2019 Private Equity Midyear Review and Outlook

Introduction

The first half of 2019 has seen increased clarity on a number of substantial issues that have affected both general and limited private equity partners. While the outcome of Brexit remains unclear, the preparations of European firms and regulators have intensified. There is also now the prospect of welcome consistency in Europe on the regulation of fund pre-marketing. Meanwhile, in the United States, a number of key provisions in the Tax Cuts and Jobs Act have been finalized, and rulemaking is underway for the Foreign Investment Risk Review Modernization Act. In addition, important proposals and guidance came out of the Securities and Exchange Commission, and there were notable legal rulings regarding M&A valuation.

Our Midyear Review and Outlook summarizes these developments, as well as important trends in financing, as funds look to raise capital and close deals in what continues to be a highly competitive market.

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The strong global fundraising market continues—although more capital flows into fewer hands. Approximately $100 billion was raised in the first quarter of the year alone, making it one of the most successful first quarters of the past decade, and fundraising activity levels remain strong as we enter the second half of the year. At the same time, the period saw less than two thirds the number of fund closings than in the first quarter of the previous year, largely due to continuing capital concentration. Prior to 2012, there were only a handful of funds each year with target sizes of $10 billion or more. With these so-called "mega funds" being raised on a more regular basis, more capital is being raised by fewer sponsors. We expect this trend to continue for the remainder of the year.

Complex structures and products are becoming more common. Limited partners are looking for increasingly creative, tailored and cost-effective means by which to make their investments, fueling demand for sophisticated liquidity solutions, and GPs are responding accordingly. As the market expands to include more single-asset, fundless sponsor and stapled transactions, it becomes ever more critical for participants in this space to have a deep understanding of the commercial and legal issues faced by existing investors, secondaries, purchasers and GPs and to think creatively to address those concerns outside of a traditional commingled fund context.

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Fundraising

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The GP stakes market keeps growing. Staking funds has become an attractive alternative for LPs looking to diversify their investments. Staking transactions are also appealing to GPs who wish to secure long-term capital without taking their firm public. Investing in staking funds has become an attractive alternative for LPs looking to diversify their investments.

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In fund finance, sponsors are exploring different ways of raising finance at the fund level:

- It is well established that private equity sponsors raise investment-specific additional debt in SPV holding companies above a particular investment (such as holdco PIK debt). An alternative to this type of financing is developing in the fund finance market. There is a growing availability of finance at the fund level to raise debt against "concentrated NAV" (*i.e.*, a small pool of private equity investments). This new strategy could achieve the same result for a sponsor looking to raise holdco PIK in more than one investment.
- We are also seeing sponsors raise funds at the fund level through preferred equity structures. Increasingly, lenders are helping preferred equity investors provide that equity funding through leverage to the investor with security over the preferred equity investment.

As fund finance products and structures continue to diversify, new lenders—including credit funds—are entering the market.

US M&A and Leveraged Finance

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In the first quarter of 2019, we saw a brief slowdown in the number of private equity M&A deals getting done; sellers still expected the full EBITDA multiples to which the market had been accustomed, while buyers took a more cautious approach following the sharp stock market declines of late 2018. Although debt financing was hard to come by toward the end of 2018, financing markets started to stabilize in the first quarter of this year. Issuers found secured high-yield bonds an attractive alternative as investor demand led to upsized bond tranches, attractive pricing and other issuer-favorable terms.

The second quarter saw a return to "business as usual," with sponsors competing vigorously for deals, and deal volume picking back up. While bouts of market volatility persisted, debt markets continued the recovery that began in the first quarter, with financing available at higher leverage multiples and on sponsor-favorable terms. Renewed focus on debt activists led sponsors to propose provisions to limit voting by "net-short" derivative holders; these provisions are becoming more prevalent in the market.

Looking ahead, we expect sponsors to face similar challenges to those in recent years in terms of getting deals done, given competition for assets and high multiples. In light of this, **we expect continued focus from sponsors on alternatives to traditional control buyouts, including PIPEs, growth investments and minority stakes.**

CFIUS Reform

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Companies, investors and regulators are still becoming comfortable with the requirements and implications of the Committee on Foreign Investment in the United States ("CFIUS") Pilot Program in practice. The Pilot Program, launched last November, requires submitting for CFIUS review any transaction by which a non-US person *(i)* acquires control over, *(ii)* obtains access to material non-public technical information from, or *(iii)* has substantive decision-making or board seat rights in, a US business that produces, designs, tests, manufactures, fabricates or develops "critical technologies" designed for use or used in certain specified Pilot Program industries. As previously reported, a declaration for a transaction covered by the Pilot Program must be filed with CFIUS by no later than 45 days before the closing.

To err on the side of caution, parties to a transaction that is or may be covered by the Pilot Program are, in general, making these filings, even if it is unclear whether the transaction is covered by the Pilot Program. This risk aversion is understandable, given that the penalty for not making the filing can potentially be as high as the transaction's value. And it appears that in many cases, CFIUS is neither approving nor rejecting the transactions; instead, it invites parties to file a notice to obtain CFIUS clearance, though they are not required to do so. As CFIUS gains more experience with the Pilot Program, it may become more comfortable providing parties with definitive guidance at the end of the review period.

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CFIUS Reform

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The US Department of Commerce ("DOC") is now reviewing the public comments on defining "emerging technologies." In November 2018, the DOC published an Advance Notice of Proposed Rulemaking ("ANPRM") to assist it in developing criteria for identifying "emerging technologies" within 14 broad categories—including artificial intelligence, machine learning, nanotechnology, additive manufacturing, and biotechnology—that are essential to US national security. Once identified, these will be subject to US export controls and also will be considered "critical technologies" for the purpose of CFIUS review, including under the Pilot Program.

In response to the ANPRM, nearly 250 foreign and domestic corporations, industry associations, advocacy groups, and educational institutions submitted comments. Many of those comments urged the DOC to avoid a broad-brush approach to defining "emerging technologies" because doing so could negatively affect US technological innovation and global competitiveness. Moreover, they noted, most of the ANPRM's technology categories have been in widespread commercial use for years, so they are hardly "emerging" and should not be subject to export controls. Accordingly, commenters urged that "emerging" technologies should be *(i)* limited to early-stage, developmental technologies, and not those that are widely available or are in broad production use, *(ii)* subject to export controls only if the technologies are both "essential" to national security and not already covered by existing export control regimes, and *(iii)* adopted through multilateral regimes and be based on end uses and end users.

The DOC is expected to identify "emerging technologies" for further comment later this year; it will propose new Export Control Classification Numbers governing the export, re-export or transfer of these technologies. Because non-US acquisitions or equity investments in US companies that develop or are otherwise involved with "emerging technologies" may come within CFIUS' jurisdiction, private equity firms that invest in such US companies will want to pay attention to these developments. Similarly, non-US private equity firms doing deals in the US will have to negotiate the rules carefully.

Regulations are needed to further implement FIRRMA's expansion of CFIUS's jurisdiction. Regulations are needed to cover a non-US person's non-controlling investments in critical technology, critical infrastructure, and personal data companies, if that person is accorded access to material non-public technical information, board seat rights, or substantive decision-making. Regulations also are required to implement the expansion of CIFUS to certain real estate transactions and to accord flexibility to investors from to-be-specified allied nations. The Treasury Department is currently developing these regulations, with the involvement of certain interested parties and groups. The regulations are expected to significantly shape the breadth and impact of FIRRMA's CFIUS reforms. They will be issued by no later than February 2020.

US Capital Markets

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Proposed amendments to the SEC's financial disclosure requirements regarding significant acquisitions and dispositions could prove a boon to M&A and IPOs. The SEC's most recent effort to streamline disclosure requirements would alleviate the burden on registrants of preparing these financial statements and accelerate the process of presenting acquisition-related information to investors. Proposed changes include, among other items, revisions to the test for calculating the significance of an acquisition in order to eliminate anomalous results, an expansion of the ability to provide abbreviated carve-out financial statements in connection with acquisitions of business components, and new requirements related to the presentation of pro forma financial information. While the proposed amendments will prove beneficial for reporting compliance and capital raising, it remains unclear how the proposed rules might affect the private placement and leveraged finance markets.

Although the proposed rule changes would affect all SEC-reporting companies, private equity firms stand to benefit in particular from certain of the proposed changes. Proposed revisions to the "income test" for determining significance, for example, would allow applicants to use the more favorable of income or revenue. As a result, many highly leveraged registrants, who might otherwise fail the significance test due to the impact on net income of ongoing debt payments, will now be able to avoid triggering the disclosure requirements that would accompany a finding of significance. The proposed expansion of the ability to provide carve-out financial statements will create greater certainty for acquirers and remove the need to negotiate for the sellers' cooperation to provide a complete set of audited financial statements under difficult conditions. Finally, the proposed changes to the presentation of pro forma financial information should allow acquirers to more realistically present the impact of the transaction to investors, including through adjustments reflecting expected synergies. (However, the preparation and inclusion of synergy adjustments will require increased attention from management and their auditors to ensure accuracy and compliance with the rule requirements.)

The House Committee on Financial Services passed a bill that would codify the prohibition on insider trading. No provision of the Securities Act or the Exchange Act explicitly prohibits insider trading, leaving prosecutions to rest solely on judicial interpretation of rules that prohibit fraud in securities transactions. The proposed "Insider Trading Prohibition Act" would address this gap by expressly setting forth the requirements to prove insider trading and broadly expanding insider trading liability. Under current interpretation, insider trading liability largely depends on the government proving that a defendant breached a fiduciary duty, or other duty of trust and confidence, to keep material nonpublic information confidential. The proposed bill would prohibit trading on information "wrongfully" obtained or communicated, where "wrongful" is defined as not only a breach of a duty, but also "theft, bribery, misrepresentation or espionage," "a violation of any federal law protecting computer data or the intellectual property or privacy of computer users," or "conversion, misappropriation or other unauthorized and deceptive taking of such information." These and other changes eliminate the current requirement for the government to prove that a "tipper" received a personal benefit from sharing the confidential information. Under the bill, the

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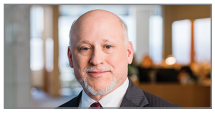
government would merely need to prove that the "tippee" was aware, or recklessly disregarded, that such information was wrongfully obtained or communicated.

Asset managers should note the proposed bill's standard for "control person" liability, which provides that a control person shall not be liable if that person or their employer did not "participate in, profit from, or directly or indirectly induce the acts constituting the violation." Time will tell how narrowly this provision will be interpreted, but the proposed bill may put institutions at a greater risk of incurring liability due to the insider trading of their employees than under current law. The Insider Trading Prohibition Act must be passed by both the House and Senate and then signed by President Trump before going into effect, but if passed it would likely have a substantial impact on the prosecution of insider trading and bring welcome clarity to this area of law.

Slack's direct listing proves Spotify was not a one-off—but are PE-backed companies likely to follow suit? Slack's decision to go public through a direct listing in June 2019—following Spotify's decision last year to do the same—spawned numerous headlines suggesting a fundamental shift in the IPO market. Direct listings let investors trade in a company's existing stock without the company selling any shares, meaning it does not actually raise money for itself or pre-IPO investors. Instead, the purpose is to trigger a liquidity event for the existing shareholders or facilitate future capital raises. The success of this strategy thus depends upon the company having no immediate need for new funding and a large, diverse shareholder base that can provide sufficient liquidity on the first day of trading. (These requirements may be why only two big, VC-backed companies have utilized it so far.) Although we expect an uptick in interest in direct listings, we do not see this as a desirable option for PE portfolio companies which *(i)* frequently use an IPO event to de-lever their balance sheet to levels acceptable to public equity investors and *(ii)* are unlikely to have a diverse enough investor base of non-affiliates to enable a liquid market in the stock.

US Regulatory



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This June saw the Securities and Exchange Commission ("SEC") complete a major rulemaking initiative that requires broker-dealers to act in the best interest of their retail customers. As part of this initiative, the SEC issued the final version of its interpretative guidance regarding the standard of conduct for investment advisers and the fiduciary duty that an investment adviser owes to all—not just retail—clients. These duties include the duty of care, which requires that an investment adviser provide advice that is in the best interests of the client, and the duty of loyalty, which obligates an investment adviser to eliminate or make full and fair disclosure of all conflicts of interest such that a client "can provide informed consent to the conflict."

The interpretation includes several notable clarifications made in response to comments received when the interpretation was proposed last year. For example, the interpretation seeks to address concerns that some conflicts of interest are too complex to be addressed with full and fair disclosure. The interpretation recognizes that disclosures should be "clear and detailed enough for the client to make an informed decision to consent" and notes that whether a client has provided informed consent will depend on the facts and

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US Regulatory

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circumstances, including the sophistication of the client. Importantly, the interpretation emphasizes the differences between retail and institutional clients, recognizing that institutional clients "generally have greater capacity and more resources than retail clients to analyze and understand complex conflicts and their ramifications," and that their objectives are commonly "shaped by [their] specific investment mandates."

We expect that the SEC's Division of Investment Management will now turn its efforts to developing amendments to the Investment Advisers Act's "advertising" rule to address provisions imposing unnecessary burdens on private equity fund sponsors. The Division is also continuing its review of the Investment Advisers Act's "custody" rule.

European Regulatory

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Hurry up and wait for Brexit. UK firms' Brexit planning reached fever pitch in the first quarter of 2019. For some firms, this activity culminated in new office openings and team moves made in advance of the original March 29 deadline. For others, their work amounted to a dress rehearsal, with full implementation postponed when Brexit was deferred. Given the continuing political uncertainty, firms continue to plan for both a "Hard Brexit"—one with no Withdrawal Agreement or transitional arrangements—and a measured withdrawal, guaranteeing continuity until at least December 31, 2020. With October 31, 2019 the next possible Hard Brexit date, there is little respite.

Similarly, steps taken by the UK government and the financial services regulators to accommodate the regulatory impact of a Hard Brexit—including the onshoring of EU legislation and the establishment of a temporary permissions regime for EU firms currently passporting their activities into the EU—were largely concluded by March 29. Only toward the end of the process was there willingness by EU governments to establish reciprocal arrangements that would provide continuity for UK firms exercising passport rights into the EU. But while many states ended up providing some similar transitional relief, it was without the benefit of co-ordination at the EU level. The application of those regimes has now been deferred until 31 October 31 at the earliest.

Brexit continues to inform EU legislation. **New legislation from the European Commission governing investment firms' capital requirements includes changes to the right of access for third-country firms that was contemplated by the EU's Markets in Financial Instruments Regulation (MiFIR).** The conditions for access—originally designed to provide consistent standards for access by third-country firms to wholesale clients in the EU—will be significantly tightened. In particular, where third-country firms provide services into the EU at a scale that is of systemic importance for the EU (such as commercial lending), the "equivalence" assessment is recast into a detailed assessment of the UK's rules, while also taking into account future convergence or divergence of the UK's rules to their EU equivalents. Access by UK firms under MiFIR and other Directives continues to rely heavily on this concept of equivalence, an uneasy combination of technical assessment and political decision making.

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European Regulatory

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The legislation governing investment firms' capital requirements mentioned above amounts to a fundamental change in scope for those firms in terms of capital, remuneration and associated disclosures and reporting. European private equity firms structured as investment advisers (as opposed to fund managers) and subject to the Markets in Financial Instruments Directive (MiFID) will need to hold substantially more capital—equivalent to a quarter of annual fixed overheads—than at present, and larger firms will need to step up to remuneration and governance rules similar to those for banks and broker-dealers under the Capital Requirements Directive. UK private equity firms that are authorized under MiFID are concerned that the regulatory and financial burden of these new rules will place them at a significant competitive disadvantage to their EU-based counterparts.

ESG becomes part of the regulatory equation. The European Commission continued its push to ensure that environmental, social and governance (ESG) factors are taken into account in how asset managers structure products and make investment decisions. There was political agreement on a Regulation that will require firms to disclose how sustainability risks are taken into account in decision-making, and related proposals from the European regulator, ESMA, for amendments to the operational requirements in the Alternative Investment Fund Managers Directive (AIFMD). There has been considerable debate as to what it means to take sustainability risks into account in investment decision-making, and whether firms should be required to incorporate factors that do not have a material, foreseeable impact on portfolio value. The final Regulation represents a compromise, requiring firms to explain how they take into account ESG factors that affect value and to say whether and how they take account of ESG factors that do not affect value. All firms that do not take non-value issues into account must explain why not and, after a transition period, larger firms will lose this right and must explain how they take all material ESG issues into account. Clearly, the sustainability agenda will continue to permeate regulatory policy-making and firms' investment decision-making, governance requirements and their disclosure and reporting obligations.

Consistency arrives for pre-marketing. The Commission also adopted the Directive and Regulation on cross-border distribution of funds. These rules introduce consistency in Member States' approaches to "pre-marketing" funds in Europe under the marketing passport and a consistent "de-notification" procedure. Although designed to improve the operation of the fund marketing passport, Member States are expected to also apply these rules to non-EU managers marketing under private placement regimes, although, as with other initiatives governing EU managers, there is some uncertainty as to the practical application to non-EU managers. The legislation also tightens the "reverse solicitation" exemption (with a new filing required of managers that pre-market), giving regulators the means to more closely supervise this exemption and possibly signalling less tolerance of its use.

More attention to stakeholders in the UK. In the UK, new corporate governance rules will have an impact on larger portfolio companies. Concerned that insufficient attention was being given to "stakeholders" in corporate decision-making, the UK government has mandated that UK companies will need to explain how employee and other stakeholder interests have been taken into account by board directors. Any company that is not

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European Regulatory

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"small" or "medium-sized," and any company with at least 250 UK employees in its group, will have to publish additional information on stakeholder engagement. These rules are likely to change boardroom behavior in many companies. At the same time, very large private companies—with either 2,000 or more employees or turnover above £200 million and a balance sheet in excess of £2 billion—will have to disclose which corporate governance code they comply with, or explain their corporate governance arrangements in some detail. The new Wates Principles have been developed in tandem with this new reporting requirement and are designed to be used by large private companies. It is expected that they will be widely adopted.

US Tax

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A number of the changes made by the Tax Cuts and Jobs Act (TCJA) were clarified and finalized by the IRS and Treasury this year. Of particular interest for private equity firms was the release of proposed regulations regarding Section 1446(f) withholding. The TCJA introduced a tax on a foreign partner's gain from the sale of a partnership interest to the extent of that partner's share of the partnership's built-in gain that would be "effectively connected income" (or "ECI"). Section 1446(f) requires the purchaser of a partnership interest to withhold 10 percent of the amount realized by a foreign seller unless an exception applies. In addition, if the purchaser fails to withhold, the partnership is required to withhold distributions from the purchaser.

The IRS initially issued a Notice suspending the partnership withholding provisions. However, recently released proposed regulations reinstate the obligation of a partnership to withhold on future distributions to a transferee if the transferee fails to withhold on the transferor or to provide an appropriate certification. The proposed regulations will go into effect beginning with transfers that occur 60 days after the final regulations are published. Taxpayers are generally permitted to rely on either the Notice or the proposed regulations until the proposed regulations are finalized.

For secondary transfers, because there is currently no secondary liability on a fund for failures to withhold, a fund technically does not need to do anything until final regulations are issued. For subsequent closings, if a fund has no ECI investments or only has dry closings, there is no need to take action. If a fund has an ECI investment and prior draw-downs, the fund could provide a "25 percent certificate"—stating that if the fund sold all of its assets, less than 25 percent of the gain would be ECI—to the new partners as part of the admission process (assuming, of course, that this is factually accurate). If a 25 percent certificate cannot be provided, the Fund should consider alternative structures to address withholding.

Other notable changes for private equity funds arising from the TCJA involve the taxation of carried interest. In order for carried interest to be subject to the favorable long-term capital gain rate, a fund must generally hold a capital investment for three years. Similarly, in a GP sale, carry recipients must have held their partnership interest in the GP entity for three years. The relevant regulations to implement these provisions have not yet been released and there is some uncertainty around how these rules will actually be applied. It is worth noting that there have been further legislative proposals in Congress

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US Tax

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regarding carried interest, such as Senator Ron Wyden's (D-OR) bill to impose annually a current "deemed compensation" amount subject to ordinary rates. Thus, it seems that the final chapter in the saga of carried interest may not yet be written.

Finally, the TCJA introduced significant changes to the taxation of international operations under the controlled foreign corporation (CFC) rules. Previously, US persons were taxed on active foreign earnings only on repatriation, while passive foreign earnings were generally currently taxed. Under the TCJA, US persons are also taxed on active foreign earnings that exceed a specified formula, whether repatriated or not. The new rules were particularly stacked against US individuals (*e.g.*, GP members), creating traps for unwary PE funds. The IRS just released new sets of complex regulations that may significantly change the landscape for PE funds and their US individual investors once again—this time, mostly for the better. In particular, the new rules may level the playing field between US and offshore venues when funds are choosing jurisdiction. We will be covering these changes in detail as they develop.

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A federal court ruling reminds investment advisers that communications with compliance professionals may not be privileged. In *S.E.C. v. Alderson*, an investment adviser sought a compliance firm's advice during the course of an SEC examination. Although most of the compliance firm's employees who provided the advice to the investment adviser were attorneys, they did so pursuant to a contractual relationship that explicitly disclaimed that they were providing legal advice. As a result, the US District Court for the Southern District of New York concluded that most of the communications between the adviser and the compliance firm were not protected by the attorney-client privilege. For private equity firms that engage compliance professionals, whether in-house or externally, the decision is an important reminder that communications with such professionals often may not be protected by privilege. Firms should therefore consider hiring law firms —particularly during SEC exams—to engage and direct the work of third-party compliance firms to ensure that communications are protected by the attorney-client privilege.

The SEC's ability to bring certain negligence-based enforcement actions alleging "willful" misconduct has been curtailed. In the past, the SEC took the view that an investment adviser or its employees were engaged in "willful" conduct by simply engaging in a voluntary act. This allowed the SEC in enforcement proceedings to seek industry bars, suspensions and censures without establishing that the actor had behaved intentionally or with extreme recklessness. A recent decision by the US Court of Appeals for the DC Circuit in *The Robare Group v. S.E.C*, however, rejected the SEC's interpretation in a case concerning an adviser's failure to disclose conflicts of interest in its Form ADV. The court held that an adviser only acts "willfully" for purposes of Section 207 of the Investment Advisers Act of 1940, which prohibits filing false or misleading Forms ADV with the Commission, if the adviser intentionally or with extreme

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SEC Enforcement

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recklessness made a material misstatement or omission—in other words, merely completing or filing a Form ADV is not a "willful" act. This decision provides comfort to private equity advisers: As a practical matter, the SEC will only be able to allege Section 207 violations against the person or persons who directly drafted and reviewed the Form ADV where it can be shown that the person acted intentionally or with extreme recklessness. Further, to bring an action against an advisory firm, the Commission will need to establish that intentional or extremely reckless conduct of a person can be imputed to the firm. Additional litigation will determine whether the decision curtails the SEC's ability to obtain bars, suspension and censures for any negligence-based violations, since those measures require "willful" conduct as well. In settled proceedings, however, the Commission appears to be taking the position that it can continue to seek those remedies for negligence-based violations.

Asset Management Litigation

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In April 2019, the Delaware Supreme Court issued an opinion in Verition Partners Master Fund Ltd. v. Aruba Networks, Inc., reaffirming the path laid out in DFC Global and Dell for the Chancery Court to place a significant emphasis on deal price when determining fair value. Although the Supreme Court has not created a bright-line standard or even presumption in favor of deal price, it has emphasized that when unaffiliated, unconflicted parties negotiate at arm's length in an efficient market, deal price should be given significant weight. A more detailed discussion on the topic can be found here.

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