

Compensation
for Investors
when
Investment
Firms Fail

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COMPENSATION FOR INVESTORS WHEN INVESTMENT FIRMS FAIL

Introduction

The current crisis in the financial markets has brought the Irish Deposit Protection Scheme, as administered by the Financial Regulator, into the spotlight. This, however, is only one of the two main compensation schemes that provide compensation to individuals when regulated firms go out of business. The other compensation scheme, the Investor Compensation Scheme (the 'Scheme'), provides compensation for clients of failed investment firms. The Scheme's workings are also worthy of analysis.

Background to the Scheme

Prior to the introduction of the Investor Compensation Directive (Directive 97/9/EC) (the 'ICD') in March, 1997, the implementation of investor compensation schemes in EU Member States was, to a large extent, left to the discretion of the national governments, the upshot being that varying levels of unprotected exposure to investment losses existed for investors across the EU.

The ICD sought to enhance investor protection by providing for a harmonised minimum level of investor protection across the EU. The ICD was transposed into Irish law on 1st August, 1998, by the enactment of the Investor Compensation Act 1998 (the 'ICA'), the principal feature of which is the provision for the incorporation of the Investor Compensation Company Limited (the 'ICCL').

The ICCL is now the specialist, independent body which is charged by the ICA with establishing and maintaining funds out of which compensation payments can be made to 'eligible clients' (as the term is defined in the ICA) of certain categories of failed investment firms.

Operation of the Scheme







Authorised investment firms (see below) are required to contribute to the Scheme by making annual contribution payments to the funds maintained by the ICCL. There are currently, in fact, two funds - Fund A and Fund B - each designated to meet claims from investors of different categories of authorised investment firm. The question of which fund a firm contributes to depends on the nature or category of the authorised investment firm. The

amount required to be contributed by each authorised investment firm depends on criteria such as the number of 'eligible clients' (as defined in the ICA) that are managed by the firm or the amount of the firm's total income from investment and insurance business in the previous financial year.

The Financial Regulator ('FR') is appointed as the supervisory authority for the purpose of the ICA and is vested with a significant amount of control over the operation of the ICCL itself and over the compensation funds established by it. For example, FR prior approval must be obtained in respect of the establishment by the ICCL of any new compensation funds (section 19(2), ICA) and in respect of the borrowing or raising of money by the ICCL (section 13(1), ICA). The ICA also vests in the FR the power to impose severe penalties on investment firms who do not comply with their obligations under the ICA.

Who must contribute to the Fund?

Section 21(2) of the ICA provides that 'authorised investment firms' must make contributions to the investor compensation funds. The term 'authorised investment firms' is defined in the ICA. The ICCL categorise authorised investment firms as follows:

-  investment firms and insurance intermediaries regulated by the FR;
-  stockbrokers regulated by the FR;
-  insurance brokers, agents and tied agents of insurance companies;
-  banks and building societies that carry out investment services and are licensed by the FR;
-  accountants certified by their professional bodies to conduct investment business;
- and,
-  credit unions that provide investment and/or insurance services.

The ICCL's Review of Funding

There have been three separate cases to date (two in 1999 and one in 2001) involving failed investment firms which have given rise to claims (almost 3,000 in all) for compensation being made to the ICCL. This has impacted upon the level of funds held by the Scheme.

The ICCL, whose board includes a number of industry representatives, including a representative from the Professional Insurance Brokers Association Limited and The Irish Banking Federation, reviews the structure of and the rates of contribution to the Scheme every three years. The results of the most recent review, carried out in 2006, were published

in June 2007. See the ICCL document 'Arrangements for the Funding of the Investor Compensation Scheme Operated by ICCL – June 2007'. This latest review reports that the ICCL believes that the best way of building up the levels of funds is through the authorised investment firms' continuing their annual contributions payments. The review notes that the ICCL is in ongoing discussions with the Financial Regulator to develop a coordinated billing and collections system for the ICCL contribution.

In order to ensure that authorised investment firms make their required payments to the Scheme, the ICA provides for a variety of sanctions against those who default in their contribution obligations.

Enforcement of Obligations to Contribute to the Scheme

The ICA seeks to create a two-tier system in which the ICCL and the FR interact with each other to encourage and enforce compliance with investment firm contribution obligations.

In the event that an investment firm does not make the required contribution payment within 35 days of payment falling due, the ICCL will issue 2 reminder notices to the investment firm. The reminder notices will highlight to the investment firm that an interest penalty of 1.25 per cent. per month (or part of a month) applies in respect of late payment. Any sums due to the ICCL are recoverable in court as a simple contract debt (section 21(5), ICA).

If payment is not made within 10 days of the ICCL's second reminder notice, the ICCL will report the investment firm's non-compliance to the FR, which in turn is vested with powers to enforce compliance and sanction non-compliance. Section 27(3), ICA provides that the FR may direct the authorised investment firm and its directors and managers to among other things (i) comply with the investment firm's obligations under the ICA and/or (ii) suspend the carrying on of the business of an authorised investment firm or to suspend entering into certain transactions (including the acquisition or disposal of assets) for a period not exceeding twelve months. Any FR direction given under section 27, ICA, can be appealed by the investment firm.

Failure to comply with any direction of the FR given in accordance with section 27, ICA may result in further penalties. Section 28, ICA provides the FR with a discretionary power to revoke the authorisation of investment firms under the relevant authorisation legislation. In the case of the non-compliance of credit institutions, this power is not discretionary and the FR must amend the authorisation of the credit institution so that it may no longer provide investment business services. In the case of the non-compliance of an investment firm that

is an insurance intermediary or an investment business firm (as so defined in the Investment Intermediaries Act, 1995), the FR must inform the product producers who have appointed the insurance intermediary/investment business firm of the non-compliance, in which case the product producers must cancel the written appointments of the insurance intermediary/investment business firm.

The severity of the sanctions provided for in section 28 is somewhat mitigated by section 28(10) where in the case of certain categories of investment firms the Financial Regulator is required to give not less than twelve months' notice to the investment firm of its intention to revoke the investment firm's authorisation.

Enforcement in Practice

To date, the FR has not found it necessary to exercise its powers of sanction under the ICA against non-compliant investment firms. In practice, it is the ICCL which is most active in enforcing compliance with contribution obligations.

As mentioned, sums due to the ICCL are recoverable in court as a simple contract debt. Since its incorporation, the ICCL has threatened to take legal action against a number of investment firms for failure to make the required contribution to the Scheme. Often, the threat of legal action has been sufficient to elicit payment from defaulting firms. However, certain cases have necessitated the issuing of debt recovery proceedings in the District Court by the ICCL.

Conclusion

Considering the current crisis in the financial markets, coupled with the desire of the ICCL to build-up the level of funds in the Scheme over the coming years, it is expected that the ICCL is likely to adopt an increasingly strict approach with regard to payment of investment firm contributions to the Scheme. Accordingly, increased legal action by the ICCL against defaulting investment firms in the coming months would not be surprising.

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