TC Notes

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Creating an Investor Fund Compensation Fund

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Objectives for Creating an Investor Compensation Fund[1]

Consideration of creating an investor compensation fund often begins with a public policy objective, such as "To foster a healthy and active capital market by contributing to the security and confidence of investors."[2]

Evolution of Capital Markets

The development of a country's capital markets usually begins with the issuance of debt by the government and the distribution of that debt to institutions and individuals. Government savings bonds may be the first investment that an individual makes beyond having a deposit bank account and possibly related bank savings certificates. (The protection funds for bank deposit accounts and related savings certificates are discussed in another online unit.)

The equity markets may begin with either the privatization of government owned enterprises[3] or private companies that require more capital. As with the debt markets, investors may be large institutions such as insurance companies and pension funds or individual investors.

Privatization

A government may wish to transfer state owned companies to the private sector by selling company shares to the public. The objectives can be to liberalize the economy and to place more reliance on market mechanisms and the private sector. The results sought include increased investment in capital assets and increased efficiency.

Private Companies

Private companies initially arrange private loans or bank loans. If these are unavailable or not sufficiently large for the company's needs, the company may access money from venture capitalists or the public equity markets to raise funds in exchange for giving up a percentage of their equity ownership.

Public Market Regulatory Regime

The public equity markets typically have a regulatory regime specifying the necessary disclosure required to sell shares to investors and the registration requirements for those dealers entitled to do so. The effectiveness of the disclosure regime will depend on adherence to the accounting and legal requirements, and the enforcement capabilities of the regulator.

Growth of the Investor Market

The speed with which the individual investor market grows is a function of many things including the country's economic growth, the individual savings rate, access to public company shares, confidence in the disclosure of information concerning the companies, liquidity of the market, tax incentives, and the cost and ease with which an individual can execute a trade and arrange safe custody for a security.
Once the incidence of individuals investing in debt or equity securities increases there is often a need to respond to systemic problems and desire to retain confidence and participation in the market place. Either government or the industry may consider an investor compensation fund.

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[1] This note was prepared by Rozanne Reszel on behalf of Toronto Centre.
[2] Canadian Investor Protection Fund, Canada, Annual Report 2005.
[3] Somalipress.com, Egyptian Privatization Plan, December 12, 2009.

Fund Design & Public Policy

How the fund is designed is influenced by the public policy objective and whether the creation of the fund is preventative or in response to a problem situation.

An investor compensation fund designed in the absence of a specific crisis, may seek to ensure the safety of un-invested funds held by a dealer and the safe custody of any resultant purchase of securities. The fund could be designed to return the cash and securities held by the dealer within defined limits.[4]

Conversely if the fund is designed to respond to a specific crisis, such as mis-advice or fraud by an issuer, the coverage may be very different and seek to restore the investor's loss of investment value. This is a very different type of coverage from returning an investor's assets and has a material impact on the design of the fund.[5]

If no investor compensation fund existed, and a dealer failed, regulators could encourage another dealer to assume the obligations. This would probably only occur if a financial guarantee was provided by the regulator. Alternatively, investors could seek civil remedies that can be expensive and time consuming with the possibility of no financial compensation.

Regulatory Regime

An investor compensation fund is only a part of a regulatory framework, which should include registration requirements for intermediaries, capital and compliance requirements and enforcement penalties. The investor compensation fund should not be a substitute for adequately addressing these elements.

Government- or Industry-Sponsored

Whether an investor compensation fund is government or industry sponsored, it should be clear which dealers participate.

Mandatory participation is more desirable than voluntary participation because larger, more capital-intensive dealers may not perceive a need or benefit to joining and this could result in a concentration of riskier firms in the fund.

It is also important that the role of the fund and who participates is clearly understood by investors and therefore it is simpler to communicate if participation is mandatory as it removes an element of uncertainty for the investor.

Government-Sponsored

Many investor Protection Funds are sponsored or created by government agencies. This can be a function of external obligations such as the European Union Directives or the domestic legislation necessary to require participation in the fund and to compel participants to comply with paying assessments. A government sponsored fund may also have access to direct government funding or lines of credit or guarantees for financing that provide additional resources or a backstop to the resources of the fund.

It is important that the terms and limits of protection are clear and communicated so that investors do not assume that because it is government sponsored, it provides 100 per cent protection.

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[4] SIPC.org, Securities Investor Protection Corporation, USA, The SIPC Mission, 2010.

[5] FSCS.org.UK, Financial Services Compensation Scheme, UK, When is FSCS Cover Triggered?

Industry-Sponsored

Industry-sponsored funds may arise to accomplish specific objectives such as guaranteeing the completion of trades at a stock exchange, satisfying government or regulatory requirements, or enhancing investor confidence in capital markets. These funds may be supervised by the regulators to ensure fairness and transparency to investors. Investor protection in most jurisdictions is a matter of public interest and appropriate governance structures to balance industry and public concerns are usually required.

Government agencies can also create the requirement for a fund to be created, and they may supervise the design and implementation of the fund by industry.

Communication Policy

A policy mandating disclosure of the extent and nature of the fund's coverage is useful to ensure information is accessible to investors. Investors should have contact details to follow up and obtain any information they require.

Funds Created by Statute

Generally funds created by government agencies will be created by statute to provide a transparent and legally enforceable context. Any changes to the statute are subject to the legislative process and therefore impacted by the political priorities of the day.

In some jurisdictions, a statutory fund may be integrated with the applicable insolvency or bankruptcy legislation. This approach is to ensure consistency and fairness in the liquidation or restructuring process for a dealer and the compensation provided by the protection fund.

Funds Created by Contract

Funds created by an industry are likely to be created by contract. There are two contracts involved. First dealers seeking to create or join the fund do so directly by contract or through a self-regulatory process. This structure can provide more flexibility to change and update elements of the fund design in shorter time frames and more frequently.

The second contract is between the fund and investors and is represented by the holding out by the fund of coverage. This is different than a statutory right to recover. The protection afforded may or may not constitute insurance for legal or regulatory purposes.

Fund Resources

A challenging question for all funds is what amount and type of financial resources are needed to provide the compensation that has been described to investors.

All funds must decide whether to "pre-fund" (ex-ante) or collect after the need arises (ex-poste).

Pre-Funding

The advantages of pre-funding include adding credibility to the promise to compensate by demonstrating that resources are available. Readily available resources also reduce the delay in providing compensation, which reinforces confidence in investors.

Having the time to collect resources over a number of years, rather than in a single large sum, reduces the impact on the industry in a possible economic downturn.

The dealer that fails has contributed to the fund.

Post-Funding

Collecting resources after the need arises can be favoured if the fund has sources of liquidity that it can draw upon to provide compensation and subsequently repay once resources have been collected.

In order to maintain the confidence of investors, the resources of the fund should be sufficiently well understood so that investors believe the fund will be able to meet its obligations.

Once a fund has reached a certain size, there may be a desire not to remove more capital from the industry unless absolutely necessary. In this case, the contingent assessing capacity of the fund should be clearly explained.

Start-Up Funds

The initial target size of a fund that is starting up is a function of the level of protection the fund wishes to offer to investors and what amount is reasonable to charge to the participating firms given other regulatory expenses and profitability of the firms.

A start up fund may have access to alternative resources such as insurance, lines of credit, or government back stops.

The amounts collected will also be impacted by the methodology used by the fund to assess risk of payment i.e. flat fee, economic model, credit based model. A flat fee or fixed percentage of a financial factor such as revenue or the market value of investor securities held is a simple and easily verified calculation for a start-up fund.

Coverage Policy

The Coverage Policy must be carefully prepared to define and clearly communicate key elements.

Trigger event

Investors should understand when they are eligible for protection from the fund and this results from the fund design.

Funds are designed to respond when the dealer cannot, so the event is likely the regulatory suspension of the dealer or an act of insolvency such as the appointment of a receiver or trustee.

Eligible Investors

A coverage policy should specify who is eligible for compensation. The fund may be designed to protect only individual investors, on the basis that institutions are sophisticated and able to perform adequate due diligence. Conversely the policy may make no distinction between individuals and institutions as the category of high net worth individuals can blur this distinction.

The policy objectives of the fund must determine whether only country residents are eligible for coverage or if foreign investors of domestic dealers are also eligible. There may be relevant “home/host” rules to be consider.[6]

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[6] Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes.

Limits of Compensation

The limit of coverage and whether it is applied on a per-account or per-investor basis should be specified. If the coverage is per account, then it is necessary to specify the maximum number of accounts eligible for coverage or how they may be combined for a single beneficiary for coverage purposes. If the coverage is per investor, the coverage policy should specify if the compensation is applied for each eligible dealer or on a cumulative basis with a single maximum for the investor across all dealers.

The value of compensation must be described and if foreign assets are eligible for coverage, the currency of the compensation should be specified. If the local country currency is used, the foreign exchange risk of other currencies is borne by the investor. If the currency of the investment is used, the foreign exchange risk is borne by the fund and should be considered in the mix of resources that the fund gathers or employs.

Method of Delivering Compensation

Any requirements that the investor must meet to receive compensation should be fully transparent, such as claims forms, filing deadlines, and if necessary, an appeal process.

The compensation fund may reimburse investors by delivering cash and/or securities to the investor. This may reinforce the effectiveness of the protection to the investor, but it can be a costly and time consuming process.

Alternatively, the fund may transfer investor accounts to an active dealer by financing the transfer with necessary cash and/or securities. This is a lower cost alternative as much of the administration and liaison with the investor is handled by the receiving firm.

Appeals of Denied Compensation

Investors who believe that they are entitled to protection but have not received any, should have a process to appeal the decision that is independent of the initial decision. Ultimately, this may be a claim to a regulatory tribunal or the civil courts depending on the design of the compensation fund.

Assessment Methodologies

Fixed Amount

A fixed amount may be used to collect the initial funding for a new investor compensation fund. The disadvantage of using a fixed amount assessment over time is that it is not proportionate to the size or potential exposure that different intermediaries create for the fund.

Fixed Rate

A fixed rate based on a uniform measure for all dealers is simple to implement and transparent. The measure could be revenue, investor assets held in a custodial function, or regulatory capital required. The measure will not necessarily relate to the exposure of the fund if a dealer fails, but will be a method of allocating the total assessment among the dealers in some proportionate way.

In order to implement a rate based on a specific measure, the fund must receive or have access to the data for each dealer. There is added assurance of the validity of the measure if it is an item from the audited financial statements for the dealer.

Variable Rate

A variable rate assessment allows different rates of assessment for different levels of risk presented by the dealers.

A model to assess the risk of each dealer will require that the fund have data inputs for each dealer. If the model is statistically based, a number of years of data may be required and therefore a variable rate model may only be feasible in a more established fund.

The variable rate is applied to a specific measure (revenue, investor assets, etc.) for each dealer as described above.

Fixed Rate vs. Variable Rate

The fixed rate is easier to apply but if there is a wide disparity among the size and nature of dealers, the variable rate may be more appropriate as it will more fairly allocate the assessment based on risk.