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HOT TOPIC

MANAGING AND RESOLVING HEDGE FUND AND PRIVATE EQUITY FUND DISPUTES

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David K. Momborquette focuses on complex commercial litigation and regulatory matters primarily for financial services industry clients, including hedge funds, funds of funds and private equity funds. Mr Momborquette has substantial experience in private securities litigation and securities regulatory matters, investigations by the Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA), as well as investor disputes and class action litigation.

CD: What are the key factors driving fund-related disputes in the current market?

Momborquette: In the US, the single biggest factor driving fund-related disputes is regulatory risk, primarily involving the Securities and Exchange Commission (SEC). The SEC remains very focused on the investment management industry and this includes the SEC's enforcement programme. In the SEC's last fiscal year, which ended 30 September 2016, approximately 20 percent of all enforcement actions were against an investment adviser. Financial Industry Regulatory Authority (FINRA) and certain state-level regulatory agencies also have been very active over the last several years with respect to investment managers.

CD: Have any recent, high-profile fund disputes caught your attention? What lessons can fund managers learn from these cases?

Momborquette: The SEC has focused a lot of attention in recent years on those who are charged with supervising individuals who violate insider trading laws. A good example of this is an administrative proceeding filed last year by the SEC against an investment adviser, Artis Capital Management, and one of its senior research analysts, for failure to supervise a junior analyst who improperly obtained material, non-public information. The junior analyst utilised that information to make trade recommendations that turned out to be very profitable. With the filing of this action, the SEC has made it clear that investment professionals play a key role with respect to preventing the misuse of confidential information, including investigating so-called red flags that may indicate that information has been obtained improperly. In recent years, the SEC also has been very focused on conflicts of interest, in particular the failure of investment advisers to adequately disclose a conflict. Recent SEC actions involving Apollo and WL Ross, respectively, are good examples of the SEC's recent focus on this area.

CD: Could you outline some of the common types of fund disputes and the different strategies that can be deployed to resolve them? What are some of the

specific challenges associated with fund disputes?

Momborquette: The biggest challenge with respect to most regulatory or investor disputes is to minimise the risk that the dispute leads to a material amount of investor redemption requests. Investors' appetite to stick with a manager that is involved in a dispute with regulators, or even a material one involving other fund investors, is extremely low. Accordingly, the same degree of care and attention that a manager gives the counterparty to a dispute often needs to be given to those investors not directly involved in that dispute. Some of the most interesting and challenging fund disputes often never make their way into the press or court docket. This is especially so with respect to disputes arising in the course of winding down a fund. Fund wind-downs are complicated affairs that require a well-planned and thoughtful approach with respect to investors, or problems will almost certainly arise, especially with respect to issues relating to the return of capital.

CD: How well are fund managers equipped to deal with the dispute process? What lessons can we draw from this?

Momborquette: As a general matter, investment managers are not very well equipped to deal with the dispute process, whether it involves the regulators or investors. Understandably, most managers do not manage their business as though an enforcement action is imminent or that litigation will arise between the manager and investors. In addition, most investment managers that become involved in litigation or a regulatory investigation have an unrealistic perception of how quickly such disputes will be resolved. This can often lead a manager to make strategically unwise decisions at the outset of such disputes in an effort to make the dispute go away quickly, something that rarely happens. The lesson that should be drawn from this is that it is more important to make the right strategic decision, even if that leads to a longer resolution of the dispute.

CD: If a dispute arises, how important is it to evaluate all the available options, including negotiation, mediation, arbitration or litigation?

Momborquette: It is very important to evaluate the options available. There really is no 'one-size-fits-all' approach to these types of disputes. A strategy that may work in one context may not be effective in another. Accordingly, investment managers should explore and evaluate all available options and pursue the ones that make the most sense given the particulars of the dispute.

CD: In your opinion, when should expert witnesses be introduced into the dispute resolution process? What benefits can they bring to the table, particularly in areas such as calculating damages, for example?

Momborquette: The no 'one-size-fits-all' approach to disputes also applies to the use of expert witnesses. As a general matter, I am somewhat cynical about the effectiveness of introducing expert witnesses into a dispute before one would normally do so in the context of an actual litigation. Too often, all that is accomplished by introducing experts early into the process is to give an adversary a preview of your arguments and they will adjust accordingly. However, if it appears that an expert can clarify, or at least narrow, the gap between the parties, particularly with respect to damages, then a manager should seriously consider surfacing an expert earlier rather than later. In addition, experts can educate the client regarding the strengths and weaknesses of its case, particularly with respect to the issue of damages.

CD: What final piece of advice can you offer to fund managers on resolving their disputes as quickly and efficiently as possible, with minimal financial and reputational impact?

Momborquette: The best piece of advice I can offer is the old adage that 'an ounce of prevention is worth a pound of cure'. The best way to avoid an issue with regulators is to have a robust internal compliance programme. Communication and transparency are typically the best ways for a manager to avoid disputes with its investors. Once a dispute does arise, the manager's focus should be on making sound strategic decisions. Unfortunately, that approach can often clash with resolving the dispute quickly and cheaply and with a minimal-to-no reputational impact. However, managers should resist the urge to rush to 'sweep things under the rug' quickly. That approach too often creates more problems than it solves. CD

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