Investor-compensation schemes

2010/0199(COD) - 12/07/2010 - Legislative proposal

PURPOSE: to extend the scope of compensation under the Investor-Compensation Schemes (ICSD) and amending Directive 97/9/EC.

PROPOSED ACT: Directive of the European Parliament and of the Council.

BACKGROUND: Directive 97/9/EC on Investor-Compensation Schemes (ICSD) provides for clients receiving investment services from investment firms 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. In recent years, the Commission has received numerous investor complaints about the application of the ICSD in a number of important cases involving large investor losses. The complaints relate to the coverage and funding of schemes and delays in obtaining compensation. The main problem with the application of the Directive is the large margin for discretion it grants to Member States. Moreover, there are issues such as the current non-compensation of investors who, due to the default of a depositary or third party, cannot recover their assets or suffer a loss in the value of their units or shares in a UCITS. These need to be addressed at EU level, since other solutions could fragment the protection of investors in the EU markets. An additional element relates to the fact that through the amendment of the Directive on Deposit Guarantee Schemes (Directive 94/19/EC), the level of protection for bank depositors was increased. Moreover, the functioning of the Deposit Guarantee Schemes (DSG) is being modified (see COD/2010/0207). Investment firms should not be undermined due to the increase of protection in the bank deposits sector. Therefore it is necessary to assess the level of protection of investors at EU level, to take into account any regulatory change that might have consequences in the field of investments.

This initiative is part of a broader package on compensation and guarantee schemes that will comprise two proposals for amendment of the Directives on Investor Compensation Schemes and on Deposit Guarantee Schemes and a White Paper on the insurance schemes.

IMPACT ASSESSMENT: the Commission conducted an impact assessment of policy alternatives. Policy options were mainly related to the funding of the schemes, the payout delays, the coverage of the compensation and the level of compensation. Each policy option was assessed against the following criteria: investor protection and confidence, level playing field in the protection provided for different types of investments or services in the EU and cost-effectiveness that is the extent to which the option achieves the sought objectives and facilitates the operation of securities markets in a cost effective and efficient way.

LEGAL BASE: Article 53(1) of the TFEU.

CONTENT: the proposal aims at improving the practical functioning of the ICSD, at clarifying the scope of the ICSD taking into account the financial crisis and recent changes in the EU regulatory landscape, at reducing gaps in the regulatory system and disparities between the protection of clients of investment firms and of banking depositors. In the light of the existing differences in the functioning of the schemes at national level, the proposal introduces common rules to ensure a degree of harmonisation in the funding of the schemes and in the day-to-day practice. It also introduces a provision of a borrowing mechanism among national schemes as a last resort tool to compensate any temporary needs from schemes, subject to a rigorous assessment carried out by the European Securities and Markets Authority and to the obligation to repay any loan within the maximum period of five years.

The main points are as follows:

Alignment with MiFID - services covered and classification of clients: the scope of the ICSD is currently cross-referenced to investment services as defined under the Investment Services Directive (Council Directive 93/22/EEC). The Markets in Financial Instruments Directive (Directive 2004/39/EC on MiFID) has repealed the ISD and broadened the scope of services covered under the sectoral legislation (e. g the operation of Multilateral Trading Facilities is included in the scope of MiFID). A number of technical issues have also arisen, such as the coverage of firms depending on the scope of their authorisation (i.e. whether the firm is authorised to hold client assets or not).

The proposed amendment clarifies that **all investment services and activities covered under MiFID should be subject to the ICSD** and that if firms 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. Another amendment deriving from MiFID provisions concerns the classification of clients. National legislation in Member States may provide that professional and institutional investors can be excluded from coverage under the ICSD. However, since the ICSD pre-dates the MiFID, the list of professional and institutional investors under the ICSD does not coincide with the corresponding list under MiFID. The proposal **aligns the classification of clients in the ICSD with the MiFID definition of clients considered as professional**. This will ensure consistency between the two Directives, and result in better protection for medium-sized enterprises which may currently be excluded from the protection granted by the ICSD and are instead normally classified as retail clients under the MiFID.

Failure of a third party custodian: the ICSD protects investors when a firm is unable to return financial instruments or money held on a client's behalf in connection with investment services. Under MiFID, financial instruments can be held in two different ways: (i) by the investment firm itself holding financial instruments for a client, or (ii) by a custodian usually selected by the firm. Investors may not only be exposed to the failure of the firm, but also to the potential failure of a custodian. In a case where a third party custodian is not able to return the financial instruments to its client, the client will not be able to benefit from any payment by the compensation scheme established under the ICSD. As a result, there is 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 proposal **extends compensation to investors for claims relating to the failure of a firm to return financial instruments due to the failure of a third party custodian**.

Failure of a UCITS depositary: the management of Undertakings for Collective Investment in Transferable Securities (UCITS) is not a MiFID investment service. As a result the ICSD does not cover UCITS and their units' holders in cases where losses are suffered due to the failure of a UCITS depositary or sub-custodian. This situation however is comparable, in substance, to the one described above where losses are suffered due to the failure of an investment firm custodian or sub-custodian. As a consequence, the proposed measure will give UCITS holders the right to be compensated by the investor-compensation scheme if the assets cannot be returned to the UCITS, because of the failure of a UCITS depositary or sub-custodian. The cost of this extension in coverage should be borne by these entities rather than investment firms.

Exclusion of claims involving market abuse: the ICSD excludes claims where a criminal conviction has been obtained for money laundering but not claims by investors who have engaged in market abuse. The proposal modifies the relevant provisions so that **the ICSD will explicitly exclude any claim for compensation where the investor has engaged in actions that are prohibited under Directive 2003/6 /EC on insider dealing and market manipulation**. The investors who have committed these acts should be excluded from compensation.

Level of compensation: the ICSD harmonises the minimum level of compensation (EUR 20 000) for each investor, and this was aligned with the one set under the Deposit Guarantee Scheme Directive (EUR 20 000 at the time). But the compensation limit of EUR 20 000 was never adjusted to reflect inflation or the increased exposure of European investors to financial instruments since the ICSD entered into force.

Furthermore, the Deposit Guarantee Schemes Directive (DGSD) was recently amended to provide for at least EUR 50 000 per depositor per credit institution, to be increased to a fixed level of EUR 100 000. The Commission proposes to **increase the level of compensation to a fixed amount of EUR 50 000**. As some Member States have currently a higher level of compensation, a grandfathering clause of three years will allow them to adapt to the EUR 50 000 coverage level.

In the case of credit institutions doubts may arise as to the coverage under the ICSD rather than the DGSD of monies deposited in a bank in the context of the provision of investment services. To deal with situations of possible uncertainty due to the specific nature of banks which may provide both banking activity and investment services, the ICSD is being amended to specify that **in cases of doubt the investor is to be compensated under the DGSD** (which provided a higher level of coverage).

Funding principles: the broad discretion under the ICSD about how to fund schemes (e.g. ex ante or ex post, in respect of the occurrence of any loss events) and huge differences in the way funding is organised by individual Member States create a number of problems. A new article is introduced specifying the basic principles about the funding of the investor-compensation schemes. In particular:

- in principle, the cost of financing schemes should continue to be borne by market participants;
- the schemes should be adequately financed in proportion to their potential liabilities;
- in order to provide a sufficient level of funding, a minimum target fund level will be established for all the schemes. This target fund level will be fully ex ante funded. Taking into account the current differences at national level, the target fund level should initially be reached within a 10-year period;
- when, in concrete cases, the ex ante funds are not sufficient to cover the liabilities of a scheme, additional calls for contributions from entities covered under the scheme should be ensured. However, they should not jeopardise the stability of the financial system of the Member State ;
- once these funding sources have been exhausted, the scheme may have recourse to borrowing from other compensation schemes;
- access to further multiple funding sources has to be ensured, including borrowing facilities;
- schemes should publish details about their level of funding.

Borrowing last resort mechanism between national schemes: together with the establishment of consistent funding rules between Member States, the introduction of cooperation arrangements among national schemes will provide greater protection to investors and promote investor confidence in investment services. The system is based on the principle of solidarity between the national schemes. A borrowing mechanism among schemes is introduced as a last resort tool. These measures should provide schemes with an alternative back up source of funding, under specific conditions and on a temporary basis. Detailed funding principles and a repayment (mid-term) obligation upon the borrowing scheme will limit the risk of moral hazard between undersized and better funded schemes. Under the proposal:

- schemes should have the right to borrow from the other schemes if their funds are insufficient to cover their immediate needs;
- a portion of ex-ante funding in each compensation scheme will have to be available for lending to other schemes;
- ESMA should receive any borrowing request, assess whether the relevant requirements are met and, if this is the case, transmit it to the other schemes;
- loans should be repaid to the lending schemes at the latest after 5 years since the request. Interests should accrue on the loans; the interest rate shall be equivalent to the marginal lending facility rate of the ECB;
- the borrowing mechanism should be limited to the claims covered under the Directive. For instance, schemes will not be able to borrow for any needs arising from the default of entities not included in the scope of the directive;
- a limit of 20% of the portion set aside for lending may be used for each case.

Compensation limit ("co-insurance principle"): 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. The reason for this option in the ICSD was to encourage investors to take some care in choosing investment firms, but 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. Eliminating this option will provide increased investor protection under the ICSD as clients will no longer have to bear part of the loss if there is fraud at a firm or other problems with the firm's systems. Moreover, the provision giving Member States the option of excluding from coverage of the compensation scheme funds in currencies other than of the Member States' is eliminated. This provides better protection to investors as it ensures that clients' funds are covered irrespective of the currency involved.

Payout delays: the ICSD establishes a strict deadline for reimbursement (at the latest within three months). However, processing claims takes considerably longer than the limits set, possibly up to several years as evidenced by recent cases. The proposed amendment introduces the obligation for schemes to **provisionally pay partial compensation based on an initial assessment of the claim if payout delay exceeds a specified time period**. The level of the partial payment will amount to one third of the initial assessment of the claim. The balance will be paid out later once the claim had been fully verified. Schemes will also need the ability to recover amounts provisionally paid out if it was subsequently determined that the claim was not in fact valid.

The amendments also provide that **a competent authority must make a determination** of whether a firm is unable to meet its obligations to investors within three months. This is to mitigate concerns about individual cases where competent authorities could be very slow to make a determination.

Investor information: the ICSD requires Member States to ensure that investment firms make available to 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. However, concerns have been raised about how this provision has been applied in practice in the Member States. The directive is amended to require that UCITS managers disclose to investors in clear terms what is effectively covered by schemes (e.g. investment risk is usually not covered). Under this proposal the existing obligation for investment firms to provide information about compensation schemes to new clients will be supplemented by requiring further detail to be provided about what is compensated under the ICSD and how it applies in cross border situations and require them to clearly explain that certain losses (e.g. due to investment risks) are not subject to the payment of compensation under the ICSD.

FINANCIAL IMPLICATIONS: the proposal has no implication for the Union's budget.