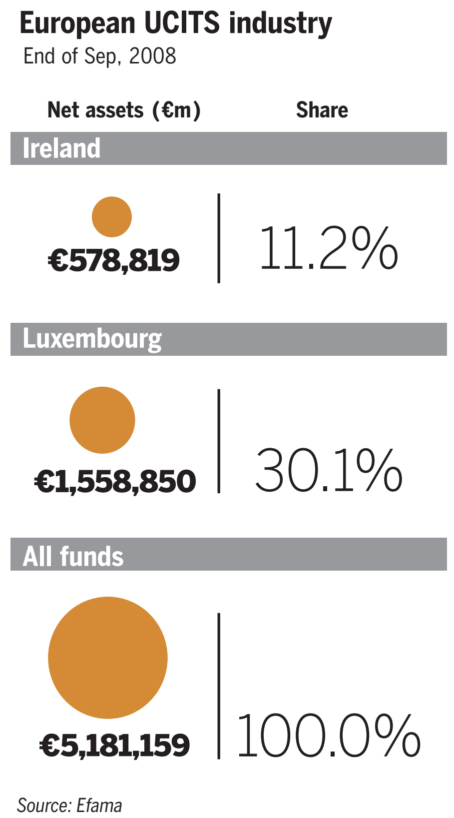
Luxembourg called upon to 'brush up' governance



The Big Picture

The country's regulator is being accused of failing to implement rules to protect Ucits funds, says Sophia Grene

The whole point of Ucits funds, the European cross-border investment vehicles, was that they should be simple and safe enough for the retail investor.

With more than 30 per cent of Ucits funds domiciled in the Grand Duchy, Luxembourg has become virtually synonymous with cross-border Ucits funds.

Recently, however, as disappointed investors try to discover what happened to the money they put into Ucits funds invested with Bernie Madoff, Luxembourg's regulator has come under fire amid accusations of failing to implement regulations stringently enough.

Under the Ucits directive, a key player in the oversight of the fund is a depositary, which is responsible both for making sure the fund manager is managing the money as promised and for ensuring the custodian really has the assets it is supposed to be looking after.

Even if custody of the assets is delegated, as it was in the case of the Madoff feeder fund promoted by UBS, the depositary retains responsibility for supervision of the assets.

"The Luxembourg regulator was really caught with its knickers down," says Mark Tennant, a senior adviser to many companies in the asset management and securities services industry. "Luxembourg has to beef up the rules regarding depositaries. Unless they do it, and do it quickly, the great brand name of Ucits will disappear."

Custody of the assets was delegated to a US broker that was a Madoff entity, raising questions about the safe-keeping.

Alfi, the Luxembourg fund industry association, has set up a taskforce to examine precisely what happened and whether better safeguards could be set in place for investor protection. The eight-person taskforce is expected to report by the end of February.

Charlie McCreevy, the EU internal markets commissioner, says in a foreword to a report from Invesco (see FTfm page 1): "These situations . . . can do significant damage to the perception of Ucits as a safe haven, and weaken the trust and confidence needed to support cross-border distribution."

Independent ethics and compliance consultant Jérôme Turquey also warns Luxembourg faces a serious problem.

"The [financial centre of Luxembourg] wants to brush up its governance. If it doesn't do that in the next few months, the centre will collapse." He predicts, if the regulatory situation is not sorted out, dissatisfied investors and asset managers will move their business elsewhere.

> 'Depositary legislation in Luxembourg not tough enough'
>
> **Mark Tennant**
> **industry adviser**

Luxembourg's neighbour, France, for example, is stirring up trouble. According to Christine Lagarde, Minister for Finance, French depositaries in such a case would have a duty to restitute the assets to the fund, regardless of whether they had carried out the requisite due diligence on the sub-custodian.

According to figures released by French regulator AMF, French investors have €500m (£470m, $641m) of assets invested with Madoff, mainly through Luxembourg-based Luxalpha, whose depositary is UBS, and Ireland-based Thema, whose depositary is HSBC.

Ms Lagarde has written to Mr McCreevy asking for a review of the implementation of the depositary regulation. Following discussions between the European finance ministers last week, it seems likely such a review will take place.

"This Madoff issue has caused concern about whether the rules on custody are being properly implemented," says Jarko Syyrilä, head of European affairs at the UK's Investment Management Association.

There seems to be little consensus in the industry about what is standard practice or in line with the Ucits directive. One expert, speaking off the record, echoed precisely Ms Lagarde's comments, while another was scornful of the idea that it had anything to do with the Ucits directive at all.

The Luxembourg regulator refuses to speak about the affair, offering only a written response to questions.

"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," it declares.

Mr Tennant is scathing about this claim. "Depositary legislation in Luxembourg was not written tough enough." He is a fan of the UK model, where the depositary has clearly defined responsibilities and a fiduciary duty to oversee both fund manager and custodian in the interests of the fund.

While he dismisses the idea of depositaries being required effectively to guarantee subcustodians, he does say one of the key duties of a global custodian, to be subject to scrutiny by the depositary, "is to choose subcustodians wisely ".

Luxembourg law requires the depositary to be satisfied the third party holding the fund's assets is "reputable and competent and has sufficient financial resources".

The Luxembourg regulator is aware of the reputational risk to Ucits, but where many commentators call on the Duchy to strengthen and clarify its regulation of depositaries, it feels the reform should be at a higher level.

"Finally, we may inform you that there are potential risks that the Ucits brand in general might be undermined due to the situation relating to Bernard L. Madoff Investment Securities. In the case where there is a need for reinforcement of European-wide investor protection, such an initiative would be supported by the CSSF."

As with all European directives, there are significant differences in how different nations interpret the text. Until now, these differences have largely been regarded as technical problems, possibly adding costs to the industry but not posing significant risk.