II

(Preparatory Acts)

ECONOMIC AND SOCIAL COMMITTEE

Opinion on the proposal for a Council Directive on Investor Compensation Schemes [1]

(94/C 127/01)

On 13 December 1993 the Council decided to consult the Economic and Social Committee, under Article 198 of the Treaty establishing the European Community, on the abovementioned proposal.

The Section for Industry, Commerce, Crafts and Services, which was responsible for preparing the Committee's work on the subject, adopted its Opinion on 5 January 1994. The Rapporteur was Mr R. Pelletier.

At its 312th Plenary Session (meeting of 26 January 1994) the Economic and Social Committee adopted the following Opinion unanimously.

On 10 May 1993 the Council adopted Directive 93/22/EEC on investment services in the securities field.

At the same time the Council took note of the Commission's statement that it would submit proposals on the harmonization of compensation systems covering transactions by investment firms by 31 July 1993 at the latest. The proposal for a Council Directive on investor compensation schemes constitutes the proposal which the Commission announced when the Investment Services Directive was adopted.

1. Introduction

1.1. Business failures are not unusual in market economies. They pose particular problems in the case of investment firms, however, as these are required, as providers of investment services, to return the financial instruments entrusted to them.

A healthy financial system requires that, among the clients of investment firms, households be protected against possible loss in a socially equitable and economically reasonable way.

1.2. It is also in the interests of the investment firms themselves that investors should enjoy appropriate protection and be informed as to the details of this protection.

Losses suffered by investors as a result of the insolvency of an investment firm have an impact on public opinion. The whole of a Member State's financial sector risks being brought into disrepute.

1.3. It is therefore understandable that the supervisory authorities and the investment firms themselves want to adopt measures to protect investors.

This is why the Commission is proposing a Directive. It recognizes the fact that an investment firm, even though subject to very strict regulation and stringent prudential supervision, may encounter financial problems, particularly with keener competition arising from the development of investment services in the Internal Market.

1.4. The Economic and Social Committee applauds the quality of the Commission's work and the scope of the preparatory work carried out. It attaches great importance to the Commission's thoughts, and would like, in this Opinion, to make a constructive contribution, taking into account the suggestions and concerns of the economic and social interest groups. However, in the absence of any comparative study of the various systems of international private law relating to company failure, the Committee has considerable reservations as to the detailed provisions for the application of this Directive.

[1] OJ No C 321, 27. 11. 1993, p. 15.

It would be consistent with single-country supervision by the country of origin for the principle of single and universal failure to be adopted. Thus a single judgement of company failure by the courts of the country in which the company was principally established would be binding in all the other Member States.

2. Content of the Directive

2.1. *Purpose of the Directive*

The Directive stipulates that all Member States have an investor compensation scheme or schemes in which all investment firms holding the single licence provided for by the Investment Services Directive must take part.

The scheme must cover all funds and instruments held by the investment firm in connection with its investment activities, which, in the event of the failure of the firm, cannot be returned to the investor.

2.2. *Scope of the Directive*

The firms covered

Investment firms holding the single licence provided for by the Investment Services Directive. This would include credit institutions authorized to provide investment services within the meaning of Section A of the Annex to the Investment Services Directive.

Instruments covered by the compensation scheme

The funds and instruments listed in Section B of the Annex to the Investment Services Directive, which, in connection with investment transactions, are held physically, administered or managed for the account of the client.

Investors covered

Persons who have entrusted money or instruments to an investment firm, in connection with investment business. Member States may, however, provide that certain categories of investor are to be excluded from the coverage of the scheme or granted a lower level of coverage.

Amount of compensation

Member States are to ensure that the scheme provides for coverage of not less than ECU 20 000 per investor.

3. General comments

3.1. *Minimum harmonization of the compensation scheme*

The Economic and Social Committee considers that, following the establishment of a system of minimum compensation for cash deposits [1], the adoption of an investor compensation scheme is also necessary, but it is a very different problem, for the following main reasons:

— investors in securities and financial instruments are by definition better informed than cash depositors;

— the investment services Directive contains a number of provisions completely protecting investors against the consequences of the failure of an investment firm.

First of all, investment firms have to ensure that investors' property rights over their securities are preserved in the event of the insolvency of the firm. In accounting terms, for example, clients' securities have to be kept strictly separate from the firm's balance sheet, and firms may not use investors' securities on their own account. As the securities remain the investors' property, their claims are not pooled with those of the firms' creditors on failure, and can thus easily be retrieved.

Secondly, investment firms (with the exception of credit institutions) are forbidden to use for their own account cash entrusted to them by investors, which remains separate from the investment firm's cash and can therefore be recovered if the firm has not executed the client's order.

The existence of these rules does not, however, prevent the investment firm in receivership from failing to comply with them or falling victim to fraud or negligence, entailing the loss or disappearance of the assets.

In all cases of fraud or embezzlement, there is a danger of investors' claims being pooled with those of other creditors in the event of failure. Investors thus risk losing their investment if assets are insufficient, and they will have to wait for the winding-up of the firm to be completed.

Specific compensation would be in order, therefore.

These considerations should, however, be borne in mind in deciding on the amount of compensation to be adopted in the Directive.

3.2. *System of compensation covering deposits of cash and securities*

In order not to distort competition between investment firms, according to whether or not they are also credit institutions, the Economic and Social Committee con-

[1] OJ No C 332, 16. 12. 1992, p. 13.

siders it desirable that there be a single system of compensation able to cover both cash and financial market instruments, and that the same minimum level of compensation be applied across the board, i.e. ECU 15 000 for certain Member States and ECU 20 000 for the others in respect of both risks (cash and securities).

3.3. *Coherence between the deposit guarantee and investor compensation Directives*

In the interests of the efficient management of guarantee funds, it is essential that these two texts be entirely mutually coherent.

4. **Specific comments**

The Committee would like to draw the Commission's attention to a number of points requiring clarification or amendment.

4.1. *Article 2(3)*

The Member States should be empowered to exclude sophisticated instruments such as financial futures, options, interest-rate futures and swaps. Such instruments are used by well-informed investors and their nominal amount is much higher than the amount of the compensation provided. Moreover, administering compensation for these instruments would be very time-consuming and might entail a longer wait for compensation.

Clearly, firms would be required to inform investors specifically where instruments are not covered by the compensation scheme.

4.2. *Article 2(2), first paragraph*

The Committee would like to see the stipulation dropped that the scheme shall cover investors when an investment firm is likely to be unable to meet its obligations.

A supervisory authority, fearing criticism of the quality and efficiency of its work, might be tempted to grant compensation prematurely.

It would be a good idea to adopt the concept of the 'unavailable deposit', as it appears in Article 1(c) of the Council Common Position on the proposal for a Directive on deposit-guarantee schemes, and consider extending it to securities.

Article 2(2), second paragraph

This requires 'the return to investors of any instruments belonging to them and physically held on their behalf in connection with investment business'. This means that only investors awaiting the allocation on repayment of their deposits are covered. This paragraph expressly excludes sight deposits taken by an investment firm, in violation of its statutes and of the monopoly of credit institutions, and used for its own account for credit or general banking transactions.

The wording of the second and third indents of Article 2(2) should be amended.

As far as 'instruments' are concerned,

— either these are physically held. The investor remains the owner of the instruments; he may claim them and must be able to obtain their return (see Explanatory Memorandum, page 4). The return of instruments to their owner will not be done at the expense of the compensation scheme.

— or the instruments have been dishonestly appropriated. Recovery is impossible. The investor has a claim to damages and interest. If, as is probable in such a case, the firm's assets are worth less than amounts owed to investors, the investor compensation scheme will intervene (see Explanatory Memorandum, page 4).

At all events, the compensation scheme will be required to reimburse claims, whether representing non-returned funds or damages and interest in compensation for the non-return of instruments.

This principle is important in assessing the application of the scheme to credit institutions.

Compensation will work rather like insurance. It will be independent of legal proceedings (civil liquidation proceedings or criminal proceedings against persons charged with embezzlement or other offences) (see Explanatory Memorandum, sixth paragraph on page 9).

With regard to the calculation of an investor's claim (Article 2(4)), the reference date should be the date of the decision referred to in Article 2(2), and not the time at which the obligation to make repayment or return the instruments arises. As these are generally repayable at sight, an obligation to make repayment or return the instruments exists from the moment of deposit.

4.3. *Article 2(3)*

No claim arising from funds belonging to investors and held for their account in connection with investment transactions shall confer entitlement to compensation under both the deposit guarantee scheme and the investor compensation scheme.

As it is difficult to distinguish ordinary bank deposits from funds intended for the purchase of securities or arising from their sale, it is essential that the Member States be able to decide themselves whether such claims fall under the investor protection or the deposit guarantee Directive.

However, the Article should make it clear that a credit institution can meet the requirements of this Directive either by joining a compensation scheme or by extending deposit guarantees to the protection of investors.

4.4. *Article 2(4)*

The obligation to make repayment or to return the instruments belonging to the investor arises legally at the moment the investment is made. Thus instruments which the investment firm is unable to repay should be valued only 'at the time of the decision referred to in Article 2(2)' of the Directive and not, as is also proposed, 'at the time the obligation to make repayment or return the instruments arises'.

This final phrase should be deleted.

4.5. *Article 3(1)*

To ensure that this proposal for a Directive and the proposal for a Directive on deposit guarantee schemes are consistent, Member States which at the time of entry into force of the Directive do not provide ECU 20 000 cover for investments should be able to limit cover to ECU 15 000 for a transitional period.

The Directive should make it possible to establish limits to the compensation scheme to ensure that the scheme's expenditure does not endanger the solvency of its member institutions or the stability of the financial Community as a whole. To this end, the spirit of the provision of the 23rd recital of the Council's Common Position on the proposal for a Council Directive on deposit-guarantee schemes that contributions to the funding of the scheme must not endanger the stability of the banking system of the Member State concerned should be given the force of law.

The Committee proposes that a new paragraph be added to Article 3 excluding cover for investors who make false declarations in order to exploit the investor compensation schemes. Persons committing acts of fraud in connection with the compensation scheme, or the laws and regulations applicable to investment firms or governing relations between investment firms and their clients, would also be excluded.

4.6. *Article 4, first paragraph*

This paragraph should also provide that the amount of protection offered by the home country's scheme to the depositors of branches of home country firms established in another Member State may not exceed the amount available in the host country.

This principle occurs in the proposal for a Directive on deposit guarantees.

4.7. *Article 4, second paragraph*

The Article must not be limited to objective conditions but must be non-discriminatory. It would be advisable to have an Annex II, similar to that attached to the Council Common Position on the proposal for a Directive on deposit-guarantee schemes, listing the guiding principles governing the conditions for joining a scheme in the host country in order to obtain additional cover.

4.8. *Article 5, second paragraph*

The consent of the competent authorities would not appear essential in this case.

4.9. *Article 5, third paragraph*

Where an investment firm is excluded from a scheme, coverage of money or instruments belonging to investors is to be maintained for twelve months from the date of exclusion. The Committee feels that the proposal should stipulate that only investors whose business with the investment firm was transacted before the date of exclusion will be entitled to compensation. From the date of exclusion investors must be informed that they will no longer be covered by the scheme.

Moreover, where an investment firm becomes unable to fulfil its obligations to an investor within the twelve-month period, the text does not make it clear whether the investor's instruments are to be valued on the basis of their market value the day the claim is established, as provided for in Article 2(4), or on the day of the exclusion of the investment firm from the scheme. The Committee would like to see the text clarified on this point.

4.10. *Article 6(1)*

The provision is to apply 'irrespective of .... the currency'. The draft deposit guarantee Directive, on the other hand makes it possible to exclude deposits in currencies other than those of the EC Member States or the ecu (Annex I, No 13). The Member States should be able to exclude securities denominated in currencies other than those of the Member States or the ecu.

4.11. *Article 7(1)*

The Commission points out in its comments on Article 7 that it is not feasible to lay down a rigid timetable for the payment of compensation to investors. Accordingly, the Article simply states that an investor's claim should be settled rapidly — within a period of three months from the firm's failure provided that the eligibility and amount of the claim have been properly established. The Committee nonetheless considers that this period could be insufficient. Account should be taken of the time required to determine the value of the instruments underlying the claim. The Committee feels that the period should be extended to six months. There should be an additional provision allowing the competent authorities to extend this period, if necessary.

4.12. *Article 7(2), second paragraph*

It is understandable that an investor should not be deprived of the benefit of cover if, due to absence or for any other good reason, he has been unable to assert his claim within six months from the time at which the investment firm became unable to honour its obligations. There should, however, be a time limit. The Committee feels that a suitable maximum period would be twelve months. A paragraph should be added to Article 7 by virtue of which the compensation scheme could suspend payment of a claim submitted by an investor in the event that the investor in question is the subject of criminal proceedings directly or indirectly related to money laundering, as defined in Article 1 of Directive 91/308/EEC, until the verdict is known.

4.13. *Article 8(1)*

The Commission requires that managers of the investment firm provide actual and potential investors with information on its investor compensation scheme. This should be the responsibility of the investment firm as an entity. The word 'managers' should, therefore, be deleted and the Article amended accordingly.

4.14. *Annex I — additional point 15*

The Member States may exclude instruments denominated in currencies other than those of the EC Member States or the ecu.

4.15. *Annex I — additional points 16 and 17*

The Member States may provide that certain categories of investor shall be excluded from the coverage of the scheme or granted a lower level of coverage. The purpose of the directive is to protect the small investor against the failure of an investment firm. The Committee considers that the Directive should not require the coverage of professional investors and firms. This exclusion could be incorporated in the form of two points added to Annex I:

Point 16 — Other professional investors

Point 17 — Legal persons.

The Member States would thus be able to exclude professional investors and legally incorporated businesses.

Done at Brussels, 26 January 1994.

The Chairman

of the Economic and Social Committee

Susanne TIEMANN