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The Top Ten Regulatory and Litigation Risks for Private Funds in 2019

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An increasingly sophisticated and active OCIE division, innovative market disruptors, a maturing credit cycle, and a philosophical change in how the private fund industry views and utilizes litigation are likely to lead to increased regulatory scrutiny and litigation risk for advisers (and their funds) in 2019. With that backdrop, we are pleased to present our Top Ten Regulatory and Litigation Risks for Private Funds in 2019.

1. Increasing Sophistication of OCIE

OCIE continues to function as an important referral pipeline to the SEC's Division of Enforcement. OCIE's role in Enforcement referrals is due, in large part, to the industry-specific knowledge and sophistication of the OCIE exam staff, particularly with respect to the structural and operational aspects of private fund advisers. This developing subject matter expertise has resulted in OCIE examining 17% of registered advisers in fiscal year 2018 and progressively more detailed requests for information and documents from OCIE staff in targeted areas. OCIE also continues to allocate a portion of its resources to ERA oversight, including recent inquiries evaluating investment activities involving virtual currencies. Advisers have always been appropriately attuned to an OCIE exam. However, given OCIE's increased understanding of the private funds industry, and the correlation between exams and Enforcement referrals, advisers should treat every exam request as an inquiry that could lead to further regulatory scrutiny.

2. Disclosure of Fees, Expenses, and Conflicts of Interest in Enforcement

OCIE and the Division of Enforcement will continue to focus on complete and accurate disclosure of fees, expenses, and conflicts of interest. OCIE made this point clear in a recent Risk Alert discussing the most frequent fee and expense compliance issues identified in recent OCIE exams. The SEC's focus on timely disclosure is part of a multi-year trend dating back to at least May 2016 when Andrew Ceresney, then-Director of the Division of Enforcement, stated that it was "critically important that [private equity fund] advisers disclose all material information, including conflicts of interest, to investors at the time their capital is committed." Accordingly, disclosure of existing conflicts after a capital commitment generally will be insufficient, especially in the illiquid fund space where investors may be subject to extended commitment periods and have limited options for liquidity outside of the secondary markets. Where pre-capital commitment disclosures either were not made or would have been impracticable, private fund advisers should consider what curative actions, if any, may be appropriate, including whether to refrain from taking an action that presents a potential conflict, or to disclose the conflict and obtain consent from an LPAC or the limited partners in accordance with the terms of the LPA. Just as failing to adequately disclose carries risk, corrective actions that fall short of adequate disclosure or consent carry risk as well.

3. Blockchain-Related Investments (cryptocurrencies, ICOs, bitcoin)

Regulatory scrutiny surrounding blockchain-based technology—such as cryptocurrencies and Initial Coin Offerings—has increased over the last year, and will likely continue to build. The SEC continues to pursue antifraud and registration violations involving ICOs and cryptocurrencies, and has more recently broadened its focus to include related activities, as illustrated by several celebrities who found themselves facing liability for improper ICO promotional activities. The volatility of various cryptocurrencies, including the rapid decline of bitcoin (as we predicted in our 2018 Top Ten), also continues to be a fertile ground for private disputes. While Section 29(b) of the Exchange Act and Section 12(a)(1) of the Securities Act both provide mechanisms to unwind securities transactions, such disputes can be quite costly if the proper precautions are not taken. Coupling these risks with increasing regulatory scrutiny, fund managers should carefully consider their investment choices and prepare for varying degrees of legal scrutiny between those choices.

4. Cybersecurity, Privacy and Data Security

We expect this year will bring a continuation of the SEC's heightened focus on private fund cybersecurity, both from OCIE and Enforcement. OCIE has already stated that cybersecurity is one of its top exam priorities for 2019. For Enforcement, the Division's Cyber Unit has been up and running for over a year. To date, much of the Unit's cybersecurity focus has been on public companies, but there is good reason to expect that its focus will expand to include private funds as well. Registered investment advisers are subject to Regulation S-P, which requires that firms adopt written policies and procedures designed to prevent and detect cyber breaches. Given the SEC's continued focus on this area and the widespread prevalence of increasingly creative cyber-attacks, private fund managers should consider beginning the year with a careful review of their cybersecurity policies and procedures – and take steps to ensure operational compliance.

5. Unicorns: Overvaluations leading to conflicts

A study published in 2018 confirmed what many have been speculating for years – that some unicorns may have been substantially overvalued. These valuation issues and the risks they create for private investment funds will become difficult to ignore as investors' expectations for liquidity increases in 2019. The successful liquidity of certain high-profile unicorns will likely encourage others to follow suit, ready or not. Disappointing outcomes may cause investors and employee shareholders to pursue litigation. In addition to private litigation claims, the SEC and DOJ have made it clear with Theranos and others that they will step in when a unicorn's actions amount to fraud or other regulatory violations. Funds – and particularly those with a heavy concentration in unicorns (or directors on unicorn boards) – should be paying careful attention to these inquiries, and in the meantime should be reviewing their insurance coverage program.

6. Alternative Data

Fund managers continue to turn to alternative data sets to inform investment decisions, including geolocation data, web scraping, satellite data, credit card transactions and other data sets commonly referred to as "big data." However, alternative data is not without risks. Recent press articles have highlighted concerns relating to geolocation data pulled from hundreds of smartphone apps that fund managers can purchase to predict trends involving public companies. This creates a host of potential risks under applicable U.S. privacy and data security laws. Furthermore, securities regulators may focus on the use of big data sets, particularly where they suspect potential material nonpublic information has been collected in a manner considered "deceptive," or has been "misappropriated" in breach of a duty owed to the source of the information. Ongoing diligence on the precise source of the data and collection methods is of paramount importance, particularly under agency theories or when issues may have been raised early in the data collection chain of custody. Data vendors may have different levels of risk tolerance and may be more focused on technological advances than maintaining low levels of acceptable risk that are tolerable to advisors, which makes it all the more critical that the end-users of this information undertake sufficient due diligence procedures.

7. Performance Marketing and Credit Facilities

Both regulators and private fund investors continue to scrutinize performance information of private fund advisers. It is routine for OCIE staff to request and closely review private placement memoranda and pitch decks to determine if performance data has the potential to mislead investors. And as the utilization of subscription credit facilities has increased, OCIE is taking a closer look at the corresponding performance marketing materials. In certain circumstances, examiners have requested a recalculation of private fund performance without application of the subscription line. Investors are taking notice as well. As one private equity consultant recently commented, "[U]sage of [financing lines] made it difficult for a simple, straightforward apples-to-apples comparison of managers based on investment returns. Firms use these lines differently and some don't use them at all . . . now, stripping out the effects of subscription lines is critical to manager assessment and benchmarking. Deconstructing investment performance is now more necessary than ever." In light of this focus – by both regulatory agencies and investors – advisers should consider whether disclosures are appropriate when communicating performance information that might have been impacted by credit facilities. Likewise, for the reasons set forth in No. 5 above, advisers should monitor unicorn valuations dynamically if there is a shakeout or volatility develops.

8. Private Credit Industry Primed for Disputes

Private credit lending remains on track to become a $1 trillion industry by 2020. The landscape for deals is becoming more competitive, with higher leverage and deal terms that are looser or have deteriorated. In the 1980s and early 1990s, commercial banks assembled dedicated teams and developed sophisticated systems to work-out troubled commercial loans. It remains to be seen how private credit lenders would respond to a similar situation, but if necessary they would be doing so with substantial resources and many tools at their disposal.

9. Litigation Funding Alters the Landscape

Limited partners are not typically in the business of initiating litigation – in part because their primary objective is to maximize the value of their investment and litigation is viewed as having certain costs with an uncertain return. At the same time, limited partners – unlike managers who can often rely on indemnification from the fund and other sources – must cover their own legal expenses. These factors have contributed to relatively low levels of litigation involving private funds. Enter litigation funders, who are raising capital at an unprecedented pace and whose business strategy is to invest in claims by covering the expenses of litigation in exchange for a share in the recovery – something that could be attractive to limited partners considering litigation alternatives. Litigation funding, therefore, has the potential to fuel a new wave of litigation affecting private funds, whether involving disputes at the portfolio company level, the fund, or even the adviser.

10. Portfolio Company Litigation on the Rise

Indicia of control of portfolio companies – through directorships or otherwise – has always been a source of litigation risk for advisers and their funds. That risk has only increased as it has become more common for plaintiffs to name fund advisers, as well as their funds and board-designees, as defendants in high-stakes litigation matters. Aggressive plaintiffs' lawyers view advisers as lucrative targets because of their deep pockets and desire to avoid litigation. And we continue to see a steady uptick in something that was once viewed as taboo in the industry – advisers and their funds suing other advisers and their funds in post-closing disputes. We expect this trend to continue in 2019 and beyond, given the institutionalization of the fund industry, increasing competition, and litigation funding.

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