Final Report of the Morrogh Working Group

October 2006

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Introduction

W&R Morrogh Stockbrokers ceased trading in April 2001 on the direction of the Central Bank and lengthy legal proceedings followed. The Morrogh case highlighted certain important issues in relation to investor compensation arrangements and the management of liquidations / receiverships in the event of the failure of an investment firm. These issues have implications for the investment industry as a whole.

On 30th March 2004, the Minister for Finance announced the establishment of a Working Group to examine the issues arising from the Morrogh case. Membership was drawn from a wide range of Governmental, financial industry, regulatory and consumer protection interests. The Department of Finance chaired the Group and also provided the Secretariat.

The Working Group established that two sub-groups should be established (terms of reference at Appendix 1) to examine (i) legislative and regulatory issues and (ii) investor compensation funding arrangements. The work of the Morrogh Working Group and sub-groups was carried out in two distinct phases.

In the first phase a comprehensive survey of both legislative/regulatory and investor compensation funding issues was undertaken by the two sub-groups. The terms of reference were very broad and as the work of the sub-groups progressed, it focused on a smaller number of key issues which are dealt with in detail in this report. The work of the sub-groups during this first phase was completed and presented to the Working Group in November 2005. The interim report of the sub-groups is attached as Appendices IV and V to this report.

The second phase of the review was initiated at the Working Group meeting in November 2005 when it was decided that more detailed consideration of the specific options brought forward in the interim report was required with a view to agreeing recommendations for the way forward. Two further 'technical groups' were established. The technical groups met regularly and in March 2006 completed an assessment of the options identified in relation to legislative / regulatory change and funding of investor compensation.

The final report to the Working Group summarises the conclusions and recommendations of the technical groups' assessment. Part 1 of the Report assesses the legislative and financial regulation issues that emerged from the Morrogh Stockbroker's failure while investor compensation funding issues are considered in some detail in Part 2. The Morrogh Working Group approved this final report of its deliberations in September 2006.

Executive Summary and Recommendations

This report is divided into two parts. Part 1 deals with the legislative and regulatory issues highlighted by the Morrogh case and Part 2 deals with options for the funding of the Investor Compensation Fund.

The recommendations of the report are as follows –

Legislative and regulatory issues

1. Pre-determined rules should be developed for the distribution of client assets in circumstances where a shortfall in client assets arises following the failure of an investment firm.

2. The proposed pre-determined rules should have a statutory basis and take account of case law and international developments.

3. The word "controlled" should be removed from section 52(5)(b) of the Stock Exchange Act, 1995 and section 52(7) of the Investment Intermediaries Act 1995.

4. The approach to funding receiver/liquidator costs in section 52(5) of the Stock Exchange Act, 1995 should remain unchanged.

5. A set of principles should be prepared by the Financial Regulator and the ICCL to guide and inform the certification of claims by the Administrator. The principles should be supported by regulatory and legislative changes as necessary.

6. Following the certification of the majority of the Morrogh claims, ICCL should carry out an analysis of the claims with the objective of:

   - identifying any efficiencies that could be introduced into the certification process;
   - assessing the reliability of the information contained in the claim forms; and
   - informing the preparation of practical guidelines to support certification of compensation claims on a speedier basis.

7. Details of the claims and their reconciliation with client records should be made available by the Morrogh Administrator to ICCL to facilitate their analysis of claims.

8. The Group noted the range of other measure being taken to protect investors and, in particular, welcomed the proposals in relation to dematerialisation of shares which will strengthen investor protection. The Group recommended that work on the dematerialisation of shares be progressed with a view to implementation at the earliest possible date.

Investor Compensation Funding

9. The current requirement, whereby industry meets the cost of investor compensation following the failure of a firm should continue. The Group supports ICCL's 'cascade model' as the structured funding framework for investor compensation.

10. The ICCL should continue to review its target levels of reserves for each compensation fund to ensure that reserves in each fund are adequate to meet what might be regarded as reasonably foreseeable funding requirements for investor compensation.

11. A cap should be placed on calls which may be made on industry for additional top-up funding in any one year. The Group considers that the cap recommended by the ICCL at twice the annual firm contribution is appropriate. The imposition of a cap cannot be considered in isolation from the issue of borrowing, or the level of annual contribution and the appropriate target level of reserves to underpin the sustainability of the funding structure.

12. The existing policy of ICCL in relation to inter-fund borrowing should be continued.

13. The difficulty in providing repayment assurances to secure commercial borrowing facilities is recognised. It is recommended that the ICCL and the Department of Finance further examine the international experience on the provision of the repayment assurances sought by commercial lenders.

14. The difficulties faced by ICCL in accessing commercial borrowing, including the requirement to clarify the legal position regarding State support for investor compensation, should be brought to the attention of the EU Commission in the context of its work on investor compensation schemes.

15. A range of legislative, risk management and operational difficulties would need to be considered further before borrowing from the Deposit Guarantee Scheme or the Central Bank. In view of these difficulties this option is not favoured at this stage. Recognising that some other jurisdictions have such borrowing arrangements in place the Group agreed that this matter be brought to the attention of the EU Commission in the context of its work on deposit guarantee schemes, in conjunction with those issues referred to in recommendation 14 above.

16. The amalgamation of the Investor Compensation Scheme and the Deposit Guarantee Scheme is not recommended.

17. While the matter should be kept under review by the ICCL in consultation with the fund contributors, the amalgamation of the two funds maintained by ICCL is not recommended at this time.

18. As no conclusion could be reached, the introduction of a product levy on relevant transactions and alternative sources of funding are not recommended.

19. ICCL should continue to carry out assessments of the potential investor compensation funding needs. While it is difficult and complex to estimate the risk of firm failures, there is scope for undertaking further modelling and scenario analysis. Simple stress testing could produce useful results.

20. The purchase of insurance to cover investment compensation needs is not considered to be economically viable and it is not recommended on that basis.

PART 1

Legislative and Regulatory issues

1. Context

1.1 The analysis of the legal / regulatory issues contained in the report of the first phase of the review (circulated for meeting of the Working Group on 22 November 2005) highlighted the areas for further examination.

1.2 Very significant legal costs were incurred in the Morrogh case which were defrayed from client assets and resulted in an even greater shortfall in client assets, which in turn led to substantially higher investor compensation claims. The existence of pre-determined distribution rules has the potential to reduce these costs in the future.

1.3 Section 52 of the Stock Exchange Act, 1995 contains a number of references to assets which are "controlled" by a firm. The use of the term "controlled" in the legislation has led to concerns that in the event of the winding-up of an investment firm, a receiver/liquidator might have access to a client's custody account with a third-party custodian, creating a perception that a receiver's/liquidator's access to client assets might be much wider than previously anticipated.

1.4 It is a priority to ensure that notwithstanding the other issues that may serve to delay the process the compensation scheme operates as efficiently and effectively as possible. Speedier certification of compensation which is payable to investors should be supported by legal and regulatory changes where necessary.

1.5 The work of the technical group examining legislative and regulatory issues has focused on these matters.

2. Possible Pre-determined Distribution Rules

Phase 1 Interim Report:

"There would undoubtedly be problems in designing and implementing a comprehensive set of distribution rules. However there are potential benefits in distribution rules in that they provide some certainty and should reduce the costs of a liquidation/receivership. There is a case for more work on the possibility of framing limited predetermined distribution rules for specified circumstances."

The views of the Group are as follows:

2.1 The absence of legal rules regarding the basis upon which pooled assets should be returned to investors, in circumstances where there is a shortfall in such assets, is considered to have contributed considerably to the very significant legal costs that arose in the Morrogh case. Under the High Court judgement these costs were defrayed against client assets, leading to very substantial increases in investor compensation claims.

2.2 One possible solution to reduce the length and hence cost of future receiverships/ liquidations is to attempt to reduce the ambiguity that necessitated the receiver/liquidator going to Court to seek guidance in relation to the distribution of client assets. In this regard default or pre-determined rules for distribution of client assets may expedite the distribution of client assets in the future. It was noted that if predetermined rules are applied it may be necessary to provide for indemnification for the Receiver against actions taken relating to the distribution of the shortfall.

2.3 A principle established in equity case law and reviewed by the High Court in the Morrogh case, is that payments out of an account in circumstances where there is a shortfall in client assets are attributed to payments into the account in the order in which payments were made in – the first payment out is attributed to the first payment in, and so on (i.e. the "First In First Out" (FIFO) rule). If the FIFO rule had been adopted in the Morrogh case, this would have resulted in some claims being satisfied in full while other claimants would have been left with substantial losses based on the order in which payments were made. A rateable

distribution which was the broad approach adopted in the Morrogh judgement (where shortfalls in client assets arose) would on the other hand impose proportionate losses on all claimants.

2.4 The practical effect of the FIFO rule is to establish a reverse order of priority. The later the payment into the account the greater the prospect of that payment not being attributed to payments out and hence of still being represented in the remaining credit balances. From an examination of the rule in a number of legal cases the following key points have emerged:

- FIFO should not apply if a fund is a common fund and not allocated to individual investors;
- the effect of the FIFO rule is to apportion a common misfortune through a test which has no relation whatsoever to the justice of the case;
- FIFO is not appropriate for those who had the common misfortune of falling victim to a large scale fraud;
- the rule could be applied but only if it is convenient and not if it would result in injustice and there was a preferable alternative;
- FIFO does not apply to competing beneficial entitlements to a mingled trust fund where there have been withdrawals from the fund.

Relevant International assessments

2.5 The UK Financial Markets Law Committee (FMLC) concluded that complex tracing rules (FIFO) that apply in equity for determining how shortfalls in mixed accounts should be borne are difficult to apply in modern markets in the context of large appendices and rapid transfers. The FMLC emphasised that what is needed above all is clarity regarding the steps to be taken if the intermediary is insolvent.

2.6 The FMLC noted that pro-rating removes the possibility of one customer arguing that a shortfall should be borne exclusively by another customer, on the basis of evidence that the shortfall is operationally attributable to the business of that other customer. The Committee felt that in the case of pro rating, the risk of unfairness through cross-subsidisation is outweighed by the benefit of avoiding

the risk of uncertainty, delay and expense in complex litigation. The FMLC support the general principle that shortfalls should be borne proportionately and have referred the issue for further consideration by the UK Law Commission where it is under active consideration.

2.7 Work is currently underway which may in time establish international and / or EU standards for treatment of shortfalls in client assets. This is being carried out both in the context of the work of the European Commission's Legal Certainty Group and in the preparation by UNIDROIT[1] of a draft Convention on harmonised substantive rules regarding securities held by an intermediary.

2.8 Article 18 of the draft UNIDROIT Convention states that a shortfall in securities held by an intermediary shall be allocated among the account holders, in proportion to the respective numbers of amounts of securities so credited (unless the rules of the system otherwise make provision for the manner in which the shortfall is to be eliminated). In any such allocation no account shall be taken of the order in which or time at which any securities are credited or debited to the respective securities accounts of account holders.

2.9 The EU Legal Certainty Group[2] have recognised in their work that tracing is one approach that can be adopted in case of shortfalls in client assets in the wake of insolvency but this approach is often considered to be operationally impractical. The alternative approach is that all those who claim to have holdings (at the level of the same account provider) must share a loss which can not be made good by the account provider.

2.10 In December 2005 the European Commission was authorised by the Council to open negotiations with UNIDROIT for a future convention on harmonised substantive rules regarding securities held with an intermediary which would be

[1] The International Institute for the Unification of Private Law (UNIDROIT) is an independent intergovernmental organisation with its seat in Rome. Its purpose is to study needs and methods for modernising, harmonising and co-ordinating private and, in particular, commercial law as between States and groups of States.

[2] The European Commission's Legal Certainty Group analyses issues of legal uncertainty and advises the Commission accordingly.

expected to include the issue of investor protection from insolvency of the intermediary and the allocation of shortfalls. However the completion of this work is likely to take some time, and the outcome is likely to be the identification of principles rather than detailed and specific rules. The Group therefore concluded that there was merit in proceeding at a national level with the preparation of rules now rather than awaiting international developments which could take some years.

2.11 Principles to be incorporated in pre-determined distribution rules

An outline of the issues which the Group considers should be addressed in pre-determined rules is as follows:

- Accept the concept of a proportionate rateable distribution of assets (both for cash and securities)
- Recognise the concept of traceability
- Traceability rules for cash may need to be different from those relating to securities
- Respect for intact pools of stock (if unaffected by a fraud intact pools should be left intact)
- No distinction to be made between certificated and electronic shares
- Specific consideration is required on the treatment of holdings of very small monetary value.
- Application of the distribution rules to be mandatory

Pre-determined distribution rules should also specify:

- The time limit within which clients can seek to establish a claim for ownership of client assets
- The valuation date to be used for determining the value of holdings of very small monetary value (in the Morrogh case this was set as the date of sale)
- Procedures to deal with unclaimed shares
- Whether the receiver can sell and distribute the cash when an owner of shares does not nominate a broker.

2.12 The Group also considered a possible broader role for the ICCL to have the option to make good the shortfall in client assets as a more economic alternative to paying compensation. This would require legislative change. Such an arrangement may only work in limited circumstances where the shortfall was likely to be less than the costs of receivership and where a consequential distribution to clients could be completed quickly. The Group saw benefits in the adoption of such an approach, but noted that its implementation could be extremely complex. Account would need to be taken of potential difficulties in ensuring the continuation of an entity in such circumstances and the fact that individuals could challenge any interference with their individual rights.

Recommendation 1: The Group recommends that pre-determined rules should be developed for the distribution of client assets in circumstances where a shortfall in client assets arises following the failure of an investment firm.

Recommendation 2: The proposed pre-determined rules should have a statutory basis and take account of case law and international developments.

3. Review of section 52 (5) (b) of the Stock Exchange Act, 1995 [3]

The Phase 1 Interim Report:

The Group concludes that there would be merit in the further review of S52 (5) (b), and in particular its application to client assets 'controlled' by the firm.

The views of the Group are as follows:

3.1 The legislative provision which allows access by a receiver/liquidator to client assets to meet the costs of receivership / liquidation in cases where firm assets have been depleted is based on a principle established in equity case law. This principle holds that where assets are held in trust, the beneficial owner should bear the cost of distributing the assets where the trustee is in receivership/liquidation. Under the current legal framework a receiver/liquidator can, therefore, subject to Court approval, claim costs associated with the distribution of clients' assets and costs incurred in performance of functions under the Stock Exchange Act, 1995.

3.2 The legislation appears to go further than the established legal principle in that it appears to encompass assets "controlled" by the firm. The term "controlled" is not defined for the purposes of the legislation. Although the question of what constitutes assets "controlled" by an investment firm did not arise specifically in the Morrogh case and was not considered by the High Court, the case appears to have had the effect of creating a perception that a receiver's/liquidator's access to client assets might be much wider than previously anticipated. In particular that accounts containing client assets which are opened by a client with a third party in the name of a client and over which the firm is mandated to issue instructions may be encompassed under the provision.

3.3 The Group noted that these accounts, while under the "control" of the firm (i.e. over which the firm can issue instructions), are not held in the name of the firm and should not fall under the direction of the receiver/liquidator. Given the independent client/custodian relationship, the receiver/liquidator does not have

[3] The corresponding section in the Investment Intermediaries Act, 1995 is section 52 (7)

to determine the question of ownership of the assets in these accounts because the accounts are in the name of the client and the client should be able to access the assets without the intervention of the liquidator/receiver. In that scenario no costs that warrant recovery under section 52(5) should arise for the receiver/liquidator. The removal of the word "controlled" from the relevant sections of the legislation would provide clients of investment firms with greater reassurance that receivers/liquidators would be precluded from gaining access to accounts held by the client with third party custodians over which an investment firm may have some degree of control.

3.4 If the legislation was amended to remove the reference to "controlled", it would logically follow that other references to "controlled" in the legislation should also be eliminated. The effect of such amendments would be that the Financial Regulator's client money rules would not include requirements in relation to money or investment instruments controlled by a firm arising from its business as an investment business firm. This is consistent with the approach adopted in the UK where the FSA client money rules do not deal with monies held in the name of the client, over which the firm can issue instructions other than imposing an obligation on firms with control over client money to maintain adequate control systems and accounting procedures.

3.5 Such an approach would also appear to be consistent with the approach in the EU Markets in Financial Instruments Directive which is due to be implemented in November 2007. If the control of client assets was removed from the ambit of section 52 and consequently the Financial Regulator's client money requirements, the firm's handling of such accounts would fall under the Financial Regulator's General Supervisory Requirements. Essentially these require firms to have adequate control systems and accounting procedures to facilitate effective management of the firm and control risks.

3.6 In the event that the reference to "controlled" were removed, it would need to be clear that the term "held" for the purposes of section 52 included client assets held by the firm with third parties and client assets registered in the name of nominee companies established by the firm or related companies.

Recommendation 3: The Group recommends that the word "controlled" be removed from section 52(5) (b) of the Stock Exchange Act, 1995 and section 52(7) of the Investment Intermediaries Act 1995.

4. Funding of receiver / liquidator costs in the event of a wind-up

The Phase 1 Interim Report:

"There is probably no realistic alternative to the existing basis to funding receiver/liquidator costs from firm and client assets, although there may be benefit in clarifying how section 52 of the Stock Exchange Act 1995 should be applied."

The views of the Group are as follows:

4.1 The approach in Ireland to funding receiver/liquidator costs, where there are insufficient assets to cover the possible costs associated with their distribution, is set out in section 52(5) of the Stock Exchange Act, 1995. The approach set out in section 52(5) is consistent with the U.K. approach, except that in Ireland the receiver/liquidator has access to client assets only where the firms assets have been depleted (U.K. does not have these restrictions). Section 52 allows the receiver/liquidator access to client assets and indirectly thereby to the Investor Compensation Fund to cover receivership/liquidation costs (i.e. in circumstances that compensation is payable to investors for their assets which the firm cannot return to them because the receiver/liquidator has used these assets to defray costs).

4.2 There are only limited alternatives to the section 52 approach and each of these has significant drawbacks. The establishment of a separate fund based on industry levy is one option, but this could have a negative impact on competitiveness. State funding is another option but only a few EU countries provide State funding of liquidators and in Ireland the Company Law Review Group has recommended against State funding. A requirement that the Financial Regulator pays is in essence another form of State or industry funding. None of these alternatives therefore found favour with the Working Group.

4.3 Clarification of application of section 52 of the Stock Exchange Act, 1995:
Under section 52 if funds are held and controlled by or on behalf of the intermediary they will be included in the receivership by virtue of being "held". Funds purely controlled and not held by or on behalf of the intermediary should

not incur a cost to the receiver and there should be no doubt about ownership. There would therefore not be any rationale for the receiver to have access to such funds to cover the costs of the receivership. The amendment of section 52 to drop reference to "controlled" clarifies this beyond doubt.

Recommendation 4: The Group recommends that the approach to funding receiver/liquidator costs in section 52(5) of the Stock Exchange Act, 1995 should remain unchanged.

5. Possible speedier compensation system

The Phase 1 Interim Report:

"There could be real advantages if an Administrator could manage speedier certification of claims…The Group considers that this option should be pursued further."

The views of the Group are as follows:

5.1 Where an investment firm cannot meet its obligations to return client assets the Financial Regulator, with the agreement of ICCL, can appoint an Administrator under section 33 of the Investor Compensation Act 1998. Where the firm is in liquidation or receivership the Administrator is likely, for practical reasons, to also act in the role of liquidator/receiver. While delays arising in the receivership process in the Morrogh case gave rise to delays in the Administrator's certification of compensatable losses, no delays were experienced in the payment of compensation by ICCL, once these had been certified by the Administrator.

5.2 The primary issues in this context relate to the responsibilities of the Administrator and the manner and process through which compensation claims are certified. Complete accuracy cannot be achieved until such time as the liquidator/receiver confirms accuracy. The Group considered the issues arising where the Administrator might, in advance of a conclusion by the receiver / liquidator, confirm the accuracy of the books and records as they relate to client assets and certify claims for compensation.

5.3 To facilitate speedier certification of claims the Administrator needs to confirm, on a prima facie basis, that the claimant is an eligible investor, has suffered a compensatable loss and that the claim is not unreasonable. A requirement for speedier certification of claims by an Administrator suggests the adoption of a lesser standard of accuracy which could result in possible under or overpayment. Where overpayments are identified, attempts by ICCL to pursue repayment could, in many cases, prove difficult or uneconomical. Furthermore,

even this lesser level of certification would require access to the firm's books and records and a basic level of checking and verification.

5.4 The Group concluded that a set of principles should be prepared by the Financial Regulator and ICCL to guide and inform the certification of claims in future administrations. While some of these principles have already been applied on a case by case basis, it would be more beneficial for them to be clearly stated. Where possible, the principles should encompass the following issues and should be supported by regulatory/legislative changes as necessary:

- Where early certification is possible and there is no doubt about entitlement, early payment of compensation should be made.
- Where the amount claimed is well in excess of the maximum allowable payments of €20,000 and there is certainty with regard to the client's eligibility to receive compensation, early payment of compensation should be made.
- The option of paying a certain proportion of the claim and then making a supplementary payment if necessary requires further exploration.
- In circumstances where a lower standard of accuracy is applied to certification, there is clearly a risk of overpayment and consideration is required with regard to who should bear the additional costs associated with such risk.
- The MMI Liquidator recommended a change in the Investor Compensation Act, 1998 to allow for the administrator to rely on declarations completed by claimants to the effect that they are eligible for compensation. Appropriate sanctions would have to be put in place against claimants who make false or erroneous declarations.

5.5 The ICCL intend to undertake an analysis of the Morrogh claims and of the process applied to their assessment and certification in order to inform the certification principles for future administrators. An analysis comparing the

detail as submitted in the original claims against the detailed reconciliation of the client records would be very instructive when determining the extent to which the details on the original claim forms can be relied upon (i.e. how accurate are the claim forms). The ICCL is reliant on the Administrator providing details as a basis for the analysis.

5.6 It is noted that interim certification of compensation could give rise to increased administrator fees (given the requirement for an interim and final accurate statement of compensatable and net losses).

Recommendation 5: The Group recommends that a set of principles should be prepared by the Financial Regulator and the ICCL to guide and inform the certification of claims by the Administrator. The principles should be supported by regulatory and legislative changes as necessary.

Recommendation 6: Following the certification of the majority of the Morrogh claims ICCL should carry out an analysis of the claims with the objective of:

- **identifying any efficiencies that could be introduced into the certification process;**
- **assessing the reliability of the information contained in the claim forms; and**
- **informing the preparation of practical guidelines to support certification of compensation claims on a speedier basis.**

Recommendation 7: The Group recommends that details of the claims and their reconciliation with client records should be made available by the Morrogh Administrator to ICCL to facilitate their analysis of claims.

6. Other measures taken / planned to provide improved protection to investors

6.1 The Market in Financial Instruments Directive (MiFID)

The MIFID will result in a major overhaul of legislation in the area of investment services. Major parts of the Investment Intermediaries Act 1995 and the Stock Exchange Act 1995 will be replaced. A modern EU-wide regulatory regime, aimed at protecting consumers, will be put in place. Investment firms will have to comply with strict requirements in areas such as: avoidance of conflicts of interest; complying with practices on "best execution" and "client-suitability"; improved market transparency and reporting obligations. The existing Irish regulatory regime already covers many of the requirements set down in the MIFID, either through legislative provisions or by way of the Financial Regulator's Handbook for regulated firms. However, the new regime will put all Member States on an equal footing and allow investment firms to operate more freely throughout the EU.

The MiFID, which will represent an enhancement of existing harmonisation measures, requires that investment firms make arrangements for the safeguarding of clients' ownership rights when holding financial instruments and funds belonging to clients. The supporting Level II implementing measures proposed by the EU Commission also refer to the holding of client assets.

6.2 Proposals on dematerialisation of relevant Irish securities

The Group discussed and supported a proposal to dematerialise Irish securities which are admitted to trading on an exchange and some other Irish registered CREST settleable securities. The rationale for the proposal to dematerialise such securities is that it has been clear for some time that the holding of shares through share certificates does not lend itself to an efficient settlement process and is an outdated and cumbersome process. There are costs and inefficiencies associated with the current paper based system. There is a requirement therefore to "dematerialise" shares, or change them from paper to electronic form prior to completing a transaction.

Dematerialised shareholdings are increasingly common throughout developed securities markets and the UK market is also currently engaged in its own dematerialisation process. An Irish Dematerialisation Implementation Group was established in January 2005 to progress dematerialisation of Irish securities. The Dematerialisation Group, which is a cross industry group with broad market as well as regulatory and governmental participation, is under the Chairmanship of the Irish Stock Exchange.

The Implementation Group published a consultation paper, entitled "A Proposal to Improve Efficiency for Investors and Streamline the Settlement of Irish Securities", in September 2005. The paper can be accessed at www.ise.ie in the "Exchange News" section of the site.

The aim is to bring about the removal of share certificates and the CREST Transfer Form from the issuance, securities trading and post trade processing cycles. The proposal is to replace the current documentation by a paper Shareholder Statement and Shareholder Reference Number (SRN). There is also a proposed new requirement for Registrars to mail shareholders a statement of their shareholding by the following business day after every transaction has been carried out on the shareholders' account.

This statement which would be in addition to the requirement on stockbrokers to provide clients with a contract note following every transaction will act as a key deterrent to fraud. Any unauthorised transaction will be brought to the attention of the shareholder immediately. Currently, a shareholder might not become aware of fraud until an expected dividend was not received, which could be some time later. While it is never possible to completely prevent fraud, this would significantly mitigate against an individual from successfully carrying out a fraud over any extended period of time.

It is important to note that there will not be any change to the legal position of shareholders who choose to hold share certificates as their names will continue to remain on the share register, which is the legal register of their ownership of the shares in question. The dematerialisation initiative will however remove

the disadvantages experienced by certificated shareholders due to the time delays experienced by them when dealing in the current system.

The responses to the Dematerialisation Implementation Group's consultation paper made clear that there is strong support from the market for the proposal to dematerialise shares, albeit with some comment on the timing, costs and on other operational details of the proposal. The Group has committed itself to progressing dematerialisation but legislative change needs to be in place for this to be implemented.

6.3 Relevant changes in regulatory system / regime

The most significant change in the regulatory system since the appointment of a receiver to W&R Morrogh was the establishment of the Irish Financial Services Regulatory Authority (the Financial Regulator) in May 2003.

In February 2004 the Financial Regulator issued revised Client Money Requirements (the Requirements) under both section 52 of the Stock Exchange Act, 1995 and section 52 of the Investment Intermediaries Act, 1995. These replaced the original Requirements issued in 1996 and addressed issues arising from experience in monitoring compliance with the Requirements. The main changes to the Requirements included:

- More frequent reconciliation of client assets;
- Annual Auditor's report on a firm's compliance with the Requirements;
- Maintenance of a minimum surplus sum in client money accounts;
- Segregation of fully paid (non-collateral) client assets from assets held in respect of margin transactions;
- Client written consent to the pooling of their assets in a client account with the assets of other clients.

In December 2003 the Financial Regulator, in consultation with the Irish Stock Exchange revised a number of existing regulatory requirements and also imposed some new requirements on its member firms. The purpose of these requirements was to strengthen risk management arrangements and to provide

more explicitly for independent governance in these firms. These requirements[4] oblige stockbrokers authorised under the Stock Exchange Act, 1995 to:

- Appoint a full time compliance officer;
- Appoint two non-executive directors/partners;
- Establish a compliance committee;
- Prepare an annual compliance plan and monthly compliance reports;
- Maintain adequate professional indemnity insurance.

Recommendation 8: The Group noted the range of other measures being taken to protect investors and, in particular, welcomed the proposals in relation to dematerialisation which will strengthen investor protection. The Group recommended that work on the dematerialisation of shares be progressed with a view to implementation at the earliest possible date.

[4] Certain elements amended to reflect the lower risk profile of firms providing limited services to clients.

PART 2

Investor Compensation Funding

7. Context

7.1 European Investor Compensation Schemes, including that in Ireland, are based on EU Council Directive 97/9/EC, known as the Investor Compensation Scheme Directive. The Directive is seen as an integral part of the framework for the establishment of a single market in financial services and applies to all investment firms. Directive 97/9/EC (the Directive) was given effect in Ireland through the Investor Compensation Act, 1998 (the Act).

7.2 The Act established the Investor Compensation Company Ltd (ICCL) as a company limited by guarantee, on 1st August, 1998. The principal objective of the ICCL is to establish and operate a financially sound statutory investor compensation scheme. The Act provides that authorised investment firms and insurance intermediaries must become members of an investor compensation scheme and contribute to its funding. The Directors of ICCL are nominated by the Minister for Finance or bodies representing the financial services industry or the interests of clients of investment firms. Further details in relation to the Directors and members of the Board of ICCL can be viewed on the company's website at www.investorcompensation.ie

7.3 ICCL maintains two compensation funds- Fund A and Fund B.

Fund A was established to meet claims from eligible clients of investment firms authorised under section 10 of the Investment Intermediaries Act 1995, Stockbrokers authorised under the Stock Exchange Act 1995, Credit Institutions that provide investment services and certain certified persons who provide investment business services. At the end of the ICCL reporting year in July 2005 there were 228 contributors to Fund A.

Fund B was established to meet the claims of eligible clients of firms defined in section 36 of the Act as insurance intermediaries. These include Multi Agency Intermediaries authorised under the Investment Intermediaries Act

1995, Authorised Advisors authorised under the Investment Intermediaries Act 1995, Tied Insurance Agents, Credit Unions authorised under the Investment Intermediaries Act 1995 in relation to their insurance activities and certain other certified persons. At the end of the ICCL reporting year in July 2005 there were 3,030 contributors to Fund B.

7.4 The EU Directive under which the investor compensation scheme is established states that the cost of financing investor compensation must in principle be borne by investment firms. The Directive also states the requirement that the financing capacities of such schemes must be in proportion to their liabilities; whereas that must not, however jeopardize the stability of the financial system of the Member State concerned. The Investor Compensation Act, 1998 which transposed the Directive into Irish law requires that the Investor compensation scheme must be in a position to meet reasonably foreseeable[5] investor compensation needs.

7.5 The Morrogh experience demonstrated how reserves can be depleted and emphasised the requirement for alternative funding options to enable the scheme to swiftly put in place the funds required to meet the legislative requirements of the Compensation Scheme. While existing funding arrangements in place in the Irish Compensation Scheme have so far proved adequate, albeit with necessary recourse to exceptional top-up funding, the Morrogh case has highlighted a number of important issues for the current compensation system. Notwithstanding the fact that large scale failures represent low probability events, a compensation funding system should be such that it ensures that there is adequate funding capacity to meet reasonably foreseeable compensation needs.

7.6 The interim report of the sub-group on compensation funding (Appendix V) described the current operation of the Investor Compensation Scheme and examined the existing funding arrangements put in place by ICCL as well as other funding options that might be made available to ICCL to cope with

[5] Section 22(3)(a) Investor Compensation Act, 1998.

future failures. It also considered the advantages, disadvantages and obstacles that might attach to each of those options.

7.7 The sub-group decided to focus its work on assessing the additional financial measures that might be taken to allow ICCL to operate its statutory mandate in the most strategic and effective manner and to ensure that adequate funds would be available to provide for compensation claims that may arise in the future. The sub-group broadly supported the decisions already taken by the ICCL and outlined in the "Arrangements for Funding of the Investor Compensation Scheme" published in May 2004, which utilise the investment industry's capacity to fund compensation using the various options available to the Scheme. The sub-group highlighted a number of funding options:

- Build up of a reserve
- Capping top-up payments
- The development of borrowing arrangements
- Other medium term solutions

The sub-group's interim report recognised, however, that many issues identified with each of the funding options above and in particular with the borrowing options needed to be considered further. The report also noted that other medium term options such as the amalgamation of Funds A and B, a product levy and restructuring should be considered further.

7.8 At its meeting in November 2005 the Morrogh Working Group established a technical group to further assess the structured funding framework and this section and its recommendations represent the outcome of that assessment.

8. A Structured Funding Framework

Phase 1 Interim Report:

"Looking to the future, consideration needs to be given to the best form of structured framework of potential funding options and the circumstances in which each of those options would be put into effect"

The views of the Group are as follows:

8.1 The claims history experienced by the Investor Compensation Scheme has demonstrated that funds can be quickly absorbed when claims and associated costs arise. Notwithstanding the fact that large scale failures represent low probability events, a funding framework is required which ensures that there is adequate funding capacity to meet reasonably foreseeable compensation needs.

8.2 The objective of the structured funding framework is to map out the steps that can be undertaken by the ICCL in an agreed sequence drawing on various sources of funding to meet investor compensation requirements that might arise. In essence, the structured framework is intended to smooth out contributions by firms over time.

8.3 The Group agreed that building a reserve of funds with a combination of other funding options, employing the current 'cascade approach' is the most suitable model going forward. The 'cascade' represents a prioritised approach to be taken by ICCL, depending on the seriousness of the collapse, to access funds for the purposes of making compensation payments. Under the cascade model a hierarchy of funding sources is established, with each source of funding availed of only when the preceding source has been exhausted. This approach reflects the Oxera study conclusion that adequacy of funding structures requires flexibility of funding and, in particular, the availability of multiple funding sources.

8.4 The 'cascade model' would proceed as follows –

- Payments out of the reserve of funds built up in Fund A or Fund B as appropriate;

- Additional top-up payments collected subject to a cap on the amount that may be raised in any one year.

- Inter-fund borrowing, subject to consultation with the Financial Regulator.

- Other borrowing facilities arranged under the ICCL's statutory borrowing powers.

8.5 The maintenance of the structured funding framework by the Investor Compensation Company provides greater certainty to industry regarding future funding requirements to meet investor compensation needs. This will assist contributing firms by allowing them to better plan to meet funding requirements over time.

Recommendation 9: The current requirement, whereby industry meets the cost of investor compensation following the failure of a firm should continue. The Group supports ICCL's 'cascade model' as the structured funding framework for investor compensation.

9. Build-up of Reserves

Phase 1 Interim Report:

"The Group concluded that the preferred option would be to continue the ICCL policy of building a reserve of funds, over time……"

The views of the Group are as follows:

9.1 Reserves built up in the investor compensation fund through firm contributions should comprise the first element of the cascade model. The availability of sufficient reserves provides reassurance to both investors and contributors that funds are already in place intended to meet compensation requirements that might arise.

9.2 A significant issue for ongoing consideration by the ICCL is to ensure that the reserves are adequate to meet reasonably foreseeable funding requirements for investor compensation thereby ensuring that reserves held by the ICCL will minimise recourse to additional elements of the structured funding framework. The ICCL has had three reviews to date and will be having its next review in the coming twelve months.

9.3 It is accepted that there are significant challenges in projecting on an ongoing basis an appropriate or target level of compensation reserves, owing to the high degree of variability in investor compensation requirements.

The views of the Professional Insurance Brokers Association:

9.4 The Group noted the views of the representatives of the Professional Insurance Brokers Association (PIBA) that while Fund A had been significantly diminished by the Morrogh compensation requirement, Fund B is in a healthy position. There are over 3,000 contributing firms and a reserve of almost €10 million has been accumulated. According to PIBA Fund B firms represent a low risk category as they are, generally, non-cash handlers and when they do handle cash it is under indemnity from the insurance company. This is reflected by the fact that Fund B has only experienced one drawdown in the past eight years, amounting to €20,000 of which €15,200 was recovered from

the insurance company, a total loss of only €4,800. PIBA's view is that the eight year period of operation of Fund B should be sufficient to make inferences to potential future liabilities and as such funding of Fund B should now be limited to covering the administrative costs of maintaining the fund.

Recommendation 10: The Group recommends that the ICCL continues to review its target levels of reserves for each compensation fund to ensure that reserves in each fund are adequate to meet what might be regarded as reasonably foreseeable funding requirements for investor compensation.

10. Top-up Funding

Phase 1 Interim Report:

"In the event of a shortfall in the Fund additional top-up payments would be collected but there should be a cap on the amount that may be raised in any one year in the event of a top-up call."

The views of the Group are as follows:

10.1 A key element of the structured funding framework is access to top-up contributions from individual firms to the investor compensation fund. However, it is important to avoid open-ended special top-up levies in the event of significant claims arising particularly where there is only a small pool of contributing firms.

10.2 The Group is conscious of the need to provide industry with certainty regarding the maximum top-up contribution that may be necessary in any one year and therefore supports the introduction of an annual cap on top-up contributions. Given the very small funding base in Ireland, a realistic cap is required to ensure that there is not an undue burden on contributing firms and that they do not have an unlimited funding liability in any one year.

10.3 A cap on annual contributions does not absolve investment firms from bearing the costs of failures but rather it extends the period over which the cost is borne. In the case of a significant insolvency event, where a contribution cap was put in place, a shortfall in funding could still occur. The question of alternative funding sources would come into play very quickly thereby requiring that capping of contributions is linked to borrowing facilities.

Recommendation 11: The Group recommends that a cap should be placed on calls which can be made on industry for additional top-up funding in any one year. The Group considers that the cap recommended by the ICCL at twice the annual firm contribution is appropriate. The imposition of a cap cannot be considered in isolation from the issue of borrowing, or the level of annual contribution and the appropriate target level of reserves to underpin the sustainability of the funding structure.

11. Inter- Fund Borrowing

Phase 1 Interim Report:

"This option has the benefit of dealing with the short term liquidity pressures currently faced by Fund A... No additional contribution levies for Funds A or B would be required in the short term…This option is less expensive than commercial borrowing."

The views of the Group are as follows:

11.1 The cascade model anticipates that where investor compensation reserves combined with capped top-up contributions are insufficient to meet the demands imposed by a specific incident, requirements will next be met by recourse to inter-fund borrowing. Under current legislation the ICCL is already empowered to undertake inter-fund borrowing.

11.2 The potential for inter-fund borrowing to contribute to bridging funding gaps that may temporarily arise in meeting compensation funding needs should be maximised. Under existing policy, ICCL will meet investor compensation requirements arising in relation to one fund from the other, where it can meet these additional demands consistent with the maintenance of a prudent level of reserves for the fund providing the borrowing.

11.3 The Board of ICCL has decided that 'no-margin' rates should apply and, as a guideline, borrowing should be up to a maximum of one third of the Fund with a repayment schedule of not more than three years. Levying a positive interest rate on inter-fund borrowing would be counter-productive as it diminishes the benefit to the investment industry as a whole from the immediate availability of funds to meet investor compensation demands.

Recommendation 12: The Group recommends that the existing policy of ICCL in relation to inter-fund borrowing should be continued.

12. Other Borrowing Facilities

Phase 1 Interim Report:

"Many issues identified with each of the borrowing options still need to be addressed. Proposals for contingency borrowing facilities, whether from the Deposit Guarantee Scheme or the Central Bank, or the provision of a State guarantee to borrowing by the ICCL, raises complex procedural and legal issues along with practical difficulties."

(i) Commercial Borrowing

12.1 Because no type of ex-ante funding will ensure certainty of payout from accumulated funds, the structured funding framework must include contingency borrowing arrangements. In circumstances where there was a substantial call on the investor compensation fund over and above that which could be met through reserves and inter-fund borrowing, borrowing by the ICCL from commercial lending institutions would be expected to play a major part in underpinning the operation of the cascade model. The ICCL is empowered under the current legislation to undertake commercial borrowing. Borrowing, at market rates, would allow the ICCL to meet compensation needs while allowing contributors to spread their contributions over a number of years to service the borrowing necessary.

12.2 The Group was advised by the ICCL that potential commercial lenders have confirmed that they would be prepared to lend to the ICCL and the Oxera Report indicates that arrangements with commercial lenders have been concluded in other EU countries. However, the ICCL have been informed that appropriate repayment assurances to commercial lenders of funds would be required in the form of additional security. The future income stream derived from industry contributions over time may not suffice in this regard, in view of the possibility of further compensatable events arising over the term of the lending. In initial discussions with ICCL commercial lenders have indicated a requirement for State guarantees as security.

Recommendation 13: The Group recognises the difficulty in providing repayment assurances to secure commercial borrowing facilities. It recommends that the ICCL and the Department of Finance further examine the international experience on the provision of the repayment assurances sought by commercial lenders.

(ii) State support – State guarantees/last resort borrowing

12.3 In the course of its work a number of members of the Group highlighted the need for some form of "last resort" borrowing or State guarantee to be put in place which would allow the Scheme to manage the unlimited liability of the ICCL's contributors.

The legal context

12.4 Recital 23 to the Investor Compensation Directive states that the cost of funding the relevant investor compensation schemes "*…must, in principle, be borne by investment firms themselves*" and "*...the financing capacities of such schemes must be in proportion to their liabilities*". It does go on to acknowledge that this must not "*…jeopardise the stability of the financial system of the Member State concerned*".

12.5 The Investor Compensation Act, in implementing the Directive in Ireland, reflects this concern. Section 22 of the Act empowers the ICCL to decide on the level of contributions to be paid by authorised investment firms and the balance to be maintained in the relevant fund or funds. In making this decision, section 22 provides that the ICCL shall endeavour to ensure that it is in a position to meet any reasonably foreseeable obligations and, in doing so, shall have regard to the amount standing to the credit of the fund(s), the funding capacity of those authorised investment firms which are obliged to make contributions to those funds, and any other matters which are thought to be relevant.

12.6 In considering the appropriateness of a State guarantee the Group was conscious that any such support must be consistent with EU State Aid rules

and cannot confer a competitive advantage on contributing firms' vis-à-vis firms from other EU countries.

Under Article 86 (1) of the EC Treaty, the provision of aid, through the granting of State guarantees to a public undertaking to underwrite commercial borrowings, is prohibited as a State aid. In addition, under Article 87 (1) of the EC Treaty any State aid that distorts or threatens to distort competition is incompatible with the common market. Decision making on this issue is an exclusive competence of the Commission and therefore any measure involving State support for investor compensation would require EU Commission approval. The Commission's assessment is based on the so-called 'market economy investor principle' which holds that a State measure qualifies as a State aid if a private investor would not be willing to provide the aid under similar circumstances. There is scope for derogation from State aid rules where measures are necessary to remedy a systemic crisis.

Assessment of issues arising

12.7 The Group recognises that the management of an annual cap on levies requires a backstop borrowing arrangement. ICCL is of the view that to give appropriate repayment assurances to lenders of funds, where there is unlimited liability and a restricted contributor pool, would require the provision of a State guarantee. Some other members of the Group expressed support for this position and expressed the view that the Investor Compensation Directive itself is deficient in failing to recognise the need for State guarantees to support borrowing by an investor compensation fund, where all other sources of funding are exhausted. They claimed that the situation in Ireland, where only a small number of investment companies are faced with a potentially unlimited liability, clearly demonstrates the difficulty in establishing and maintaining an adequate compensation fund under the existing statutory framework.

ICCL stated that the objective of State guarantees for commercial lending would be to allow the ICCL to extend the burden of funding over the medium term in exceptional circumstances and not to confer commercial advantage. In

this context the ICCL drew attention to the existence of such guarantees in other jurisdictions together with statements contained in the Oxera Report that the existence of government guarantees (or similar arrangements) is likely to enhance the financial viability of compensation schemes and that guarantees may be the only credible means of funding the costs of a large loss event.[6]

ICCL also indicated that the provision of a State guarantee in respect of commercial borrowing would represent temporary assistance only to the ICCL while it made arrangements to top up its funds from its contributor firms. In support of its case ICCL drew attention to arrangements in place under the Deposit Guarantee Scheme.

12.8 The Department of Finance expressed concern that the provision of a State guarantee in respect of commercial borrowing by the ICCL could result in the creation of a significant potential liability for the Exchequer. While acknowledging the view of the ICCL that only interim support would be required, the Department was nonetheless concerned that the creation of last-resort lending facilities would create a significant risk that the Exchequer could, in practice, be required to provide funding for future investor compensation needs contrary to the intention of the EU and domestic legal framework for investor compensation. The Department also pointed out that according to the Oxera report only a few EU countries provide State guarantees/last-resort borrowing facilities for national investor compensation arrangements and that these are intended to cover large-loss events. There is also significant legal uncertainty regarding these arrangements. As far as the national legal position is concerned the Department confirmed that a guarantee may only be issued where there is a specific statutory authority to do so and that the Investor Compensation Act, does not provide statutory authority for a State guarantee.

[6] Description and assessment of the national investor compensation schemes established in accordance with Directive 97/9/EC, January 2005; page 90.

Recommendation 14: The Group considers that the difficulties faced by ICCL in accessing commercial borrowing, including the requirement to clarify the legal position regarding State support for investor compensation, should be brought to the attention of the EU Commission in the context of its work on investor compensation schemes.

(iii) Borrowing from the Deposit Guarantee Scheme or the Central Bank

12.9 The Central Bank consulted with representatives of the banks in relation to the proposal to permit borrowing by the ICCL from the Deposit Guarantee Scheme. These discussions confirmed that there were a number of significant impediments to a borrowing facility being put in place between the Deposit Guarantee Scheme and the Investor Compensation Scheme, including legislative, risk management and operational issues. In addition, to avoid inequitable transfer of the financial burden of compensation to members of the Deposit Guarantee Scheme, provision of any lending from the Deposit Guarantee Scheme would be expected to be at market rates of interest.

12.10 The opinion of the European Central Bank (ECB) would be required on any proposals to link the Deposit Guarantee Scheme to the Investor Compensation Scheme. An assessment carried out by the CBFSAI highlighted the issues that would be likely to inform any such opinion. Under Article 101 of the EC treaty National Central Banks within the European System of Central Banks are prohibited from extending "overdraft facilities or any other type of credit facility in favour of …central governments…other public authorities, other bodies governed by public law, or public undertakings of Member States…." The ECB considers that this prohibition must be strictly interpreted. The CBFSAI indicated that ICCL could be defined either as a "public undertaking" or "a body governed by public law" and as such, any proposal to set up a credit facility between the Deposit Guarantee Scheme and the Investor Compensation Scheme could be considered by the ECB as being ultra vires Article 101 of the Treaty.

12.11 The legal difficulties with the provision of a contingency borrowing facility by the Deposit Guarantee Scheme are likely to apply equally to the option of contingency borrowing from the Central Bank.

12.12 The Group noted that the 2006 Convergence Report published by the ECB[7] stated the following –

> *"National legislation foreseeing the financing by NCB's [National Central Banks] of a public sector national deposit insurance scheme for credit institutions or a national investor compensation scheme for investment firms would not be compatible with the monetary financing prohibition, if it is not short term, it does not address urgent situations, systemic stability aspects are not at stake, and decisions do not remain at the NCB's discretion."*

Recommendation 15: A range of legislative, risk management and operational difficulties would need to be considered further before borrowing from the Deposit Guarantee Scheme or the Central Bank. In view of these difficulties this option is not favoured at this stage.

Recognising that some other jurisdictions have such borrowing arrangements in place the Group agreed that this matter be brought to the attention of the EU Commission in the context of its work on investor compensation and deposit guarantee schemes, in conjunction with those issues referred to in recommendation 14 above.

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[7] European Central Bank Convergence Report, May 2006, "Financial support for Deposit Insurance and Investor Compensation Schemes" p.68.

Medium Term Funding Options

13. Amalgamation of Investor Compensation Scheme and Deposit Guarantee Scheme

13.1 Both the Investor Compensation Scheme and the Deposit Guarantee Scheme have objectives specific to their respective Schemes. Each fund has a clear role and responsibilities in relation to separate and distinct client groups (i.e. depositors on one hand, investors on the other) with clear divergences in the respective risk profile. It would not be appropriate in those circumstances for one group to subsidise the higher risk appetite of the other.

Recommendation 16: The amalgamation of the Investor Compensation Scheme and the Deposit Guarantee Scheme is not recommended.

14. Amalgamation of Fund A and Fund B

14.1 Separate funds were established by the ICCL on the basis of important differences in the risk profile of the two sets of contributor firms. The scale of demands that have been made on the two funds subsequently have borne out that the differentiation made by the ICCL between the two groups of firms is appropriate. The option of inter-fund borrowing is considered to represent an appropriate level of support from one fund to another consistent with the overall objectives of the investor compensation scheme.

14.2 The Professional Insurance Brokers Association (PIBA) believe that the creation of a single consolidated investor fund might give rise to inappropriate cross-subsidisation and have the potential to create inequitable burden sharing in relation to the funding of investor compensation that may arise in the future. PIBA state that under the existing legislation compensation payments in relation to a firm contributing to a particular fund can only be paid out of that particular fund and any proposed amalgamation of Fund A and Fund B would, therefore, require legislation.

Recommendation 17: While this is a matter which should be kept under review by ICCL in consultation with the fund contributors, the amalgamation of the two funds maintained by ICCL is not recommended at this time.

15. New Sources of Funding

15.1 The application of a product levy would broaden the current funding base for the investor compensation fund. Some members of the Group were opposed to a levy citing:

(i) difficulties in the administration, monitoring and enforcement burden of such a levy
(ii) the potential of significant costs and competitiveness effects
(iii) the fact that the levy would also contribute directly to higher costs for consumers of investment products
(iv) the need to ensure consistency with the requirement under the Investor Compensation Directive that the cost of investor compensation schemes must be borne by investment firms.

15.2 Constituencies supportive of the introduction of a levy are of the view that:

- While clients of solvent firms are in effect subsiding clients of insolvent firms, this is necessary because of the limited size and number of firms involved in the Irish financial services market. Every effort should be made to broaden the contribution base to facilitate an adequately funded compensation scheme for the entire market and to mitigate the volatility of the ICCL's funding requirements,

- While it is true that there would be an additional charge on clients, the charges currently paid by industry to the ICCL are ultimately passed on to consumers anyway,

- The levy would be restricted to a low fixed rate per person which would not be unduly burdensome on individual investors,

- Certain industry sectors already have systems in place to collect other charges such as stamp duty and the Irish Takeover Panel levy and would be capable of implementing systems to collect another levy,

- The fact that some sectors are opposed to an additional levy should not mean that other sectors that are in favour of it should not be able to impose

it. Implementation could, subject to competition requirements, be done by industry sector rather than having to be market wide.

15.3 The representative of the IIF on the Group expressed concerns about any development that might have the effect of extending the scope of the current scheme (which is intended to cover retail intermediaries) and which might overlap with the regime applicable to insurers.

15.4 The Consumers Association of Ireland expressed the view that any future calls for the setting of a consumer product levy to help fund the Investor Compensation Scheme must be discussed on the assumption that a full disclosure of all fees, transaction charges, commissions or additions will be required, as well as a refund, in the event of cancellations.

15.5 The Irish Stock Exchange (ISE) believes that it would be appropriate that relevant monies received by the Financial Regulator arising from its financial sanctions regime should be directed to the ICCL compensation funds. The ISE point out that this is a feature of some other European jurisdictions and is appropriate as it means that firms that have been found to be non-compliant and hence posing a greater level of risk contribute more to fund the ICCL while compliant entities benefit. The ISE and certain other Group members were of the view that the Financial Regulator should give further consideration to this issue.

15.6 The exploration of the option of using the existing 2% insurance levy as a possible source of additional funding for investor compensation was favoured by some members of the Group. The Department of Finance advised the Group that the insurance levy is paid into the Central Fund from which monies cannot be earmarked for specific purposes.

Recommendation 18: As no conclusion could be reached on these issues, the introduction of a product levy on relevant transactions and alternative sources of funding are not recommended.

16. Forecasting Funding Requirements - Risk Assessment

16.1 Under section 22 of the Investor Compensation Act, 1998 the ICCL is required, in deciding the contributions to investor compensation funds or the balances of the funds to be maintained, to endeavour to meet any "reasonably foreseeable obligations", having regard *inter alia* to the funding capacity of authorised investment firms. This highlights the importance of forecasting future funding needs.

16.2 Limitations on risk assessment were identified in the report prepared by Oxera consultants for the EU Commission i.e. that the current and past financial position of a scheme may not be a robust indicator of funding adequacy going forward, that sophisticated measurement techniques may be difficult to apply if limited data is available and that costs of measurement may outweigh the benefits to the compensation schemes of having a more precise understanding of their potential loss exposure and funding adequacy.

16.3 According to the Oxera report certain information is required in order to attempt to financially model a scheme's potential exposure e.g. the amount of protected assets held by participating firms, the number of eligible clients and protected balances held by firms on behalf of those clients. However, the report points out that this information is not currently available to schemes. The Financial Regulator has clarified that the information, which it collects for regulatory purposes, is not compatible with that needed by the ICCL in forecasting future failures. Access by ICCL to individual company details is limited by the boundaries that exist in relation to confidentiality in relation to the work of the Financial Regulator.

16.4 Preliminary analysis was carried out by the ICCL of funding requirements that could arise under a number of different hypothetical scenarios for each of the two funds. The ICCL preliminary assessment highlighted that substantial compensation requirements could give rise to lengthy repayment terms for ICCL borrowing as well as having implications for contribution levels.

Recommendation 19: ICCL should continue to carry out assessments of the potential investor compensation funding needs. While it is difficult and complex to estimate the risk of firm failures, there is scope for undertaking further modelling and scenario analysis. Simple stress testing could produce useful results.

17. Insurance

17.1 No other EU Investor Compensation Scheme has opted for investor compensation fund insurance. The ICCL was advised that, in order to secure quotations for such insurance, it would be required to undertake a very detailed risk analysis of the firms covered by the Scheme and an actuarial assessment. The scale of the costs which would be involved and the limits on cover which would be imposed would undermine the economic viability of using insurance to cap the exposure of participants.

Recommendation 20: The Group is satisfied that insurance is not considered to be economically viable and it is not recommended on that basis.

APPENDIX I

Working Group to Examine Legislative and Financial Regulation Aspects

Terms of Reference

In light of the failure of W&R Morrogh Stockbrokers, this Working Group is being set up to examine and make recommendations on:-

1. The changes, if any, required in the regulatory and legislative framework arising from the experience of the W&R Morrogh failure;

2. The scope of section 52(5) of both the Investment Intermediaries Act, 1995 and the Stock Exchange Act, 1995;

3. Reputational or integrity issues that arise in relation to electronically held shares. The means of ensuring statutorily, regardless of the form of shareholding, either in dematerialised/electronic or certificated form, that the associated rights are equal and that the integrity of beneficial ownership is beyond doubt;

4. The funding of costs arising from liquidation and/or receivership of investment firms;

5. The treatment of client assets in situations where investment firms go into liquidation or receivership;

6. The legislative amendments that could be implemented to ensure timely payment/return of assets to clients where investment firms fail;

7. The legal position with regard to client funds being used, in effect, to finance legal cases arising from the need to clarify uncertainties in the interpretation of relevant legislation;

8. The most appropriate way to guarantee receivership costs;

9. Whether statutory defined distribution rules to govern client assets in the event of the default of an investment firm are required;

10. The particular problems that arise where investment firms are "partnerships" and the extent to which legislative amendments could address this;

11. The implications for Trust Law;

12. Any relevant improvements for the Irish environment that could be identified from the systems in place in other countries;

13. Any other matters which the members of the Working Group consider to be relevant.

Working Group to Examine Compensation Funding Aspects

Terms of Reference

This Working Group is being set up to examine the structure of compensation schemes for clients of the financial services industry and make recommendations on:-

1. The impact and sustainability of the existing “unlimited liability” of contributory firms in terms of funding investor compensation;

2. The manner by which receiver/liquidator costs are funded;

3. The legislative amendments that could be implemented to expedite compensation payments to clients;

4. Legislative provisions governing the role of the regulatory authorities with regard to investor compensation schemes;

5. The implications of any funding arrangements in the context of domestic and European law;

6. The structure in place in other countries governing funding, payment and administration of investor compensation;

7. The issue of combining compensation funds;

8. Compensation arrangements for clients of insurance companies and Unit Trusts;

9. Any other matters which the members of the Working Group consider to be relevant.

APPENDIX II

Membership of the Working Group

Consumers' Association of Ireland;

Department of An Taoiseach;

Department of Enterprise, Trade and Employment;

Department of Finance;

Dublin Custodian Group;

Dublin Funds Industry Association;

Investor Compensation Company Ltd;

Irish Association of Investment Managers;

Irish Association of Pension Funds;

Irish Bankers' Federation;

Irish Brokers' Association;

Irish Financial Services Regulatory Authority;

Irish Insurance Federation;

Irish Stock Exchange;

Professional Insurance Brokers' Association;

Representatives of the stock broking firms,

The Funds Group.

APPENDIX III

Follow up on recommendations

No	Recommendation	Follow up
1	Pre-determined rules should be developed for the distribution of client assets in circumstances where a shortfall in client assets arises following the failure of an investment firm.	This issue will be referred to the Financial Legislation Advisory Forum to be established by the Department as part of its forthcoming financial services regulation consolidation and modernisation exercise.
2	The proposed pre-determined rules should have a statutory basis and take account of case law and international developments.	As for recommendation number 1 above.
3	The word "controlled" should be removed from section 52(5) (b) of the Stock Exchange Act, 1995 and section 52(7) of the Investment Intermediaries Act 1995.	Department of Finance.
4	The approach to funding receiver/liquidator costs in section 52(5) of the Stock Exchange Act, 1995 should remain unchanged.	No follow up required.
5	A set of principles should be prepared by the Financial Regulator and the ICCL to guide and inform the certification of claims by the Administrator. The principles should be supported by regulatory and legislative changes as necessary.	Financial Regulator and ICCL to draw up the principles. Any legislative changes required to be prepared by the Department of Finance
6	Following the certification of the majority of the Morrogh claims, ICCL should carry out an analysis of the claims with the objective of: - identifying any efficiencies that could be introduced into the certification process; - assessing the reliability of the information contained in the claim forms; and - informing the preparation of practical guidelines to support certification of compensation claims on a speedier basis.	Analysis of claims to be carried out by ICCL.
7	Details of the claims and their reconciliation with client records should be made available by the Morrogh Administrator to ICCL to facilitate their analysis of claims	ICCL to raise this issue with the Administrator.
8	The Group noted the range of other measure being taken to protect investors and, in particular, welcomed the proposals in relation to dematerialisation which will strengthen investor protection. The Group recommended that work on the dematerialisation of shares be progressed with a view to implementation at the earliest possible date.	No follow up required. The Group noted however that a programme of work to progress dematerialisation is being pursued by the Department of Enterprise, Trade and Employment and the cross-industry Dematerialisation Group

9	The current requirement, whereby industry meets the cost of investor compensation following the failure of a firm should continue. The Group supports ICCL's 'cascade model' as the structured funding framework for investor compensation.	No follow up required.
10	The ICCL should continue to review its target levels of reserves for each compensation fund to ensure that reserves in each fund are adequate to meet what might be regarded as reasonably foreseeable funding requirements for investor compensation.	Reviews to be carried out by ICCL.
11	A cap should be placed on calls which may be made on industry for additional top-up funding in any one year. The Group considers that the cap recommended by the ICCL at twice the annual firm contribution is appropriate. The imposition of a cap cannot be considered in isolation from the issue of borrowing, or the level of annual contribution and the appropriate target level of reserves to underpin the sustainability of the funding structure.	For follow up by ICCL.
12	The existing policy of ICCL in relation to inter-fund borrowing should be continued.	No follow up required.
13	The difficulty in providing repayment assurances to secure commercial borrowing facilities is recognised. It is recommended that the ICCL and the Department of Finance further examine the international experience on the provision of the repayment assurances sought by commercial lenders.	ICCL and Department of Finance.
14	The difficulties posed in accessing commercial borrowing, including the requirement to clarify the legal position regarding State support for investor compensation, should be brought to the attention of the EU Commission in the context of its work on investor compensation schemes.	Department of Finance to raise with EU Commission.
15	A range of legislative, risk management and operational difficulties would need to be considered further before borrowing from the Deposit Guarantee Scheme or the Central Bank. In view of these difficulties this option is not favoured at this stage. Recognising that some other jurisdictions have such borrowing arrangements in place the Group agreed that this matter be brought to the attention of the EU Commission in the context of its work on deposit guarantee schemes, in conjunction with those issues referred to in recommendation 14 above.	Department of Finance to raise with EU Commission.

16	The amalgamation of the investor compensation scheme and the Deposit Guarantee Scheme is not recommended.	No follow up required.
17	While the matter should be kept under review by the ICCL in consultation with the fund contributors, the amalgamation of the two funds maintained by ICCL is not recommended at this time.	No follow up required.
18	As no conclusion could be reached on these issues, the introduction of a product levy on relevant transactions and alternative sources of funding are not recommended.	No follow up required.
19	ICCL should continue to carry out assessments of the potential investor compensation funding needs. While it is difficult and complex to estimate the risk of firm failures, there is scope for undertaking further modelling and scenario analysis. Simple stress testing could produce useful results.	Assessments of funding needs to be carried out by ICCL.
20	The purchase of insurance to cover investment compensation needs is not considered to be economically viable and it is not recommended on that basis.	No follow up required.

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APPENDIX IV:
Interim Report of the Legislative and Financial Regulation Sub-Group

APPENDIX V:
Interim Report of the Compensation Funding Sub-Group

APPENDIX IV

Morrogh Working Group

Interim Report of the Legislative and Financial Regulation Sub-Group

Key Strategic Issues arising from the review of the Legislative and Financial Sub-Group

Difficulties with Receivership

Perhaps the key issue in the Morroghs case has been the length and subsequent cost of the receivership and the drain this has placed upon client assets. While receiverships are necessary and it is to the benefit of clients that their assets are identified and returned in an orderly fashion, it is a legitimate question to consider how receivership costs may be reduced in future cases. Other issues raised by the Morrogh receivership process include the duration of the receivership process and the perception that a liquidator could gain access to client assets. It is important to the maintenance of the reputation of the Irish investment/securities regime that such issues are addressed fully.

The issue of access to client assets is of crucial concern in particular to the custody industry where clients' assets are ring-fenced. It has been generally accepted to date that assets held by the custodian's nominee are unlikely to be available to the creditors of the nominee or its parent company in the event of the insolvency of the custodian. However, if their assets are held in co-mingled accounts a degree of administration will be necessary to re-distribute them. In such cases where the firms assets are insufficient to meet the costs of the receiver, is it not reasonable for the receiver's costs to be met from client assets and in line with established legal principles?

Section 52(5) of the Stock Exchange Act 1995

Section 52(5) of the Stock Exchange Act 1995 provides that receivership costs associated with the distribution of client assets can be claimed against client assets in certain circumstances. This appears to include assets held in a client's custody account. Section 52(5)(b) seems to allow a receiver/liquidator access to client assets held, controlled or paid on behalf of a client by the firm. There seems to be some uncertainty as to the extent of access to client funds controlled by a firm. Does the application of S52(5) need to be clarified?

New Role for ICCL Administrator

It may be worth exploring a possible new role for the Investor Compensation Company Ltd (ICCL) in the receivership process through an expanded role for the administrator appointed under the Investor Compensation Act, 1998. The administrator could review the books and where a claim is considered reasonable, distribute client assets and certify claims for compensation. A separate receiver may also have to be appointed to oversee the receivership generally and the wind-up of the firm. There are, however, potential difficulties associated with this option, including consistency with the winding-up process and the increased costs to the ICCL.

Pre-determined Distribution Rules

One solution to reduce the length and hence cost of future receiverships is to attempt to remove the ambiguity which necessitated the receiver going to Court to seek guidance as to his actions. In this regard, default rules for receivership or pre-determined rules for distribution of client assets could greatly expedite future receiverships.

Would it be practicable to design a detailed set of rules to be fully applicable to all cases? An alternative would be a broad set of high-level principles which may remove the necessity for the receiver to go to court and place the burden of action upon any party dissatisfied with the outcome of the process. While the development of such rules or principles would raise a number of difficulties, and would not preclude an application to the courts to establish their implementation in practice, it is an avenue that still merits further investigation.

Dematerialisation

A secondary approach towards resolving the difficulties faced by the receiver in the Morroghs case, and hence expediting the receivership process, is to ensure that the uncertainties relating to the ownership of client assets, particularly regarding dematerialised holdings, are not encountered in the future. If clients were to receive independent verification of their assets, this would go a long way towards avoiding a situation where the assets in the possession of the firm do not match those that should be held for clients. The delays in the receivership process would have been attenuated if all holdings had been certificated, as there would have been no doubt as to the

ownership. The implication is that a more robust regime governing dematerialised shares is desirable.

The Irish Stock Exchange (ISE) strongly advocates moving towards full dematerialisation. Apart from keeping pace with industry practice around the world, such a move would also provide a reduction in the opportunity to commit fraud. The ISE is pursuing the dematerialisation agenda separately to the work of the Group and is currently concluding a consultation process on the topic.

1. Introduction

W&R Morrogh Stockbrokers ceased trading in April 2001 on the direction of the Central Bank and lengthy legal proceedings followed. The Morrogh case has highlighted certain fundamental issues in relation to the management of the Investment Compensation Scheme and the management of liquidations/receiverships in the event of the failure of a firm. These issues have implications for the investment industry as a whole and clarification of their application is required. On 30th March 2004, the Minister for Finance announced the establishment of a working group to examine the issues arising from the Morrogh case. Membership was drawn from a wide range of Governmental, financial industry, regulatory and consumer protection interests. The Group was chaired by the Department of Finance who also provided the Secretariat. The Group operated through the use of working papers prepared and distributed prior to meetings. Papers discussed by the Group are posted on the Department of Finance's website at www.finance.gov.ie .

While the terms of reference are broad the main issues fell into two groups:

- the purpose of, funding and practical application of the Investment Compensation Fund and
- the basis for and the extent of access of a liquidator to client assets in the event of the collapse of a firm.

Two Working Groups were established; one to look at compensation funding issues and the other at legislative and financial regulation issues. The Funding issues are considered in some detail in the Interim Report on Compensation Funding.

This report assesses the legislative and financial regulation issues that emerged from the collapse of Morroghs. Its detailed terms of reference are at Appendix 2. Four working papers were prepared for the Legislative Working Group. These were as follows:

1. *"Implications for Financial, Regulatory and Legislative Framework" prepared by the Irish Financial Services Regulatory Authority.*
2. *"Custody post Morrogh" prepared by the Dublin Custodian Group*

3. *“Forms of Share ownership – Integrity and Competitiveness issues” prepared by The Irish Stock Exchange.*

4. *“Investment Firms in the form of Partnerships” prepared by the Irish Financial Services Regulatory Authority.*

This Report reviews a range of issues highlighted in the working papers, looks at the questions arising, assesses the implications and suggests some possible conclusions for consideration by the Group.

The issues considered in this Interim Report are:

- Funding Costs of Receivership / Liquidation
- Assets Controlled by an Investment Firm
- Distribution of Client Assets – Repatriation
- Distribution of Client Assets – Compensation
- Insufficient firm or client assets to cover costs of receivership or liquidation
- Capitalisation.
- Custody Issues
- Shares, and
- Partnerships

2. Funding the Costs of Receivership / Liquidation

If a receiver/liquidator is to be appointed it is essential that the costs of the insolvency official are financed. The provisions of Section 52 of both the Stock Exchange Act, 1995 and Investment Intermediary Act, 1998 are intended to facilitate the orderly winding-up of firms and the distribution of client assets in a situation where there are insufficient firm assets. Section 52 provides that the costs of liquidation / receivership associated with the distribution of client assets, the liquidator's / receiver's functions under the Stock Exchange Act and the Investor Compensation Act can be claimed against client assets. This does not extend to covering general receivership / liquidation costs. The approach adopted in the case of investment firms is broadly consistent with that followed for insurance companies and credit institutions.

There are in practice a limited number of funding options for meeting the costs of the insolvency.

Firm and Client Assets: The existing legislation provides that the funding of costs associated with the distribution of client assets, where sufficient firm assets are not available for this purpose, may fall to client assets.

Industry Funding of liquidations would have important implications for the international competitiveness of the financial services sector in Ireland. There is already an element of industry funding of liquidation expenses under the investor compensation scheme.

State Funding: Ireland does not currently operate a system of state funding of receiverships / liquidations. This is a matter which extends to all companies, including those providing financial services. This issue has been examined by the Company Law Review Group which concluded after intensive discussion that it would not recommend the establishment of a State-funded insolvency service in Ireland.

The Regulator: In the Irish context, any funding of insolvency procedures by the Financial Regulator would constitute state and/or industry funding. State funding

(including the financial regulatory authority) of liquidations occurs only in a limited number of EU member states.

The core questions are:

Does the regime in place for the funding of receiver/liquidator costs need to be reviewed?

If so what alternatives would be appropriate?

Assessment

The Irish approach to funding receiver/liquidator costs is set out in S52(5) of the Stock Exchange Act, 1995.

The Irish approach is consistent with the U.K., except that in Ireland the receiver/liquidator only has access to client assets where the firms assets have been depleted (U.K. does not have these restrictions).

Limited alternatives:

- The establishment of a separate fund based on industry levy, which could have a negative impact on competitiveness.
- The regulator pays: in essence this is state or industry funding.
- State funding: only few EU countries provide state funding of liquidators and Company Law Review Group has recommended against.

Possible Conclusion of the Group

There is no realistic alternative to the existing basis to funding receiver/liquidator costs from firm and client assets, although there may be benefit in clarifying how Section 52 of the Stock Exchange Act 1995 should be applied.

3. <u>Client Assets 'Controlled' by an Investment Firm</u>

Section 52 (5) of the Stock Exchange Act explicitly refers to assets "controlled" on behalf of a client by a member firm. This would appear to include assets held in a firm' clients' custody account with a third party custodian, bank accounts subject to the power of attorney and securities held in CREST personal membership accounts. In the context of the winding-up of a firm the question arises as to whether the liquidator / receiver could claim against such assets in respect of costs under Section 52 (5) of the Stock Exchange Act.

It appears that where assets are held in accounts in the name of <u>individual</u> clients such accounts should not fall under the direction of the receiver / liquidator, although there are circumstances where this may be subject to legal challenge. This question did not arise in the Morrogh's case and was not considered by the High Court. Previously [Smith/MMI case] the courts had safeguarded this type of account against the interest of a liquidator. The Financial Regulator's client money rules states that where a firm exercises control over an account in a client's name the arrangements in place should return control to the client should an insolvency occur.

The question which arises is whether in view of the Smith/MMI case the legislation is sufficiently clear on this issue. It is also questionable if in those circumstances it is equitable that all of the costs of the distribution of client assets should be carried by clients whose assets are 'held' by the investment firm rather than 'controlled' by it, given that the work of the receiver / liquidator may also benefit the latter.

Consideration is required as to whether Section 52 (5)

- **should be clarified to the effect that assets controlled by the firm should not come under the control of a receiver / liquidator and/or**
- **should be amended to narrow the range of client assets against which a receiver / liquidator can have recourse in respect of certain costs**

Assessment

S52(5) seems to encompass client assets "controlled" by the firm.

Precedent in the High Court (Smith/MMI case) suggests that where assets are held in accounts in the name of individual clients they should be returned to the client by the receiver/liquidator. Furthermore Financial Regulator rules (2004) provide where the firm exercises 'control' in a clients name that control should return to the client on the occurrence of insolvency.

Costs would be associated with distribution of client assets controlled by a firm back to the client. Is it equitable that these costs should be borne only by clients whose assets are held by firms? Given that clients benefit from transfer back of control, should they not bear some of the cost of assessment and distribution?

Possible Conclusion of the Group:

The Group concludes that there would be merit in the further review of S52(5)(b), and in particular its application to client assets 'controlled' by the firm.

4. Distribution of Client Assets – Repatriation rules?

In the Morrogh's case the decision by the receiver to seek High Court directions as to the appropriate methodology for the distribution of client assets has been one of the factors that caused the delay in the process. The need to obtain direction from the Courts was a direct result of the shortfall in overall client assets and the High Court considered the various options for the distribution as argued by the representative parties for various client groups. It has been argued that if predetermined legally binding distribution rules (default rules) had existed, no application to court would have been necessary. In such circumstances the lengthy delay in distributing client assets could conceivably been avoided and costs could have been substantially reduced.

The question arises as to whether it would be practical and legally sustainable to put default rules in place. Certainly it would be difficult to construct client distribution rules which would apply generally when the circumstances of company failures vary substantially. The High Court decision in the Morrogh case was specific to the circumstances of that case.

Default rules would require a high level of detail and significant challenges would be expected to arise in designing rules that would be fair to all clients. An approach to put in place legally binding rules in the interest of clients in general, but which disadvantaged certain clients, could be subject to legal / constitutional challenge. A broad system of high-level principles is likely to result in application to the courts to establish their implementation in practice.

To the extent that such rules apply in other EU jurisdictions they are based on pro-rata distribution. Such an approach could generate such difficulties as uneconomic holdings - where the value of holding is significantly reduced if not eliminated by distribution costs. How would the rules apply in such circumstances or to unclaimed holdings?

Even if it were possible to develop and impose default rules a number of important implementation issues arise. It could be attempted to introduce these rules on the

basis that they are not open to review but it is difficult to see how a system of default rules could be established in the absence of appeal rights. In any event, it would appear that legislation would be necessary to protect liquidators/receivers from being sued where default rules were applied.

The questions which need to be addressed are:

Can predetermined distribution rules be introduced which would negate the need for applications to Court regarding the methods of distribution?

Could rules be developed which are detailed enough to cover the circumstances which are likely to arise in a liquidation/receivership where there is a shortfall in client assets?

Would there be any benefit in introducing such rules?

Assessment

- There would be problems which would limit any benefit from such rules.
- To avoid the necessity to go to Court, detailed rules, not principles, would be necessary.
- While detailed rules may serve the greater good, they may not be equitable in application and certain classes of clients may be disadvantaged.
- Rules based on pro-rata distribution could raise cost/benefit issues where the cost of the distribution could exceed the value of the stock.
- Most likely the rules would be subject to appeal to the Courts.
- Predetermined distribution (default) rules are possible. U.K. has distribution rules for client money, not for investment instruments, but their application does not preclude a court appeal.

<u>Possible Conclusions of the Group:</u>

There would undoubtedly be problems in designing and implementing a comprehensive set of distribution rules. However there are potential benefits in

distribution rules in that they provide some certainty and could reduce the costs of a liquidation/receivership. There is a case for more work on the possibility of framing limited predetermined distribution rules for specified circumstances

5. Distribution of Client Assets – Compensation

Where client assets cannot be returned the Financial Services Regulator can appoint an Administrator under the Investor Compensation Act. Where the firm is in liquidation or receivership the Administrator is likely, for practical reasons, to also act in the role of liquidator/receiver. When considering the issue of the speed of compensation payments, the question as to whether a separate Administrator would facilitate speedier payment arises.

If the Administrator is required to certify the accuracy of compensation claims there a full reconciliation of the books and records would be required. A requirement for speed in payment would appear to suggest a lesser standard of accuracy resulting in possible under or overpayment. Complete accuracy could not be achieved until such time as the liquidator/receiver confirmed accuracy and while supplemental payments could be made in the case of underpayments the retrieval of overpayments would prove more problematical.

If a separate Administrator was to be appointed to facilitate speedier payment the exact role of the Administrator would need to be changed to so that he/she could confirm that on the face of things the claimant appears to have been a client of the failed firm and that the claim is not unreasonable. However, even this lesser level of certification would require access to the books and records.

The questions to be addressed are:

Should the administrator for the purposes of the Investor Compensation Act, 1998 be independent of any receiver/liquidator?
and

What standard of confirmation should be required before claims for compensation are certified for payment?

Assessment

A separate administrator role could speed up the payment of compensation only if the role of administrator under the ICA Act were changed to confirm that the claimant appears to be a client of the firm and the claim is not unreasonable (This happens in the U.K. with a resultant claim made in the liquidation for compensation paid out).

But:

- Once liquidator clarifies issues, there may have to be corrective payments/re-payments.
- If the administrator is required to certify the accuracy of the books, there is little option but to reconcile the books.

Where administrator is the same as liquidator/receiver it avoids duplication in reconciling the books and avoids reconciling the conclusions of two different reviews of the books.

Possible Conclusions of the Group:

There could be real advantages in the appointment of an administrator to manage speedier payments to clients although this would require legislation and there are a number of issues to be resolved as to the role of the administrator vis-à-vis that of the liquidator/receiver. The Group considers that this option should be pursued further.

6. Insufficient firm or client assets to cover costs of receivership or liquidation

The Group considered arrangements that potentially could be put in place to provide for the return of client assets where there may be insufficient assets to cover statutory receivership / liquidation functions or to cover the possible costs that might be incurred with their distribution

An expanded role for the administrator appointed under the Investor Compensation Act, 1998 could address this issue where in the absence of a receiver/liquidator the administrator would confirm the accuracy of the books, distribute client assets and certify claims for compensation.

An obvious difficulty with this proposal is how to establish if there are sufficient assets to wind-up the firm. This approach also generates a possible inequity as where there are sufficient client / firm assets to allow a receiver / liquidator to be appointed the costs may be borne from client assets while in circumstances that these assets are insufficient the costs are borne by the ICCL (and by extension by the industry generally).

The consistency of this approach with other sectors of the financial services industry (i.e. credit institutions, insurance companies) would also require examination. An issue of equity also arises vis-à-vis the payment of other creditors as the non-appointment of a liquidator / receiver would result in failure to ensure an orderly winding up of the relevant firm.

Would an appointment of an administrator under the ICA Act, 1998 resolve a situation where there are insufficient assets to cover costs of a receiver/liquidator?

Assessment

There would be a number of problems with this proposal:

- Administrator would also have to seek Court direction if there is a shortfall in client assets.
- Potentially inequitable to charge to client assets in some cases and cover by ICCL in others.
- Unfair to resolve the client portion through administrator but not provide for orderly winding up of the company.

Possible Group Conclusion:

The Group does not see any merit in pursuing this option further.

7. Capitalisation

Investment firms are required to comply with capital requirements under the Capital Adequacy Directive (CAD) to cover certain exposure risks. They are not required to cover fraud risks which would be extremely difficult to quantify.

The issue of additional capital requirements could be considered in two contexts - higher ongoing requirements so that a firm would be in a better position to deal with possible misappropriations and additional requirements to cover the cost of a potential winding up. The CAD allows for the establishment of stricter rules than those provided for in the Directive itself. If additional capital requirements were to be imposed a number of factors need to be considered –

- the additional costs that would arise to existing firms
- any competitive issues that might arise for the smaller independents
- the potential for high capitalisation requirements to act as a barrier to entry
- the need for additional capital to be readily realisable and non-diminishing.

Relevant questions are:

Should additional capital requirements be imposed on investment firms in addition to those in the CAD?
What should be the level of any such additional requirements and how should additional capital be held?

Assessment
Additional capital requirements could ensure that firms are in a better position to deal with any possible misappropriation of funds and to cover the cost of a potential rounding up.

But:
Capital requirements additional to CAD Directives.

- Will be an additional cost to firms
- Could be a barrier to entry

- Would likely be opposed by industry, and
- Would disadvantage smaller firms, giving rise to competition issues.

Furthermore, additional capital would have to be held in realisable cash or bonds and protected from diminution in value.

<u>Possible conclusions of the Group:</u>

The Group does not see any merit in pursuing this option further.

8. Custody post Morrogh

Custody agreements provide that the assets of a client must be kept at all times separate from the assets of the custodian. The custodian will usually register the assets of its clients in a nominee company name under its control. It has been generally accepted that assets held by the nominee company are unlikely to be available to the creditors of the custodian in the event of custodian insolvency.

Prior to the Morrogh judgment custodians have been able to assure clients that their assets are ring-fenced. The key issue for custodians arising from the Morrogh judgment is the perception that a cornerstone of the provisions of custodial services has been undermined in that segregation of assets via nominee, supported by detailed record keeping, may not safeguard the assets and entitlements of a particular client.

Other custody issues

- Certain institutions may be registering client's assets in a nominee name under their control, but do not provide custody services as their core business product
- custody contracts are not entered into with clients for safe-keeping functions and firms are not regulated for provision of custody services.
- the appointment of a custodian in the case of certain products may not be apparent to the customer. The provision of custody services to these products needs to be regulated.

The Custody paper also raises a number of specific issues and suggests best practice for Custodians and outlines operating standards for Custodians

Possible conclusions for the Group:

The Group accepts that the implications for custody agreements need to be taken account of in any review of Section 52(5) of the Stock Exchange Act, 1995. However issues of best practice and operating practices and general regulation for Custodians are beyond the scope of this Review.

9. Forms of Share Ownership

Forms of Share Ownership in Ireland

1) Nominee Company or Account: When client assets are held in a nominee account or company, whether by a custodian or otherwise, the beneficial owner of the assets is the client but the legal ownership is in the name of the nominee company or account, as the shares are registered in the name of the nominee on the share register. The Financial Regulator's Client Money Rules require client assets to be segregated from assets of the firm, but it is possible to pool individual client assets with the assets of other clients.

2) Certificated Shares: The shareholder receives a physical certificate and is both the legal and beneficial owner of the shares, which are registered in their name in the share register.

3) Shares Held in CREST: An investor enters an agreement with a sponsor who is a CREST participant and the sponsor has operational control of the client's account. In this form of holding, the client is both the legal and beneficial owner of the shares, as the shares are registered in their name in the share register. CREST also offers Personal Membership accounts where shareholders may hold their shares electronically in their own name.

The main difference in the integrity of client shares in the above categories is that in the case of certificated shares, a third-party market participant does not have access to the investor's holdings, placing certificated shares at less risk of fraud. The judgment in the Morroghs' case found that the beneficial owners of electronically held stock are to be treated in the same manner as the holders of certificated stock.

It has taken up to four years after the default for clients whose shares were held in a Morrogh Nominees Account to receive their holdings, while certificated shareholders received their holdings earlier in the receivership process. This was largely due to the absence of appropriate provisions for default. Furthermore, in the case where there is a deficiency in the number of shares held by the nominee company, the Receiver was mandated to sell the shares and distribute the proceeds on a pro-rata basis. The UK

market has more defined default procedures, which mean that lack of clarity regarding the procedures to be used in a default does not apply to the same extent in the UK.

The main thrust of forward looking policy in the EU and US is a preference towards complete dematerialisation with the eventual removal of the option to obtain physical certificates. Notably, in recommending this, CESR and the ECB also state “a customer’s securities must be immune from claims made by third party creditors of its custodians.” The Irish Stock Exchange (ISE) recommends a move towards full dematerialisation but notes this will be contingent upon addressing the legislative deficiencies surrounding share ownership in Ireland. Apart from keeping pace with industry practice around the world, such a move could also provide a reduction in the opportunity to commit fraud. The ISE is pursuing the dematerialisation agenda separately to the work of the Group and is currently concluding a consultation process on the topic.

The ISE considers it inequitable that the clients of the firm, already victims of a fraud, have to bear further costs related to the development of case law on default due to the absence of sufficiently clear statutory or quasi-statutory, provisions. The presence of a clear and efficient legislative basis for shareholding and the implementation of timely and effective mechanisms for handling default situations is a pre-requisite for any well developed capital market. Legal uncertainties and the accompanying reputational damage could act as a disincentive to participation in the market.

Possible Conclusions of the Group:

The Group welcomes the move towards dematerialized shares and considers that such a development will reduce the potential for fraud and provide more clarity as to ownership of client assets in the event of a company failure. As previously noted, the Group supports the view that the potential for development of predetermined default rules should be explored further.

10. Investment Firms in the Form of Partnership

Under the current legislative framework, investment firms can be constituted as partnerships but there are currently a very limited number of firms constituted as partnerships which are authorised as investment firms. These are firms that were operating prior to the enactment of the Stock Exchange Act, 1995 or the Investment Intermediaries Act, 1995. The preference of applicants for authorisation to establish as limited companies reflects the both the taxation regime and the limitation of liability.

While there is a substantial appendices of company law governing the liquidation of limited companies, the same cannot be said in relation to the winding-up of a partnership. The rights and duties of a liquidator in the case of the liquidation of an investment firm constituted as a partnership are not as well specified as in relation to limited companies.

Questions/Assessment:

The following issues arise:

- Should a receiver of a partnership have the same powers as a liquidator under company law to the extent that such powers are relevant to partnerships?

- In the context of ongoing supervision, should there be a facility in the legal and regulatory framework for partnerships in relation to independent oversight?

- Should disqualification provisions analogous to those existing under company law be available in respect of partners of failed partnerships?

Possible conclusions of the Group:

The issues raised here relate to company law and as such were considered by the Group to be outside their remit.

Appendix 1 - Membership of Working Group

Representatives of the following organisations participated in the Working Group

Department of Finance.
IFSRA (Prudential Supervision and Consumer Director)
Department of Enterprise, Trade & Employment.
Department of the Taoiseach.
Investor Compensation Company Limited [ICCL]
Irish Stock Exchange.
The Funds Group.
Irish Association of Investment Managers.
Consumers Association of Ireland
Irish Bankers Federation
Irish Association of Pension Funds
The Dublin Funds Industry Association
The Dublin Custodian Group
Professional Insurance Brokers' Association
Irish Brokers' Association
Representatives of the Stock broking firms.

Terms of Reference **Appendix 2**

The Legislative and Financial Regulation Working Group was set up to address the following issues –

1. The changes, if any, required in the regulatory and legislative framework arising from the experience of the W&R Morrogh failure;

2. The scope of Section 52(5) of both the Investment Intermediaries Act, 1995 and the Stock Exchange Act, 1995;

3. Reputational or integrity issues that arise in relation to electronically held shares. The means of ensuring statutorily, regardless of the form of shareholding, either in dematerialised/electronic or certificated form, that the associated rights are equal and that the integrity of beneficial ownership is beyond doubt;

4. The funding of costs arising from liquidation and/or receivership of investment firms;

5. The treatment of client assets in situations where investment firms go into liquidation or receivership;

6. The legislative amendments that could be implemented to ensure timely payment/return of assets to clients where investment firms fail;

7. The legal position with regard to client funds being used, in effect, to finance legal cases arising from the need to clarify uncertainties in the interpretation of relevant legislation;

8. The most appropriate way to guarantee receivership costs;

9. Whether statutory defined distribution rules to govern client assets in the event of the default of an investment firm are required;

10. The particular problems that arise where investment firms are "partnerships" and the extent to which legislative amendments could address this;

11. The implications for Trust Law;

12. Any relevant improvements for the Irish environment that could be identified from the systems in place in other countries;

13. Any other matters which the members of the Working Group consider to be relevant.

APPENDIX V

Morrogh Working Group

Interim Report of the Compensation Funding Sub-Group

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1. Introduction

W&R Morroghs Stockbrokers ceased trading in April 2001 on the direction of the Central Bank. Lengthy legal proceedings followed and on 30th March 2004, the Minister for Finance announced the establishment of working groups to examine the issues arising.

Two Working Groups were established; one to look at legislative and financial regulation issues and the other at compensation funding issues. Membership was drawn from a wide range of Governmental, financial industry, regulatory and consumer protection interests. The Groups consulted with the Morrogh's Investors Action Group, the receiver in the W&R Morrogh (in receivership) case and the Liquidator in the Money Markets International Stockbrokers (in liquidation) Limited (MMISL) case.

This report summarises the deliberations at the meetings of the Working Group established to examine Compensation Funding. The report includes an update of some factual information which became available subsequent to the conclusion of deliberations.

Outline of the Group's conclusions

Having examined the issues regarding funding of the Investor Compensation Scheme raised by the collapse of W&R Morrogh Stockbrokers, the main conclusions of the Working Group were that the preferred option would be to allow a reserve of funds to build up over time and that a combination of the options it considered, employing a 'cascade effect' would be the most suitable model going forward.

The 'cascade' represents a prioritised approach to be taken by ICCL, depending on the seriousness of a collapse, to access funds for the purposes of making compensation payments. The Group ranked the sources of funding available to ICCL starting with the preferred option of allowing reserves to build up. Each subsequent source of funding would be accessed when the potential for the use of preceding sources had been exhausted.

2. Terms of Reference and Methodology

The Compensation Funding Group was set up to address the following terms of reference -

1. The impact and sustainability of the existing "unlimited liability" of contributory firms in terms of funding investor compensation;
2. The manner by which receiver/liquidator costs are funded; *(it was subsequently decided that this issue would be considered by the Working Group established to look and the Legislative and Regulatory aspects)*
3. The legislative amendments that could be implemented to expedite compensation payments to clients; *(it was subsequently decided that this issue would be considered by the Working Group established to look and the Legislative and Regulatory aspects)*
4. Legislative provisions governing the role of the regulatory authorities with regard to investor compensation schemes;
5. The implications of any funding arrangements in the context of domestic and European law;
6. The structure in place in other countries governing funding, payment and administration of investor compensation;
7. The issue of combining compensation funds;
8. Compensation arrangements for clients of insurance companies and Unit Trusts;
9. Any other matters which the members of the Group considered to be relevant.

The Morrogh's experience demonstrated the requirement for a capacity to swiftly put in place funding to meet the legislative requirements of the Compensation Scheme, insofar as it is not possible to predict the potential for a future collapse. The Compensation Funding Working Group decided to focus on an examination of the funding options that might be made available to ICCL to cope with a future collapse, to consider the advantages, disadvantages and obstacles that might attach to each of those options and to outline an approach to ensuring the long-term sustainability of the Scheme. This would allow ICCL to operate its statutory mandate to fund investor compensation in the most strategic and effective manner and to ensure that adequate funds would be available to provide for claims that may arise in the future.

Methodology

The Group was chaired by the Department of Finance who also provided the Secretariat. The Group operated through the use of working papers prepared and distributed prior to meetings. Papers adopted by the Group are posted on the Department of Finance's website at www.finance.gov.ie.

3. The Investor Compensation Scheme

European Investor Compensation Schemes, including that in Ireland, are based on EU Council Directive 97/9/EC adopted by the European Council in March 1997. Known as the Investor Compensation Scheme Directive the Directive is seen as an integral part of the framework for the establishment of a single market in financial services. The Directive applies to all investment firms (including Credit Institutions authorised to provide investment services).

Directive 97/9/EC (the Directive) was given effect in Ireland through the Investor Compensation Act, 1998 (the Act). The Act established the Investor Compensation Company Ltd; (ICCL) as a company limited by guarantee, on 1st August, 1998.

The principal objective of the ICCL is to establish and operate a statutory investor compensation scheme. The ICCL is not involved in the regulation or supervision of investment firms. This role falls to the Irish Financial Services Regulatory Authority (the Financial Regulator). The Act provides that authorised investment firms and insurance intermediaries must become members of an investor compensation scheme and contribute to its funding.

The Directors of ICCL are nominated by the Minister for Finance or bodies representing the financial services industry or the interests of clients of investment firms. The nominating bodies are prescribed by the Minister for Finance while the Governor of the Central Bank and Financial Services Authority of Ireland (CBFSAI) nominates and appoints the Chairperson and the Deputy Chairperson of the Board. Further details in relation to the Directors and members of the Board of ICCL can be viewed on the company's website at www.investorcompensation.ie.

Compensation Funds

ICCL maintains two compensation funds- Fund A and Fund B.

Fund A was established to meet claims from eligible clients of investment firms authorised under Section 10 of the Investment Intermediaries Act 1995 (that are not exempt under Section 2(5) of Investor Compensation Act 1998), Stockbrokers authorised under the Stock Exchange Act 1995, Credit Institutions that provide investment services and certain certified persons who provide investment business services other than those provided by Multi Agency Intermediaries or Authorised Advisors (e.g. accountants providing investment services in a manner which is not incidental to their main professional activities). At the end of the ICCL reporting year in July 2005 there were 228 contributors to Fund A.

Fund B was established to meet the claims of eligible clients of firms defined in Section 36 of the Act as insurance intermediaries. These include Multi Agency Intermediaries authorised under the Investment Intermediaries Act 1995, Authorised Advisors authorised under the Investment Intermediaries Act 1995, Tied Insurance Agents, Credit Unions authorised under the Investment Intermediaries Act 1995 in relation to their insurance activities and certain certified persons who provide investment business services other than those provided by Multi Agency Intermediaries or Authorised Advisors (e.g. accountants providing investment services in a manner which is incidental to their main professional activities). At the end of the ICCL reporting year in July 2005 there were 3,030 contributors to Fund B.

Following a consultation process in early 1999 with relevant bodies in the financial services sector and various investment firms ICCL established an overall target funding level of €10.16 million, divided equally between Fund A and Fund B, to be achieved by the end of a five year period. Annual contributions to Fund A consist of a combination of a flat and variable rate contributions based upon the number of eligible clients. Annual contributions to Fund B are based on income bands depending upon the type of business undertaken. Provision was also made for additional “top up” funding in the event that claims on either fund required it. It was anticipated that over time the funding arrangements put in place would have built up sufficient reserves to facilitate the Compensation Scheme in paying compensation arising from a collapse.

Claims against the Funds to date

Since the establishment of the Scheme there have been two determinations made under the Act resulting in claims for compensation from Fund A. The first claim, in February 1999, arose out of the insolvency of Money Markets International Stockbrokers Limited and involved compensation to the end of July 2005 of €752,294. Total payments in this case could ultimately be as high as €800,000. The costs and expenses of the Administrator associated with this case are estimated to be in excess of €300,000 and are payable by the ICCL. The second claim on Fund A arose out of the insolvency of W&R Morrogh Stockbrokers and is as yet not fully resolved. In its financial statements to 31 July 2005, the ICCL has made provision for compensation payments of €10.3 million, of which €3.278 million had already been paid out. A large balance of the provision is to cover the estimated €5.5 million of costs, fees and expenses of the receivership, which the High Court ruled are to be borne by client assets on a pro rata basis. As a result of the collapse of Morrogh's the long-term sustainability of the Fund was called into question.

Only one determination has been made requiring payment from Fund B. This related to the case of Andrew Casey (Life & Pensions) in October 1999 which required a payment of €20,000. In accordance with Section 36 of the Act, €15,200 was reimbursed by one of the product producers with which Andrew Casey held a written appointment.

Top-Up Funding

In the light of the substantial claim arising from the insolvency of W&R Morrogh, the Board of ICCL implemented a scheme for "top up" funding for Fund A to ensure that sufficient funds would be available to pay compensation to claimants in accordance with the Act. Fund A firms with eligible clients were required to contribute circa. €5 million to the Morrogh top-up, with stockbrokers contributing 50 per cent of the requirement and the other Fund A firms contributing the balance. The ICCL decided that the "top up" payments would be phased over three years. Thus, in addition to the normal annual contributions, additional "top up" contributions to Fund A were invoiced in 2002, 2003 and 2004.

Fund A has a relatively small contributor base which amounted to just 228 bodies at the end of 2005. The investment services industry therefore expressed its concerns in relation to the potential for its 'unlimited liability' to the Scheme in the event of major collapses.

4. Funding Issues and Options Considered

The recent claims history experienced by the Scheme has demonstrated that funds can be quickly absorbed when claims and associated costs arise. In this context the ICCL Consultation Paper of August 2003 identified a number of important issues for consideration. These include the manner in which the compensation scheme is funded, the merging of Fund A and Fund B, the level of funding considered necessary in the light of claims experience to date, the possibility of capping the level of annual contributions, the use of a risk weighting in setting annual contributions, the possibility of using borrowing facilities and the possibility of access to the Deposit Guarantee Scheme. ICCL also noted suggestions that the Scheme could be funded by levies on products, contracts or transactions.

The ICCL advised the Group that its view was that the continued payment of annual contributions is the best way of building up the levels of funds available and proposed that, in the event of a determination or ruling, claims would initially be handled through payments out of Fund A or Fund B, as appropriate. In the event that inter-fund borrowing is required, the Board of ICCL has decided that 'no margin' rates should apply and, as a guideline, borrowing should be up to a maximum of one third of the Funds in total, with a repayment schedule of not more than three years. The ICCL must consult with IFSRA regarding any inter-fund borrowing. In addition, utilisation may also be made of borrowing facilities arranged under the ICCL's statutory borrowing powers. As prescribed by Section 13 (1) of the Act, the IFSRA must approve any borrowing.

Contributors have expressed a wish to the ICCL that the Scheme's ability to meet its payment obligations be funded mainly by annual contributions, supplemented as appropriate by borrowings and that the liability burden be smoothed over time. Contributors also expressed a wish to avoid open ended special top-up levies in the

event of significant claims arising. The ICCL supports the introduction of a cap on the amount that may be raised in any one year in the event of a top-up call on Fund A contributors. The ultimate liability to repay the borrowing would still rest with the ICCL contributors. However, the introduction of such a cap is contingent on the scheme's capacity to fund compensation payments by the putting in place of last resort funding arrangements.

The Group examined a number of issues, identified by the Board of ICCL and decided to focus its work on assessing the additional financial measures that might be taken to allow ICCL to operate its statutory mandate in the most strategic and effective manner and to ensure that adequate funds would be available to provide for compensation claims that may arise in the future.

The Group decided that there were a number of funding options which, if implemented on their own or on a consolidated basis, would provide the best opportunities for funding the Investor Compensation Scheme as follows -

- Inter-Fund Borrowing;
- Access to the Deposit Protection Scheme (DPS);
- Commercial Borrowing;
- Access to a contingency borrowing facility;
- Direct/Indirect State involvement in burden-sharing;

The following options were also considered -

- Amalgamation of Fund A and Fund B;
- Product Levy on consumers of investment products;
- Restructuring;
- Risk assessment;
- Other financial services compensation schemes;
- A combination of a number of the above options.

In examining these options, the Working Group attempted to assess the advantages and disadvantages of each proposal.

Inter-Fund Borrowing

This option has the benefits of dealing with the short-term liquidity pressures currently faced by Fund A, as Fund B is liquid and has a much wider contributor base. No additional contribution levies for Funds A or B would be required in the short-term. As only one relatively small claim has been made against Fund B the capacity to lend is real. This option is less expensive than commercial borrowing. There is no State involvement in burden-sharing. Security for loans is not an issue. There is no need for legislation as Section 19 of the Investor Compensation Act, 1998 allows ICCL to determine the rate of interest to be charged. A zero rate could be struck.

The Group took the view that, in isolation, the option of inter-fund borrowing may not represent a realistic long-term solution to the issue of sustainability and that while there would be limited burden sharing, such sharing would not be of any real significance. In addition, there would be limited advantage if anything greater that a zero rate of interest were to be charged by the lending Fund. Inter-fund borrowing also reduces the capacity of the lending Fund to deal with any future failures in its own sector and carries limitations in the event of simultaneous hits on both Funds.

Access to the Deposit Protection Scheme

The advantages to allowing a borrowing facility from the Deposit Protection Scheme (DPS) include the liquidity of that scheme which has a much stronger contributor base. The DPS has no claims history and in the short term there would be direct burden-sharing among the financial services industry as a whole. Access to the Scheme could help to smooth out risk impact over time and, cross subsidisation, in the form of favourable interest rates, could, apart from the option of inter-fund borrowing, contribute to the achievement of sustainability of Funds A and B more quickly than any other option.

The Central Bank and Financial Services Authority of Ireland (CBFSAI) has no objection, in principle, to allowing access to the DPS subject to:

- an analysis of the impact on the DPS;
- appropriate arrangements being made with the banks concerned;
- suitable limits being placed on the level of access;
- adequate security being available to the DPS;

- consistency with the CBFSAI's legislative mandate regarding financial stability;
- EU prohibition on central bank lending to public authorities not being an issue.

The CBFSAI also expressed the view that the banks concerned would need to be consulted to seek their agreement on the option and that unanimity is a pre-requisite.

The Irish Bankers' Federation, whose members' deposits the proposal relates to agrees in principle but indicated that it could not fully endorse the proposal without:

- A detailed scenario analysis as to the likely future funding requirements of the Investor Compensation Scheme;
- Clarity being obtained that the proposal is legally feasible;
- The Deposit Protection Scheme being compensated for any risks assumed.

The Group noted that several EU schemes operate joint Investor and Deposit Compensation Schemes and that allowing access to the DPS would mean that there would be no direct state involvement in burden sharing. It may be necessary to place a monetary amount on the degree of access to be allowed to the DPS.

Having considered the views of the CBFSAI and the Irish Bankers' Federation the Group noted that a number of issues remain to be resolved. For example, if less than commercial interest rates were applied, the financial burden may be transferred inequitably to future contributors to the DPS. There may also be implications for repayment of advances from the DPS in the event of future claims against the Investor Compensation Scheme. The ICCL made it clear that the only security which it can offer is the future income streams from its contributors. As this proposal could potentially reduce the capacity of the DPS to deal with a possible future failure in the banking sector, its participants may feel the need to assess the level and quality of security available.

<u>Commercial Borrowing</u>

The ICCL expressed the view that the option of commercial borrowing should be explored only when the options of inter-fund borrowing and borrowing from the DPS have been exhausted.

Borrowing from commercial sources would deal with the potential short-term liquidity pressures on the fund. There would be no Exchequer involvement in burden-sharing and no need for new or amending legislation. The Group noted that the application of commercial rates of interest could impair the sustainability of the borrowing Fund. Commercial lenders are also likely to seek adequate security possibly based on the future flow of income to ICCL and its statutory 'right to levy'.

Access to a Central Bank Contingency Borrowing Facility

The CBFSAI indicated that it has no objection in principle to lending to ICCL but the provision of such a facility would be subject to satisfactory resolution of issues related to consistency with the CBFSAI's legislative mandate and EU prohibition on central bank lending to public authorities not being an issue.

Difficulties associated with central bank lending to public bodies need to be examined further as the exact status of ICCL in this regard is not clear. The Group took the view that legal advice should be sought to determine whether or not ICCL falls within the definition of a 'public body'. It is possible that legislation would be required which would have to be referred to the European Central Bank for consideration.

Direct/Indirect State Involvement

The Group considered the issue of direct or indirect State involvement. A number of options for State involvement were discussed, the net effect of which would be to commit the State to either making a once off subvention to the Scheme or to provide on-going financial support for the Scheme, allowing time for the investment services industry to reimburse the State. Specific options discussed included a once-off injection of seed capital, an open-ended contingency provision to sustain any future claims on the Scheme, funding of winding up costs or legal cost associated with winding up of entities, the provision of a State guarantee or the State acting as a lender of last resort. Funding difficulties would be ameliorated to the degree that State assistance would underpin the financial requirements of the Investor Compensation Scheme.

The Group noted the view expressed by the Department of Finance and the ICCL that in accordance with the Investor Compensation Directive the issue of funding of

investor compensation is primarily a matter for the investment services industry. The Department is of the view that the involvement of the State could potentially erode investment services market discipline and lead to conditions of moral hazard, whereby the presumption of state intervention might lead to inappropriate risk-taking. The Group noted that the State had, on occasion, intervened in other EU countries but accepted the view that any proposal for State involvement would be subject to EU State Aid rules.

5. Other Options Considered

Amalgamation of Fund A and Fund B

The Group noted that there are a number of advantages to this course of action. Only one relatively small claim has been made against Fund B which is liquid and has a much wider contributor base. The wider contributor base implies that additional contribution levies would be less burdensome on individual contributors. In addition, amalgamation would entail burden-sharing among the investment services industry only rather than the financial services industry as a whole. There is no Exchequer involvement in burden-sharing and the provision of security would not be an issue.

However, reserves that have been built up must be used solely to pay certified claim to clients of a class or category of investment firm that have contributed to that reserve in the first instance. Therefore the Investor Compensation Act would require amendment for this proposal to be implemented.

The Financial Regulator and the ICCL have no objection in principle to this option but arising from its 2003 consultation process, the ICCL highlighted that contributors were opposed to this option at this point in time, particularly given the current disparity in reserve levels between Fund A and Fund B. The contributors to Fund B are opposed to the suggestion on the basis that it implies cross-subsidisation and an unacceptable level of burden-sharing for them.

Product Levy on Consumers of Investment Products

The Group discussed the potential for a product levy to cover retail focused products, to be paid at point of transaction by the client and similar approaches for other

relevant transactions and products across the financial services market. It noted that such a levy would have the advantage of broadening the current funding base of ICCL and that a relatively low impact at an individual transaction level could still raise a material aggregate contribution to funding. The introduction of a permanent levy would reduce the burden on the investment services industry in the event of a future collapse and would mitigate the volatility of the ICCL's funding requirements. Structural options as whether a levy might be imposed on purchases only or on both purchases and sales or the introduction of a minimum transaction amount below which there would be no charge were discussed.

The key principle would be to raise a charge on the ultimate beneficiaries of compensation arrangements. No cost would accrue to the Exchequer, while implementation could be effected by the investment sector rather than the financial services market as a whole.

It was noted that precedents for levies already exist in Ireland examples of which include the general insurance industry levy of up to 2% on policy holders, and the Irish Takeover Panel levy, which is a fixed amount of €1.25 on transactions (on both purchases or sales) in Irish securities where the consideration is over €12,500. The view was expressed that while EU Directive 97/9/EC envisages the cost of investor compensation schemes being borne by the investment firms themselves it may be somewhat ambiguous on the possibility of recourse to alternative sources of funding such as levies.

The Group noted the reservation of ICCL that it would not be possible to monitor the introduction of a levy in an independently verifiable way without a significant investment in systems and resources by both the fund participants and ICCL. ICCL believes that the use of eligible clients as a proxy for the potential level of exposure of participants remains the best method of allocating contributions for Fund A.
The Group also noted the Irish Insurance Federation (IIF) view that it would have significant concerns about any attempt to broaden the current scope of the regime by requiring insurers to operate a product levy. The IIF also pointed out that a product levy on insurance would have the effect of increasing the cost of vital covers such as motor, property, and mortgage protection insurances.

The Irish Bankers Federation pointed out that in its view the clients of solvent firms would be subventing clients of insolvent firms. It noted the significant administrative burden involved in enacting this proposal and argued that there could be impacts upon competitiveness within the investment services industry.

The Group felt that new legislation might have to be introduced or existing legislation amended to facilitate a systemic central application of such a levy and that further detailed consideration would have to be given to the structure and scope of any proposed levy.

Re-structuring

The Group noted the findings of the Oxera[8] study that only a few countries operate completely separate schemes for investor compensation and deposit guarantee. Instead, many countries have integrated investor compensation into the already existing deposit guarantee schemes in terms of either common ownership or management, or, in some countries, in terms of pooling the available funds to protect clients with respect to both their investments and deposits held with credit institutions. While the options considered both by the ICCL and the Working Group included allowing the ICCL to borrow from the Deposit Protection Scheme, the Group also noted the possibility of a radical overhaul of the structure of all compensation schemes in operation in Ireland, including the amalgamation of individual schemes into a single over-arching compensation scheme.

Having regard to current structures the Group felt that the complexities involved in a re-structuring involving the amalgamation of all individual compensation funds into a single scheme would require detailed further study and consultation within the financial services industry as a whole.

Risk Assessment

The Group noted the findings of the Oxera study that the current and past financial position of a compensation scheme is not a robust indicator of funding adequacy going forward, as failures to date have generally been infrequent and of a

[8] A European Commission report on national investor compensation schemes prepared by Oxera Consultants

comparatively small scale, while potential loss exposures are higher. The study suggests the need for a more rigorous assessment of the potential loss exposures and the likelihood of these losses occurring. No detailed analysis of future funding requirements for investor compensation in Ireland is available.

ICCL pointed out that while its experience since the commencement f the Scheme provides some basis for calculating the impact of a given failure size, there is limited experience, either in Ireland or in other countries operating similar schemes, on which to base estimates for potential failures.

In the UK, which operates a scheme that allocates liability for compensation-related contributions on a sectoral basis, there is no attempt to further allocate contributions based on any individual risk assessment within particular sectors. ICCL noted that in some schemes operated in Member States, such as the UK and France, any risk analysis is undertaken by the financial services regulator, which has access to detailed confidential financial information on the enterprises which it regulates. The ICCL noted that the Financial Regulator, as part of its regulatory and supervisory functions, is examining the possibility of implementing a risk assessment programme for its own purposes. The ICCL stated its intent to liaise with the Financial Regulator to see if there is any basis upon which it could determine an alternative method for allocating liability to make contributions to the Scheme.

The Working Group discussed the extensive complexities involved in conducting a large scale risk analysis of the financial services sector, concluding that the inherent difficulties of attempting to predict failures negated the benefits of any such analysis.

The Group noted the Oxera finding that stress tests are adopted, in particular in the banking sector where they are a common supplement to credit risk models used by banks for day-to-day risk management. The Group considered that it should be possible to consider funding adequacy by considering hypothetical scenarios to stress test the compensation scheme and determine its capacity to withstand possible future surges in claims. The aim of such tests would be to evaluate the scale or range of claims that could be settled on the basis of current funding arrangements, and the level of claims that would result in difficulties for the scheme.

Other Financial Services Compensation Schemes

The Working Group noted the contents of the paper, "Compensation for Clients of Insurance Companies" and the following in particular -

General features of the Insurance Compensation Fund are:

- It applies only to non-life insurance companies;
- It operates under the jurisdiction of the High Court;
- The Accountant of the High Court has day-to-day responsibility for the Fund;
- It can be funded either by a levy on policyholders of up to 2 % or by advances from the Minister for Finance.[9]

In relation to Non-Life, the three main areas of debate are: not covering refund of premia (though this may not be a major issue as policyholders generally desire cover); restriction of compensation for claims to 65% of the value or a maximum payment of €825,330; and funding. Failures in life assurance are rarer than failures in non-life insurance world-wide, because the business is longer term and emerging problems should be obvious at a stage where remedial action is still possible. Even where a life company is experiencing difficulties, it may be possible to interest another company in buying the book of business.

As a result of an Irish initiative, the EU Commission convened a working group in 2002 with a view to establishing a minimum level of harmonisation in relation to compensation schemes in member states. The EU work is considering compensation for both life and non-life insurance. To date, the Commission has begun work on drafting legal texts, but a number of important issues remain to be resolved.

The Group also noted the contents of the paper *Compensation Arrangements for Clients of Collective Investment Schemes*. The Group noted the importance of the funds industry to the IFSC and the level of supervision it is subject to. The Group also noted there have been no representations to the Financial Regulator from consumers or industry regarding the establishment of a compensation scheme for collective investment schemes, nor are there any moves towards such at EU level. It

[9] The levy, when activated, is payable to the Central Bank by insurance companies, based on their premium income; the Bank transmits the funds to the ICF.

was noted however, that all Irish authorised collective investment schemes are required to appoint a trustee whose function is to safeguard the assets of the scheme and to oversee the actions of the scheme's manager. This provides an additional protection to investors.

6. The Oxera report on Investor Compensation Schemes

The detailed comparative description and evaluation of the national investor compensation schemes provided by the study by Oxera Consulting Ltd, (*Description and Assessment of National Investor Compensation Schemes Established in Accordance with Directive 97/9/EC)* reveals a diversity of approaches to investor compensation among EU member states.

The Working Group took the view that any policy initiatives pursued in Ireland should be coherent with the framework for investor compensation at European level. With this in mind, the Group notes the Oxera Report's conclusion that the adequacy of funding arrangements depends on flexibility and, in particular, the availability of multiple funding sources. It further notes the Oxera conclusion that unexpected large failures could impose more compensation costs than had been anticipated or can be covered by participating firms, that a compensation scheme requires back-up sources of funding, the main one of which may be borrowing.

The Group recognised that while most EU compensation schemes have borrowing powers, few have explicit credit facilities in place. It noted the Oxera finding that the supply of commercial credit may be limited, particularly in larger failures where the lender has no certainty about the capacity of the scheme and its participating firms to repay borrowed funds in the future. While Oxera did not make any explicit recommendations, it posits that the existence of a guarantee from the State or other forms of state funding can enhance the financial viability and credibility of a compensation scheme. Nonetheless, only a few EU Member States have explicit and irrevocable state guarantees provided under law to fund compensation costs.

The EU Commission has published an Executive Report and Recommendations based on the Oxera evaluation exercise. The report concludes by outlining the Commission's proposed action plan i.e. to launch "*a debate at the level of the ESC among Member States and at the level of the national compensation schemes in order to consider the implications of the report's findings and promote best practice*" and by inviting Member States and the National Investor Compensation Schemes as well as other interested parties to provide the Commission with their comments.

7. Conclusions

While existing funding methods in Ireland have so far proved adequate, the collapse of Morroghs has highlighted the danger of the current system being placed under serious strain. Notwithstanding the fact that large scale failures represent low probability events, a compensation funding system is required which ensures that there is adequate funding capacity to meet compensation needs.

The Board of the ICCL has successfully taken and implemented a number of necessary and important decisions which enabled the Investor Compensation Scheme to meet its funding obligations to date. In order to fund the Morrogh's collapse ICCL was required to collect 'top-up' funding from a small number (65) of the Scheme's contributors. The Group notes that, as a result of that collapse, Fund A is now at a low level and is therefore exposed to potential future collapses.

Looking to the future, consideration needs to be given to the creation of a structured framework of potential funding options and the circumstances in which each of those options would be put into effect. The Working Group broadly supports the decisions already taken by ICCL and outlined in the "Arrangements for Funding of the Investor Compensation Scheme" published in May, 2004 which utilise the investment services industry's capacity to fund compensation using the various options available to the Scheme. The Working Group is concerned to ensure that in the short-term, the investment industry has the capacity to fund compensation in a crisis situation.

Having examined all of the issues regarding funding of the Investor Compensation Scheme raised by the collapse of W&R Morrogh Stockbrokers, the Working Group

concluded that the preferred option would be to allow a reserve of funds to build up, over time, to meet the compensation costs arising from any future potential collapse. The Group recognised however that the accumulation of such reserves is time dependant and that it is not possible to accurately forecast the scale or timing of any future collapse. The Group therefore agreed with the ICCL's view that a combination of the options it considered, employing a 'cascade effect' would be the most suitable model going forward. The 'cascade' represents a prioritised approach to be taken by ICCL, depending on the seriousness of the collapse, to access funds for the purposes of making compensation payments. The Group ranked the sources of funding available to ICCL starting with the preferred option of simply allowing reserves to build up over time. Each subsequent source of funding would be accessed when the potential for the use of preceding sources had been exhausted. The 'cascade' would proceed as follows –

- Payments would be made out of the reserve of funds built up in Fund A or Fund B as appropriate;
- Additional top-up payments would be collected. The ICCL supports the introduction of a cap on the amount that may be raised in any one year in the event of a top-up call on Fund A contributors to take account of contributors wish to avoid unlimited special top-up levies. However, the ultimate liability to repay the borrowing would still rest with the ICCL contributors and a cap may have to be applied in conjunction with other funding solutions.
- Utilisation would be made of inter-fund borrowing.
- Utilisation may be made of borrowing facilities arranged under the ICCL's statutory borrowing powers:
    - Commercial borrowing
    - Access to the Deposit guarantee Scheme
    - Access to Central Bank borrowing
    - Possible State support

The Group recognises however that many of the issues it has identified with each of the borrowing options will still need to be addressed. Proposals for contingency

borrowing facilities, whether from the Deposit Protection Scheme or the Central Bank, or the provision of a state guarantee to borrowing by the ICCL, raise complex procedural and legal issues along with practical difficulties.

The Group noted that in the medium term other options such as the amalgamation of Funds A and B, a product levy and restructuring will have to be considered further.

This model reflects the Oxera study conclusion that adequacy of funding structures rests upon flexibility of funding and, in particular, the availability of multiple funding sources. Unexpected large failures could impose more compensation costs than a scheme had anticipated and than participating firms would be able to cover. The report therefore concludes that a scheme requires back-up sources of funding.

8. Possible Recommendations

The Department of Finance will circulate possible recommendations for the meeting on 22 November which support these conclusions -

- build up of a reserve
- capping top-up payments following the development of borrowing facilities, and
- the exploration of other medium term solutions.

The Department will be proposing the establishment of a small expert technical group to bring this work forward.

Appendix 1 - Membership of Working Group

Representatives of the following organisations participated in the Working Group

Department of Finance;
Department of An Taoiseach;
Department of Enterprise, Trade and Employment;
Professional Insurance Brokers' Association;
Dublin Funds Industry Association;
Irish Insurance Federation;
Irish Bankers' Federation;
Irish Stock Exchange;
Dublin Custodian Group;
Irish Association of Investment Managers;
Irish Financial Services Regulatory Authority;
Investor Compensation Company Ltd;
Representatives of the stock broking firms,
Consumers' Association of Ireland;
Irish Brokers' Association;
Irish Association of Pension Funds;
The Funds Group.

APPENDIX 2 - Background to the collapse of W&R Morrogh's

W&R Morroghs Stockbrokers ceased trading in April 2001 on the direction of the Central Bank, following the discovery of financial irregularities. In May 2001, the High Court, on the petition of the Central Bank, appointed a receiver to the firm, Mr Tom Grace FCA of Price Waterhouse Coopers. In June 2001, the Central Bank made a determination under the Investor Compensation Act 1998 (the Act) that the firm was unable to meet its obligations to investors. Under the Act, this determination resulted in the ICCL managing the appropriate compensation payments for eligible investors.

The failure resulted from the actions of a junior partner of the firm, who had incurred losses in trading derivatives instruments. These losses were covered by the misappropriation of assets from clients' accounts, including cash as well as securities, and continued over a long period of time. The accounting irregularities were discovered after concerns were raised by another employee. As a result, the firm was unable to submit a routine return to the Central Bank. This in turn led to an immediate inspection by the Bank, during which it concluded that the firm was insolvent.

After the determination of the Central Bank, the ICCL wrote to over 9,000 investors, informing them about the incident, the compensation entitlements and how to submit a claim for compensation. It received approximately 2,600 claims by the closing date for applications in December 2001. In accordance with the Act, once the ICCL had received the claims from investors, it forwarded them immediately to the Administrator, who in this case, was also the Receiver. The ICCL itself was not involved in assessing the eligibility of the claims, but subsequently paid claims as certified by the Administrator.

Due to the shortfalls in client assets and as a result of the accounting irregularities, establishing the validity of claims was problematic. Given the nature of the irregularities, all client records of the firm had to be examined and reconciled. The Receiver consulted the High Court in July 2002 about the difficulties experienced. These related to asset distribution and establishing the ownership of certain stocks and shares held by the firm. The High Court delivered its judgement in May 2003, concluding that it would appear that particular clients had been targeted. In general,

the firm's client records were reliable, and, while unauthorised sales of shares had occurred, these sales were not undertaken on a wide scale.

The non-client assets of the firm were insufficient to cover the fees of the receivership, which were substantial. A High Court ruling established that the Receiver had a right to be paid and that costs, in accordance with Section 52 (5) of the Stock Exchange Act 1995, should be borne pro rata by all of the client assets. Furthermore, in July 2004 the Receiver applied to the High Court for the right to sell such proportions and amounts of shares held by the firm as was necessary to cover the share pool's proportion of the costs, fees and expenses of the receivership. The High Court ruled that the Receiver had the right to sell shares accordingly.

The lengthy legal process considerably delayed the certification of claims, and the payment of compensation to investors. According to the Act, the ICCL has a statutory obligation to pay compensation within three months of the certification of the claims. However, delays in the certification of claims meant that the statutory time limit for the investors to receive their claimed funds was not relevant. By July 2005, the ICCL had dealt with 819 of the 2,618 claims and made compensation payments amounting to approximately €3.278 million.

The legal process has also had a major impact on the costs of the compensation process. The total costs of the Receiver are currently estimated at approximately €5.1 million. These costs are being deducted from client assets, and the resulting additional deficit in the client assets (i.e. in addition to the initial deficit occasioned by the fraud) is covered by the ICCL.

APPENDIX 3 –The Oxera study on national investor compensation schemes

A major research study, conducted on behalf of the European Commission, by Oxera Consulting Ltd, entitled *Description and Assessment of National Investor Compensation Schemes Established in Accordance with Directive 97/9/EC* was published in January 2005.

Although the Working Group completed its deliberations prior to the publication of the report the major findings of the report were made available to and noted by the Group. The principal objective of the Oxera study was to provide a comparative description and evaluation of national investor compensation schemes in the EU countries with respect to their operating performance, financial position, and ultimately, the level of protection they afford to investors. The study comprises of four main elements –

- an inventory of the national investor compensation schemes
- an analysis of the operating arrangements of the national schemes and their performance
- an analysis of the funding position and financial resilience of the national schemes and
- an analysis of the risks for retail investors and the schemes' coverage of the principal types of loss event.

The comments below summarise some of the major findings of the study.

<u>Inventory of the national schemes</u>

The research study focussed on investor compensation arrangements in place in the EU 15 (including Ireland) and also provided an overview of the most important features of the schemes established in the ten member states that entered the EU in May 2004. The study notes that each EU member state is responsible for implementing appropriate schemes and determining the most suitable way of organising and financing them. While all member states have implemented the Investment Compensation Directive and established one or more statutory schemes to

provide investor compensation in the event of a failure, there are considerable differences across countries.

Analysis of the operating arrangements

There have been few cases of firm failure in the EU member states that have triggered the operation of investor compensation schemes and as such most schemes have no or very limited experience in handling compensation claims. Where failures do occur, difficulties beyond the control of the schemes can lead to delays in the compensation payment process. Among the principal difficulties identified in the study are delays in the legal process, in particular if claims processing depends on the outcome of the insolvency proceedings against the defaulted firm.

Only a few countries operate completely separate schemes for investor compensation and deposit guarantee. Instead, many countries have integrated investor compensation into the already existing deposit guarantee schemes in terms of either common ownership or management, or, in some countries, in terms of pooling the available funds to protect clients with respect to both their investments and deposits held with credit institutions. However, a particular issue arising in this respect is how cash held by credit institutions in connection with investment business is distinguished from cash held in deposits, with some countries allocating all claims on investment monies to the deposit guarantee scheme.

The major advantage of pooling is that it improves liquidity. A unique global fund would also benefit from diversification and would receive improved solvency, as it would insure a more varied set of institutions and investment business. However, differentiated funds also have advantages – in particular, they can be set up to reflect more closely the characteristics of particular industry segments. The also avoid cross-subsidies between firms and thus potential conflicts between them. In any such analysis however, consideration would need to be given to developments at EU level towards an Insurance Guarantee Scheme Directive and any future requirements this may impose. At present, work on this Directive is progressing steadily, with the Commission currently drafting initial legal texts. However, a number of outstanding issues remain to be resolved and it not yet clear what the outcome of the final Directive will be.

Analysis of the funding position

The study notes that although alternative funding sources are available, the national schemes are principally funded by contribution levies from participating firms but the ways in which the contributions are levied differ considerably across countries.

Some schemes levy contributions after a compensation event has occurred and the compensation costs are known; others require firms to make ex ante contributions, on an annual basis, to accumulate a reserve to cover future compensation costs.

The principal advantage identified for ex ante funding is that money is readily available in a fund to compensate investors, if a failure were to occur. It also offers the benefit of smoothing firm contributions over time, while ensuring that a firm that fails has contributed to the fund that will compensate its investors. Finally, ex ante funding reduces cross-subsidisation of weak firms by their stronger peers. However, ex ante funding may raise issues relating to fund management. Costs have to be weighed against benefits, while levies collected ex ante will rarely be equal to losses ex post, such that a fund will always be in a situation of surplus or deficit. For this reason, all ex ante schemes within the EU have the power to levy additional contributions if the built-up reserves are not sufficient to cover compensation costs. Additionally, if funds are invested in safe and liquid assets, participating firms suffer opportunity costs relative to their cost of capital. Finally, if firm failures are rare and require low compensation payments, the management costs are likely to be quite high in relation to the efficiency gain in cases of firm failures.

Risk-weighting in calculating firms' contributions to compensations schemes can have several advantages over fixed level contributions. Risk weighted contributions can serve to control risk-taking by participating firms that may otherwise have incentives to engage in riskier activities while the cost is kept constant and, hence, can reduce concerns about moral hazard. It is also argued that risk-weighting can help to maintain a level playing field, if firms that undertake activities that are more likely to draw from scheme resources are required to make higher contributions. However, risk-weighting may impose considerable information and human-resource requirements on a compensation scheme and is more costly to operate than a flat-rate

contribution system. Most compensation schemes in the EU were sceptical about their ability to operate such a system.

The most important policy question identified is whether available funds are adequate. None of the EU 15 reported any shortfalls that resulted in compensation payments being delayed or not made but difficulties were reported where compensation costs had to be financed soon after a scheme was established or where contributions had to be levied from a relatively small number of contributors. In certain instances, the State intervened to provide assistance.

The study finds that the current and past financial position of a compensation scheme is not a robust indicator of funding adequacy going forward as failures to date have generally been infrequent and of a comparatively small scale. It suggests that potential loss exposures are higher. This is not to say however that schemes should be able to cover all potential exposures or that they should be considered inadequately funded because they are not able to cover those exposures. Rather, the study suggests the need for a more rigorous assessment of the potential loss exposures and the likelihood of those occurring. Only a few EU investor compensation schemes appear to have undertaken such an assessment.

It is noted that stress tests are adopted in other areas, in particular in the banking sector where they are a common supplement to credit risk models used by banks for day-to-day risk management. Stress testing is also widely used within the financial services sector and could be a useful tool in identifying the need for contingency plans that may need to be implemented in the event of very large failures. In other words, stress tests, in determining the loss scenarios that would stretch firm's capacity to pay, could be applied to evaluate the need for alternative funding sources and allow schemes to specify a contingency plan. The methodologies described in the literature usually refer to deposit guarantee schemes but the view is expressed that the relevance of these techniques to investor compensation schemes could be explored further.

The view is expressed that adequacy of funding arrangements depends on flexibility and, in particular, the availability of multiple funding sources. Schemes therefore need back-up sources of funding. One main source is borrowing. Most but not all EU

schemes have borrowing powers but few have explicit credit facilities in place however the supply of commercial credit may be limited. This raises the question of whether a guarantee from the state or other forms of state funding may be required in these cases. The study expresses the view that even if never activated, the existence of guarantees or similar arrangements can enhance the financial viability and credibility of a compensation scheme.

Nonetheless, only a small number of countries have introduced explicit provisions that allow borrowing from the State, or with state guarantee, in the event of large failures that could not be covered by other funding sources. Except for a small annual grant made by parliament to the Swedish scheme, schemes do not benefit from regular state contributions. As regards other types of state funding, Austria, Denmark, the Netherlands, Spain and Sweden all explicitly enable compensation schemes to borrow directly from the state or with state guarantee from other credit providers. However, with the exception of the Netherlands, the borrowing is restricted to exceptional circumstances only.

Risks to retail investors

The study notes that the schemes protect investors' assets against the risk of theft, embezzlement and other forms of fraudulent misappropriation and that they may also provide protection where the loss of investor assets in the event of firm default has resulted from unintentional errors, negligence or breakdowns in the firms' systems and controls. There is a range of other risks, in particular losses arising from bad investment advice, that do not qualify for compensation cover under the Investment Compensation Directive and national laws, or where compensation is not certain.

Investor compensation schemes provide only one form of protection against the various risk exposures for retail investors. Other protection mechanisms are in place: these either are prescribed by regulation (e.g. prudential regulation, segregation requirements, other conduct of-business rules, supervision and enforcement), or emerge from institutional arrangements (e.g. economic capital of investment firms, firm reputation, private insurance cover). The study points out that the better the protection provided by the alternative protection mechanisms, the less the need and resource requirements for the statutory investor compensation schemes.

Appendix 4

Tables 1 and 2 provide a summary of the funding levels of Fund A and Fund B at 31st July 2004, as detailed in the ICCL's Annual Report for 2004.

Table 1:

INCOME and EXPENDITURE SUMMARY	Fund A €	Fund B €	Total €
Income from annual contributions	1,795,200	1,738,761	3,533,961
W&R Morrogh top-up	1,690,083	–	1,690,083
Interest Income	116,598	131,166	247,764
Compensation costs and provisions	(3,362,733)	–	(3,362,733)
Administration expenses / bad debts / provisions for bad debts	(317,599)	(403,032)	(720,631)
Surplus/(deficit) for Year	**(78,451)**	**1,466,895**	**1,388,444**

Table 2:

BALANCE SHEET SUMMARY	Fund A €	Fund B €	Total €
Cash at bank	7,849,992	7,082,360	14,932,352
Fixed assets	13,212	13,211	26,423
Debtors	350,854	27,287	378,141
Creditors	(137,151)	(121,054)	(258,205)
Provision for liabilities and charges	(7,692,107)	(9,142)	(7,701,249)
Share capital	(2)	(2)	(4)
Fund Reserves	**384,798**	**6,992,660**	**7,377,458**