

MADOFF: implications for Luxembourg funds
(EFAMA memo)

Introduction

This memo will give ALFI's view on the Madoff affair and the affected UCITS funds domiciled in Luxembourg. ALFI would like to particularly stress the following:

- Luxembourg regulation on the responsibility the depositary of an investment fund complies with the UCITS Directive and is equivalent to regulation in France;
- the Luxembourg government and the country's applicable regulatory and supervisory bodies acted as soon as the scandal broke to analyse and manage the consequences of the Madoff affair;
- the first court ruling in Europe concerning the Madoff affair was given by a court in Luxembourg and was in the interests of investor protection;
- Luxembourg is in favour of a constructive process of reflection on investor safety in Europe and would like to see a debate based on an objective analysis of the situation.

ALFI believes that the priority for EFAMA members should lie in building the public's confidence in the principal savings product in Europe: UCITS. Although the size of the fraud and its international consequences make the Madoff affair unique, we should attempt to learn as many lessons as possible from it to stop similar cases occurring in the future.

1) Current situation

In view of the size of our industry, it is unsurprising that Luxembourg funds had invested (directly or indirectly) with Madoff and now find themselves amongst the victims in this affair. According to the CSSF, 16 funds or sub-funds (out of over 12 300) have been affected and have suspended their activities. Total investments of Luxembourg funds with Madoff amount to 1.9 billion euros (0.15% of all assets under management in Luxembourg funds).

The Luxembourg funds affected that have been most commonly referred to in the press are:

- the Luxalpha fund (American Selection sub-fund) and the Luxembourg Investment fund Luxinvest (US Equity Plus sub-fund). These funds have been most commonly referred to in France. Their promoter was UBS, with other entities in the UBS group serving as the manager and depositary of the funds. The final manager of the Luxalpha fund was Access International Advisors Luxembourg, a company under Luxembourg law, which had been recently appointed. Notable amongst its board members were, the fund managers Patrick Littaye and Thierry Magon de la Villehuchet (who committed suicide on 23 December in New York). These close acquaintances of Madoff transacted business via an American company also named Access International Advisors.
- the Herald (Lux) fund (US Absolute Return sub-fund). This fund has been most commonly referred to in Germany and Austria. Its promoter was the Austrian bank

Medici (since put under the control of the Austrian authorities) and its depositary was HSBC Luxembourg.

All of these funds are SICAVs under Part I of the Luxembourg law of 20 December 2002, i.e. they benefited from the European passport under the UCITS Directive.

2) Potential liabilities under Luxembourg law

ALFI has believed since the beginning of this affair that, although responsibility lies principally in the USA, and inasmuch as European (and thus also Luxembourg) investment vehicles had served as bridges between Mr Madoff and his ultimate victims, it was necessary to check if those working with these vehicles had acted with all due diligence. The CSSF shares this view, and stated in a press release that it would check that all concerned parties “have acted with the diligence imposed by Luxembourg law”. Other European regulators are likely to take the same attitude.

2a) Discussions on the provisions of Luxembourg law

Although many parties are involved in this affair, the current debate mainly focuses on the liability of the depositary of the funds (UBS for Luxalpha-Luxinvest, HSBC for Herald).

Certain public figures in France have encouraged this debate by publicly stating, right from the start of the affair, that French investors affected by Madoff would have been reimbursed if they had invested in a French fund and that they were thus tangibly less well protected as investors in a Luxembourg fund.

However, such accusations are completely unfounded. Indeed, as the CSSF stated in a press release on 2 January 2009:

“Luxembourg law applicable to Luxembourg based depositary banks in their role of safe-keepers of investment funds' assets reflects faithfully the provisions of the European Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities.”

The CSSF continues by saying:

“When a fund's assets are deposited by the depositary bank with a third party, these deposits are under the monitoring and supervisory responsibility of the depositary bank, implying that the latter must know at all times in which manner the assets are invested and where and how these assets are available. This responsibility is not affected by the fact that the depositary has entrusted to a third party all or part of the assets in its safe-keeping. The CSSF considers that the provisions laid down in Luxembourg law offer an appropriate framework in order to ensure an adequate protection which is in accordance with the European standards of an investment fund's assets on behalf of its investors.”

A further obligation is imposed by the Luxembourg Civil Code: the obligation of safekeeping (Article 1927) and of refunding of assets at the customer's request (Article 1932).

In our surprise at the views conveyed in the French press, casting doubt on the very existence of these obligations, we were probably a little late in providing information on the law. Last week, Minister Luc Frieden and then Prime Minister Jean-Claude Juncker unequivocally stated that Luxembourg has faithfully transposed the UCITS Directive and there is no difference between French and Luxembourg legislation with regard to the responsibility of the depositary.

2b) Discussions on specific cases

Although the law is unambiguous, it must be also verified whether it is respected by all industry players in Luxembourg. This is what the CSSF's inquiry is establishing, but it will ultimately be up to the law courts to decide on damages. This investigation will also establish the precise nature of the contractual relationships between Madoff and these parties, whether he was a sub-custodian, a (sub-) manager, etc.

It would appear that most direct investors in the funds were institutionals, acting in their own name or on behalf of customers. It thus seems that the final victims were partly high-net-worth individuals but also retail investors. As such, the press has reported cases where private individuals have taken out a life assurance policy only to find that "their" portfolio had invested in a fund which placed its money with Madoff.

The first Luxembourg court ruling concerning the Madoff-Luxalpha affair (the ruling on the ODDO case) has shown that the Luxembourg courts are ready to make rapid, firm decisions in favour of investors, even though the legal basis in this specific case does not apply to all investors (ODDO had asked to redeem its shares before the fraud was uncovered).

3) Challenges at European level – investor safety the priority

The letter sent by Ms Lagarde to Commissioner McCreevy, with a copy sent to Prime Minister Juncker, has taken what had been a French or Franco-Luxembourgish debate to a pan-European level. Minister Frieden has already stated that he would support any initiative to further reinforce investor protection, as long as it could be useful and necessary.

The letter has also met with a very muted reception both from sector professionals and investors affected by the Madoff affair because it casts doubt on the effectiveness and even the existence of investor protection measures currently in place under European law. There is a real danger that this declaration of uncertainty could continue to shake the confidence of investors in Europe (and the world) in the UCITS brand.

At the same time, we wish to congratulate the Commission for opening an inquiry on the transposition of the UCITS Directive in various countries of the EU because it will answer the French criticisms of Luxembourg in this case.

The letter will certainly re-open the debate on European harmonisation of rules concerning fund depositaries. This is nothing new and has already been covered by a European Commission report in 2004. ALFI welcomes with interest this re-examination of current regulation and believes the first question to be asked should be what the status of the depositary is. Depositaries in Luxembourg must be banks.

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