Ft.com - June 2, 2013 5:46 am

Luxembourg regulator acts to salvage reputation

By Ellen Kelleher

Luxembourg's role in the 2008 Bernard Madoff fraud came under attack after several Ucits funds based there funnelled money into the Ponzi scheme.

The good name of Luxembourg's financial regulator took a hit last week.

The European Securities and Markets Authority, the financial supervisory authority that monitors regulatory standards across Europe, revealed at the end of last month that it is investigating allegations against Luxembourg's Commission de Surveillance du Secteur Financier. The charges are that the CSSF failed to appropriately deal with a bond fund that violated its investment rules.

The case marks the second time in recent years that the actions of Luxembourg's financial regulator have been questioned in public.

Esma's examination of the merits of claims against the CSSF follows the 2008 Bernard Madoff fraud in which Luxembourg's role also came under attack after several Ucits funds based there funnelled money into the Ponzi scheme.

This time around, investors in a failing bond fund have lashed out at the CSSF for neglecting to offer them compensation, despite the regulator acknowledging in written correspondence that the fund in question – Petercam's L Bonds Eur Inflation-linked fund (formerly known as Eur Medium) – broke Luxembourg's fund laws.

Both the investors in the Petercam bond fund and the Madoff fund investors are scathing in their criticism of the CSSF. They argue that the regulator rubber-stamped the funds and turned a blind eye to subsequent problems.

In the latter case, European Madoff funds were promoted as Ucits-compliant funds invested in shares included in the S&P 500 that sought to neutralise market risk by making use of option strategies; they were sold as low-risk investment strategies, characterised by stable returns, which held appeal for risk-averse investors.

The reality, however, was that despite most of the funds' assets being entrusted to Madoff, his name never surfaced in the fund literature.

"According to the offering circulars, the funds' assets were managed and kept in custody by major European institutions such as UBS and HSBC," wrote lawyers from Deminor, the recovery firm representing the aggrieved Madoff investors in December 2012. "In reality, Madoff managed and kept the assets in custody."

The lawyers added: "Not a single investment decision was made by the entities appointed in the offering circulars as the investment managers of the funds."

In the former example, meanwhile, the CSSF also acknowledged in written correspondence sent to Petercam investors in October 2011 that the prospectus for Petercam's L Bonds Eur Inflation-linked fund did not comply with Luxembourg's laws, which state that the "simplified prospectus ... must contain the information necessary" for investors to assess the investment and the "risks inherent in it".

The regulator also admitted that the fund's investments in perpetual bonds were "not permissible", as the fund's managers said they would invest only in bonds of a limited duration.

Esma's interest in the case has intensified in the two weeks since FTfm broke the story that Petercam's investors are on a campaign to alert politicians and industry players to the "lax and selective" supervision of funds listed in Luxembourg.

Albert Biebuyck, managing partner at Investor Protection Europe, the group representing disgruntled Petercam investors, last month sent a flurry of letters to Luc Frieden, Luxembourg's minister of finance, Jean-Claude Juncker, the prime minister, and Steven Maijoor, chairman of Esma, to complain about the regulator's failure to offer compensation.

"You will certainly agree that a lax, selective or oblivious supervision of Luxembourg funds might have negative consequences, besides the losses incurred by investors," Mr Biebuyck wrote.

Erik Bomans, a partner at Deminor, is equally eager to take on the CSSF, which also told the Madoff investors to take their fight to court. After months of legal battles against the custodian banks bearing liability for the funds in Luxembourg's courts, Mr Bomans says that there has not been a single legal debate on the merits of the case. "There is a real risk that investors will be left empty-handed," he says. "The banks involved have come up with incredible procedural tactics to delay the case."

Mr Bomans notes that investors in the Luxembourg-based Madoff feeder funds watched enviously last week as sparse details were revealed of a settlement reached in Dublin by investors in the Thema International fund, another Madoff feeder fund. Shareholders in Thema and HSBC Holdings, the custodian bank managing the fund, settled for an undisclosed amount regarding the London-based bank's liability for the losses of about $1.1bn. The settlement in Dublin represents one of the first resolutions of the numerous cases against the banks, which served as custodians to the investment funds that deposited money with Madoff.

Hundreds of suits were lodged in Luxembourg against UBS and HSBC over their custodian responsibilities to funds that invested most of their money with Madoff such as Access International Advisors' Luxalpha Sicav-American Selection.

Well-connected lawyers conducting business in the grand duchy, however, hesitate to pass judgment on the CSSF.

For his part, Marc Seimetz, a partner at Dechert Luxembourg, argues that the CSSF does not appear to be in the wrong in failing to come down harder on funds that breach its investment rules. "It's clear that the regulatory authority is there to deal with complaints. But it's up to the courts to take a decision on those complaints," Mr Seimetz says. "Investors sometimes think the CSSF has more powers than it actually has ... Not all complaints from investors can come to a positive conclusion."

Matthew Feargrieve, a funds lawyer at Withers in Switzerland, who handles business in Luxembourg, adds: "I don't think the Luxembourg regulator is lax," he says. "But I wouldn't be inclined to criticise them because we work with them every day."