Madoff 4th Anniversary
Deminor Position statement
December 12, 2012

The fraud that should never have happened.

How the service providers of so-called "Madoff feeder funds" closed their eyes and accepted undue risks for investors. And how European national authorities are letting them escape their responsibilities.

Executive Summary

On December 12, 2008, Bernard Madoff admitted to perpetrating a massive Ponzi scheme and defrauding investors for tens of billions of dollars. It took a few days for the press and world-wide investor community to digest the news and estimate the fallout. But then the real shock came : investment funds distributed, managed and kept in custody by major European financial institutions admitted having lost virtually all of their assets in the Madoff fraud. Today, four years later, investors who invested in these so-called "Madoff feeder funds" are still struggling to get their monies back, and even worse, are simply trying to be heard by European courts.

This is the major lesson from the Madoff fraud: European investor protection in relation to investment funds looks nice on paper, but it does not work in practice. There is no effective enforcement of laws aimed at protecting investors and there is no fair access to justice. The banks and auditors are exploiting the inefficiencies of European investor protection to escape their responsibilities. Investors are just left in the cold.

Since the Madoff fraud, European authorities have come up with new regulations to avoid that such a horrible fraud would happen again. More regulations, more red tape, more compliance will result in more costs for investors who, at the end of the day, will pay the bill. What is really needed, however, is an urgent focus on effective enforcement. How can we expect financial institutions to comply with new regulations, if they are not held accountable for having violated the old or existing rules?

The problem is not that our legislation is deficient. We do have clear rules in Europe on custodians' and auditors' responsibility in relation to investment funds, such as on responsibilities of due diligence and permanent supervision over sub-contractors, separation of duties of custody and management, reconciliation of assets and transactions, to name only a few. All these rules aimed at protecting investors have been blatantly violated by major financial institutions and auditing firms. Four years after the revelation of the facts, none of them has been held accountable. Worst, as of today, not even a single debate on the merits has taken place before a European court.

In this Position Statement Deminor presents a summary of its findings about why the service providers are responsible for investors' losses, and why they should be held accountable. Most of these findings have been made public by Deminor during press conferences, web cast presentations or presentations at conferences since December 2008, but we believe it is useful, four years after the facts, that the basic message is repeated once more**:**

The Madoff fraud did not have to happen, it happened because those who had been appointed to look after the investors' interests failed to carry out their legal and contractual duties.

In the light of this observation, the passivity of European courts and regulatory authorities can no longer be justified. Four years after the facts, investors in feeder funds should not have been left with empty hands. If they have not yet recovered a single euro cent, it is because European national authorities have failed to enforce basic investor protection rules.

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The very set-up of Madoff feeder funds as UCITS funds was illegal

European Madoff feeder funds were promoted as funds invested in shares included in the S&P 500 that sought to neutralize market risk by making use of option strategies. They were sold as low-risk investment strategies, characterized by stable returns. They appealed to conservative European investors who had become increasingly risk averse after the 2001-2003 stock market crisis.

While the initial Madoff feeder funds were set up in off-shore financial centers, at a later stage they were also established in Ireland and Luxembourg as funds carrying the UCITS label. Pursuant to European and national UCITS legislation, once these UCITS funds had been approved by the supervisory authorities of an E.U. Member State they could be widely sold to European retail investors across the European Union on the basis of the "European Passport". To be set up as UCITS funds, these funds and the service providers acting for them needed to comply with strict rules relating to risk management, separation of duties, supervision and controls, and investor protection.

The UCITS funds had no resemblance to a Madoff investment at all. Whereas in reality all of the funds' assets had been entrusted to Madoff, his name was not mentioned a single time in the offering circulars. According to the offering circulars, the funds' assets were managed and kept in custody by major European institutions such as UBS and HSBC. In reality, Madoff managed and kept the assets in custody. Not a single investment decision was made by the entities appointed in the offering circulars as the

investment managers of the funds. Not a single asset was kept in custody by the entities mentioned in the offering circulars as the custodians of the fund. As a result, Madoff ended up combining the central roles of investment manager, broker and custodian of the UCITS funds' assets. The accumulation of these roles in one single entity is prohibited by European and national UCITS rules (see below).

Under Luxembourg law, investment managers can delegate their functions to a third party, but only under very strict conditions (art. 85, 1 of the Luxembourg law of December 22, 2002):

- The CSSF [Luxembourg supervisory authority] must be adequately informed of such delegation
- The delegation can only be made to authorized and controlled investment management companies
- If the delegation is made to a foreign entity, « the cooperation between the CSSF and the foreign regulator must be ensured »
- No delegation can be made to the depositary
- There must be measures in place allowing the manager to effectively control the beneficiary of the delegation
- The prospectus must specify the functions that the manager can delegate

The investment managers of the Madoff feeder funds breached all of these conditions.

Article 85, 2 of the Luxembourg law of December 22, 2002 states in very clear terms : « *In any event, the fact that the management company has delegated certain functions to a third party can have no incidence on the responsibility of the management company and the depositary, and the management company shall not delegate its functions in such a way that it would become a letter-box company* (« une société boîte aux lettres ») » (our underlining)

We believe Article 85, 2 of the Luxembourg law of December 22, 2002 is a special Luxembourg provision that is aimed to act against the so-called "*fund hotel business*" practice according to which investment managers or advisors outside of Luxembourg appoint a Luxembourg entity as official investment manager of the fund, who then delegates its entire function to a third party who effectively acts as the investment manager. Whereas this practice is prohibited for UCITS funds, it was widely used by UCITS Madoff feeder funds. Only Madoff set the investment strategy, decided when to stay in or exit the investment strategy, and made investment decisions. The official investment manager did practically nothing and gave a blank cheque to Madoff to invest the assets.

In the case of UBS Third Party Management Company S.A. which acted as investment manager of Luxalpha, a Luxembourg based UCITS fund, there are even serious indications that UBS tried to create the false impression that it was making effective management decisions. According to an internal operating memorandum issued by UBS, the bank had decided to issue back-dated investment recommendations. By back-dating the recommendations, UBS could issue the recommendations in function of the trades reported by Madoff. This could at least give the impression to the authorities that UBS was effectively making investment recommendations, that there was no illegal delegation of the investment management function to Madoff, and that it was not acting as a letter box company. This evidence also suggests that UBS knew that it was acting in breach of the law.

The auditing firms did not report this clear violation of Luxembourg laws to the authorities or to investors.

As a conclusion, major financial institutions had accepted important duties as investment manager, custodian or fund administrator of the UCITS Madoff feeder funds, and in this way lent their credibility to these funds. However, in reality, Madoff was left in charge of all central functions of the funds. The official service providers' duties only existed on paper. These service providers illegally delegated their

duties to Madoff and acted as pure letter box companies in breach of European and national rules relating to UCITS funds.

Investors and authorities were not informed about Madoff's uncontrolled and unlimited powers

Investors relied on the credibility and creditworthiness of institutions like UBS and HSBC when deciding to invest in the Madoff feeder funds. How could they ever have reasonably thought that institutions with such a name and reputation would be found willing to act in breach of fundamental UCITS rules?

Apart from the fact that the Madoff feeder UCITS funds were illegal from the outset, the investors in the funds and the regulatory authorities had not been informed about the fact that Madoff was effectively in control of all essential functions and that the official "service providers" had not put in place the necessary safeguards to protect investors' interests (see below).

The Luxembourg supervisory authority repeatedly stated that it was not aware of the kind of delegation that had been assigned to Bernard Madoff. This means that none of the funds, the official investment managers, the official custodians and the auditing firms had bothered to report these irregularities to the authorities.

Deminor has seen evidence, however, that UBS Luxembourg S.A., in its capacity as custodian of various Madoff feeder funds, not only omitted to mention Madoff as a sub-custodian in its yearly control report submitted to the CSSF, but that it misrepresented the CSSF about the identity of the sub-custodian that it had appointed to safe-keep the assets of the Madoff feeder funds. We do not believe such misrepresentation can be an error, given the large size of the funds at stake, and the fact that such control report had to be submitted on a yearly basis. Given the fact that the delegation of custody function to Bernard Madoff was illegal (see above), one may question whether the misrepresentation was made in a deliberate attempt to hide the illegality of the delegation from the controlling authorities.

We reasonably conclude from all this that, if the controlling authorities had been correctly informed about the extent of the delegation, they would not have approved the funds, and as a result investors would never have had an opportunity to invest in these funds. This is one of the reasons why we think the custodian banks bear a significant part of the responsibility for the losses suffered by investors.

The custodian banks failed to conduct due diligence and to permanently monitor Madoff

Bernard Madoff did not allow any serious due diligence into his own activities and operations. This was however not what investors were told. Investors invested their monies in the Madoff feeder funds assuming that the officially appointed investment managers and custodians would carry out the required due diligence and permanent supervision over any sub-contractors that they would appoint. According to European and national UCITS rules, the liability of custodians is not affected by the fact that they have delegated certain of their tasks to sub-custodians (Art. 7 of the European Directive 85/661). Luxembourg authorities interpret this rule in the sense that a custodian is responsible if, due to a lack of supervision, the sub-custodian loses the assets.

The custodian banks acting for the Madoff feeder funds did not carry out the required due diligence and supervision. Despite the fact that billions of euros were handed over to Bernard Madoff, there was no permanent electronic link between the officially appointed custodians and Madoff that could have made it impossible for Madoff to construct his trades *ex post* in function of the known prices of the securities. The trades reported by Madoff to the officially appointed custodians and investment managers contained visible errors. The reported volumes did not fit with reported market volumes and the size of the reported options was so important that it would have had a destabilizing effect on the market. The custodians and auditors did not verify the existence of the assets and the transactions with independent third parties. The banks did not regularly carry out thorough on-site operational due diligence.

To our knowledge only one bank, HSBC, attempted to carry out such thorough due diligence with the assistance of auditing firm KPMG. KPMG's report highlighted various essential risks, including about possible fraud and the existence of the assets. Despite having been informed about these risks, various HSBC entities continued acting as custodian of several Madoff feeder funds and even accepted to act as custodian of the Herald Lux fund, which was set up after discovery by HSBC of the important risks.

The custodian banks are therefore liable for the losses suffered by investors and have a duty to return the assets to the funds and their investors.

The auditors failed to report essential operational weaknesses to the investors and the regulatory authorities

The mission of auditors is not limited to controlling accounting documents but also includes an analysis of the internal functioning and procedures of an investment fund. This analysis includes the central administration and relations with depositary and other intermediaries. Auditors are under an obligation to communicate any weaknesses to the regulatory authorities. The auditors shall also control whether the management company performs its obligations in accordance with legal and contractual obligations.

In the case of the Madoff feeder funds, the auditors failed to report to the authorities and the investors the illegal nature of the delegation to Madoff, which constitutes in itself a basis for their liability for the losses suffered by investors.

One of the central functions of the auditor of an investment fund is to carry out reconciliations between the fund assets (as reported) and the assets held by the depositary. As in the case of the Madoff feeder funds the fund information and the depositary information had the same source (i.e. Madoff), any reconciliation between these two positions was useless. This was a direct result of the illegal delegation. Auditors should therefore have recommended other procedures, such as controls with independent third parties.

Finally, the auditors of the Madoff feeder funds failed to verify the existence of all balance sheet items, as well as the correctness of the amounts and of their accounting. The auditors did not check with any independent third parties whether the funds effectively held the securities which Madoff had stated to have purchased. Again, relying on a custodian statement from Madoff did not make any sense as the balance sheet information was itself based on information provided by Madoff. Only checks with independent parties from whom Madoff had stated to have purchased the securities would have been efficient. If such checks had been carried out, the fraud would have been detected immediately.

Deminor has filed litigation against Ernst & Young Luxembourg and against PricewaterhouseCoopers in connection with their role as auditor of Madoff feeder funds.

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