Debevoise & Plimpton

The Private Equity Report Quarterly

Fall 2020 | Volume 20, Issue 3

From the Editors

This issue of the *Private Equity Report* comes during a time of reflection—not merely due to the events of this turbulent year, but because it marks the twentieth anniversary of the founding of the publication. To celebrate the occasion, six Debevoise partners who have shaped the Report over the past two decades—including founding editor Franci Blassberg—gathered for an Editors' Roundtable discussion on private equity's past, present and future. We've included the takeaways from that discussion, which can be found below under our 20th Anniversary Spotlight Section.

The range of features and articles in our anniversary issue reflect how evolved, complex and ubiquitous private equity has become within the world's economy:

20TH ANNIVERSARY SPOTLIGHT

Celebrating the Private Equity Report

- **The *Private Equity Report* at 20: Where We've Been, Where We're Going**
  To celebrate our twentieth anniversary, private equity leaders and editors of the Debevoise *Private Equity Report* came together for a virtual roundtable to discuss where the industry has been and where it is going. We invite you to: WATCH HERE
- **Progressing from Goal to Reality on Diversity, Equity and Inclusion**
  Like organizations in other sectors, private equity firms are critically reassessing their cultures and the systemic impediments for underrepresented groups. This fall, Debevoise hosted a virtual gathering in which private equity senior legal leaders shared strategies for making the industry more diverse, equitable and inclusive.

- **Thinking Through the Tax-Blocker End Game**
  The increased participation of both U.S. tax-exempt organizations and non-U.S. investors in private equity fundraising has led to the widespread use of blocker corporations to mitigate possible U.S. federal income tax obligations. However, blockers introduce a new set of strategic questions when it comes time to exit investments.
- **SPAC Attack: A Re-Emergence to the M&A Market Gains Momentum**
  Special purpose acquisition companies have grown in both number and size this year, making them an increasingly visible player in the M&A market. Traditional private equity firms should keep in mind how SPACs are evolving their structures to be stronger competitors for investor capital.

Fall 2020 Issue Editors

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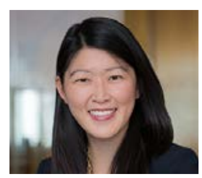

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Editorial Board

- **Navigating the Nuances of Continuation Funds**
  Continuation funds can give sponsors the best of both worlds: the liquidity of an exit while retaining control and future upside. But to deliver on their promise, these complex arrangements require a clearly articulated rationale, a detailed strategy and careful management.

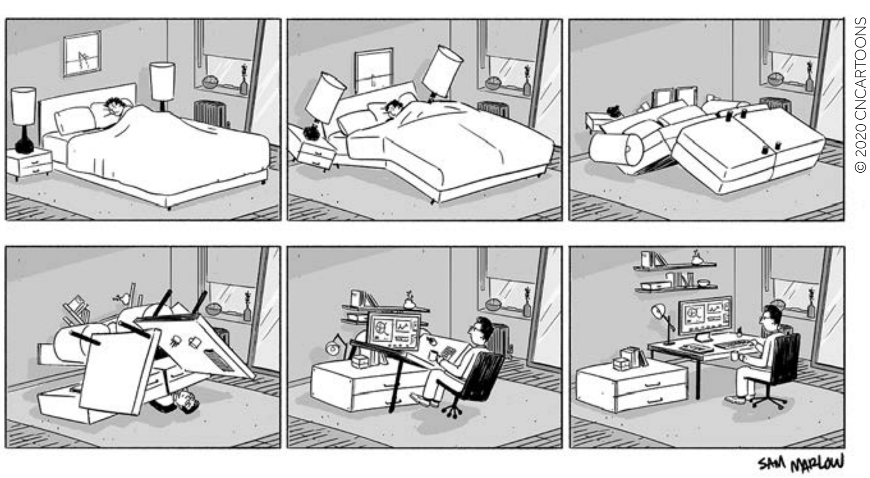
- **Hasta Mañana: What Will Tomorrow Bring for Latin American Private Equity?**
  The pandemic, currency depreciation and risk aversion by foreign investors have delivered a triple whammy to private equity in Latin America. Despite the current turbulence, some experienced investors are encouraged by investor-friendly reforms and see opportunity in low valuations and favorable exchange rates.

- **Exit Trends in Asia**
  The pandemic, regulatory changes and geopolitical developments have all contributed to shifting deal trends in Asian markets this year. IPO listings on local exchanges have gained in popularity; going private transactions of U.S.-listed Chinese companies have helped bolster the number of M&A deals getting done in an otherwise slowing M&A market; and Asian sponsors have increasingly used continuation funds as a third-track exit option.

- **ESG Becomes Part of the EU Investment Equation**
  The European Union's new ESG Regulatory Framework, set to come into effect starting in March 2021, entails a substantial change in operations for funds managed or marketed in the European Union. In addition to the immediate issue of disclosure compliance, fund managers need to prepare for ESG factors to be more deeply integrated into investment decisions and investor queries.

We hope that you find this issue of the *Private Equity Report* to be a thought provoking look at both the evolution of private equity over the last two decades and at some of the important issues and trends shaping it today.

The Editors



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Debevoise & Plimpton

20TH ANNIVERSARY SPOTLIGHT
Celebrating the Private Equity Report

The *Private Equity Report* at 20: Where We've Been, Where We're Going

> Private equity has always been a relationship-based business, but this is particularly true today when the quality and depth of a PE firm's relationships, including with strategic partners, can be critical in getting access to investment opportunities that might otherwise be unavailable.

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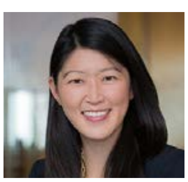

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Successful private equity investing is a collaborative undertaking. The same is true of the Debevoise *Private Equity Report*, which has been led since its founding by a group of editors and private equity leaders whose collective careers span the arc of the industry. To celebrate our twentieth anniversary, six of those leaders —**Franci Blassberg, Paul Bird, Rebecca Silberstein, Kevin Schmidt, Jennifer Chu and Sally Bergmann**—came together for a virtual roundtable to discuss where the industry has been and where it is going.

We invite you to: WATCH HERE The roundtable included these key takeaways:

- **Relationships are more important than ever.** Private equity has always been a relationship-based business, but this is particularly true today when the quality and depth of a PE firm's relationships, including with strategic partners, can be critical in getting access to investment opportunities that might otherwise be unavailable. The pandemic provides a further case in point: firms have had to rely on their deep investor relationships in order to make the shift to virtual fundraising and to obtain approvals from their investors to adapt to changing market conditions.
- **Private equity's growth enters a new phase.** As core investor pools mature, sponsor firms are increasingly going further afield to continue to diversify their investor base. This requires sponsors to be able to nimbly respond to and comply with local regimes, including with respect to EU regulations and other local marketing requirements. Firms are making inroads into Latin America in the wake of the region's more private equity-friendly regulations and eyeing yield-hungry high-net-worth individuals (which is likely to prompt a larger conversation about risk). There also remains untapped opportunity among sovereign wealth funds, many of which have yet to enter the private equity investing space.
- **Financial sponsors are the new conglomerates.** As financial sponsors differentiate themselves based on their ability to act as true partners with portfolio companies, the traditional ten-year fund time horizon is giving way to longer-term, and even indefinite, commitments. This shift in orientation, combined with a reach across regions and industries, is causing financial sponsors to resemble global conglomerates, with a professionalized infrastructure spanning continents and sophisticated capabilities to match rising transparency and compliance expectations.

- **A complex PE ecosystem has emerged.** The growth of private equity has been supported by not just a web of legal counsel and financial advisors, but also by consulting firms and other advisors that can enhance a sponsor's knowledge base to put it on par with, or even beyond, that of the M&A/business development group at even a sophisticated strategic. With M&A being a seller's market, that additional insight helps PE firms develop the complex and creative solutions that can close a deal.
- **"Private capital," is the new paradigm for "private equity."** Sponsors have become much more flexible in their investing structures. It's not just about control LBOs anymore. Debt, preferred equity, growth equity, PIPEs and co-investment are all part of the toolbox. Private equity has thus evolved from being a niche investment strategy to being a multichannel source of capital for organizations across a wide swath of the corporate life cycle.
- **ESG issues are no longer peripheral.** Increasingly, investors are taking a private equity sponsor's approach to ESG into account in making their decision of whether to invest in a fund—and walking away when they don't like what they find. Tellingly, investors are doing so not just because of investment guidelines or regulations, but because they see weak ESG follow-through as a warning sign of other problems. Private equity sponsors, for their part, are ramping up their commitment to diversity, equity and inclusion in light of this year's events underscoring racial justice and gender equity concerns.

We are proud to be associated with the many private equity firms and investors we have been fortunate to work with over these many years. We look forward to continuing our commitment to the industry, as it continues to evolve and expand in the years ahead.

20TH ANNIVERSARY SPOTLIGHT
Celebrating the Private Equity Report

Progressing from Goal to Reality on Diversity, Equity and Inclusion

Private Equity GCs Share Strategies on the Road to Making Diversity a Reality

The events that gripped much of the nation earlier this year regarding racial injustice and inequality led organizations around the country to critically reassess their cultures and the systemic impediments for underrepresented groups. The private equity industry was no exception to this self-examination. Debevoise & Plimpton recently hosted a virtual roundtable for private equity general counsel to exchange observations and strategies on meeting today's higher standards for diversity, equity and inclusion. Panelists included:

- **Joann Harris**, Partner and Chief Compliance Officer, TPG Global
- **Harsha Marti**, Managing Director, Deputy General Counsel, Warburg Pincus
- **Jack Pitts**, Managing Director, Blackstone Alternative Asset Management, The Blackstone Group
- **Ryan Toteja**, Principal and Head of Global Fund Formation, The Carlyle Group

The key takeaways included the following:

The fight against injustice is a fight against inertia. The disruption from the pandemic notwithstanding, the past decade has been a good one for private equity. But financial success can blunt the drive for change necessary to tackle DE&I over the long haul. Firms need to remember that a strong bottom line doesn't mean that there aren't systemic issues within firms that need to be addressed.

DE&I challenges are experienced on a personal level, but addressing them requires an institutional response.

Establish a DE&I infrastructure. DE&I challenges are experienced on a personal level, but addressing them requires an institutional response. To approach DE&I systematically, certain firms have established councils with members representing different departments and levels and subcommittees focusing on either functional

elements (*e.g.*, external engagement) or underrepresented groups (*e.g.*, LBGTQ+, veterans). Firm-wide councils also reinforce the idea that DE&I is a matter for the firm as a whole rather than a task for the legal and compliance department.

Don't drop the ball on development. Hiring diverse candidates is only the first step—they then need to be developed to reach leadership ranks. Failure to do this consistently is why many institutions become less diverse the higher up the org chart you go. Our panel pointed to two powerful strategies to keep development on track. First, make sure that diverse employees not only have mentors, but also sponsors who can act as advocates when personnel decisions are being made. Second, look for unconscious bias in how tasks are allocated. Do some people routinely get opportunities to shine while others are stuck with the grunt work?

Small affirmations can have a big impact. Casual acknowledgement by a team leader of a junior person's contribution in a meeting—"Jenna made a good point"—or letting a junior person run a client call fosters opportunity and sends a powerful message. And let your service providers, including outside counsel, know that you welcome them developing their own diverse talent in their meetings with you.

Don't pull punches on feedback. There can be a tendency to handle diverse employees with kid gloves. But glossing over weaknesses allows shortcomings to go unaddressed and fester into real impediments to advancement—making the pipeline excuse a self-fulfilling prophecy.

Invest in measuring success. Setting DE&I goals means little without meaningful metrics to establish baselines and measure progress. But obtaining this information is no small task; firms need to be prepared to make the effort necessary to identify data that are needed and then to establish mechanisms to obtain such data in a usable and consistent form.

Expect your DE&I agenda to change. Ongoing conversation within PE firms regarding impediments to diversity, equity and inclusion will deepen understanding, but will also uncover new layers of issues to be addressed. The path to creating a more equitable workplace is not linear.

Look outside your walls. In their DE&I efforts, firms need to examine both their own organizations and the entities with which they interact, including vendors, portfolio companies and the colleges or professional schools from where they recruit. Make conscious choices and have expectations of the institutions with whom you partner. Portfolio company board seats are particularly visible signs of a PE firm's success in promoting DE&I; one panelist reports their firm has set a goal of having 30 percent of board seats held by diverse directors by 2023—and to do so by recruiting as many first-time directors as possible, rather than relying on the same short roster of over-boarded diverse directors.

Prepare to be evaluated on DE&I metrics. Firms are receiving DE&I questionnaires from their stakeholders, including their limited partners, and the SEC has begun gathering diversity data from PE firms on a voluntary basis. Firms are responding by incorporating DE&I efforts and success stories in how they position themselves. Prepare to tell your DE&I story, and ensure that you have a story to tell regarding concrete initiatives and future goals.

Debevoise has long regarded community, fairness and cooperation as core values of the firm. Those values cannot be achieved without a strong culture of diversity, equity and inclusion. Our approach to DE&I can be found here.

Debevoise & Plimpton

Thinking Through the Tax-Blocker Endgame

> Before the use of blockers as the preferred method for private equity funds to accommodate Tax-Sensitive Investors, such investors relied on ECI and UBTI convenants for protection.

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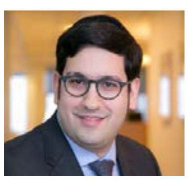

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Over the past few decades, private equity sponsors have raised a substantial amount of capital from both U.S. tax-exempt organizations and non-U.S. investors ("Tax-Sensitive Investors"). While Tax-Sensitive Investors generally do not incur U.S. federal income tax on the disposition of capital investments, they require specific structuring to mitigate U.S. federal income tax filing and payment obligations that can arise with respect to certain investments. Fortunately for private equity sponsors, using a blocker corporation (*i.e.*, an entity treated as a corporation for U.S. federal income tax purposes that is interposed between the Tax-Sensitive Investor and the underlying investment) satisfies most of these tax structuring needs, as described below.

This Article describes some of the history of blocker usage in the private equity world as well as recent developments, some of which were triggered by changes in law and some by shifts in business trends.

Overview of Tax-Sensitive Investors and Blocker Structures

Tax-Sensitive Investors

Notwithstanding their moniker, most types of U.S. tax-exempt organizations are subject to tax on income that constitutes "unrelated business taxable income," or "UBTI." UBTI generally includes income derived by the organization from any trade or business not substantially related to the basis for its exemption from taxation. In the private equity context, UBTI arises in two principal forms. First, if the fund invests in an operating partnership (*e.g.*, a limited liability company or other pass-through entity for U.S. tax purposes) that is engaged in a trade or business anywhere in the world, a tax-exempt partner's share of the income of such operating partnership is generally UBTI. Second, a portion of income derived from property that was acquired using "acquisition indebtedness" also constitutes UBTI if the leverage is outstanding or only recently repaid. For example, if the fund purchases securities in part with leverage and sells securities within a year, a portion of the gain generally will be UBTI. However, many state and local government pension plans take the position that they are exempt from all taxation, including UBTI. If a U.S. tax-exempt organization incurs UBTI, it generally is required to file an income tax return with the IRS.

Non-U.S. investors are subject to U.S. federal income taxation on their income that is "effectively connected" with a U.S. trade or business, or "ECI." Similar to UBTI, if the fund invests in an operating partnership that is engaged in a trade or business within the United States, a non-U.S. partner's share of such operating partnership's income and any gain from the sale of such operating partnership is usually ECI. If a non-U.S. investor has any amount of ECI or is otherwise engaged (or deemed to be engaged by virtue of its investment in a pass-through entity that is itself engaged) in a U.S. trade or business, it must file an income tax return with the Internal Revenue Service. Non-U.S. corporations are also generally subject to the "branch profits tax", a tax at 30% (or a lower treaty rate) on the "dividend equivalent amount" of the non-U.S. corporation, which is approximately equal to the amount of the corporation's earnings and profits attributable to ECI that is not treated as reinvested in the United States.

A unique group of non-U.S. investors, foreign governments, receive benefits under Section 892 of the Internal Revenue Code ("Code") on certain forms of income, including dividends, interest and gains on the sale of certain securities. However, they are subject to federal income taxation on their "commercial activity income" or "CAI." The rules on CAI are similar to those on ECI, and therefore foreign government investors often invest through a blocker alongside other non-U.S. investors. For certain foreign government investors, if they have any CAI, they can lose their "892" status. They are therefore more sensitive to incurring CAI than non-U.S. investors are to incurring ECI.

Blocker Structures

Due to the above concerns, private equity sponsors often use blockers to "block" UBTI or ECI for Tax-Sensitive Investors. The blockers shield tax-exempt investors from directly incurring UBTI in respect of operating partnerships (and some debt-financed UBTI as well depending on the structure) and shield non-U.S. persons from directly incurring ECI, in each case, together with the associated filing obligation. Furthermore, a non-U.S. corporation that invests in an operating partnership is subject to the branch profits tax but avoids such tax if it invests through a blocker. Of course, the blocker itself pays tax on its share of the operating partnership's income at the corporate income tax rate, reducing net returns to the Tax-Sensitive Investors who invest through the blocker. The private equity sponsor, to avoid tax leakage on its own interest, often creates a partnership (*i.e.*, a "splitter") below the blocker, through which it runs its capital contributions and receives its carried interest.

While selling an operating partnership interest usually does not generate UBTI (unless the interest was debt-financed), it may generate ECI. Therefore, even if an operating partnership produces no current income, a foreign partner may still incur ECI when exiting an unblocked investment. Since 1991, the IRS has taken the position that foreign partners must look through to the assets of the partnership to determine whether income from disposition of a partnership interest constitutes ECI.[1] Under the IRS's view, if the partnership was engaged in a U.S. trade or business, the income from disposition of a partnership interest would constitute ECI to the extent the assets of the partnership would generate ECI if they were all sold off at fair market value. In 2017, Congress added Section 864(c)(8) to the Code to codify the IRS's view. Moreover, a new withholding regime was added to collect taxes from sales by non-U.S. sellers of interest in partnerships unless the seller can establish an exemption from withholding.

The Early Days: Before Widespread Blocker Usage

Before the use of blockers as the preferred method for private equity funds to accommodate Tax-Sensitive Investors, such investors relied on ECI and UBTI covenants for protection. These covenants would prohibit funds from making any investment that would generate ECI or UBTI or provide for a cap on the amount of ECI or UBTI investment that could be made. However, these covenants often constrained investment opportunities to corporate investments and were disliked by private equity sponsors.

Nonetheless, private equity sponsors often agreed to such covenants because many potential portfolio companies were in corporate form, and so the real-world limitations created by these covenants were somewhat low.

The Rise of Blocker Usage

During the 1990s, use of limited liability companies ("LLCs") rose as state legislatures enacted LLC statutes.[2] Entrepreneurs became

1. Rev. Rul. 91-32, 1991-1 CB 107.
2. *See* John Dwight Ingram, *Limited Liability Companies*, 6 BUS. L. REV. 1, 2-3 (2007).

more comfortable with the entity in part because the corporate law on LLCs started to develop and become more stable. Preference for LLCs also grew because they afforded limited liability to all owners, flexible sharing of economics and, perhaps most importantly, pass-through taxation. Coinciding with this development was the advent of the check-the-box regulations in 1996, under which business owners could simply choose to treat an LLC as a partnership for tax purposes (as opposed to running through a multi-factor test to determine whether it was a corporation or a partnership for tax purposes).[3]

As a consequence, the investment opportunities for private equity sponsors in pass-through entities grew rapidly, putting tension between sponsors who wanted the flexibility to pursue such opportunities and Tax-Sensitive Investors who wanted to avoid the negative tax impacts to them from operating partnership investments. Investments in operating partnerships are attractive in part because the buyer generally receives an amortizable step-up in the basis of the assets of the company. In addition, the buyer can generally obtain a higher price on exit since their next buyer will also receive a step-up. To accommodate Tax-Sensitive Investors while retaining flexibility to pursue operating partnership deals, sponsors began to rely more on using blocker structures rather than on ECI and UBTI covenants. Some sponsors also started to utilize shareholder leverage to reduce a blocker's tax liability. Typically, this involved the fund entity structuring a portion of their investment in the blocker as a loan. The loan would generate deductible payments for the blocker, subject to the business interest limitation rules. As an added benefit, repayment of the loans would be treated as return of capital rather than as a dividend and would not be subject to dividend withholding tax.

Non-U.S. investors, on the other hand, generally preferred to invest through blockers in most cases to avoid the tax return filing obligation. Moreover, unlike tax-exempt investors where blockers were largely tax inefficient, blockers had a tax-neutral impact on non-U.S. investors. Indeed, for non-U.S. corporations, using a blocker often is more tax efficient because it avoids the branch profits tax. Over time, these investors too became savvier and began to push for blocker leverage to reduce tax leakage. The blocker corporation is able to use interest deductions (subject to the business interest limitation rules) to reduce its tax liability, and the non-U.S. tax-sensitive investors are able to repatriate cash tax-free as return of principal. This was aided by a clarification in the Treasury regulations that for purposes of applying the portfolio interest exemption from withholding taxes, the IRS will look through a partnership for determining if an investor is under the 10% ownership threshold and therefore qualifies for the exemption.[4] The clarification allowed non-U.S. investors to take the position that they qualify for the exemption if they own less than 10% of the blocker.

Over the same decade, tax-exempt investors became savvier and began to focus more on after-tax returns, as opposed to avoiding UBTI entirely.

Over the same decade, tax-exempt investors became savvier and began to focus more on after-tax returns, as opposed to avoiding UBTI entirely. As tax-exempt investors are not subject to UBTI on sales of interests in operating partnerships (unless the interests are debt-financed and the debt is still outstanding or recently repaid), such investors are often comfortable receiving UBTI from current income, if any, in exchange for maximizing their after-tax returns on exiting the investment. As such, many began to invest unblocked because they did not want to incur the tax leakage at the blocker level. They also became more comfortable with the tax filing obligation to report UBTI as a matter of course.

3. T.D. 8697, 61 Fed. Reg. 66584-66593 (Dec. 18, 1996).

4. Treas. Reg. §1.871-14(g)(3)(i).

Modern Issues in Blocker Usage —Exiting Blocked Investments

Potential Tax Leakage when Exiting Blocked Investments

With the proliferation of blocker usage, sponsors and limited partners started to think more carefully about exiting blocked investments. A fund generally faces two options when exiting a blocked investment. The fund and the blocker can each sell their interests in the investment, and the blocker can then distribute the after-tax proceeds to the fund (possibly in liquidation, if the blocker only held a single investment). Alternatively, the fund can sell the blocker itself along with the interests it holds directly in the investment.

For example, assume a fund owns 50% of an operating partnership directly and 50% through a blocker. The total cost of the investment was $200 and its fair market value at the time of exit, ignoring the blocker, is $400. Further assume that there is no depreciation during the holding period so that tax basis in the assets remains $200. If the blocker sells its partnership interests, it and the fund will each receive $200. This is because the buyer is not purchasing the blocker and therefore will pay full fair market value. Of the $200 the blocker receives, it must pay $21 of taxes on the $100 of profit based on a corporate tax rate of 21%, leaving the fund with a total of $379. On the other hand, the buyer gets the benefit of a full basis step-up of $200, which generally will be amortizable over 15 years.

However, if the fund instead sells the blocker alongside its direct interest in the operating partnership, the buyer is losing out on $100 of tax basis to amortize, which is $21 of tax shield. However, this tax shield is spread over 15 years, whereas the $21 of cost to the fund in the first scenario is immediate. Overall, the benefit to the sponsor of selling the blocker outweighs the cost to the buyer, and, in a rational world, the tax saved by the selling fund will be greater than the discount in price paid by the buyer due to the reduction in amortizable tax basis, the so-called "blocker discount." Sales of blockers have become increasingly common in a competitive sale process.

Sharing the Blocker Discount

If a fund decides to sell a blocker, it must decide who must bear the blocker discount economically. Some fund agreements have all partners share the discount, usually for one of two reasons. First, the fund needed capital from all partners to make the investment and so it is only fair for everyone to bear the discount. Second, it can be difficult to calculate the blocker discount.

Most funds, however, allocate the blocker discount only to the investors who chose to invest through the blocker. While this approach is often more burdensome to implement, many sponsors and investors see it as a fair way to address the issue. With respect to the general partner and its carried interest, most funds calculate carried interest on a pre-blocker taxes basis and a pre-blocker discount basis.

Some complications may arise at the deal level if the operating partnership has co-investors and management who own interests alongside the fund. Under the joint venture agreement with the co-investors and management, it is common for all selling parties to receive the same price per unit irrespective of whether they are selling direct interests or blocker stock. This effectively means that the blocker discount, if any, is borne by all holders. If that is the case, it can be harder to separate at the fund level what the blocker discount amount is and how to allocate it among the limited partners, other than on a pro rata basis. For an unblocked limited partner, they may prefer having the blocked limited partners bear the entirety of the blocker discount at the fund level, even if that means that, at the deal level, the co-investors and management will not bear any of it.

Buying an Existing Blocker and Using it as the Fund's Blocker

When a private equity funds buys an operating partnership from another private equity fund, the selling fund will likely want the purchasing fund to acquire its blocker. The purchasing fund has two main options when it comes to addressing the existing blocker. Historically, funds generally viewed the purchase as two investments: one investment in a corporation and one investment in the operating partnership. The fund would then add a blocker for the investment in the operating partnership. For example, assume a fund is buying an operating partnership that is 50% owned directly by the selling sponsor and 50% owned by a blocker and that the purchasing fund also needs to be blocked for 50% for its investment in the operating partnership. For the investment in the operating partnership, most fund sponsors have historically set up a second blocker. As a result, 75% (50% held by the fund for all investors through the existing blocker and 25% held by the fund for its tax-sensitive investors through the second blocker) of the interests in the underlying operating partnership are held through blocker, while the fund only needs 50% to be blocked. Because the exit will be structured as a sale of the blockers, creating multiple blockers shrinks the amount of step-up available that can be offered to a future buyer.

It would be tempting in this scenario to try a second option—namely, to use the selling fund's blocker as the blocker for the purchasing fund's blocked investors and therefore to avoid creating excess tax leakage due to setting up a second blocker. While tempting, there are tax detriments to the purchasing fund's blocked investors in purchasing the existing blockers—most significantly, there is no amortizable step-up associated with a purchase of the blocker. However, it may be possible to implement this second option in a manner that is fair to all investors, for example, by having the blocked investors of the purchasing fund receive the full benefit of any blocker discount associated with the purchase of the blocker. Needless to say, this approach creates additional complexity and may still raise structuring concerns, especially where the existing blocker is larger than necessary for the purchasing fund.

> Private equity sponsors and investors have become more sophisticated in their approach to UBTI or ECI and in structuring investments through blockers, with more focus on tax efficiency, including reducing tax leakage through the use of leverage and the sale of blockers.

Conclusion

Private equity sponsors and investors have become more sophisticated in their approach to UBTI or ECI and in structuring investments through blockers, with more focus on tax efficiency, including reducing tax leakage through the use of leverage and the sale of blockers. More recently, as investments are increasingly sold from one private equity sponsor to another, we may see purchasing funds looking for creative ways to use a selling fund's existing blocker for their Tax-Sensitive Investors.

Debevoise & Plimpton

SPACs Could Become Formidable Bidders in the M&A Market

Signs suggest SPACs will be more frequent and formidable bidders in the M&A market, competing for larger deals than they have in the past.


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2020 has been a record-breaking year for U.S. special purpose acquisition company (SPAC) activity, marked by significant growth in both the size and number of IPOs, novel changes in SPAC terms and the continued development of creative financing arrangements providing SPACs with capital incremental to IPO proceeds. These signs suggest SPACs will be more frequent and formidable bidders in the M&A market, competing for larger deals than they have in the past.

SPACs, also known as blank check companies, are non-operating entities formed to identify and complete a business combination, often in a targeted industry or sector, within a specified period of time after the SPAC's IPO. IPO proceeds are held in a trust until a business combination is identified, then used to fund the transaction together with proceeds raised through other financing agreements.

U.S. SPAC shareholders typically have the right to vote on whether to approve the business combination transaction and, independent of how they cast their votes, can elect to redeem their shares in advance of the transaction. Following the business combination, the surviving company continues to trade its shares publicly, meaning that SPACs can provide a fast-track to public capital markets for the target company.

Significant Growth

Through September, there have been over 100 SPAC IPOs in 2020, compared to 59 in all of 2019 and 46 in all of 2018, according to SPACInsider.com. SPAC IPOs are growing not only in frequency but in size: the average IPO size in 2020 has been $385 million, almost double the $230 million average IPO size of the past two years, and 2020's gross proceeds from SPAC IPOs total approximately $42 billion, a significant increase from the $13.5 billion raised by SPAC IPOs in 2019. Already, 2020's total capital raised from SPAC IPOs equals more than half the amount raised in all previous SPAC IPOs from 1995 through 2019.

Incremental Financing

SPACs frequently raise additional proceeds through financing commitments from institutional investors or the SPAC's sponsor or affiliate of the sponsor. These arrangements are typically for the purchase of common stock through a PIPE ("private investment in public equity"). The market has developed three variations of these agreements: forward purchase agreements, entered into at the time of the IPO, as well as subscription agreements and backstop agreements, both of which are typically signed concurrently with entry into the business combination agreement (or shortly thereafter).

PIPEs, the continued ability of SPACs to access debt financing in connection with a business combination transaction, and the fact that many recent SPAC deals have used SPAC stock as partial acquisition consideration (and occasionally have used SPAC stock as the entire acquisition consideration) results in opportunities for SPACs to target companies that have enterprise values substantially in excess of the amount of a SPAC's IPO offering.

> Many recent SPACs have entered into multiple PIPE agreements, frequently raising more than half of the amounts raised in their IPOs.

Funding for backstop agreements is conditioned upon either a shortfall in total cash needed to consummate the transaction or upon redemption of SPAC shares by shareholders. Funding conditions are present in some backstop agreements but are not a feature of subscription agreements, which are typically conditioned only upon consummation of the business combination.

Many recent SPACs have entered into multiple PIPE agreements, frequently raising more than half of the amounts raised in their IPOs. While it has historically been rare for a SPAC to raise more funds from PIPEs than in its IPO, several SPACs this year have done just that. For example, Churchill Capital Corp III raised $2.6 billion in subscription agreements, more than double the $1.1 billion raised in its IPO.

The combination of bigger IPOs, the significant amount of cash raised from

Churchill Capital Corp III's PIPE funding enabled it to pursue its $11 billion deal with MultiPlan in July of 2020, paid in a combination of cash and stock, with the transaction value dwarfing the $1.1 billion raised in its IPO. After raising $450 million in its IPO, Conyers Park II Acquisition Corp. raised an additional $700 million of PIPE investments and in September of 2020 signed a deal with Advantage Solutions, Inc. in an all-stock deal valued at approximately $2.27 billion, using the cash to pay principal and interest on debt and any remaining proceeds for working capital and general corporate purposes.

Similarly, in September 2020, Gores Holdings IV raised $425 million in its IPO and an additional $500 million in a private placement in connection with a deal valued at approximately $16 billion, paid in cash and stock.

Innovative Terms

The $4 billion IPO (July 2020) of Tontine Holdings, a SPAC sponsored by Bill Ackman's Pershing Square, not only set a new record for its size, but introduced innovations in deal terms that, if they catch on, could make SPACs a more appealing opportunity to investors going forward. One of the most noteworthy changes was removing the typical 20% sponsor "promote," which consists of founder shares provided to the sponsor for nominal consideration. Instead, Pershing Square will purchase sponsor warrants that are not transferrable or exercisable until three years after the closing of the business combination, will represent only 5.95% of the post-business combination company and will have a strike price 20% above the IPO price. Pershing Square has stated that it hopes these features will better align the sponsors with the stockholders and potential merger partners.

Paul Ryan's SPAC (IPO announced August 2020), Executive Network Partnering Corp., seems to have followed this trend, providing only a 5% promote as well as "performance shares" for the founders, which, following the business combination, convert into common shares based on a formula that awards a greater number of common shares for a higher stock trading price.

Pershing Square also reduced investor incentives to arbitrage. In a typical SPAC, investors are issued warrants along with shares of the SPAC stock and are able to keep all of the warrants even if the investor elects to redeem its shares (frequently receiving all or almost all of its investment back), resulting in opportunities for arbitrage. In contrast, Pershing Square requires that an investor give up 2/3 of their warrants if the investor elects to redeem its shares.

Further, Pershing Square will distribute all warrants received by the company through such redemptions pro rata among the shareholders who did not redeem their shares, providing further incentive for an investor not to redeem. Starboard Value Acquisition Corp. (IPO announced August 2020) similarly introduced a novel variation on the warrant structure by issuing only one-sixth of a warrant with each share of common stock in its IPO, together with a contingent, non-transferrable right to receive an additional one-sixth of a warrant that is redeemable following the initial business combination redemption.

These innovations may allow Pershing Square to target companies that otherwise would not consider a SPAC bid for fear of post-closing dilution by the 20% sponsor promote. The Ackman-led SPAC revealed in its filings that it will search for a "mature unicorn," or company with a valuation of $1 billion or more. Having committed to an additional $1-3 billion in PIPE commitments, Pershing Square's war chest of $5-8 billion enables it to take a stake as a minority investor in targets that are significantly larger than what a typical SPAC might pursue. This strategy broadens the horizons for SPACs by opening up a new caliber of company to SPAC investments.

Potential Drawbacks to Dealing with a SPAC

Despite SPACs' growing size and access to cash, the fact that the funds are held in a trust until a deal is entered into or the SPAC's investment period ends means that very little economic recourse is available to a target in the event that a SPAC breaches. Occasionally, if a SPAC is sponsored by a financial investor or fund, that sponsor has provided a guarantee of a portion of the damages, or a reverse termination fee, in the event the SPAC fails to close a deal when required. This is not, however, the prevailing practice.

In accepting this recourse risk, targets may be comforted by the economic motivation of the SPAC founders to complete the deal. Also, some targets may be willing to accept this risk because they view the SPAC primarily as a vehicle to an IPO rather than means for their investors to cash out directly. Indeed, this "long-term" view is reflected in the number of all-stock deals with SPACs announced this year, including Mosaic Acquisition Corp. (Vivint Smart Home, Inc.), Conyers Park II Acquisition Corp. (Advantage Solutions, Inc.), Tottenham Acquisition I Limited (Clene Nanomedicine, Inc.) and B. Riley Principal Merger Corp. II (Eos Energy Storage LLC).

Future Developments

With this record year of SPAC IPOs, there are over 130 SPACs currently searching for targets, far more than ever before. Time will tell how many of these ventures will be successful, but the flexibility afforded by their outsized equity commitments, coupled with the ability to take a minority stake in a larger private company, means that a great deal of the SPACs currently hunting for deals may be successfully completing sizable business combinations in the near future.

Debevoise & Plimpton

Navigating the Nuances of Continuation Funds

Once a niche strategy, but now an increasingly popular path to liquidity, Continuation Funds allow sponsors to exit from an investment while still keeping control and future upside.


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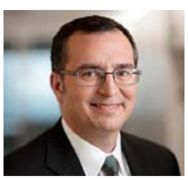
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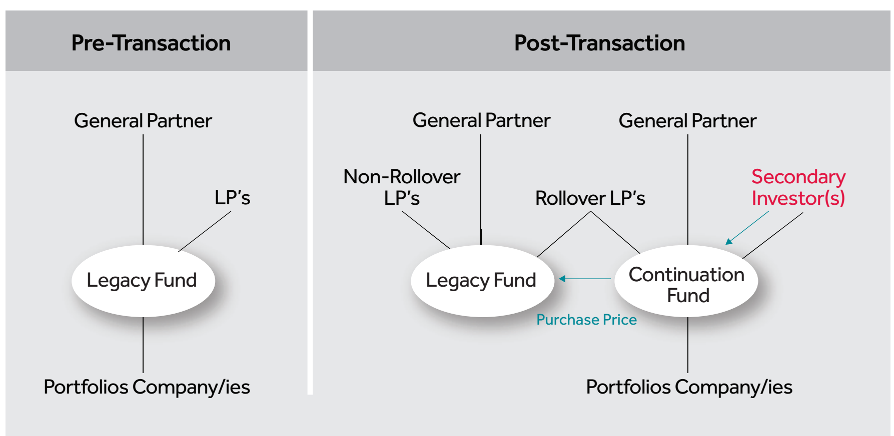
Introduction

Once a niche strategy, but now an increasingly popular path to liquidity, Continuation Funds allow sponsors to exit from an investment while still keeping control and future upside. This note explains how Continuation Funds work and outlines some of the key issues to consider.

Structuring

In a typical Continuation Fund transaction, one or more assets of an existing fund (often one that is nearing the end of its term) are acquired by a new vehicle managed by the same sponsor (the "Continuation Fund"). Investors in the existing fund may be offered the option either to sell (*i.e.* to cash out) or to "roll" their interests into the Continuation Fund (*i.e.* to remain invested in the underlying asset). New investors will make a cash contribution to the Continuation Fund, providing liquidity for investors in the existing fund who have elected to sell. The terms of the Continuation Fund are negotiated between the sponsor and the new investors, often reflecting asset-specific nuances. At a high level, the transaction structure of a GP-led transaction may look something like this:



When strategically deployed, a Continuation Fund can satisfy diverse stakeholders and achieve multiple goals: providing a liquidity option for investors who want to exit, realigning interests, tailoring incentives, and extending the runway to maximize value creation. However, these are complex transactions, and a weak process can reflect poorly on the sponsor. A successful Continuation Fund involves articulating a clear rationale, creating a transaction structure that solves for the key legal and tax issues, and managing an efficient legal and commercial process.

Framing The Narrative

A significant portion of GP-led secondary transactions are never completed. Common reasons include disagreement on value and concerns about the rationale for the deal. The dynamics of a Continuation Fund can be more complex than a typical portfolio company exit, because the sponsor is effectively on both sides of the deal. To generate an attractive liquidity option, the sponsor must offer a compelling business case and price to prospective buyers. On the other hand, the sponsor also has a fiduciary duty to the existing fund as seller (and, on a more practical note, a sale cannot occur unless a sufficient number of existing investors are incentivized to sell). Sometimes the sponsor may also seek a "stapled" commitment from buyers to another fund being raised by the sponsor, adding a further complication. With conflicting interests at play, it takes the right assets and the right narrative to make a sponsor's case credible on both sides.

Starting The Process: Engaging Advisors, Diligence and Planning

When considering a Continuation Fund, we strongly recommend consulting with advisors at an early stage. Counsel should review the existing fund and portfolio asset documentation carefully to identify approval requirements and potential gating items such as regulatory issues or transfer restrictions. Tax advisors may be retained to assist with transaction structuring, which can be complex, particularly if the intention is for existing investors to roll into the Continuation Fund without triggering a taxable event. Financial advisors are often hired to help co-ordinate marketing/commercial diligence and investor relations, and to demonstrate a robust valuation and sale process. Sometimes fairness opinions are also obtained. Continuation Fund transactions typically require approval from the Advisory Committee of the existing fund (because they are related-party transactions), and it is a good idea for the sponsor to engage with the Advisory Committee before getting too far down the road. This helps to show transparency and alignment with the investor base, which is critical for a smooth process.

> The dynamics of a Continuation Fund can be more complex than a typical portfolio company exit, because the sponsor is effectively on both sides of the deal.

Finding Buyer(s) and Negotiating the Deal

Having assembled its team of advisors, the next step for the sponsor is to identify buyer(s), which may be a single investor or potentially a consortium. Often this is done through an auction process, typically managed by a financial advisor, to assist with price discovery and to mitigate concerns about conflicts of interest on the part of the sponsor.

Once the buyer(s) have been identified, negotiations can be a significant workstream, requiring both funds and M&A expertise. While existing fund terms may be leveraged as a baseline for certain provisions, the key terms for Continuation Fund transactions are typically bespoke, including:

- **Fee/Carry.** Continuation Fund economics are significantly more variable than the "market" for private equity fund terms. For example, their waterfalls are often more complex, with different rates of carried interest at different return hurdles. Investors from the existing fund may be offered a "status quo" option to maintain their existing economics or they may be offered the opportunity to re-invest on the same economic terms as the new money investors.
- **Sponsor Commitment.** Buyers will often want the sponsor to commit a significant amount to the Continuation Fund to increase alignment. Sponsors are generally comfortable with this but may also be looking to take some money off the table, particularly if they are realizing significant carry in connection with the transaction.
- **Buyer Protections.** Key issues for buyers may include the scope of representations and warranties about the asset(s); indemnity caps; the survival period for claims; recourse

to the existing fund; the existence of holdbacks or escrows (especially if the existing fund may wind up); and conditions to closing.

- **Dry Powder.** Sometimes the Continuation Fund may include undrawn commitments for follow-on investments in the asset, or other accretive acquisitions. Existing fund investors who re-invest in the Continuation Fund may or may not also make undrawn commitments, which can add complexity to the economics and governance of the Continuation Fund.
- **Minimum Sale.** Buyers often require a "floor", *i.e.* a minimum percentage of interests to be sold by existing investors, to make the deal worthwhile. Sometimes buyers may also have a "ceiling", *i.e.* a maximum amount they can invest, meaning that a certain percentage of investors in the existing fund must roll into the Continuation Fund (or additional new investors must be recruited).

As the Continuation Fund involves a fundraising, sponsors should be mindful of applicable regulatory requirements (*e.g.* filings or approvals relating to fund marketing).

To Sell or to Roll: Existing Investor Process

A disclosure memorandum will be prepared for existing investors. This explains the deal, provides important legal disclosures and includes an election form allowing investors to exit or to roll their interests into the Continuation Fund. Any outstanding approvals from the Advisory Committee or existing investors would also be obtained at this point. (Approval may be sought from existing investors, *e.g.* if required under the existing fund partnership agreement, or if the sponsor chooses to seek approval from existing investors in addition to the Advisory Committee to further protect themselves from liability risk.)

Closing

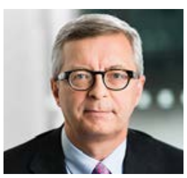
Once the election form process has been completed, and any conditions precedent have been satisfied (*e.g.* regulatory approvals), the transaction can close. The selling investors will receive their proceeds, the existing fund can notch up another exit, and the Continuation Fund will take the asset forward.

Debevoise & Plimpton

Hasta Mañana: What Will Tomorrow Bring for Latin American Private Equity?

Regarding deal volume by country, Brazil remains the frontrunner with more than half of all regional M&A activity, followed by Mexico and Chile.

Peter A. Furci
Partner



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The pandemic hit harshly most Latin American countries, especially given underlying structural, political and economic factors that exacerbated the crisis's impact. Beyond the pandemic, companies and investors in the region have grappled with considerable depreciation in some key currencies, fueled in part by foreign investors' risk aversion, trade tensions and political volatility. For example, the Brazilian Real declined against the U.S. Dollar from an annual average of approximately 3.9 Reais per USD in 2019 to over 5.6 Reais per USD in October 2020, with year-to-date devaluation nearing 30%. These adverse developments help explain the International Monetary Fund's recent forecast that combined regional GDP in 2020 will decline by 8.1%.

Although overall M&A activity in the region in terms of deal value has decreased by more than 50%[1] during the first half of 2020 compared to the same period last year, private equity investors in Latin America have remained busy pursuing USD 5.1 billion worth of exits, primarily through the equity capital markets.[2] In Brazil, the market for public equities expanded as retail investors moved their savings away from debt instruments, now less remunerative due to consistently lower interest rates. In the meantime, exits through strategic dispositions have been much more challenging as potential buyers constrained by lack of liquidity are demanding unattractive deferred payment mechanisms and tending to value assets more conservatively.

On the buy-side, most of the interest is in sectors perceived as more COVID-resilient. These include technology, particularly mature startups seeking large rounds of funding from an increasingly active regional venture capital industry, including Fintech as a tool to bypass the region's expensive payment systems and reach the unbanked population; healthcare; education; and infrastructure, including logistics, especially with an upcoming privatization wave in Brazil. Investments in quasi-equity debt instruments of distressed entities likewise have been active and are likely to find fruitful ground as the economic effects of the crisis continue to unfold. Regarding deal volume by country, Brazil remains the frontrunner with more than half of all regional M&A activity, followed by Mexico and Chile.[3] Interestingly, while fundraising increased 30% year-over-year during the same period, much of the new money flowing into these funds seemingly does not come from abroad but rather from local investors searching for higher yields.[4]

1. Standard & Poors, *S&P Global Market Intelligence, Deal Trends in Latin America, Issue 12* (Sept 2020).
2. LAVCA and EMPEA, *Latin America Mid-Year 2020 insights*.
3. Standard & Poors, *S&P Global Market Intelligence, Deal Trends in Latin America, Issue 12* (Sept 2020).
4. LAVCA and EMPEA, *Latin America Mid-Year 2020 insights*.

What's Next?

Some pessimism about the near term future of the regional economies persists among LPs and GPs, particularly with respect to 2021. Looking ahead, the International Monetary Fund does not expect any growth in the region through 2025. But is this a case of *it's always darkest before dawn?* Does this negative sentiment actually offer good opportunities to foreign investors willing to adopt a contrarian view on the region's future and to take advantage of low valuations and favorable exchange rates? Experienced investors in the region believe that these opportunities indeed could materialize, particularly if the business-friendly legal reforms, privatizations, and partnerships with the private sector being launched by regional governments succeed.

For example, Brazil has adopted important reforms over the last two years involving the country's expensive pension system and complex labor legislation. In addition, last year, Brazil enacted Law No. 13,874, an Economic Freedom Act aimed at reducing government intervention in business activity. And the Brazilian Congress now has approved a simplified legal framework to draw investments to its sanitation sector and amended the Bankruptcy Code to, among other things, facilitate distressed investments. The federal government's executive branch, in turn, has promised auctions of dozens of state-owned assets by year end, as well as tax and administrative reforms in 2021.

Especially significant to private equity investors is Brazil's recent clarification of its private-equity tax regime for FIPs (*Fundos de Investimento em Participações*), which exempts offshore investors from paying taxes on exit gains. In recent years, the Brazilian tax authorities have challenged the eligibility of non-resident investors to the FIP exemption. This has included asserting that the jurisdiction of such investors' beneficial owners—and not just that of the investing vehicles—should be considered in assessing their tax domicile. In December 2019, however, the Brazilian tax authorities acknowledged that the investing vehicles' jurisdiction should be operative, except for sham or fraudulent circumstances.

Other reforms aimed at attracting investments are occurring across the region. Colombia, for instance, recently issued new regulations deferring income from private equity or collective investment funds, as well as rules on permanent establishments. And Chile has enacted new tax legislation allowing tax amortization of all intangibles acquired from June 2020 to December 2022.

The third-quarter business headlines provide anecdotal support for a more optimistic view, with: (1) a large global sponsor raising a USD 2 billion Latin American-focused fund; (2) the Brazilian IPO market on track to a record year since 2007, and deal activity giving signs of a rebound; and (3) stiff competition for large Brazilian assets (*e.g.* Localiza, StoneCo and Laureate Education).

Overall, the pandemic's difficulties have created an impetus from local governments to attract foreign capital to help jumpstart the region's economies. If some of these reforms succeed, and the third quarter's positive outlook continues, their impact—together with low valuations and cheap currencies—could increase private equity activity. But to the extent new interest in Latin American targets indeed materializes, investors still will have to continue focusing on the other risks that comprise the regional landscape.

Of particular relevance, compliance risk persists as a significant consideration in PE deal-making, only exacerbated by the COVID-19 pandemic and associated challenges. The anti-corruption enforcement revolution that began several years ago in Brazil has continued reverberating throughout the region, notwithstanding various difficulties encountered along the way. Because compliance risk can materially impact the value and appropriateness of a potential investment, PE firms in Latin America and beyond are increasingly mindful of such risk when screening, managing and exiting their investments. Against this backdrop of institutional development on the compliance front, other contemporary legal concerns are incrementally making their way into the region's legislative agendas and business practices, with an increased focus on data privacy being particularly noteworthy in Brazil and beyond.

The near-term outlook for private equity in Latin America remains quite uncertain. Nevertheless, given that private equity investments as a percentage of GDP are, according to the Emerging Markets Private Equity Association, less than 0.3% across the region as compared to more than 1.5% in the United States, there still appears to be significant potential for growth in the region.

Debevoise & Plimpton

Exit Trends in Asia

> While IPOs remain an important exit route, the rapidly evolving global regulatory environment, macroeconomic conditions and geopolitical landscape have brought about a shift in preferred listing destinations and investment themes.

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Overview

Private equity exits in Asia often adopt a dual track approach where a portfolio company prepares for an initial public offering and concurrently pursues a possible trade sale through an M&A process. For Asia-based financial sponsors, the capital markets process typically involves a U.S. or Hong Kong stock exchange, although an exit through an A-share offering on a PRC stock exchange has increasingly become a popular alternative. While IPOs remain an important exit route, the rapidly evolving global regulatory environment, macroeconomic conditions and geopolitical landscape have brought about a shift in preferred-listing destinations and investment themes. In addition, as buyers and sellers re-evaluate the risks, and private equity firms adapt to the global pandemic impact on trade sales, PE-to-PE secondary transactions have emerged as a third exit track for financial sponsors in Asia.

IPO Exits

While there were a number of high profile, U.S. IPO exits by Asia-based private equity sponsors this year, largely driven by Chinese technology and "new economy" companies (such as the multi-billion dollar offerings by Lufax and XPeng Motors), domestic Chinese IPO activity has surged due to a combination of geopolitical tensions, regulatory changes that increased the appeal of local listings and continued development of PRC capital market capabilities. In the first three quarters of this year, the Shanghai and Shenzhen stock exchanges recorded 294 new listings for a combined RMB 355.7 billion, representing a 154% increase in funds raised compared to the comparable prior-year period. Furthermore, the "Nasdaq-style" Science and Technology Innovation Board in Shanghai (the "STAR Market") recorded 113 listings and raised a total of RMB 187.2 billion during such period, constituting approximately 53% of all funds raised in the A-share market.

At the same time, the Hong Kong Stock Exchange remains an attractive listing destination, with activity driven by, among others, U.S.-listed Chinese companies pursuing "take private" transactions and secondary listings as well as private equity exits. As of September 30, 2020, seven of these secondary listings have been completed, including those of JD.com, NetEase and Yum! China, raising a total of HK$102 billion and representing approximately 48% of the funds raised during such period. Moreover, the currently suspended dual listing in Hong Kong and the STAR Market of Ant Group would have been one of the largest IPOs in history, and there are reports that ByteDance (the parent of TikTok) and DidiChuxing (the Uber of China) are similarly considering Hong Kong IPO plans.

M&A Activities

M&A exit activity in Asia has slowed significantly as a result of the Covid-19 pandemic, and while cross-border transactions continued to take place, they have been conducted on a much more selective basis, often involving market leaders and high quality companies. On the other hand, deal-making in certain sectors, especially those utilizing technology to provide healthcare products and services, such as telehealth and online pharmacy, have increased in light of Covid-19.

On the other hand, deal-making in certain sectors, especially those utilizing technology to provide healthcare products and services, such as telehealth and online pharmacy, have increased in light of Covid-19.

"Going private" transactions by U.S.-listed Chinese companies have been a key driver of cross-border M&A activity in Asia, with four deals representing an aggregate transaction value of US$8.1 billion announced in the first half of 2020 (including deals involving Sina Corporation, Sogou Inc. and 58.com). With the possible adoption of legislation that would make it more difficult for Chinese companies to remain listed on a U.S. stock exchange, these going private transactions are expected to continue driving deal volume.

Finally, 2020 has been a record year for SPACs (Special Purpose Acquisition Companies), and not surprisingly there has been a significant number of SPAC mergers involving Chinese counterparties. One of the larger transactions involved Chinese co-working space operator Ucommune, which combined with Orisun Acquisition Corp. at a valuation of US$769 million after Ucommune's failed IPO attempt in 2019.

GP-led Fund Secondaries

In light of the significantly higher market volatility and lower M&A activity level prevailing this year in Asia, PE-to-PE secondary transactions have emerged as a third track in exit processes. While there are many different ways to execute these transactions, GP-led secondaries where existing portfolio assets are transferred into a continuation fund (for more discussion on continuation funds, *see page 15*) backed by one or more new anchor LPs have gained immense traction as an additional exit route. GP-led deals typically focus only on a few or even a single asset, and they allow managers to maximize value across a given pool of assets, conduct due diligence and address individual challenges of portfolio companies without the time pressure of expiring funds. Earlier this year, Beijing-headquartered Legend Capital completed a restructuring of its 2008-vintage fund, moving the remaining assets of the fund into a US$200 million continuation vehicle backed by Hamilton Lane for a period of five years. TR Capital also backed a renminbi-to-U.S. dollar restructuring involving seven assets with a net asset value of approximately US$100 million managed by Beijing-headquartered Kinzon Capital, with follow-on capital for new investments. The transaction allowed Kinzon's fund to return a significant portion of capital to existing LPs, particularly domestic LPs who wished to see distributions from their capital commitments. In September of this year, IDG Capital completed a US$600 million Renminbi fund restructuring in which the remaining assets in a mature yuan-denominated fund were transferred into a U.S. dollar-denominated vehicle backed by a consortium of secondary investors led by HarbourVest Partners. The Asian GP-led market looks set to continue growing as GPs seek additional avenues to exit investments and return value to their LPs.

Debevoise & Plimpton

ESG Becomes Part of the EU Investment Equation

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Two important pieces of legislation relating to fund managers' consideration of environmental, social and governance (ESG) factors in their investments will come into force over the next two years, starting in March 2021, namely the Sustainable Finance Disclosure Regulation (the "Disclosure Regulation") and the related Taxonomy Regulation. These regulations will entail a substantial change in operations for most EU fund managers, as they will require fund managers to incorporate ESG considerations into their investment management decisions, and to explain and disclose to investors (as well as the public at large) how they do so.

These regulations will entail a substantial change in operations for most EU fund managers, as they will require fund managers to incorporate ESG considerations into their investment management decisions, and to explain and disclose to investors (as well as the public at large) how they do so.

The new regulations are relevant to EU private equity fund managers, as well as non-EU fund managers that market to European investors under the national private placement regimes in EU Member States.

1. What is changing for fund managers in March 2021?

In March 2021, EU firms will be required to disclose their approach to the consideration of ESG factors in their investment decisions and to make new disclosures for products that take into account ESG factors, in each case, as a condition to marketing and managing funds in the EU. Firms will be required to make much of this disclosure publicly available on their websites. The obligations apply to EU firms that manage and market separately managed accounts as well as commingled funds.

Non-EU managers marketing their funds in the EU are taken to be in scope of these obligations, at least in respect of their funds that are marketed under the national private placement regimes.

There are various "tiers" of disclosure required, depending on the approach a firm takes to integration of ESG factors.

Tier	Application
1 Integration of sustainability risks in investment decision-making process, meaning at the time the investment decision is made and on an ongoing basis during ownership All firms will be required to disclose on their website information about their policies on the integration of **sustainability risks** in their investment decision-making process and remuneration policies. Sustainability risks are environmental, social or governance events or conditions that could cause a **material negative effect on the investment's value**. The rules are not prescriptive on the form of this disclosure. Firms will take different approaches, but it is likely that many will make fairly high level statements about their approach to consideration of ESG factors in their investments.	All firms (firm and product level)

Tier	Application
2 Principal adverse impacts - Non-value items Firms are required to disclose, at entity and product level, information about their policies on **principal adverse impacts (PAI)** on sustainability factors. Sustainability factors are environmental, social and employee matters, respect for human rights and anti-corruption, **irrespective of the effect on an investment's value**. There is currently uncertainty as to the form of the principal adverse impacts statement; draft rules put forward a list of at least 32 "impact indicators" (such as carbon emissions) that all firms must assess and monitor at the initial investment stage, and on an ongoing basis, on a firm-wide and product level. Many EU private equity managers are able to opt-out of the requirement and are likely to do so, at least on the basis of the current draft rules, as most firms do not obtain the level of detailed information on ESG factors foreseen in the draft rules. Some larger managers are expected to opt-out of the "firm-wide" disclosure, but use best efforts to adopt a form of the disclosure on a product-by-product basis. Investor expectations in this regard will need to be monitored.	Larger firms[1]; opt-in approach for smaller firms (firm and product level)
3 Products that promote "environmental or social characteristics" Managers that actively offer **products that promote environmental or social characteristics** are subject to special disclosure (Article 8 funds). This level of disclosure ensures extensive information on the approach to ESG considerations. The draft rules require disclosure of information on the sustainability indicators considered, how the indicators are monitored, the methodologies used and a description of due diligence and engagement policies. Disclosures need to be made at the pre-contractual stage and as part of the annual investor reporting (which will show the degree to which the environmental or social characteristics are attained). Firms will be required to make all the information disclosed to investors publicly available. Although there is some uncertainty about the level of promotion of ESG factors that entails compliance with this tier of disclosure, it is likely to apply to any manager that describes its product, on its website or in its PPMs, as one that incorporates ESG factors.	Funds that promote environmental or social characteristics
4 Products with sustainable investments as their objective Products with **sustainable investments as their objective** (Article 9 funds) are subject to specific disclosure requirements similar to those for products that promote environmental or social characteristics, focusing on the specific goals, how the goals are measured and the degree to which they are attained.	Impact funds

1. A larger firm for this purpose is a firm that has more than 500 employees or is the parent of a "large group" (a consolidated group for accounting purposes) which employs more than 500 employees.

2. Investors' perspective

The Disclosure Regulation provides for different levels of disclosure, and it is possible to "opt out" of certain of the requirements. That said, EU managers should be mindful of the expected preference for EU institutional investors to seek products that are classified as "sustainable" according to the EU definitions, in part due to public opinion and also because of the regulatory requirements to which such institutional investors will themselves become subject. Certain regulated EU investors (such as managers of private pension schemes) will be subject to the Disclosure Regulation and will request disclosure of ESG considerations in standardised form from EU firms in order to meet their own objectives and commitments. For other investors, such as insurance companies, it is expected that similar changes will follow in their regulatory framework (*i.e.* Solvency II Directive).

3. Taxonomy Regulation: a new classification system to measure performance

The other important piece of legislation is the Taxonomy Regulation which is in part linked to the Disclosure Regulation. Reflecting the EU's plan to achieve carbon neutrality by 2050, the Taxonomy Regulation initially focuses on climate change issues. It introduces uniform technical "screening criteria" to be applied where a fund either promotes environmental characteristics (see tier 3 above) or contributes to an environmental objective (see tier 4 above). With respect to such funds, the screening criteria of the Taxonomy Regulation must be applied to determine whether and to what extent an economic activity (such as wind power generation, reforestation or building renovation) is environmentally sustainable. The Taxonomy Regulation is effective on 1 January 2022 (in respect of the two climate change objectives) and 1 January 2023 (for the other environmental objectives).

The Taxonomy Regulation requires that with respect to such funds, the pre-contractual information must exactly specify to what extent the product invests in economic activities that qualify as environmentally sustainable and that are in accordance with the technical screening criteria.

Because the Taxonomy Regulation provides a common framework for assessing the environmental sustainability of an activity, investors are likely to ask whether a manager complies with the taxonomy, in particular for a product with environmental goals. For products that contribute to an environmental objective, firms must use the standards set in the Taxonomy Regulation to determine whether an activity qualifies as environmentally sustainable or not, and there is some uncertainty as to the approach that managers should adopt where they cannot collect the relevant data from the underlying investments.

About the Debevoise Private Equity Group

A trusted partner and legal advisor to a majority of the world's largest private equity firms, Debevoise & Plimpton LLP has been a market leader in the Private Equity industry for over 40 years. The firm's *Private Equity Group* brings together the diverse skills and capabilities of more than 300 lawyers around the world from a multitude of practice areas, working together to advise our clients across the entire private equity life cycle. The Group's strong track record, leading-edge insights, deep bench and commitment to unified, agile teams are why, year after year, clients quoted in *Chambers Global, Chambers USA, The Legal 500* and *PEI* cite Debevoise for our close-knit partnership, breadth of resources and relentless focus on results.

Debevoise & Plimpton LLP is a premier law firm with market-leading practices, a global perspective and strong New York roots. We deliver effective solutions to our clients' most important legal challenges, applying clear commercial judgment and a distinctively collaborative approach.

Law 360

GROUPS of the YEAR 2019

PRIVATE EQUITY CAPITAL MARKETS

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GROUP of the YEAR 2020

FUND FORMATION

British Legal Awards

BANKING AND FINANCE TEAM OF THE YEAR, 2020

Private Equity International Awards Hall of Fame 2019

20 PEI AWARDS

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2019 Investment Funds

LAW FIRM of the YEAR

Chambers Global, Chambers USA, The Legal 500 US

Ranked as a leading private equity-focused law firm

Benchmark Litigation

Private Equity lawyers recognized among Top 250 Women in Litigation

Private Equity Report

Circulated to more than 15,000 private equity professionals worldwide