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Dear Mr. McCreevy,

#### **Call for evidence on Investor-Compensation Schemes Directive - 1997/9/EC (ICSD)**

I write in response to the above call for evidence on behalf of the Legal & General Group of Companies. The Legal & General Group, established in 1836, is one of the UK's leading financial services companies. Over 5.75 million people rely on us for life assurance, pensions, investments and general insurance plans. The Legal & General Group is responsible for investing over £260 billion worldwide (as at 30 December 2008) on behalf of investors, policyholders and institutions.

In setting the context of our response, it is important to briefly explain the current role of Financial Services Compensation Scheme (FSCS). It is the UK's statutory compensation regime for consumers of UK-based financial services paying compensation to predominantly individuals if a firm is unable, or is likely to be unable, to pay claims against it. The ability of FSCS to provide this service is underpinned by its ability to raise the appropriate funds when there is a need to pay compensation. FSCS is currently funded on a 'pay as you go' basis by compulsory levies from UK-authorized firms. FSCS covers all retail financial service providers and intermediaries and is divided into 5 classes, including an investment class which is further divided into sub-classes for intermediation and provision. Each firm will contribute to a levy if it is part of the class and sub-class in which there is a default. There is cross-subsidisation between the sub-classes where claims exceed the capacity of the sub-class and additionally, there is a general retail pool that creates a cross-subsidy between classes if a compensation requirement in one sub-class exceeds the capacity of that pool.

For investment firms, this means they could be required to cross-subsidise claims for deposit takers which we do not believe is appropriate for either the UK nor pan-EEA application. Whilst this amendment to the scheme nearly doubled the capacity of the scheme, it puts a liability on firms to pay for failures of others operating in totally different markets in which they had no involvement. Further detail is provided in our response to the questions.

In addition to FSCS, UK also has a pension specific compensation arrangement, which focuses solely on defined pensions (a product not covered by FSCS). Pension Protection Fund was established to pay compensation to members of eligible defined benefit pension

schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover Pension Protection Fund levels of compensation. Similar to FSCS, each pensions scheme in operation contributes to the fund.

FSCS is super-equivalent to ICSD, and in our opinion offers a generally more suitable level of consumer protection to that mandated by the current ICSD. With more firms utilising the EEA passport, there is a greater need for harmonisation of investor compensation arrangements.

We feel that the following principles should influence ICSD:

- Protection under compensation schemes should be proportionate to an investor's sophistication, i.e. full protection should only extend to retail investors, not professional or institutional.
- Losses arising from investment risk should not be covered by compensation schemes.
- Retail investors should expect similar outcomes in terms of level of protection and speed of payment, regardless of the home state of the firm they are invested in.
- Retail investors should share responsibility for managing their risks, i.e. protection should be capped at a reasonable level.

Lastly, and critically, any proposed changes to the current compensation arrangements must be fully vetted against appropriately robust cost benefit analysis. For example, the cost implications of increasing the compensation coverage to include third party defaults may make the scheme unaffordable for financial services companies to support due to the significantly increased levies required to fund the enlarged scheme. Therefore any improved scheme that offers better protection to consumers must be balanced with the economic cost for the firms that fund the scheme.

This response should be treated as Private & Confidential and should not be made public nor shared with other firms or organisations.

Yours sincerely,

Philippa Scott  
Compliance Strategy Director

Q1:	Should the operation of multilateral trading facilities be excluded from the scope of the ICSD?
	Multilateral trading facilities (MTFs) should be brought into the scope of ICDS only where they deal directly with retail investors. If, as market practice indicates, MTFs mostly deal with professional counterparties, then it is important that these dealings should remain excluded from ICSD. Firms only operating MTFs dealing with professional investors should be able to opt out from compensation schemes.
Q2:	Would it be appropriate to include in the scope of the ICSD all investment firms seeking authorisation to the provision of investment services, although their authorisation would not allow holding clients' assets?
	Yes - these firms should be brought into scope in relation to their dealings with retail investors (as is currently the case with FSCS). As captured in the paper, FSCS is the only scheme that offers compensation for advice failings. Compensation for poor investment advice is where an obligation to a customer is most likely to arise from these firms, and it is important that retail investors, who will in general be dependent on advice, are confident that they can receive suitable redress for any detriment they suffer from unsuitable advice.
Q3:	Would it be appropriate to include in the scope of the ICSD all investment firms seeking authorisation to the provision of investment services, although they provide their services only to non-retail clients?
	Non-retail investors should continue to be outside the scope of the scheme. Firms should be allowed to differentiate between business conducted for retail investors and professional counterparties, to ensure they are only levied for business that is within the scope of the compensation scheme.
Q4a	Should investors be able to claim compensation in the case of default of the third party where their assets had been deposited?
	<p>Including third parties within the remit of any compensation arrangements would add an additional layer of complexity to customer understanding of the scheme. This approach would operate contrary to recent moves in the UK to simplify the scheme and make it more assessable and understandable to consumers. For example, under the proposed expanded remit, a fund of funds unit trust, could on a daily basis switch between deposits, equities and investments, which all have differing compensation arrangements (including equities which are not covered at all). In such circumstances, explaining to a customer the coverage of the scheme would be extremely difficult. It would also increase the costs to investment firms and effectively provide significant cross-subsidisation to other classes, such as deposit takers.</p> <p>Such a change would vastly increase the size and reach of the scheme and a detailed cost benefit analysis needs to be undertaken to ensure that it balances the benefits for the consumer with the cost burden for the participants of the scheme. If such a proposal is to be considered, it is important that the class of the underlying assets should meet the compensation costs rather than the wrapper within which that asset is held i.e. if the third party that defaults is a deposit taker, then the costs should met by other deposit takers not unit trust providers. This is the approach currently adopted for Self Invested Personal Pension products in UK.</p> <p>We are also concerned that this change would also start to undermine the exclusion of investment performance from any compensation consideration. The implications of this move need to be carefully considered. Clearly, if an investor has been misled about the nature of their investment, they should have the ability to make a claim for mis-selling and our strong preference is to use this approach to protect consumers.</p>

Q4b	Should investors (such as UCITS or a UCITS unit holder) be able to claim compensation for loss of assets under the ISCD in those cases where the UCITS depositary or the institution which has been mandated to safe keep the assets, fail to perform its duty?
	We believe that individual underlying beneficial holders should be entitled to claim. However, for expediency and efficiencies, we would suggest that an aggregate claim, in this instance, should come from the UCITS or nominal holder on behalf of the affected individuals.
Q5:	Should loss events include also any losses suffered by (retail) investors as a consequence of the violation of conduct of business rules?
	We agree with this proposal, where the losses are caused by the rule breach.
Q6:	Do you agree with the idea that the amount covered by the ICSD should be adapted following the updating of the DGSD?
	Given its significance, the impact of any change to the current differential limits need to fully consider both the short term and long term implications of such a convergence. As such, we would advocate that formal consultation should be undertaken on this matter. To assist, we would suggest that a thorough cost benefit analysis is undertaken and published as part of the consultation.
Q7:	The ICSD does not harmonize the funding systems of the schemes. Should the ICSD provide for some general principles concerning the funding of the schemes?
	There should be a harmonisation of "outcomes" that affect the retail investor, i.e. in the level of protection and the speed of payment, regardless of the home state. However, the responsibility for operating and funding the scheme should rest with the individual home state and not harmonised at EU level. However, the performance against outcomes should be monitored at EU level to ensure schemes are properly operated and funded and action taken to address any shortcomings identified in schemes operated by member states.
Q8a	Does the legislation of the Member State you know the best provide mechanisms aimed at limiting compensation schemes' obligations over time? If yes, how many clients saw their compensation unpaid as a result of such mechanisms?
	<p>The current approach by FSCS through the general retail pool approach means that the scheme capacity is over £4bn. The general retail pool, as briefly summarised on the covering letter, means that if the compensation limit for a set class of business is exhausted, it is incumbent upon the other types of business within the remit of FSCS to meet the remaining compensation costs. The scheme also allows FSCS to borrow money from the National Loans Fund to enable it to fund claims in advance of receiving payments from firms. This means it can fund compensation claims over several years.</p> <p>The general retail pool was designed to increase the size of the resources available to FSCS. However, it still does not provide the capacity to cope with the failure of even a medium-sized deposit-taker, for example, and yet it creates unjustified and unacceptable risks and costs for unrelated financial service companies:</p> <ul style="list-style-type: none"> <li>• It is much more likely that a non-deposit-taker will have to contribute to the general retail pool - if a deposit-taker were to fail, there is likely to be a substantial call on the general retail pool in the year of failure; whereas for an insurance company, the claims are likely to emerge over several years with levies made over those years. Thus, it is likely that only deposit-takers will be beneficiaries of the general retail pool;</li> <li>• It is inherently unreasonable for our customers to bear the cost of a materially different risk incurred in another unconnected financial service sector; and</li> <li>• The general retail pool creates competitive disadvantage relative to our European competitors who are not forced to subsidise the banking sector in this way.</li> </ul>

	<ul style="list-style-type: none"> <li>Given the newly created ability for the FSCS to borrow from the National Loans Fund, there is no longer any rationale for the general retail pool to remain.</li> </ul> <p>We believe that the provision of funding support through the general retail pool is a fairer and less risky mechanism than cross-subsidisation. Additionally, cross-subsidisation creates competitive disadvantage for investment and insurance firms operating in countries where such an approach is adopted.</p> <p>Whilst the ability to borrow from the National Loans Fund provides additional capacity to the current scheme, it needs to be highlighted that this does not mean that the FSCS compensation is limitless. Beyond this, whilst the intervention of the Tripartite Standing Committee, after such an event, may lead to some further extension in the capacity to pay, there can be no certainty of this. As such, there needs to be an appreciation that, at some stage and in certain circumstances, there may be instances where compensation could be unpaid.</p>
Q8b	<p>Should this kind of mechanisms be prohibited?</p> <p>We have no comments on this proposal.</p>
Q9a	Should the process of recognizing the eligibility of the claim be regulated for the purposes of the ICSD?
Q9b	Should, at least, a mechanism be introduced providing for provisional partial compensation based on a summary assessment of clients' positions?
Q9c	Irrespective of the harmonisation of their funding systems, should compensation schemes ensure that they have minimum reserve funds in order to comply rapidly with any immediate needs?
	The focus of the ICSD should be on harmonising the consumer outcomes (as in our response to Q7 above). Measures to harmonise the mechanisms are likely to be constrained by differences in insolvency laws in member states.
Q10:	<p>Do you think special attention should be given to money market funds?</p> <p>We disagree with the suggestion that investors in money market funds should be compensated for any investment losses.</p> <p>There has, however, been a misconception among investors in these funds that their investments are protected from investment losses. There is clearly a need for providers and intermediaries to ensure that investors fully understand the investment risks related to money market funds and to ensure that these are clearly and properly explained in product disclosure documents. Consumer protection should be provided through the ability to claim for mis-selling rather than compensating for the crystallisation of investment risk.</p>
Q11:	<p>Based on the concrete application of the ICSD do you see further issues other than the ones mentioned in the present document that might be of relevance to this analysis?</p> <p>We have no further comments.</p>