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LITIGATION AND REGULATORY ENFORCEMENT RISK FOR UK BASED HEDGE FUND MANAGERS – WILL WE FOLLOW THE US EXPERIENCE?

By Angela Hayes, Pat. S. Conti and Sean Casey

Particularly during the past 2 years of market turmoil, hedge fund managers in the US have encountered a step change in the intensity of regulatory investigation and litigation pressure. The SEC Enforcement Division has a dedicated Hedge Fund Working Group, which is investigating fraud and market manipulation by hedge fund investment advisers/managers. More than 100 cases involving hedge funds have been brought by the SEC in the past five years, with more than 20 so far this year. The SEC already has brought more enforcement actions involving hedge funds in the first four months of this year than all of last year. A significant proportion of the transatlantic information flow from the FSA to the SEC under cooperation arrangements has related to SEC activity in this area. Litigation in the US courts by aggrieved investors has been numerous and various, with fraud-based claims still in the majority. Though there has been egregious behaviour related to funds managed and advised from the US, this bias in the nature of claims filed is in part because of the legislative background and lower evidential hurdles in the US to filing claims based on fraud. Many matters framed as "fraud" in US proceedings would not be characterised in that way in UK litigation.

In contrast in the UK, though the Financial Services Authority has been active in investigating issues in the hedge fund sector, it has not singled out the sector for special enforcement attention and its own expertise in the area is feeling somewhat run down. For example in the area of insider dealing/market abuse it is rogue individuals that the FSA has concentrated on recently, rather than the fund management firms (recent fines against hedge fund managers Steven Harrison and Loic Montsterret rather than the firms that employed them). Broadly, systems and controls in UK regulated management firms sampled by the FSA have been given a clean bill of health. Perhaps in part because of this, the FSA has seriously lost ground and credibility with other European regulators that wish to use the hedge fund sector as a scapegoat for the financial crisis. The FSA's relatively light touch (compared to the SEC approach) on hedge fund managers to date may well, therefore, have had the perverse impact that the FSA has had limited effective influence on the draft text of the proposed directive on regulation of EU alternative investment fund managers. This has the potential for a much more negative impact on UK managers than an intrusive FSA would have had.

We may well have reached a turning point in the UK, however, in the attitude of the authorities. The Serious Fraud Office, following soundings in the financial services sector, recently identified the hedge fund sector as an area of particular fraud risk on which it should proactively focus, even though to date the public record of UK regulated hedge fund

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managers has been fairly clean. There have been issues that have not reached the public domain, and the SFO's new stance has been quickly vindicated by the collapse of the Weavering hedge fund with the apparent involvement of its UK FSA regulated adviser, which has also spawned litigation in the UK courts brought by the administrators of the UK adviser.

The majority of US litigation against hedge fund managers is investor driven. This involves identifying a cause of action that the investor is entitled to bring direct against the manager as opposed to the fund in which the investor subscribes. This applies in circumstances where the manager's primary legal duties are to the fund under an investment management agreement and as a fiduciary. This need to identify a direct legal nexus between manager and investor explains the popularity of fraud based claims in the US. For example in litigation arising from the collapse of Beacon Hill Asset Management it is alleged that the managers deliberately and fraudulently inflated Net Asset Values and misrepresented the continuing investment strategy of the fund.

In the UK our "loser pays" rule on legal costs (an unsuccessful claimant must pay the defendant's legal costs, not just its own) has always acted as a brake on filing claims that push the boundaries of accepted legal causes of action and against claims that are not cogently made on the basis of evidence available at the time the claim is filed. There is also a lengthy pre action process of exchanging information and exploring settlement imposed by the UK court rules which results in many disputes reaching an agreed settlement before a claim is ever filed in court, sometimes with substantial sums paid by potential defendants to avoid litigation. Consequently despite record redemptions and restructurings affecting funds managed by UK based managers and some wind downs and collapses, aggrieved investor litigation of the type seen in the US has not hit the UK courts. The litigation that there has been involving fund managers has been of the mainstream commercial and banking litigation variety, often with funds themselves as the claimants or interveners, such as in relation to the Lehman Brothers administration.

It would be wrong, however, for UK based hedge fund managers to conclude from the foregoing that "litigation" risk and "regulatory enforcement" risk are not real and present dangers to the business. Investors have been looking to find redress, or at least a way of avoiding being locked into underperforming funds, where there has been misvaluation of illiquid/complex assets, severe underperformance, "style drift" away from investment objectives/misrepresentation of portfolio profile and so on. Liquidators and administrators must also routinely explore possible claims against the manager. This has and is continuing to result in a significant amount of "shadow litigation", stopping short of claims being filed in court, but achieving concrete results in dispute resolution. Here the legal costs risk identified above is less of an issue for the would-be claimant. Defending such putative claims effectively can be expensive for the manager and hard fought. It is often not difficult to find direct representations by managers to investors, for example during the investor's due diligence process and subsequent communications, that could potentially found a direct claim by the investor against the manager for misrepresentation where those statements are later seen to have been inaccurate. In all these types of cases, however, proving what actual monetary loss, if any, has flowed from the failure in question can be difficult. Issues such as misvaluation are also drawing in administrators, brokers, auditors and the fund itself into shadow disputes about respective responsibilities. "Shadow litigation" has also been deployed to good effect by investors jockeying for position in potential fund restructurings and seeking to influence their terms. It has enabled investors, including hedge fund managers themselves, to force ailing funds to accept that the world has changed and that an orderly wind down is the only reasonable option to return value to investors. These issues all create parallel risk of regulatory investigation by the FSA against the manager and senior individuals within it where the concerns may reflect regulatory breaches.