Proskauer

The Top Ten Regulatory and Litigation Risks for Private Funds in 2017

The Capital Commitment Blog on **February 10, 2017**

Private investment funds and advisers are likely to face new regulatory challenges and increased litigation risks in 2017, not only because of a change in the administration, but also because many advisers have not corrected and aligned past practices with current regulatory guidance. In this post, we have highlighted ten areas that should be on the top of every private fund adviser's list for 2017 – and how to assess and manage the associated risks.

1. Managing Regulatory Uncertainty: Is the Tide Rolling In or Out?

The 2016 Election exacerbated the uncertainty around regulation for advisers to private funds. Prior to the 2016 Election, the biggest operational challenge was managing the uncertainty of where the regulatory lines would be drawn. There was no question, however, that the proverbial regulatory tide was still "rolling in."

Post-election, the new administration has pledged to "roll-back" Dodd-Frank, making it unclear whether the regulatory tide is rolling in or out. This uncertainty will likely continue through 2017 – and certainly until the new administration appoints the full slate of new federal agency heads.

Advisers, however, should not treat this uncertainty as an opportunity to defer compliance. Instead, the prudent approach is to assume that the existing guidance, in the form of SEC Orders, stated staff priorities, and policy speeches, will continue to be enforced. Absent a wholesale repeal of Dodd-Frank – which seems unlikely for the reasons that we have discussed previously – advisers must assume that they will remain subject to regulatory oversight. This assumption is particularly true with respect to the proper allocation of fees and expenses because that obligation is grounded in the core fiduciary relationship between the adviser and the fund – which exists regardless of Dodd-Frank requirements or past industry practices. As such, an adviser's highest priority should be ensuring that current practices comply with existing standards and expectations. It would also be prudent to consider an audit of past practices to assess regulatory risks in light of current SEC guidance. Advisers who delay compliance while waiting for greater clarity on the direction of regulatory activity do so at their own peril.

2. Conflicts of Interest

In the SEC's 2017 priorities announced last month, the exam staff noted that conflicts of interest and disclosures of actual or potential conflicts remain primary risks for advisers. As we have seen in recent enforcement actions, the SEC has focused on conflicts relating to the disclosure of fees and expenses. While fee and expense allocations are classic examples of a potential conflict of interest between the adviser and the fund, they are by no means the only instance where conflicts arise. Advisers must always be mindful that they are fiduciaries to the funds that they advise, and any act that benefits the adviser can be viewed as a creating a potential conflict of interest.

To avoid such a conflict, the adviser must evaluate whether an act or practice that benefits the adviser was specifically and expressly disclosed to the LPs up front at – or prior to – the time of the investment decision, such that the investors were informed when they agreed to it. Advisers should not assume that historical industry practices are conflict-free just because "that's the way we have always done it." There is certainly a conscious trend among advisers to view any potential conflict or contractual interpretation in the light most favorable to investors.

3. Whistleblowers

If advisers needed any added motivation to proactively address suspected violations, one word should suffice: *whistleblower.* Dodd-Frank's whistleblower protections and incentives, including bounties to certain whistleblowers, are now an established and fruitful pipeline for SEC tips. The SEC has continued to market this initiative broadly, and this year the agency has continued to file enforcement actions alleging retaliation against whistleblowers. The SEC's program means that the clock starts ticking for advisers as soon as management becomes aware of a potential regulatory issue, because the universe of potential whistleblowers can be vast.

4. Pay-to-Play

In early 2017, the SEC announced a series of settlements involving a sweep of alleged pay-to-play violations, with resolutions involving monetary penalties and censures but not disgorgement. As in prior years, the SEC will continue to police and enforce the pay-to-play rule. The lesson from the sweep is that even a small contribution by an adviser's personnel, with no intent to influence or apparent connection whatsoever to any investment decision, can give rise to an inquiry, potential enforcement action, and the resulting negative consequences. In our experience, and as the pay-to-play sweep confirms, even small-dollar contributions from someone who the adviser does not consider to be a "Covered Associate" can trigger enforcement activity that is expensive and disruptive for the adviser. A carefully crafted and vigilantly enforced compliance policy in this area will pay for itself.

5. Unicorns and Internet Bubble 2.0: Separating the Wheat from the Chaff

A successful IPO of Snap will be an inflection point for so-called unicorns and will lead to a cleaving between the winners and the losers. The winners will receive additional funding and face pressure to go public or otherwise create liquidity for their investors and employees. The losers – or "undercorns" – will go out of business or be acquired on less than favorable terms. In either case, these events will result in an intense focus on unicorns – and the private funds that invested in them. Advisers to private funds naturally tend to celebrate their winners and downplay their losers. This time, however, advisers should expect some unwanted attention around "undercorns" that fail to meet expectations.

The cleaving of unicorns creates at least three primary risks for advisers in 2017. First, advisers must manage SEC and LP scrutiny of valuations (see #6 below). Second, the SEC will scrutinize pre-IPO equity transactions and other investments in privately-held shares, so secondary trading and late-stage investments will come under scrutiny. Third, the insolvency or bankruptcy of former unicorns will give rise to numerous potential conflicts, between and among shareholders (including private funds), officers and directors, employees, and creditors of former unicorns. Advisers should also focus on potential disputes involving a fund's designee on a failed unicorn's board of directors and the potential for conflicts between the adviser and the funds over failed investments.

6. Valuation Practices

The commercial and economic failure of a number of unicorns will bring further scrutiny to industry valuation practices, particularly for private funds. Rather than challenging the significant professional judgment needed to determine fair value, the SEC will likely focus on issues "around" valuation practices. For example, regulators will examine whether actual valuation practices were consistent with disclosures to investors, review gaps between stated valuation policies and practices, and scrutinize inconsistencies in applying those policies. The SEC is already focused on potential issues concerning auditor independence. It is natural for an adviser to be proud of, and confident in, its valuation practices and procedures. That pride is about to be tested.

7. Performance Marketing and Advertising

Disclosure of prior performance has also come under the regulatory microscope. For example, a misstep in a fund's initial performance figures – such as presenting performance gross of fees – will invite SEC scrutiny of disclosures to investors. Over the past year, the SEC sanctioned a number of advisory firms for repeating misleading third-party performance claims and also enhanced the recordkeeping obligations for performance advertising. Challenges concerning valuation practices will likely bring challenges concerning performance marketing and advertising. Regulatory scrutiny of this area will continue.

8. Internal and External Response to Potential Regulatory Violations

Advisers who are (or should be) aware that their practices are inconsistent with SEC guidance and expectations will face heightened risk of an enforcement proceeding. It is critical, therefore, that advisers take steps to proactively identify and address potential violations before an OCIE examination. We recommend that advisers consider engaging counsel to (a) evaluate the relevant facts to determine the risk of a finding of a violation, (b) recommend appropriate remedial measures, and (c) provide guidance on internal messaging to employees and, if needed, external messaging to fund investors, the media, and the regulators.

9. Navigating Conflicts in Fund Restructurings

As we have discussed, conflicts inevitably arise in most fund restructurings because they typically occur when things have not gone according to plan. For example, fund restructurings – and in particular so-called "stapled" secondaries – are fertile ground for potential conflicts involving advisers. Practically every relationship could involve a conflict of interest: (i) within the adviser/management company; (ii) between the adviser and fund; (iii) between the adviser and cashing-out LPs; (iv) between the adviser and rolling LPs; (v) between the adviser and new LPs; and (vi) between the adviser and the portfolio company. As is evident from this list, the adviser is in the cross-hairs of almost every potential conflict of interest.

10. Funds and Advisers as Defendants

While there is always the potential for conflicts between GPs and LPs (particularly during restructurings, see #9), one commonly overlooked scenario that is trending and likely to rise in 2017 is where the fund and its adviser are named as defendants in litigation. For example, plaintiffs' lawyers are increasingly reaching beyond traditional defendants in M&A disputes to name both funds and fund advisers (and their principals) as defendants. This is especially true where the funds and advisers made – or could be deemed to have made – representations and warranties in connection with a sale or merger transaction. Unfortunate as it may be, funds and advisers are viewed as easy targets and deep pockets for acquirers looking to pass the blame following an unsuccessful acquisition.

View original.

Related Professionals

- **Mike Hackett**
  Partner
- **William D. Dalsen**
  Senior Counsel
- **Timothy W. Mungovan**
  Chairman of the Firm
- **Joshua M. Newville**
  Partner