

CUSTODIAN LIABILITY: DOES THE DECISION IN PRIMEO FUND GO BEYOND THE AIFMD STANDARD?

by Peter McMaster and Daniel Hayward-Hughes

3 November 2017

On 23 August 2017 the Financial Services Division of the Cayman Islands (**Justice Andrew J Jones QC**) delivered the landmark judgment in *Primeo Fund v HSSL* in which findings of breach of contract, negligence and gross negligence were made against the custodian and administrator of the fund in the face of arguments by them that they had implemented standard commercial practices.

This article looks at how the approach to the custodian's liability in *Primeo* compares to the approach under the Alternative Investment Fund Managers Directive depository liability (**AIFMD**) and considers whether Jones J's decision in *Primeo* held the custodian of the fund to a higher or lower standard of liability than would generally apply under the AIFMD.

Background

The *Primeo* Fund (*Primeo*) was a Cayman Islands incorporated investment fund that invested with Bernard L Madoff Investment Securities LLC (BLMIS). *Primeo* appointed Bank of Bermuda (Cayman) Limited (BBCL) as administrator and HSBC Securities Services (**Luxembourg**) SA (**HSSL**) as custodian. Both BBCL and HSSL were later acquired by HSBC.

In late 2008 BLMIS was revealed to be the vehicle for the infamous Madoff Ponzi Scheme. In 2013 *Primeo* instituted its claim and sought to recover US\$2 billion from BBCL and HSSL.

Custodian Liability

Custody was provided by HSSL under an arrangement with BLMIS as sub-custodian. The judge made findings against HSSL, as custodian, at two levels. The first was its liability for the default of BLMIS. The judge found

that because BLMIS's default was wilful, HSSL was liable for that default regardless of whether it was at fault for its choice of BLMIS as sub-custodian and regardless of whether its supervision of BLMIS was inadequate. This was referred to as "strict liability".

As the second level, HSSL was also found to have fault-based liability and was found to have been negligent. The judge found that HSSL should have insisted on the following measures being adopted by the sub-custodian (BLMIS):

1. BLMIS held a single Depository Trust Company (**DTC**) account meaning that any assets that it held were not segregated. This meant that where a transaction was recorded BLMIS was on both sides of the transaction and it was not possible to verify transactions using DTC information. The only information available came from BLMIS itself. The judge held that HSSL should have insisted that a separate DTC account (or sub-account) be established for Primeo. This would have meant that DTC would have been able to send transaction confirmations to HSSL and for month end holding statements to be produced by the DTC.
2. The DTC ID system could have been used to ensure that HSSL obtained notifications of trades and settlement directly from the DTC. The judge found that it should have been.
3. BLMIS kept uninvested cash held as sub-custodian in its operating account with JP Morgan. The cash could have been kept in a separate account and the judge found that it should have been.

Despite these findings, Jones J held against Primeo, dismissing its claim entirely, as the judge found that Primeo had failed to prove causation because Primeo "was firmly committed to Madoff" and he was not persuaded that had HSSL acted differently that Primeo would have pulled its managed account with BLMIS and re-invested the proceeds in some other way. Separately, he found that the rule against reflective loss barred the claim entirely. Limitation was also a reason why many of the claims were time-barred. Some might say that HSSL had a lucky escape.

Alternative Investment Fund Managers Directive

Partly in response to the Madoff Ponzi Scheme, the global financial crisis, and an acknowledgment that many funds delegated custody and administrative functions to single or non-independent parties, the European Union sought to introduce regulatory conditions and oversight to private funds. On 21 July 2011 the Alternative Investment Fund Managers Directive (**AIFMD**) came into force. AIFMD regulates alternative investment fund managers (**AIFMs**) but not the underlying alternative investment funds (**AIFs**) themselves. The scope of AIFMD is wide, applicable not just to EU AIFMs but also any non-EU AIFMs that market AIFs in the EU.

The aim of AIFMD is to provide greater investor protection and to ensure investors receive regular and comprehensive information relating to their investments and to ensure that regulators can identify any potential systemic problems.

The AIFMD introduced the concept of a 'depository' who primarily acts as a custodian. The AIFMD also makes depositaries liable to the investors in an AIF and to the AIFMD for loss of any financial instrument held by the depository (subject to certain defences) and for negligent and intentional failures to properly fulfill depository obligations pursuant to the AIFMD. So how does the AIFMD approach compare with the judge's?

AIFMD Liability

The judge did not find that it was wrong of HSSL to delegate the custody arrangements to a sub-custodian. Under the AIFMD the depository may not delegate its functions to a third party (create a sub-custody arrangement) unless there is an objective reason for the delegation (**Article 21.11(b)**). The reason for the delegation in Primeo was BLMIS's insistence on performing the three functions of broker-dealer, investment manager and custodian. It is unlikely that this would provide objective justification under the AIFMD. In this respect the AIFMD imposes a higher standard than the judge did.

Under AIFMD the depositary that delegates must exercise due skill and care in the ongoing review and monitoring the third party to whom it has delegated (**Article 21.11(c)**). The failings identified by the judge regarding segregation of cash and securities would be held under AIFMD to amount to a breach of this duty. In this respect the judge and the AIFMD imposed the same standards.

Under AIFMD there is an express requirement that the sub-custodian segregate the relevant assets from its own asset in such a way that they can be clearly identified as belonging to the clients of a particular custodian (**Article 21.11(d)(iii)**). This is the same standard as the judge held HSSL to.

Under AIFMD there is an express requirement that cash sums are booked in cash accounts in the name of the AIFM (**Article 7**) and if those accounts are opened in the name of the depositary, they have to be segregated from accounts containing the custodian's own cash (Article 21.7). This is broadly similar to the standard required by the judge for cash segregation.

The AIFMD imposes a form of strict liability when there is a sub-custodian. The custodian is liable for all losses of financial instruments subject to two exceptions to this: 1) where an external event akin to a force majeure occurs which could not have been avoided despite all reasonable efforts; and 2) where a sub-custodian loses the assets and the depositary has a) agreed with the AIF that it may transfer its liability to the sub-custodian; and b) has met its obligations under the AIFMD as to that delegation such that the AIF can properly pursue a claim against the sub-custodian for the loss.

What is considered an "external event" is quiet narrow. Avoidable fraud or wilful breach of duty of a sub-custodian is not an external event. In this respect the AIFMD and the judge would reach similar conclusions.

Of course, AIFMD, if effectively implemented, would entirely rule out the concentration of functions in a single entity seen in BLMIS (broker-dealer, investment manager and custodian). The investment management and custodian functions are stringently separated (**Articles 20.2, 21.1 and 21.4**) and no prime-broker can act as a counter party to the AIF without stringent safeguards being in place (**Article 21.4(b)**).

Conclusion

The AIFMD disallows many of the more risky previous standard commercial practices and places greater emphasis on the role of custodians and AIFMs as safeguards of the assets, requiring very specific measure to be put in place and creating far reaching legal responsibilities to investors. Overall the standards introduced by AIFMD are higher and more onerous than the common law and contractual obligations to which HSSL was held by the judge.

This article has been written by:

Cayman

Peter McMaster

Partner

+1 345 814 2795

pcmaster@applebyglobal.com

Cayman

Daniel Hayward-Hughes

Associate

+1 345 814 2956

dhaywardhughes@applebyglobal.com