

ILA

Fund Directors' Liability Insurance

10 March 2009

The logo consists of the letters 'ILA' written in a stylized, blue, cursive script. The 'I' and 'L' are connected, and the 'A' has a long, sweeping tail that extends to the right.

Institut Luxembourgeois  
des Administrateurs

# Agenda

Introduction

Fund Directors' Liability under Luxembourg Law

Key Elements to Consider in Fund Directors' Insurance Coverage

Panel discussion

Conclusion

# Introduction

## Introduction to the Investment Fund Committee of ILA Initiatives Events



## ILA Investment Fund Committee

- Formed Q1 2008
- Members:
  - John Parkhouse Chair, PricewaterhouseCoopers
  - Monique Bachner Bachner Legal
  - Alan Crutchett Independent Director
  - Richard Goddard Independent Director, The Directors' Office
  - Graham Goodhew Dirigeant JPMorgan Asset Management Europe
  - Paul Guillaume Carne Group
  - Henry Kelly Independent Director, KellyConsult
  - Bill Lockwood Dirigeant Franklin Templeton, Chair ALFI Dirigeant Forum
  - José Longrée Managing Director CACEIS and chair of ALFI code of conduct
  - Jérôme Wigny Elvinger, Hoss & Prussen
  - Martin Vogel Independent Director



## Objectives of the group

- Lead development of the governance framework at board level for all regulated Luxembourg funds
- Provide technical and market support for directors of Luxembourg funds
- Liaise with respective stakeholders as needed (ALFI, CSSF etc) on behalf of the Luxembourg fund directors community
- Implement ILA level initiatives within the fund environment as relevant
- Ensure close interactions with ALFI initiatives



# Initiatives

- Code of Conduct
  - ALFI working Group ongoing
- Frequently Asked Questions
  - Simple guide to Luxembourg fund directors on key practical issues related to fund governance
- Membership drive
  - Amended rates and procedure
  - Fund-level membership entitling all directors to become members with one application



# Events

- “Members Only” Event
- Fund director’s role in valuation
- Custody responsibilities and implications for fund boards
- Fund restructuring – what is the role of the fund director?
- Regulation – mainstream and alternatives
- EVCA





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arendt  
arendt & medernach

# Fund Directors' Liability under Luxembourg Law

**ILA - Liability Management and Insurance for Fund Directors**

**Michèle Eisenhuth, Partner, Arendt & Medernach**

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# Agenda

- I. Introduction: liability of directors of investment companies/ManCo
  - What are the powers, duties and consequent liability of fund directors?
  - Under which conditions are the directors liable and can they be sued?
  - How can fund directors be appropriately covered in case of claims?
- II. Specific aspects related to the current turmoil: are the board responsibilities different that the ones existing before the current market crisis?
- III. Current financial crisis and corporate governance: measures to be taken by fund boards
- IV. Conclusion

# I. Introduction

## General

Powers, duties and consequent liability of fund directors governed by the amended 1915 Law on commercial companies:

- directors of a public limited company are agents thereof
- when acting in the company name, they are not personally liable but they bind the company vis-à-vis third parties
- a fund board has the right to do any and all acts to achieve its corporate purpose (except those reserved to the shareholders meeting) i.e. all acts of administration and management of the fund's assets
- a fund board is a collegiate body but tasks may be delegated to any of its members or company's officers or other agents
- ONLY specific tasks or the fund daily management may be delegated > no general delegation of powers by the fund board

# I. Introduction (ctd.)

## 1) Civil Liability

### A) Contractual Liability for management faults

(i) Board of directors to manage the fund with diligence

at fault when it does not act in the way a diligent and prudent board would in the same circumstances

Ex: - providing inaccurate or inadequate information in the fund prospectus, whether intentionally or due to negligence  
- liability for damage to the fund due to market timing practices when it does not see to implement procedures to prevent these transactions

(ii) Individual or collective liability but no joint liability

(iii) Only shareholders meeting may claim contractual liability but no shareholder individually (creditors only through « action oblique »)



## I. Introduction (ctd.)

(iv) Actions for contractual liability on account of management faults can succeed only if the plaintiff establishes a damage suffered by him + a management fault + a casual link between both

B) Aggravated liability for breaches of the 1915 law or of company's articles of incorporation

(i) joint liability

(ii) not only shareholders meeting but also creditors or individual shareholder (separate damage) may bring proceedings

C) Quasi-tortious liability for any actions or omissions other than those committed in the performance of their management duties

(i) individual liability

(ii) may be brought by the company but also by creditors or an individual shareholder

# I. Introduction (ctd.)

## 2) Criminal Liability

A) The 1915 Law provides for specifically corporate criminal offences:

- failure to publish financial and management reports by the statutory deadlines;
- payment of fictitious dividends not taken from actual profits;
- presentation of falsified balance sheets or profit and loss accounts;
- improper use of corporate assets.

B) The 2002 Law and the 2007 Law lay down criminal penalties for UCIs applicable to directors:

- not having determined issue and redemption prices at the specified intervals;
- having violated provisions of sales documents on valuation principles and time limits for payments of issued/redeemed shares;
- not having called an EGM when the assets have fallen below the legal minimum;
- not complying with the investment policy for Part I of the 2002 Law UCITS;
- distributing shares without having obtained/applied for the relevant CSSF approval.

C) Liability for breach of AML provisions

## 3) Liability in the event of bankruptcy

## I. Introduction (ctd.)

### 4) Liability of the delegates of the management body

#### - General delegates

##### A) Liability: rules applicable to agents:

- Delegates are liable vis-à-vis the management body;
- Delegates are liable vis-à-vis third parties on the basis of quasi-tortious liability;
- Shareholders may not individually act for damages suffered by the UCI;
- Delegates cannot be released from liability as board members;

##### B) Advisable to exclude joint liability in particular in the decision appointing the two conducting persons as daily management delegates

##### C) Consequences of delegation for the liability of the management body

- Management body liable vis-à-vis the UCI for delegate's acts or omissions if the person chosen was clearly incompetent;
- Obligation to monitor delegates and to fix limits to their autonomy;
- If the management body is held liable for the acts of its delegate, it may take action against the delegate (the management body remains liable vis-à-vis the UCI and third parties);

## I. Introduction (ctd.)

- Special delegates (ex: services providers)
  - \* contractual liability vis-à-vis the UCI
  - \* quasi-tortious liability vis-à-vis third parties

### 5) Liability of the conducting persons (Part I of the 2002 Law)

Conducting persons may be:

- Directors → general rules on liability of directors;
- Directors that have been entrusted with the daily management of the fund by the management body → additional rules on liability of the delegates of the management body;
- Third parties delegated to the daily management without being directors → liability under the rules of the mandate;
- Employees of the promoter → liability under their employment contract.

## II. Specific aspects related to the current turmoil

### **Are the directors/conducting persons responsibilities different now from the ones existing before the current market crisis?**

#### 1) Civil liability → to prevent management faults

A) Setting up of an appropriate risk assessment and continuous overview of risk management

- The two conducting persons must play an active role in the approval of the method chosen by the board for an appropriate risk management process;
- Circular 07/308 (for UCITS):
  - \* the board should allocate risk management duties to a specific risk management unit composed of experts INDEPENDENT of the fund management;
  - \* such unit should monitor the risks and report on a regular basis to the conducting persons;
  - \* the conducting persons in turn control such monitoring and report to the board;
  - \* the board is responsible for ensuring that the risk management complies with all applicable legal and regulatory requirements on a continuous basis → directors should ensure that risks are adequately managed by continuously assessing the risks to respond to the changing risk landscape of the current crisis

## II. Specific aspects of the current turmoil (ctd.)

Which risks?

(i) Credit risk

→ the board/conducting person should assess on an ongoing basis the issuer/exposure risk, the risks related to e.g. structured products (ABS, CDO, etc...) and other investments to endeavor to mitigate such risks

(ii) Counterparty risk

→ the board/conducting persons should

- assess whether the terms of the contractual relationships between the fund and its counterparties do provide for the most efficient protection of the fund investors in case of bankruptcy of such counterparties
- assess whether such contractual provisions are enforceable and whether appropriate segregation of the fund's assets is ensured
- ensure that all exposures are appropriately collateralized

(iii) Liquidity risk

→ the board/conducting persons should assess on an ongoing basis the liquidity of the market and of the underlying assets: illiquidity may entail inability of the fund to satisfy massive redemptions from shareholders

## II. Specific aspects related to the current turmoil (ctd.)

### B) Inadequate or inaccurate information in the prospectus:

- accrued controls in the light of the financial crisis;
- need of « investor friendly » information in the sales documents, accrued transparency in terms of investment strategy, types of instruments used, connected risks and adequate investor risk profile

Why? Because even an appropriate risk management process does not eliminate risks!

#### → Practical solutions:

##### (i) adequate provisions in the fund constitutional and sales documents to permit:

- in case of specific market conditions: application of fair valuation principles, dilution levy, swing pricing, recourse to borrowings to meet redemptions, redemption gates, redemptions in kind, delay in payment of redemption proceeds;
- in extreme circumstances, on escalation by the management: suspension of redemptions, side-pockets, liquidation/merger of sub-funds/the entire vehicle;

##### (ii) the intervention of the promoter in order to ensure liquidity;

##### (iii) the setting up of appropriate committees:

- e.g. a pricing committee to assess, in particular, whether the price used for subscriptions/redemptions is fair within a range of prices given for illiquid or unpaired securities

## II. Specific aspects related to the current turmoil (ctd.)

- (iv) Regular assessment of the eligibility of the assets (+regulator inquiries)
- compliance with applicable laws and regulation (Eligible Assets Directive, CSSF Circular 07/308, CSSF Circular 08/356 e.g. for the eligibility of the collateral) and sales documents
- Why? → consequences of the financial crisis on the eligibility of assets:
- eligibility of assets considered previously as automatically eligible may need to be reassessed as they become illiquid (e.g.; structured products)
  - but category of assets benefitting from a state guarantee may be broadened
- (v) Board meetings to be held more frequently and board agendas to include not only statutory obligations (approval of financial statements, etc.) but new items like – investment management report, - risk management report, - valuation procedures, - distribution reports, - compliance reports, - legal reports, - conflicts of interest, - liquidity issues, - market crisis events, etc. with the duty for board members to proceed to an in-depth review of the supporting documents.

## II. Specific aspects related to the current turmoil (ctd.)

### (vi) Conducting persons

They are in charge of:

- (i) the overview of the compliance of the investment strategies and policies with the sales documents and Luxembourg law;
- (ii) the continuous assessment of risk management process;
- (iii) the adequate training of the distribution network, etc...

BUT

within the context of the current market conditions, it is strongly advisable that all sensitive decisions (especially those related to credit risk/liquidity risks, valuation, etc.) be taken by the fund management body

## 2) Criminal Liability

Certain criminal offences could more likely happen in the context of the financial crisis:

- failure to cause the issue and redemption price of the units or shares to be determined at the specified intervals
- failure to issue and to redeem shares at the net asset value (for funds under the 2002 Law);
- failure to comply with valuation principles and methods as per the articles of incorporation
- failure to comply with the time limits fixed to pay subscriptions/redemptions;
- etc...

### III. Current financial crisis and corporate governance

- (i) Currently: no code of conduct existing for funds (market self-regulation) but Alfi working group on corporate governance is expected to start working again on such a code of conduct to protect investors and facilitate the exercise of their rights
  - currently only a few rules of conduct are imposed by UCITS III as well as by MIFID for management companies of funds exercising additional activities
  - board members have a fiduciary duty vis-à-vis the funds investors
  
- (ii) Major impacts of the financial crisis on the corporate governance for investment funds: measures to be taken by the board regarding:
  - investors protection: they have the right to exit the fund and to be treated equally (e.g. to avoid that only illiquid assets remain in the fund in case of massive redemptions)
  - risk assessment: the crisis revealed new types of risks: specific credit risk, liquidity risk, valuation risk to be taken into account
  - risk management: new risk models have to be conceived
    - \* managers to participate in the fund capital to avoid moral hazard problems (risky decisions to maximize performance)
    - \* managers to provide regular information to fund directors/conducting persons
    - \* fund board/conducting persons to develop guidelines with regards to adequate pricing and rating of fund assets
  - transparency in the sales documents of the investment policy and the associated risks

### III. Current financial crisis and corporate governance

- portfolio liquidity and adequate valuation: boards to put in place escalation procedure to ensure that valuation problems are monitored, reported and resolved by specific teams, e.g. pricing committee
  - disclosure of pricing procedure in the fund prospectus
  - contingency plans to be put in place for funds facing massive redemption requests
- adequate training for distribution entities
- product quality management: directors have the responsibility to ensure that products sold correspond to investors expectations and risk profile
- reputational risk of specific fund types
- compliance:
  - \* compliance officers to immediately implement new applicable regulations in their corporate structures and to contribute to the development of the new procedures
  - \* fund directors to enhance the role of the compliance officers in particular for sophisticated funds and funds sold to retail investors
- conflicts of interest to be highlighted in the fund prospectus and way to prevent/resolve them to be disclosed



## IV. Conclusion

- Rules are the same than before the financial crisis, but the current turmoil imposes accrued vigilance for management bodies and conducting persons
- Possibility to cover civil liability with insurance coverage, but no insurance coverage for criminal liability



## « A deaf and blind director is liable for negligence »

« Un administrateur sourd et aveugle est coupable de faute ou de négligence »

- to supervise and monitor the risk management process and procedures
- to supervise and monitor all the tasks delegated
- to apply good corporate governance principles
- to take any strategic decision

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# Insurance For Fund Directors

- Exposures for directors to consider
- Directors' and officers' liability (D&O) insurance policy highlights
- Key problems - exclusions and definitions in D&O policies
- The claims process
- Group insurance policies versus fund specific policies