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European Commission
Internal Market and Services DG
Financial Services Policy and Financial Markets
Securities markets

per e-mail: markt-g3@ec.europa.eu

The Bundesverband der Wertpapierfirmen an den deutschen Börsen e.V. is registered in the list of interest representatives with the European Commission under Registration No. 1880407752-10

your reference

your message of

city_date
Frankfurt/Main, 08.04.2009

Directive 1997/9/EC on Investor-Compensation Schemes
Call for Evidence

Dear Sir, dear Madam,

The *Bundesverband der Wertpapierfirmen an den deutschen Börsen e.V. (bwf)* is a trade association representing securities trading firms and brokers at the stock markets throughout Germany. All its members, insofar as they are not natural persons or supporting members, are investment firms for the purposes of EU law. In the recent past – not least against the background of an unfortunate implementation of the Investor-Compensation Schemes Directive in Germany with its highly fragmented compensation landscape - some association members have applied for authorization to conduct deposit-taking business, and in addition to their capacity as investment firms are today also credit institutions for the purposes of EU law. It may also be emphasized that virtually all the bwf member firms deal solely with institutional clients, and thus with clients not eligible for compensation.

This being premised, the bwf expressly welcomes the opportunity to participate in the *"Call for Evidence"* to sound out a possible need to modify the current Investor-Compensation Schemes Directive dating from the year 1997. In view of the overwhelmingly negative experience to date – from the view of the (non-bank-affiliated) investment firms – with the implementation of the Investor-Compensation Schemes Directive in Germany under the *Einlagensicherungs- und Anlegerentschädigungsgesetz* (Deposit Insurance and Investor Compensation Act) that entered into force on August 1, 1998, we consider a revision of the EU rules to be urgently needed. In our view, the *"Call for Evidence"* also sets the right accents with the issues identified therein. We may comment as follows on the specific questions raised:

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

Yes! – Even though the equal treatment as far as possible of regulated markets and MTFs intended by the MiFID does not appear appropriate in all respects, it would be inadequate, on the other hand, to include the latter within the scope of investor compensation. This is indicated already on the grounds that the operator of an MTF normally does not have any direct contractual relationship with, and thus no obligations to investors who are potentially eligible for compensation. Insofar as counterparty risks can arise for the investor in the course of securities transactions conducted on an MTF, these risks do not lie within the sphere of protection that should reasonably be covered by investor compensation.

For the aforesaid reasons operators of MTFs should continue to be excluded from the scope of investor compensation regardless of whether or not they are operators of regulated markets.

Question 2): Would it be appropriate to include in the scope of the ICSD all investment firms seeking authorization to the provision of investment services, allthough their authorization would not allow holding clients' assets?

No! – The widespread practice to date – also in Germany – of including investment firms that, in their authorization-compliant provision of investment services, have no access to clients' assets, and consequently do not present a compensation risk, means that the investment firms concerned have to bear an – ultimately arbitrary – financing burden without benefiting themselves from the protection afforded by the Investor-Compensation Schemes Directive in respect of the services they provide. Neither can there objectively be any interest in this from the viewpoint of the clients of the aforesaid group of firms[1] as the firm simply has no repayment obligations or obligation to surrender assets.

Conversely, for the investment firms that do have obligations in connection with securities transactions to clients who are potentially eligible for compensation, and in so far are directly covered by the objective of the protection afforded by investor compensation, the inclusion of investment firms who as a rule have no access to their clients' assets constitutes an externalization of costs that is conducive to encouraging "*moral hazard*".

There is another aspect, too: Through the prescribed participation in a compensation scheme the investment firms are placed under a far-reaching obligation to

[1] This applies so long as the Member States, when implementing the Directive, have heeded the requirements to create a viable compensation system, the funding capacity of which is in reasonable proportion to its obligations (Recital 23). If this is not the case, however, there is a shortcoming in the Member State's implementation that should not be remedied by placing the financing burden on a group of firms that themselves do not present any compensation risk.

compensate loss events arising at other firms with which they compete.[2] According to the intent of the Directive's legislators this liability even covers losses caused by criminal behaviour (Recital 3). Such a far-reaching liability for malpractice on the part of third parties would be grossly unfair if the group of liable parties – as distinct from society at large – does not in its turn have a sufficiently concrete benefit from its participation in a compensation scheme. However, such a direct benefit is only enjoyed by those investment firms that have obligations to their clients and, consequently, can themselves potentially provoke a compensation claim. For the clients of these latter investment firms the investor protection scheme has the same quality as an indemnity bond, whereby the protection provided by also benefits the investment firms concerned in terms of their market standing. – Only if investors have entrusted funds and/or financial instruments to the safe-keeping of an investment firm is there a need for investor protection on the lines of the regulatory objective, and only in that case are investor-compensation schemes conducive to maintaining confidence in the financial system (Recital 4).

There are two arguments opposing the view advocated here - that investment firms having no access to clients' assets should not participate in funding investor-compensation schemes – which are occasionally voiced but are not convincing in our view:

The first argument states that the existence of an investor-compensation scheme would create a general element of confidence in the financial system and in the investment firms active in it as a whole, from which firms that cannot themselves provoke a compensation claim would also benefit, at least indirectly. Even if one were inclined to accept such an abstract, indirect benefit, this would hardly be sufficient to warrant such a far-reaching joint liability extending as far as bearing losses caused by criminal behaviour as provided for by the coverage stipulated by the Investor-Compensation Schemes Directive. It also ignores the question as to whether there are not other groups of economic entities who do not participate in the financial burdens of investor compensation even though their business success is also positively influenced, directly or indirectly, by the confidence in the financial system that the investor protection is intended to further. It should be reasonable to assume that this applies at least to all market participants and "suppliers" on the services and supply side of the investment market (namely: operators of stock exchanges, providers of market information and trading tech-

[2] However, this only applies insofar as the compensation schemes are funded by contributions from the investment firms assigned to them as the Directive's legislators intended (Recital 23). An important point in this connection, however, is that the Directive does not prescribe the form and manner in which the schemes are to be financed. Such a prescriptive rule would also conflict with Art. 249 sentence 3 of the EC Treaty which limits the prescriptive power of EU directives to the achievement of the objectives formulated therein and leaves the decision regarding the appropriate means for achieving them expressly to the sovereignty of the Member State's national jurisdiction.

nology, operators of computer centres, specialised consultants and law firms, etc.).

Moreover, the threat to the economy as a whole arising from the current financial crisis has made it plainly clear that the confidence in the financial system is a public good whose importance for society at large has ultimately to be considered as no less material than the benefit for the firms directly active in the financial sector.[3]

Another argument for including investment firms not authorized to own or hold clients' funds and financial instruments in the investor compensation regulated by EU law is that such firms, too, could in certain circumstances cause loss to investors should they overstep the framework set by the authorization granted and obtain access to clients' assets unlawfully. Indeed, it cannot be ruled out that such instances might actually occur. However, it is not clear how they should be treated within the framework of a compensation scheme as regulated in EU law. Whether the investor compensation is also intended to cover cases where the loss to investors is caused by the deliberate overstepping of the concrete scope of authorization has to be considered at least questionable.

One possible ground for inclusion in the liability of the compensation scheme might be that the granting of authorization to provide investment services, even though limited, could create basic confidence among the public, and the investor who is to be protected does not differentiate between regulated investment firms with different scopes of authorization.[4] However, an argument against this is that the Directive's legislators quite evidently did *not* assume that the granting of authorization would *per se* already create the expectation on the part of the investor that a customer relationship with that firm would necessarily also be covered by the statutory investor compensation. Otherwise, it would be difficult to appreciate why investment firms are placed under the express obligation to inform their clients about any possible (sic!) application of an investor-compensation scheme (Recital 20 in conjunction with Article 10 of the Investor-Compensation Schemes Directive). Moreover, it cannot be the sense and purpose of the investor compensation regime to release the (retail) investors meriting protection *completely* from their duty of care in regard to their own basic responsibility for their financial actions.

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[3] The recent report of the High-Level Group of Financial Supervision in the EU (de Larosière Report) for instance also talks of the *"public good of financial stability"* (loc. cit. p. 21, para. 79) The German Chancellor Angela Merkel expressed this in even clearer terms in her government statement on the state of the financial markets of October 7, 2008, declaring that with regard to the stability of the financial system, for which the confidence of society at large is doubtless an essential precondition, "*(the issue at stake is) no more and no less than the confidence in our economic and social order*" (Bundestags Drucksache BT16161, p. 21).

[4] This is also the direction in which the considerations set out in section 3.1.2 (a) sentence 2 of the "Call for Evidence" could be interpreted.

However, even if one were to advocate a right to compensation in the case of investment services provided in breach of the scope of authorization, this would still not be a sufficient argument for subjecting all investment firms, *“pruden-tially”* as it were, to an investor-compensation scheme, and thus to funding compensation claims that arise there, if such risk does not exist for them at all in the services they provide in conformity with their authorization. Another point to be considered is that investment firms with limited scope of authorization are also subject to extensive reporting duties vis-à-vis the respective regulatory authority, and the latter also has far-reaching investigatory powers in cases of suspected irregularities. Assuming a regulatory regime that is appropriate and effective for the purposes of the requirements of prevailing EU law, it follows that the regulatory authority generally has sufficient information at its disposal to gain an overview of the actual business profile of an investment firm under its supervision and can intervene in a timely manner in case of shortcomings and irregularities, which includes especially any overstepping of the framework set by the scope of authorization.[5]

To sum up, including investment firms that by virtue of their business profile – reflecting their scope of authorization – cannot provoke any compensation claims in their authorization-compliant activities as participants within the scope of the Investor-Compensation Schemes Directive is highly inappropriate and unfair.

For the sake of completeness, it may be added that, in principle, our criticism is not directed at investment firms without access to clients’ funds or financial instruments being formally “assigned” to an investor-compensation scheme. This would at least be unproblematic so long as the funding rules of the respective compensation schemes provide for the burden borne by the participating investment firms to be calculated proportionally according to their potential compensation risk determined with sufficient accuracy on the basis of their *actual* business structure. This would mean that the aforesaid group of investment firms that present no actual compensation risk would also make no contributions to funding investor-compensation claims, or at least very small contributions determined by the pro rata administrative costs of the scheme.

Question 3): Would it be appropriate to include in the scope of the ICSD all investment firms seeking authorization to the provision of investment services, allthough they provide their services only to non-retail clients?

No! – The case discussed here describes the situation for almost all the investment firms represented by the bwf that deal virtually exclusively with institutional clients who are not covered by investor-compensation schemes. The pre-

[5] If they fail to do so and this results in a claim, this is plainly a shortcoming in the supervision that gives rise to government liability. This therefore raises the justified question as to whether such claims – to the extent that they should fall within the scope of investor compensation anyway – ought in principle to be financed by government funds.

sent assignment of these investment firms to an investor-compensation scheme for (retail) investors under the German Deposit Insurance and Investor-Compensation Act thus appears to bear no relation to the risk and is totally unfair.

The arguments in reply to question 2 apply accordingly here, especially as in this case firms have no business relationships with the circle of economic subjects whom it is the objective of the Directive to protect.

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

No! – As depicted in the *"Call for Evidence"*, this is a liability law problem that investors can face according to how the respective national legal framework of the Member States is regulated. The problem, which incidentally affects both the retail investors who are covered by the compensation schemes and the professional investor, could be suitably countered – insofar as this were to be considered necessary – by a harmonization of liability law within the EU.

Insofar as the claims attributable to malpractice on the part of third parties discussed here involve risks that arise in connection with the safe-keeping and administration of securities it might also be pointed out that these are not primary investment services for the purposes of the MiFID. In so far, it would also be inappropriate from a systemic viewpoint to address this issue within the framework of investor compensation.

Question 4b): 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 depository or the institution which has been mandated to safe keep the assets, fail to perform its duty?

No! – As already argued above, the problem of protecting property rights and the liability problem that can arise from the activities of custodian banks or the existence of safe-keeping chains can be treated as a separate issue in the political discussion – alone on the grounds of its paramount importance for financial market stability.

Moreover, a separate regulatory framework was created for collective-investment models at the EU and national level that has stood the test. The exemption provided for in Article 4 clause 2 in conjunction with Annex 1 No. 1 5th indent of the Investor-Compensation Schemes Directive, under which collective-investment undertakings are *excluded* from the circle of investors covered, should therefore also be adhered to in future. One reason is that otherwise this would open up a corresponding *"circumvention option"* for all investors excluded from investor-compensation schemes by channelling investments through collective-investment undertakings.

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

No! – It is our conviction that the protection afforded by investor-compensation schemes should, as a harmonized minimum level of protection under EU law, remain clearly confined to those cases where, in principle, the eligibility for compensation can be ascertained by the competent regulatory authority and compensation by the investment firm appears impossible for objective reasons. Investor compensation should therefore not be re-interpreted as a *"substitute"* for the enforcement of private-law claims for damages, as can arise for instance as a consequence of unsuitable advice.[6]

The member states are thereby free to extend the coverage of their investor-compensation schemes if this is deemed necessary in deference to their legal traditions and specific business circumstances.[7]

However, we might raise the reservation that such an extension of the coverage to unsuitable advice and similar events appears extremely problematic from an incentive point of view and is likely to stimulate *"moral hazard"* behaviour both on the part of investment firms and on the part of investors.[8]

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

No! – While a unified level of protection in the areas of deposit insurance and investor compensation appears desirable insofar as this would largely avoid distorting inducements in capital allocation between the substitute products of bank deposits and security investments, it cannot be ignored that if the level of protection in investor compensation is increased on the same scale, initially to EUR 50,000 and then to EUR 100,000, the combined protection would reach a

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[6] Besides suing for damages in a court of law, investors also have access as a rule to the ombudsman scheme, which is free for investors and is coordinated on a cross-border basis, created in 2001 at the Commission's initiative with the out-of-court financial disputes resolution network (FIN-NET).

[7] However, experience in countries such as the United Kingdom where there is claim to compensation as a consequence of unsuitable advice shows that this compensation element can assume proportions that additionally impedes the creation of a risk-equivalent and cause-commensurate funding structure for the compensation scheme – For details on the proportion of compensation for unsuitable advice in the total compensation paid by the scheme see Oxera, Funding of the Financial Services Compensation Scheme, Report prepared for The Financial Services Authority, March 2006, p. 8.

[8] While investment advisers would use the existence of coverage under a statutory investor-compensation scheme as an additional sales argument, the possibility of compensation for actual or at least credibly alleged unsuitable advice could cause a significant shift in risk tolerance among investors.

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total of EUR 200,000, which would be well above the average level of household per capita financial assets in Europe.[9]

Raising the level of protection in such a way would doubtlessly benefit higher-net-worth households more than proportionally, which would hardly be consistent with the original idea behind a minimum level of protection. Moreover, an argument supporting a higher level of protection in deposit insurance is that experience shows that savings and bank deposits account for a much higher proportion of assets among the smaller investors meriting special protection. In so far, a *"full harmonization"* appears neither necessary nor desirable also in light of the quintupling of the level of protection resolved in the area of deposit insurance.

Question 7): The ICSD does not harmonize the funding system of the schemes. Should the ICSD provide for some general principles concerning the funding of the schemes?

Yes! – In view not least of the extremely negative experience the non-bank-affiliated investment firms in Germany have made with the implementation of the Investor-Compensation Schemes Directive here and the administrative practice based thereon, it would appear welcome and necessary to formulate more precisely the hitherto largely discretionary wording of the Directive concerning the regulation of the funding of the investor-compensation schemes.

Here, the issue is not to prescribe a specific standard funding system that is defined down to the last detail. Rather, in our view, it is a question of ensuring that, when the structure of the compensation schemes is regulated, best possible - in the prevailing circumstances and with due consideration for the interests of all investors and investment firms covered by the Investor-Compensation Schemes Directive - account is taken of the principles of

financial capacity,[10]

administrative efficiency,

risk commensurateness[11], and

neutrality in respect of competition and relative equality of the burden-sharing.

On the other hand, it should be avoided that constitutive criteria unrelated to or even inconsistent with the Directive's purpose are superimposed. Although, es-

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[9] According to figures published by Allianz Dresdner Economic Research, average per capita financial assets (bank deposits, securities, insurance) in the EU (old) was EUR 61,100 in 2006; see Allianz Dresdner Economic Research, author: Dr Renate Finke, Vermögensreport 2007, Working Paper No.: 89, 5.9.2007, p.5 – Internet: http://www.bpb.de/files/98X21R.pdf

[10] Already raised today in Recital 23, according to which the funding capacity of the schemes must stand in reasonable relation to their obligations.

[11] This applies especially with regard to the regulation of the contribution structure

sentially, this requirement already follows from the principle of *"effet utile"*, according to which, in the implementation of EU directives, they are to be interpreted in such manner that the directive's objective can be achieved as effectively as possible. That this is not always the case in practice may be illustrated by the following outline of the situation in Germany.

Experience with the implementation of the Investor-Compensation Schemes Directive in Germany from the viewpoint of the non-bank-affiliated investment firms

With the *Einlagensicherungs- und Anlegerentschädigungsgesetz*, or *EAEG* for short (Deposit Insurance and Investor Compensation Act) of July 16, 1998[12], the Investor-Compensation Schemes Directive (97/9/EC) of March 3, 1997 was transposed into German law together with the Deposit Guarantee Schemes Directive (94/19/EC) of May 30, 1994. At that time Germany was behind schedule with the implementation of the Deposit Guarantee Schemes Directive, which had to be transposed into national law by July 1, 1995. This was due to an appeal filed with the European Court of Justice against the Deposit Guarantee Schemes Directive to which Germany was basically opposed – as later with the Investor-Compensation Schemes Directive – in deference to the interests of the German banking industry. After the European Court of Justice dismissed the appeal on May 13, 1997, the appeal against the Investor-Compensation Schemes Directive that had originally been planned was also dropped.

Germany therefore had to transpose both directives into national law under not inconsiderable time pressure given the overdue implementation of the Deposit Guarantee Schemes Directive, the expiring deadline for implementing the Investor-Compensation Schemes Directive, and the additional pressure to act caused by the approaching end of the legislative term.[13]

It is therefore not surprising that, in implementing the rules of EU law that were felt to have been *"dictated"* upon it, it was Germany's openly declared intention to orient itself strictly to the minimum requirements set by the directives, with greatest possible consideration being given to the (voluntary) deposit insurance structures that were already in place.[14]

[12] Which already entered into force two weeks later on August 1, 1998.

[13] See Sethe, Rolf, Einlagensicherung und Anlegerentschädigung nach europäischem und deutschem Recht, in ZBB 5/98, pp. 305-329, here p. 308.

[14] See Deutscher Bundestag, 13th Electoral Term, bill presented by the CDU/CSU and FDP parliamentary parties, Entwurf eines Gesetzes zur Umsetzung der EG-Einlagensicherungsrichtlinie und der EG-Anlegerentschädigungsrichtlinie, Drucksache 13/10188 dated March 24, 1998, p. 2.

From the choices made at that time regarding the structure of German compensation and deposit guarantee schemes it is apparent that in drafting the EAEG precedence was quite clearly given to a fragmentation of the German compensation landscape – in congruence with the sectoral structure of the German banking industry, and desired for political reasons but ultimately not conductive to furthering the actual regulatory objective of improving investor protection and confidence in the financial system – over the regulatory principle of greatest possible risk-bearing capacity.

As a result, by drawing on the exemption rule – initiated by Germany – in Article 2 clause 1 of the Investor-Compensation Schemes Directive in conjunction with Article 3 clause 1 of the Deposit Guarantee Schemes Directive, in Germany about two-thirds of all institutions belonging in principle to the realm of investment firms, namely the public-sector savings banks and cooperative banks[15] were withdrawn, as members of so-called *"institution-continuity guarantee schemes"* (institutssichernde Einrichtungen"), from the scope of application of investor-compensation coverage (and deposit insurance, too). The remaining group, which had been greatly decimated as a result, was then divided up into three completely unequal sub-groups, again oriented, for purely political reasons, quite obviously to the banking industry's respective sector-specific interests. They in turn were assigned by statutory ordinances to individual compensation schemes set up for this purpose, for deposit insurance and/or investor compensation, respectively, namely:

- the *Entschädigungseinrichtung deutscher Banken GmbH* (German banks compensation scheme) (202 members, position as of 2007)
- the *Entschädigungseinrichtung des Bundesverbandes Öffentlicher Banken Deutschland GmbH* (German public-sector banks compensation scheme) (18 – sic! members[16], position as of 2007), and

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[15] As universal banks, these two groups of institutions also regularly provide investment services and are therefore also *"investment firms"* for the purposes of the Investor-Compensation Schemes Directive (see Recital 9).

[16] The Deutsche Bundesbank already came to the conclusion in 2000 that, in view of the small number of institutions assigned to the Entschädigungseinrichtung des Bundesverbandes Öffentlicher Banken Deutschland GmbH compensation scheme, a reasonable risk diversification was *"impaired"* (*"erschwert"*). – A statement, which considering the extremely reserved diction typical of central banks generally, can probably not be interpreted in any other way than as a clear criticism of the economic parameters chosen in the EAEG implementation; see Bundesbank, 2000, loc. cit., p. 38. An added factor is that with the small number of institutions the risks are by no means of the same *"granularity"*; a large part of the contributions (and the risks) is attributable to one institution. See J. Bigus, P.C. Leyens, Reform der Anlegerentschädigungseinrichtungen und Einlagensicherungssysteme in Deutschland, expert opinion commissioned by the Federal Ministry of Finance (unpublished), March 2008, p. 52. –

- the *Entschädigungseinrichtungs der Wertpapierhandelsunternehmen* (securities trading firms' compensation scheme) (750 mostly small and mid-sized members, position as of 2007).

While the first two compensation schemes are operated as subsidiaries of the respective banking industry associations, the third compensation scheme, the Entschädigungseinrichtung der Wertpapierhandelsunternehmen (EdW) is a special entity attached to the Kreditanstalt für Wiederaufbau (KfW) without legal capacity of its own. The EdW quite obviously has the character of a *"catch-all"* for all the investment firms that are not at the same time credit institutions for the purposes of EU law (*"Einlagenkreditinstitut"* or *"deposit-taking credit institution"* in the diction of the German Banking Act), which is plainly irrelevant for the purposes of investor protection. The membership structure is correspondingly heterogeneous. It mainly includes independent investment advisors and brokers but also investment companies insofar as they provide the (individual) service of portfolio management. Another decisive factor, however, besides the heterogeneity of the business activities, is that they are quite overwhelmingly mid-sized, small or very small firms ranging down to one-man firms with, as a result, comparatively small financial resources. Furthermore, a whole number of *"bad risks"* (criteria: private investors as clients and access to clients' assets) in the shape of firms previously active in the *"grey capital market"* were assigned to the EdW.

Empirically, this can be borne out not only by the particularly glaring *"Phoenix-Kapitaldienst"* compensation case in 2005 with an estimated total compensation sum in the region of EUR 200 million but also by the fact that since it was established in 1998 the EdW has faced a total of 17 compensation claims, a high figure relative to the number of member institutions. There are neither economically nor legally justified reasons why such risks should be borne solely by investment firms that have just as few business related or sector-specific points of contact with unsound firms such as Phoenix, who provoke compensation cases through dolose conduct, than the members of other compensation schemes or the savings and cooperative banks that were excluded at the outset.

Furthermore, the EdW members, although mostly presenting no de facto compensation risk, were burdened from the outset disproportionately strongly in relative terms by annual funding contributions of up to 10% of their annual net income. Admittedly, the total funding averaged not more than EUR 3-4 million altogether, with about half or more at a

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The very small number of institutions belonging to the compensation scheme is due to the fact that most of the public-sector institutions were excluded from the scope of the law as members of so-called *"institution continuity guarantee schemes"* as already outlined above.

time just covering the compensation scheme's administrative costs. It is therefore not surprising that the economically highly inefficient EdW compensation scheme, despite the even under normal conditions comparatively high burdens placed on many of its members, has never managed to build up reserve funds that could at least have covered a mid-sized loss event.

It is all the more remarkable that, even after the "Phoenix" case, attention continued to be averted from the fundamental structural problems of the highly fragmented statutory investor compensation. Instead, in an *"act of force"* launched at the end of 2008 the attempt was made to raise an additional EUR 30 million through special contributions from the EdW members. A sum that was totally inadequate to cope with the *"Phoenix"* claims but would have been roughly equivalent to the total sum of all contributions paid into the compensation scheme since it was set up.

Only after virtually all the EdW members had taken legal action – ultimately with success – against the enforcement of the administrative decisions and the Administrative Court in Berlin had stopped their enforcement on grounds of serious constitutional reservations, the EdW, which was evidently on the verge of insolvency, was granted a federal government loan of EUR 128 million, probably also out of concern about litigation over government liability that was already partly pending before the courts of law. – Meanwhile, a number of the biggest contributors had reacted to the high and not risk-equivalent burdens borne and turned their back on the EdW by extending their scope of authorization to (deposit-taking) credit institution. Compared with these institutions' previous six-digit annual contributions and the *"Damocles sword"* of the *"Phoenix"* case hanging over their heads, with a likely total burden calculated to be equivalent to about 60-times the annual contribution, these institutions are now assigned to the Entschädigungseinrichtung Deutscher Banken compensation scheme where, as a rule, they only have to pay an amount equivalent to or close to the minimum contribution of EUR 1,000 per year.

Conversely, it is obvious that the *"Phoenix"* case could have been digested comparatively easily if Germany had not pursued, ultimately from arbitrary or unrelated motives, a fragmentation that significantly weakened the financial capacity of the compensation structure, and had included the de facto existing community of all investment firms as a whole in the compensation coverage.[17] The draft, too, of a revised

[17] The Executive Board of the International Monetary Fund also drew attention recently to the problem of the stability-threatening fragmentation of the German protection schemes, albeit with regard to deposit insurance, and in this connection called on Germany to reform its schemes: "*Directors called*

EAEG currently in the legislative process brought about formally by the new EU rules in the area of deposit insurance does not offer even rudimentary evidence of a political will to create a viable investor-compensation regime structured on the basis of economic rather than ideological criteria.[18]

Fundamental considerations on a concretization of the funding structure of investor-compensation schemes in EU law

In light of this concrete experience it should above all be made clear within the framework of a revision of the Investor-Compensation Schemes Directive that a fragmentation of the member states' investor-compensation schemes may not be pursued for unrelated reasons, given the weakening of their financial capacity that this necessarily causes, but must be justified in light of the regulatory objective.

Furthermore, it should be ensured emphatically that competitive distortions as a consequence of relative imbalances in the burden-sharing for providers of one and the same service are avoided. As in other areas, too, the idea of a "level playing field" or *"same business same rules"* must be realized here. Any party providing, say, portfolio management or securities brokerage services to clients who are eligible for compensation should participate in funding the investor compensation in like manner according to the scale of its business. This cannot depend on whether the provider of investment services covered by an investor-compensation scheme is a universal bank or a firm engaged solely in the provision of investment services; both types of institution are *"investment firms"* for the purposes of EU law (ISD and MiFID). Let alone, wholly unrelated criteria, such as differentiations with regard to ownership structure (private versus public-sector), should not play a role.

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for strengthened deposit insurance, a critical element of the financial safety net, given the risks associated with the existing multiple protection schemes that have typically relied on ex post burden-sharing. A base layer of mandatory deposit insurance -ex ante funded by contributions from all banks – would provide unified terms of protection for depositors and reduce incentives to shift deposits among the existing schemes. The evolving European Union rules should provide guidance on coverage limits."; IMF Executive Board, 2008 Article IV Consultation with Germany Public Information Notice (OPIN) No. 09/05, January 22, 2009.

[18] The legal affairs and economic committees of the Deutsche Bundesrat (Upper House) have at least expressed in a recommendation that "*in the further legislative process a fundamental reform of the existing deposit insurance and investor-compensation schemes should be reviewed with a view to creating a funding basis for loss events that currently have to be compensated by the Entschädigungseinrichtung der Wertpapierhandelsunternehmen (EdW) that comprehensively guarantees any necessary compensation payments to investors without unreasonably burdening the institutions assigned to the compensation scheme*", Bundesrat Drucksache 170/1/09 of March 23, 2009.

However, such a joint liability community of all institutions covered in substantive terms by the scope of the Directive as investment firms (in other words universal banks and non-bank-affiliated investment firms) does not necessarily imply that all the firms need to belong to the one compensation scheme for administrative purposes[19], so long as a financial burden-sharing mechanism is established between different compensation schemes, under which the other compensation schemes would have to contribute *pro rata*, on the basis of a suitable criterion[20], towards funding a claim within the administrative sphere of another compensation scheme.[21]

***Ex-ante* vs. *Ex-post*-funding**

Assuming a risk-equivalent and thus, for contribution purposes, fairly shared funding *"across"* all investment firms covered in substantive terms by the scope of the Directive, the accumulation of sufficient reserve funds certainly has the advantage that the compensation scheme would have the *"capacity to act"* without delay with regard to possible compensation payments. However, since establishing the substantive basis and the amount of compensation claimable is a more complex process as a rule in the case of investor compensation proceedings, and thus more time-consuming, than in the area of deposit insurance for instance, the importance of the argument of quick availability would appear of limited weight, viewed in isolation.

Nonetheless, there are a number of other considerations that argue in favour of *ex-ante* funding of the investor-compensation schemes on the basis of expected losses in a given period:[22]

- One is the circumstance that only in the case of *ex-ante* funded schemes does the investment firm provoking a compensation case at least share in the burden of paying the compensation through its past contributions towards funding the reserve.
- A second is that in situations where there can be an elevated number of compensation cases as a result of general market crises the *ex-post* levying of funding contributions would have an undesirable procyclical effect, especially as, in a phase of potentially declining earnings, the in-

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[19] Although this would certainly be the most efficient solution from administrative-economic aspects.

[20] For instance on the basis of the liabilities to clients potentially eligible for compensation represented, as a percentage of the total.

[21] See also J. Bigus, P.C. Leyens, Reform der Anlegerentschädigungseinrichtungen und Einlagensicherungssysteme in Deutschland, expert opinion commissioned by the Federal Ministry of Finance (unpublished), March 2008, pp. 94ff (*"overflow"* or *"reciprocal obligation to support"*).

[22] Conversely, it is obvious that no ex ante funded scheme can cover all conceivable worst-case scenarios.

vestment firms concerned would be more strongly exposed to additional financial burdens jeopardizing their profitability. In the extreme case this could increase the risk of further compensation cases occurring.

- Another point to be considered is that in an environment characterized in large measure by universal banks and with identity to a large extent between the institutions covered by the regulatory areas of investor compensation and deposit insurance, and assuming that the contributors' financial capacity is given, this leads ultimately to funding competition between investor compensation and deposit insurance. As there are limits to the loss-bearing capacity of any joint liability scheme – and even more so in times of crisis – and, additionally, since the coverage in the case of deposit insurance constitutes a very much higher overall volume than in the case of investor compensation, there is a certain risk of deposit insurance *"crowding out"* investor compensation. In other words, the occurrence of one or several significant deposit insurance events could lead to the group of universal banks objectively reaching the limits of its loss-bearing capacity, with the result that subsequent investor compensation events can no longer be settled or could only be settled by placing a much higher burden on the non-bank-affiliated investment firms. – Similar crowding-out or depletion effects accentuating the basic problem can also arise if, beyond the harmonized minimum level of protection at the EU level, additional statutory or voluntary coverage commitments in the area of deposit insurance and/or investor compensation are made at the national level.[23]

To conclude, we therefore consider *ex-ante* (basic) funding of investor-compensation schemes to be preferable. However, it needs to be ensured that sufficient time is available for corresponding switches and that such switches do not have a procyclical effect by placing additional burdens on the investment firms concerned, especially in view of the current crisis situation.

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[23] A prominent example which may be cited is the compensation of clients of the German subsidiary of Lehmann Brothers by the (voluntary) deposit insurance fund ranking below the statutory Entschädigungseinrichtung deutscher Banken compensation scheme. The fund (or its members) would quite obviously not have been able to cope with the total sum paid, which according to press reports was over EUR 6 billion and up to EUR 260 million per bank customer (sic!), without the funding structure that was chosen in the form of a bond guaranteed by the federal government, which enabled it to be refinanced with the Deutsche Bank. Furthermore, all the Lehmann clients enjoying the benefits of the protection were institutional investors or public entities that in the overwhelming majority of cases would not have had any claim to compensation under the statutory deposit guarantee and investor-compensation schemes.

Management of the schemes

High demands, already concretized at the EU level, should be placed on the professional suitability and personal reliability of the persons entrusted with the management of the compensation schemes given the systemic importance of investor compensation. This applies all the more should precedence be given to *ex-ante* funding in future. The solvency rules already applicable to investment firms and credit institutions today would provide a suitable basis for this.

Furthermore, professional supervision should be assured not only by the respective regulatory authority but appropriate advisory board structures – likewise regulated in EU law - should be created to oversee the compensation schemes on which the investment firms participating in the scheme should also be adequately represented.

Pooling of funds across participating firms

Since, logically enough, the issue of a mechanism to be established for sharing the funding between individual sub-schemes only arises if the investor compensation regime is divided up, and since - as with any joint liability scheme - the simple principle applies that *"broad shoulders"* can carry more than "*narrow*" ones, it might be stressed once again that system fragmentations should only be permitted if they can be justified on the strength of the Directive's regulatory objective.

Assuming a certain minimum size of the sub-schemes, there would, in principle, be no objection from our point of view if the investor-compensation scheme is divided up according to the services provided, as it is practised in some Member States. In such a regime, compensation claims arising for instance in the area of portfolio management (with access to clients' assets) would first be settled only within this *"funding cluster"*.[24] In the event that the available funding or the reserve funds in the respective sub-scheme should not be sufficient, the other sub-schemes would be involved in funding the *"external"* compensation case on the basis of a suitable formula taking account of their respective financing power.

However, the higher degree of incentive compatibility – in the sense of market-disciplining behaviour - of such functionally sub-divided compensation regimes should not be overrated. Set against this there is not only the much higher administrative cost but also the experience that

[24] As already discussed above, it would not be absolutely necessary for all investment firms covered to belong to the one compensation scheme for administrative purposes but it is essential that all providers of the same investment service participate in like manner in the funding regardless of whether they are investment firms in the form of universal banks or non-bank-affiliated investment firms.

investor compensation events are caused not infrequently by the fraudulent or criminal behaviour of individual firms. Insofar as the compensation paid does not de facto cover a market inherent insolvency risk originating from primary economic factors but merely constitute a form of victim compensation, a sub-division by industry segments appears less plausible. At any rate, it should be difficult to justify per se on the principles of the rule of law that a group of law-abiding investment firms should be brought closer to and, with this, be expected to accept funding responsibility for the criminal behaviour of others simply because they happen to hold authorization to provide the same service(s). Against this backdrop, an investor-compensation scheme that is essentially unified, and thus offers maximum financial capacity, and to whose financing all investment firms covered for substantive purposes would contribute according to the actual compensation risk they present, continues to hold great appeal.

Conversely, in the event that the option of system fragmentation should be chosen, appropriate funding-related *"overflow rules"* between the respective sub-schemes should be prescribed as mandatory (catchword: *"communicating tubes"*).

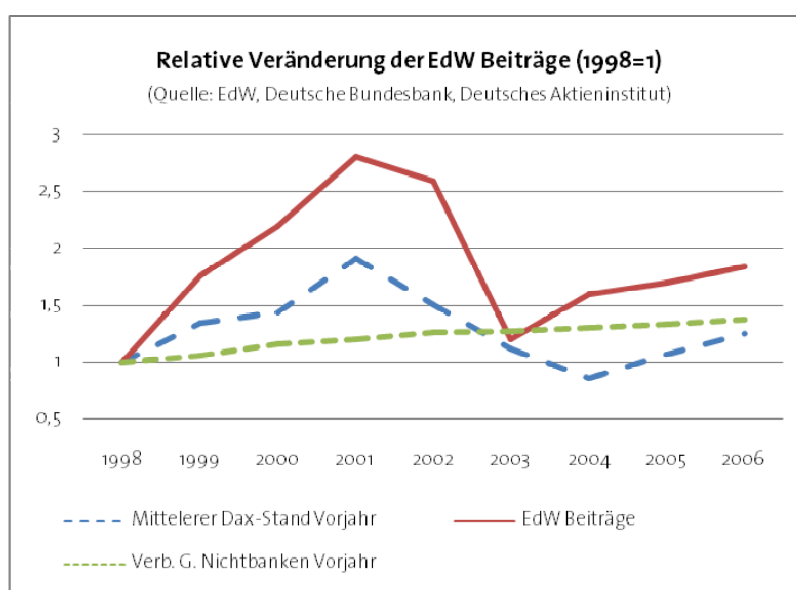
Calculation of Contributions

As already argued, the calculation of the funding burden should at any rate be oriented to the principles of risk equivalence and relative equality of the burden-sharing. Only in this way can an appropriate level of funding be assured while at the same time avoiding competitive distortions. The base for calculating the contributions should therefore primarily be the liabilities to clients that are eligible in principle for compensation. Whether a uniform contribution rate or a contribution rate differentiated according to the type of service provided – possibly supplemented by premiums or discounts depending for instance on audits of risk management, compliance with *"conduct of business rules"* and *"sound governance"* in general - is then applied to that base should then be decided according to the results of a corresponding factual discussion at the political level.

The present lack of prescriptive rules regarding the regulation of the funding of the compensation schemes results in structural *"flaws"* in the fabric of compensation schemes at the national level, brought about by political opportunism, being compensated by a competition-distorting, disproportionately stronger burdening of individual subgroups. Here, too, the fragmented German compensation landscape provides significant examples:

As mentioned, in Germany three compensation schemes exist alongside each other that differ quite considerably in size and in the financial

strength of their member firms. Regarding their funding structure it is conspicuous that the two compensation schemes administrated by the private-sector and public-sector banking associations (whose purpose is to cover both deposit insurance and investor compensation) have a more or less fully harmonized system of contribution calculation. Although they are of quite different size, both schemes levy an annual contribution at the rate of 0.008% of their members' balance sheet item *"liabilities to customers"*. The base for calculating the funding burden is thus comparatively closely correlated to the potential compensation risks actually presented. In so far, there was no reason why this system of contribution calculation, which is altogether appropriate to the circumstances and neutral for competition purposes, should not have been applied to the investment firms assigned to the EdW as well.[25] However, owing to the balance sheet structure and size of the investment firms assigned to the EdW this would have meant that the scheme would have scarcely had any significant funding from contributions. It would be difficult to explain otherwise why the EdW's calculation of contributions, based on the less risk-sensitive calculation bases of "*gross commission income*" and *"gross income from financial transactions"*, should differ radically from that of the two other compensation schemes. In end effect, this leads not only to an exorbitantly higher burden placed on the participating firms but – as the chart below shows – also to a very strong procyclical pattern of the contribution funding which cannot have been the intention in light of the regulatory objective.



[25] This would have been risk-equivalent and more than appropriate considering that in the case of the EdW members no allowance has to be made for deposit insurance risks and also that the majority of the investment firms assigned to the scheme do not objectively present any investor-compensation risk given their scope of authorization and/or clientele.

[Caption for the chart displayed above:

Relative Veränderungen der EdW Beiträge (1998=1):

Relative change in EdW contributions (1998=1)

(Quelle: EdW, Deutsche Bundesbank, Deutsches Aktieninstitut):

(Source: EdW, Deutsche Bundesbank, Deutsches Aktieninstitut)

Mittlerer Dax-Stand Vorjahr: Average DAX level, previous year

EdW Beiträge: EdW contributions

Verbindlichkeiten G. Nichtbanken Vorjahr: Liabilities to nonbanks, previous year]

Contribution limits

It is readily apparent that there are limits to the loss-bearing capacity of any sector-based, contribution-funded joint liability scheme. If these are exceeded, there is the danger that the scheme, designed in principle for the purpose of stabilization, can itself become a *"systemic risk"* because the unreasonably high burden is capable – directly or with creeping effect – of jeopardizing the stability of the firms themselves that are affected by the contribution burden, thus triggering *"domino effects"*.

The lack of a sufficiently precise regulation of a maximum ceiling for the burden on the participating investment firms in the currently prevailing EU rules on investor compensation therefore constitutes a primary problem, taken over from the area of deposit insurance, of the present legal framework that urgently needs to be corrected.[26]

Different funding arrangements (borrowing power & state contributions)

Emerging directly from the foregoing comments on the previous point is the requirement that compensation schemes should provide for alternative types of funding when the limit of the funding burden that the contributors can reasonably be expected to bear is reached.[27] Here, the cited instruments of borrowing and state (co-) financing are intertwined. One reason is that the authorization for borrowing by a compensation scheme if its contribution-funded resources are not sufficient

[26] The lack of more concrete rules on a maximum burden was, for instance, one of the reasons why the Administrative Court in Berlin, in its decisions of September 17, 2008 (VG 1A74.08 inter alia), granted an injunction on EdW's levying of special contributions to finance the *"Phoenix"* compensation case on grounds of serious constitutional reservations.

[27] Here, attention may be drawn again to the fact that, by virtue of the restrictions of Art. 249, sentence 3 of the EC Treaty, a contribution-based funding of the compensation schemes cannot be prescribed as mandatory anyway and, in so far, it could be quite conceivable - and even required under the national law of a Member State - that the investor compensation be financed entirely by public funding.

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in practice to settle a compensation case runs the risk of foundering[28] unless there is at least a corresponding government statement of guaranty. This follows already from the fact that an economic entity's credit standing is invariably considered negative when in the mid to long term the level of its income is clearly not in proportion to its payment obligations – and precisely this is likely to be the case as a rule for a compensation scheme that relies on debt financing.

Moreover, the instrument of borrowing is always unsuitable if the imbalance between a compensation scheme's income and payment obligations is of a structural nature; either because it did not have a viable structure from the outset, or because the underlying conditions have changed materially over time.

In such a case, but also if there are unexpectedly large compensation cases, as can doubtlessly occur for instance in the wake of systemic market crises, it would appear necessary and meaningful to provide for the possibility of government loans and / or subsidies also in the case of schemes that are in principle contribution-funded. This circumstance, too, should be given appropriate consideration within the framework of a revision of the present directive.

Question 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?

No! – The German Deposit Insurance and Investor-Compensation Act does not provide for such time restrictions, barring the general statute of limitations rules of law.

Question 8b): Should this kind of mechanisms be prohibited?

As the experience with rules of this kind is lacking we are unable to comment on this point.

Question 9a): Should the process of recognizing the eligibility of the claim be regulated for the purpose of the ICSD?

No! – The reason for the considerable delays to be observed lies both in the complexity of the cases to be assessed and in the peculiarities of the, in this regard, often heterogeneous national legal frameworks of the Member States.

[28] That was also the experience in Germany, for instance, in coping with the *"Phoenix"* case.

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

Yes! – On the condition that a right of claim to compensation has in fact been established and that just its amount is as yet either known only approximately or is already determinable with sufficient plausibility, consideration should be given in future to the possibility of provisional partial compensation.

It is indeed not acceptable, and would run counter to the Directive's regulatory objective, if investors who have suffered losses – assuming that the claim to compensation is undisputed in substance – had to wait unreasonably long, possibly years, before they received compensation. However, the same strict criteria now provided for in the area of deposit insurance should not be applied to the time limits for payment. There is a substantive difference whether it is a question of access to funds for the purposes of settling day-to-day payment obligations or a question of winding up an investment where the investor expected the capital to be tied up for a certain period of time at the outset.

Another consideration that would appear important in this connection is that, if provision is made for provisional partial compensation, a clear or legally assured repayment obligation should also be provided for in the event that the compensation payment effected has subsequently proved to be too high.

Question 9c): Irrespective of the harmonization of their funding systems, should compensation schemes ensure that they have minimum reserve funds in order to comply rapidly with any immediate needs?

See reply to Question 7, sub-heading *"Ex-ante vs. ex-post financing"*.

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

No! – Firstly, the situation in Europe does not appear to us to be comparable with that in the USA in this regard. Quite apart from that, if their inclusion in the protection schemes should be considered nonetheless in deference to their character as substitute products for bank deposits, money market funds should be dealt with within the framework of deposit insurance.

In this connection we consider it desirable and necessary for attention to be drawn once again emphatically within the framework of a revision of the directive to the difference between and demarcation of the regulatory spheres of investor compensation and deposit insurance. The circumstance that, in a market environment characterized to a large extent by universal banks, many investment firms are at the same time credit institutions must not lead to a "blurring" of the two regulatory spheres. In other words: The circumstance that universal banks fall within both regulatory spheres must not lead to non-bank-affiliated investment firms running the risk of having to cover losses in the area of deposit insurance.

Question 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 for this analysis??

Yes! – The approach that the firms falling within the regulatory sphere of investor compensation should themselves compensate losses caused by the criminal actions of others, which is not unproblematic in itself to begin with, acquires still more brisance if viewed against the background of possible failures in regulatory supervision.

The *"Phoenix"* case, already referred to several times, with a, for statutory investor compensation in Germany, so far unparalleled estimated expected total compensation sum of at least EUR 180 million may be cited once again as an example of an instance where it is at least indicated that existing omissions in the supervisory regime, if not making a significant compensation claim possible in the first place, was at least a contributing factor.

Like the Madoff scandal that is currently making headlines worldwide, the *"Phoenix Managed Account"* (PMA) intensively marketed since the late 1990s by the investment firm *Phoenix Kapitaldienst GmbH* was a *"snowball system"* or a so-called *"Ponzi scheme"* where, with promises of high returns, investors were pressed into participating in a collective investment[29] which, however, never generated any real profits. Alleged returns were in fact simulated through *"dummy"* entries and forged bank statements, and payments were made to investors from newly acquired client funds. The scandal only came to light by chance after the firm's founder and managing director *Dieter Breitkreuz* was killed in a plane crash in April 2004.

A point worth special highlighting is the circumstance that Phoenix operated the *"PMA"* as a collective account (so-called *"omnibus account"*) which, on the one hand, was a clear violation of German and EU law requiring the maintenance of separate accounts and, on the other, is likely at least to have considerably facilitated the year-long manipulations and deceptions. The critical point is that Phoenix's violation of the law was already long known to the German supervisory authority and the *Bundesaufsichtsamt für den Wertpapierhandel* (BaWE), as it was known then, had already instructed Phoenix by administrative order served in March 2000 to stop operating the omnibus account but never enforced its own administrative order even after a final decision was passed by the Federal Administrative Court (BVG), as court of last instance, in April 2002. And even after a special audit conducted at Phoenix revealed serious organizational shortcomings the supervisory authority still did not intervene.

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[29] A question, which has never been satisfactorily clarified and which we do not intend to discuss in detail at this point, is whether, by virtue of the collective character of the investment, it was in fact an investment service eligible in principle for compensation.

Expressed in figures, this means that of the total capital of approximately EUR 468 million paid into the *"Managed Account"* over 90% (sic!) was acquired after the BaWe had already banned the operation of the omnibus account with its restraining order, and still 75% of the investors' funds acquired were at a time after the BVG, as court of last instance, had confirmed the legality of the administrative order to maintain separate accounts. – In so far, it is not surprising that the judge presiding over the criminal proceedings against two Phoenix employees who were materially involved in the fraud affirmed an objective failure on the part of the regulatory authority in its duties of supervision in his judgment statement of July 2006.[30]

It is therefore beyond doubt that the *"Phoenix"* compensation case ought to have been brought to light very much earlier and should never have reached the exceptional dimensions of a three-digit million loss – which now has to be borne alone by the coerced members of the EdW – if the competent supervisory authority had not put off enforcing its restraining order from the year 2000 more or less *ad finitum*.

In light of this experience and the considerable negative consequences resulting therefrom for the investment firms confronted with the burden of financing the case we strongly urge that the question of dealing with possible failures on the part of the supervisory authorities should also be regulated within the framework of a revision of the Investor-Compensation Schemes Directive. For instance, conceivable would be that the investor-compensation schemes or the participating investment firms be granted a right to a judicial review in such form that in case of a proven breach of the state supervisory authorities' duties to exercise due diligence and avoid loss the burden of funding the respective compensation case would also have to be borne wholly, or at least partly, by the state.

Yours faithfully,

Michael H. Sterzenbach Geschäftsführer	Dr. Hans Mewes Justiziar

[30] See judgement of the Frankfurt am Main District Court of 11.07.2006, Az 5/26 KLs 7570 Js 210600/05 WI <26/05>, p. 40