ASPECTS OF INVESTMENT SURVEILLANCE AND PROTECTION OF CLIENTS' ASSETS

Assist. Prof. Dr. Diyana Miteva-Boncheva,

Finance Department, UNWE

Summary: *The protection of clients' assets has a key role for the financial markets not only in terms of their development, but also in terms of their stability and steadiness. In this paper issues of a current importance are reviewed concerning the protection of clients' assets in Bulgaria and the EU. Simultaneously there is a review of the risks to which the investors in the capital markets are exposed, as well as the framework for protection of those investors. The goal of the paper is to point out the imperfections of the protection and also to propose some directions for amendments aiming for better investors' protection. The paper emphasizes on the financial regulation in Bulgaria and the EU.*

Key words: *protection of clients' assets, financial regulation, capital market.*

Clients' assets protection is mainly connected with preventive and follow-up measures, which aim to limit and oppose the risks of loss on capital markets. That does not include the traditional investment risk, which is inherent to all investments on the capital market and is in regard to fluctuations of financial instruments' prices. In this paper issues connected to risks which arise from investors' relations with the intermediary (investment firm, bank, etc.) are analyzed.

This topic is interesting and important having in mind the enormous losses investors went through since 2007. The discussed period includes the world financial crisis, as well as some of the biggest investment banks and investment firms failures. [1] The weak regulation, non-transparent behavior of capital market participants and complicated financial instruments, as well as too big to fail investment companies were most often pointed out by economist and regulators as reasons for the crisis.[2]

As a response to the chaos in USA and EU there was a massive regulatory campaign for tightening the legal framework requirements and increase of investment survailence over capital markets. The theoretical explanation for the necessity of regulations is in terms of market failures as imperfect competition, information asymmetry etc. The probability of

[1] The bankruptcy of Lehmen Brothers in 2008, as well as the Ponzi scheme of Bernerd Madof in December 2008 brought billions of losses for investors.

[2] The de Larosière Group report from February, 2009, p. 3, also: Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, 2008.

market failure in the context of the key role that capita markets have determine the existence of a certain level of financial regulations.[3]

The Lehmen Brothers failure had a systemic importance which the “too-big-to-fail” institutions have. The enormous costs caused by that failure as well as the number of parties who suffered was an evidence that regulation could have been better grounded. As a consequence the American government responded with a new financial legislation – the Dodd-Frank Act from the summer of 2010 which was later named as the most massive financial reform since the Great depression.[4]

The amendment in Europe were mainly in the EU but the process of implementation is still on the way.[5] As a part of the measures after the crisis there are new structures created responsible for the supervision of the financial sector, as well as new regulations aiming to obtain higher investor protection.[6]

Besides the actions which were taken there are still many imperfections which may impose risk of loss for investors. In the present paper a stress on the clients assets protection is put as to those part of the legislative framework which should be considered as problematic and should be reviewed in order to prevent losses and misappropriations for investors.

CLIENTS’ ASSETS PROTECTION FRAMEWORK

Financial regulations could be structured using different approaches. Frederic Mishkin for example overviews 10 main categories.[7] From the perspective of clients investing on the capital market protection could be discussed in three levels: (Figure 1).

[3] Howells, P., Bain, K., Financial markets and institutions, 2000, p. 360

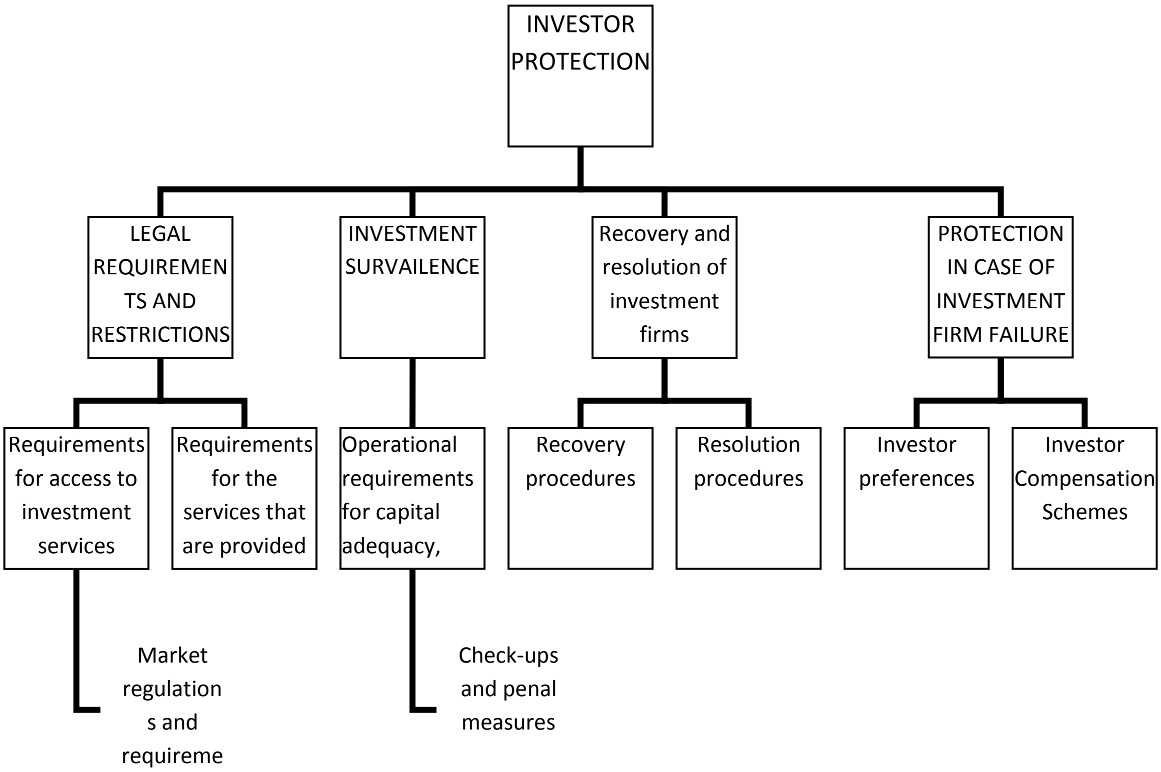
[4] Dodd-Frank Wallstreet reform and Consumer Protection Act from July, 21st 2010 and FDIC’s 2010 annual report, p. 6.

5 By the end of 2015 the new directives for deposit insurance schemes and for resolution and restructuring of credit institutions and investment intermediaries has been adopted and implemented in the national legislation, while the new directive on investor compensation schemes has been put on hold since 2011.

[6] The European Banking Authority was created, also the European Securities and Markets Authority, the European Insurance and Occupational Pensions Authority , as of 2011.

[7] According to F. Mishkin the ten basic financial regulation categories are: the government safety net, restrictions on asset holdings, capital requirements, prompt corrective action, chartering and examination, assessment of risk management, disclosure requirements, consumer protection, restrictions on competition, and macroprudential supervision.. See: Mishkin F., The Economics of Money, Banking and Financial Markets, 10th Edition,2013, p. 242.

Fig. 1



Source: Author's review and oppinion

First of all, we could outline the legal requirements that investment firms, financial instruments and capital markets should fullfill. There is a threshold for access to the right to provide investment services such as capital requirements, fulfillment of criteria for persons who are allowed to managed an investment firm, a detailed activity programm to be presented and many others, where the aim is to limit the probability for fraud actions.[8] Moreover the services provided by investment firms are prescribed by the legislation as well as the financial instruments traded are also subject to supervision.[9] Many changes and improvements were adopted in this regard after the world financial crisis. For instance, in the UK new financial instruments could not be traded anymore without the approval of the FCA (Financial Conduct Authority).

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[8]See for example Art. 8-13 of Markets in Financial Instruments Act, last amended SG No. 94/4.12.2015.

[9]See for example Art. 5 of Markets in Financial Instruments Act, last amended SG No. 94/4.12.2015. Also, the requirements for the public companies and the IPOs are limiting the risk for investors. Also the admission to trade of investment instruments especially after the financial crisis has been tighten since many derivative instruments happened to fail on the market and caused enormous losses for both market and investors.

Investment survailence includes further requirements for capital adequacy, reporting and the process of administration and operation of clients assets once the investment firm has started its business. The effective supervision is performed through check-ups by the national supervision authority and through its right to impose administrative measures where the law has been infringed.

In some cases, the number of market participants could be enourmous which would hinder the effective supervision, or it will be uneffective where there is deliberate fraud actions.[10] As part of the survailence different actions could be taken – administrative resolutions and punishments, imposing a temporary requisitor, changing the operational structure etc. Furthermore, if the survailence has failed or the investment company has managed to hide some illeagal actions, frauds or losses and it turned out to experience troubles with its financial position two more steps of protection are prescribed.

The first one is in regard of the new requirements for recovery and resolution of investment companies which were enacted through the Directive 2014/59/EU for the recovery and resolution of credit institutions and investment firms that should have been implemented in the national legislation in 2016.[11] The new recovery and resolution measures impose the creation of huge administrative bodies who will be responsible in case a credit institution or investment firms is facing significant financial difficulties that could lead to large investor losses and contengiency effect in regard to systemic risks. That was provoked again from the recent crisis and the use of the state aid financing in those type of cases. In short this pillow of investor protection includes a variety of measures for recovery and resolution where the funding is meant to be gathered ex-ante from the regarded institutions subject to this legislation.

If the third pillow fails to prevent an investment firm from a failure or it has been thought to be too late for its activation the last resort protection is also foreseen. In a case of investment firm failure investors could benefit from investor preferences and priviliges in the process of liquadion, as well as of the compensation provided by the investor compensation schemes.[12]

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[10] For instance on the UK and American capital markets there are more than 4 thousand investment firms and it could be practically impossible or too expensive to closely supervise each of them on a regular basis compared with other markets as many of the EU member states where the number of investment companies is often about 100 or less.

[11] See DIRECTIVE 2014/59/EU of the European Council for the recovery and resolution of credit institutions and investment firms from May 2014.

12 Those are legal entities who have the obligation to cover investor losses to a certain limit amount where and investment firm has failed to return clients assets and where certain legal action has been undertaken against the firm. Usually the funds for those compensation payments are ex-ante or ex-post gathered from all investment firms on the respective regional market. There is an EU Directive which impose the existence of such scheme in every EU member-state (See Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes).

The changes and actions after the world financial crisis were in regard of all four pillows of investor protection aiming at higher legal requirement, stricter survailence, measures for recovery and resolution, as well as higher last resort protection and compensation in case of eventual losses. When observing investor protection pillows and measures it is important to understand the nature of risks on which capital market investments are exposed.

Risks for investments on the capital market

The common division of risk for investors on the capital market the could be a subjected to control is to financial and operational risk. The financial risk is connected to the consequences in a case of failure of investment firm or a third party. Operational risk is rather in regard of issues that may arise in the process of administration or holding clients assets. Table 1 shows systemized information for both types.

Table 1. Risk for investors assets on the capital market

Financial risk	Description
1.Risk of investment firm default	➢ Treating clients assets as part of defaulting firm rather than belonging to ➢ Freezing assets - imposing costs to clients in terms of disruption and inconvenience connected with transfer of clients assets.
2.Risk of third party default	➢ The risk of client asset losses in the event of a default by a third party (custodian bank, or an intermediate broker, clearing house or other party to which the firm transfers client funds for transaction purposes).
Operational risk	Description
1. Theft or embezzlement	➢ The risk of client assets being stolen or otherwise misappropriated by employees or managers of the firm or third party
2. Fraud	➢ The risk of an unauthorised transfer or fraudulent use of client assets (eg, to cover own-account trading losses, or other dishonest behaviour conducted by employees or managers of the firm or third party)
3. Segregation error	➢ The risk that client assets are incorrectly identified as firm assets rather than client assets, or vice versa.
4. Settlement error	➢ The risk that there is a mismatch between delivery of securities and payment of client funds.
5. Reconciliation error	➢ The risk that the firm is unable to reconcile client balances in its own internal records with those in the reports of third parties
6. Accounting or record-keeping error	➢ The risk that, due to recording problems, the firm is unable to allocate client assets to individual clients. Accounting frauds.
7. Failure to execute (or other breaches of) client instructions	➢ The risk of losses arising from a firm’s failure to execute a client’s transaction on time or in the correct manner, or to otherwise breach instructions

8. Other poor investment management	➢ The risk of churning, mispricing, corporate action failures, stocklending failures , etc. which result from failure in the corporate management (including bad investment decisions) [13]
9. Bad investment advice	➢ The risk of receiving negligent financial advice (eg, advice without a reasonable basis)

Source: *OXERA, Description and assessment of the national investor compensation schemes established in accordance with Directive 97/9/EC, 2005.*

Financial risk includes investment firm default risk and third party default risk. The issues that arise in a case of investment firm default refer mainly to transferring or paying back clients assets to investors. If the firm has treated part of the clients assets as its own that could impose losses for investors. In this regard a key issue turned to be the segregation of clients assets. Particularly risky are the money funds in a number of countries, including Bulgaria, as they are practically compounded with the funds of the investment firm and are kept in its bank account.[14] When there isn't a clear segregation of clients assets they could be treated as unprotected because of the fact that the identification of ownership is difficult to be established.[15] A solution to this problem is a separation of clients assets from firms' ones – in a sub-accounts or in a special accounts on which firms to have limited rights to operate with. Those measures are implemented in some countries where the investment firms' bank accounts are with a special regulation. [16]

Another risk, which the compounding of firms' and clients money brings is the failure of the bank in which the investment firm keeps its funds. In this case the investment firm being a professional investor is not protected by the relevant deposit insurance scheme and thus the money which are in the account of the firm are not to be repaid. Following that even the small investors will lose their money which alternatively could result in firm's default if it is unable to refund the clients assets with own assets. A solution to this problem is the separation of clients money in the bank accounts and its inclusion in the scope of protection of deposit insurance schemes. The default situation regards also the issue for the regulation of liquidation of assets of the defaulted firm. Those issue has not been harmonized in the EU perspective. A significant issue is also the investors preferences in the liquidation order and the rights of investors compared with those of the creditors of the defaulted firm. Investors should be on a front position. The liquidation of a default investment firm in Bulgaria is

[13] The biggest investment bank in USA JPMorgan Chase has removed its investment manager due to bad investmen decision which lead to loss of 2,3 bill. dollars. http://www.bloomberg.com/news/articles/2012-05-11/jpmorgan-loses-2-billion-as-mistakes-trounce-hedges

[14] The risk of misuse of financial instruments is lower.

[15] For instance, there is a requirement the clients money funds to be classified in the balance sheet of the investment firm, and in a case of no segregation that could lead to a misuse.

[16] For instance the „Escrow" accounts which are popular in USA and UK and which suppose such asset segregation.

prescribed in the Trade Act as there are no preferences for investors among other creditors. There should be significant changes in this regard in order to obtain higher investor protection.

A third party default could impose significant losses not only for investment firms but also for investors. The use of second intermediary has been popular especially during the globalization of the capital markets. Trading on the international market requires domestic brokers to connect with foreign ones. Those relationships lead to certain risk and it is mainly connected with the probability the foreign broker to fail supply money or financial instrument subject to the contract. Currently, no last resort protection is foreseen in this relation, but it is discussed on EU level.[17]

Bad investment advice is one of the operational risks which triggers a significant discussion and is subject of application only in the UK. Those risk appears when one financial consultant or adviser gives advice to a client to invest his money in a particular instruments without giving the client the full information for the level of risk this investment carries. Thereafter the client could experience significant losses and the intermediary could happen to be unable to cover them which would trigger investor compensation scheme to interfere. The UK investor protection scheme (FSCS Financial Services Compensation Scheme) pays compensations mainly for bad investment advice. This protection is getting more attention on EU level.

Regulatory arbitrage and cross national differenced in the clients assets protection

The default of Lehmen Brothers and its subsidiaries some of which investment firms, brought the questions for the different clients assets protection across different states. The different treatment of clients assets brings various difficulties in regard mainly to investors interests. Also, the different conditions impose difficulties on liquidators in the process of determination of clients claims. The delay in those processes was admit as a result of Lehmen Brothers default and brought to losses and lost benefits for the clients.

In regard to member-states of EU and respectively to states in the European economic area there is recommendation enacted with the Directive for the markets of financial instruments which states that there should be introduced appropriate requirements for

[17] See art. 6 of EC proposal for changes in Directive 97/9/EO from July 2010, which foresees investor compensation schemes to protect investors and pay compensations in case of third party custodian default. This proposal has still not been into force and no clarification on when and if it will be adopted. Currently only Sweden is an example of providing protection for third party failure.

facilitating the distinction of own and clients assets not only for financial instruments but also for money funds.[18] Each member-state has the discretion to use its own judgement how and to what extent to apply this recommendation.

In Bulgaria those type of regulations are prescribed in the Financial instruments market Act and further developed in Ordinance 38 of the FSC where an investment intermediary has no right to use clients assets for own account or for the account of other clients. The intermediary should ensure a clear segregation of its assets from those of its clients and in the cases of custodian services that should be done through separate accounts. In practice, it turns that bank accounts investment firm compile of all type of ownership money as currently banks could not separate clients money from those of the investment firm. That is discussed as possible only in a case of opening separate clients accounts which will trigger the relevant service costs.

When the country of the custodian does not allow separation of clients accounts those clients assets are written on the name of the investment firms as it is an obligation of the firm to provide proper identification of clients assets in another way.[19]

The existence of different requirements from the regulatory authorities in each state could be a serious gap in the notification of investors in regard of their own funds. In Spain when and investment firm has to hold clients assets in omnibus account in a third party custodian it has to receive a written assent from the clients. While in France there is a distinction on basis of the type of the firm – in a case of a bank no segregation is needed, but if it is investment firm it is imperative. In USA on the other side it is allowed clients assets to be held in omnibus accounts but only if there are not encumbered. In Italy non bank investment firms do not have right to held clients assets, instead they have to have contract for custodian services with a third party. It is an interesting example of USA where the legislation allows a temporary deficit on clients accounts and a decent time deadline is allowed to restore the deficit. The latter creates a precondition for misuse of clients assets. Clients assets deficit in other states is reckoned as malpractice and in most of the cases leads to triggering the investor compensation scheme, which should refund the losses up to a certain limit and in accordance to prescribed conditions.

Problems with the last resort protection for investors

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[18] Directive 2004/39/EC on markets in financial instruments.

[19] Clients assets are hold separately from those of the investment firm but in the so called omnibus accounts. Usually those are accounts of investment intermediary in a third party where clients assets are held separately but in aggregate type in contrast to individual accounts which are on the name of each clients.

Investor compensation schemes has the major problem of inadequate funding which may lead to risk of shortage of funds for compensation payments. A solution in this direction is introducing funding model bound with the amount of eventual payments.[20] Another issues which are important to be investigated in future projects and workings are connected with analysis of the limit of protection and funding of compensation schemes, both for investors on the capital market and for depositors, in the context of their sustainability levels. The latter is very important for developing and maintaining a reliable financial safety net.

Conclusion

It could be concluded that investments on the capital market are exposed to a number of risks. Globalization and free market of financial services are increasingly imposing measures for synchronization of investor protection, but as pointed out briefly in this paper there are still many issues and gaps at place and a number of actions should be taken in order to provide a better clients assets protection. That could be done by using a common structure which will allow easy identification of clients positions.[21]

Having in mind the investment risk which investment instruments bare and the significant place of capital market financing in the financial market especially in a time of bank crisis it is important to establish and maintain relevant investor protection framework.

To reach a higher level of protection all levels of financial regulation should be active and appropriate to the development of capital market. Regulation of markets of financial instruments should be the light of increasing transparency and investor protection, strengthening credibility, limiting non regulated fields and providing appropriate authorities necessary to the supervisory bodies to fulfil their goals.

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[20] See Miteva, D. Development of investor protection schemes and limits of protection, PhD Dissertation ,UNWE, 2013.
[21] For example the requirement for a Single Customer View introduced in deposit insurance could be a good practice.

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