GLOBAL BANKING & Finance review®

TOP STORIES

U.S. Hedge funds face heightened enforceme in France

*By **Margot Laporte, Miller & Chevalier Chartered (Washington, DC) and Viviane Tse,** Freshfields Bruckhaus Deringer LLP (Paris, France)*

On April 17, 2020, France's securities regulator, the Autorité des marchés financiers ("AMF"), levied one of its largest combined fines ever against Elliott Advisors UK Ltd. and Elliott Capital Advisors L.P., imposing a €20 million penalty for charges that included failure to adequately disclose their positions in a takeover bid. This case marks the second time in the past year that a U.S. activist hedge fund has found itself in the cross-hairs of the AMF and reflects renewed interest by French authorities in regulating short-sellers and activist hedge funds. Since 2019, France's Finance Minister Bruno Le Maire, the French National Assembly's Finance Commission, and the AMF, among other market participants, all have endorsed enhanced disclosures for short-sellers and activist investors. In this political environment, and particularly during the COVID-19 crisis and resulting economic downturn, the AMF is likely to demonstrate heightened focus on activist hedge funds whose activities it views as destabilizing to the French market and public companies.

U.S. hedge funds should anticipate heightened regulatory scrutiny and enforcement risk in France. U.S. hedge funds seeking to invest in the French market, therefore, should balance their investment strategies with steps to mitigate enforcement risk. These steps include assessing disclosures and trading strategies in light of French regulatory requirements and the expectations of French regulators as well as taking into account key differences between U.S. and French securities enforcement procedures.

April 2020 AMF Report on Shareholder Activism

On April 28, 2020, the AMF published a report regarding "Shareholder Activism" ("*Communication de l'AMF sur l'activisme actionnarial*"), which provides insight into how the French regulator views the activities of short-sellers and activist investors. The AMF's report considered recommendations made by French lawmakers and market participants, including an October 2019 report by the Finance Commission of the French National Assembly, urging heightened disclosure requirements when activist investors and short-sellers take large positions in French companies. While stopping short of denouncing activist investing, the AMF's report concluded that certain activities undertaken by activist investors have a "destabilizing effect" on the market. These activities, according to the AMF, include a lack of adequate transparency regarding investors' holdings, intentions, and conflicts of interest; destabilization of companies; dissemination of false or misleading information; and price manipulation.

The AMF recommended several non-binding measures aimed at improving transparency regarding investors' positions, financial exposure, and communications with issuers as well as increasing the AMF's ability to respond to "activist campaigns." The AMF's proposed measures include:

- Lowering the legal threshold at which an investor is required to disclose its position in a French company from 5% to 3%;
- Updating AMF policies with provisions to enhance investor disclosures to issuers during activist campaigns;
- Supplementing the reporting of net short positions in equities with information on investors' debt instrument holdings; and
- Several procedural reforms and amendments to French law to enhance the AMF's ability to rapidly respond to activist campaigns.

The AMF, which is aware of the potential impact of any additional regulation on the attractiveness of Paris as a financial center, concluded that the current legal framework is sufficiently "flexible and robust" to enable it to intervene when it detects "investor activities that are potentially destabilizing for the market and issuers."

Significantly, while the report discusses the AMF's intention to "intervene" in the face of perceived "destabilizing" conduct by short-sellers and activist investors, the report does not identify all "destabilizing" conduct as illegal under governing law. The report, therefore, suggests that the AMF will take a broad view of the "flexible and robust" legal framework and vigorously enforce France's securities laws against investors whose conduct it views as "destabilizing" to the market and public companies, particularly during times of economic instability.

Recent AMF Enforcement Actions Against U.S. Hedge Funds

The AMF has a history of enforcing France's securities laws against U.S. activist hedge funds. Recently, the AMF's Enforcement Committee ("AMF EC") has initiated several investigations and enforcement actions against U.S. activist hedge funds for alleged disclosure failures and insider trading in connection with takeover bids and short-selling involving French public companies.

Elliott Enforcement Action for Disclosure Violations (2020)

In April 2020, the AMF EC fined Elliott Advisors UK and Elliott Capital Advisors €20 million for inadequate disclosures and obstruction of the AMF's investigation in connection with a takeover bid by XPO, a U.S. company, for Norbert Dentressangle SA, a French public company. To date, Elliott has not appealed the decision. The enforcement action arises out of Elliott's acquisition of shares and derivatives relating to Norbert Dentressangle securities in 2015, through which Elliott acquired enough shares and voting rights to prevent a mandatory "squeeze-out" of minority shareholders contemplated by XPO.

The AMF EC's decision focused on whether Elliott accurately disclosed the size and nature of its positions. The AMF EC found, first, that Elliott failed to accurately report the nature of its shareholding in Norbert Dentressangle because Elliott declared in its threshold crossing notifications to the AMF that it had purchased contracts for difference ("CFDs") when, in fact, it held equity swaps. Second, the AMF EC found that Elliott failed to timely disclose its intention not to tender its Norbert Dentressangle securities to the public offer, as required under French law after Elliott surpassed a 5% ownership threshold. Finally, the AMF EC found that Elliott Advisors UK obstructed the AMF's investigation by delaying and providing incomplete information.

Elliott argued that it is not obligated under French law to specify the type of derivatives it held, particularly since the market does not differentiate between CFDs and cash-settled equity swaps, and that its inaccurate disclosure therefore did not harm market participants. Elliott further argued that it was not required to disclose its intentions regarding shares it did not hold at the time the ownership threshold was crossed (via its derivatives holdings)and emphasized the uncertainty around its ability to subsequently purchase the shares.

At the heart of the AMF EC's decision regarding the amount of the penalty appears to have been its view, as reflected in statements by an AMF Board representative at a public hearing on February 7, 2020, that Elliott's failings were "not just negligence" and were "particularly serious in bringing a manifest attack on the integrity of the market." Indeed, the AMF EC's decision stated that the €20 million penalty against Elliott reflected, among other factors, "the fact that the inaccurate reportings and the delay in submitting a declaration of intent to the AMF were intended to conceal from the market, for as long as possible, the strategy of blocking the squeeze-out offer in order to negotiate a reassessment of XPO's offer price."

Muddy Waters Warning Letter (2019)

In December 2019, the AMF EC issued a warning letter to U.S. hedge fund Muddy Waters Capital in connection with a report regarding French public company Casino Guichard Perrachon SA ("Casino") that triggered a share price drop. In 2015, Muddy Waters, which held a short position in Casino, issued a report stating that Casino's main investor, Rallye SA, was overvalued. The report led Casino and Rallye's share prices to drop by 20% within hours. The AMF's investigation focused on whether Muddy Waters timely disclosed its short position after it crossed a threshold and potential market manipulation. The AMF Board ultimately determined not to bring an enforcement action but issued a warning letter to Muddy Waters emphasizing "the importance of compliance with the principles of honesty, fairness and impartiality" when issuing investment recommendations regarding French securities, "including from abroad." The AMF Board also warned Casino about the quality of its financial information, and Rallye was placed under protection from creditors in May 2019.

Elliott Enforcement Action for Insider Trading (2014)

In 2014, the AMF EC fined Elliott Management Corp. and Elliott Advisors UK €16 million, the largest combined penalty ever imposed at the time, for insider trading in connection with a takeover bid of French motorway operator Autoroutes Paris-Rhin-Rhone SA ("APRR"). The AMF EC found that, in 2010, Elliott Advisors UK passed inside information to Elliott Management regarding negotiations to sell its APRR shares to APRR's major shareholder, and that Elliott Management traded on this information. Elliott's sale of its shares enabled APRR's major shareholder to trigger a "squeeze-out" of minority shareholders, and the AMF alleged that Elliott's knowledge of the transaction "indisputably gave Elliott Management an advantage over others in the market."

Elliott denied that it traded on inside information, noting, among other points, that its acquisition of APRR shares between 2005 and 2010 had been part of a long-term strategy and that it had established an information barrier between Elliott Management and Elliott Advisors UK concerning APRR in 2010. In finding Elliott liable for insider trading, the AMF EC did not credit Elliott's information barrier, concluding that inside information likely was passed between certain equity partners and that the establishment of an information barrier "necessarily implies that some staff of the Fund may hold, at least in the future, inside information which would, in essence, affect the share price."

The AMF EC, however, declined to uphold charges against Elliott for price manipulation. Elliott's subsequent appeals of the decision have been denied.

Steps for U.S. Hedge Funds to Mitigate Enforcement Risk in France

Given the AMF's heightened focus on short-sellers and activist investors, and particularly in light of the current economic instability, U.S. hedge funds investing in the French market should mitigate their enforcement risk by taking the following proactive measures:

- **Assess Disclosures to French Regulators and the Market.** As demonstrated by the AMF's report on "Shareholder Activism" and the recent investigations and enforcement actions against U.S. hedge funds, the AMF is focused on increasing transparency regarding activist investors' holdings and even their intentions (in the case of a public tender offer) in executing trading strategies. The AMF has demonstrated that it will not hesitate to bring an enforcement action against activist hedge funds it views as "destabilizing" the market on the basis of inadequate disclosures. U.S. hedge funds investing in the French market, therefore, should balance their trading strategies—which may not be well-served by disclosing their intentions to regulators and the market—with enforcement risk if they do not meet the AMF's expectations with respect to transparency.
- **Assess Trading Strategies in Light of the AMF's Expectations Regarding Insider Trading and Market Abuse.** U.S. hedge funds investing in the French market must comply with both U.S. and French insider trading laws. France's market abuse law is based on the 2014 EU Market Abuse Regulation, which broadly defines covered offenses. The AMF thus has wide discretion in bringing enforcement actions for conduct it determines to sanction. The 2014 enforcement action against Elliott further suggests that the AMF EC may exercise its discretion, based on its assessment of the facts, not to credit certain compliance procedures, such as information barriers, that are viewed in the United States as an affirmative defense to insider trading allegations. In addition to pursuing trading strategies in France in accordance with their insider trading policies and applicable law, U.S. hedge funds should analyze whether the AMF may perceive their strategies as "destabilizing" in order to assess and mitigate their enforcement risk.
- **Understand AMF Enforcement Procedures.** U.S. hedge funds should understand differences in securities enforcement procedures between the United States and France in order to properly assess their enforcement risk when developing disclosures and trading strategies as well as in the event of an enforcement action. Several key differences between U.S. and French enforcement procedures are worth note:

First, unlike in the United States, once the AMF Board has determined to initiate an enforcement action, a "*rapporteur*"—a member of the AMF EC—is appointed to independently assess the case. The *rapporteur* reviews the investigation file, interviews the defendant, and issues an opinion regarding the charges against the defendant. Although the *rapporteur*'s opinion is non-binding, the AMF EC often accords significant weight to the *rapporteur*'s findings.

Second, while enforcement actions brought by the U.S. Securities and Exchange Commission ("SEC") often are settled without trial, settlements with the AMF are limited to cases regarding breaches of professional obligations or market abuse with low financial stakes. In anticipating legal and reputational risk, U.S. hedge funds should be aware that AMF procedures include a public hearing before the AMF EC, which may be attended by the press, before the AMF EC renders a public written decision.

Third, it is less common in France than it is in the United States for regulators to move back and forth between the public and private sectors. While numerous members of AMF staff are former private lawyers, the AMF EC is chaired by judges from French Supreme Courts (administrative and judicial) and composed of professionals with a legal or financial background. As a result, their approach when evaluating charges against U.S. hedge funds is likely to be strictly legal rather than incorporating a practical consideration of hedge funds' business, investment strategies, and trading activities.

Conclusion

U.S. hedge funds face increasing scrutiny from French regulators, lawmakers, and politicians, especially during the current period of economic instability following the COVID-19 crisis. Therefore, U.S. hedge funds seeking to invest in French companies, and particularly those pursuing activist or short-selling strategies, should take proactive steps to assess and mitigate their enforcement risk in light of their investment strategies.

Gbaf News