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Regulation and litigation: Hot topics for 2016

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Private funds are likely to face increased regulatory scrutiny and litigation risk in 2016, write Proskauer Rose attorneys Timothy Mungovan, Michael Hackett and Joel Cavanaugh.

Private investment funds are likely to face increased regulatory scrutiny and litigation risk in 2016, not only based on the US Securities and Exchange Commission's focus on the industry but also due to transparency and compliance initiatives of limited partners and other market developments. Here are several areas that should be on the top of every private fund sponsor's list and how to assess and manage the associated risks.

Fees and Expenses

Fees and expenses will continue to be a top enforcement priority for the SEC in 2016. The SEC has challenged sponsors' practices of allocating certain fees and expenses to the funds they manage, such as overhead costs and broken deal expenses where there were potential co-investors, unless such costs and expenses were adequately disclosed in the LPAs and/or offering documents. The critical issue is whether the challenged fee/expense was adequately disclosed to investors at the time of the investment decision, which is often viewed in hindsight through the lens of current market practices. Where there is uncertainty, the SEC has challenged certain fees and expenses. Sponsors should perform a comprehensive review to confirm adequate disclosure of fund expenses. At a minimum, sponsors should update the disclosure in their Form ADV where necessary, and if there is a question as to the adequacy of the disclosure, also consider remedial action, including obtaining waivers from the LPs, amending the LPA, or reimbursing the fund.

Devaluation of Tech Unicorns

If there is a wave of unicorn devaluations and failures, as some are predicting, sponsors should be prepared for large-scale SEC investigations and private litigation. The SEC is reportedly already investigating the secondary market for trading in unicorn shares, and separately, mutual fund valuations of those companies. Stories in the press about down rounds and the impact on employees and early stage investors will fuel greater scrutiny. Potential areas of dispute could include preferential stockholder rights, such as liquidation preferences, valuation practices, trading in private companies, transfer restrictions, and various insolvency, creditor rights, and bankruptcy issues. Late stage investors, in particular, should be mindful of these risks.

Valuation Practices and Performance Marketing

Any significant devaluation of unicorns is likely to amplify the scrutiny of valuation practices, particularly of funds with significant exposure to unicorns. The SEC and investors will almost certainly focus on sponsors' adherence to their own valuation policies, as well as discrepancies in valuations between private funds and mutual funds. Other areas of focus may include the quality of a sponsor's valuation policy and whether it tracks the FASB Accounting Standards Codification for Fair Value Measurement (Topic 820). From there, the SEC may expand its review to the sponsor's marketing and fundraising activities, particularly where a sponsor's track record is based in part on the valuation of unrealized gains.

Fund Extensions

By some accounts, there are more than 1,100 so-called zombie funds that are near or beyond the end of their contractual life with more than $120 billion in unrealized assets in their portfolios. If market conditions deteriorate, opportunities to exit will diminish and the problem will worsen. More specifically, the SEC is reportedly evaluating the circumstances and terms of fund extensions, including the continuation of management and incentive fees and other potential conflicts of interest between the management company and LPs. Sponsors who seek to extend the terms of their funds should document the justifications for

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any extension, including the commercial benefits of the extension for their LPs, and their strict compliance with the terms of the fund agreements for such extensions.

Litigation Risk to Sponsors Relating to Portfolio Companies

In litigation involving portfolio companies, there is a growing trend for plaintiffs to name as defendants not only the board of directors, including a sponsor's designees, but also the investment fund and affiliated sponsor entities. The claims often relate to the management and decision-making of the company involving change of control transactions, conflicts of interest, unfunded pension plans or catastrophic tort-related events. While there are a variety of suitable risk management precautions, the most important consideration for sponsors is to recognize that the economic benefits of control are not cost-free but they come with legal obligations and increased risk of liability.

Cybersecurity

The SEC recently offered the following guidance when settling charges related to an investment adviser's alleged failure to establish cybersecurity policies and procedures: "Firms must adopt written policies to protect their clients' private information and they need to anticipate potential cybersecurity events and have clear procedures in place rather than waiting to react once a breach occurs." Sponsors should proactively evaluate their exposure to cybersecurity threats from an operational perspective at both the firm and portfolio companies, and, if necessary, retain experts to assist.

Professional Liability Insurance

In the face of increased regulatory and litigation risk, sponsors should re-examine their professional liability insurance programs in light of the scope of available indemnification rights, not just at the fund level but also from portfolio companies as shareholders and directors. A typical "off the shelf" general partner liability policy may be deficient in a number of important areas. Coverage review should include an assessment of regulatory risks (subpoenas, informal and formal investigations, enforcement actions, and the corresponding coverage triggers), whether the customary "insured versus insured" exclusion excludes claims by LPs against the GP or sponsor entities, and the relative priority between policies and with respect to indemnification rights.

It is clear that the regulatory and litigation climate for private fund sponsors is rapidly changing. However, sponsors who take early and proactive steps to manage their risk will be well-positioned to weather the storm.

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