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UK Contact:



Simon Firth
Partner
simon.firth@arnoldporter.com
+44 (0)20 7786 6178

US Contact:



Stephen Culhane
Partner
stephen.culhane@arnoldporter.com
+1 212.836.7035

Arnold & Porter

Brussels | Chicago | Denver | Frankfurt | Houston | London | Los Angeles | Newark
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Legal Risk for Fund Managers: A case study



Simon Firth
Partner
Investment Funds/Hedge Funds
Arnold & Porter
[Email Simon Firth](mailto:Simon.Firth@arnoldporter.com)



Charlotte Mallorie
Counsel
Commercial Disputes
Arnold & Porter
[Email Charlotte Mallorie](mailto:Charlotte.Mallorie@arnoldporter.com)

Kathleen Harris
Partner
UK Enforcement and Investigations
Arnold & Porter
[Email Kathleen Harris](mailto:Kathleen.Harris@arnoldporter.com)

Henry Clinton-Davis
Partner
Employment/Data Privacy
Arnold & Porter
[Email Henry Clinton-Davis](mailto:Henry.Clinton-Davis@arnoldporter.com)

Dr Beatriz San Martin
Partner
Intellectual Property/Patent Litigation
Arnold & Porter
[Email Dr. Beatriz San Martin](mailto:Dr.Beatriz.SanMartin@arnoldporter.com)

In this article we present a scenario that raises a series of concerns for a fund manager and explores key legal considerations that would apply as a matter of law in the UK¹

Scenario

The new general counsel of Wayward Fund Management ("Wayward"), Jemima, calls her lawyers, presents some facts and asks for an assessment of the potential legal and regulatory liabilities facing Wayward.

Wayward is an FCA regulated full scope AIFM and runs a flagship Cayman Islands hedge fund, Wayward Fund (the "Fund"). Through feeder funds the Fund's investor base is global, including a number of high net worth individuals and institutions.

Jemima discloses that the Fund's offering memorandum states that the Fund may not invest more than 10% of its net asset value ("NAV") in unlisted shares. That level has been breached (it is

now 20% of NAV). These shares are now worthless and are the main cause of a decline of 10% of NAV this year.

Further, Jemima has discovered that marketing material used by Wayward's third party distributor contained misrepresentations about the Fund's performance, exaggerating its performance record. Jemima has also discovered that one of Wayward's sales team employees, Mr Wiley, has been planning to leave to join another manager, Overwhelming Capital (Overwhelming), and has passed personal details of investors and other trade secrets of Wayward to Overwhelming.

Assessing the Legal Risks

Review Contractual Documentation

When considering potential claims, the relevant contractual documentation must be reviewed. In our scenario this is the AIFM agreement between Wayward and the Fund. It is also important to assess the factual matrix and whether what has

¹ As an organization with international operations, Wayward must assess potential legal issues that may arise in non-UK jurisdictions, including the Cayman Islands and jurisdictions in which capital raising activities have been conducted, including the U.S.

occurred amounts to a minor or material breach of contract and/or misrepresentation.

Wayward's AIFM agreement contains standard exclusion clauses excluding Wayward's liability for loss incurred except in the case of fraud, wilful misconduct and gross negligence. In English law the meaning of such terms is a matter of interpretation and depends on the wording and context of the contract as a whole.

The Courts will seek to find the objective meaning and look at the natural and ordinary meaning of the clause together with the documentary, factual and commercial context. Where there are competing interpretations, the Court will give weight to what makes commercial common sense in the context of the agreement as a whole.

It is critical that Wayward assess the relevant contractual provisions with their lawyers at the outset to establish what breaches or claims could potentially be put, and whether those breaches/claims have any merit and, if they do, whether they will be covered by any relevant exclusion.

Wayward would also need to consider other matters with their lawyers such as ensuring privilege is established and maintained, gathering evidence through preservation of documents, identifying and interviewing Wayward's portfolio managers and service provider personnel and managing initial communications with potential investor claimants, including the basis of those communications and who sends them.

Dispute Resolution Clause

It is important to check the AIFM Agreement dispute resolution clause. Is any claim to be determined by a Court or via arbitration? Is there a provision in the contract providing for negotiation or mediation before any proceedings are commenced? Arbitration proceedings are confidential which avoids the public glare attaching to court proceedings. Having disputes aired in public raises concerns as to reputation and may inform how matters are dealt with at an early stage. For instance, can matters be resolved without resorting to proceedings and the costs associated with that (bearing in mind that in English proceedings the general rule is that the loser pays the winner's costs as well as its own).

Reputation Management

Reputational risk management is key. Reputational damage can negatively impact staff retention and market/investor confidence and can impact value reduction (for example, by the imposition of financial penalties, costs of remedial action and/or loss of future revenue). In a crisis like this it is important that Wayward's leadership and legal teams work together to coordinate communications and put clear protocols in place to ensure no information is leaked, intentionally or otherwise, at any level of the business.

Statutory Regime

As an FCA regulated firm, and a full scope AIFM, Wayward is subject to FCA regulations and the UK Financial Service and Markets Act 2000 ("FiSMA"). In this scenario Wayward and/or its distributor have likely breached FiSMA and FCA rules (the "Rules") which can render them susceptible to action by their investors.

Under section 138D of FiSMA, investors who have suffered a loss as a result of a breach of a Rule might have a right of (derivative) action for damages for those losses. Provided conditions specified in 138D are met, Wayward's investors might be able to recover losses simply by showing that there has been a breach of a Rule causing them to suffer loss. Private persons (generally individuals) have many more grounds for action under this section than other legal persons such as corporations.

Rights of action under 138D are only available for contraventions of Rules made under FiSMA, and generally not for contraventions that fall under the FCA Handbook. However, the FCA is permitted to specify that rights of action are not available for certain of its Rules, and it has done so for example for breaches of the FCA's Code of Conduct Sourcebook.

Breach of FCA Principles and Rules

The FCA's Principles for Businesses 1-7 include obligations for regulated firms such as Wayward to conduct their business with due skill, care and diligence, organise and control their affairs responsibly and effectively with adequate risk management systems and pay due regard to the information needs of clients, and communicate



information to them in a way which is clear, fair and not misleading.

The Principles do not give rise to a direct cause of action for breach of statutory duty, whereas breach of the Rules may give rise to a direct cause of action against a regulated firm.

As an FCA regulated AIFM Wayward must comply with various Rules covering:

- communications with investors in the Fund, including conduct of business rules;
- certain operating duties and responsibilities, including ensuring that the Fund is operated in accordance with its offering memorandum;
- its systems and controls (although contravention of the Systems and Controls chapter of the FCA's Handbook is not actionable under 138D);
- requirements for robust governance arrangements, including an obligation to establish, implement and maintain adequate risk management policies and procedures, including effective procedures for risk assessment.

Jemima should be advised that Wayward may be in breach of any or all of these requirements.

Misrepresentation

The Financial Services Act 2012 (the "2012 Act") defines the offence of making false or misleading statements. In the context of Wayward's distributor, this offence requires that the Fund performance misrepresentations were made with the intention of inducing investors to invest in the Fund. If Wayward or the distributor were charged with making a false or misleading statement in that context, it must be proved either that they knew it was false or misleading, or that they were reckless as to whether it was.

The offence is punishable by imprisonment a fine, or both, the length of the sentence and the amount of the fine depending in whether the conviction is summary or in indictment.

A statement is false if it asserts a proposition that is not true. Whether it is misleading depends on who it is, or is likely to be, made to because different people may draw different inferences from it. For example, some statements might be misleading for private investors, but not for a market professional. The statement must also be false or misleading "in a material respect".



Officers of a corporation and members of a partnership that commits an offence under FiSMA or the 2012 Act with their consent or connivance, or attributable to their negligence, are guilty of the offence as well as their firm, and so Wayward's and the distributor's directors could be in the firing line here.

Unauthorised Disclosure of Confidential Information

The starting point is for Wayward to determine what confidential information has been disclosed. In our scenario it is personal investor details and "trade secrets," which we take to mean business confidential information. It can be tricky identifying precisely what information is truly confidential, but the fact the information is referred to in a confidentiality clause in Wiley's contract would help, as would evidence of efforts made by Wayward to keep the information secret. There is less ambiguity with identifying personal data, which would include individual investor names and contact details.

Data Breach

The disclosure of personal details represents a serious data breach and could amount to a statutory criminal offence (Data Protection Act 2018). Wayward, as data controller, has a duty to notify the investors, take steps to mitigate the consequences of the breach and possibly report the breach to the Information Commissioner's Office within 72 hours.

Protective Measures

- Wayward could apply to court for an injunction restraining the misuse of the confidential information and personal data. If Overwhelming has encouraged the breach, Wayward would have a claim against them too as well as Wiley.
- Obtain contractual undertakings from Wiley and Overwhelming not to use or disclose the confidential information and personal data. This would put Overwhelming on notice of the unauthorized disclosure. Even if Overwhelming does not provide the requested undertaking, the notice will serve to make Overwhelming potentially liable for any misuse of the confidential information.
- Check for a non-compete clause. This may allow Wayward to delay Wiley starting employment with Overwhelming.

Employment

Mr Wiley is likely to be in breach of an express confidentiality obligation contained in Mr. Wiley's employment contract. If not, common law implies a duty of confidentiality on employees. Therefore Wiley should be suspended pending disciplinary proceedings.

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