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# Hedge Funds, Hot Markets and the High Net Worth Investor: A Case for Greater Protection?

*By Helen Parry*

## I. INTRODUCTION: HEDGE FUNDS AND HIGH NET WORTH INDIVIDUALS

*“Hedge funds, so often booed and hissed by politicians and regulators, are now strutting their stuff in the limelight to the acclaim of pension funds, unit trusts and private investors.”<sup>1</sup>*

### A. Hedge Funds Are Back

Jaded and shocked investors, reeling from the devastating effects of the dot.com crash, are turning to hedge funds and other forms of alternative investment in the hope of beating current downward trends in equity markets. The proud boast of hedge fund managers that they can produce absolute returns even when such market conditions prevail is inevitably alluring, and there is ample evidence that the hedge fund market is “red hot.”<sup>2</sup> Of particular interest are classic hedge fund strategies, in the tradition of the father of modern hedge fund investing, Alfred Winslow Jones. These strategies are based on the principle of taking long positions in undervalued stocks and short positions in overvalued stocks with a modest element of leverage.<sup>3</sup> Highly-leveraged hedge funds, in the style of Long Term Capital

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<sup>1</sup> *Sprucing Up Their Appearance*, MONEY OBSERVER, Sept. 19, 2000.

<sup>2</sup> Robert Clow, *UBS Attacks Hedge Market*, FINANCIAL TIMES, March 8, 2001.

<sup>3</sup> “Imagine for instance that Jones had \$10,000 to invest. He would borrow 50% of this figure, then buy perhaps \$10,000 of stocks and sell short \$5,000. Capital had to be put up to enable the short sales to take place, or to be held in reserve for topping up margin calls if they didn’t perform as expected. So while the total involvement in the market represented \$15,000 (150% of his capital) his net exposure as a percentage of his capital was potentially

Management, are clearly not in favor today, as the market is still recovering from the shock of the LTCM collapse.

In further great contrast to the LTCM style of investing, Jones, who was actively trading in the 50's and 60's, had to devise his strategies without the benefit of the sophisticated mathematical and computing techniques so beloved by the "quant jocks" of the 90s.

#### B. Hedge Funds And High Net Worth Investors In The U.S. And U.K.

In terms of private client investment, the new wave of hedge fund opportunities is principally being targeted at high net worth individuals ("HNWIs"), or in some cases "ultra high net worth individuals."<sup>4</sup> Given the growing disparity between the richest and the poorest in society, more and more individuals are falling into this category. Armies of bankers, brokers, lawyers and accountants eager to tap into this lucrative and expanding market are eagerly courting them. Indeed, regulatory regimes are reacting to the pressures caused by these changing market conditions of increased private client investment in more risky and exotic investments, like hedge funds and derivatives generally, by making subtle adjustments to the scope of their regulatory reach.

In the U.S., the Investment Company Act of 1940 provides regulatory relief from registration as an investment company under Section 3(c)(1). This applies to private investment companies with less than 100 shareholders that make no public offerings of securities. However, in 1992, the Securities and Exchange Commission ("SEC") decided that this exclusion was inappropriately restrictive in the context of changing market conditions and the growing numbers of wealthy and sophisticated investors. The SEC proposed also granting relief from registration to companies that sold investments solely to "qualified purchasers" considered by the SEC to be sufficiently sophisticated, based on their wealth, not to require protection. Investment companies may now have unrestricted numbers of qualified purchasers under this Section 3 (c) 7 exclusion. An individual may be a qualified purchaser if he owns not less than \$5 million in investments.<sup>5</sup> This has opened the door to larger pools of hedge fund investors. These new rules came into effect in June 1997.

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only 50%, the \$10,000 of stocks he had bought less the \$5000 he had sold short. If the stocks he had bought went up and the shorts he had sold went down, returns would be magnified." Peter Temple, *The Long and Short of Hedge Funds*, FINANCIAL TIMES, March 3, 2001.

<sup>4</sup> "We are really interested in high net worth individuals who have \$1million to \$10 million, and ultra high net worth individuals who have \$10 million plus to invest." John Maitland, managing director for the Merrill Lynch Britain and Ireland private client division, quoted in 'Money and Banking: do you have a million dollars?' Sunday Business Post Ireland February 25, 2001.

<sup>5</sup> Investment Company Act, 15 U.S.C. Section 80(a)(2)(51)(a).

The Commodity Futures Trading Commission (“CFTC”) also provides regulatory relief for commodity pools involving “qualified eligible participants.” An individual may be a qualified eligible participant if he owns and controls for his own account at least \$2 million in securities or other investment assets or has deposited at least \$200,000 initial margin and options premiums with a futures commission merchant for commodity futures trading.<sup>6</sup> The CFTC has also recently adopted an amendment to Rule 4.7 to add several categories of persons to the definition of qualified eligible participant.<sup>7</sup>

Hedge funds are normally categorized in the UK system as unregulated collective schemes and, as such, they are covered by fairly severe marketing restrictions. The basic position under the new Financial Services and Markets Act of 2000, when it is implemented later this year, will be that firms are prohibited from communicating or approving a financial promotion relating to an unregulated collective investment scheme to individuals unless they are “sophisticated” investors. There are no significant changes to the existing Financial Services Act regime.<sup>8</sup>

### C. Risks In Hedge Fund Trading Strategies

While in today’s market climate there is particular interest in the classic Jones “long/short” and the related “market neutral” strategies for investing in hedge funds, investors who are new to this market should be aware that, in the past, regulators have had to deal with a number of problems with funds using these techniques. When, contrary to the best expectations of the best computer programs in the world, the supposedly undervalued stocks decrease in value, and the overvalued stocks increase in value, serious losses can quickly mount up. Such losses may be exacerbated to devastating effects when leverage is factored into the situation.

The D.E Shaw fund used complex mathematical formulae to predict market behavior and the managers of the fund devised computer models to take advantage of market inefficiencies in the pricing of various securities.

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<sup>6</sup> 17 C.F.R., ch. 1, Section 4.7(B)(1)(i)-(ii).

<sup>7</sup> The Year in Review, CFTC, 2000, at 9.

<sup>8</sup> Section 76(1) of the Financial Services Act prohibits the marketing of unregulated collective investment schemes (i.e. any scheme which is not a unit trust, U.K. Open Ended Investment Company or a non-U.K. scheme recognized by the Financial Services Authority (FSA)). Financial Services Act, 1986, ch. 60, Section 76(1) (Eng.). There are, however, exemptions contained in the 1991 Financial Services Regulations (Promotion of Unregulated Schemes). Section 76 of the Financial Services Act will soon be replaced by section 238 of the Financial Services and Markets Act 2000, and the regulations will be replaced by the Conduct of Business Rules at 3.11 (COB 3.11 regime). Under this regime, a financial promotion relating to an unregulated collective investment scheme may be communicated or approved for communication to authorized persons, exempt persons, sophisticated investors and high net worth companies, provided that the relevant provisions of the exemption order are satisfied.

If the model price was lower than the market price, the program would recommend selling the security and waiting to buy at a lower price in the future. If the model price was higher than the market price the opposite would follow. The fund was leveraged and designed to capitalize on small variances in the price of securities. In the summer of 1998, Shaw's trading strategy was based on the theory that the spread between U.S. treasuries and foreign corporate debt would narrow. Unfortunately, the Russian default of August 17, 1998 meant that instead of narrowing, such spreads widened considerably as investors rushed to get out of risky and into safer investments — the so-called "flight to quality." In an increasingly downward spiral, the hedge funds with the most highly leveraged portfolios fell first, which caused the spread to widen ever further, piling up greater losses for the fund.

Some hedge fund managers seriously misjudged the timing of the fall in prices of technology and dot.com stocks, shorting them when they were still rising. Faced with such a potentially disastrous situation, there is a temptation to try to disguise such losses and sweat it out in the hope of the market turning in a more favorable direction. One technique that has been applied in this situation is to disguise the downward effect on the price of securities caused by stock splits in an attempt to mislead investors as to the success of their ill-fated short selling strategies. The many well-documented cases of fraud and malpractice in involving hedge fund managers and advisers demonstrate only too clearly, however, that many rich and supposedly experienced investors may be just as susceptible to the blandishments of the investment fraudster as are the ordinary Joes who buy into mutual funds or the stock market.<sup>9</sup>

## II. HIGH NET WORTH INVESTORS AND OTC DERIVATIVE MARKETS

### A. Asymmetry of Information

Derivatives, including OTC products, feature heavily in the portfolios of some hedge fund managers. Long Term Capital Management was a fund that was set up expressly to create profits through the use of such derivatives.<sup>10</sup> While exchange-traded products are themselves heavily regulated and subject to significant disclosure regimes, the OTC markets are, in comparison, relatively opaque. This lack of regulation and disclosure creates

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<sup>9</sup> For a more substantive discussion of these cases, see Helen Parry, *From Masters of the Universe to Aunt Agatha: Protecting the Investor in the Hedge Fund Environment*, in HEDGE FUNDS LAW AND REGULATION, 173-193 (Cullen and Parry eds., 2001).

<sup>10</sup> "Unlike Procter and Gamble, Gibson Greetings and Orange County, Long Term Capital is a hedge fund that was expressly created to reap profits by trading derivatives." Lynn A Stout, *Why the Law Hates Speculation: Regulation and Private Ordering in the Market for OTC Derivatives*, 48 DUKE L.J. 701, 781 (1999).

additional problems with the asymmetry of information that inevitably exists between contracting parties, leaving investors vulnerable to the sellers of products with regard to fair valuation and other issues. The law reports bristle with cases involving extremely sophisticated investors, including the treasury departments of major corporations and public sector institutions, who have suffered huge losses as a result of their involvement in such markets. High net worth individuals are potentially even more vulnerable. The availability of resources to employ in the project of redressing gross asymmetries of information between contracting parties is not necessarily the answer to the problem. In many cases, it is very difficult for the end user of a derivative product to discover its true value, given the way in which such products are created and marketed by investment banks. Regulatory regimes, however, do presume that the availability of resources and/ or know-how on the part of an end user leaves him free to engage in highly risky investment strategies in a relatively unregulated environment. For these investors, it really is a case of *caveat emptor*.

#### B. Customer Classification and the High Net Worth Individual in the U.K.

In the U.K., private clients who are advised by market professionals as to their choice of investment have been well protected by the regulatory regime of the Financial Services Act of 1986 ("FS Act") and the rulebooks of the self-regulatory organizations ("SROs"). Such investors must not be advised to enter into investments that are not suitable for them in their circumstances. However, under the rules of the Securities and Futures Authority ("SFA"), private clients may choose to contract out of such protection and agree to be classified as expert investors. Expert investors lose much of the basic protection afforded ordinary private clients. The firm must, however, believe, on reasonable grounds, that the investor has sufficient understanding and experience to waive SFA protection.<sup>11</sup> Clients may be tempted to waive their rights on economic grounds. Firms usually charge lower fees to expert investors. Some firms simply will not entertain any protected private client business at all.<sup>12</sup> Recent case law shows us, however, that when markets move against client positions, high net worth individuals may seek to run for the cover of the enhanced protection afforded to the private client, querying the validity of the classification or even the regulatory regime governing their investments.

The one crucial right of action which clients waive when they are classified as an expert investors under SFA rules is the right to sue the firm if it is found to be in breach of an SRO rule and to have caused loss to the client

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<sup>11</sup> *Larussa-Chigi v. First Boston Ltd.*, Q.B. (Comm. Ct.) (1997), 1997 WL 1103582.

<sup>12</sup> See e.g. Trevor Norwood and Patrick Thompson, *Investor Classification*, Compliance Monitor, Oct. 1996, 58-59.

as a result.<sup>13</sup> If firms err in classifying a customer as expert, when they cannot show that they had reasonable grounds to believe that the investor had sufficient understanding and experience, and if they then fail to maintain adequate regimes of compliance, they risk such litigation and the resultant risk of bearing great market losses if they lose.

A recent case before the High Court in London concerned a breach of contract action brought by a major investment bank against an HNWI who had failed to repurchase a heavily leveraged and complex forex related structured note. The investment was predicated on the notion that the peseta and the lire would remain as strong against the dollar and the yen, or would get stronger. In the currency markets turmoil of September 1992, the investment lost seventy percent of its value. In the face of such losses (approximately \$7,000,000), the client declined to repurchase the investment at the original price and was therefore, *prima facie*, in breach of contract.

The firm that sold the notes claimed initially that the client was an expert investor, but it did eventually concede that this was not the case because, although he did have some experience in currency swaps markets, he had not previously invested in such highly complex and leveraged products. He did, however, "acquire a certain amount of knowledge about foreign currencies, their strengths and weaknesses and the fact that a weak currency would normally give a higher interest rate on investments than a strong one."<sup>14</sup>

The report of the litigation includes details concerning the client's previous experience in the markets, and provides an interesting analysis of the nature of investment experience that an investor needs to have in order that he may be found to have properly waived his rights and to have properly been categorized as an expert. He had experience with straight forward currency swaps, investments that had not involved any borrowing, and had previously invested in a currency fund, the objective of which was to "achieve exceptional returns for sophisticated investors willing and able to bear the risks of prudent but aggressive trading strategy in spot and forward contracts and in over-the-counter (OTC) options FX."<sup>15</sup> That fund was leveraged, in that it was fund policy to maintain positions of up to 10 times the fund's net asset value at any one time. The scheme was categorized as an unregulated collective investment scheme that, under the FS Act, may not normally be marketed to individual investors, unless they are experienced investors in accordance with the regulations governing these schemes or existing clients for whom such investments were suitable.<sup>16</sup>

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<sup>13</sup> Financial Services Act, 1986, c. 5, Section 62 (Eng.) [hereinafter FS Act].

<sup>14</sup> J. Longmore in *Morgan Stanley UK Group v. Puglisi Consentino*, C.L.C. 481 QBD (Comm. Ct. 1998).

<sup>15</sup> *Id.*

<sup>16</sup> See *supra* text accompanying note 8.

Although the issue of suitability was not specifically at issue with regard to the investments in these funds, the court did express the view that in all the circumstances the investment was not suitable for such a client. The regulation that permits firms to market unregulated schemes to existing customers for whom the scheme is deemed to be suitable is one of the main provisions allowing the marketing of such schemes to HNWI's.

With regard to the dispute concerning the structured notes that were the subject of the litigation, the firm initially argued that the client was an expert investor and was not therefore protected by many of the rules of the SRO specifically addressing the protection of private clients, but it eventually conceded that this was not the case. Although the client did have previous experience with both currency markets and leverage, the court considered the products that he bought under the structured note agreement to be in a different league. The level of complexity was very much greater than that involved in his previous trades. The investments consisted of a bond, the redemption value of which was to be calculated by reference to a formula based on a short position in one or more hard currencies, and a long position in one or more soft currencies. The redemption value of the bond however, could never be negative, according to an express term in the bond, which, although referred to commercially as an "embedded option", was expressed contractually as a proviso.

Once it had been accepted that the defendant was a private client for the purposes of the legislation, he was able to use the right to suit contained in Section 62 of the FS Act as a shield and the basis for a counterclaim for breach of statutory duty.

Although the facts were hotly disputed, the court decided, on the basis of the testimony presented to it, that the bank was in breach of several SRO rules relating to, *inter alia*, risk warnings and suitability. The case also raised issues connected to the documentation provided to the client. The product was not adequately explained — particularly in the light of the fact that the client did not speak good English; there were no product-specific risk warnings; the client was not given sufficient time to consider complex legal documentation before being asked to sign it and the classification notification omitted the terms of business which were to be attached.

The court also found that the bank sold him a product that was contrary to his recorded investment objectives (conservation of capital and long term growth) and that they had lacked an appropriate basis for classifying him or assessing his wealth.<sup>17</sup>

The parties agreed that any damages due to the plaintiff for the defendant's breach of contract would be at least equalled by the damages they

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<sup>17</sup> See also *Kwiatkowski v. Bear, Stearns & Co. Inc.*, No. Civ. 4798 (JGK), 1999 U.S. Dist. LEXIS 19966, at \*1 (S.D.N.Y. Dec. 29, 1999).



would owe him for breach of statutory duty under Section 62(1) of the FS Act.<sup>18</sup>

In another case, a HNWW, whose currency trades had turned sour, sought to claim that margin calls of £2.6 million made on a letter of credit that she had provided, as security, had not been properly made. A preliminary point at issue was the question of which regulatory regime applied to her relationship with her broker. She was initially classified as an expert investor under SFA rules, but the London Code of Conduct for Wholesale Markets governed the currency trades that were done for her.<sup>19</sup> She argued that the initial classification was made in breach of SFA Rules because it was made on the basis of an investor classification questionnaire which she claimed to have signed without answering any of the questions that appeared on it except for those inquiring as to her name and address. If the court had decided that SFA Rules did apply to this classification, and that there had been a breach of these rules, then she may have had a right of action against her broker under Section 62 of the FS Act. The court, however, found against her on the point with regard to the applicable regime, holding that her forex trading constituted London Code transactions within the wholesale markets regime and so that was the regime that applied contractually to the relationship between herself and her broker. The court rejected her argument that SFA rules applied to precontractual communications. There was therefore no possibility that she could seek to take action against the firm under Section 62.

### C. Ultra High Net Worth Individuals and the U.S. OTC Derivatives Market

The quite startlingly high levels of leverage and speculation engaged in by the client in the *Puglisi* case (up to \$60 million at risk through a number of products) pale into insignificance when compared to the several billion dollars in forex and other products traded by an ultra high net worth individual who recently sued his bankers for fraud, breach of fiduciary duty and negligence.<sup>20</sup> His net worth was stated to be \$100 million. The slump in the price of the dollar caused him to lose over \$200 million. Speculation on this scale carries a high risk of creating such huge losses, which frequently provoke the parties concerned to seek the intervention of the courts. In this case, the client instigated an action for fraud (which he lost) and then continued with a civil action for damages on grounds of breach of fiduciary duty and negligence. An action for summary judgement brought by the brokers seeking to close the civil case was, however, dismissed by the court. The client claimed that his broker failed to make sufficient inquiries

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<sup>18</sup> See *Morgan Stanley U.K. Group v. Puglisi Consentino* C.L.C. 481, Longmore, J. QBD (Comm Ct. 1998).

<sup>19</sup> Promulgated by the Bank of England for certain categories of exempt persons carrying out business under section 43 of the FS Act.

<sup>20</sup> See *Kwiatkowski*, 1999 U.S. Dist. LEXIS 19966, at \*1.

as to his investment objectives, failed to warn him that certain investments were not suitable for him, and failed to advise him about the heightened risk that he ran when his on-exchange positions were moved into the OTC market without his knowledge. Disputes between clients and their brokers and bankers frequently turn on disputed facts concerning issues such as these. Perhaps it is easy to assume that such wealthy individuals have only themselves to blame when they enter into such large and risky positions and should not seek to escape from their losses when the markets move against them.

End users may have access to very sophisticated analytical tools to help them understand and calculate the risks that they run when investing in complicated investment products. In one significant recent case, a first instance decision in favor of an investor was reversed on appeal. The investor was the treasurer to a group of community colleges and he lost \$50 million — about half of the colleges' investment portfolio — in the collateralized mortgage obligations ("CMO") market. He purchased very risky and volatile principal only "G" and "H" tranches of the issue that would receive no payments until all preceding letter tranches had been paid. However, he did have access to a split screen Bloomberg system, which cost \$20,000 per year to run. This system provided information about mortgage rates and analyzed yield tables. The investor admitted to the court that he "had learned to pull up the yield table and to put in the price of securities as it was offered and to substitute various PSAs in the table and to see [how] these things would affect the projected yield and payment window."<sup>21</sup>

In addition to his admitted skill in dealing with this system, the court found that the investor had significant experience trading in this particular type of security with other brokers; that he was initially reticent about entering into a relationship with the seller; and that his investment strategy of buying and selling quickly, taking a profit, showed that he was a sophisticated and experienced investor. The statements that were at issue with regard to the question of misrepresentation on the part of the seller were, however, concerned with predictions about future movement of interest rates. The court found in favor of the seller, holding, *inter alia*, that the investor was experienced and should have known that it was not possible to predict the future movement of interest rates.

### III. OTC DERIVATIVES AND ENFORCEABILITY UNDER U.S. LAW

#### A. Forex, Swaps and Hybrids

While the CFTC has traditionally enjoyed jurisdiction over exchange-traded futures and options, anyone found trading in off-exchange futures was considered to be committing a crime. Forex futures contracts entered

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<sup>21</sup> Westcap Enter.s et al. v. City Coll.s of Chi., 230 F.3d 717, 730 (2000).

into off-exchange were, on the other hand, specifically allowed by the Treasury Amendment to the Commodity Exchange Act.<sup>22</sup> Off-exchange forex options are also covered by the Amendment.<sup>23</sup> While most forex trading takes place in a wholesale environment by experienced market professionals, it is clear from the U.S. and U.K. cases cited above, that high net worth individuals are now being drawn into these markets, often with rather disastrous consequences.

Given the stark choice of either engaging in a fully valid and enforceable contract when trading futures and options on-exchange, and committing a criminal act when trading them off-exchange, it is hardly surprising that market players in the 80's and 90's have been plagued by a sense of uncertainty and ambiguity concerning the precise legal status of the plethora of financially-engineered OTC products, such as swaps and hybrids, that dedicated rocket scientists in investment banks have introduced into an increasingly bewildered and bemused marketplace. While some derivatives (such as mortgage backed securities) are clearly categorized as securities, many of these instruments lack clear statutory definition. They do perform similar economic functions to exchange-traded derivatives and some commentators consider that they should in fact be classified as futures and options, which should only be traded on an exchange in a highly regulated environment overseen by the CFTC. Some swaps and hybrids have been given specific protection,<sup>24</sup> but the absence of a clear overarching statutory regime to cover OTC derivatives generally has become an increasingly difficult problem for the markets to deal with. Matters came to a head in 1998 when the CFTC informed the world that it was going to look again at the whole issue of OTC derivative regulation, warning that they might be prepared to take the view that they were in fact futures and options and should be brought into an exchange-traded environment.<sup>25</sup>

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<sup>22</sup> See Commodity Exchange Act, 7 U.S.C. Section 2 (1997). "Nothing in this chapter shall be deemed to govern or be in any way applicable to transactions in foreign currency, security warrants, security rights, resales of instalment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade."

<sup>23</sup> See *Dunn v. CFTC*, 519 U.S. 465, 465 (1997) (where position was clarified regarding forex futures contracts entered into off exchange).

<sup>24</sup> See Futures Trading Practices Act of 1992, Pub. L. No. 102-546, 106 Stat. 3590 (1992) (where the CFTC was granted this exemptive authority). Structured notes that are hybrid financial instruments could be futures or commodity options contracts if they do not meet the terms and conditions of the CFTC hybrid instrument exemption. Regulation of Hybrid Instruments, 17 C.F.R. pt. 34 (2001). The CFTC granted swaps and hybrids administrative exemptions from the CFTC Futures Trading Practices Act of 1992.

<sup>25</sup> See Press Release, CFTC, *CFTC Issues Concept Release Concerning Over-the-Counter Derivatives Market* (May 7, 1998), available at <http://www.cftc.gov/opa/press98/opa4142-98.htm> (last visited April 6, 2001).

## B. The Commodity Futures Modernization Act 2000

This provocative stance provoked a storm of protest by banking and securities industry regulators and the issue has now been addressed in the Commodity Futures Modernization Act of 2000 ("CFMA"). This act makes it clear that OTC derivatives, swaps and hybrids do not come within the jurisdiction of the CEA and the CFTC and are not illegal or unenforceable contracts.<sup>26</sup> The threat of heavy regulation of the OTC market had been sufficient to induce some major investment banks to threaten to close down their U.S. operations and move to the more benign regulatory environment of London.<sup>27</sup>

Some commentators have proposed that a better solution would be to expressly decriminalize all OTC trading and to render it contractually unenforceable unless it could be shown to have been carried out for the purpose of hedging. Such a regime would simply be a harking back to the basic common law position concerning contracts for differences.<sup>28</sup> This would, it is argued, help to rid the markets of excessive speculation, including speculation by HNWI's, because the only players that would be able to take part would be those with significant reputational capital. Some contemporary economic theorists have suggested that excessive speculation is bad for the economy as a whole and that it would be beneficial for excessive speculation to be squeezed out of the markets. It is hard to disagree entirely with such a view when looking at contemporary markets in the throws of the spectacular bursting of the speculation-fuelled dot.com bubble.<sup>29</sup>

## C. Enforceability and Derivatives Contracts Under English Law

The proposition that an OTC derivative contract was unenforceable, unless carried out for hedging purposes, was argued in a case heard in the Court of Appeal in London. The dispute centered on the issue of the en-

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<sup>26</sup> See Commodity Futures Modernization Act of 2000, H.R. 4541, 106<sup>th</sup> Cong. Section 102 (2d Sess. 2000).

<sup>27</sup> "Let me be frank. If the legal uncertainty posed by CFTC assertions of jurisdiction is not removed, Chase will be forced to move this business to another location, probably London, where we don't have the specter of legal jeopardy that has been raised by the CFTC. A substantial portion of this business is mobile. In the case of products done with individual customers, if the customers are in the U.S. and we can't avoid the legal uncertainty by booking the business outside the U.S., we may stop doing business with U.S. customers." *Financial Derivatives Supervisory Improvement Act of 1998 and Financial Contract Netting Improvement Act: Hearing on H.R. 4062 and H.R. 4239 Before the House Comm. On Banking and Financial Services*, 105<sup>th</sup> Cong. 11 (1998) (statement of Dennis Oakley, Managing Director of Global Markets, The Chase Manhattan Bank).

<sup>28</sup> "Under the common law traders were free to enter off-exchange difference agreements that did not serve an indemnity (hedging) purpose. However, because such agreements were legally unenforceable, traders had to find private mechanisms to enforce them." Stout, *supra* note 10, at 777.

<sup>29</sup> *Id.*

forceability of a gambling debt, which a young city worker was facing after he placed a spread bet with his financial bookmaker, betting on the movement of the Dow Jones index and the price of Treasury Bonds.<sup>30</sup> When sued for the debt, the defendant punter argued that it was unenforceable under the Gaming Acts as a gambling debt. The plaintiff's case was, however, that while that may be true, such debts are nevertheless enforceable by virtue of Section 63 of the FS Act. This section provides that while an agreement may be a gambling debt for the purposes of the Gaming Acts, if it falls within the definition of investment business as defined in the FS Act, it will be enforceable. The plaintiff argued that a spread bet on a financial index was an investment, as defined in paragraph 9 of Schedule 1 of the FS Act and that the business of a financial bookmaker was investment business as defined in the FS Act.<sup>31</sup> The Court of Appeal found for the plaintiff and held the gambling debt to be enforceable against the losing punter.

#### D. The Background to the Litigation: Enforceability and Contracts for Differences at Common Law

Section 63 of the FS Act clarified the legal position concerning the enforceability of contracts for differences. This category of investment covers a range of OTC derivative products, including swaps and structured notes.<sup>32</sup> The common law position was unclear. There is a strand of judicial opinion that considers contracts for differences to be void and unenforceable as gambling contracts, unless both parties had an actual intention that the title

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<sup>30</sup> For each possible bet, financial bookmakers quote a "spread", which consists of 2 numbers, the second higher than the first. With each bet, customers have a choice. They can either choose a number below the lower number (effectively going short) or higher than the higher number (going long). They must then choose how much money to bet on each point. If they guess correctly as to the direction of the index they win a sum of money calculated by multiplying the amount bet per point by the number of points above or below the spread. If they are incorrect in their prediction, their losses are calculated in the same way.

<sup>31</sup> Section 63(1) provides that "No contract to which this section applies shall be void by reason of (a) section 18 of the Gaming Act 1845, Section 1 of the Gaming Act 1892 or any corresponding provisions in force in Northern Ireland.(2) This section applies to any contract entered into by either party by way of business and the making or performance of which by either party constitutes an activity which falls within paragraph 12 of Schedule 1 to this Act or would do so apart from parts II and IV of that Schedule." Financial Services Act, 1986, c. 60 sect. 63, sch.1.

"Investment Business" includes business concerning investments which include "Rights under a contract for differences or under any other contract the purpose or intended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in the value or price of property of any description or in an index or other factor designated for that purpose in the contract." *Id.*

<sup>32</sup> For the position on swaps, see text *infra* at p. 19. Structured notes were classified as contracts for differences in *Morgan Stanley U.K. Group v Puglisi Cosentino* [1998 C.L.C. 481 (QBD) (Comm Ct)]. For a discussion of this case see Helen Parry "How Black Wednesday Broke Morgan Stanley's String of P.E.R.L.S " Compliance Monitor May 1998 pp. 407 - 409.

of the shares or commodities concerned would pass between them and delivery would take place.<sup>33</sup> However, there is another strand of judicial opinion that asserts that, provided that the contract does provide, in terms, for delivery, then the subjective intentions of the parties are irrelevant.<sup>34</sup> This latter approach would have provided comfort at least for futures markets contracts that have delivery provisions within their terms, but even this more liberal approach casts doubt on the validity of purely cash-settled contracts based on commodities or financial instruments or indices. In London in the early 80's, the derivatives community was naturally concerned that a court could declare that a significant proportion of the contracts traded on the floor of the various futures exchanges were unenforceable gaming contracts. This created a significant legal risk. The exchanges formed a committee to lobby the government to press for a specific statutory reform to make it absolutely clear that this was not the case with regard to the business on the London exchanges. Such a statute never came into being, but the essence of the request was dealt with through the inclusion of Section 63 of the FS Act.

#### E. The Decision of the Court of Appeal

However, the Court of Appeal had to agree that financial spread betting could not be distinguished from exchange-traded cash-settled futures and index futures. Such bets were contracts for differences or other contracts within paragraph 9 of Schedule 1 of the FS Act and therefore were indeed enforceable. Undaunted, the defendant then argued that the wording of paragraph 9 should be interpreted to apply only to a hedging contract and not to a naked bet because the expression "to secure a profit" in paragraph 9 must mean to hedge an existing profit. His argument, however, was not accepted by the court. It examined the legislative ancestry of the section and decided that it was probably derived from an earlier statute, the Prevention of Frauds (Investments) Act of 1939, where the word "secure" was used to mean "obtain" and not to protect an existing profit.

A few years later, paragraph 9 again fell to be interpreted by the High Court in an action brought by the same bookmaker to recover a debt based on a sporting index. Lord Justice Legatt, in *City Index v. Sadri* (unreported), reluctantly decided that he could not interpret paragraph 9 in such a way as to distinguish between spread betting financial and sporting indices. The defendant punter was found liable to pay up on his gambling debts on cricket and horse racing. This judgment has produced the rather bizarre result that a spread bet on, for example, the number of stretcher cases that may be carried off the field during a major football tournament, is classified

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<sup>33</sup> See *Universal Stock Exch. Ltd. v. David Strachan*, 1896 A.C. 166; *Grizewood v. Blane*, 11 C.B. 526 (1851).

<sup>34</sup> *Cooper v. Stubbs*, 2 K.B. 753 (1925); *Salt v. Chamberlain*, 1979 S.T.C. 750, 753.

as an investment. Legatt, in his judgment, did, however, recommend that the Secretary of State at the Department of Trade and Industry exercise his powers under Section 2 of the FS Act to remove this anomaly by expressly excluding sports spread betting from the ambit of paragraph 9. Treasury Minister Anthony Nelson appeared to have taken this suggestion to heart when he went on the record to describe the inclusion of such spread betting within the definition of investment as "unintended." A proposal to do precisely this was included in the proposals by the government "Deregulation Task Force". Surprisingly, however, this proposal was later dropped and the position remains the same. This *volte-face* followed a strong lobby mounted by the bookmakers, arguing a case for maintaining the status quo on the basis of the high risk involved in such betting and the need for consumer protection.

The question as to whether swaps are gaming contracts was considered in *Morgan Grenfell v. Welwyn Hatfield DC*,<sup>35</sup> a dispute concerning the issue of restitution in the context of interest rate swaps cases in the aftermath of the notorious *Hazell v. Hammersmith and Fulham*. In *Hazell*, the court had decided, much to the consternation of the professionals in the swaps market, that local authorities lacked the power to enter into swap contracts.<sup>36</sup> Mr. Justice Hobhouse, in *Grenfell*, which was a case concerning an interest rate swap in which the defendant local authority was to pay a floating rate of interest to the plaintiff in return for a fixed rate, took the view that swaps were contracts for differences and could possibly be seen to be gaming contracts.<sup>37</sup> Although the court has not directly addressed the point, it is presumed that even if swaps were found to be gaming contracts, they would still be enforceable by virtue of Section 63 of the FS Act.

#### F. Bear Markets and Investor Demand for Speculative Short Selling — Equity Contracts for Differences and Single Stock Futures

While the bear market conditions prevailing in 2001 and the concomitant demand for short selling opportunities are the engine driving the renewed vigor of the markets for hedge funds, that same demand is prompting the financial services industry, both on- and off-exchange to develop new products that provide investors with opportunities for taking short speculative positions that can offset some of the losses they are carrying on their equity portfolios. In London, financial bookmakers and futures brokers are starting to offer equity contracts for differences ("ECFDs"), which are arrangements whereby one party agrees to either pay or receive the difference between the market value of a share or a basket of shares on a specified future date and the value of a strike price, usually the value of the single share

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<sup>35</sup> 1 All E.R. 1, 7 (1995).

<sup>36</sup> See 1 All E.R. 545 (1991).

<sup>37</sup> *Grenfell*, 1 All E.R. at 7.

on the date of the agreement. They are similar to both call options and the new single stock futures contracts being launched by exchanges in London. ECFDs are offered on single stocks on margins of between 10 and 20 percent and are promoted as being particularly suitable for large volume short-term speculation. Transaction costs for these products generally exceed those for financial spread betting, partly because of the added cost of betting tax involved in spread betting. On the other hand, financial spread betting profits are not subject to capital gains tax. ECFDs are the true ancestors of the equity contracts for differences which feature in the nineteenth century cases cited above.<sup>38</sup> The terms of business of these Victorian CFDs included, in one instance, conditions that were not dissimilar in effect to terms that bankers use today when selling swaps to major corporations. They made it crystal clear that the seller was purporting to eschew any possible liability for fiduciary duties towards clients, stating explicitly that they were acting as principals and at arms length and absolutely not as agents. The terms went on to provide that the customer must understand what that means and that they should understand "all the rudiments of stock and share dealing." The company furthermore stipulated that "it is an absolute condition that a customer, before opening an account should satisfy himself as to, and acknowledge that he fully understands the company's terms and methods of doing business."<sup>39</sup>

Single stock futures contracts have recently been introduced as an exchange traded product in London; they are expected to be on offer in the U.S. by the end of the year. This is becoming possible now that the Commodity Futures Modernization Act, signed by President Clinton in December 2000, has removed the prohibition on trading such products and futures based on narrow equity indices that was imposed by the Shad Johnson Jurisdictional Accord of 1982. The reason for the ban was the SEC's concern that such products would be subject to abusive practices such market manipulation and insider dealing. This concern arose because the CEA did not specifically contain a prohibition on insider dealing, and because the CEA antifraud provisions were inadequate to prevent fraudulent price manipulation because they dealt only with trading for or on behalf of another person, and not for one's own account.<sup>40</sup>

Liffe, the London derivative market, has signed an alliance with Nasdaq that covers single stock futures. This alliance was announced in March 2001 to the effect that Nasdaq and LIFFE, the London International Financial Futures and Options Exchange will form a U.S. regulated entity,

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<sup>38</sup> See, Universal, *supra* note 31.

<sup>39</sup> *Id.*

<sup>40</sup> Daniel F. Zimmerman, *CFTC Authorisation in the Wake of Long Term Capital Management*. 121 COLUM. BUS. L. R. 9 (2000).



which will list single stock futures on global companies through LIFFE's electronic trading platform CONNECT™.<sup>41</sup>

#### IV. FOREX MARKETS AND THE RETAIL INVESTOR IN THE U.S. AND U.K.

The CFMA does, however, grant jurisdiction to the CFTC to deal with unregulated retail Forex trading.<sup>42</sup> The Act makes it clear that the CFTC has the jurisdiction and authority to investigate and take legal action to close down a wide assortment of unregulated firms offering or selling forex futures and options to the general public. The CFTC further has jurisdiction to investigate and prosecute forex fraud occurring in its registered firms and their affiliates. The CFTC has issued a major warning to consumers to be aware of the risks in such trading.<sup>43</sup> Retail customers in the U.K. and other European countries have also been targeted by Forex boilerhouses in the past few years. One major regulatory issue which was raised by such activities was the effect of EU "passporting" provisions, which allow those doing investment business in one member state to be "passporting" to carry out investment business throughout the EU under the terms of the Investment Services Directive. A number of forex and other boilerhouse operations were set up in Copenhagen in the 1990s in an attempt at regulatory arbitrage. Denmark had not yet fully implemented its financial services regulatory regime and was still processing applications for authorization under its system. While such applications were being considered, it was lawful to carry out investment business in Denmark. One firm started to solicit forex investors in the U.K., claiming that it was passported to do so. The court found subsequently that the passport provision applied only to those whose applications had been accepted and who were fully authorized under Danish law.<sup>44</sup>

#### V. THE CASE FOR GREATER PROTECTION FOR HIGH NET WORTH INDIVIDUALS

##### A. Customer Classification

Regulators generally do not spend sleepless nights worrying about the plight of millionaires who invest unsuccessfully in alternative markets such as hedge funds and OTC derivatives. Their regulatory zeal is properly directed at protecting the interests of investors of relatively modest means and

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<sup>41</sup> Nasdaq Press Release March 26, 2001.

<sup>42</sup> *Supra* note 24.

<sup>43</sup> Commission Advisory "Beware Foreign Currency Trading Fraud.", available at [www.cftc.gov/opa/enf98/forexa.15htm](http://www.cftc.gov/opa/enf98/forexa.15htm).

<sup>44</sup> *Securities and Investments Board v. Scandex Capital Management A/S* [1998] 1 W.L.R. 712.

limited expertise, who potentially are more vulnerable to being “missold” more mundane investment products. Such investors are transparently at a disadvantage, given the severe asymmetry of information that is likely to exist between themselves and the sellers of such products, and they clearly need the enhanced regimes of investor protection that exist in the U.S. and the U.K. However, in recent years, as more and more individuals are drawn into the markets (particularly in the U.S. and increasingly in the U.K.) and in today's bear markets, they are being tempted to venture into those sectors which carry more risk and leverage and which have, for the most part, traditionally been considered to be the exclusive province of professionals. Such markets have proved to be very strange, volatile and frightening places even for relatively experienced investors, such as those who work for the treasury departments of major corporations or public sector agencies. The relatively new rich are particularly ripe targets for unscrupulous derivatives salesmen and hedge fund advisers and managers. Unlike the traditional English target for an investment scam, who is quaintly known as “Aunt Agatha” — a term redolent with images of elderly upper class spinsters, replete with inherited wealth but with no husband to look after it — the new rich of today are more likely to be entertainers, sports stars or those who have amassed wealth in the dot.com sector, and they may have practically no knowledge of or experience of any significance with financial markets or investing.

Such targets may be easily flattered into thinking that they have suddenly entered the magic kingdom and are members of an exclusive group with access to unheard-of weird and wonderful investment opportunities denied to their more down-market brethren. They may be seduced by the prospect of lower commissions into agreeing to do business at arm's length and as experienced investors, thereby potentially losing regulatory protection and the possibility of taking action against sellers for breach of statutory or fiduciary duty. They may feel embarrassed and inadequate because they cannot understand the real nature of the products that they are being sold and they may fail to ask sellers for detailed explanations. The fact that they may equip themselves with attractive toys such as Bloomberg Systems (which they may only partially understand) may count against them in the event of a lawsuit against their brokers. Furthermore, they may lack the psychological fortitude necessary to deal with either the elation of success or the crushing disappointment of failure in the markets.

I suggest that any regulatory regime that categorizes investors in terms solely of their disposable income or wealth is inadequate. In order for an investor to be apt for classification in terms of a reduced regime of investor protection, the classification process must include a genuine filter based on a real assessment of the level of sophistication and experience of that investor. Firms that fail to comply with the full rigour of regulatory provisions concerning customer classification should do so at their peril.

### B. Alternative Investments and the Mass Market

While the hedge fund sector is seen to be heading for a boom period in markets generally, with many new funds being set up targeted at high net worth investors, there are increasing signs that the sector is now also going down-market. The Chairman of the Financial Services Authority, Sir Howard Davies, recently issued a warning to investors to be aware of the risks involved in "exotic ISAs."<sup>45</sup> ISAs provide a means of tax-free investing and they are aimed at the mass market of ordinary savers. Sir Howard is exercised by the emergence of a number of funds of funds based ISAs, which involve a manager selecting a range of hedge funds on behalf of the investor. The firms offering these products are avoiding the general restrictions on marketing hedge funds either by running the schemes through investment trusts structured as listed companies, listed in London, Dublin or the Channel Islands, or by marketing them indirectly through financial advisors.<sup>46</sup> The minimum investment for these products typically is £5000. The consumer alert issued by the FSA warns consumers that ISAs that invest in hedge funds or use derivatives linked to the performance of a complex hedge fund index are now on offer to small savers and that such products may not be suitable for a core investment. They may be high risk, difficult to understand and may feature costs and charges that are not clear. It warns further that shares linked to hedge funds and issued outside the U.K. are being made available in an ISA wrapper. Similar schemes are emerging elsewhere. In Australia, for example, new funds of funds schemes are being launched that require minimum investments of \$A10,000.<sup>47</sup> Regulators must increase their vigilance and surveillance of these trends.

## VI. CONCLUSION

In 1998, the financial world held its breath as Long Term Capital Management dragged the markets towards the abyss of total systemic meltdown. Since those torrid days, forests have been cut down to supply the mountains of paper produced by the many committees and working parties that have peered into that abyss in the hope of being able to devise a means of preventing a reoccurrence. Such events may seem far removed from the world

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<sup>45</sup> Individual Savings Account. These were introduced in 1999 to replace personal equity plans. They are not products in their own right, but tax-free wrappers, which means that capital gains from the investment will not be taxable.

<sup>46</sup> Investment trusts are companies which exist purely to make money. They buy and sell shares in other companies. They pool investors' money, enabling them to buy shares in hundreds of other companies. They can invest in companies listed in the U.K. and foreign stock markets. They are closed-end funds, where the amount of money that the trust raises to invest is fixed at the start.

<sup>47</sup> See John Collett, *Opt for multi-managers, fund-of-fund*, SYDNEY MORNING HERALD, Feb. 10, 2001.

of hedge fund ISAs, but the basic principles of hedge fund trading apply whether the manager has 1000 clients who have put in £5000 each or 10 clients who have put in \$500,000 each. Collective investment schemes that deal in high-risk strategies such as short selling, the use of derivatives and leverage are potentially a danger to investors. There is a need or greater disclosure. This has been recognized by the Financial Services Authority in the U.K. It is clear that most of the significant issues concerning LTCM were well-understood and flagged up in the days immediately succeeding the crisis, but the ground perceptibly shifted from an initial wariness at directly regulating hedge funds, to the active endorsement by the FSA of public disclosure requirements, combined with an ongoing program of voluntary industry-based reform of hedge fund risk management practices.

The nettle has been grasped, but the threat remains that if hedge funds do not put their own house in order they may find themselves facing a full-scale regime of regulation similar to that regulating authorized firms in the U.K. Regulators must be alert to the fact that there is an army of individual investors out there, both rich and not so rich, who have had their fingers burned in the dot.com crash. Many of them may never have heard of Long Term Capital Management, and may be avidly pouring over glossy brochures and websites proclaiming their ability to make money in a bear market by engaging in alternative investment strategies such as hedge funds, CFDs, financial spread betting and single stock futures. Increasingly, such investments are not engaged in for frivolous reasons, but rather to provide for basic necessities such as health education and retirement income. In bear markets, regulators must be acutely alive to the extra risks that inexperienced investors may unwittingly be taking on, driven, all too often, by a toxic combination of fear and greed. Even millionaires need to be protected.

