

Comment to the Call for Evidence regarding

Directive 1997/9/EC on Investor Compensation Schemes (ICSD)

– Response of the ECT-Group –

I. Introduction

We are representing the Energy Commodity Traders Group ("ECT-Group"), a group of mostly German energy trading firms which established a joint working and discussion group for the exchange of experiences in financial and physical energy trading and for the coordination of the communication with German and European authorities. We would like to respond to the Call for Evidence regarding Directive 1997/9/EC on Investor Compensation Schemes (ICSD).

The ECT-Group consists of entities active in the energy trading sector; several of them pursue also banking activities or render financial services related to energy derivative products. Entities which pursue banking activities or render financial services related to commodity derivatives are according to the German Banking Act investment firms which have to apply for a license in order to carry out the banking activities or financial services related to commodity derivatives and which are supervised by the German Financial Supervisory Authority Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin"). These norms fall under the ICSD. The ECT-Group serves as a platform for such firms in order to develop common positions with respect to the financial supervision and to communicate them to BaFin and other legislative and administrative bodies. There has been a steady and successful cooperation between BaFin and the ECT-Group in order to develop an adequate supervisory regime for investment firms rendering financial services related to energy derivative products.

II. Introductory Remarks

The firms joined under the ECT Group are normally professional players in the energy (derivatives) markets. As such, they are no retail clients in terms of the ICSD. Therefore, they cannot benefit from compensation payments. Some of the firms, however, have been licensed by the Federal Financial Supervisory Authority (BaFin) as financial service providers in Germany. Thus, they have the permission to provide commodity-related financial services. As a rule these are services which can be provided without having to use client funds.

In Germany these firms are subject to the Deposit Protection and Investor Compensation Act [*Einlagensicherungs- und Anlegerentschädigungsgesetz - EAEG*] that represents the

implementation of the ICSD into German law. Accordingly, they are members of the Compensatory Fund of the Securities Trading Companies [*Entschädigungseinrichtung der Wertpapierhandelsunternehmen – EdW*]. Hence, the ECT group's comment on the call for evidence is limited to those questions being relevant from the mentioned perspective.

III. To the individual questions

1. Should the operation of multilateral trading facilities be excluded from the scope of the ICSD?

In the opinion of the ECT group, the question, whether the MTF operators should become members of the compensatory fund, shall not be evaluated according to the rendered financial services but according to the same generally admitted principles, which are addressed to in the following. Operating a MTF presents the same risk for an investor as e.g. an investment broker.

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

As regards the question as to what kind of losses should be covered, the ECT group too thinks that the fundamental protection aim of the directive should be taken into consideration, i.e. preserving for an investor what he has invested. The protection does not apply to capital growth and profit expectations. It is merely about clients' assets being in a bank as safe as if they were hidden under one's own pillow. Against this background, including also securities traders in the protection provisions, originally intended for banks, is only justified if these also hold their clients' assets directly (thereby possibly jeopardizing them).

In the end, the fact that an authorised firm enjoys a higher market acceptance will not change either. According to our experience, an average client does not build a connection between having an authorization and being member of a compensatory fund. These are two different pieces of information which as a rule a typical end customer is not even aware of. In this context, when talking about financial services such as investment advice, investment brokering or the like, it cannot be relevant that a company has been granted an authorization at all since the clients' assets are not subject to a greater risk than at a company providing services without having an authorization.

Thus, it would not be appropriate to include in the scope of the ICSD also those securities trading firms not being authorized to hold clients' assets.

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

The question as to who should be entitled to the compensatory fund also depends on the intended aim of the directive. The principal idea is clearly the protection of small savers and/or small investors. Although the directive does not clearly define who shall be entitled to benefit, the fact that the minimum compensation amounts to €20,000 shows that it is rather meant for the protection of private persons than for commercial enterprises. An amount of €20,000 would barely be much of a help for professional investors.

For instance in Germany, pursuant to Section 3 para. 2 no. 9 EAEG all joint stock companies reaching a certain minimum size are not entitled to compensation. This minimum size is reached e.g. when a firm has more than 50 employees and sales revenue of about 8 million EUR. Due to this minimum size no ECT group member deals with a trading partner being entitled to compensation. However, this does not concern only these companies but the whole energy trade sector. An energy supply company being smaller than that will hardly be interested in energy derivatives or the like as hedging instruments.

As a consequence, investor protection does not present a relevant matter from the point of view of the commodity derivatives traders. Therefore, it is inappropriate to demand contributions from these companies, if they have no clients who would be entitled to claim compensation. The general reasoning against this would be: even commodity derivatives traders who have only professional (non-retail) clients participate in the creation of the systematic risk in the entire market. Considering this, it would be justified that these companies too make a solidarity contribution. However, we definitely disagree: it would be utopian to believe that the reserves of the compensatory fund would help if the financial market collapsed altogether. The reserves are only calculated to compensate the "normal" loss of single companies. The systematic overall risk, however, is not affected where only single financial providers defaults.

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

Based on the assumption that the investor's assets must be protected, the inclusion of a certain liability for violation of conduct of business rules contradicts the system. The particular risk of a client who entrusts his assets to someone else is not comparable to the risk a client takes when he makes economically disadvantageous decisions due to bad advice. Thus, assuming that the protection aim is solely limited to the assets, it is consistent to not provide compensation in these cases. If, however, firms that particularly provide financial services without holding their clients' funds are also required to pay contributions, it would be just fair to grant the clients of these companies too (like all the ECT group member firms) the right to compensation.

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

Adjusting the amounts covered by the ICSD to those of DGSD is not an end in itself. Both directives concern different elements of the financial market; otherwise they would be contained in one and the same directive. However, the amounts of compensation must be adjusted in the appropriate and proportionate way to the actual further development. If by doing so both directives come to the same compensation amount, then this is correct. In the opinion of the ECT group, it is particularly important to determine standardized compensation amounts throughout Europe so that standardized contributions are paid by the financial service providers. Varying compensation amounts and the thereto related varying contribution amounts lead to market distortion.

7. The ICSD does not harmonize the funding systems of the schemes. Should the ICSD provide for some general principles concerning the funding of the schemes?

For the ECT group a common financing system of the compensatory funds throughout Europe (just like the aforementioned uniform compensation amount) would be an important step to a common level playing field. Otherwise, German companies having to finance the compensatory fund only with contribution payments would have an immanent competitive disadvantage towards financial service companies from countries in which the financing is partially taken over by the state.

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

Talking from the experience with the implementation of the ICSD into German law, there are in fact some issues worth noting. One thing that led to dispute was the concrete calculation of the contributions, which in the ideal case should be based on the company's risk for the system. If a company's main business is not subject to supervision and it performs financial services only to a negligible extent, it might be obliged to pay very high contributions to the compensatory fund although the risk arising from the financial services (as only this must be hedged) is negligible.

A further problem arises in the event of big compensation cases for which the reserves would by far not be sufficient. The same happened in Germany in the case Phönix Kapitaldienst. It was not a market failure or something similar but the criminal intent in the company. Nevertheless, this caused a damage that exceeded by far the normal contributions and reserves. As a result the member firms are burdened with additional payments. However, the current version of the Act does not contain any cap for such additional contributions. In any case, such a cap provision should be included in the directives on European level, as it is unacceptable that a member company pays additional contributions to the compensatory fund until it almost comes to a compensation case for this company too.

Berlin, April 2009

Contacts:

Dr. Ines Zenke
Lawyer
Becker Büttner Held
Köpenicker Straße 9
D-10997 Berlin
Tel.: +49 (0)30 611 284 080
Fax.: +49 (0)30 611 284 099
ines.zenke@bbh-online.de
www.ect-g.de

Dr. Christian Dessau
Lawyer
Becker Büttner Held
Köpenicker Straße 9
10997 Berlin
Tel.: +49 (0)30 611 284 080
Fax: +49 (0)30 611 284 099
christian.dessau@bbh-online.de
www.ect-g.de