Proskauer

Top Ten Regulatory and Litigation Risks for Private Funds in 2020

The Capital Commitment on **February 20, 2020**

The private fund industry is more in the public eye than ever before. Private capital and private markets have experienced massive growth over the last two decades, substantially outpacing the growth of public equity. We have witnessed that trend continue during the past year, and have worked with our clients to navigate the greater uncertainty that results with greater litigation risk and regulatory scrutiny. And as predicted, the ride seemed to get a little bumpier in the second half of 2019, with several events suggesting that litigation and regulatory risks have ratcheted higher. With that backdrop, we are pleased to present our Top Ten Regulatory and Litigation Risks for Private Funds in 2020.

1. Unicorns – The Re-Set

In March 2019, *Bloomberg* dubbed 2019 the "year of the tech unicorns." While that turned out to be true, it was not always for the positive reasons predicted. Rather, 2019 seemed to be the year that investor sentiment may have shifted from bullish to somewhat bearish, as near-daily negative press was published on some of the highest profile unicorns and former unicorns (now public). This shift may lead to increased litigation in the private fund space. If the bearish sentiment persists, longer term systemic issues could surface affecting unicorns, others seeking unicorn status, and investors. Highly valued but unprofitable companies have limited options. They need to develop a path to profitability before running out of cash, raise more capital, or close up shop. With the recent travails of certain high profile unicorns and the disappointing stock prices of certain former unicorns, raising more capital may prove difficult for some unicorns. In the coming year, the market should prepare for the prospect of down rounds and diminished expectations on returns for certain unicorms. Weaker performers may get edged out of the market, with some sold to strategics and some facing liquidation. If more unicorns falter, investors should be aware of the possibility for regulatory scrutiny and private litigation, particularly for those funds that also hold a director seat.

2. Increased Restructuring and Reorganization on the Horizon

Heading into 2020, private equity firms are sitting on record levels of dry powder, and many are anticipated to target distressed businesses. While distressed assets have delivered poor returns recently, they are known to perform well during economic downturns, which many expect to occur within a couple of years. Distressed assets and other businesses that come under acute pressure in a decreased liquidity environment present particular litigation risk. With diminished access to capital, fewer IPOs and closing credit windows, portfolio companies running low on cash may be faced with the possibility of restructuring or reorganizing, which may in turn increase litigation exposure for both funds and fund managers. For example, officers and directors, including fund managers with board seats on portfolio companies, may be subject to greater scrutiny and face a greater risk of exposure if those companies are at or near the "zone of insolvency." Under this doctrine, which many jurisdictions employ in some variation, portfolio company asset transfers could result in liability for officers and directors if they impair repayment of debt. Private equity firms that choose to invest in (or that already own) distressed assets should consider the risks inherent in such investments, especially in a challenged liquidity environment that may result in the restructuring and reorganization of those assets. Distressed businesses–and the anticipation of distress–may become a key driver of deals in the coming year, but for many, they may also be a key driver of litigation.

3. Valuation Continues to Be A Focus

Fund managers may face increasing scrutiny over valuations from both regulators and private fund investors. First, as noted above, recent events (both leading up to, and following, IPOs) have raised questions concerning valuations of unicorns. At a minimum, regulators and investors are likely to take a hard look at all parties involved in unicorn valuations that may have been too optimistic in hindsight. This is particularly true given the fact that private fund investors often play a key role in establishing the valuation of portfolio companies. Second, SEC Enforcement will continue to investigate and bring actions against private fund advisers regarding valuations. We expect to see the SEC continue its past approach to valuation cases: rather than challenging the actual valuations adopted by a fund adviser, it will typically bring an action focused on a failure to use the valuation methodology the adviser has disclosed to its investors or, as in the Deer Park settlement from last year, failure to maintain appropriate compliance policies and procedures relating to valuations. In light of the SEC's recent proposed amendments to the Advertising Rule, Enforcement is also likely to focus on valuation and performance claims, particularly claims regarding performance based on unrealized gains, in marketing materials. The proposed amendments include a provision that would prohibit an adviser from presenting performance results in advertising materials in a manner that is not "fair and balanced." Third, we expect that the SEC's Office of Compliance Inspections and Examinations ("OCIE") will continue to raise questions regarding valuations during exams. OCIE has made clear that it will focus on fund advisers that rely on third-party vendors, including vendors that provide valuation services. We expect that OCIE will look closely at the due diligence performed by an adviser when selecting a vendor to provide such services. OCIE will also likely continue to question advisers who rely on credit facilities and their effect on internal rates of return. We have seen OCIE raise questions regarding disclosure of this practice in exams of private fund advisers and expect that to continue this coming year. And finally, especially in the event of an economic downturn, credit funds may be fielding questions about their valuation of credit holdings as defaults, and the risk of defaults, increase.

4. Private Credit Risk in a Softening Market

Private credit lenders face dual challenges in 2020. First, they face an increasing risk of future defaults on current deals, as the credit cycle continues to mature and the global economy softens (even though the domestic economy remains solid). At the same time, strong financial covenants—a typical first line of defense against borrower defaults—are becoming increasingly uncommon, with approximately 65-70 percent of recent credit deals being "cov-light" or "cov-loose" as deal terms migrate toward the syndicated market.

Both challenges increase risk for private credit lenders in 2020. Defaults on older deals may require the exercise of creditor remedies in conjunction with (or in lieu of) a restructuring solution. On newer deals, the lender's lack of information (*e.g.*, due to liberal EBITDA add-backs) and narrowed recourse (*e.g.*, due to lists of excluded assets from collateral packages) may inspire jockeying between lender groups prior to a default, and litigation over the scope and enforceability of security interests when an event of default occurs.

Many private credit lenders anticipate at least some increase in restructuring activity in a changing economic environment with fewer covenant and collateral protections. It will be important for private credit lenders to identify and navigate risks of borrower default or inter-lender litigation as early as possible.

5. Cryptocurrencies and Other Digital Assets – A Continuing Alphabet Soup of Regulation

While cryptocurrencies and digital assets continue to make headlines, the regulatory landscape remains murky. In October 2019, the SEC, FinCen, and the CFTC issued a joint statement asserting that each had jurisdiction to bring cases "involving digital assets" under the anti-money laundering ("AML") and counter-terrorism financing provisions of the Bank Secrecy Act. The statement underscores how each of these regulators is simultaneously pushing to expand its jurisdiction in these areas without meaningful coordination. The CFTC has never brought an anti-money laundering case (under the Bank Secrecy Act or otherwise). Further, in a case recently affirmed on appeal by the Second Circuit, the court suggested the SEC's books and records rules requiring broker-dealers to report potentially suspicious transactions under the Bank Secrecy Act grant the SEC jurisdiction to bring enforcement actions, signaling expansion of the SEC's jurisdiction over AML cases.

Enforcement actions surrounding Initial Coin Offerings (ICOs) appear to have peaked now that the SEC has clamped down on several massive fraud schemes. However, while the SEC has provided some guidance regarding how to distinguish blockchain-linked assets that are securities from those that are not, this area will continue to evolve. Even though the SEC has taken the view that ICOs are generally subject to regulation as securities and that some cryptocurrencies (such as bitcoin and ether) are not, this does not alleviate the regulatory risks for either type of blockchain-linked investment. Although the SEC may not assert jurisdiction over certain cryptocurrencies as securities, cryptocurrencies and other digital assets are subject to increasing state regulation, for example, by the New York State Department of Financial Services ("DFS"). Fund managers investing in digital assets should carefully consider the applicable regulatory scheme and prepare for varying degrees of legal scrutiny, depending on the regulator *du jour*.

6. Anti-Money Laundering and Sanctions Enforcement Continued Priority in Private Funds Space

AML and sanctions issues should be top of mind for private funds going into 2020, thanks to new guidance from OCIE, the DOJ, the Treasury's Office of Foreign Assets Control ("OFAC"), and recent court decisions. In January 2020, OCIE announced its 2020 Exam Priorities, which included–as they have for the last several years–a continued review of broker-dealers and investment companies for compliance with AML requirements. The SEC's continued focus on AML affects even those private funds that are not subject to a mandatory AML program rule, due to enhanced scrutiny facing fund affiliates, counterparties, and institutions that custody funds. Potential areas for examination could include compliance with new beneficial ownership requirements, books and records requirements, and suspicious activity reporting.

The focus on AML is an area of global interest, reflected most recently in Europe with implementation of the 5th Money Laundering Directive ("MLD5"). MLD5 brings a wider range of entities into the scope of the EU AML rules and tightens up requirements for firms' customer due diligence processes. Much like the SEC's focus, these changes include new beneficial ownership verification requirements and will require firms to report discrepancies in customer information they hold to the Companies House (in the UK).

Over the last five years, the amount of AML penalties imposed globally has been steadily rising, to more than $8 billion in 2019. In contrast to prior years, less than half of those fines were levied against banks, signaling that AML enforcement is expanding to other types of financial services firms. In December 2019, the DOJ revised its policy for business organizations regarding voluntary disclosures of sanctions violations, signaling a continued push towards self-disclosure. In May 2019, OFAC released new compliance guidance that suggests for the first time that companies, including private funds, have an affirmative obligation to maintain effective sanctions compliance programs. Finally, a recent federal court decision vacating an OFAC penalty against ExxonMobil, on the grounds that the company lacked fair notice that its conduct was prohibited, suggests that we might see an increase in litigation and a corresponding shift in some of OFAC's enforcement strategies.

7. Ongoing Focus on Cybersecurity and Privacy

In 2019, OCIE initiated a third round of cybersecurity-focused examinations of registrants with a focus on (i) governance and risk management; (ii) access rights and controls; (iii) data loss prevention; (iv) vendor management; (v) training; and (vi) incident response. These examinations are a continuation of an ongoing focus on cybersecurity that began in early 2014. Further, OCIE stated in its 2020 Exam Priorities that it will continue to prioritize cyber and other informational security risks across the entire examination program. Given the significant amount of Commission attention devoted to cybersecurity related issues in recent years, we expect that OCIE staff will refer significant deficiencies to the SEC's enforcement staff.

The increased focus on cybersecurity and privacy has also extended to the state enforcement level. Notably, the California Consumer Privacy Act of 2018 ("CCPA") became operative on January 1, 2020 and requires qualifying businesses to enable consumers to know about and control the information collected about them. Because the CCPA defines consumers and businesses broadly, investment funds and their managers may be considered "qualifying businesses" and information that they collect and use about their employees, job applicants, investors, and prospective investors (including KYC information) residing in California could be subject to the CCPA.

Outside of the US, the UK Financial Conduct Authority ("FCA") has blazed a trail in the area of operational resilience as more firms under its supervision are embracing and leveraging technology to deliver services. The FCA's focus in this area means firms' arrangements for business continuity and robust cyber-attack deterrents are a top priority for the regulator. Large fines have been levied by the FCA in response to operational outages and cyber-attacks in recent years, which have put cyber-attack resilience into sharp focus. There will be further consultation in this area following the Prudential Regulatory Authority ("PRA") and FCA's joint Discussion Paper in December focusing on operational resilience. Firms that have multi-jurisdictional operations should take note that regulators globally are becoming increasingly focused on cybersecurity-related issues.

8. Increased Scrutiny on Alternative Data Use by Fund Managers

The use of alternative data, such as geolocation data, web scraping, satellite data, credit card transactions and other data sets, continues to expand among fund managers seeking an edge in making investment decisions. With increased use has come increased attention from regulators, along with the potential for liability on material non-public information ("MNPI") and other theories. At the SEC, OCIE has publicly identified alternative data among its 2020 Exam Priorities, and we expect the SEC to examine fund managers' compliance and control functions surrounding their diligence process for alternative data vendors, protections against the receipt of personally identifiable information, and potential MNPI considerations involving alternative data. New laws like the CCPA give consumers broad rights over their personal information that may complicate managers' use of alternative data sources. Amid the broader focus on data privacy, there has been increased scrutiny of the integrity of consumer geolocation data. In 2018, the FCC announced an investigation concerning all of the major mobile carriers and their practices for safeguarding customers' geolocation information. Since then, enforcement actions on the part of various regulatory and enforcement agencies concerning geolocation data collection and sharing practices have led also to civil litigation, including several consumer class actions in various jurisdictions across the country.

9. Regulatory and Enforcement Uncertainty In an Election Year

The 2020 election promises to portend continued uncertainty surrounding regulatory enforcement as well as legislation. Over the past three years, the SEC's enforcement activity relating to asset managers has continued apace (and has not slowed as much as some predicted), but the composition of the Commission may change dramatically in the coming year. Enforcement typically views conduct through the lens of hindsight, and depending on the outcome of the election, a new administration may take a more aggressive approach when evaluating past conduct.

2020 promises to bring consideration of a number of potential sweeping changes in the regulation of private fund managers both through congressional action and agency administrative action. With respect to the former, in recent months, the U.S. Senate has seen the introduction of Senator Elizabeth Warren's (D-MA) Stop Wall Street Looting Act, as well as the Private Fund Board Disclosure Act of 2019 and the Investment Adviser Alignment Act in the U.S. House of Representatives.

Meanwhile at the SEC, the past several months have seen significant changes proposed to both the advertising and cash solicitation rules under the Investment Advisers Act, as well as proposed revisions to the definition of an "accredited investor" under the Securities Act and applicable to private placement offerings. Additionally, the SEC's rulemaking agenda indicates that the agency's Division of Investment Management is considering recommending changes to the custody rule under the Investment Advisers Act. The results of the 2020 election may push these efforts dramatically—in one direction or another.

10. Fiduciary Obligations Overlay: Fees, Expenses, and Potential Conflicts

OCIE and the Division of Enforcement are always focused on accurate disclosures of fees, expenses, and conflicts of interest, and this year promises to be no different. Following the SEC's recent Interpretation Regarding Standards of Conduct for Investment Advisers, OCIE has reiterated that it will focus on whether advisers are complying with their fiduciary obligations to clients. Specifically, "whether RIAs [Registered Investment Advisers] provide advice in the best interests of their clients and eliminate, or at least expose through full and fair disclosure, all conflicts of interest which might incline an RIA, consciously or unconsciously, to render advice which is not disinterested." In particular, OCIE has prioritized examinations of private fund managers advising private funds side-by-side with separately managed accounts, BDCs or registered investment companies, and will also scrutinize private fund managers' disclosure of fees and expenses and use of affiliated service providers. While we have seen a decrease in the number of Enforcement actions against private funds generally, that has not been true for matters involving fees and expenses. In the past year, the SEC brought numerous actions against advisers to private funds for undisclosed fees as well as cases involving undisclosed conflicts involving affiliated entities. Private fund advisers should thus ensure that fees received in any form and from all sources are disclosed, correctly calculated, and correctly offset against management fees if required by provisions in fund agreements. OCIE is also focused on increasing the number of examinations, so the chances of undergoing an exam are higher compared to years past—particularly for private fund managers that have never been examined or have not recently been examined.

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