WealthBriefing
News Insight Intelligence

When Investors Sue Fund Managers For Breaching National Marketing Rules – The French Example

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20 October 2023

The author of this guest commentary argues that to mitigate distribution risks when fundraising overseas, alternative investment fund managers and asset managers should comply with country fund marketing rules at all times. This article examines what happens in France.

This news service has carried a number of commentaries on the opportunities and perils facing firms seeking to market funds into different wealth management markets, such as those of the European Union, and Asia. The articles have come from Cathy Brand, chief executive of Sales Road Maps Online Ltd®.

The editors are pleased to share these insights. The usual editorial disclaimers apply to guest contributions. To respond, email tom.burroughes@wealthbriefing.com

Alternative investment fund managers (AIFMs) and asset managers must comply with country fund marketing regulations when marketing and selling their funds to investors in any jurisdiction.

In our bespoke compliance advisory, clients have asked us: "Sometimes we have to take some risks in order to onboard some investors into our funds. What is the worst that can happen to us in practice if we breach local fund marketing regulations during our fundraising process because we made a business risk decision to take a ticket from the investor outside the country's rules?"

Some AIFMs/asset managers believe their worst downside risk for breaches of country fund marketing regulations is sanctions by the country's regulator (national country authority). Managers sometimes mentally file this in a category called "Seemingly remote risk" or "Nothing to worry about." This gives them a false sense of security, thinking that they have limited downside risk if they breach country fund marketing regulations to market and sell their funds to investors.

What is a fund manager's "Trifecta of Trouble" when investors seek redress in the courts using three-part arguments against fund manager's breaching country fund marketing regulations?

How do the "risk dominoes" fall when investors become:

1. Disgruntled;
2. Sue fund managers for breaches of their country's fund marketing regulations; and
3. Request rescission rights?

All of these actions, in effect, allow the investor to exercise their "free put" option?

How can the fund manager be prepared for litigation and rescission rights risks?

We will explore this topic with a real case study from France.

But first, a bit about the basis of fund distribution risks inherent in cross-border marketing that can impact your fundraising campaigns.

Is cross-border fund marketing risk-free? No.

Marketing funds cross-border constitutes a regulated activity in each jurisdiction. This is why there are regulations in each country governing the promotion of financial products or services to investors in that country. Compliance with country fund marketing regulations is not optional. Fundraising cross-border (overseas) inherently entails risk, including potential litigation and rescission rights risks.

We advise clients to mitigate their distribution risks as much as possible by investigating each country's laws in advance of marketing and by complying with local regulations on marketing funds to investors in each country.

Understanding five key distribution risks

Any marketing of AIFM/asset managers' funds in any country could potentially incur five key distribution risks. These are:

1. Sanctions risk;
2. Litigation risk;
3. Investor rescission rights risk;
4. Business franchise risk; and
5. Reputation risk.

How the "Risk dominoes" can fall: Typical scenarios when investors sue fund managers and exercise rescission rights

If litigation risks and investor rescission rights risks are two of the "risk dominoes" representing the fund manager's five key distribution risks, when these two dominoes fall, they can lead to the fall of all five dominoes, including risk of sanctions, business franchise risk and reputation risks.

A typical scenario goes like this:

Your fund investors become disgruntled (for whatever reason: bad fund performance, market conditions, etc.) and file a complaint against the AIFM/asset manager with their local regulator. If you breached their country's laws while marketing and selling the fund to them, they could sue you in court and demand rescission rights (demand their money back) and could declare all fund contracts null and void (contract dissolution). These risks could trigger your business franchise and reputation risks.

In the scenario above, all five "risk dominoes" have fallen because all of these five key distribution risks are connected.

Litigation risk: What is a fund manager's "Trifecta of Trouble" when facing investor lawsuits?

While each investor lawsuit against fund managers is filed based on the specific fact set of each investor, there are three arguments used in court by investors which could represent a "Trifecta of Trouble" for fund managers if they were not compliant with local fund marketing regulations when they marketed and sold their fund to the investor:

Investor Argument 1: "You (the fund manager) marketed your fund to me in breach of my country's fund marketing regulations. You breached my country's private placement/fund passporting/notification/prospectus registration rules; therefore, all our fund contracts are null and void."

Investor Argument 2: "You (the fund manager) marketed your fund to me in breach of my country's licensing regulations governing the marketing of funds. You did not have a licence to solicit your fund to me in my country; therefore, all our fund contracts are null and void."

Investor Argument 3: "You (the fund manager) mis-sold your fund to me. You misrepresented the risks and did not provide me with key information and did not disclose it in your fund offering documentation and contracts; therefore, all our fund contracts are null and void."

Free Put 101: What is the impact to fund managers?

Investors have filed their case in court against you (the fund manager) based on the three "Trifecta of Trouble" arguments. They have claimed that you have breached their country's fund marketing regulations.

The investor's conclusion: Because you (the fund manager) broke their country's laws in soliciting your fund to the investor (conducting a regulated activity in a foreign country in breach of regulations), then all fund contracts are null and void and therefore, the investor wants to claim rescission rights, simply, they want their money back.

In our experience advising fund managers, the process of investor litigation and servicing investor rescission rights claims is rarely a pleasant one. Lawsuits can get very nasty, costly, tying up a fund manager's in-house legal resources and negatively impact profitability due to a drag on resources and higher legal costs.

Litigation risk in practice. Case study: France

Our French counsel is a leading global law firm's affiliate in France who worked on a litigation case brought by a French institutional investor against a US AIFM (hedge fund manager) after they lost money by investing in the US AIFM's hedge fund. Here is our understanding of the case background:

The French institutional investor reached out to the US hedge fund manager (after conducting their own research) and requested information about their hedge fund. Subsequently, the French institutional investor invested in the hedge fund and lost money, becoming disgruntled.

Apparently the US AIFM did not solicit the French investor first. Rather, this was a genuine case of "reverse solicitation" by the French investor. However the US AIFM did not document this instance in their compliance files. When the French investor lost money, they filed suit in French courts against the US AIFM.

While the details of the case were kept confidential, we can imagine that the French investor claimed that the US AIFM illegally solicited a foreign (non-EU domiciled) AIF (i.e., Cayman Islands AIF) to them in breach of France's ban on solicitation of open-end non-EU AIFs to investors in France (without fund registration with France's regulator AMF, which is not feasible) in addition to breaches of France's licensing regime.

The investor could also have possibly argued that the US AIFM mis-sold the hedge fund to them without fully disclosing the fund's risks. Even if the US AIFM did not (proactively) "solicit" their hedge fund to the French investor, the burden of proof is on the US AIFM to prove they did not market their fund in France in breach of France's funds regulation.

The court case dragged on in French courts as a contentious lawsuit for four years, tying up the US hedge fund manager's resources, while incurring large legal fees costs as well as business franchise and reputation risks to the US AIFM.

Breaches of AIFMD in France can incur criminal penalties including imprisonment and fines. However it is important to note that investor litigation and rescission rights risks are equally real risks to consider for fundraising in France.

As a standout statutory regime compared with other countries, under French statutes, civil penalties can apply (in addition to criminal sanctions noted above) as the French investor invested in funds managed by AIFMs/asset managers is entitled to take the following action in a civil court in France against the AIFM/Asset Manager:

The investor can ask the court for cancellation of their subscription to the AIFs (for any reason and at any time) and sue the marketer/seller for breach of duty to provide sufficient information for them to make their investment decision.

AIFMs/asset managers: How to protect yourself from investor litigation risk

Some of our AIFM/asset manager clients say: “Well, we can get sued by investors in our funds for any reason at any time. Litigation risk is always a risk for us.”

To which we reply: “Yes, litigation by investors against fund managers is always at the forefront. But don’t give your investors the no-brainer Trifecta (3) of arguments for an easy court judgement win because you broke the investor’s country laws when you marketed and sold your fund to them.”

It’s as if the non-compliant AIFM/asset managers holds a silver tray with free put options deftly arranged and handed out to investors, ready to be exercised by the investor whenever they are ready. Is that what you really want?

Summary

The way AIFM/asset managers can mitigate their five key distribution risks when fundraising overseas is to comply with country fund marketing rules at all times.

Don’t kick off the “domino” effect. Since all five distribution risks are related to each other, the last thing AIFM/asset managers want to do is give investors a valid reason for them to seek justice in the courts and demand their money back because you breached the laws in their jurisdiction when marketing and selling your fund to the investor.