



## EUROPEAN COMMISSION

Internal Market and Services DG

FINANCIAL SERVICES POLICY AND FINANCIAL MARKETS  
**Securities markets**

### **DIRECTIVE 1997/9/EC ON INVESTOR-COMPENSATION SCHEMES**

#### **CALL FOR EVIDENCE**

The present document constitutes a call for evidence to be submitted to the European Commission services in relation to the review of Directive 1997/9/EC<sup>1</sup> on investor-compensation schemes ("ICSD"). The financial crisis is affecting not only banking activities but also the provision of investment services in financial instruments both by investment firms and credit institutions. Moreover, malpractice and fraud is likely to happen in turbulent situations. In addition, in recent years the Commission services have received information from investors about cases where delinquencies were committed and investors perceived that the schemes regulated by the Directive did not work efficiently.

Therefore, after 10 years of the entry into force of the ICSD and under the current financial markets circumstances, it is considered necessary to launch a call for evidence to gather information about the application of the Directive and whether and how it should be modified in order to better protect investors. This call for evidence is also in line with the parallel initiatives concerning the Deposit Guarantee Schemes Directive 94/19/EC<sup>2</sup> (proposal of amendment presented by the European Commission in the context of the financial turmoil<sup>3</sup>) and the insurance guarantee schemes (a consultation paper was circulated in May 2008<sup>4</sup>).

The present document focuses on some specific aspects which may require the revision of the ICSD. Respondents are invited to indicate any other issues which they consider relevant in the context of this work.

#### **1. INTRODUCTORY REMARKS**

The purpose of this call for evidence is to obtain information from Member States, market participants and other stakeholders, in particular investors, about the application of the ICSD across Member States and about the need to modify it in order to take into account the

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<sup>1</sup> OJ L84, 26.03.1997, p.22.

<sup>2</sup> OJ L 135, 31.5.1994, p. 5.

<sup>3</sup> [http://ec.europa.eu/internal\\_market/bank/guarantee/index\\_en.htm](http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm)

<sup>4</sup> Summary feedback statement at: [http://ec.europa.eu/internal\\_market/insurance/docs/guarantee/summary\\_en.pdf](http://ec.europa.eu/internal_market/insurance/docs/guarantee/summary_en.pdf)

changes of a regulatory or economic nature that have materialized in the EU financial markets. The information received will help the Commission services to focus on the real issues of concern for the review of the ICSD.

Evidence, to one or several of the issues below, can be submitted by all interested parties to the following email address: [markt-g3@ec.europa.eu](mailto:markt-g3@ec.europa.eu).

The call for evidence will be open for comment until **8 April 2009**.

Contributions, together with the identity of the contributor, will be published on Directorate-General for Internal Market and Services website, unless the contributor objects to publication of the personal data on the grounds that such publication would harm his or her legitimate interests. In case additional information is needed, the Commission services retain the right to contact the respondents.

## **2. BACKGROUND**

The Investor Compensation Scheme Directive 1997/9/EC ("ICSD") aims at facilitating the proper functioning of the single market in investment services by improving the confidence of investors through a harmonised set of minimum protective measures. More specifically, the ICSD protects investors, to a certain extent, against the risk of losses in the event of an investment firm's inability to repay money or return assets held on behalf of their clients.

The ICSD was adopted in 1997 and complemented the existing Investment Services Directive 1993/22/EEC<sup>5</sup> ("ISD"). In line with the "home country control" principle which was the basis for the single licence for investment firms under the ISD, the schemes adopted at national level intended to cover national providers of investment services, including those cases where firms are established and/or offer services in other Member States. However the "top-up clause"<sup>6</sup> gives branches of investment firms established in a host Member State the right to join the host country's scheme if it provides a higher level of compensation than their home country's scheme.

The main purpose of the Directive is to protect investors' money and financial instruments in the case where insolvency or default events result in the inability of an investment firm to return them to (essentially retail) investors. The schemes therefore protect investors' assets against the risk of fraudulent misappropriation. They may also provide protection where the loss of investor assets in the event of a firm default derived from errors, negligence or problems in the firms' systems and controls<sup>7</sup>.

The ICSD had been modelled on the Deposit Guarantee Schemes Directive ("DGSD") which set minimum rules for compensation of customers of credit institutions that fail. The Directive only contains the minimum harmonisation necessary to achieve the objectives being pursued. Many

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<sup>5</sup> OJ L 141, 11.6.1993, p.27.

<sup>6</sup> Recital 15 and Article 7 of the ICSD.

<sup>7</sup> Recital 8 and Article 2(2) of the ICSD.

topics, such as the legal form, the organisation and the funding of the schemes, are left to the discretion of the Member States<sup>8</sup>.

### **3. ISSUES AT STAKE**

A series of new elements that have emerged have brought DG MARKT services to consider whether a discussion on a review of this directive may be needed. These new factors are the following:

– First, with effect from 1 November 2007, the ISD has been repealed and replaced by Directive 2004/39/EC<sup>9</sup> ("MiFID"). In line with Article 11 of MiFID, authorisation for providing the services and activities covered by this directive shall only be granted to an investment firm provided that it complies, among other conditions, with its obligations under the ICSD. However, the scope of the MiFID is broader than the ISD both in terms of investment services and in terms of financial instruments covered<sup>10</sup>.

– Second, in the context of the current financial turmoil, the European Commission has presented a proposal for amending the DGSD. As a consequence, since the Investor Compensation Scheme Directive was modelled on the DGSG, there may be a need to maintain that initial alignment.

– Finally, the practical functioning of the ICSD has revealed some limits and some differences in national application. This may hamper the Directive from producing its desired effects and undermine investor confidence.

This document focuses on those issues that may have an important impact on the expectations by investors to be compensated for loss occurred in connection with the provision of investment services<sup>11</sup>. A specific paragraph is dedicated to the treatment of money market funds.

This call for evidence is focused on the following issues:

- (i) the scope of the ICSD and whether the scheme established by the ICSD is adequate after the entry into force of the Directive 2004/39/EC on markets in financial instruments (MiFID) with regard to the new financial services covered;
- (ii) the amount of compensation;
- (iii) the funding of the compensation schemes;
- (iv) the restrictions on the carryover of unpaid reimbursement debts;
- (v) the reduction of payout delay.

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<sup>8</sup> Recital 18 and 23 of the ICSD.

<sup>9</sup> OJ L 145, 30.4.2004, p. 1.

<sup>10</sup> Article 1 (1) and Sections A and B of the Annex of Directive 93/22/EEC. Article 4, n. 2 and Annex I, Section A and C of Directive 2004/39/EC and Articles 38-39 of Commission Regulation n. 1287/2006.

<sup>11</sup> In analysing these issues, the Commission services took also into account a report on Directive 97/9/EC prepared for the Commission in 2005 (Description and assessment of the national investor compensation schemes established in accordance with Directive 97/9/EC – Oxera, 2005). Although based on an EU15 Member States inventory and preceding the implementation of the MiFID, this report is still, in our view, a useful tool.

### 3.1. Scope - Investment services covered by the ICSD and loss events (Article 1, point. 2 and Article 2 (2) of the ICSD)

#### 3.1.1. MTFs

Initially, the ICSD covered the provision of the investment services included in the ISD<sup>12</sup> and the non-core service of safekeeping and administration of securities. Currently the MiFID applies to a broader scope of investment services and activities, notably, investment advice and operation of multilateral trading facilities (MTFs)<sup>13</sup>.

Questions have been raised on whether the ICSD is adapted to all types of new services covered by the MiFID and notably to the management of MTFs. An MTF is essentially a trading platform bringing together multiple third-party interests in accordance with certain rules: due to this specific nature, this service receives a peculiar treatment under MiFID and is assimilated to a regulated market. In fact, many relevant rules of MiFID do not apply to the transactions concluded under the rules governing an MTF<sup>14</sup>; in addition, already in the case of MTFs operated by market operators, the membership of an investor compensation scheme is not required<sup>15</sup>.

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

#### 3.1.2. Loss covered

A different issue refers to the kind of loss covered by the ICSD<sup>16</sup>. The ICSD focuses on compensation for physical losses of investors' assets held by the investment firms. Some events - such as the failure of the issuer of the securities or the failure of persons which provided investment services illegally (that is, without any authorisation) - seem therefore clearly outside the scope of the ICSD. The following circumstances may however deserve some attention:

(a) Firms not holding client's assets. Under the ICSD, investment firms authorised to provide investment services but not to hold clients' assets might be kept outside the scope of the ICSD. There may be though a need that each investment firm should participate to the compensation scheme, irrespective of the legal possibility they have to hold clients' assets: in fact, also in such cases investors are confident to operate with an authorised entity and they may not perceive any limitations to the scope of the authorisation. Consistently with the rationale of the ICSD, the existence of an authorisation to the provision of at least one investment service may justify the coverage under the directive, even in the cases clients' assets are only *de facto* held by the investment firm.

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?*

<sup>12</sup> Article 1, point 1 and Sections A of the Annex of Directive 93/22/EEC.

<sup>13</sup> Annex I of the MiFID lists investment services and activities and financial instruments.

<sup>14</sup> Article 14 (3) of the MiFID).

<sup>15</sup> Article 5 (2) of the MiFID, which exclude the application of Article 11 of the same Directive.

<sup>16</sup> Recital 8 and Article 2(2) of the ICSD.

(b) Investment services to non-retail clients. A similar issue may arise in respect of firms providing services only to non-retail clients (where the national scheme does not cover losses of such clients). In fact, the ICSD allows Member States to exclude certain categories of clients, such as professional and institutional investors, from cover by schemes<sup>17</sup>. As a consequence, firms only providing services to non-retail clients, in principle, do not give rise to a claim against the scheme.

*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?*

(c) Failure of third parties. Another case in which the scheme does not provide protection to investors is when an investment firm holds investor funds at a bank or transfers the funds to another party (e.g. another investment firm) in order to undertake transactions on behalf of the investor. In these cases investors may not only be exposed to failures of the firm, but also to failures at the level of these third parties. If the third party defaults but the firm has applied due care and diligence in selecting the third party to which it transferred client assets, in some jurisdictions the firm could not be held liable for any losses of client assets arising from the default of the third party. The scheme does not apply to protect Undertakings for Collective Investment in Transferable Securities' unit holders, nor does it apply to the depository, e.g. the institution safe keeping of such undertakings' assets. The question is whether an investor (such as an individual, a UCITS or a UCITS unit holder) should be able to claim compensation for losses provoked by the third party, even if he may not have a direct contractual relationship with that party.

*4a) Should investors be able to claim compensation in the case of default of the third party where their assets had been deposited?*

*4b) Should investors (such as UCITS or a UCITS unit holder) be able to claim compensation for loss of assets under the ICSD in those cases where the UCITS depository or the institution which has been mandated to safe keep the assets, fail to perform its duty?*

(d) Violation of conduct of business rules. Important client losses could result from the violation of conduct of business rules, in the case the firm is unable to compensate the investor itself. This kind of event is clearly outside the current scope of the ICSD (which covers the inability of the firm to refund the money or securities belonging to investors<sup>18</sup>) - though some Member States may have chosen to cover them on a national basis. The issue may relate to events such as losses suffered by the investor as a consequence of unsuitable advice, inappropriate investments (without the warning required by MiFID<sup>19</sup>) and, more in general, losses in circumstances where the violation of conduct of business rules has been a decisive factor in the investor choice. The question is whether the ICSD should cover such losses, in the case the investment firm is unable to compensate the investor because of default or insolvency events.

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

<sup>17</sup> Recital 17, Article 4 (2) and Annex I of the ICSD.

<sup>18</sup> Recital 8 and Article 2(2) of the ICSD.

<sup>19</sup> Article 19 (5) of the MiFID.

### 3.2. The amount of compensation (Article 4 of the ICSD)

A harmonized minimum level of compensation (90% of the debt and EUR 20 000) for each investor has been considered sufficient to protect the interests of the small investors where the firm is unable to meet its obligations. This level was originally in line with the one established under the DGSD. The likely increase of the coverage of the DGSD may justify a parallel adaptation of the ICSD.

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

### 3.3. Funding of the investor compensation schemes (Recital 23 of the ICSD)

The ICSD does not harmonize the way in which the schemes are to be financed<sup>20</sup>. Although compensation schemes are generally funded by way of contributions of participating firms, there are important differences as regards:

- 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,
- the existence of different funding arrangements (such as borrowing power, the reception of fines imposed to firms, any State contributions).

The different national funding systems may have an impact on the organization of the schemes, on the rapidity of compensation to clients, on the contributions required to participants in the event of losses, on the distribution of contributions among participants, even on the ability of the schemes to integrally meet their obligations under the ICSD. On the other hand, the leeway given to Member States in regulating these aspects is fully consistent with the minimum harmonization approach taken by the ICSD.

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?

### 3.4. The restrictions on the carryover of unpaid reimbursement debts

Some Member States have introduced measures aimed at preventing the carryover of unpaid reimbursement debts of the compensation schemes. Recital 23 of the Directive underlines that the financing systems should not jeopardize the stability of the financial system of the Member State

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<sup>20</sup> Recital 23 of the ICSD.

concerned. Nevertheless the described measures would prevent *a priori* compensation schemes from carrying their debts over a certain period of time (e.g. one year). This kind of measures may jeopardize the objective of the ICSD and deceive investors expecting to receive at least the 90% of their credits (with the current limitation of EUR 20 000).

*8a) 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?*

*8b) Should this kind of mechanisms be prohibited?*

### **3.5. The reduction of payout delay (Article 9 (2) of the ICSD)**

The ICSD establishes a strict deadline for reimbursement (three months). However, this deadline only runs once the "*eligibility and the amount of the claim*" have been established.

The deadlines for establishing the eligibility and the amount of the claim are determined by national law (notably insolvency law). The responsibility to establish the eligibility of the claim and its amount lies with different persons (mainly the liquidator or receiver of the insolvent firm or the scheme itself). In some Member States these deadlines can extend to several years, prolonged also through court proceedings in which the conclusions of the insolvency administrator are contested.

*9a) Should the process of recognizing the eligibility of the claim be regulated for the purposes of the ICSD?*

*9b) Should, at least, a mechanism be introduced providing for provisional partial compensation based on a summary assessment of clients' positions?*

*9c) 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?*

## **4. OTHER ISSUES TO BE DISCUSSED: MONEY MARKET FUNDS**

At EU level no compensation scheme exists with respect to money market funds shareholders. The question has arisen whether some form of guarantee or investor compensation scheme should be extended to cover investments in these schemes in order to avoid competitive distortion between different types of savings or investment products. This question needs to be considered from the purpose of the guarantee and the type of risk that it is designed to protect against.

### **4.1 Custodian risk or claims arising from operational failure/default of institutions holding investor assets**

The current ICSD is limited to protecting investors against the risk that the financial instruments that they own are lost through failure or error of the institution which holds the instruments on

their behalf. This Directive extends to investor claims relating to all losses in respect of financial instruments – including units in collective investments (which will include money market funds). Any review of ICSD will therefore be directly applicable to money market funds.

In addition to coverage by the ICSD, investors in UCITS money market funds will be protected by UCITS safeguards on asset segregation and depositary oversight.

#### **4.2 Investment risk**

A second consideration is related to whether investors in money market funds should be compensated for any investment losses in money market funds because fund investments lose value.

Money market funds have been perceived to be a safe investment within the global financial landscape, providing funds' shareholders with a constant value on their shares. It means in practice that investors are expecting their shares to be redeemed at a price that will at least be equivalent to the amount of money they have initially invested. Under Directive 2006/73/EC implementing MiFID, investment firms are allowed to place clients' funds into an account opened, inter alia, with "a qualifying money market fund" (Article 18 of Directive 2006/73/EC)<sup>21</sup>.

It has been a mainstay of our approach to financial regulation that investors in financial investments should not be protected from investment risk associated from their investments. This approach has applied to money market funds as to any other financial instrument. One main reason to depart from this principle would be if money market funds were deemed to be systemically relevant institutions – by virtue of their role as a means of helping governments and important institutions to raise short-term capital and providing a secure short-term and liquid investment for institutions with surplus cash.

In response to the recent crisis, the U.S. authorities announced in September 2008 a temporary guarantee program for the U.S. money market mutual fund industry, allowing money market funds to sell their illiquid assets to special purpose vehicles to release them from liquidity pressure they've been facing from shareholders redemption requests. At EU level, no similar measure has been taken so far.

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

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

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<sup>21</sup> Article 18 par. 2 of Directive 2006/73/EC mentions the conditions to be fulfilled to be a "qualifying money market fund".