This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Performance Advertising

Ten Risk Areas for Private Funds in 2018

May 3, 2018
By Vincent Pitaro, *Hedge Fund Law Report*

A recent program presented by Proskauer Rose examined the key regulatory and litigation risks currently facing private fund managers. Unsurprisingly, near the top of the list were prominent issues on the regulatory radar, including cryptocurrency and blockchain; data privacy; and performance claims. A common theme among many of the risks covered in the presentation is that the law has not yet sufficiently developed to address current business practices.

The program, entitled "Top Ten Regulatory and Litigation Risks for Private Funds in 2018," featured Proskauer partners Timothy W. Mungovan and Joshua M. Newville; counsel Anthony M. Drenzek; and associate Michael R. Hackett. This article explores the speakers' insights.

For coverage of the 2017 Proskauer presentation, see "Ten Key Risks Facing Private Fund Managers in 2017" (Apr. 6, 2017).

Risk 1: Cryptocurrencies and ICOs

Cryptocurrencies and initial coin offerings (ICOs) have been a key SEC priority in the last year, Newville said. There is new technology, a lot of money pouring in and a great deal of media attention. Most importantly, the market is developing ahead of laws and regulation.

The SEC has been treating ICOs as securities offerings. SEC Chair Jay Clayton has said, "I have yet to see an ICO that doesn't have a sufficient number of hallmarks of a security," Newville noted. There may also be registration issues for cryptocurrency exchanges. See "SEC Halts Registration of Cryptocurrency Mutual Funds, Calling for Dialogue Regarding Valuation, Liquidity, Custody, Arbitrage and Manipulation Risk" (Feb. 15, 2018).

At the same time, the CFTC has been treating cryptocurrencies as commodities. That regulator recently won a ruling that cryptocurrencies can be regulated as commodities. See "U.S. District Court Rules That Virtual Currencies Are Commodities Under the Commodity Exchange Act" (Apr. 12, 2018).

One regulatory gap is in the spot market for non-security tokens and cryptocurrencies, which are likely beyond the reach of the CFTC. The cryptocurrency exchanges are being regulated largely by a patchwork of state-by-state licensing regimes. Whether a cryptocurrency is a currency, a commodity or a security is being decided case-by-case, Newville explained.

To date, enforcement in this area has focused on offering fraud and registration violations. "There is still a sense that cryptocurrencies are a common vehicle for illicit activity," Newville continued. If a portfolio company is involved in blockchain technology, "the exam staff's

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
antennas are going to be up." Therefore, "anyone who really touches this market in some way should be cautious."

The SEC's new Cyber Unit has been paying a lot of attention to cryptocurrencies, and the agency has issued dozens of subpoenas to ICO market participants, including some attorneys involved in structuring ICOs. In addition, in March 2018, the media publicly reported that the SEC's Office of Compliance Inspections and Examinations (OCIE) intends to examine up to 100 fund managers as part of a sweep of funds that have investments in cryptocurrencies or crypto-focused funds, Newville noted. The sweep is likely to focus on risk disclosures to investors; risk management policies and procedures; compliance of investments with applicable law and regulations; custody; and anti-money laundering and know-your-customer compliance.

See "Virtual Currencies Present Significant Risk and Opportunity, Demanding Focus From Regulators, According to CFTC Chair" (Feb. 8, 2018); and "SEC Cyber Unit Files Charges Against Allegedly Fraudulent ICO" (Jan. 11, 2018).

See also our three-part series on blockchain and the financial services industry: "Basics of the Technology and How the Financial Sector Is Currently Employing It" (Jun. 4, 2017); "Potential Uses by Private Funds and Service Providers" (Jun. 28, 2017); and "Potential Impediments to Its Eventual Adoption" (Jul. 12, 2017).

Risk 2: Bitcoin Bubble

There are three factors that may result in distortion of the market for cryptocurrencies, according to Newville:

1. Investors are "pouring in."
2. Early stage investors are now asking for concessions based on growing regulatory risk.
3. Wealth generated in cryptocurrency investments is being used as additional capital in the market.

Private litigation often follows adverse regulatory action, Newville observed. Investors may claim that an adviser has failed to adequately disclose the risks involved with cryptocurrencies or that the adviser has breached its fiduciary duty by failing to manage those risks prudently. In addition, if a security is defective, or some part of the distribution chain is defective, a downstream participant may have the right to rescind a transaction. Finally, court-appointed receivers and bankruptcy trustees may seek clawbacks in disputes over cryptocurrency.

Similar disputes arose in prior market distortions such as the dot-com bubble. Disruptions in one market can have a ripple effect in adjacent markets, because regulators and investors in the adjacent markets may get "skittish," Mungovan added.

See "How Blockchain Will Continue to Revolutionize the Private Funds Sector in 2018" (Jan. 4, 2018).

Risk 3: Unicorns

So-called tech "unicorns" exist in a "highly unusual and, in many respects, unprecedented environment" with a "significant amount of paper wealth" but few realized gains, Mungovan said.

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL
Although there is growing pressure to provide liquidity, not many of these companies are moving toward initial public offerings (IPOs) at this time.

If unicorns do not provide liquidity through IPOs, institutional investors may find liquidity in the secondary market. Lack of liquidity will cause tensions over valuation and control between early investors and long-time employees with equity stakes on the one hand, and newer investors on the other.

Risk 4: Cybersecurity, Privacy and Data Security

This year could see a major SEC enforcement proceeding against a private fund manager over a data security or privacy breach, Mungovan predicted. In recent years, significant breaches have received wide attention, as did the "WannaCry" ransomware attack. The fact that sophisticated companies like Uber, Yahoo, Verizon and Equifax have all been subject to cyber attacks suggests that it will be hard for managers to prevent all attacks.

The SEC expects managers to have not only robust and proactive privacy and data security policies, but also strong remediation capabilities, Mungovan continued. Managers must be "constantly vigilant" about their cybersecurity practices and those of their vendors. They should also pay attention to what their peers are doing. Data security is likely to be a common topic in exams.

In recent years, the SEC has issued four cybersecurity Risk Alerts and conducted two examination initiatives. The regulator recognizes that "no entity can be completely secure or safe from a potential cyberattack," Drenzek observed. As a result, SEC staff are no longer focusing solely on proactive measures; they are also looking at response and remediation. OCIE's August 2017 Risk Alert specified what the SEC had seen in its cybersecurity exams and detailed expected best practices. See "SEC Review of Cybersecurity Finds Gains Since 2014, but Cites Gaps in Training and Compliance" (Aug. 24, 2017).

See also our three-part series on how fund managers should structure their cybersecurity programs: "Background and Best Practices" (Mar. 22, 2018); "CISO Hiring, Governance Structures and the Role of the CCO" (Apr. 5, 2018); and "Stakeholder Communication, Outsourcing, Co-Sourcing and Managing Third Parties" (Apr. 12, 2018).

Risk 5: Big Data

Managers have embraced big data because of its predictive powers in making investment decisions, Newville said, adding that it "turbocharges" traditional research. Tools include web scraping; debit and credit card transaction data; satellite and drone data; and anything tracked by cell phones or social media sites.

This is another area that has outpaced existing law and where there is a potential "kitchen sink" of claims from unauthorized use of data. For example, breach-of-contract claims may arise if web scrapers exceed a site's terms of use. Market participants are subject to numerous laws, including:

- the Electronic Communications Privacy Act and Stored Communications Act, which prohibit intercepting electronic communications and unauthorized access to stored communications;

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

- the Computer Fraud and Abuse Act, which prohibits unauthorized access to computers; and
- sector-by-sector federal and state privacy laws.

Moreover, obtaining information in violation of any of those statutes may support a claim under the misappropriation theory of insider trading, Newville continued. Whether a purchase of data will give rise to liability depends on whether that data was obtained in violation of a breach of duty. Managers should ask vendors two important questions, he added:

1. Does the vendor have the right to obtain and use the relevant data?
2. Did the vendor use deception to obtain the data or circumvent security measures?

Current technology and business models are "way ahead of the law," said Newville. Vendors are in a race to obtain an edge and provide useful data, but what might be an acceptable risk to a vendor may not be acceptable to a fund manager. The more tailored the information a vendor provides – especially when provided at the request of a manager – the more likely the vendor will be deemed an agent of the manager, which could give rise to the manager's liability for the vendor's acts. Consequently, due diligence on vendors is very important. Vendor representations and insurance are also important, but they will not shield a manager from litigation or bad publicity.

See our three-part series on the opportunities and risks presented by big data: "Acquisition and Proper Use" (Jan. 11, 2018); "MNPI, Web Scraping and Data Quality" (Jan. 18, 2018); and "Privacy Concerns, Third Parties and Drones" (Jan. 25, 2018). See also "Tips and Warnings for Navigating the Big Data Minefield" (Jul. 13, 2017).

Risk 6: Performance Claims

The SEC continues to pay close attention to performance calculations and claims, which must comply with requirements enunciated in a series of no-action letters, Drenzek said. They must also be consistent with a fund's disclosures. In September 2017, OCIE issued a Risk Alert on the most common advertising violations. See "Risk Alert Highlights Six Most Frequent Advertising Rule Compliance Issues" (Oct. 19, 2017).

The key takeaways for private fund advisers in Drenzek's view are:

- *Advertising Net Performance Returns*: Returns must be presented net of fees and other expenses. The fact that this is addressed "quite high up in the alert" indicates that it is a key concern.
- *Use of Benchmarks*: An adviser should use only appropriate benchmarks and should disclose their inherent limitations. In determining whether a benchmark is appropriate, an adviser should consider "size, strategy and sector."
- *Claim of GIPS Compliance*: If an adviser claims compliance with the Global Investment Performance Standards (GIPS), it must ensure that its presentation conforms to them. If the adviser deviates from GIPS, it must, at a minimum, notify investors and may be required to amend the fund's limited partnership agreement (LPA).

The Risk Alert also notes that the SEC is on alert for cherry picking of investments to improve results, along with hypothetical or backtested performance, Drenzek continued.

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Recordkeeping to support performance claims is essential, Drenzek continued. Advisers should keep records to support any expenses claimed to be paid at "market rates," especially when paid to related persons. In addition, they should also consider how fee waivers or reduced fees affect performance and how they are disclosed.

The October 2017 amendment to Rule 204-2(a)(16) under the Investment Advisers Act of 1940 now requires an adviser to maintain backup for performance representations made to any investor. The prior version of the rule only applied to representations made to ten or more investors. In addition, revised Rule 204-2(a)(7) under that Act requires advisers to maintain communications relating to the performance of managed accounts.

See our two-part series providing a roadmap to maintaining books and records: "Compliance With Applicable Regulations" (Nov. 2, 2017); and "Document Retention and SEC Expectations" (Nov. 9, 2017).

After the 2008 financial crisis, market participants thought that the rules of the road on performance presentations were set, Mungovan added. An adviser, however, should not assume that a track record or performance presentation is compliant "because it is something you have always done." An adviser should periodically reevaluate and make sure it is in compliance with current standards.

See our three-part series on advertising compliance: "Ten Best Practices for a Fund Manager to Streamline Its Compliance Review" (Sep. 14, 2017); "Five High-Risk Areas for a Fund Manager to Focus on When Reviewing Marketing Materials" (Sep. 21, 2017); and "Six Methods for a Fund Manager to Test Its Advertising Review Procedures" (Sep. 28, 2017).

Risk 7: Subscription Credit Facilities

A subscription credit facility can smooth capital flows and allow for quicker closings, Drenzek explained. Some investors like them for that reason, but others object to the negative impact that finance costs have on performance. A subscription credit line may increase a fund's internal rate of return (IRR) by shortening the time that investor capital is deployed.

Both the SEC and the Institutional Limited Partners Association (ILPA) have concerns about disclosure of risks associated with these credit facilities and their economic impact because they affect performance reporting and make it harder to compare funds that use lines with those that do not. Duration of credit lines has increased from 3-6 months to 12-18 months and, in some cases, as long as 24 months.

In 2017, ILPA issued a set of recommended best practices for managers that use subscription lines of credit, Drenzek continued. They include the following:

- The credit line draw date should be the starting point for calculation of IRR.
- The maximum line should be no more than 15 to 25 percent of uncalled capital and should have a maximum extension date of 180 days.
- Managers should disclose the start and end dates for performance calculations and the impact of borrowing costs.
- Managers should disclose risks, including risk of default or acceleration of the line.

A manager should also disclose the conflicts of interest that may arise if the manager uses an affiliated lender or receives other benefits from a lender, Drenzek added.

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

The terms of a manager's relationship with its investors are largely set at the time of investment, Mungovan observed. The addition of a credit line can be a positive innovation for a fund, but it may not be contemplated by the LPA. If it is not, the use of a credit line could draw SEC scrutiny or give an angry investor ammunition to claim that the manager violated the LPA. If a credit line is not clearly contemplated by the LPA, the manager may have to seek consent from investors to amend it.

See our three-part series on understanding subscription credit facilities: "Popularity and Usage Soar Despite Concerns" (Mar. 1, 2018); "Principal Advantages and Key Points to Negotiate" (Mar. 8, 2018); and "Key Concerns Raised by Investors and the SEC" (Mar. 15, 2018).

Risk 8: Private Credit

The market for private credit is booming, Mungovan said. Simultaneously, the competition for deals is increasing, the credit cycle is maturing and interest rates are rising, all of which increase the risk of default and litigation.

Private equity firms are major consumers of private credit products. In almost every troubled private credit deal, a private equity sponsor is involved in some way, usually through a portfolio company. Disputes and litigation arise over portfolio company loans and bankruptcies, defaults and workouts.

Private credit has filled a void left by banks, which were experts in managing defaults, workouts and litigation risk. In contrast, private credit firms, which do not necessarily have similar experience, may face more disputes and litigation.

See our three-part series on hedge funds as direct lenders: "Tax Considerations for Hedge Funds Pursuing Direct Lending Strategies" (Sep. 22, 2016); "Structures to Manage the U.S. Trade or Business Risk to Foreign Investors" (Sep. 29, 2016); and "Regulatory Considerations of Direct Lending and a Review of Fund Investment Terms" (Oct. 6, 2016). See also "Opportunities Abound for U.S. Managers As European Regulators Relax Restrictions on Alternative Lending" (Aug. 10, 2017).

Risk 9: Litigation Funding

Litigation funding firms advance the cost of litigation in exchange for a share of the proceeds from the lawsuit, Hackett explained. Repayment to the lender is usually contingent on success and is non-recourse, so the recipient never has to reimburse the lender.

Assets flowed into litigation finance strategies in 2017. As a result, litigation funding firms' funds will now be seeking to deploy capital. Fund investors have typically shied away from litigation, viewing it as a guaranteed cost with no guaranteed return. Litigation funders could make litigation against managers more attractive.

In the mergers and acquisitions context, a portfolio company's pending litigation claims are hard to value in an acquisition and are typically valued at "zero," Hackett noted. A litigation funder could help value the claim for a seller. Similarly, a buyer might decide to take on certain assets with litigation funding backing.

See "Opportunities and Challenges Posed by Three Asset Classes on the Frontier of Alternative Investing: Blockchain, Cannabis and Litigation Finance" (Dec. 14, 2017); "How Can Hedge Funds

www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL

Mitigate the Risks of Investments in Litigation? An Interview With Kenneth A. Linzer" (Jun. 21, 2012); and "In Turbulent Markets, Hedge Fund Managers Turn to Litigation Funding for Absolute, Uncorrelated Returns" (Jun. 24, 2009).

Risk 10: Portfolio Company Litigation Risk

It is increasingly common for fund sponsors and their portfolio company board designees to be named as defendants in lawsuits involving those companies, Hackett said. They are seen as additional deep pockets. In addition, the sponsor and related parties may be deemed to be making a seller's representations in deal documents. When there is buyer's remorse, every word of deal documents is crucial, particularly representations and warranties; indemnifications; and limitations on claims and liability. "Every word matters," he said.

In the event of a claim, the sponsor should consider all potential sources of insurance coverage. For example, the fund or a portfolio company may have the duty to defend or indemnify the sponsor or its board designees, and there may be director and officer liability insurance.

Litigation between sponsors has increased, Mungovan added. It is also increasingly common for the bankruptcy trustee of a portfolio company to seek to claw back from fund investors the distributions they received on the sale of the portfolio company. This puts pressure on deep pocket investors and puts "extraordinary pressure" on fund sponsors to make the problem go away. "Litigation funding could be a game-changer in this area," because it would enable investors to sue without advancing litigation costs, he cautioned.

See "Hedge Fund Managers Must Exercise Restraint in Deploying Indemnification Provisions" (Nov. 19, 2015); and "Stanley Druckenmiller's Counsel Provides a Tutorial for Negotiating Exculpation, Indemnification, Redemption, Withdrawal and Amendment Provisions in Hedge Fund Governing Documents" (Feb. 6, 2014).

IMPORTANT: This article contains information protected by copyright which can only be used in accordance with the terms of your Hedge Fund Law Report subscription agreement. You must not therefore copy or forward this article, its contents, or any contents on the password-protected Hedge Fund Law Report website. (Your subscription agreement explains how you can use contents for reports and presentations.) UNAUTHORISED USE OR DISCLOSURE IS UNLAWFUL.

© 2019 Mergermarket Limited. All rights reserved.

This material has been printed by and is for their consumption only. The full Terms of Use are available at www.hflawreport.com.
UNAUTHORIZED USE OR DISTRIBUTION IS UNLAWFUL