fund size as of end 2007 and the contributions collected in 2008?

(€ million)	
Accumulated fund size as of end 2007	
Contributions collected in 2008	
Total amount of readily available funds as of end 2008	

11. Have you calculated the maximum amount of ex post contributions your scheme might collect if needed based on existing regulation? Please take into account any increase in the ordinary amount of ongoing contributions and any exceptional/surplus /ex post contributions which might be collected.

(€ million)	
Increase in the ordinary amount of ongoing contributions	
Any exceptional or surplus contributions	
Any other ex post contributions	
Maximum amount of ex post contributions	

## Compensation limit

12. In your view is the minimum compensation amount of €20 000 in the Directive still appropriate? Please provide us with any available data to support your view.
13. How would you assess and what would be the impact on the amount of ex ante contributions and/or potential ex-post contributions if the minimum level of

compensation (currently €20 000) would be increased? Please explain your methodology based on the following scenarios.

	<b>Scenario 1: Level of coverage € 50,000</b>	<b>Scenario 2: Level of coverage € 100,000</b>
<b>Increase in the amount of covered securities</b>		
<b>Increase in the amount of ex ante contributions</b>		
<b>Increase in the amount of ex post contributions</b>		

Please specify the reference date (if different from 31/12/2008):

Please specify the level of coverage applied by your DGS as of the reference date:

Please add any comment on the data you provided:

### **Establishing claims and payout delays**

14. Is your ICS able itself to determine the eligibility and amount of a compensation claim? If so, please explain how this is done. If not, please explain who determines the eligibility and amount of each claim.

15. How many months from the trigger event (e.g. failure of the investment firm) were necessary to pay compensation to investors in the last 5 cases you dealt with?

<b>Name of failed investment firm</b>	<b>Year</b>	<b>Months needed to pay the first claim</b>	<b>Months needed to pay the last claim</b>

Name of failed investment firm	Year	Months needed to pay the first claim	Months needed to pay the last claim

16. If your ICS provides for the possibility to pay out provisional compensation in the case of long delays, what are the specific requirements for a provisional payout and the mechanisms to claim back the amount of the provisional compensation if it is later determined that the compensation claim was not eligible?

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Note: in these questions:

An "investment firm" is a firm to whom the Directive applies.

A "security" is a financial instrument referred to in the Directive.

The "Directive" is the Investor Compensation Schemes Directive.

If there is confidential information, please feel free to provide any data and/or information on an anonymous basis.

## ANNEX III – OPERATION OF COMPENSATION SCHEMES

### *Structure of schemes*

The structure and organisational set-up of the schemes varies between Member States.

Some Member States (Austria, Cyprus, Germany, Greece, Netherlands, and Spain) have different compensation schemes for non-bank investment firms and credit institutions. In these cases the role of investor compensation as regards credit institutions is played by the deposit guarantee scheme. In Austria, non-bank investment firms fall under the Austrian investor compensation scheme (AeW). Austrian banks are covered by five different schemes with respect to investor compensation<sup>125</sup>. In Cyprus there are three schemes: one scheme covers banks, the second covers clients of investment firms and the third scheme covers clients of cooperatives. In Germany, there is also a split between bank and non-bank firms, as there are three Compensation Funds, one for investment firms (EdW), one for private banks and one for public banks. In addition, separate schemes are operated by the association representing credit cooperatives and the regional associations of savings banks<sup>126</sup>. In the case of Greece, investor compensation is provided by the Athens Stock Exchange (ASE) Member's Guarantee Fund for members of the ASE and for non members of the ASE such as investment companies and mutual funds in the case they provide portfolio management services. In February 2009, the Hellenic Deposit & Investment Guarantee Fund (HDGIF) was established by virtue of the Greek law 3746/2009 to cover, besides deposits, the investment services provided by credit institutions not participating in the Athens Stock Exchange Member's Guarantee Fund. In Spain there is also a split between the ICS for non-bank investment firms and banks.

The schemes are either set up as a public body or a private company. The public schemes are run as independent legal entity under public law (Belgium, Estonia, Portugal), or owned and operated by the national financial regulators (Latvia, Slovenia), or are administered by a separate public entity / company (Germany, Sweden's National Debt Office). In Germany, the ICS is a special federal fund without legal capacity administered by the public bank KfW. Although public bodies, these schemes may have some form of involvement or representation by the participating firms. The private schemes can take the form of either a limited company with participating firms and/or public authorities as shareholders (Austria, Ireland, Romania, Slovakia, Spain), either a private entity managed by the relevant trade association (Finland), either an independent legal entity (Denmark, France, Italy, Hungary, United Kingdom), either a private non-profit association (Luxembourg). In the case of Denmark the fund is a private independent body although it is operated by the Central Bank. The scheme in Cyprus is also operated by the Central Bank. The Dutch scheme operated by the Dutch Central Bank is a

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<sup>125</sup> There are five different schemes covering different banking sectors (savings banks, commercial banks, cooperatives, etc.): Österreichische Raiffeisen-Einlagensicherung eGen, Einlagensicherung der Banken & Bankiers, Sparkassen-Haftungs AG, Schulze-Delitzsch Haftungsgenossenschaft, and Hypo-Haftungs-Gesellschaft mbH.

<sup>126</sup> Entschädigungseinrichtung deutscher Banken (EdB) for private deposit banks, Entschädigungseinrichtung öffentlicher Banken for public deposit banks. Sicherungseinrichtung des Bundesverband der Volksbanken und Raiffeisenbanken for the association representing credit cooperatives. Sicherungseinrichtungen der regionalen Sparkassen- und Giroverbände for the regional associations of savings banks

foundation directed by a Board in which the two supervisors for the financial sector in the Netherlands (DNB and AFM), as well as the investment firms are represented.

Although in most of the cases independent, the schemes maintain a close relationship with the financial regulator, and are accountable and subject to the oversight of that regulator.

### ***Funding of schemes***

#### Ex ante and ex post funding

Schemes are principally financed by contributions levied from participating firms. These contributions can either be collected to build a reserve in anticipation of future losses (ex-ante funding) or when needed to cover compensation costs of failures that have occurred (ex-post funding).

A majority of the investor-compensation schemes are pre-funded (e.g. the Austrian scheme for investment firms (AeW), Belgium, Bulgaria, Cyprus, Czech Republic, France, Germany, Greece, Hungary, Ireland, Lithuania, Netherlands, Poland, Romania, Slovakia, Spain).

In addition most of these schemes (e.g. Austria (AeW), Belgium, France, Germany, Greece, Hungary, Ireland, Netherlands, Poland, Romania, Slovakia, Spain) have the possibility to request exceptional/surplus contributions if the assets held by the investor-compensation scheme are not sufficient to cover the payment of the claims.

In the case of Austria (AeW), it is worth noting that legislation was recently amended to improve the funding of the scheme in light of the recent major claims (see Amis case). The ex post funding mechanism was replaced by ex ante funding supplemented by surplus contributions in the case the funds available are insufficient to cover claims.

Following the Phoenix case, the contribution system of the German ICS for non-bank investment firms (EdW) was reformed in 2009. The annual contributions were increased to around €10m in order to achieve an adequate funding level of €30-40m. The level of contributions per firm is differentiated taking into account a certain number of risk factors (see risk weighting paragraph below).

A few schemes are funded through a mix of ex ante and ex post funding (e.g. Denmark, Estonia, Finland, Malta). The funding principles of the Danish and Finnish schemes are quite similar. Only part of the minimum capital of the fund has to be paid in cash. In Finland this minimum capital has been set at €12m, of which €4.2m needs to be provided in cash. The rest of the minimum capital may be covered by insurance or by a binding commitment from a credit institution to lend. In the case of Denmark, the remaining capital takes the form of pledges by member firms. The Estonian scheme is pre-funded but part of the payment can be deferred if the investment firm assumes the obligation to pay the deferred part upon request or even suspended if the assets of the scheme have reached a certain minimum threshold. In Malta, the annual variable contribution is not paid to the scheme but accounted for and held by each firm until such time that the scheme makes a call on such funds. The variable contribution is required to be held in a "reserve" and may be invested by the firm with a third party approved in writing by the scheme. Such third party shall hold the funds on pledge in favour of the scheme.

These schemes with ex ante funding or funded through a mix of ex ante and ex post funding do not usually have any explicit ex ante target fund level except in the case of Greece (ASE Guarantee Fund), Estonia, Ireland and the Netherlands. In Greece this target fund level is re-assessed annually taking into account general and individual risks. Estonia has a target fund level of € 2 million to be reached by 2020. Ireland undertakes a formal funding review every 3 years and sets target fund levels to be reached by the end of every new 3-years funding period. In the Netherlands the target fund was set at €11.3 million by law when the fund was established in 1998. The Bulgarian scheme has an implicit target fund level whereby the annual contributions are suspended when the funding available reaches a level equal to 5% of the client's assets eligible for compensation.

In most Member States there is no formal methodology to assess the appropriateness of the level of ex ante funding. Contributions are collected based on pre-determined formulas.

Schemes are post-funded in eight Member States (the five Austrian schemes for banks, Italy, Latvia, Luxembourg, Portugal, Slovenia, Sweden, United Kingdom). However some of these schemes levy ex-ante contributions to cover administrative costs. In Italy the scheme has an initial endowment (€7.7m) to face any pressing or unexpected need. In the case of Portugal, the ex post contributions are guaranteed by pledges on the financial instruments. In the case of Slovenia, the investment firms must hold a certain amount of liquid eligible assets. It should be noted that Luxembourg is planning to introduce ex ante funding.

In 2006/2007 the UK Financial Services Compensation Scheme (FSCS) conducted a reform of its funding arrangements. The reform did not touch upon the "pay-as-you-go" model in which contributions are paid to cover actual compensation costs and those known to arise in the near future (12 months extended to 24 months in the new scheme). At the time of the reform to introduce a pre-funding element was not considered appropriate because of the legal and practical difficulties involved.

#### Pooling of assets and cross-subsidisation

Countries may create one global fund to cover firms across industry sectors (deposit and investment activities) or across investment activities or create several sub-funds per type of investment activities. In the first case the funds are pooled across the different investment activities with explicit cross-subsidisation between them. In the second case funds are differentiated by investment activity.

As explained above some Member States (Austria, Cyprus, Germany, Greece, Netherlands, and Spain) have different compensation schemes for non-bank investment firms and credit institutions. Austrian banks are covered by five different schemes with respect to investor compensation. If one scheme has insufficient funds to cover a failure, members of the other schemes are obliged to contribute up to a certain maximum (1,5% of risk-weighted assets). In the Netherlands, in the case the funding of the ICS for non-bank investment firms would be insufficient to cover compensation costs even after the payment of surplus contributions by its members, the banks and non-bank investment firms would have to compensate for the gap. In Spain, the ICS for non-bank investment firms had to cover compensation costs arising from failures having taken place prior to its incorporation date<sup>127</sup>. As the newly incorporated

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<sup>127</sup> See Oxera report pages 56-59

scheme had nearly no reserves, the costs were mainly borne by the separate deposit and investment guarantee scheme for banks.

In a few Member States (e.g. Belgium, Denmark, Estonia, France, Lithuania, Luxembourg, United Kingdom) the investor-compensation scheme and any other guarantee schemes are operated and managed by the same fund. In Belgium there is a single pool of funds which can be used to cover all liabilities, regardless of whether these liabilities arise on deposit-taking activities or investment business. In Denmark the fund is divided into 3 departments (credit institutions, mortgage banks, investment companies). In Estonia the Fund has 4 sectoral pools of assets (deposit guarantee, investor protection, pension protection, pension insurance contract). But in none of these two examples are the assets pooled. However inter-borrowing is possible (see additional funding arrangements). In France, the ICS and the DGS are both owned and managed by the "Fonds de Garantie des Dépôts" but there is no pooling of assets between both. The situation is the same in Lithuania where the ICS and the DGS are both owned and managed by the same entity, namely the "Deposit and Investment Insurance". There is a separate pool of assets for each scheme, but inter-borrowing between the ICS and the DGS is possible. In Luxembourg the ICS and the DGS are both owned and managed by the "Association pour la Garantie des Dépôts", but there is a separate pool of assets for each scheme and no inter borrowing is possible. In the United Kingdom the scheme has 5 broad pools/classes (deposit taking, investment, life and pensions, general insurance and home finance) with two sub-classes each for provider and intermediation activities. There is explicit cross-subsidisation between and within the classes. This cross-subsidisation was a major change introduced by the reform of the scheme's funding arrangements conducted in 2006/2007.

Before the reform, the UK scheme was divided into 12 contribution groups, each of which was completely insulated from the compensations costs born by the other groups. In addition the relatively small numbers of firms in some contribution group raised concerns about the sustainability of the group. The new model introduced five broad classes (deposit taking, investment, life and pensions, general insurance and home finance) with two sub-classes each for provider and intermediation activities. If a default occurs in a sub-class the firms in this sub-class will bear the compensation costs up to the sub-class annual threshold. The annual threshold determines the maximum amount firms could be required to pay to cover defaults. If one sub-class has reached its annual threshold, the other sub-class will be required to contribute to the compensation costs. In addition there is a general retail pool above the five classes and their sub-classes to which all firms would contribute if there is a major failure. As a result, the funding capacity of the scheme was reinforced by (i) increasing the maximum annual thresholds and (ii) introducing explicit cross-subsidy arrangement within and between the classes. The funding capacity of the scheme was designed in order to be able to meet the compensation claims arising from a medium-sized default (or a series of smaller defaults) with cross-subsidy being only used as a contingency plan in case of a major failure. The borrowing group has to reimburse the lending group as soon as possible.

The other countries have separate deposit and investor compensation scheme. Within the investor compensation scheme the funds are generally pooled across all types of investment activities, the exception being Ireland.

In Ireland the investor-compensation scheme operates two separate sub-funds (fund A and fund B). The categories of investment firms and insurance intermediaries which contribute to each of these sub-funds are derived from the type of their regulatory authorisations.

### Calculation of contributions

There are up to three types of contributions: entry/one-time contributions, ongoing contributions on a yearly or quarterly basis and exceptional/surplus/top-up contributions. Entry contributions have to be paid by new members in Bulgaria, Cyprus, France, Germany, Greece, Hungary, Netherlands, Romania and Slovakia. All ongoing contributions, except in Estonia, are annual although the payment might be made in several instalments (two instalments allowed in the case of Spain and France, quarterly instalments for Bulgaria, Poland and Slovakia). In the case of the Estonian fund the contributions are calculated and paid on a quarterly basis. Most of the ex ante schemes (Austria (AeW), Belgium, France, Germany, Greece, Hungary, Ireland, Netherlands, Poland, Romania, Slovakia, Spain) have the possibility to levy surplus contributions.

The assessment basis used to calculate the amount of contributions varies between schemes. The basis used might also differ within a scheme depending on the type of contribution (entry or ongoing contribution) or it can be a mix of different assessment basis. The assessment bases used are the following:

- the value of the covered monies and financial instruments held or managed;
- the number of clients;
- the revenues or income generated by investment businesses;
- the level of capital of an investment firm;
- the maximum amount of compensation per client;
- the average turnover of the securities sale and purchase transactions
- the number of approved persons or traders

Maximum limits for ongoing contributions exist in several Member States (Belgium, Bulgaria, Cyprus, Denmark, Estonia, Finland, Germany (EdW), Lithuania, Netherlands, and Poland). There might also be maximum limits on the exceptional/surplus contributions (e.g. Austria (AeW), Germany (EdW), Greece (the Hellenic Deposit & Investment Guarantee Fund), Hungary, Romania). Ireland might introduce such a maximum limit which would be equal to twice the annual contribution rate. There is a cap on ex-post contributions in Latvia, Luxembourg, Portugal, Slovenia, and the UK. In the United Kingdom the annual thresholds per sub-class determine the maximum amount firms could be required to pay to cover defaults.

### Risk weighting

From an economic rationale it might make sense to differentiate the calculation of the contributions according to the specific risks imposed by each individual investment firm on the scheme (i.e. risk-based approach). But such a risk-weighting calculation is very difficult to implement as there are no appropriate and objective criteria to define which investment firms would be more prone to fraud (unpredictable nature of claims).

The French and the German (EdW) schemes are the only schemes that adopted an explicit risk weighting methodology. The French scheme takes into account the probability of default of a firm when calculating its annual contribution. The assessment base (investor assets held by the firm) is multiplied by a risk indicator that reflects the capital adequacy and operating profitability of the firm. Following the reform of its contribution system, the German scheme distinguishes between different groups of institutions and assigns differentiated contribution rates to these groups taking into account the license, the actual contractual situation, and the risk of compensation of the institution.

Although no scheme, except the French and the German (EdW) schemes, have adopted an explicit risk weighting methodology, the criteria used to calculate the ongoing or ex post contributions might be differentiated. Ongoing or ex post contributions rates or amounts are differentiated based on the firm's authorisation or the types of investment services provided by the firm (Finland, Ireland, Italy, Slovakia, and United Kingdom).

In the UK the structure of the different contribution groups/classes was redefined as part of the reform mentioned above. Under the previous structure the firms were grouped according to their FSA authorisation. There were 12 contributions groups whose small number of participants within each group rose concerned about the sustainability of the group in case of a medium or large failure. The reform introduced 5 broader classes based on 5 identifiable industry sectors (deposit taking, investment, life and pensions, general insurance and home finance). Each class with the exception of the deposit class is divided between providers and intermediation activities. As a result of these sub-classes, contributions are differentiated based on the activity a firm undertakes.

	Ex ante or ex post funding	Different pools of fund by type of business	Calculation of contributions	Maximum limit on contributions	Risk weighting
Austria <sup>128</sup> (AeW fund)	Ex ante (with ability to raise surplus contributions)	No (but the ICS only covers non-bank investment firms)	As of 2010, investment firms have to pay annual contributions of (depending on the number of customers) 1% –3% of the free income on license-requiring business. Half of the annual contributions (at most) shall be used for an insurance premium (“fidelity insurance”).	Surplus contributions are limited to 2,5% of firm's annual fixed costs (maximum to be paid two times in five years)	No
Austria (funds for banks)	Ex post	The members of the five sectoral bank schemes have to support the scheme which needs additional funds, up until a certain limit (1.5% of risk-weighted assets)	n.a.	n.a.	No
Belgium	Ex ante (with ability to raise	No (but one single scheme with pooling of	Annual contributions based on 0.7% of annual turnover and	Contributions for an individual firm cease if	No

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The Austrian government reviewed the efficiency of the existing scheme, especially in light of the major claims recently raised by investors. As a result the Austrian Securities Supervision Act 2007 has been amended to improve the funding of the scheme (changes effective as from 1 May 2009). The ex post funding mechanism was replaced by a mix of ex ante and ex post funding. Investment firms are now required to pay annual contributions. In the case the funds available are insufficient to cover claims; the members will need to make surplus contributions.

	surplus contributions)	assets between deposit-taking and investment activity)	0.001% of the covered financial instruments.	the "net total of its contributions" since the inception of the fund reached an amount set at seven times the total of its contributions paid over the last three years.	
Bulgaria	Ex ante	No	Two types of contributions: Entry contributions – calculated on the basis of the minimum required capital. Annual contributions paid in quarterly instalments - calculated on the basis of the total value of covered financial instruments (up to 0,1%) and cash (up to 0,5%)	Yes, contributions are suspended when the funding available reaches a level equal to 5% of the client's assets eligible for compensation	No
Cyprus (fund for clients of investment firms)	Ex-ante	No (but there are two ICS, one for credit institutions and one for non-bank investment firms)	Two types of contributions: Entry contribution which is a fixed amount Annual contributions calculated as 0.1% of the eligible funds (monies + financial instruments) held by firms	Yes; If the total contributions of an investment firm exceed 0.05% of the previous year total eligible funds, no contribution is being made	No
Cyprus (fund for clients of banks)	Ex ante	No (but there are two ICS, one for credit institutions and one for non-bank investment	Two types of contributions Entry contributions are fixed. Ordinary annual contributions	n.a.	No

		firms)	amount to a percentage of up to one per mile (1‰) of the eligible funds and financial instruments of the members' clients.		
Czech republic	Ex-ante	No	Securities dealers make an annual contribution amounting to 2% of the volume of fees and commissions generated by their investment services activities. Management companies providing asset management services are also required to pay annual contributions.	No	No
Denmark	Mix of ex ante and ex post funding (25% of the minimum capital has to be paid in cash, the rest takes the form of pledges by member firms)	One single fund for deposit guarantee and investor protection divided into 3 departments by type of firm (credit institutions, mortgage banks, investment companies), but no separation by activity.	The contribution payments for investment firms are calculated on a prorata basis: at least 55% is based on the value of the clients' securities and cash balances held by a firm, and the remaining share is based on the number of employees of the firm.	Yes; No new contributions as the funds available exceed the required minimum.	No
Estonia	Mix of ex ante and ex post funding (right to defer part of the payment if	No	Quarterly contributions based on the average turnover of securities transactions and the market value of the cash and securities held or managed by the firm	Yes; Contributions are suspended when the assets exceeds the minimum required capital	No

	commitment from the firm to pay upon request)				
Finland	Mix of ex ante and ex post funding (only part of the minimum capital of the fund has to be paid in cash, the rest being covered by insurance or by a binding commitment from a credit institution to lend.)	No	Contributions are differentiated by type of investment activity (transmission and execution of orders, asset management, placing of financial instruments, custodial and management services, etc.).  10% of contributions is fixed and 90% variable. The variable part is calculated based on the number of customers covered.	Yes; No new contributions as the funds available exceed the minimum capital (contributions raised just to cover the administrative costs arising from the insurance and the lending commitment from the bank)	Implicit risk weighting as contributions are differentiated by investment service or activity.
France	Ex ante (with ability to raise surplus contributions)	No	Two types of contributions: Entry contributions (certificates of association)  Annual contributions calculated based on half the value of securities, and for non bank investment firms, on all cash balances, weighted by a risk factor	No	Yes; the level of contribution takes into account the probability of default of a firm

Germany (EdW)	Ex ante (with ability to raise surplus contributions)	No (but the ICS only covers non-bank investment firms)	Two types of contributions: Entry contributions 0.35% or 3.5% of the liable capital depending on the scope of the licence.  0.1% or 1% of the liable capital depending on licence  Annual contributions are determined by scope of the licence for rendering financial services and amounts to 1.23%, 2.46%, 3.85% or 7.7% of gross commission income and of gross earnings on financial transactions, however, not more than 10% of net income. so trade on their own account	Surplus contributions can be raised, but must not exceed 5 times the last annual contribution due. The overall charge from all types of contributions must not exceed 45% of annual net income.	Yes, contributions are based on the type of licensed / authorised investment business, and on the risk of compensation of the institutions.
Greece (ASE Guarantee Fund)	Ex-ante (with the ability to raise surplus contributions)	No	Entry contributions and annual contributions comprising a fixed and a variable element	No	No
Greece (Hellenic Deposit & Investment Guarantee Fund)	Ex ante (with the ability to raise surplus contributions)	No	Decision of calculation of annual contributions is still pending.	Supplementary contributions may be up to three times the annual contributions.	No
Hungary	Ex ante funding (with	No	Two types of contributions: Entry contributions with a	Surplus contributions cannot exceed the	No

	ability to raise surplus contributions)		maximum of €11 000 Annual contributions calculated on the basis of the average value of all funds deposited by investors with the Fund member in the form of liquid assets or securities to which the Fund's protection applies, with a maximum of 3‰ of the base amount	preceding year's annual contributions	
Ireland	Ex ante funding (with ability to raise surplus contributions)	Yes; The ICS consists of two sub-funds designated as Fund A and Fund B. The categories of firms which contribute to each of these sub-funds are derived directly from the type of Financial Regulator's authorisations.	Fund A firms pay a fixed rate of contribution plus a variable contribution which is determined by the band of eligible client numbers into which they fall.  Fund B firms pay a fixed contribution, the amount of which depends on the income band of the firm.	No	Implicit risk weighting as contributions calculations are based on the type of authorised investment business (fund A or fund B)
Italy	Ex post  The scheme has an initial reserve (€7.7m) to face any pressing or unexpected	No	Fixed annual contributions to cover administrative costs.  Ex post contributions collected on the basis of income generated by investment businesses, with different rates based on services/activities and the situation of credit institutions already members of a deposit guarantee	No maximum limit for ex post contributions (minimum limit: €260).	Implicit risk weighting as ex post contributions are differentiated for some services/activities

	need.		scheme.		
Latvia	Ex post	No	Value of the financial instruments held or managed by the firm	Maximum 4% of the aggregate portfolio of financial instruments capped at the maximum level of compensation	No
Lithuania	Ex ante	No	Annual contributions calculated as 0.01% of the value of the transactions carried out	Yes; maximum annual contribution is LTL 20 000	No
Luxembourg	Ex post	No	Ex post contributions to cover compensation costs allocated according to the amount of protected investment balances	Ex post contributions cannot exceed per calendar year 5% of a firm's equity capital	No
Malta	Ex ante and ex post funding	No	Annual contributions consist of a fix and a variable part:  - a fix contribution whose amount depends on the category of investment firm  - a variable contribution calculated as a 0.1% of the total revenue of the firm but this variable contribution is not paid to the scheme (held by the firm in a	No	No

			reserve until the scheme makes a call for these funds)		
Netherlands	Ex ante (with ability to raise surplus contributions)	No (but the ICS only covers non-bank investment firms)	Two types of contributions: Entry contribution  Annual contributions consisting of a fixed and a variable part, the latter depending on the number of non-professional clients per investment firm	Total annual contribution per firm limited to 3% of its net worth Besides, the variable contribution is capped at a maximum of nearly € 113.000 (2009).	No
Poland	Ex ante (with ability to raise surplus contributions)	No	Annual contributions calculated as a % of the value of the cash (0.4%) and of financial instruments (0.01%) held on investor's account  In case the funds available are not sufficient to cover the compensation claims, the annual contributions can be increased by an amount not greater than 1.8%	Yes; Annual contributions are suspended when the member's participation in the scheme is ten times the amount of the defined rate	No
Portugal	Ex post (with ex ante pledges)	No	Fixed annual contributions of €2 500 to cover administrative costs; Ex post contributions collected in the form of binding pledges	Yes; maximum 0,2% per year of total protected funds and securities of a firm	No
Romania	Ex ante (with ability to raise surplus contributions)	No	Two types of contributions: Entry contribution which represents 1% of the minimum initial capital required according to	No maximum limits on annual contributions, but the surplus contribution may not	No

			the business activity authorised Annual contributions calculated by applying a % (1,80% for 2008 contributions) on the income/fees from the different investment activities	exceed twice the amount of the most recent annual contribution levied for a member.	
Slovakia	Ex ante (with ability to raise surplus contributions)	No	Two types of contributions:  Entry contribution  Annual contributions calculated as (a) a % of the amount of fees charged to clients for investment services and ancillary services and as (b) a % of the value of client assets and as (c) a fix contribution increased per each client which is entitled to compensation from the fund ranging from 1 to 20 euros	No	Implicit risk weighting as contributions are differentiated by type of investment business
Slovenia	Ex post	No	Although there is no ex ante funding, investment firms must hold a certain amount of liquid eligible assets calculated based on the number of clients	Every investment firm must hold eligible assets in the amount of €50 per client but not less than €50 000 and not more than €300 000	No
Spain (Fogain)	Ex ante (with ability to raise surplus)	No (but the ICS only covers non-bank investment firms)	Annual contributions consist of a fix and a variable part:	No	No

	contributions)		<p>- a fix contribution whose amount depends on the income band the firm belongs to</p> <p>- a variable contribution calculated as a % of the value of the financial instruments held or managed, as a % of the investment monies held, and as % of the maximum amount of coverage provided by the scheme for each covered client.</p>		
Sweden	Ex post	No	Yearly fees to cover administrative costs of the fund	No	No
United Kingdom	Ex post	Yes. The UK scheme is divided into 5 classes (deposit taking, investment, life and pensions, general insurance and home finance), with sub-classes for providers and intermediation activities. There is explicit cross-subsidisation between and within the classes.	<p>Annual contributions to cover management expenses.</p> <p>Ex post contributions in different contribution groups are allocated based on multiple criteria. In the case of the Class D "Investment", the criteria used to calculate contributions are:</p> <ul style="list-style-type: none"> <li>- the income for the sub-class D1 "Fund management"</li> <li>- the number of approved persons or traders for the sub-class D2 "Investment intermediation"</li> </ul>	Annual threshold per sub-class determines the maximum amount all firms in that sub-class could be required to pay to cover defaults.	Implicit risk weighting as contributions are differentiated based on the firms' activity (provider or intermediation)

### Additional funding arrangements

Schemes need back-up sources of funding in case the funding available and any surplus contributions are insufficient to cover compensation claims.

#### *Borrowing*

All the schemes except Italy, the Netherlands, Poland, and Slovenia have the power to borrow funds when its funds are insufficient to pay compensation claims. In the Netherlands however, since the Central Bank is operating the ICS and pre-finances the scheme in case of insufficient funding, the scheme in effect borrows the funds from Central Bank. In France, the scheme can only borrow from participating firms. Some funds (e.g. Czech Republic, Ireland, and Romania) stressed the fact that there is a commercial limit on the scheme's ability to borrow. A state guarantee might be necessary for commercial borrowing.

Borrowing between the different compensation schemes is usually not allowed. The only exceptions are Slovakia, where the investor-compensation scheme and the deposit protection scheme can borrow funds from each other, but only for compensation payments purposes. In Belgium there is only one Fund covering deposits and securities. The funds are pooled and can be used for compensation purposes whether it is to cover deposits or securities. In Denmark, Estonia, and Lithuania where the investor-compensation scheme and other guarantee schemes are managed and operated by the same Fund, intra-borrowing between the different departments or the different pools of assets is allowed. In Ireland the investor-compensation scheme operates two separate sub-funds (fund A and fund B) and borrowing between these two sub-funds is allowed.

#### *State funding*

State support might be envisaged in the form of a guarantee granted by the state for a loan made to the fund in the following countries: Austria, Denmark, Estonia, and Hungary. In Estonia the fund may also apply for a state loan. In Czech Republic and Slovakia, the fund may also ask for a state loan and in addition ask for government subsidies. In the case of Spain the scheme may borrow funds from the Spanish securities supervisor but on a commercial basis. In Germany, following the Phoenix case<sup>129</sup>, an urgent measure of last resort giving public funds to the national investor-compensation scheme was introduced in order to avoid the fund being unable to payout partial compensation payments after the affiliated firms contested the legality of special contributions and refused payments. In Lithuania the "Deposit and Insurance Fund" is a state undertaking. In Sweden and in the United Kingdom the schemes can borrow from their National Debt Management Office.

#### *Insurance*

Taking out insurance is allowed for a number of investor-compensation schemes: Austria, Belgium, Cyprus, Czech Republic, Finland, Greece, Hungary, Ireland, Italy, Malta, Portugal, and United Kingdom. In the case of the Austrian scheme (AeW), it is not only allowed but obliged to take out insurance. The Czech scheme has been unable up to now to find an insurance company ready to cover this type of risk. The Irish fund has also analysed this

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<sup>129</sup> <http://www.e-d-w.de/en/Phoenix-Stand.html>

option on various occasions. Their conclusion is that it would be costly and require the collection and analysis of a significant quantity of data.

	Borrowing power	Borrowing between schemes or pools	State funding	Insurance
Austria (AeW)	Yes	No	Yes; fund can borrow with state guarantee	Obligated to take out insurance, but no insurance contracted yet
Austria (fund for banks)	Yes	If one scheme needs additional funds, other schemes need to contribute up to a certain limit (1.5% of risk-weighted assets)	Yes; fund can borrow with state guarantee	n.a.
Belgium	Yes	Single fund covering deposits and securities	No	Allowed but no insurance taken out
Bulgaria	Yes	No	No	No
Cyprus (fund for investment firms)	Yes	No	No	Allowed but no insurance taken out
Czech republic	Yes	No	Yes; fund can borrow from the state	Allowed but no insurance taken out
Denmark	Yes	Yes, inter-borrowing possible between the different departments	Yes; fund can borrow with state guarantee	No
Estonia	Yes	Yes; borrowing possible between sectoral funds	Yes; fund can borrow from the state or with state guarantee	No
Finland	Yes	No	No	Allowed but no insurance taken out

France	Yes but only from participating firms	No	No	No
Germany (EdW)	Yes	No	Last resort measure in the Phoenix case (the financing for the partial compensation payments has been assured by a loan granted to EdW by the German Government)	No
Greece (ASE Guarantee Fund)	Yes	No	No	Allowed but no insurance taken out
Hungary	Yes	No	Yes; fund can borrow with state guarantee	Allowed but no insurance taken out
Ireland	Yes	Yes; inter-borrowing allowed between the two sub-funds of the ICS	No	Allowed but no insurance taken out
Italy	No	No	No	Allowed but no insurance taken out
Latvia	Yes	No	No	No
Lithuania	Yes	Yes; inter-borrowing allowed between the ICS and the DGS	Yes; the Fund is a state undertaking	No
Luxembourg	Yes	No	No	No
Malta	Yes	No	Such funding would always be envisaged in a worse case scenario	Allowed but no insurance taken out (not feasible)
Netherlands	No	No	No	No
Poland	No	No	No	No
Portugal	Yes	No	No	Allowed but

				no insurance taken out
Romania	Yes	No	No	No
Slovakia	Yes	Yes; inter-borrowing possible between the ICS and the DGS	Yes; fund can borrow from the state	No
Slovenia	No; the scheme is not a legal entity	No	No	No
Spain (Fogain)	Yes	No	Yes, the fund can borrow from the financial regulator but on a commercial basis	No
Sweden	Yes, via the National Debt Office	No	Yes, the fund can borrow from the National Debt Office	No
United Kingdom	Yes (credit facility in place)	There is explicit cross-subsidisation between and within the 5 pools/classes.	Yes, the fund can borrow from the Debt Management Office	Allowed but no insurance taken out

### *Estimate of securities and monies held by investment firms*

A small minority of schemes have detailed information on the amount of securities and monies held by investment firms and on the number of securities accounts held for retail clients.

As of 2008 (in € million for absolute figures and in € for averages)	Securities and monies held on behalf of retail investors	Covered securities and monies held on behalf of retail investors	Number of securities accounts held for retail clients	Average securities and monies held per securities account	Average covered securities and monies held per securities account
Bulgaria	1.029	122	n.a.	n.a.	n.a.
Cyprus (fund for investment firms)	n.a.	514	n.a.	n.a.	n.a.

Cyprus (fund for banks)	n.a.	109	n.a.	n.a.	n.a.
Denmark	n.a.	48	n.a.	n.a.	n.a.
Estonia	170	n.a.	16.500	10.279	n.a.
Greece (ASE Guarantee Fund)	n.a.	n.a.	427	n.a.	n.a.
Hungary	22.399	6.360	847.725	26.422	7.502
Latvia	491	n.a.	58.902	8.336	n.a.
Luxembourg	n.a.	1.820	n.a.	n.a.	n.a.
Netherlands <sup>1</sup>	n.a.	3.400	170.000	n.a.	20.000
Poland	75.362	n.a.	1.750.000	43.064	n.a.
Portugal	103.205	18.179	2.343.372	44.041	7.757
Romania	839	200	92.800	9.041	2.152
Spain (Fogain)	18.497	3.065	n.a.	n.a.	n.a.

<sup>1</sup> Statistics relating to non-bank investment firms only

### ***Funds available***

With respect to the ex ante schemes we have tried to assess the coverage ratio, i.e. the ratio between the readily available funding and the total monies and securities held by investment firms on behalf of retail investors. Due to limited data available we have only been able to calculate this coverage ratio for a few schemes.

	Accumulated fund size as of end 2007 (€ mln)	Contributions collected in 2008 (€ mln)	Total amount of readily available funds as of end 2008 (€ mln)	Coverage ratio based on total monies and securities (%)	Coverage ratio based on covered monies and securities (%)
Austria (AeW)	n.a.	n.a.	n.a.	n.a.	n.a.
Belgium	n.a.	50,9	802,7	n.a.	n.a.
Bulgaria	1,21	1,06	2,32	0,23%	1,90%

Cyprus (fund for investment firms)	5,1	0,7	5,8	n.a.	1,13%
Cyprus (fund for banks)	1,0	0,19	1,2	n.a.	1,11%
Czech republic	0,9	4,4	5,3	n.a.	n.a.
Denmark	Mix of ex ante and ex post funding				
Estonia	Mix of ex ante and ex post funding				
Finland	5.3	0.17	12 *	n.a.	n.a.
France	n.a.	n.a.	n.a.	n.a.	n.a.
Germany (EdW)	n.a.	3,34	8,52	n.a.	n.a.
Greece (ASE Guarantee fund)	n.a.	n.a.	n.a.	n.a.	n.a.
Hungary	5,0	4,0	9,0	0,04%	0,14%
Ireland	19,4	4,8	24,5	n.a.	n.a.
Italy	Ex post funding				
Latvia	Ex post funding				
Lithuania	n.a.	0,07	1,5	n.a.	n.a.
Luxembourg	Ex post funding				
Malta	1.09	n.a.	1.13	n.a.	n.a.
Netherlands	9,1	1,8	10,9	n.a.	0,32%
Poland	13,95	3,4	16,35	0,02%	n.a.
Portugal	Ex post funding				
Romania	1,17	1,45	2,62	0,31%	1,31%
Slovakia	1.64	0.30	1.87	0.32%	2,01%
Slovenia	Ex post funding				
Spain (Fogain)	38,5	7,0	45,5	0,25%	1,48%
Sweden	Ex post funding				

United Kingdom	Ex post funding
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*(\*) In Finland, the minimum capital for the compensation scheme of €12m is provided in cash up until a certain threshold, the remainder may be covered by insurance or by a binding commitment to lend.*

### ***Level of compensation & co-insurance principle***

In most Member States the maximum amount of compensation is €20 000 (Austria, Belgium, Bulgaria as from 1<sup>st</sup> of January 2010, Cyprus, Czech Republic, Denmark, Estonia, Finland, Germany, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Romania as from 2012). A few Member States (Greece up to € 30 000, Poland up to €22 000, Portugal up to €25 000, Slovenia up to €22 000, Sweden up to SEK 250 000) provide compensation slightly in excess of the compensation level foreseen in the ICSD. France and the UK offer significantly higher compensation levels. Spain has increased, as a result of the financial crisis, the level of investor-compensation from €20 000 to €100 000 in October 2008. The Slovakian scheme is the only scheme to compensate for 100% of the value of the client's assets.

Only 7 Member States (Finland, Germany, Hungary, Ireland, Latvia, Malta, Poland) have adopted and/or maintained the co-insurance principle and cover 90% of the claim up to €20 000. The UK scheme has beginning of 2009 removed the co-insurance principle and as a result, increased the compensation limit for investments to £50 000. The objective was to match the compensation limit for deposits. The deposit limit was increased in October from 100% of €35 000 to 100% of £50 000.

	Maximum compensation (€)	Level of coverage (%)
Austria	€20 000	100%
Belgium	€20 000	100%
Bulgaria	Equivalent amount of €15 339 in 2009 with transitional arrangement to increase the compensation limit to the equivalent of €20 000 as from the 1 <sup>st</sup> of January 2010.	90%
Cyprus	€20 000	100%
Czech republic	€20 000	100%
Denmark	€20 000	100%
Estonia	€20 000	100%
Finland	€20 000	90%

France	€70 000 on financial instruments, €70 000 on investment monies	100%
Germany (EdW)	€20 000	90%
Greece (ASE Guarantee Fund & HDIGF)	€30 000	100%
Hungary	€20 000 as from 1 <sup>st</sup> November 2009	100% of claims up to HUF1 million; 90% of claims above HUF1 million
Ireland	€20 000	90%
Italy	€20 000	100%
Latvia	€20 000	90%
Lithuania	€20 000	100%
Luxembourg	€20 000	100%
Malta	€20 000	90%
Netherlands	€20 000	100%
Poland	€22 000	100% of claims up to €3 000, 90% of claims above €3 000
Portugal	€25 000	100%
Romania	Transitional arrangement in order to reach the compensation limit of €20 000 in 2012.	100%
Slovakia	100% of the value of client's assets	100%
Slovenia	€22 000	100%
Spain	€100 000 since October 2008	100%
Sweden	SEK 250 000 (€24 000)	100%
United Kingdom	£48 000; will be increased to £50 000 as from 1 January 2010	100% of the first £30 000 and 90% of the next £20 000; 100% as from 1 January 2010

The impact of an increase of the compensation limit in terms of compensation amounts and/or investors coverage has been assessed by three schemes.

Based on the Phoenix case in Germany, an increase of the compensation limit

- to € 50 000 would result in the compensation costs rising by 23%
- to € 100 000 would result in the compensation costs rising by 37%

An increase in the maximum compensation to EUR 50,000 in this compensation case would benefit approximately 4.5% of the investors and an increase to EUR 100,000 an additional 1.5%.

Based on data collected by the Irish scheme in relation to the W&R Morrogh case, an increase of the compensation limit

- to € 50 000 would result in the compensation costs rising between 15% and 31%
- to € 100 000 would result in the compensation costs rising between 46% and 73%

An increase of the compensation limit to € 50 000 would have benefit approximately 2.9% of the investors and an increase to EUR 100,000 an additional 1.5%.

According to the Portuguese scheme, with the current level of coverage € 25 000, in average, 82.6% of covered investors would be fully compensated if the ICS was triggered. The increase in the level of coverage to € 50 000 and to €100 000 would lead to an increase in the proportion of investors that would be fully compensated to respectively 91.4% and 96.1%.

### ***Time limits and right to partial compensation***

The time limit on compensation payment generally ranges from 3 months to 6 months. It is important to note that this time limit usually applies after the establishment of the eligibility and the amount of the claim. But the time between the case's trigger event and the establishment of eligibility and the amount of the claim can be very long:

	Months needed to pay the first claim	Months needed to pay the last claim
Germany (EdW)	Between 7 months and 37 months for the Phoenix case	Between 28 months and 45 months; the Phoenix case is still open since 2005 which is more than 4 years.
Hungary	Between 1 month and 4 months	Between 4 months and 21 months
Ireland	24 months	120 months in the case of MMI; the W&R Morrogh case is still open after 8 years with 1% of the claims remaining to be certified

Lithuania	2 months	2 months
Netherlands	Within 3 months	Within 3 months
Poland	20 months	33 months
Sweden	n.a.	24 months

There are a few Member States where the time limit of 3 to 6 months starts to run from the date the financial regulator has ascertained the scheme's payment obligation (Finland, France), from when an investor has submitted a compensation claim (Netherlands), or from the date the inaccessibility of the funds has been ascertained (Slovakia). This might in practice reduce the payout delays.

Another option to reduce delays in payments is partial compensation. Partial compensation is never allowed except in Belgium, Czech Republic, Germany, Slovenia and the United Kingdom. In Czech Republic, partial compensation has been used by the fund because of insufficient funds to cover the entirety of the claims. In Germany the scheme has started since February 2009 to pay partial compensation to investors in the Phoenix case.

"Carry-over mechanisms" are usually not allowed – that is mechanisms aimed at preventing schemes from carrying their compensation debts over a certain period of time. The only exception is the Czech Republic where compensation rights expire after 5 years. But the fund has never encountered any problem to make compensation payments within this period of 5 years.

### ***Compensation cases***

According to Oxera, the number and size of the compensation cases between 1999 and 2004 suggests that "many schemes have had no or limited experience of the actual operation of their schemes". Six Member States (Austria, Finland, France, Luxembourg, Portugal and Sweden) had not experienced any failures between 1999 and 2004 that would have triggered the operation of the compensation scheme. In all other EU-15 Member States failures had occurred but only infrequently (except in the UK). Most of the compensation cases generated a small number of claims except in the case of Spain and Ireland. Among the EU-10 new Member States only the Czech Republic and Hungary had experienced compensation cases over this period.

The higher number of claims in the UK can be attributed to the inclusion within the scope of the UK scheme of claims relating to poor investment management and negligent investment advice. According to the Oxera report (page 40): "only 1-2% are due to losses resulting from embezzlement or theft of client assets". The most frequent case of misselling relate to pensions. According to the Oxera report (page 27): "in the financial year 2002/2003, 88% of the activity of the UK scheme related to claims resulting from cases of pension mis-selling".

There are a few schemes which have dealt with compensation cases since 2004: 9 cases in Czech republic, 3 cases in Germany (among which the Phoenix case), 4 cases in Greece out of which only 2 cases have required compensation action, 5 cases in Italy, 1 case in Lithuania, 4

cases in the Netherlands, 1 case in Poland, and 1 case in Sweden. The most important case in Germany is the Phoenix case. This failure involves such a large number of investors and huge amounts of compensation claims that the German fund was unable to even start to pay partial compensation without the German government support.

In Austria there is a case before the courts (see AMIS case) as to whether amounts need to be paid out of the fund.

	Compensation cases between 1999 and 2004 ( <i>source: Oxera report pg 41 &amp; 130</i> )				Compensation cases since 2004			
	Number of failures	Total claims	Highest number of claims for a failure	Highest total payout for a failure	Number of failures	Total claims	Highest number of claims for a failure	Highest total payout for a failure
Austria (AeW)	0	-	-	-	Legal proceedings pending in 1 case (Amis case)	11 000	11 000	Still to be determined
Belgium	1	750	400	€2.6m	-	-	-	-
Bulgaria	n.a.	n.a.	n.a.	n.a.	-	-	-	-
Cyprus	0	-	-	-	-	-	-	-
Czech republic	6	n.a.	n.a.	n.a.	9	23 166	19 070	€56m
Denmark	1	204	204	€1.6m	-	-	-	-
Estonia	0	-	-	-	-	-	-	-
Finland	0	-	-	-	-	-	-	-
France	0	-	-	-	n.a.	n.a.	n.a.	n.a.

Germany (EdW)	15	2 411	723	Expected to be under €7m	3	29 441	29 427	Current estimate of €46m
Greece (ASE Guarantee Fund)	5	n.a.	n.a.	n.a.	4	5 013	1 948	€2.2m
Hungary	13	n.a.	n.a.	n.a.	-	-	-	-
Ireland	3	2 954	2 362	Expected to be under €8.5m	-	-	-	-
Italy	10	606	394	€5.7m	5	396	231	€0.8m
Latvia	0	-	-	-	-	-	-	-
Lithuania	0	-	-	-	1	16	16	€0.06m
Luxembourg	0	-	-	-	-	-	-	-
Malta	0	-	-	-	-	-	-	-
Netherlands	2	245	n.a.	n.a.	3 <sup>1</sup>	9	5	€0.1m
Poland	0	-	-	-	1	1 125	1 125	€7.6m
Portugal	0	0			-	-	-	-
Romania	n.a.	n.a.	n.a.	n.a.	-	-	-	-
Slovakia	0	-	-	-	-	-	-	-

Slovenia	0	-	-	-	-	-	-	-
Spain	0	8 818	6 852	€31.8m in one case	-	-	-	-
Sweden	0	-	-	-	1	n.a.	n.a.	n.a.
United Kingdom	1999 661 2000 360 2001 284 2002 139 2003 164	8 077 6 913 7 482 7 598 12 851	2 623	€23m	n.a.	81 305 investment claims from 2004/05 to 2008/09; on average 95% of these claims relate to misselling	n.a.	n.a.

<sup>1</sup> The number of claims and the payout amounts has not yet been determined for the most recent compensation case in 2009

### *Eligible claims and claimants*

The investor-compensation schemes do not usually cover sources of losses beyond what is required in the ICSD except in the UK. The UK scheme is the only one to cover claims for compensation resulting from poor investment management or bad investment advice in the event of default of the investment firm.

The ICS generally cover retail investors only. Non-retail investors are excluded from coverage unless the national scheme elects to cover losses of such clients. Several schemes have extended the coverage to cover claimants included in Annex I of the ICSD (Czech Republic, Denmark, Finland, France, Germany, Hungary, Italy, Lithuania, Poland, Portugal, Spain and Sweden). The United Kingdom has extended the coverage only to some pension funds. Finland and Germany cover all categories except professional and institutional investors. Four Member States (Denmark, Finland, Germany, and Lithuania) cover national and local authorities (categories (2) and (3) of Annex I). In addition one Member States (Czech Republic) covers only national authorities. Eleven schemes have elected to cover medium-sized and large companies (category (8) of Annex I). Czech Republic and Lithuania cover professional and institutional investors. Denmark also covers professional and institutional investors except when they are affiliated to the scheme. Sweden covers also professional investors to a certain extent, i.e. insurance undertakings and collective-investment undertakings.

	Coverage of claimants included in Annex I
Austria (AeW and schemes for banks)	Yes. Category (8) of Annex I is covered.
Czech Republic	Yes. The Fund covers the claimants listed in points (1), (2), (6) and (8) of Annex I.
Denmark	Yes. The Fund covers the claimants listed in points (1) apart from deposits, funds and securities made by or belonging to institutions which are affiliated with the Fund, (2), (3), (5), (7) and (8) of Annex I.
Finland	Yes. Categories (2), (3), (4), (5), (6) and (8) of Annex I are covered. Many of these will, however, inevitably fall into the category of professional investors and be thus excluded.
France	Yes. Category (8) of Annex I is covered.
Germany	Yes. The vast majority of claimants included in Annex I are covered, except professional and institutional investors (incl. pension and retirement funds).
Hungary	Yes. Categories (4), (7), and (8) are covered.
Italy	Yes. Category (8) is covered.

Lithuania	Yes. Categories (1), (2), (3), and (8) of Annex I are covered.
Poland	Yes; Pension fund management companies are covered.
Portugal	Yes. Category (8) of Annex I is covered.
Spain	Yes. Professional investors (according to the MiFID concept) that are not expressly stated in Annex I are covered as well as category (8).
Sweden	Yes. The Scheme also covers insurance undertakings and certain collective-investment undertakings.
United Kingdom	Yes. Some pension funds are covered.

*[1st questionnaire: no answers received yet from France*

*2nd questionnaire: no answers received yet from France, Slovenia]*

## ANNEX IV – SUMMARY OF THE VIEWS EXPRESSED BY INDUSTRY AND INVESTOR ASSOCIATIONS AT THE MEETING HELD ON 3<sup>RD</sup> SEPTEMBER 2009

### 1. Updating compensation limits

*The compensation limit set when the Investor Compensation Scheme Directive was introduced in 1997 was a minimum of €20 000 for each client. Is that minimum level still adequate or should it be increased? If it is increased, what is a suitable level and what is the basis for suggesting that new level?*

*Is there merit in aligning the limit to the Deposit Guarantee Scheme Directive level (i.e. at least €50 000 per client per firm increasing to a fixed level of €100 000 by December 2010)?*

Most industry participants were of the view that there should not be any automatic alignment with the DGS compensation level. In their view the nature of the risks addressed are different. One participant suggested that the minimum level of €20 000 should be maintained as the Member States have the option to go beyond this level if needed. Another respondent thought it would make sense to increase this minimum amount if the economics show that the investors are not anymore adequately protected.

A few industry participants were in favour of aligning the compensation level with the DGS level in order to maintain investor confidence and to maintain a level playing field between investment and banking products.

Investor representatives supported an alignment of compensation level with the Deposit Guarantee Scheme.

### 2. Deletion of the co-insurance principle

*The directive currently allows Member States to introduce a co-insurance principle (that is, to require clients to bear a proportion of any loss). Should the option of co-insurance be deleted so that clients cannot be required to bear any proportion of the loss (within the compensation limits)?*

There was a great consensus, both from industry and investors' associations, to remove the co-insurance principle. Investors cannot be reasonably expected to be able to assess the risk of the investment firm they choose to deal with. In addition it is a confusing message for the

investor. In the case the co-insurance principle is maintained it should at least be harmonised across Member States to avoid any competition issue.

### **3. Default of a third party depositary or custodian**

*Should compensation be payable under the Directive where the default is not by the investment firm itself but by a third party depositary or custodian appointed by the firm to hold client assets (i.e. where the default of a third party results in the firm not being able to return assets to the client)? If so, what third parties and what situations should be covered? If not, do you believe it is justifiable that the client's position should differ according to whether the firm holds client assets itself or chooses a third party to hold the assets?*

There was a clear consensus that the investor should be protected in case of failure of a third party custodian, but there were divergent views on how to achieve this or whether it was possible to do so. A number of participants pointed out that this raises very difficult technical and policy issues. For several participants the implications for investment firms of the specific MiFID requirements relating to the use of a third party depositary were not completely clear. In the event the scope of the schemes would be extended to cover failure of the third party custodian, everyone agreed that the custodians should be required to contribute to the schemes.

On the issue of compensation for failure of a UCITS depositary, a few participants advised to wait for the outcome of the UCITS depositaries consultation and the Alternative Investment Fund regulatory framework before moving forward on this topic.

### **4. Money market funds**

*Apart from bank deposits, are there any other types of investments (for example money market funds) for which an investor should be entitled to compensation if the investment is not repaid? If so, why do they deserve special treatment and could this create an unlevel playing field with other types of investments?*

All participants agreed that money market funds should not be covered by the ICSD. This would imply covering investment risk which is inherent to any investment product. The funding of such a scheme would also not be feasible in view of the extent of the losses to cover. Different options were put forward such as improved disclosure, clear definition of money market funds, etc.

There was one caveat from the investor side in the case the investment firm deposits the client's investment monies in "qualified money market funds" as it is allowed by article 18 of the MiFID Implementing Directive. In case the money market fund would decrease in value, the investor should be compensated by the scheme.

## **5. Funding of schemes**

*Should a level of pre-funding be required for all schemes? If so, on what basis would the amount required to be pre-funded be assessed?*

Most participants agreed that the schemes need to be at least partially pre-funded if they want to be credible towards the investors. Some of the participants suggested that the funding principles (ex ante or ex post) of Investor Compensation schemes should be linked to the ones of the Deposit Guarantee Scheme. One of the investors' associations was in favour of total pre-funding.

Some of the participants underlined the fact that no ex ante funding can be designed to overcome a worst case scenario. Complementary funding measures should be foreseen.

With respect to the basis on which to assess the pre-funding, the participants had either no views or thought that it was a technical matter to be dealt with at the level of each scheme.

## **6. Provisional payouts**

*Investor compensation schemes are required under the directive to reimburse investors within three months of "the establishment of the eligibility and the amount of the claim". But, as the eligibility and the amount of the claim are determined by national law (notably insolvency law), the waiting period for investors can be considerable (in some cases several years if there are court proceedings related to insolvency). Should investors be entitled to a partial provisional payment? If so, how could this work in practice?*

Some participants raised doubts about the possibility to make provisional payout while the eligibility of the claim has not yet been ascertained due to the fact that in case of establishment of non-eligibility the investor should pay-back the amount received to the fund.

Several of the participants thought there was no need to adapt the rules to the Deposit Guarantee Scheme. There was not the same need in the case of investments that the investor

gets compensated within days as it is necessary for deposits which investors use for day-to-day living expenses.

One of the participants underlined the importance to set realistic deadlines. If the schemes can not meet the shortened payout delays, this would be damaging for the credibility of the schemes.

Investors' associations were of the view that investors should be compensated within days. They also put forward the idea to link the payout delay to the trigger event, meaning the default of the investment firm. Moreover, they put forward the idea to create a special scheme to cover the cases of investors not paying back to the fund the money received as a provisional payout when the non-eligibility of the claim was established.

## **7. Information to clients about the directive**

*Is the scope and coverage of the Investor Compensation Schemes Directive generally understood by investors? Should firms provide more information upfront to clients about the scope and level of compensation provided for under the directive? Specifically, should more information be provided about what the scheme does and does not cover?*

There was a large consensus that disclosure requirements should be strengthened. But the information disclosed should be in a non-technical language and explicit about the risks which are and are not covered by the scheme.

According to one of the participants, due to the crisis, public awareness of the existence of the schemes has improved. One of the investors' associations suggested improving investor education via for example public campaigns. He also mentioned that misleading information about scheme coverage had been circulated in some Member States.

## **8. Coverage of non-retail investors**

*Should some of the non-retail investors listed in Annex I of the Directive be covered by investor compensation schemes?*

The participants had not clear views on an extension of the scope of coverage. Several of them agreed that it would make sense to align retail investor definitions across directives (ICSD, MiFID, Prospectus) and to take into account the "opt-ins" allowed by MiFID.

## 9. Other issues

*Are you aware of any other practical issues concerning the functioning of the Investor Compensation Schemes Directive that may have caused difficulties for investors or firms?*

The European Commission asked whether civil claims for breach of conduct of business obligations should be covered. There was little comment on this issue.

One of the participants wanted to draw the attention on the scope of the ICSD. If an investment firm is not allowed to hold client's assets, it should not be covered by the scheme.

## ANNEX V – THE AVERAGE AMOUNT HELD BY INVESTMENT FIRMS ON BEHALF OF RETAIL INVESTORS

### *Total securities held per household*

As there is very limited data available at the national investor compensation schemes about the average amount held by investment firms on behalf of retail investors, the average amount of securities held by household was used as a proxy. This proxy was calculated by dividing the amount of securities held by households by the number of households.

The amount of securities held by households was based on the "Financial accounts – balance sheets – households; non profit institutions" published by Eurostat (ESA-95 methodology<sup>130</sup>). The categories of financial assets usually held in a securities account by investment firms on behalf of the investor were taken into account: securities other than shares (f3), quoted shares (f511), and mutual funds shares (f52).

As there is no data available on the number of securities accounts owned by retail investors, the number of households was used as a proxy<sup>131</sup>.

Table: Average amount of securities held per household in 2007 – in Euro

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<sup>130</sup> <http://circa.europa.eu/irc/dsis/nfaccount/info/data/esa95/esa95-new.htm>

<sup>131</sup> Source Eurostat:  
[http://epp.eurostat.ec.europa.eu/portal/page/portal/living\\_conditions\\_and\\_social\\_protection/data/main\\_tables](http://epp.eurostat.ec.europa.eu/portal/page/portal/living_conditions_and_social_protection/data/main_tables)

	Securities other than shares	Quoted shares	Mutual fund shares	Total securities
Austria	10.877	7.187	14.056	32.119
Belgium	15.053	21.657	29.258	65.967
Bulgaria	36	578	17	631
Cyprus	n.a.	n.a.	n.a.	n.a.
Czech Republic	n.a.	n.a.	n.a.	n.a.
Denmark	11.324	13.918	16.390	41.633
Estonia	847	901	403	2.150
Finland	1.783	14.219	8.920	24.922
France	2.089	4.890	12.247	19.226
Germany	8.974	5.186	13.886	28.047
Greece	7.224	12.192	3.969	23.385
Hungary	1.239	354	2.503	4.096
Ireland	75	12.409	n.a.	n.a.
Italy	30.899	8.578	11.158	42.056
Latvia	8	n.a.	n.a.	n.a.
Lithuania	392	673	199	1.264
Luxembourg	n.a.	n.a.	n.a.	n.a.
Malta	n.a.	n.a.	n.a.	n.a.
Netherlands	6.927	14.295	7.425	28.647
Poland	95	1.264	2.216	3.576
Portugal	5.170	3.433	7.164	15.768
Romania	38	1.902	188	2.128
Slovakia	258	n.a.	1.183	n.a.
Slovenia	669	7.038	4.617	12.324
Spain	3.442	9.585	12.658	25.685
Sweden	3.369	15.900	13.248	32.517
United Kingdom	1.508	9.436	8.574	19.518
<b>Average EU-27</b>	<b>4.882</b>	<b>7.886</b>	<b>8.109</b>	<b>21.283</b>
<b>Average EU-15</b>	<b>7.765</b>	<b>10.920</b>	<b>12.227</b>	<b>30.730</b>
<b>Median EU-27</b>	<b>1.783</b>	<b>7.187</b>	<b>7.425</b>	<b>21.451</b>
<b>Median EU-15</b>	<b>6.049</b>	<b>10.889</b>	<b>12.247</b>	<b>28.047</b>

Source: Eurostat; Data for quoted shares were not provided by Eurostat for the UK and Italy.

Related to the UK we have used information provided by the UK Office National Statistics - Financial Statistics No. 570 October 2009 (Table 12.1N); <http://www.statistics.gov.uk/STATBASE/Product.asp?vlnk=376>

Related to Italy we have used information provided by Banca d'Italia – Statistical Appendix – Abridged report 2007: [http://www.bancaditalia.it/pubblicazioni/relann/rel07/encf07/stat\\_app\\_07.pdf](http://www.bancaditalia.it/pubblicazioni/relann/rel07/encf07/stat_app_07.pdf)

The number of households for Ireland and Sweden were not provided by Eurostat. We used respectively information published by Central Statistics Office Ireland (<http://www.cso.ie/px/pxeirestat/database/eirestat/Census%20of%20Population/Census%20of%20Population.asp>) and Statistics Sweden ([http://www.scb.se/Pages/TableAndChart\\_146284.aspx](http://www.scb.se/Pages/TableAndChart_146284.aspx)).

## ANNEX VI – DESCRIPTION OF SIGNIFICANT COMPENSATION CASES

### *The Amis case*

The AMIS group consisted of two companies: Asset Management Investment service AG (AMIS) and AMIS Financial Consulting AG (AFC) which are both commonly referred to as the "AMIS case". Both companies were not allowed to hold clients' assets and, for this reason, pursuant to Austrian law were not obliged to participate in the investor compensation scheme for non-bank investment firms (AeW). Client's money was transferred directly to Luxembourg depositary banks and invested in two UCITS funds.

AMIS became insolvent in 2005 subsequent to a fraud. Out of 16 000 investors, 12 000 have filed a claim with the Austrian compensation scheme for a total amount of €145 million. The Austrian ICS has refused to compensate investors and referred them to the Luxembourg depositary banks. This scheme position was challenged before an Austrian Court which obliged the scheme to compensate investors since "AMIS held the funds indirectly". The Austrian scheme has appealed against this judgment.

In the case the Austrian scheme would have to compensate the AMIS investors, it could only meet payment up to € 5,5 million. The amount of additional ex-post contributions would be too important in order to be sustainable for (some of) its participating members.

In light of these events the Austrian Securities Supervision Act 2007 has been amended in order to satisfy medium and large claims as well as mitigating the risks of such claims as well. Additional disclosure obligations have been introduced. For example, investment firms have to clearly inform investors that they are prohibited from holding clients' assets under Austrian requirements. The funding of the scheme has been strongly reinforced by requiring members to pay an annual fee and by including the option for the fund to be backed by a state guarantee. These changes became effective as from 1 May 2009.

### *The Phoenix case*<sup>132</sup>

In Germany, the investment firm Phoenix Kapitaldienst GmbH (Phoenix) became insolvent because of illegalities in its activities. On March 15, 2005 the German Financial Supervisory Authority (BaFin) ascertained and notified the occurrence of an event of claim at Phoenix Kapitaldienst GmbH. Investors had to file their claim for compensation within one year starting from the notification date. The German ICS for investment firms, EdW, received more than 30,000 compensation claims for a total amount of € 674 millions. The insolvency assets amounted to circa €230 million which could cover a little more than 30% of the claims. The compensation payments were initially planned to be made after the disbursement from the insolvency assets. This implied that the start of the compensation payments could only

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<sup>132</sup> <http://www.e-d-w.de/en/Phoenix-Stand.html>

start once the insolvency plan was confirmed by the insolvency administrator and the creditors. But this plan was challenged before the Court by one of the largest creditors (creditor "X"). "X" argued that a large portion of the insolvency assets were not part of the Phoenix asset pool (approx. EUR 162 million of a total of approx. EUR 230 million) and therefore may not be distributed to investors under the insolvency plan. End October 2007, the Court's ruling was in favour of "X". EdW informed via its website that "as a result, no payments to creditors are to be expected from the insolvency estate in the foreseeable future". The insolvency administrator has introduced an appeal against this ruling.

In order to be able to compensate investors, however, the EdW started preparing partial compensation payments. EdW's requested special contributions from participating members to finance the partial compensation payments. Many institutions affiliated to EdW appealed against the contribution requests and refused payments. In September 2008 the administrative court of Berlin suspended the obligation of the affiliated institutions to pay special contributions owing to "doubts about the legitimacy of the legal regulations pertaining to the collection of special contributions". EdW has introduced an appeal.

The data collection and analysis to enable the calculation of partial compensation payments was completed in December 2008. As result EdW has started paying partial compensation as from February 2009. EdW has assessed the time required to review and disburse the individual claims to about 2 1/2 years (approx. EUR 128 million over the next 2.5 years). The financing for the compensation payments has been assured by a loan granted to EdW by the German Government.

## ANNEX VII – DATA ON COMPLAINTS ABOUT INVESTMENT ADVICE

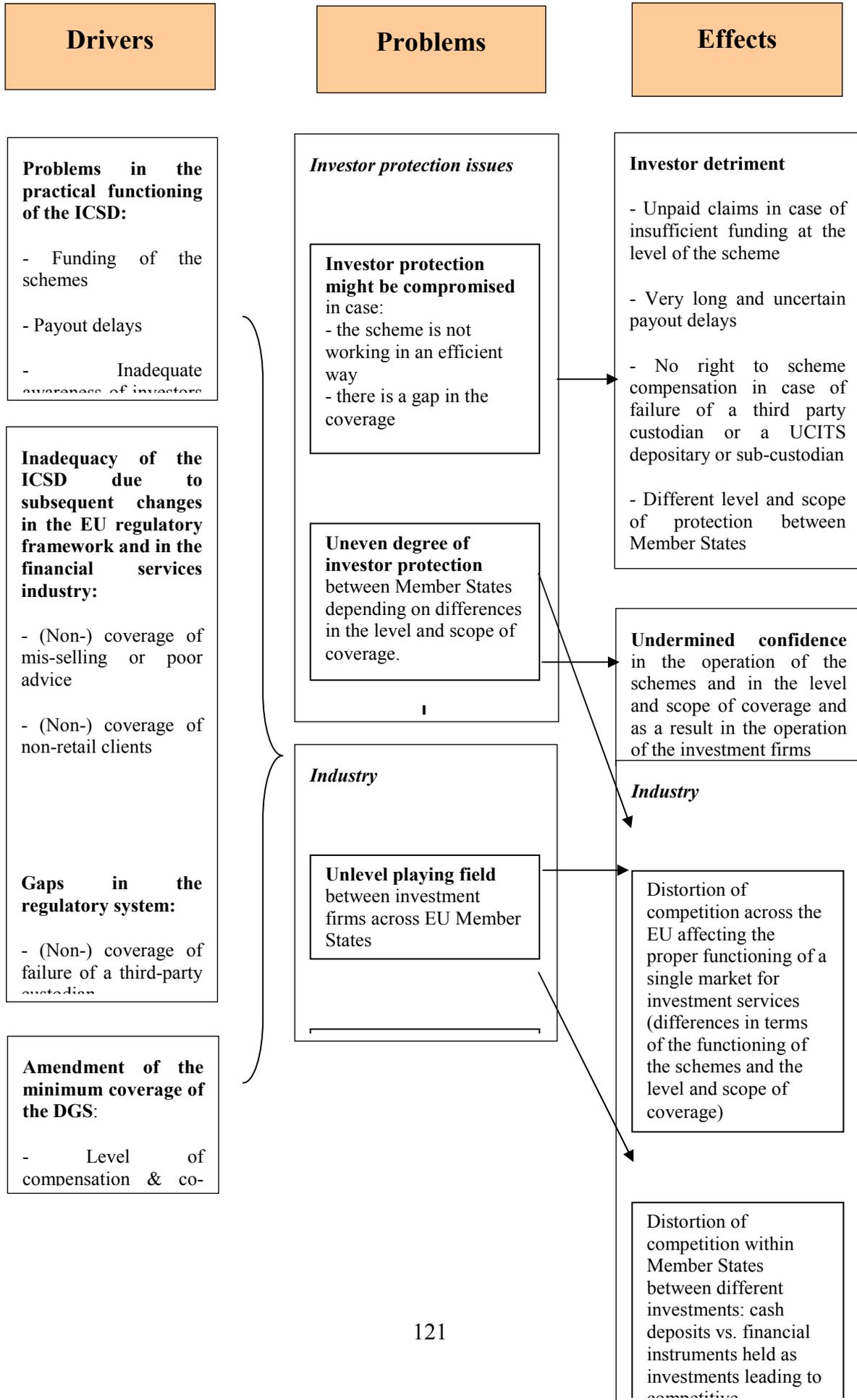
The Commission has asked FIN-NET members to fill out a questionnaire concerning complaints on financial services. Seven Member States have provided detailed data concerning complaints in the field of investment services, more specifically concerning investment advice.

Table X: Complaints on advice concerning investment products by Member State

	2007	2009	2009* – data limited to first 6 months
France	78	294	234
Belgium	62	100	103
Italy	95	63	81
Portugal	8	12	5
Germany	384	1 325	n.a.
United Kingdom	46 176	22 890	6 908
Ireland	384	1 039	860

Source: FIN-NET members, September 2009

ANNEX VIII – ICSD PROBLEM TREE



## ANNEX IX – SUMMARY OF THE MEETING WITH NATIONAL INVESTOR COMPENSATION SCHEMES ON 9<sup>TH</sup> FEBRUARY 2010

The Commission services organised a hearing on the review of the Investor Compensation Schemes Directive on Tuesday 9 February. Only the compensation schemes were invited, as discussions with Member States are taking place in the ESC and a hearing with industry and investors took place in September 2009.

The purpose of the meeting was to discuss technical issues concerning the funding, the level of compensation and the payout delays in order to further complement the information gathered via the two questionnaires we sent to the schemes in June and November 2009. Moreover, as no meeting of the compensation schemes at European level had ever been organised, the hearing gave an opportunity to the schemes to know about the practices of the other schemes.

### **Funding**

#### *How to assess the probability of firm defaults and the related potential liabilities for the scheme?*

All of the schemes did agree that it is nearly impossible to assess the probability of defaults and the related potential liabilities. There are too many uncertainties at stake: type of failed investment firm, causes of the insolvency, difficulty in gathering the necessary data, etc. As an example, bankruptcy does not necessarily lead to a case for compensation. An investment firm can indeed go bankrupt without harm to the investors. In the view of most of the schemes, they can only try to make forecasts of the short to medium term liabilities relating to known compensation cases.

In terms of the data collected by the schemes, there are two approaches. In some Member States, the schemes do act simply as a payout box and do not collect any data on the client's assets held by investment firms. In other Member States, the schemes collect such data from the investment firms themselves and/or their national regulator provides them with such data.

#### *How to assess the adequacy of your funding arrangements in light of potential liabilities? What methodologies are used to calculate funding? What is the appropriate level of pre and post funding?*

It is nearly impossible to assess the adequacy of the funding levels in light of the difficulties explained above.

Most of the schemes support the introduction of pre-funding principles and more transparent systems. Some of the schemes stressed the importance of pre-funding to enhance investor confidence. One of the schemes disagreed by saying that an explicit backing by the government would be more efficient in tackling investor confidence. In addition the matter of pre- and/or post-funding is nevertheless not as important as in the case of the DGS as having enough liquidity readily available is less critical. Another argument raised in favour of pre-funding by one of the schemes was that it might also contribute to market discipline, although this was disputed by another scheme saying this would not solve the problem of fraud.

Several schemes underline the importance of having different sources of funding. Pre-funding can serve as a first protection layer but will not be sufficient in case of failure of a major investment firm. Ex post funding can help to handle major failures. On top of that, the schemes should have access to additional sources of liquidity such as commercial loans, insurance and finally government support. Some of the schemes reacted by saying that in practice commercial loans and insurance contracts are not a viable option.

***What are the most appropriate criteria to calculate contributions? Should it be differentiated by investment business? How to differentiate the calculation according to the risks each firm imposes on the scheme (i.e.: risk-based approach)?***

Although it seems difficult to have a general rule to calculate contributions, several schemes mentioned that the contributions should be proportional to the size of the business. The volume of the assets eligible for compensation was given as an example as it is directly linked to the risks posed by the firm to the scheme. It was also stressed that the contributions should take into account the financial capability of the firms.

A few schemes have in place monitoring tools enabling them to check the accuracy and completeness of the data reported by the firms, and the related contributions paid.

***When there are limits on ongoing and/ or exceptional contributions, how to assess the adequacy of these limits?***

There were two examples given. One of the scheme stated that the limits are calculated according to the affordability of the industry, in order to avoid putting the sector in jeopardy. Another scheme explained that the limits are determined by the scheme's own assessment of the firm on a discretionary basis.

*Do schemes currently publish details of how they calculate potential liabilities?*

*Do schemes currently publish details of the funds immediately available to meet claims?*

The transparency level differs a lot from one scheme to the other. In some countries the scheme's annual report is made publicly available, in others not. The level of information disclosed in the annual report differs too.

### **Minimum level of compensation**

*How to assess whether the minimum level of compensation is still sufficient to protect the investment of retail investors?*

*How to assess the impact of any change in the minimum compensation level on the funding arrangements?*

*Have you ever seen any evidence of distortion of competition as a result of different levels of compensation between Member States, and/or between the deposit guarantee scheme and the investor compensation scheme?*

Most of them are not in favour of raising the compensation limit. A few schemes mentioned that an increase of the compensation level would mean a significant increase of compensation costs although only a small percentage of additional investors would be covered.

The issue of distortion of competition as a result of different compensation levels between the ICS and the DGS was controversial.

### **Payout delays**

*What are the main obstacles to a prompt pay out of compensation to investors?*

*How could the situation be improved within the current framework? What do you believe is a reasonable period for a payout to be made to an investor?*

The schemes do not support a reduction of the payout delays. In their view the best solution to reduce the payout delays would be to introduce in the Directive some principles to oblige the insolvency authorities to provide information to the relevant compensation scheme when examining an insolvency case or even to involve them in the insolvency procedure.

*For those schemes where partial compensation payment is allowed, how do you ensure that no undue money is paid to the investors and is there any means to recover money unduly paid out?*

In case of too large partial compensation payments, reclaiming money from investors is a very sensitive and expensive process (e.g. court proceedings).

## **ANNEX X – IMPACT OF THE INTRODUCTION OF GENERAL FUNDING PRINCIPLES UPON INVESTMENT FIRMS**

Two scenarios were developed:

**Scenario 1**: target fund level of 0.50% of the covered securities and monies held by investment firms on behalf of retail clients, and target fund level is 100% ex ante funded

**Scenario 1**

0,50%

100%

<i>Amounts in € millions</i>	Securities and monies held on behalf of retail investors	Covered securities and monies held on behalf of retail investors	Total amount of readily available funds as of end 2008	Coverage ratio based on total securities and monies	Coverage ratio based on covered securities and monies	Target fund level = 0,50% of covered securities and monies	Increase in ex ante funding needs if target fund is 100% ex ante funded	# participating firms	average costs increase per member (in €)	# securities accounts held for retail clients	average costs increase per retail client (in €) if 100% pass on
Austria	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	119	n.a.	n.a.	n.a.
Belgium	n.a.	n.a.	803	n.a.	n.a.	n.a.	n.a.	112	n.a.	n.a.	n.a.
Bulgaria	1.029	122	2,32	0,23%	1,90%	0,61	-1,71	126	-13.571	n.a.	n.a.
Cyprus (banks)	n.a.	109	1,20	n.a.	1,11%	0,54	-0,66	n.a.	n.a.	n.a.	n.a.
Cyprus (IF)	n.a.	515	5,80	n.a.	1,13%	2,57	-3,23	71	-45.451	n.a.	n.a.
Czech republic	n.a.	n.a.	5,30	n.a.	n.a.	n.a.	n.a.	54	n.a.	n.a.	n.a.
<u>Denmark</u> <sup>(1)</sup>	n.a.	48	166,10	n.a.	346,76%	0,24	-165,86	203	-817.047	n.a.	n.a.
<u>Estonia</u>	170	n.a.	0,40	0,24%	n.a.	n.a.	n.a.	24	n.a.	16.500	n.a.
<u>Finland</u>	n.a.	n.a.	12,00	n.a.	n.a.	n.a.	n.a.	151	n.a.	n.a.	n.a.
France	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Germany	n.a.	n.a.	8,52	n.a.	n.a.	n.a.	n.a.	790	n.a.	n.a.	n.a.
Greece	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	84	n.a.	427	n.a.
Hungary	22.399	6.360	9,00	0,04%	0,14%	31,80	22,80	57	400.000	847.725	26,90
Ireland	n.a.	n.a.	24,50	n.a.	n.a.	n.a.	n.a.	5370	n.a.	n.a.	n.a.
Italy	n.a.	n.a.	13,90	n.a.	n.a.	n.a.	n.a.	926	n.a.	n.a.	n.a.
Latvia	491	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	39	n.a.	58.902	n.a.
Lithuania	n.a.	n.a.	1,50	n.a.	n.a.	n.a.	n.a.	33	n.a.	n.a.	n.a.
<u>Luxembourg</u> <sup>(2)</sup>	n.a.	1.820	n.a.	n.a.	n.a.	9,10	9,10	239	38.075	n.a.	n.a.
<u>Malta</u>	n.a.	n.a.	1,13	n.a.	n.a.	n.a.	n.a.	38	n.a.	n.a.	n.a.
Netherlands	n.a.	3.400	10,90	n.a.	0,32%	17,00	6,10	346	17.630	170.000	35,88
Poland	75.362	n.a.	16,35	0,02%	n.a.	n.a.	n.a.	79	n.a.	1.750.000	n.a.
<u>Portugal</u> <sup>(2)</sup>	103.205	18.179	n.a.	n.a.	n.a.	90,89	90,89	74	1.228.284	2.343.372	38,79
Romania	839	200	2,62	0,31%	1,31%	1,00	-1,62	101	-16.052	92.800	-17,47
Slovakia	584	93	1,87	0,32%	2,01%	0,47	-1,40	38	-36.969	n.a.	n.a.
Slovenia	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	24	n.a.	n.a.	n.a.
Spain	18.497	3.065	45,50	0,25%	1,48%	15,33	-30,18	146	-206.678	n.a.	n.a.
Sweden	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	235	n.a.	n.a.	n.a.
United Kingdom	n.a.	n.a.	8,80	n.a.	n.a.	n.a.	n.a.	10.104	n.a.	n.a.	n.a.
<b>Average</b>	-	-	-	<b>0,20%</b>	<b>39,57%</b>	-	-	-	-	-	-
<b>Average excl. DK</b>	-	-	-	-	<b>1,18%</b>	-	-	-	-	-	-
<b>Median</b>	-	-	-	<b>0,23%</b>	<b>1,40%</b>	-	-	-	-	-	-
<b>Median excl. DK</b>	-	-	-	-	<b>1,22%</b>	-	-	-	-	-	-

<sup>(1)</sup> Does not take into account the amounts pledged by investment firms of €333m

<sup>(2)</sup> Being ex post funded schemes we assumed that these schemes have no funds readily available

**Scenario 2:** target fund level of 1.00% of the covered securities and monies held by investment firms on behalf of retail clients, and target fund level is 100% ex ante funded

<i>Amounts in € millions</i>	Securities and monies held on behalf of retail investors	Covered securities and monies held on behalf of retail investors	Total amount of readily available funds as of end 2008	Coverage ratio based on total securities and monies	Coverage ratio based on covered securities and monies	Target fund level = 1,00% of covered securities and monies	Increase in ex ante funding needs if target fund is 100% ex ante funded	# participating firms	average costs increase per member (in €)	# securities accounts held for retail clients	average costs increase per retail client (in €) if 100% pass on
Austria	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	119	n.a.	n.a.	n.a.
Belgium	n.a.	n.a.	803	n.a.	n.a.	n.a.	n.a.	112	n.a.	n.a.	n.a.
Bulgaria	1.029	122	2,32	0,23%	1,90%	1,22	-1,10	126	-8.730	n.a.	n.a.
Cyprus (banks)	n.a.	109	1,20	n.a.	1,11%	1,09	-0,12	n.a.	n.a.	n.a.	n.a.
Cyprus (IF)	n.a.	515	5,80	n.a.	1,13%	5,15	-0,65	71	-9.211	n.a.	n.a.
Czech republic	n.a.	n.a.	5,30	n.a.	n.a.	n.a.	n.a.	54	n.a.	n.a.	n.a.
Denmark <sup>(1)</sup>	n.a.	48	166,10	n.a.	346,76%	0,48	-165,62	203	-815.867	n.a.	n.a.
Estonia	170	n.a.	0,40	0,24%	n.a.	n.a.	n.a.	24	n.a.	16.500	n.a.
Finland	n.a.	n.a.	12,00	n.a.	n.a.	n.a.	n.a.	151	n.a.	n.a.	n.a.
France	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Germany	n.a.	n.a.	8,52	n.a.	n.a.	n.a.	n.a.	790	n.a.	n.a.	n.a.
Greece	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	84	n.a.	427	n.a.
Hungary	22.399	6.360	9,00	0,04%	0,14%	63,60	54,60	57	957.895	847.725	64,41
Ireland	n.a.	n.a.	24,50	n.a.	n.a.	n.a.	n.a.	5370	n.a.	n.a.	n.a.
Italy	n.a.	n.a.	13,90	n.a.	n.a.	n.a.	n.a.	926	n.a.	n.a.	n.a.
Latvia	491	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	39	n.a.	58.902	n.a.
Lithuania	n.a.	n.a.	1,50	n.a.	n.a.	n.a.	n.a.	33	n.a.	n.a.	n.a.
Luxembourg <sup>(2)</sup>	n.a.	1.820	n.a.	n.a.	n.a.	18,20	18,20	239	76.151	n.a.	n.a.
Malta	n.a.	n.a.	1,13	n.a.	n.a.	n.a.	n.a.	38	n.a.	n.a.	n.a.
Netherlands	n.a.	3.400	10,90	n.a.	0,32%	34,00	23,10	346	66.763	170.000	135,88
Poland	75.362	n.a.	16,35	0,02%	n.a.	n.a.	n.a.	79	n.a.	1.750.000	n.a.
Portugal <sup>(2)</sup>	103.205	18.179	n.a.	n.a.	n.a.	181,79	181,79	74	2.456.568	2.343.372	77,57
Romania	839	200	2,62	0,31%	1,31%	2,00	-0,62	101	-6.164	92.800	-6,71
Slovakia	584	93	1,87	0,32%	2,01%	0,93	-0,94	38	-24.728	n.a.	n.a.
Slovenia	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	24	n.a.	n.a.	n.a.
Spain	18.497	3.065	45,50	0,25%	1,48%	30,65	-14,85	146	-101.712	n.a.	n.a.
Sweden	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	235	n.a.	n.a.	n.a.
United Kingdom	n.a.	n.a.	8,80	n.a.	n.a.	n.a.	n.a.	10.104	n.a.	n.a.	n.a.
<b>Average</b>	-	-	-	<b>0,20%</b>	<b>39,57%</b>	-	-	-	-	-	-
<b>Average excl. DK</b>	-	-	-	-	<b>1,18%</b>	-	-	-	-	-	-
<b>Median</b>	-	-	-	<b>0,23%</b>	<b>1,40%</b>	-	-	-	-	-	-
<b>Median excl. DK</b>	-	-	-	-	<b>1,22%</b>	-	-	-	-	-	-

<sup>(1)</sup> Does not take into account the amounts pledged by investment firms of €333m

<sup>(2)</sup> Being ex post funded schemes we assumed that these schemes have no funds readily available

The countries underlined are countries where the compensation scheme is funded with a mix of ex ante and ex post funding. The countries highlighted in grey are schemes with ex post funding.

## ANNEX XI – GLOSSARY OF ACRONYMS

AES: Athens Stock Exchange Members Guarantee Fund

AeW: Anlegerentschädigung von Wertpapierdienstleistungsunternehmen GmbH (Austrian Investor Compensation Scheme for non-bank investment firms)

CESR: Committee of European Securities Regulators

DGS: Deposit Guarantee Scheme

DGSD: Deposit Guarantee Scheme Directive

ECB: European Central Bank

EdW: Entschädigungseinrichtung der Wertpapierhandelsunternehmen (German Investor Compensation Scheme for non-bank investment firms)

EFAMA: European Fund and Asset Management Association

ESC: European Securities Committee

ESMA: European Securities and Markets Authority

ESME: European Securities Markets Group

FOGAIN: Fondo General de Garantia de Inversiones (Spanish Investor Compensation Scheme)

FSCS: UK Financial Services Compensation Scheme

HDIGF: Hellenic Deposit and Investment Guarantee Fund

ICCL: Investor Compensation Company Limited (Irish Investor Compensation Scheme)

ICS: Investor Compensation Scheme

ICSD: Investor Compensation Scheme Directive

IMMFA: Institutional Money Market Funds Association

ISD: Investment Services Directive

MTF: Multilateral Trading Facility

MiFID: Markets in Financial Instruments Directive

SEC: Securities and Exchange Commission

TFEU: Treaty on the Functioning of the European Union

UCITS: Undertakings for Collective Investment in Securities

## ANNEX XII – ESTIMATION OF ADMINISTRATIVE BURDEN

Currently only investment firms are obliged to disclose information to actual and intending investors about the investor compensation scheme coverage (amount and scope).

The Directive is to be amended to include:

- i. For **investment firms** the requirements that the information provided shall be fair, clear and not misleading and in particular shall explain what is covered by the relevant compensation scheme and what is not covered under the scheme and how it applies in cross border situations.
- ii. The full set of disclosure obligations on **UCITS** similar to that on investment firms;
- iii. Annual publication of details about the level of funding and the target funding level by **national investor compensation schemes** (draft technical standards will be developed by ESMA to ensure ease of implementation).

### 1. Administrative burden for investment firms

The administrative burden from the planned amendment of the ICSD can be broken down into the costs of preparation of the required information, and costs of its publication. The latter is estimated to be marginal, since publication of other compensation scheme related information is already a legal requirement, so that the amendment will be integrated in the document already to be published.

As for the costs of preparing the information, this is considered as a one-off cost, and the number of investment firms and branches abroad are taken as a basis, since it is the investment firm (or branch) that will have to prepare the additional information once, as it is the same for all investment products that are offered.

We estimate that preparing this information will imply 2.5 hours of work of a professional.<sup>133</sup>

*Table 1: Estimation of costs of preparation and publication of information requirements on investment firms*

<i>Admin burden on investment firms and branches</i>	Professional (hours)	Extra costs ('000)
Drafting	1.5	0

<sup>133</sup> This estimation is based on a comparison with UCITS disclosure costs, as measured by CSES: *Study on the Costs and Benefits of the proposed UCITS Key Investor Information* Final report December 2009

Translation	0.5	0
Regulatory approval	0.3	0
Printing and dissemination	0.2	0.0
Total	2.5	0.0

The table below shows the number of firms and branches abroad for each Member State, the hourly rate for a professional in the given country, and the overall administrative burden within each Member State (counting 2.5 hours of work).

**Table 2: Calculation of administrative burden on investment firms, credit institutions and their non-domestic branches**

Member State	hourly wage of managers	number of investment firms, credit institutions authorised providing investment services and foreign branches	total costs
Austria	51.53	975	125,601
Belgium	50.63	132	16,707
Bulgaria	3.30	N/A	N/A
Cyprus	31.64	97	7,673
Czech Republic	11.52	57	1,641
Denmark	51.99	671	87,215
Estonia	8.10	26	526
Finland	44.75	382	42,732
France	51.14	490	62,641
Germany	46.40	2,687	311,667
Greece	26.98	116	7,826
Hungary	11.66	N/A	N/A
Ireland	49.56	235	29,117
Italy	61.50	881	135,452
Latvia	5.86	N/A	N/A
Lithuania	7.38	26	480
Luxembourg	56.63	199	28,173
Malta	16.67	91	3,793
Netherlands	36.88	N/A	N/A
Poland	13.02	80	2,603
Portugal	31.00	76	5,891
Romania	9.73	85	2,067

Slovakia	7.83	41	803
Slovenia	18.34	26	1,192
Spain	37.11	434	40,269
Sweden	50.80	271	34,416
United Kingdom	52.81	3,921	517,635
<b>total:</b>			<b>1,466,120</b>

We estimate that there will be approximately 1,500,000 euros of one off administrative burden on investment firms and credit institutions providing investment services.

## 2. Administrative burden for UCITS

UCITS funds will provide disclosure within the KID and they will have the possibility to provide disclosure at the same time with the issuing of the KID (i.e. the timelines of the KID and ICSD proposals will be aligned, or a period of compliance will be envisaged, as KIDs need to be updated once a year).

The preparation of the information is calculated in terms of man-hours and counts as a one-off cost, as the information will remain the same over years. The basis of the calculation is the number of fund managers, assuming that the information to be compiled will be the same over the various funds under their management. It is also expected that trade bodies will be able to provide assistance in terms of information or even templates that can reduce the administrative burden on individual fund managers.

The publication costs are calculated in euros, and they constitute on-going administrative burden. The basis for those publication costs is the number of Key Information Documents (KIDs) produced.

### 2.1. One-off costs: preparation of information

We estimate that for the disclosure of compensation scheme coverage to investors, on average 4 hours will be spent by a fund manager on drafting (to simplify we do not distinguish between professional and other staff). This estimation is based on a CSES survey of fund managers that identifies the following cost elements in drawing up the KID, indicating the hours spent on the different elements by professional and other staff:

*Table 3: The costs of the KID drafting*

Section	Professional time – hours	Other staff time – hours	Additional costs € '000, if any
Objectives and Investment Policy	3.8	2.5	0.2
Risk and Reward disclosure	3.5	3.3	0.6
Past performance presentation	2.2	3.2	0.7
Charges disclosure	1.9	1.5	0.1
Practical Information	1.8	3.1	0.1
Total	13.2	13.7	1.8

The information on investor compensation schemes to be provided is comparable to the "practical information" requirements of the KID, and would take about half the time to draft as all other practical information items. According to the CSES study, the drafting of practical information requires 1.8 hours of a professional and a further 3.1 hours of other staff, in total 4.9 hours, that is about one-seventh of the time required for the entire KID drafting. The ICSD amendment would thus require about half of that time, 2.5 hours, which we count here as professional time.

Besides the costs of drafting, some costs of translation and dissemination can also be expected. Drafting, translation and dissemination costs of the entire KID is displayed in the table below (column to the left), with proportionate cost estimates<sup>134</sup> indicated for the ICSD amendment (column to the right).

*Table 4: The costs of drafting and additional costs of the ICSD amendment*

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<sup>134</sup> As drafting is estimated to take half the time of KID practical information items, and practical information items require about one-seventh of the time required for the drafting of the entire KID, the time necessary for translation and dissemination is counted proportionately to be one-fourteenth of the KID drafting times.

	<b>Entire KID</b>			<b>ICSD amendment</b>	
	<i>Professional (# hours)</i>	<i>Other staff (# hours)</i>	<i>Extra costs ('000)</i>	Professional (# hours)	Extra costs ('000)
Drafting	13.2	13.7	1.8	2.5	0.1
Translation	7.7	10.6	1.6	1.3	0.1
Regulatory approval	4.0	3.0	5.4	Not applicable	Not applicable
Printing and dissemination	1.9	1.8	3.2	0.2	0.2
<b>Total</b>	<b>26.8</b>	<b>29.1</b>	<b>12</b>	<b>4.0</b>	<b>0.4</b>

Overall 4 hours can be expected to be spent on drafting the ICSD information item.

For the costing (hourly wage of fund managers/professional staff) we do not have figures about the distribution of across Member States, therefore we use an average of the EU27 hourly wage of managers, taking account of the fact that most fund managers are likely to be located in higher wage countries. The European average hourly rate of managers is 31.29 euros; here the calculations are done with an hourly rate of 40 euros. Per fund manager the costs will be approximately EUR 160 (€40/hour \* 4 hours).

There are approximately 1 500<sup>135</sup> fund managers in the EU, leading to a cost of 1 500 \* Eur 160 = Eur 240 000

As a result the on-off costs on UCITS are estimated at EUR 240 000.

## **2.2. On-going costs (publication costs):**

The CSES study on UCITS costing<sup>136</sup> reveals the number of UCITS funds, and the number of KID disclosure documents prepared for those funds in a given year.<sup>137</sup> Based on their survey,

<sup>135</sup> The Zentrum für Europäische Wirtschaftsforschung GmbH (ZEW) / Observatoire de l'Épargne Européenne (OEE) database includes information on the number of AMs in each country. It is estimated that 1441 asset managers of UCITS existed in the EU in 2005.

<sup>136</sup> CSES: *Study on the Costs and Benefits of the proposed UCITS Key Investor Information* Final report December 2009

<sup>137</sup> "Fund managers were asked to provide information on the number of funds they have and hence the number KIDs which they might have to prepare, showing KIDs for sub funds and different share classes separately. Fund

2402 KIDs are prepared for 1936 funds, which on average means 1.24 KIDs/fund. In Europe there are 37,643 funds,<sup>138</sup> producing therefore around 46,677 KIDs (in the calculation we use 47000 KIDs, to round the figure which is only an estimate).

Table 3 above shows that printing and dissemination costs are estimated at 200 euros per KID. The on-going burden then is estimated at 9,400,000 euros.

### 3. Administrative burden for schemes:

The Schemes will have to disclose information every year about their target funding level and actual level of funding. The number of investor compensation schemes across the 27 member States is 39<sup>139</sup>. The administrative burden flowing from this obligation will largely depend on schemes' internal management and record keeping practices as well as the standards that ESMA would set. As some schemes are already publishing information, not all of them would face an equal increase of administrative burden.

Even in the most convenient case there would be a yearly burden of transferring the information already collected on a business as usual basis into the format required by ESMA (that will try to find the most cost-effective solution) of 12 hours of an official. Assuming this for the 39 compensation schemes would result in approximately 15 000 Euros as recurring administrative burden. A maximum estimate figure, counting with 24 hours per scheme arrives to approximately 30 000 Euros per year.

EU average hourly rate for senior official=31.29

$31.29 * 12 = 375.48$

$375.48 * 39 = 14\ 643$

EU average hourly rate for senior official=31.29

$31.29 * 24 = 750.96$

$750.96 * 39 = 29\ 287$

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managers were asked to include just UCITS funds. In total, respondents managed a total of 1936 funds and expected to prepare 2402 KIDs; the higher number of KIDs reflects, for example, the preparation of 288 KIDs for individual share classes."

<sup>138</sup> The number of UCITS funds on 31 December 2008 was 37 643.

<sup>139</sup> The number of investor compensation schemes is higher than the number of Member States as some Member States (Austria, Cyprus, Germany, Greece, Netherlands, and Spain) have different compensation schemes for non-bank investment firms and credit institutions.

It may be reasonable to calculate a relatively higher one-off cost for adjusting national systems to the data gathering requirements, but the costs of this cannot be reasonably estimated at this stage.

For all the national investor compensation schemes together we estimate a recurring administrative burden between 215 000 and 30 000 Euros per year.