efama

European Fund and Asset Management Association

EFAMA Preliminary Position Paper on the Commission's proposal amending the Directive on Investor-Compensation Schemes

Executive summary

EFAMA[1] members support the objective that the Commission aims to achieve through the revision of the Investor-Compensation Scheme Directive (ICSD) to increase the protection provided to investors and strengthen their confidence in the use of financial services, to improve the practical functioning of the schemes and to adapt the Directive to the evolution of the regulatory environment in Europe.

However, our members have **major concerns** regarding the proposed extension of the benefit of the investor-compensation schemes to UCITS unit holders in case of default of a depositary or sub-custodian. Given the fact that many respondents to the Call for evidence organized by the Commission (including EFAMA) had expressed their opposition to that extension, we regret the absence of extensive consultation of the stakeholders on the technical details and practical implications of this proposal.

As promoters and managers of UCITS, our members will be directly affected by this proposal. They are particularly worried for the following reasons, which we will further develop in this position paper:

1. This proposal is **redundant** and **premature** since it anticipates on the outcome of the ongoing review of the UCITS depositary regime. As EFAMA already stressed, **it is only once the outlines of the depositary functions and liabilities will be clearly defined that it will be possible to assess objectively if, and to what extent, an extension of the scope of the ICSD to UCITS unit holders is needed**.

2. Furthermore, as it is currently drafted, the **scope of this proposal is insufficiently** defined, which creates important legal uncertainties.

[1] EFAMA is the representative association for the European investment management industry. It represents through its 26 member associations and 42 corporate members approximately EUR 12 trillion in assets under management, of which approximately EUR 7 trillion was managed by approximately 52,000 funds at the end of December 2009. Just under 36,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds. For more information about EFAMA, please visit www.efama.org.

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3. It also takes insufficient account of the legal structure and distribution patterns of UCITS and therefore raises **major legal and practical issues** which are likely to undermine rather than promote investors' confidence.

4. It will also entail **important additional costs (potentially amounting to 27 billion Euros)** which are very likely to be **ultimately borne by UCITS unit holders** and which appear to be **disproportionate in comparison to the benefits they would enjoy in terms of increased protection.**

5. To that extent, it also represents a serious **threat for the competitiveness of UCITS** compared to other substitute retail products that are left outside the scope of the ICSD.

1. A redundant and premature proposal

1.1. No need for an extension of the scope of the ICSD to UCITS unit holders

First of all, sufficient investor protection in the event of closure of an insolvent investment firm is already in place. In the event of closure of an investment firm pursuant to bankruptcy proceedings, the deposited assets are being segregated from the insolvency estate and investors are entitled to restitution of assets against the liquidator of the insolvent firm.

Furthermore, the ICSD already today covers losses in the context of the MiFID non-core services of safekeeping and administration of assets. Therefore, UCITS unit-holders are principally able to claim compensation in the case of default of an investment firm which has been entrusted with safe-keeping of their UCITS units. In line with the general concept of the ICSD, however, UCITS unit-holders should also in this case be able to claim compensation for loss of assets caused by fraudulent misappropriation only.

In this context, priority should be given to the fact that UCITS are heavily regulated financial products that already provide a high level of protection to their unit holders. Under the UCITS regime, unit holders are already protected to a large extent against the consequences of a depositary default by the fact that the assets of the UCITS are segregated from the assets of the depositary. The UCITS Directive (2009/65/EC) clearly establishes the basic responsibilities and liabilities of the depositary. It assigns responsibilities for safe-keeping of the fund assets to the depositary and imposes liability on the depositary in the event of wrongdoing or negligent performance of its duties. Determination of liability and its extent must be established in accordance with the relevant national civil law.
Additional claims against the investor compensation scheme should be excluded from the scope of ICSD. This is because the scope of ICSD corresponds to the scope of MiFID (EU Directive 2004/39/EC). All collective investment undertakings, whether or not coordinated at Community level, and the

depositaries and managers of such undertakings are explicitly excluded from the scope of regulation under the MiFID, since they are subject to specific rules directly adapted to their activities. Therefore, securities transactions by investment undertakings are excluded from the scope of ICSD. Extending ICSD to granting compensation to UCITS holders for losses of assets subsequent to the default of a UCITS depositary or its sub-custodian would create an inconsistency around precisely this point.
In addition, it is a basic principle of ICSD to restrict the right of compensation by a scheme to losses of assets caused by fraudulent misappropriation in cases where investor has a direct contractual relationship with the depositor. Under the UCITS regime, there is generally no contractual relationship between UCITS unit holders and depositaries or sub-custodians. Thus, the proposed inclusion of UCITS unit holders violates the general concept of ICSD.

The ongoing work of the Commission towards the revision of the UCITS depositary regime will further increase the level of investors' protection through a clarification of depositaries functions and liabilities, more stringent rules on depositaries supervision duties and due-diligence requirements in the appointment of sub-custodians, etc…

For those reasons, the situation of a UCITS unit holder is not comparable to that of an investor directly invested in financial instruments. **At this stage, EFAMA members therefore clearly question the usefulness of an extension of the benefits of the ICSD to UCITS unit holders**.

1.2. A premature proposal

As the Commission itself recognizes in its *Explanatory Memorandum* (p.8, 4.3.3), changes to the Investor-Compensation Schemes need to be envisaged in the broader context of other ongoing regulatory reforms, and in particular the already mentioned revision of the UCITS depositary regime.
By essence, investor-compensation schemes are construed as 'last resort mechanisms'. In that context, an extension of the coverage of the ICSD to UCITS unit holders only makes senses if it complements the protection that UCITS unit holders already enjoy. This is why, in its answer to the *Call for evidence* initiated by the Commission, EFAMA had insisted that changes to the ICSD should only be envisaged once the outcome of the revision of the UCITS depositary regime would be known.

Given that public consultations concerning the revision of the UCITS depositary regime still have to take place, and that concrete legislative proposals cannot be expected before next year, we believe that the proposal to extend the scope of the ISCD to UCITS unit holders comes too early. Furthermore, the proposals to amend the UCITS Directive in terms of strengthening the safeguards applying to depositaries and sub-custodians impact the handling of cases in which the schemes shall have the right of subrogation with respect to legal positions of UCITS (or UCITS unit holders) in liquidation proceedings for amounts equal to payments received by them in the course of liquidation proceedings. This involves, for instance, the question of how claims of UCITS unit holders or a UCITS against the liquidator of the depositary should be offset against compensation payments by the scheme. As long as the duties and

liabilities of the depositary or sub-custodians have not been legally clarified by EU measures, no final decision about the question of who should be entitled to compensation should be taken.

EFAMA therefore calls upon European policy makers to reject or suspend the extension of the ICSD to UCITS unit holders, at least until the outcome of the discussions concerning the UCITS depositary regime will be known. It is only once the duties and liabilities of the depositary will have been clearly defined that it will be possible to assess objectively the need to extend the benefits of compensation schemes to UCITS unit holders and, as the case may be, to determine the exact conditions under which these unit holders should be entitled to claim for coverage.

2. Lack of clarity about the risks that the Directive intends to cover in relation to UCITS activities (scope of the extended coverage)

EFAMA members also want to draw attention to the fact that, as it is currently drafted, the proposal of the Commission to extend the benefits of investor-compensation schemes also creates serious legal uncertainties and would have a number of unintended consequences which do not seem to have been taken into consideration.

The first uncertainty concerns the exact scope of the extension of the coverage of the ICSD and the risks that the Directive intends to cover in relation to UCITS activities.

In its Explanatory Memorandum, the Commission mentions that the objective of the proposal is to "*give UCITS unit 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*" (point 4.3.3, page 7).

However, Article 2, paragraphs 2(b) and 2(c) of the legislative proposal, which describes the conditions under which a UCITS unit holder is entitled to claim for compensation, does not define sufficiently clearly what needs to be understood by a depositary failure (or default). It is for instance unclear whether Madoff-like situations of fraud would count under the scope of coverage for UCITS unit holders or if pay-out events are limited to cases of bankruptcy (or similar situations of insolvency) of the depositary or the sub-custodian, as suggested by the use of the wording "*for reasons directly related to the financial circumstances of the depositary or the third party*" in Article 2, paragraph 2(b), of the legislative proposal?

Furthermore, in the proposal made by the Commission, the coverage of losses is apparently directly linked to the failure of the depositary to meet its legal or contractual obligations towards the UCITS unit holders (see proposed Article 2, paragraph 2(c)). This seems to imply (*a contrario*) that the investor-compensation scheme would not intervene in cases of loss of assets outside of the legal or contractual

liability of the depositary (e.g. force majeure), where the coverage would be most needed. It also disregards the fact that there is, in principle, no contractual relationship between the UCITS unit holder and the depositary or the sub-custodians.

It is, therefore, extremely important to better define the scope of coverage of the ICSD in cases where the assets held in custody cannot be returned to the UCITS in the event of failure or default of a UCITS depositary or sub-custodian.

3. Legal and practical issues raised by the extension of the scope of the ICSD to UCITS unit holders

Under the current ICSD, the right to claim for compensation from the scheme is given to the investor, who is the legal owner of the financial instruments held on its behalf by the investment firm (or by a custodian) and who will consequently directly suffer the loss in case these financial instruments cannot be returned.

In the case of UCITS unit holders, the situation is different. Although it may vary from one Member State to another, it is, indeed, the UCITS itself which is usually considered as the legal or beneficial owner of the financial instruments held in custody by the depositary (or by a sub-custodian). In case of loss of assets belonging to the UCITS, the UCITS unit holders will, of course, be indirectly affected (decrease of the net asset value of their units) but it is the UCITS that primarily suffers the loss.
The Commission's proposal to give each individual UCITS unit holders the right to claim for coverage from the scheme is therefore problematic in itself because it simply **disregards the legal existence of the UCITS**.

Apart from the issues that it raises in terms of legal principles, the choice made by the Commission also brings a number of unintended consequences which are likely to undermine rather than promote investors' confidence:

1. **It ignores the intermediation models in the distribution of UCITS** (most retail clients buy their units through a distributor, not directly from the UCITS or its management company) and the fact that the retail investor does not necessarily appear as direct shareholder or unit holder in the register of the UCITS (for instance, in many cases, the investor will invest through a nominee account opened by his bank, and it is the nominee who will appear in the register of shareholders of the UCITS). Since only direct unit holders are entitled to claim for compensation, this will lead to completely arbitrary results where retail investors investing in the same UCITS will benefit or be excluded from the ICSD coverage depending of the structure of the distribution channel through which they bought their units. This is a significant move away from the principle of equal treatment of shareholders.

2. **It potentially discriminates against retail investors investing in fund of funds or master-feeder structures**: if the master UCITS suffers a loss because of a depositary failure, unit holders of the feeder UCITS will be impacted as well but, unlike retail investors in the master fund, they will not be entitled to claim for compensation. Because the feeder UCITS is considered as the unit holder of the master UCITS, it will be excluded from the right to claim for compensation because of its status of professional investor (or, in the best case scenario, will be compensated only up to a maximum of 50.000 EUR, regardless of the number of its unit holders and of the total value of the assets under management). Once again it implies significant differences in the treatment of retail UCITS unit holders.

3. **It does not address the operational implications:**

   - Is the investor-compensation scheme equipped to deal with a potentially huge number of claims, including the potentially high costs of cross-border payments?

   - How to make sure that each individual UCITS unit holder will be informed in due time (and in a language they understand) of their right to file a claim for compensation (in particular in cross-border situations: e.g. a Portuguese unit holder invested in a Luxembourg domiciled UCITS)?

   - How to define the exact number of shares held by each individual investor within a UCITS scheme on a given date?

   - How to deal with the differences in Member States regulations as to the extent to which distributors are required to ensure that underlying investors have the right to benefit from claims against a UCITS into which they do not invest directly?

In view of all the above described difficulties, an alternative option would consist in giving to the UCITS itself the right to claim for compensation, which would have the effect of automatically compensating investors in the UCITS by increasing the value of their units. Although probably preferable from a legal and conceptual point of view, that option also has a number of important consequences:

1. It would make it **impossible to limit the coverage to a certain amount (e.g. 50.000 EUR) for each investor**.

2. It would make it **impossible to exclude some categories of UCITS holders from the benefit of the coverage**: under the existing ICSD, Member States have the possibility to exclude some categories of investors (typically, professional and institutional investors) from the benefit of their national schemes. If the UCITS is compensated for its loss, all the unit holders (whether retail clients, professional investors…) will benefit from that compensation to the same degree.

3. There would be **no guarantee that it is those unit holders who suffered the loss** (i.e. those who held shares of the UCITS at the time of the loss of assets) **who will ultimately benefit from the coverage**. Indeed, if unit holders redeem their shares between the moment where the loss of assets is reflected in the NAV and the time that the UCITS is compensated by the ICS, they will not benefit from that compensation. To the contrary, a unit holder who would subscribe shares during the same period would enjoy the compensation without having suffered the loss.

In other words, whether the right to compensation is given to the UCITS unit holders (as proposed by the Commission) or to the UCITS itself, each option has a number of major disadvantages.

4. Funding principles and cost implications

4.1. Funding principles

One of the objectives of the Commission with the review of the ICSD is to harmonize the basic principles about the funding of the investor-compensation schemes in order to reduce the differences in the way funding is organized by each Member State (thereby increasing investor confidence and improving the functioning of the internal market).

However, in relation to the rights of UCITS unit holders to be compensated by a scheme, the Commission proposal (new Article 4a, paragraph 6) leaves it to each Member State to decide if contributions to their respective national schemes should be borne by UCITS themselves, their depositaries (or sub-custodians) or a combination of both.

This is regrettable as it goes against the principle of harmonization that the Commission seeks to promote and may, in practice, create distortions of competition among UCITS domiciled in different Member States (potentially, leading also to regulatory arbitrage).

Fundamentally, in relation to UCITS activities, the objective of the investor-compensation scheme as it is envisaged by the Commission is to provide a coverage to UCITS unit holders in cases where the depositary (and/or the sub-custodians) fails to meet its legal and contractual obligations towards a UCITS (in particular, the obligation to protect the assets held in custody).

UCITS already pay the depositaries for their services and may, in return, expect that they will fulfill their legal and contractual obligations. In this context, asking UCITS to contribute to the financing of the schemes actually comes down to ask them to pay twice for the same service, which seems unacceptable.

It should be noted also that asking UCITS to contribute directly to the funding of the schemes would go against another basic principle presented by the Commission, following which "*in principle, the costs of financing schemes should be borne by market participants"* (see Explanatory Memorandum, point 4.3.6).

Furthermore, under the scope of the existing ICSD, a person entitled to compensation is in no case liable to pay for the costs of financing a scheme. When considering granting UCITS unit holders a right to compensation under ICSD, however, it must be noted that UCITS unit holders would also encounter higher financial burden in case the corresponding scheme contributions should be borne by UCITS. This is due to the fact that any costs relating to product administration, as well as remuneration of fund manager, are paid out of the fund assets, thus having negative impact on the performance of a UCITS.

Therefore, a large majority of our members are of the opinion that, if the scope of the ICSD were to be extended to UCITS (i.e. the fund itself) or UCITS unit holders, the costs of funding the schemes in relation to this right of compensation should exclusively be borne by depositaries and sub-custodians.

The funding principles proposed by the Commission also raise other issues:

- **UCITS would be required to contribute to the funding of the schemes on the entirety of their assets, regardless of the ownership of the units in the UCITS** (retail or professional investors). In practice, this means that institutional or professional UCITS unit holders will indirectly contribute to the funding of the schemes without being able to claim for compensation (even if they invest in a share class reserved to institutional investors) since the right to claim is usually reserved to retail investors. This raises issues in terms of equality of treatment of shareholders and would put predominantly institutional UCITS (or UCITS with institutional share classes) at a disadvantage. Institutional and professional investors are not necessarily willing to pay for risks they are fully aware of and ready to bear. It might therefore lead them to leave UCITS products.

- **UCITS would all contribute to the funding of the schemes in the same manner, regardless of their risk profile**. However, UCITS are not all exposed in the same way to the risk of a depositary default (between a Money Market fund and an Equity fund invested in emerging markets there may be considerable differences). Against this background, is it fair to adopt a "one-size-fits-all" approach?

- **There is no mechanism in place to avoid a double counting of the same assets**. This is particularly clear in the case of a master-feeder structure, for instance, where the master UCITS and the feeder UCITS would both be required to contribute to the funding of the schemes on the totality of their assets (when, in fact, they 'share' the same portfolio of assets). As a consequence, a unit holder of a feeder UCITS would actually pay twice for the ICSD protection (directly through the feeder UCITS and indirectly through the master UCITS).

- **There are no clear rules in which cases the UCITS depositary and in which cases the sub-custodian must be assigned to the investor compensation scheme.** Particularly, there is a lack of rules on how to deal with sub-custodians which are located in a third country.

4.2. Cost implications for UCITS and their unit holders

The legislative proposal also foresees that, in order to provide a sufficient level of funding, each scheme should reach a minimum target fund level of at least 0,5% of the value of the monies and financial instruments held, administered or managed by the investment firms or UCITS that are covered by the ICSD.

This target fund will have to be fully ex-ante funded and this target fund level should initially be reached within a 10 years period.

Regrettably, the impact-assessment does not contain any analysis of the impact of these rules concerning the funding of the schemes on the cost-structure of UCITS. The decision to set the minimum target fund level to 0.5% also seems to be relatively arbitrary (the Explanatory memorandum does not contain any justification concerning this funding level).

EFAMA latest industry figures as at end of June 2010 indicate that the total assets under management in UCITS are of approximately 5.49 trillion Euros.

Setting the target level at 0.5% would require **a total contribution of approximately 27 billion Euros** potentially taken out of UCITS assets over a 10 year period (if depositaries are not required to contribute to the funding of the schemes, or if they "pass on" these costs to the UCITS through an increase of the depositary fees). In comparison, the total loss for UCITS in the wake of the Madoff scandal was of approximately 1.7 billion Euros.

This represents **a considerable cost that UCITS unit holders would have to bear** in order to benefit from the coverage of the ICSD. These additional costs appear to be disproportionate in comparison of the benefits that UCITS unit holders would enjoy in terms of increased protection.

UCITS unit holders will also be contributing towards the costs of MiFID clients who are being provided services for example under a contract for individual portfolio management where terms of depositary/custody liability are not aligned with those being proposed for UCITS.

4.3. Level of compensation

The Commission proposes the modification of Article 4(1) of the Directive in order to increase the level of compensation to a fixed amount of **50.000 EUR** (currently 20.000 EUR). According to the Commission,

this new level has been fixed to take account of the effects of inflation in the EU and to better align the level of compensation to the average value of investments held by retail clients in the European Union (Explanatory Memorandum, 4.3.5, p.8). This increase does not stand up to scrutiny in several respects.

If the objective is to compensate the effects of inflation, given the yearly average rate of inflation of approximately 2% observed in all EU Member States over the period of 1997 to 2010 (corresponding to a cumulative inflation rate of less than 30% over the same period), an increase of the compensation limit up to a maximum of 26.000 EUR would appear more appropriate.

Also, the data presented by the Commission to support its conclusions on average retail investments are rather limited and based on a number of estimates and questionable extrapolations that most probably lead to a surrestimation of the average amount held by retail UCITS unit-holders (see impact assessment, p. 19).

In relation to UCITS activities, the need for an increased level of compensation is not sufficiently evidenced and needs to be reconsidered. In that perspective, it should be noted that the level of compensation will directly influence the target level of funding required for the investor-compensation schemes and, therefore, the costs ultimately borne by UCITS unit holders to benefit from the ICSD coverage.

It is therefore very important to calibrate the level of compensation to the real needs of retail UCITS unit holders.

It is also unclear from the wording of the proposal how this level of compensation would be applied in the case of umbrella funds with several sub-funds. As we currently understand it, it seems as if a unit holder would only be entitled to a single claim per UCITS, which implies that an investor holding units in two sub-funds of the same umbrella would be discriminated against an investor investing in two separate UCITS. Once again, this would lead to inconsistent results in terms of retail investors' protection, and would put umbrella funds at a disadvantage in comparison to single UCITS.

5. Threat for the competitiveness of UCITS and lack of level playing field

Under the Commission's proposal, the extension of the scope of the ICSD is limited to UCITS and does not include other substitute retail products.

This has the effect of leaving many retail investors in non-UCITS retail products uncovered, unless national compensation schemes voluntarily extend the scope of cover.

Furthermore, the additional costs that UCITS (and their unit holders) would have to bear will seriously affect their competitiveness as compared to substitute retail products. Once again, this is particularly true for institutional investors that would be pushed to leave UCITS products because they will not be prepared to pay for these additional costs without getting any benefit in return (institutional investors are usually excluded from the benefits of national compensation schemes and the level of compensation (50.000 EUR) is insufficient to offer them a real protection anyway).

Conclusion

Whilst supporting the Commission's aim to increase the protection of UCITS investors, EFAMA members believe that the proposed amendments to the ICSD will not achieve its original objective.

EFAMA remains fully committed to support the Commission's efforts in the field of investor protection, first and foremost by contributing constructively to the ongoing review of the UCITS depositary regime.

Should regulatory gaps nevertheless remain, we also stand ready to help the Commission to define a legal framework that would provide a workable solution for UCITS unit holders, allowing them – if need be – to benefit from the ICSD coverage at a reasonable cost and limiting as much as possible the legal and practical issues highlighted in this paper.

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