

## LEGAL EASE: the need to align Ucits funds



Lehman and Madoff show that the provisions concerning the depositary's role can vary depending on where in Europe the depositary is based ... Harold Parize comments.



Although relating to only four funds of the 36,000 or so Ucits products in the EU (ie, around 0.0001% of the total number of funds), the Madoff investor fraud has turned the spotlight back on the role and responsibility of the custodian bank. Together with the Lehman collapse, it has highlighted inconsistencies that can arise in the interpretation of Ucits laws across European member states and the protection offered to investors. Certain uncertainties have arisen regarding the extent to which custodians can be deemed liable as well as the investors' status and their rights in claiming for losses as exemplified in recent court decisions in Luxembourg on 4 March 2010.

### Safe keeping

Ucits are regarded as the benchmark for fund regulation and fall under the conditions of Directive 85/611/EEC (as amended). The designation of a depositary, envisaged as the guardian of investors' interests, is mandatory for the approval of all Ucits funds.

According to Articles 7 and 14 of the directive, a common fund's or investment company's assets must be entrusted to a depositary for "safe keeping". However, safe keeping is not defined. The directive specifies that the liability of the depositary is "not affected by the fact that it has entrusted to a third party all or some of the assets in its safe keeping". Lehman and Madoff show that the provisions concerning the depositary's role can, however, vary depending on where in Europe the depositary is based. It can present conflicting interpretations making any onus of liability a very difficult one to call.

In Luxembourg, for example, depositary liability falls within the scope of the civil code and the Ucits law. Regulatory guidelines indicate that the safe keeping duty of the depositary must be understood as a duty of "surveillance". While this interpretation is relevant to Luxembourg, the French courts decided in April 2009, following the Lehman collapse, that here the depositary's duties be understood as an obligation to return the assets deposited.

In April 2009, a proposal for a Directive on Alternative Investment Fund Managers (AIFM) was put forward introducing a European regulatory regime for all non-Ucits investment products. AIFM depositary liabilities are strengthened to include an inversion of the burden of proof and to enable an appropriate level of investor protection. While an institution must be appointed to safekeep its assets, clear details will be provided of the depositary's safe keeping duties alongside new eligibility conditions for institutions acting as AIFM depositaries. This directive is still under discussion.

To maintain investor confidence in Ucits, there has been pressure to improve harmonisation across the EU. The European Commission launched a consultation on the role of the depositary in July 2009, which was subsequently completed in September 2009. This showed that market players believe there is a critical need to clarify a depositary's duties. Contributions to the consultation underlined that the perimeter of the depositary's duties in the AIFM directive needed to match the provisions to be revised in the Ucits directive.

### Investor status

Another issue again raised by these cases lies with the shareholder or investor status which will vary in terms of the types of assets held (units or shares in a Ucits) and the method for doing so (direct holding or through intermediaries).

While the directive refers several times to the protection of investors' interests, there is no matching legal concept. In Luxembourg, the law only takes into consideration the persons listed in the unitholders or shareholders register of the Ucits. This is not in tune with current market practice, where most investors act through an intermediary, generally a bank, who, although acting solely on behalf of its underlying client, is the registered entity in the books of the investment vehicle.

Questions loom over the actual shareholders and their legal status, over the legal means given to investors to defend their interests. The court decisions issued in March 2010 consider that investors may be shareholders, but do not decide on the issue, and confirm that investors are not creditors of the investment fund. Without a pronouncement on the qualification of investors as shareholders, which the court decided it could not make at this stage in the procedure, one wonders what legal status is left to investors: should they be considered as third parties? The upcoming preliminary draft Securities Law Directive, aimed at providing better protection of investors' rights, will hopefully clarify this area.

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