

**Aspects of Legal Regulation of Compensation Schemes
in European and Ukrainian Co-Investment Markets**

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Problem's setting

The Ukrainian stock market is not legally stable and steady structure. It is under constant transformation caused both by internal development factors and globalization processes in the world market of financial services. Investors make a large and powerful, however at the same time potentially “weak” group in this market; therefore, the increase of investors’ right protection level is the highest priority in the stock market reforms. Asymmetric status of investors and professional stock market traders requires special approach to regulation of investors’ activities and de-risk from fraudulent actions of any kind.

In Yu. Fogelson’s opinion, the requirement of information disclosure, prudential supervision, and rules for finance service advertising – all these things ensure protection of individuals (retail customers of financial organizations), when the financial organization works successfully and fulfills

its obligations to customers. However, it is quite often that a financial organization is no more able to fulfill its contractual obligations. The situation may be caused by various factors, from volatile general market condition to supervisory error.¹ In such cases investors suffer from substantial material loss, as they cannot return their capital investment. Generally, it is impossible to anticipate and prevent these manifestations of a crisis in stock market. Therefore, the world community has found alternative option of protection of investors’ rights on money and instruments owned by them. This option may be reduced to introduction of special guarantee and compensation instruments meant to mitigate the impact of investment company’s failure before its investors.

Compensation instruments in favor of investors are relatively new in the Ukrainian stock market and they are still under

¹Fogelson Yu. B. Finance service customers right protection / Yu. B. Fogelson, M. D. Yefremova. – Moscow : Norma, Infra – Moscow., 2010. – 368 p. – page 255.

discussion. Therefore, this article is *aimed at* comprehension of feasibility and viability of introduction of guarantee and compensation instruments in Ukraine, as well as proportionality of such a measure for all participants of the national stock market, especially through analysis of theoretical basis and practice of compensation instruments functioning in Europe together with review of the Ukrainian legislation in this sphere.

Presentation of material

Directive 97/9/EC of the European Parliament and of the Council dated from March 3, 1997 on Investor-Compensation Schemes (hereinafter referred to as the ICSD) makes the legal basis for introduction of the European guarantee and compensation instruments. It assures minimum protection level, being a kind of “ultimate authority” measure for small investors in situation, when the investment company’s fails to return cash or other financial instruments to the customer.

According to p. 2, the Article 2 of the ICSD, its legal regulation covers only those investors’ losses that are related to the investment business. Investment business means any investment service as it is defined in the Section A, annex 1 to the Directive 2004/39/EC of the European Parliament and of the Council dated from April 21, 2004 on

Markets in Financial Instruments Amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (hereinafter referred to as the MIFID), as well as additional services including depositing and administration of financial instruments on customers’ accounts according to part 1, Section B, annex 1 to the same Directive. At the same time it is indicated in the MIFID that: “This Directive shall not be applied to collective investment undertakings and pension funds whether coordinated at Community level or not and to depositaries and managers of such undertakings” (“h” p. 2, the Article 1).

Therefore, the Directive 97/9/EC does not protect the rights of investors of undertaking for collective investment in transferable securities (hereinafter referred to as the UCITS) since: UCITS is not a financial service, regulated by MIFID, while depositaries or sub-custodians UCITS are not necessarily investment companies in terms of this Directive.

The European Commission observes an unequal attitude to investors here. In order to eliminate this problem, shareholders must be entitled to compensation through compensation scheme in the event of

depository or sub-custodian UCITS bankruptcy.²

The explicit suggestions of the Commission were reflected in the text of amendments to the ICSD (with Amendments 2010/0199³) prepared by the Commission. On the contrary, the European Parliament and Council place in question the possibility of expanding this Directive 97/9/EC. Their position is based on the opinion of the most EU member states, which “expressed serious concern as for expanding the Directive 97/9/EC to situations of depository UCITS failure”.⁴

The European Fund and Asset Management Association (EFAMA) name the following main reasons for collective investment market concerns⁵: 1) the offer

appears too early, i.e. coming ahead of realization of requirement for revision of the depository UCITS legal status; 2) special features of collective investment raising serious legal and practical issues have not been considered. For example, Directive’s 97/9/EC basic principle is the reduction of compensation payment reasons to the fact of direct and immediate relation between an investor as an affected party, and investment company as a defaulting party. This relation can be traced for the investment company undertaking obligation to protect, manage or perform custody over money and any other instrument on behalf of the customer (investor). Thus if the investment company cannot return these financial instruments, it is the investor who is first to suffer from the negative impact.

The situation with the UCITS is slightly different. Though, there are options in legal regulation in various EU member states, in most cases the UCITS is presented as a legal or beneficiary owner of assets entrusted to the custody of the depository. So, depository’s errors influence the investors, but indirectly as there is no direct relation between these parties. This impact results in decrease of the net value of investor’s share, which undoubtedly is a material consequence of depository’s failure. In this relationship

²Alternatives to Investor Compensation Schemes and their Impact. – Directorate-General for Internal Policies. Policy Department A: Economic and Scientific Policy, PE 492.451, – 2012–Internet source: [http://www.europarl.europa.eu/RegData/etudes/etudes/join/2012/492451/IPOL_ECON_ET\(2012\)492451_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/etudes/join/2012/492451/IPOL_ECON_ET(2012)492451_EN.pdf)

³ Proposal for a Directive of the European Parliament and of the Council amending Directive 97/9/EC of the European Parliament and of the Council on investor compensation schemes. – Internet source: – http://ec.europa.eu/internal_market/securities/docs/isd/dir-97-9/proposal-modification_en.pdf

⁴ Council of the European Union (2005a) «Interinstitutional File: 2010/0199 (COD) Note12032/11», Brussels: Council of the EU. – 24/06/2011 – Internet source: http://www.europa-nu.nl/9353000/1/j4nvg5kjg27kof_j9vvj9idsj04xr6/viqj578mndzw

⁵ EFAMA Preliminary Position Paper on the Commission’s proposal amending the Directive in Investor Compensation Schemes – Internet source: [https://www.efama.org/Publications/Public/Investor_Compensation_Scheme_Directive/10-](https://www.efama.org/Publications/Public/Investor_Compensation_Scheme_Directive/10-4088_EFAMA%20Position%20paper%20on%20ICSD%20Review.pdf)

[4088_EFAMA%20Position%20paper%20on%20ICSD%20Review.pdf](https://www.efama.org/Publications/Public/Investor_Compensation_Scheme_Directive/10-4088_EFAMA%20Position%20paper%20on%20ICSD%20Review.pdf)

pattern, the UCITS is the primary affected party, which legal existence is completely ignored in the offered changes; 3) the burden of additional cost. It was concluded by EFAMA that contributions to the compensation scheme will be paid by investors of UCITS or by the UCITS itself. In any case, these expenses will decrease investors' profit size. Besides, the ex-ante expenditures are not balanced with the profit, which may be gained by investors under future enhanced security measures.⁶

Among the weaknesses of the suggested changes we should also mention that they are discriminating towards investors, who invest into master-feeder or fund of funds UCITS institutions. While depositary's failure causes negative impact on complete investment structure, it is declared that only principal fund investors are entitled to compensation payments. The matter is that the feeder fund as the owner of the master fund's shares obtains the professional investor status. According to p. 2, the Article 4 of appendix I

to the ICSD, professional investors may be included into compensation scheme coverage.

Taking into consideration the above mentioned and other problems, the suggested changes to the Directive 97/9/EC cannot be regarded as successful in hitting their primary targets. Therefore, after negotiations the provision for placing the UCITS under terms of the ICSD was excluded from the compromise text. However, neither the problems nor Commission's objectives were the main reason for such a decision. On the contrary, during the discussion of amendments to the Directive 97/9/EC, most members of the European stock market expressed their readiness to support Commission's efforts for investors' UCITS protection. At the same time, they did not approve the key concept of realization of this initiative. Thus, EFAMA reported that the protection of investors UCITS will be achieved not through expanding of the ICSD to the UCITS, but through constructive proposals on depositary regulation revision.⁷ Depositary's UCITS fault issues may be solved only according to special legal regulation provided in the Directives

⁶ EFAMA Preliminary Position Paper on the Commission's proposal amending the Directive in Investor Compensation Schemes – Internet source: https://www.efama.org/Publications/Public/Investor_Compensation_Scheme_Directive/10-4088_EFAMA%20Position%20paper%20on%20ICSD%20Review.pdf. – C.2, C.8; Commission's proposals amending the Directive in Investor Compensation Schemes (97/9/EC) BVI's comments and technical amendments. – Bundesverband Investment und Asset Management. – 9.10.2010. – Internet source: http://www.bvi.de/fileadmin/user_upload/Regulierung/Positionen/Anlegerentsch%3%A4digung/2010-12-09_BVI_proposal_ICSD_Olle_Schmidt.pdf

⁷ EFAMA Preliminary Position Paper on the Commission's proposal amending the Directive in Investor Compensation Schemes – Internet source: https://www.efama.org/Publications/Public/Investor_Compensation_Scheme_Directive/10-4088_EFAMA%20Position%20paper%20on%20ICSD%20Review.pdf. – P.11.

concerning the UCITS.⁸ The European Parliament expressed the same attitude towards the idea of placing investors' UCITS loss compensation under the basic regulatory act for the UCITS. Under this pressure, the new version of p. 10, Premises of this Directive 97/9/EC was stated. Now the Commission is responsible for the development of suggestions on explanation of depository's UCITS fault terms if "the depository or a third party custodian, to which the assets UCITS are entrusted, is unable to fulfill its obligations to the UCITS for the reasons, which directly result from financial condition of the depository or this third party custodian, – and such fulfillment cannot be reasonably expected". The prepared suggestions had to become grounds for further amendments of the Directive 2009/65/EC.

The idea of introduction of investor protection instruments in the stock market in the form of compensation programs

⁸ Commission's proposals amending the Directive in Investor Compensation Schemes (97/9/EC) BVI's comments and technical amendments. – Bundesverband Investment und Asset Management. – 9.10.2010. – Internet source: http://www.bvi.de/fileadmin/user_upload/Regulierung/Positionen/Anlegerentsch%C3%A4digung/2010-12-09_BVI_proposal_ICSD_Olle_Schmidt.pdf; Investor Compensation Schemes – Position in the European Commission's Proposal to amend Directive 97/9/EC on Investor Compensation Schemes. – European Banking Federation. – 27.10.2010. – Electronic source: <http://www.ebf-fbe.eu/uploads/documents/positions/FinMark/15-November%202010-D1436G%20final%20clean-2010-Investor%20Compensation%20Schemes%20Directive.pdf>

(schemes) has been under discussion in Ukraine for the recent decade. There were about five versions of the draft of the law⁹ during this period; this law was aimed at improvement of the Ukrainian system of investor's right protection according to the best European traditions. Improvement concepts offered in these drafts of the laws were based on introduction of the compensation payments to investors, who have lost their investments due to the fact of their inaccessibility, in the Ukrainian stock market.

Interest groups argue for necessity to introduce such legal regulation based on Ukraine's obligations to bring national laws in compliance with the EU regulatory standards. Their key efforts are aimed at the Directive 97/9/EC implementation.

Among the most recent drafts of the laws, there is the Draft of the Law of Ukraine "On the Insurance System for Retail Investors' Investments in the Stock Market" dated from September 3, 2013, approved by the Cabinet of Ministers of Ukraine on

⁹ Draft of the Laws of Ukraine "On Stock Market Investment Insurance Fund" dated from August 23, 2011 No. 9069, brought in by the Cabinet of Ministers of Ukraine – Internet source: http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_2?pf3516=9069&skl=7; Draft Laws of Ukraine "On individual investors' deposits and investments insurance fund" of 28 August 2013 № 3132, brought in by V.I. Aryev, people's deputy of Ukraine – Electronic source: http://w1.c1.rada.gov.ua/pls/zweb2/webproc4_1?pf3511=48082.

January 15, 2014 (hereinafter referred to as the Draft 2013).

Investment insurance system provided for in the Draft 2013, consists of two components: insurance fund for retail investors' investments in the stock market (hereinafter referred to as the Fund) and the set of contracts on joint-and-several liability. Participants of investment insurance system, namely security brokers and asset management companies (hereinafter referred to as the AMC), have the right to select on their own the form of participation in the compensation scheme.

As a matter of fact, not all investments in securities are covered by this draft of the law, it is only applied to a limited category of possible investments into the Ukrainian stock market instruments. First, it excludes corporate investments from the right to compensation. Secondly, it restricts retail investors to trustors under security management agreements and investors in securities of collective investment schemes (hereinafter referred to as the CIS). As for the CIS, their list is not complete as it excludes participants of venture corporate funds and shared funds (hereinafter referred to as the CF and SF).

Definition of investments (p. 1, the Article 1 of the Draft 2013) entitled to compensation *inter alia* includes "...monies invested in securities of the CIS". At the same

time, according to c. 4, p. 9, the Article 7 of the Law of Ukraine "On Collective Investment Schemes" dated from July 5, 2012 No. 5080-VI (hereinafter referred to as the Law of Ukraine "On the CIS"), the payment of securities of stock CIS while their sale or repurchase by the issuer may be performed proportionally at the expense of assets specified in the investment declaration of such a scheme. Based on the analysis of the above regulations, we may conclude that if an investor of stock CIS is entitled to compensation, the amount of the compensation claim must be reduced by the part of investment made with financial instruments other than money. It is obvious that the restriction of investments, made by CIS investors, to money results from inaccurate consideration of provisions of the Law of Ukraine "On the CIS". Additional supporting reason for this is that for another group of entities entitled to compensation, the investments may consist of various stock market instruments, not necessarily money.

"Inaccessibility of investments" is specified in the draft of the law as a compensation case, providing the right to compensation. Investments are inaccessible if the CIS is unable to return to investors due profit because CIS's money is insufficient and one of the following event has occurred: AMC license is cancelled, except cases, when the AMC applied for such cancellation; CIS's

default. The reasons of CIS's default are as follows: the CIS refuses to fulfill its obligation to repurchase security on investor's repurchase request; the fund fails to fulfill in time its obligation to repurchase security on investor's request, the delay being longer than 30 days (c. 3, p. 1, the Article 1 of the draft of the law).

Procedures of formation of Fund's financial sources make a material and quite disputable issue of the draft of the law. Participants of investment insurance system are obliged to replenish the Fund with admission charges and current membership fees. Submission charge is 1% of security broker's or AMC's statutory capital, and current membership fee – 0,1% of average quarterly value of investments by individuals. There is no doubt that such financial loading on AMC's expenditure budget will have impact on profitability of investors. The AMC will be forced to raise prices for their services. This will add financial "burden" onto stock market, which is in extremely unfavorable conditions as it is. Now there is a threat of mass decrease of few professional players of the stock market and their customers.

It should be also mentioned that interest rates specified in the Draft 2013 have no justified estimation. As these rates are similar to the rates provided in the Law of Ukraine "On Deposit Guarantee System for Individuals" dated from February 23, 2012

No. 4452-VI, it is possible that they were taken from the latter Law. The following is the response of the European Banking Federation (EBF) in objection to such a borrowing found in the draft of the law: "Investor Compensation Schemes are fundamentally different from Deposit Guarantee Schemes and must not be modeled on that basis. While the latter play an important role in financial stability, the former serve mainly the objective of consumer protection".¹⁰

Generally, it should be stated that this draft of the law was initially based on false grounds. While including CIS investors into compensation schemes, the authors of the draft of the law were focused just on the draft of the European document, i.e. the above Commission's Proposal to the Directive 97/9/EC. Proposal 2010/0199 was regarded by the national legislature as an existing law, though it was still under discussion while the Ukrainian draft of the law was being developed. Nevertheless, the Draft 2013 actually stated the implementation of a nonexistent Directive ICSD. This was because of basically unsuccessful step ahead

¹⁰ Investor Compensation Schemes – Position in the European Commission's Proposal to amend Directive 97/9/EC on Investor Compensation Schemes – European Banking Federation – Internet source: <http://www.ebf-fbe.eu/uploads/documents/positions/FinMark/15-November%202010-D1436G%20final%20clean-2010-Investor%20Compensation%20Schemes%20Directive.pdf>

of the European legislation. The introduction of this initiative a priori could not bring the Ukrainian system of CIS regulation closer to the European legal practice. The matter is that the national draft of the law complied with the Commission's draft neither in definition of categories of co-investment entities to which the Directive 97/9/EC would be prospectively applied, nor in specification of reasons for compensation scheme coverage to CIS investors. Though such Commission's suggestions were not approved in the context of the ICSD, the investor protection concept suggested by them was used in the draft of the new Directive UCITS V.

The basic principle of both Commission's Proposal to the Directive 97/9/EC and the UCITS V (the Article 24)¹¹ is the restriction of investor's UCITS right on the compensation only to assets loss, which occurred as a result of non-fulfillment or improper fulfillment of obligations by a depositary UCITS or any third person to whose custody the assets UCITS had been entrusted. According to c. 2, p.1, the Article 24 of the UCITS V, the depositary is obliged to return to the fund or the management

¹¹ Directive 2014/91/EU of the European Parliament and of the Council dated from July 23, 2014 amending Directive 2009/65/EC in the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions – Internet source: <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1432731300799&uri=CELEX:02009L0065-20140917>

company financial instruments identical to the instruments, lost for depositary's fault, or to compensate the cost of such financial instruments. The depositary is free from responsibility, if it can prove that the loss of assets resulted from external events beyond its reasonable control, which appeared unavoidable in spite of all preventive actions. To avoid being held liable for the loss, the depositary cannot allude to fraudulent actions UCITS committed by depositary personnel (p. 26, Premises of the UCITS V).

Unlike the EU legislation, the Draft 2013 states that CIS investors become entitled to compensation payment based on actual default of the CIS or problems in AMC operations, which resulted in its license cancellation.

Mechanism of AMC property responsibility for breaches of legal, statutory, contractual requirements of co-investment market has been already provided in the basic regulation document in this sphere. The Article 67 of the Law of Ukraine "On the CIS" specifies compensation of loss, caused to the CIS by AMC' actions, from company's reserve fund and. if the reserve fund is not sufficient – using other AMC property (section VI of the Guidelines for special features of institutional investors' assets management, approved by the decree of the National Securities and Stock Market Commission on August 6, 2013 No.1414).

If the above sources are not sufficient for loss coverage, the authors of the draft of the law are sure that the investment insurance system will work. In our opinion, the latter is unacceptable at least for three reasons. Firstly, the compensation pool will be actually formed by CIS investors. Though this obligation is imposed on AMC, the company will transfer its fulfillment to CIS participants through CIS expenditure pattern redesign. This will result in decrease of investors' profit. Secondly, practical restructuring of Fund replenishing concept will result in the situation when the affected party, namely CIS investors, bears load of responsibility for illegal or unprofessional performance of the AMC. Thirdly, the AMC will be made to participate in Fund financing for all CIS, therefore, for all CF and SF assets, which are under the custody of the companies. Whereas it is not declared who is the owner of CF shares or SF investment certificates. In practice, it means that both retail and corporate CIS investors will make indirect contributions to the Fund. However, the corporate CIS participants will not be entitled to compensation. This violates the principle of equal treatment of investors and puts corporate investors in a disadvantaged position.

In view of this, AMC risk coverage mechanism should be clarified without actual formation of the Fund. According to the Draft

2013, joint-and-several liability of companies is an alternative to the Fund. This investment insurance method allows avoiding payment of admission charges and current membership fees. Participants of this mechanism are joint-and-severally liable for obligations of each contractual party to investors, who lost their investments through a fault of any professional stock market trader.

Implementation of joint-and-several liability mechanism, similarly to any other compensation scheme in the market of CIS operations, is quite a disputable issue due to risky nature of co-investment processes. Acts of commission and omission of any co-investment participant include potential risk. This risk is not specific only to professional managers, CIS asset custodians etc., but imminent the entire stock market, which is practically impossible to predict. Therefore, these management companies are allowed neither to assure CIS participants of definite income earning on purchased securities (or of certain income amount) or of absence of loss from security investment, nor to make any statement which can be regarded as warranty for the above (c. 18, p. 1, section V of the Guidelines No.1414).

Legal regulation in each EU member state requires that co-investment risks must be explained to potential investors, who then "invest in the UCITS on their own responsibility realizing that there are some

risks attached to their investments”¹². Acceptance of this fact by investors has its price. The investor realizes that investment into volatile stock market instruments, i.e. securities of instable price, will bring him all benefits from such an investment. Therefore, he agrees to take both operational and financial risks of UCITS. An investor who invests into a bank deposit, on the contrary, expects certain income amount, i.e. interest on deposit. Moreover, such an investor is not impaired with investment risk; entire risk is taken by the bank, which also gains the entire profit.

In this situation no EU member state protects investors UCITS from normal market risk of impairment of their investments. Compensation schemes that are introduced by national authorities in the European states to implement the Directive 97/9/EC, do not provide for coverage of co-investment market customers. For example, according to the Investor Compensation Act (Ireland) dated from August 1, 1998, compensation scheme does not expand to collective investment schemes such as trusts and UCITS, which are not authorized to manage individual

investment portfolios. There are similar provisions in the Law of Bulgaria “On Operations of Collective Investment Schemes” (sub-paragraph 2, paragraph 1, the Article 86) as well as in Belgian laws etc.

Legal protection system for investors of Russian investment funds is quite different. Its comparative analysis with Ukrainian “compensational” draft of the laws provides grounds to suggestion that Ukrainian legislature was oriented at investment insurance concept applied in the Russian Federation. Thus, in both cases there are similar reasons for compensation of loss to investors of investment funds: insufficient money and cancellation of creditor’s license. We can observe that participants of compensation schemes partially match¹³: management companies and corporate CIS¹⁴. The Law of Russian Federation “On Investment Funds” provides payments to investors to be made from the Federal compensation fund. However, since the latter has not been formed yet, its functions are vested on the Federal national fund for protection of the rights of investors and shareholders (the Article 63).

¹² Commission’s proposals amending the Directive on Investor Compensation Schemes (97/9/EC) BVI’s comments and technical amendments – Internet source: http://www.bvi.de/fileadmin/user_upload/Regulierung/Positionen/Anlegerentsch%C3%A4digung/2010-12-09_BVI_proposal_ICSD_Olle_Schmidt.pdf
<http://www.investorcompensation.ie/about/origin-of-the-scheme-new.212.html>

¹³ The Article 63 of the Law of Russian Federation “On Investment Funds” dated from October 29, 2001 No. 156-FL also includes specialized depositaries and persons who keep the register of investment shares owners, into the list of participants of the compensation scheme.

¹⁴ Corporate investment fund (scheme) was added to participants of the Investment insurance fund according to the previous national draft of the laws in the sphere of compensation payments regulation.

We support the objective of the Ukrainian legislature to enhance protection of the rights of CIS investors and to improve co-investment market functioning through implementation of compensation schemes. However, we believe that such critical innovations must be thoroughly regarded and soundly based. Related risks must be minimized with investors' benefits being substantial. Unfortunately, such level of compensation mechanisms has not been developed yet.

Conclusions

Analysis of the Ukrainian draft of the laws and opinions of Ukrainian and foreign experts prove that the efforts to implement investment insurance system in Ukraine are premature. They bear a great threat of using this system as a shadow mechanism for money laundering. Similar is the situation in the European market, as the EU member states show that they are not properly prepared to implementation of investors of UCITS compensation policy. These states use their entire legal, scientific and practical potential for constructive contribution into revision of UCITS depositary regime. Upgrading of penalties to depositaries for breach or improper fulfillment of their UCITS assets custody obligation is the key highlight

of EU policy in the sphere of investors of UCITS legal protection.

Consequently, we believe that the same issues must become priority to the national legislature as well. This will be in line with modern international tendencies and Ukraine's striving for the European integration. Therefore, we think that further development of protection mechanism for CIS investment participants should be targeted at improvement and amendment of legislation for upgrading of penalties to depositaries for breach or improper fulfillment of their obligations to CIS. At the same time, the mechanism of compensation payments to investors, who have lost their investments should be regarded as prospective area of focus for participants of Ukrainian and international markets of legal regulation.