Debevoise & Plimpton

The Private Equity Report Quarterly

2022 Private Equity Mid-Year Review and Outlook | Volume 22, Issue 2

From the Editors

As we head into the second half of the year, geopolitical and economic uncertainties persist, and markets around the globe have slowed accordingly. While private equity fundraising and M&A activity levels remained generally strong in the first half of the year (although comparatively weaker than 2021), the macroeconomic environment, market volatility and heightened regulatory oversight present challenges to which the private equity industry will need to adapt. We may see increasing competition in fundraising in the second half of the year, as the demand by sponsors for capital continues to be strong, as well as the increasing use of bespoke structures that are tailored to investors' needs and warehousing vehicles as alternative sources of capital. Meanwhile, as overall M&A activity slows, we anticipate that continuation funds and fund-to-fund transactions will remain popular. More generally, we expect parties to deploy more creativity in structuring and bridging valuation gaps to get deals over the finish line, including in the secondaries market as well as M&A and leveraged finance transactions.

continued on page 2

"Is it a market indicator when the Fed chairman's buying scratch-offs?"

CELEBRATING 20 YEARS THE PRIVATE EQUITY REPORT

What's Inside

Changes also continue to unfold on the regulatory front worldwide, creating additional compliance obligations for sponsors and impacting execution of transactions. We have previously reported about heightened scrutiny by U.S. antitrust regulators on the private equity industry (see *FTC Sharpens Focus on Private Equity* and *Navigating the Dynamic World of Antitrust Divestitures*). In addition, as interest in socially responsible business practices and investment strengthens, regulators in the United States, the UK and the European Union have either published or already put into effect ESG-related disclosure proposals.

We hope you find the 2022 Private Equity Mid-Year Review and Outlook to be a helpful reference to the remarkable array of market and regulatory changes currently underway.

CONTRIBUTOR
Chambers
Global Practice Guides
Private Equity
2021

Issue Editors

Jennifer L. Chu
jlchu@debevoise.com

Brett M. Novick
bmnovick@debevoise.com

Fundraising

Sally Bergmann
Partner—New York
sbergmann@debevoise.com

Jennifer R. Cestaro
Associate—New York
jrcestaro@debevoise.com

Although the first two months of 2022 were relatively slower in pace, the fundraising market has since continued the strength of the previous year. Many large sponsors deployed the capital of their predecessor funds more quickly than anticipated and are thus quickly returning to the market with new offerings. With investor allocations to private equity continuing to increase, available capital has so far kept pace with demand.

However, whether that continues to be so as sponsors continue to call for dry powder remains to be seen. Indeed, fundraising in the second half of the year is expected to become quite competitive, especially for smaller and middle market firms squaring off against larger, more established managers for capital. Because of the number of sponsors raising new funds, many investors, especially larger institutional investors, may already be fully allocated, or nearing full allocation, for the year. These investors appear to be prioritizing their relationships with larger, more established managers, who often require sizeable commitments and may be fundraising for a variety of products simultaneously. Private equity firms may therefore elect to postpone closings until next year, in order to have access to investor pipelines that are already full for 2022 but may have capital available to invest in 2023. Smaller and middle market sponsors who were originally planning to launch new funds in 2022 are now expected to move their initial closings to either late 2022 or early 2023 in order to avoid a prolonged fundraising period.

We expect to continue to see high levels of participation in private equity by retail, insurance and non-U.S. investors, as these investors seek to expand their exposure to private markets. Given the heightened competition for capital by sponsors, sponsors may be more open to considering offering bespoke structures tailored to these investors' needs in exchange for larger commitments to one or more of their funds. One such offering that we are seeing with increased prevalence is a collateralized fund obligation structure, which provides insurance companies with access to multiple funds of a particular sponsor. Sponsors are also increasingly targeting capital from high net worth retail investors in both U.S. and non-U.S. markets, particularly from banking institutions.

In terms of exits, we expect to continue to see a significant uptick in the use of continuation funds. These opportunities are suitable for sponsors looking to provide their investors with liquidity while still retaining control of portfolio companies that such sponsors believe have further value-creation potential beyond their typical hold period. By offering investors the choice of receiving cash, sponsors also hope that such cash will then be reinvested into the sponsor's new funds.

The longer-term effects of inflation and global events such as Russia's invasion of Ukraine remain to be seen. While these developments have not significantly affected the fundraising market thus far, sustained macroeconomic uncertainty could dampen investors' future allocations to private equity. Were that to occur, we would expect sponsors to continue to use warehousing vehicles and other creative methods to invest in new deals and continue to build their track records as they wait for new capital to be raised.

Private Funds Transactions

Katherine Ashton
Partner—London
kashton@debevoise.com

Ezra Borut
Partner—New York
eborut@debevoise.com

E. Drew Dutton
Partner—New York/Hong Kong
eddutton@debevoise.com

Jane Engelhardt
Partner—New York
jengelhardt@debevoise.com

Andrew C. Rearick
International Counsel—London
acrearick@debevoise.com

Zhiyan Cao
Counsel—New York
zcao@debevoise.com

Andrew J. Gershon
Counsel—New York
ajgershon@debevoise.com

Activity in the secondaries market during the first half of 2022 was colored by market volatility fueled by inflation, increased borrowing costs and the conflict in Ukraine. While there appears to be no shortage of quality assets fit for a secondaries transaction, sponsors and sellers who have the luxury of time appear to be holding off in anticipation of market corrections, while secondary buyers are tightening their deal selection criteria and, where possible, deferring deployment to 2H to see where the dust will settle. Many deals that came to market in the first half of 2022 based on Q42021 or Q12022 sponsor valuations have faced real—and often fatal—repricing risk. At the same time, sponsors have found it increasingly difficult and time-consuming to fill out the secondary investor syndicate necessary to cover the required equity check, particularly in large single-asset transactions.

In the face of these challenges, sponsors and sellers are getting creative in order to get deals over the line. For some time, sponsors have turned to earn-outs and similar provisions to bridge pricing gaps; those strategies have been joined by mechanics for multiple closings, deferred consideration or more flexible use of debt financing and cross-fund equity financing to accommodate potential secondary equity syndication shortfalls. Some sponsor strategies have been more optical in nature, such as bringing valuation dates up a quarter (when supportable by the underlying facts) or communicating deal pricing to their investors using traditional M&A vocabulary (such as multiples of EBITDA) rather than the customary secondaries formulation of discounts to trailing valuations.

The combination of buy-side constraints and growing transaction sizes, particularly at the top end of the GP-led market, have led sponsors to use several vehicles simultaneously to pursue a single transaction. Those vehicles might include a continuation fund, sponsor-managed co-investment vehicles, and one or more of the sponsor's blind pool funds. However, this structure requires the sponsor to manage different entry valuations, return profiles, time horizons and other considerations—all for the same asset(s). Doing so successfully requires sponsors to wear multiple hats at the same time, communicate well with all constituencies and have a well-considered conflicts mitigation plan from the outset.

The rise of continuation funds and strip sales to sponsor-affiliated "annex" funds has also impacted long-standing co-investment terms around exit alignment. A key underlying principle of co-investing is that the co-investor will invest and divest at the same time and on the same terms as the sponsor's fund with which it originally invests. Any transfer of assets from an original fund to a continuation fund or an annex fund, either of which would likely acquire securities from the original fund at a different valuation to the co-investor's entry valuation, may disrupt this alignment if co-investors do not also exit in that transaction. The question as to whether a continuation fund or annex fund transaction represents an "exit" in which co-investors should be able to participate—or be required to participate—is a thorny one for both sponsors and co-investors, whose views may be dependent on unforeseeable facts and circumstances.

Continued on page 5

Private Funds Transactions

Continued from page 4

As more sponsors engage in larger and more complex GP-led transactions, the investor base expands to potentially include several of a sponsor's fund vintages, and affiliated funds such as continuation funds or annex funds, as well as co-investors. Because they are all invested in the same asset but with potentially different entry points and exit considerations, we expect both sponsors and investors will have to grapple with how to manage ongoing conflicts of interest—including regarding exit—that arise in these transactions.

Fund Finance

Thomas Smith
Partner—London
tsmith@debevoise.com

Ramya S. Tiller
Partner—New York
rstiller@debevoise.com

Although the pace of fundraising for smaller and middle market firms has moderated in 2022, the fund finance market has been buoyant as more sponsors turn to fund-level financing solutions. Recent trends behind more sophisticated products, such as NAV facilities, preferred equity and hybrid facilities, have accelerated—and then have been further boosted by turbulence in the leveraged loan market.

In the subscription facility space, pricing has widened modestly, but we still see capital call facilities being raised and extended (even for SMAs) at a good pace. The increase in the use of rated feeder notes as a fundraising tool has led to more discussion regarding the mechanics needed in fund documentation to obtain borrowing base credit for debt commitments. Funds and banks are also dealing with investors tied to sanctioned persons. We have seen several amendments this year to resolve these issues.

Further, as insurance companies look for opportunities to invest in a diversified portfolio of funds, and funds look for ways to access additional capital, there is a rising demand for innovative rated note structures. The past year has seen an increase in the use of such note structures, and we expect their popularity to continue to grow so long as market performance is strong and insurance regulators do not change the investment classification of the notes issued under these structures.

We also expect to see expanded use of NAV facilities and preferred equity solutions, as well as of hybrid facilities. While the increased use of NAV facilities for buyout funds has been more pronounced in Europe, we expect the trend to begin to gain more traction in the United States. The fund finance market is poised for more growth with the increase of alternative fund finance credit providers, and with sponsors turning to fund-level credit to fill liquidity needs, both as a defensive measure and for opportunistic investments such as purchases of portfolio-level debt.

Leveraged Finance

Brett M. Novick
Partner—New York
bmnovick@debevoise.com

Ryan T. Rafferty
Partner—New York
rtrafferty@debevoise.com

Jeffrey E. Ross
Partner—New York
jeross@debevoise.com

Scott B. Selinger
Partner—New York
sbselinger@debevoise.com

Over much of the last decade, private equity sponsors and their portfolio companies have benefited from the bull market, with low interest rates and robust debt capital markets allowing issuers to add leverage at attractive rates and with borrower-friendly terms. However, beginning in the second half of the first quarter, the market began to show signs of weakness. That softening has continued, with July on pace to have the lowest level of primary issuances in the last 15 years and year-to-date volume showing a dramatic 77% decline compared to 2021.

The few new syndicated financings that made it to market during the past two months have been met with challenges. For many of these offerings, both the underwriting banks and the sponsors have sought modifications to the underwritten terms in order to increase investor demand—modifications that often have gone beyond the "market flex" provided for at signing. The types of modifications have varied depending on the nature of the transaction, but have included shortening of maturities, increasing of rates and original issue discount, increasing of amortization, replacing a portion of the indebtedness with a subordinated or term loan A tranche and a general tightening of covenants. With several large underwritten transactions yet to come to market, we expect participants to be watching to see if any trends emerge regarding which modifications are successful in driving investor demand.

Traditional investment banks have been very cautious to underwrite new transactions. For those transactions that are underwritten, banks are reducing overall leverage, increasing the cost of capital and seeking greater flexibility in terms of market flex. As an alternative to the uncertainty associated with the syndicated markets, many sponsors have turned to private debt funds to provide financing solutions. While private debt funds have increasingly shown an ability to fund transactions of any size, including multi-billion-dollar take-privates, they too have sought to limit new deal exposure in light of current market conditions, general economic uncertainty and the perceived likelihood of a recession.

Looking forward, we expect these tumultuous conditions to continue for the remainder of the year. As such, we expect both traditional investment banks and private debt providers to take a more cautious approach to underwriting new investments and to seek tighter covenant packages on the deals that they do underwrite. We also expect to see more sponsors simultaneously consider both syndicated and private debt options for their transactions in order to ensure that they are obtaining the most attractive financing available.

M&A (U.S.)

Christopher Anthony
Partner—New York
canthony@debevoise.com

Emily F. Huang
Partner—New York
efhuang@debevoise.com

While 2022 began with a continuation of the wave of M&A activity seen in 2021, we enter the mid-year mark amid a slowdown in private equity deal-making. Lingering pandemic disruptions, Russia's war in Ukraine and the economic uncertainty brought on by rising inflation and interest rates have all had a chilling effect, leading to valuation gaps between prospective buyers and sellers. In particular, private equity M&A activity has been hampered by the limited appetite of traditional lenders to provide debt financing, as those banks seek to offload commitments from deals signed before the onset of the Ukraine war and face significant losses on those loans. To fill this financing gap, the deals that are being signed are relying heavily on direct lenders and bigger equity checks. For these reasons, sponsors are being more selective about the deals they pursue and bring to their lending relationships (for a more in-depth discussion, please refer to the previous Leveraged Finance section).

We anticipate a continued transition period as buyer and seller expectations reset, particularly in light of the combination of lower asset prices and increased financing costs. We expect the relative certainty provided by continuation fund and fund-to-fund transactions to continue to be popular in this environment. Given the depressed public markets, sponsors may find take-private transactions attractive, but public boards may not be receptive in light of what they may perceive to be undervalued stock prices. However, if economic challenges persist, public companies may look to private equity sponsors to fund PIPE transactions, much as we saw in the early days of the COVID pandemic.

In addition, private equity M&A activity is increasingly in the crosshairs of U.S. antitrust authorities. Senior officials at both the Federal Trade Commission and the Antitrust Division of the Department of Justice have made public statements signaling enhanced scrutiny of private equity transactions. Particular focus has been brought to bear on private equity roll-ups in sectors such as healthcare (see our discussion of the implications of a recent consent agreement here), with regulators demonstrating willingness to use tools available to them, such as prior approval provisions, including to police deals that may otherwise not have been subject to their review.

M&A (Europe)

Dominic Blaxill
Partner—London
dblaxill@debevoise.com

Geoffrey P. Burgess
Partner—London
gpburgess@debevoise.com

Yiran Ji
Trainee Associate—London
yji@debevoise.com

European private equity M&A activity had a strong start in 2022. In the first half of the year, 4,053 deals closed with a cumulative deal value of €463.5 billion, marking year-on-year increases of 16.2% and 34.8%, respectively. This activity was supported by a continued abundance of dry powder, healthy lending markets and more advantageous deal multiples.

The desire of private equity firms to grow their AUM and expand into new sectors has led to greater M&A activity in the asset management sector. Near the end of 2021, for example, CVC acquired Glendower Capital. This year, EQT announced its purchase of

Continued on page 8

M&A (Europe)

Continued from page 7

Baring Private Equity Asia for €6.8 billion to increase its presence in Asia while Carlyle announced its purchase of Abingworth, a life sciences investment firm, enhancing Carlyle's expertise in that arena.

As a result of the war in Ukraine and deteriorating macroeconomic conditions globally, many are predicting a slowdown in deal activity. Indeed, a closer analysis of the data reveals that while deal value in H1 2022 was high, this was driven largely by deal size (as opposed to deal count) and exit volume remained flat with a cumulative exit value of €157.8 billion, marking a 25.3% year-on-year decrease in exit value. Growing fears of recession may reduce activity levels further, given private equity's preference for investing in fast-growing economies and the increased cost of capital to finance buyouts, due to rising interest rates. Consider that Germany has reduced its GDP growth forecast for 2022 from 4.6% to 1.8%. In the UK, inflation is expected to exceed 10% in Q4 2022 and GDP growth is forecast to be flat in 2023, down from a previous forecast of 2.1%.

These macroeconomic conditions may affect certain sectors more than others. Rising inflation, labor shortages and supply chain issues could lead to a preference for targets with strong balance sheets that can resist those threats. Companies that cannot pass on higher costs to customers may become less attractive targets, which could lead to greater M&A activity in the inflation-hedging industrial, healthcare and energy sectors. The recent public market sell-off might lead to greater take-private and carve-out opportunities.

In any event, we expect to see increased M&A activity driven by the quest for decarbonization. Two of the largest European buyouts in Q1 2022 (of Suez Environment and Falck Renewables) were in the sustainability sector. In February, First Reserve made a strategic investment in Venterra, an offshore wind energy services business, while Occidental Petroleum is in the process of acquiring solar power assets to power its drilling operations. As large companies look to divest their high-carbon assets, this might present deal opportunities for private equity buyers.

As predicted in our 2021/2022 Private Equity Year-End Review and Outlook, private equity firms can expect greater regulatory scrutiny. At the end of May, the acquisition of Newport Wafer Fab by Nexperia and Altice's acquisition of a 6% stake in BT became the first two transactions to be publicly called in for national security review in the UK under the wide-reaching National Security and Investment Act 2021, which came into force on 4 January 2022 (and is in effect for transactions completed on or after 12 November 2020). Meanwhile, the UK's Financial Conduct Authority announced its intention to be more assertive and to "test [its] powers to the limit" under a formal transformation program taking place in 2022. As a result, we expect regulatory approval conditions to become increasingly common in deals. Private equity buyers may be required to give economic undertakings (for instance, not to undertake employee restructurings so as to maintain employment levels) to seal regulatory approval.

M&A (Asia)

William Y. Chua
Partner—Hong Kong
wychua@debevoise.com

Sheng Shao
Associate—Hong Kong
sshao@debevoise.com

Following heightened transaction activity in 2021, the pace of Asia-Pacific M&A deals slowed in the first half of 2022, although deal volume held up relatively well compared with other parts of the world. In particular, Asia-Pacific deal volume in the first quarter of 2022 was roughly in line with pre-pandemic levels. With most countries in the Asia-Pacific region lifting their strict Covid-19 restrictions, prospects of an economic rebound in the region are firming up, although downward pressure on overall deal activity likely will persist due to the ongoing geopolitical environment and volatile market conditions. China's continued adherence to a strict Covid-19 policy adds additional uncertainty to the region's economic prospects.

Not surprisingly, much of the region's decline in PE M&A deal volume this year can be traced to China, with commitments by private equity to China down roughly 50 percent in the first four months. Even so, China continued to attract the lion's share of total private equity investments in the region in the first half of 2022. Healthcare accounted for about a quarter of total deal activity in China for this period, emerging as a favored destination for foreign investment given the heightened regulatory scrutiny of the Chinese technology, education and real estate sectors. While senior Chinese government officials have indicated that Beijing will take measures to support the economy and financial markets, it remains to be seen whether cross-border transactional activity involving China will rebound in the foreseeable future.

The shroud of uncertainty hanging over M&A in China prompted investors to look elsewhere—most notably to Australia and South Korea, where total deal volume for the first half of 2022 increased roughly 300 percent and 80 percent, respectively, compared with the first half of 2021. The jump in deal volume in Australia was partially driven by an active take-private market. Witness, for example, the A$3.4 billion acquisition of Uniti Group Limited, a publicly listed telecommunications services provider, by HRL Morrison & Co and Brookfield Infrastructure Group.

Japan is seeing its own flurry of take-private activity, including the ongoing $20 billion take-private of Toshiba (which would be Japan's biggest ever take-private deal), and Hitachi's recent sale of its 40 percent stake in logistics company Hitachi Transport System to KKR as part of a $5 billion deal.

If M&A activity in China has downshifted, exits were in overdrive during the first half of 2022. IPO activity in China raised twice the amount of funds raised on Wall Street. Chinese capital markets are expected to perform strongly for the remainder of the year, benefitting from their relative insulation from major macroeconomic and geopolitical events, including the Russia-Ukraine conflict and the U.S. Federal Reserve's reduction of its balance sheet and interest rate hikes. The implementation in the United States of the Holding Foreign Companies Accountable Act may result in significant de-listings from U.S. stock exchanges of Chinese companies starting in 2023.

GP-led secondary transactions continued to grow as an alternative exit option for private equity in Asia, with a great deal of activity driven by continuation funds. Two recent

Continued on page 10

M&A (Asia)

Continued from page 9

examples include L Catterton's $360 million multi-asset continuation fund, which is set to acquire a structured minority interest in certain private assets in the consumer services, health and wellness and specialty food and beverage categories in Asia, and Hosen Capital's $280 million single-asset continuation fund for Kilcoy Global Foods, a beef processing business in Australia.

Finally, while special purpose acquisition companies (SPACs) made their debut in Singapore and Hong Kong earlier this year, investors are cautious—just as they now are in the United States. Hong Kong's only SPAC raised $130 million and the three in Singapore raised a total of $334 million.

International Economic Sanctions

Satish M. Kini
Partner—Washington, D.C.
smkini@debevoise.com

Robert T. Dura
Counsel—Washington, D.C.
rdura@debevoise.com

Isabel Espinosa de los Reyes
Associate—New York
iespinos@debevoise.com

In response to the invasion of Ukraine, the United States has imposed an unprecedented array of sanctions, including targeted sanctions against Russian elites and entities. As a result, many wealthy Russian individuals and financial institutions are now targets of U.S. sanctions, and restrictions on new investment in Russia and on providing certain services to Russian persons raise significant challenges for continued business dealings in or involving Russia. Further, these challenges can arise even when dealing with non-sanctioned counterparties.

Private equity funds and their sponsors should be aware of the following sanctions developments:

- *Prohibition on New Investments by U.S. Persons:* All "new investments" in Russia by U.S. persons are prohibited. "New investment" is defined as the commitment of capital or other assets for the purpose of generating returns or appreciation, made on or after April 6, 2022, and includes (i) purchasing equity interests in, or equity or debt securities of, an entity located in Russia; (ii) entering into an agreement requiring the commitment of capital for projects or operations in Russia; and (iii) lending funds to persons located in Russia for commercial purposes.
- *Prohibition on Certain Services by U.S. Persons to Persons Located in Russia:* U.S. persons cannot provide accounting, trust and corporate formation, and management consulting services to any person located in Russia, unless related to (i) services to a U.S.-owned or -controlled entity in Russia; or (ii) services in connection with the wind-down or divestiture of an entity located in Russia that is not owned or controlled by a Russian person.
- *Blocking Sanctions:* Generally, U.S. persons are prohibited from any dealings involving, and are required to freeze the assets of, designated persons ("SDNs") and any entities that are owned (directly or indirectly) 50% or more by such designated persons. Although only U.S. persons are required to comply with the blocking sanctions, the United States has authority to apply "secondary sanctions" on non-U.S. persons that have "materially assisted, sponsored, or provided financial, material, or technological support for, or goods or services to or in support of" blocked persons.

Continued on page 11

International Economic Sanctions

Continued from page 10

- *Evasion of Sanctions:* Generally, any transaction that evades or avoids, has the purpose of evading or avoiding, or causes a violation of or attempts to violate U.S. sanctions is also prohibited.

We have seen these new sanctions affect private equity funds in two principal ways:

- *Designated LPs.* Once an LP in a U.S. fund or U.S.-managed fund becomes the target of blocking sanctions, nearly all dealings with that LP will become restricted. As such, absent a license or exemption, no distributions, redemptions or payments involving the LP can be processed, and no subscriptions or contributions from the LP can be accepted. The LP's interest in the fund must be blocked and segregated from other investors' interests in the fund, and the fund or its manager may be required to notify OFAC.

The implications of having an LP designated for sanctions will vary, and the limited partnership agreement of each fund may provide for or require certain actions regarding sanctioned LPs. For example, some agreements may allow for a capital call from the other limited partners or for a new limited partner to replace the sanctioned one. There may be other implications for the fund as well, regarding, for example, the fund's credit-related obligations (*e.g.*, repeating representations in a credit agreement) or representations made by the fund regarding its portfolio companies or other investments.

- *Restricted Portfolio Companies.* For western managers and investors, attempting to continue operations in Russia under the cloud of sanction risk is difficult, and many investment managers and investors are divesting local assets or are seeking to do so. In many cases, the restrictions on new investments and certain services, considered together with the increased difficulty of conducting business in Russia without involvement of sanctioned persons, has significantly altered risk assessments, leading many to seek to exit the market.

In the face of this unprecedented array of U.S. sanctions, which are coupled with significant EU and UK sanctions, we recommend that funds ensure that they have sufficient insight into their LPs to be able to quickly identify sanctions-related risks, usually through screening processes. Proactive steps also can be taken to identify relevant sanctions-related representations and commitments for funds and their sponsors, which are often set out in the limited partnership agreement, side letters and financing arrangements. Finally, many funds are now conducting sanctions-related risk assessments of their portfolio companies, probing their activities and investments regarding Russia and considering whether mitigating steps are warranted.

CFIUS

Ezra Borut
Partner—New York
eborut@debevoise.com

Jeffrey P. Cunard
Of Counsel—Washington, D.C.
jpcunard@debevoise.com

Andrew Field
Associate—Washington, D.C.
alfield@debevoise.com

At its inaugural conference, held on June 16, 2022, the Committee on Foreign Investment in the United States ("CFIUS") and representatives from across the U.S. government highlighted three important themes for acquirers, including private equity sponsors:

- The evolution of CFIUS priorities in an environment of heightened geopolitical uncertainty;
- An increased focus on data security risks; and
- The enhanced role for CFIUS in the U.S. national security framework.

Although none of these themes are surprising, CFIUS's emphasis merits an increased and broader focus on acquisitions by foreign persons in U.S. businesses.

Evolving Risk Assessment. CFIUS spotlighted three considerations when analyzing the national security risks presented by foreign acquirers of U.S. businesses:

(1) the threat posed by the foreign acquirer; (2) vulnerabilities of the U.S. business that an acquirer with ill intent could exploit; and (3) potential consequences of a foreign threat actor exploiting those vulnerabilities. Recent geopolitical developments continue to inform assessment of foreign investment risks. No longer may it be assumed, for example, that goods will flow freely across borders. Accordingly, CFIUS will be more sensitive to the effect of foreign acquisitions on U.S. supply chains, including by more carefully considering the "friendly" or "adversarial" nature of foreign acquirers' home countries. Foreign acquisitions of vendors to U.S. businesses that may be well-positioned to threaten industries implicating heightened national security risks, such as defense and telecommunications, will be the subject of special focus.

Data Security Risks. Three concerns contributing to CFIUS's increased scrutiny of data security risks were discussed: (1) remote work following the global pandemic has aggravated IT vulnerabilities; (2) advances in technology allow threat actors to better exploit those vulnerabilities; and (3) once data is breached, no mitigation is possible. These concerns are not limited to data that is personally identifiable, given that artificial intelligence, machine learning and statistical methods may permit purportedly anonymized data sets to be re-identified. Further, depending on the transaction, risks may arise from the foreign acquirer's ability to amass and combine information through large and varied data sets, even if such data is otherwise seemingly innocuous.

In analyzing potential threats, CFIUS will consider the aggravating and mitigating effect of other applicable legal regimes. For example, data that is also subject to protection by a rigorous regulatory regime, such as the Health Insurance Portability and Accountability Act, will be viewed positively. By contrast, a foreign acquirer whose home country can compel the production of proprietary data may face additional challenges when seeking CFIUS approval for a transaction.

Enhanced Role for CFIUS. CFIUS's increased resources have allowed it to be more proactive in its review of transactions. With its augmented staff, CFIUS now has greater

Continued on page 13

CFIUS

Continued from page 12

capacity to review press releases and Securities and Exchange Commission filings to identify non-notified deals that could pose national security concerns. In addition, CFIUS intends to more closely scrutinize compliance with post-transaction mitigation agreements; ad hoc site visits will become more common, especially as pandemic restrictions ease.

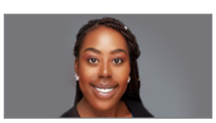
Congress has noted CFIUS's success and legislators have proposed that CFIUS (or a CFIUS-like agency) be given the authority to review outbound investment by U.S. investors into countries of concern. In addition, other jurisdictions are instituting their own national schemes for review of foreign inbound investment, modeled, in some cases, on CFIUS. As a result, national security issues will play a larger role in all types of cross-border transactions.

Capital Markets

Morgan J. Hayes
Partner—New York
mjhayes@debevoise.com

Peter J. Loughran
Partner—New York
pjloughran@debevoise.com

Steven J. Slutzky
Partner—New York
sjslutzky@debevoise.com



Chika Ojukwu
Law Clerk—New York
coojukwu@debevoise.com

In March 2022, the SEC proposed new rules and amendments designed to enhance investor protection in initial public offerings and de-SPAC transactions by special purpose acquisition companies (SPACs). The proposed changes, which reflect increased regulatory scrutiny of the SPAC market, would add significant disclosure obligations and structural limitations on de-SPAC transactions that would likely remove any advantages that de-SPAC transactions have historically had over traditional IPOs. These developments would have considerable implications on both the costs to SPAC sponsors and the exit opportunities for private companies that SPACs have long provided.

Private equity firms should pay particular attention to the proposed amendments seeking to more closely align the requirements of de-SPAC transactions with those of traditional IPOs, add fairness disclosures to the merger proxy for de-SPAC transactions and expand potential liability in de-SPAC transactions. The proposed changes include:

- A new requirement mandating that a SPAC seeking to conduct a de-SPAC transaction disclose in the merger proxy whether it reasonably believes the transaction is fair to the SPAC's unaffiliated security holders, along with the basis for that determination. This requirement is likely to prompt SPAC boards to seek fairness opinions from financial advisors before approving a de-SPAC transaction, a practice that has been historically uncommon in de-SPAC transactions—thus adding time and cost to the process.
- Enhanced disclosure requirements relating to SPAC sponsors and potential conflicts of interest, requiring that a SPAC specifically disclose any actual or potential material conflict of interest between (1) the sponsor, the sponsor's affiliates or the SPAC's officers, directors or promoters; and (2) unaffiliated security holders. These enhanced requirements also mandate disclosures relating to the dilution of shareholder interests, including tabular dilution disclosures resulting from the expected post-closing capital structure, including SPAC sponsor warrants and PIPE financings.
- Expanded underwriter liability for participants in de-SPAC transactions. Under proposed Rule 140a, an underwriter in a SPAC IPO would be deemed an underwriter

Continued on page 14

Capital Markets

Continued from page 13

in a subsequent de-SPAC transaction if the underwriter takes steps to facilitate the de-SPAC transaction, including acting as M&A financial advisor or as placement agent with respect to private investment in public equity (PIPE) financing in connection with the de-SPAC transaction. We are already seeing market practice shifting as a result, with investment banks working on de-SPAC transactions requiring enhanced diligence procedures akin to traditional IPOs, including obtaining auditor "comfort" letters and legal opinions, increasing both the costs and time of de-SPAC transactions.

- Amending the definition of "blank check company" to remove the Private Securities Litigation Reform Act of 1995 (PSLRA) safe harbor for forward-looking statements in SEC filings by SPACs, including with respect to financial projections of the target company in de-SPAC transactions. SPAC market participants have historically looked to the availability of the PSLRA safe harbor as a key differentiator from traditional IPOs due to the protections it provides for publishing projected financial information to investors.

These new rules and amendments will likely chill an already weary SPAC market, add additional costs for SPAC sponsors and lengthen the timelines for de-SPAC transactions.

UK Tax

Richard Ward
Partner—London
rward@debevoise.com

Jennifer Wheater
International Counsel—London
jwheater@debevoise.com

Paul Eastham
Associate—London
peastham@debevoise.com

Christopher Gossage
Associate—London
cgossage@debevoise.com

Investment funds should be mindful of two key tax measures that came into effect in the UK this April, as well as ongoing developments regarding proposals from the EU and OECD relating to taxation.

Qualifying Asset Holding Company Regime

The UK's new QAHC regime, designed to put the UK on par with Luxembourg as an attractive jurisdiction for establishing fund investment holding entities, came into effect on 6 April 2022. While imperfections remain in the current legislation, HM Revenue & Customs are actively engaged in understanding market concerns and, indeed, released certain helpful modifications to the regime (in draft) on 20 July 2022. Interest in the regime among UK investment funds appears strong. (For more on the QAHC, please see the Spring 2022 Private Equity Report.)

Health and Social Care Levy

The UK's Health and Social Care Levy also came into effect on 6 April 2022, increasing certain UK tax rates by 1.25%, affecting the UK's tax rates for salaries (among other remuneration) and dividend income. National Insurance Contributions (NICs) are now 3.25% for employees and 15.05% for employers, while dividend income tax increased to 39.35% for additional rate taxpayers.

ATAD III

The EU's draft Anti-Tax Avoidance Directive III (also known as the "Unshell" Directive), published on 22 December 2021, introduced provisions for a regime aimed at countering the misuse of shell entities for tax purposes. If adopted, the regime would require EU

Continued on page 15

UK Tax

Continued from page 14

resident entities determined to be "at risk" of being shell companies to submit enhanced reporting to tax authorities in order to confirm the entity's "substance." The Directive would also deny certain tax benefits under tax treaties or EU Directives (such as the Parent-Subsidiary Directive or Interest and Royalties Directive) to shell entities that do not meet the minimum substance requirements.

On 12 May 2022, ECON, the Committee on Economic and Monetary Affairs of the European Parliament, published proposed amendments to the draft Directive that would significantly limit its application to the funds industry in two key ways. Under the current draft, an entity would be determined to be a shell entity if the entity has outsourced the administration of day-to-day operations and the decision-making on significant functions in the preceding two tax years, even where it does so to another group entity in the same jurisdiction which has real substance there. ECON proposes that the outsourcing of management to an "associated enterprise" within the same jurisdiction would not trigger ATAD III. Second, the current draft excludes from the scope of the Directive "regulated financial undertakings" (*e.g.* AIFMs, supervised AIFs, and UCITS)—but not holding entities set up below those undertakings. ECON proposes that these holding entities, such as below-the-fund holding companies that commonly access treaty benefits in investment fund structures, be excluded as well. The vote on these proposed amendments is expected to be held in September 2022.

In light of the controversy that ATAD III has generated among EU member states, its proposed adoption has been pushed back a year, to 1 January 2025. However, as certain key tests under this regime apply a two-year lookback, the substance of EU resident entities in 2023 and 2024 remains relevant and should already be factored into investment fund structuring.

BEPS 2.0

In the past year, the OECD has published follow-up materials on the two pillars of BEPS 2.0, its flagship measures to address tax issues arising from the increasing digitalization of global economies.

Pillar One

Broadly, Pillar One introduces a new approach to the allocation between jurisdictions of a business's taxable profit, focusing on the location of the business's customers or markets rather than the location of its physical presence. These rules are only envisaged to apply to the largest business groups—those with revenues greater than €20 billion (eventually reducing to €10 billion) and profit margins greater than 10%. In the UK, Pillar One would replace the Digital Services Tax.

On 6 May 2022, the OECD published proposals that would exclude regulated financial institutions, such as banks, insurers and asset managers, from the scope of Pillar One. In practice, per the OECD's July 2022 progress report, revenues and profits derived from these "regulated financial services" would be excluded when calculating whether

Continued on page 16

UK Tax

Continued from page 15

the revenue and profitability thresholds have been met. Further, the revenue threshold should serve to exclude most portfolio investments. However, many details of Pillar One remain to be finalised, with the OECD indicating that it will not be implemented before 2024.

Pillar Two

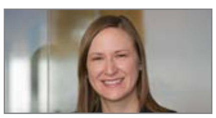
Pillar Two, the global minimum tax (GMT), is developing more quickly than Pillar One but still faces challenges. Fund structures are expected to be largely unaffected provided they do not meet the requirement to prepare consolidated financial accounts, under the applicable accounting standards, for their overall groups or portfolio companies. This position reflects the OECD intention that the Pillar Two rules align with the scope of equivalent rules on Country-by-Country Reporting (CbCR). However, this will need to be reflected in the domestic implementation in each jurisdiction.

On 20 December 2021, the OECD published its model rules on the domestic elements of Pillar Two, which are to be substantively implemented by participating jurisdictions beginning in 2023. The publication of the Model Rules was closely followed, on 22 December 2021, by a draft EU Directive, aimed at facilitating their adoption throughout the EU. Subsequently, the UK, Canada, Japan, Australia and other countries initiated their own processes; the OECD responded by publishing commentary on the Model Rules. However, both the EU (particularly in the face of opposition from Poland and Hungary) and the UK (which published draft domestic legislation on 20 July 2022) have now delayed the commencement of any domestic Pillar Two rules until accounting periods beginning after 31 December 2023. Furthermore, although the Model Rules serve to introduce domestic provisions needed to implement Pillar Two, implementation will also require changes to treaties via a Multi-Lateral Instrument, on which there has yet to be progress. The reality of a GMT thus remains some way off.

Data Strategy & Security | Employment Litigation

Avi Gesser
Partner—New York
agesser@debevoise.com

Jyotin Hamid
Partner—New York
jhamid@debevoise.com



Tricia Bozyk Sherno
Counsel—New York
tbsherno@debevoise.com

Anna R. Gressel
Associate—New York
argressel@debevoise.com

Rachel Tennell
Associate—New York
rmtennell@debevoise.com

A growing number of employers are turning to artificial intelligence (AI) tools to assist in hiring and other employment decisions, including employee promotions, evaluations and terminations. At the same time, regulators and legislators are subjecting these tools to greater scrutiny out of concern that they may be inadvertently discriminatory. These systems, for example, might penalize older women with gaps in their resumes because they have taken time off for childcare. Sponsors and their portfolio companies therefore should pay close attention to the AI tools they use to manage human capital to ensure that they are compliant with these emerging regulations.

At the federal level, the U.S. Equal Employment Opportunity Commission (EEOC) has made it a priority to ensure that AI does not "become a high-tech pathway to discrimination." The Department of Justice also joined the EEOC in warning of potential discrimination risks due to the increased use of AI by employers. In May 2022, the EEOC issued its first non-binding technical guidance regarding how employers' use of AI may violate existing requirements under the Americans with Disabilities Act. Among other things, the EEOC recommends that employers give applicants or employees written notice that they are undergoing an assessment by an AI tool and that they may request a reasonable accommodation or exemption from the tool.

At the local level, New York City recently became one of the first jurisdictions to pass a law aimed at reducing bias in automated employment decisions. As of the date of this publication, similar bills are pending in California and Washington, D.C. The New York City law, which may be a harbinger of legislation elsewhere, takes effect on January 1, 2023 and places several requirements on employers using "automated employment decision tools." The new law defines such tools as any "computational process, derived from machine learning, statistical modeling, data analytics, or artificial intelligence, that issues a simplified output" and replaces or substantially assists decision-making. Notably, the breadth of this definition extends the law to cover a wide variety of tools that do not rely on AI, including game-based tests, resume review tools, and personality assessments. Employer obligations under the New York City law include:

(1) an independent bias audit of the tool;

(2) publishing the results of the bias audit on the employer's website;

(3) notifying any candidate or employee who is a New York City resident that a tool will be used and the characteristics it will consider;

(4) provide candidates or employees residing in New York City with the ability to request an alternative selection process or accommodation; and

(5) disclosing information about the type of data collected for the tool, the source of the data and the employer's retention policy.

Employers using AI tools to hire or promote talent in New York City should assess whether they must take any additional steps to ensure compliance with this new law. Even if they are not covered by the New York City law, most employers using AI are subject to other general anti-discrimination laws. As a result, employers should understand the emerging compliance obligations associated with these tools and the steps that can be taken to reduce risk, including assessing the results of any bias testing conducted by the tool provider.

U.S. Funds Regulatory

Marc Ponchione
Partner—Washington, D.C.
mponchione@debevoise.com

Sheena Paul
Counsel—Washington, D.C.
spaul@debevoise.com

Sasha Burger
Associate—New York
sdburger@debevoise.com

The year so far has seen unprecedented rulemaking activity by the Securities and Exchange Commission directed at investment advisers, including private equity fund managers. As we discussed in the Spring 2022 Private Equity Report, rules proposed during the first quarter of the year included those relating to Form PF, cybersecurity, special purpose acquisition companies, climate change disclosure for public companies, and groundbreaking amendments to the Investment Advisers Act of 1940 that would impose new disclosure and reporting requirements and impose significant new restrictions on private fund advisers. Then, on May 25, the SEC proposed two new rules relating to Environmental, Social and Governance (ESG) practices applicable to investment advisers and to funds registered under the Investment Company Act of 1940. Please see additional discussion of the SEC's May 25 rule proposal in the ESG section below, in addition to a recent short video conversation concerning developments as part of our *Private Equity in Focus: SEC Recap series*.

The first rule relates to ESG-related investment adviser and registered fund disclosure, and includes the following requirements and guidance applicable to private fund advisers:

- *Amendments to Form ADV:* Amendments to Form ADV Part 1A and Part 2A would require disclosure of advisers' consideration of and use of ESG factors and require an adviser to private funds to classify its strategies as "ESG integration," "ESG-focused," and "ESG-impact" depending on the significance of ESG factors in the adviser's investment strategies.

- *Guidance Related to Compliance Procedures and Marketing:* The proposed rule includes guidance reminding advisers that they are prohibited from distributing advertisements that include any untrue statement of a material fact or material omission with respect to ESG representations. The release offers the example of an adviser overstating in an advertisement the extent to which ESG factors into managing its client portfolios.

The second proposed ESG rule would extend the investment company "names rule" under the Investment Company Act of 1940 to ESG funds registered under that act, so that a registered fund using ESG terminology in its name would be required to invest 80% of its assets consistent with that focus. The comment period for these two proposed rule changes ends on August 16. (These and other ESG-related regulatory developments in the United States, the United Kingdom and the European Union are further discussed in the ESG section of this issue.)

The SEC also released its Spring 2022 rulemaking agenda on June 22 (the link to the short-term agenda is here; the link to the long-term agenda is here).

Continued on page 19

U.S. Funds Regulatory

Continued from page 18

The agenda includes several proposed rules and rules to be adopted:

Proposed Rules	Expected Proposal Dates
Rules Amending Regulation D and Form D	October 2022
Rules Amending the Definition of "Held of Record" for purposes of Section 12(g) of the Securities Act of 1934	October 2022
Rules Amending the Advisers Act Custody Rule	October 2022
Rules Proposing Additional Amendments to Form PF	October 2022
To Be Adopted Rules	**Expected Adoption Date**
Public Climate Disclosure Rule	October 2022
Form PF Proposal	April 2023
Private Fund Adviser Rule	April 2023
Advisers Act Cyber Security Rule	April 2023

Given the SEC's breakneck pace since the beginning of this year, we expect the second half of 2022 to continue to be a period of intense U.S. regulatory activity for private equity advisers.

European Funds Regulatory

Patricia Volhard
Partner—London / Frankfurt
pvolhard@debevoise.com

Christopher Dortschy
Partner of Debevoise & Plimpton Luxembourg S.à.r.l. / International Counsel—Luxembourg
cdortschy@debevoise.com

Jin-Hyuk Jang
International Counsel—Frankfurt
jhjang@debevoise.com

John Young
International Counsel—London
jyoung@debevoise.com

In Europe, ESG regulation continues to further expand across both sectors and stakeholders. The EU Sustainable Finance Disclosure Regulation (SFDR), which went into effect in March 2021, sets the standards for funds that incorporate environmental, social and governance considerations into their investment approach and imposes significant sustainability-related transparency and disclosure requirements on managers and funds marketed in the European Union. Similar to the SEC's recently proposed changes regarding ESG disclosure (see more details provided in the U.S. Fund Regulatory and ESG sections), the SFDR provides for three categories of funds: funds that only integrate ESG risk in their decision-making; funds that pursue certain environmental or social themes; and funds that make sustainable investments.

The European Commission has signaled that elements of the SFDR will be incorporated into its forthcoming Corporate Sustainability Reporting Directive (CSRD), which will considerably expand the sustainability reporting required from EU companies in their annual financial statements. Moreover, the forthcoming Corporate Sustainability Due Diligence Directive will impose additional environmental and human rights-related due diligence and process requirements on EU companies (and certain non-EU companies as well).

The separate Taxonomy Regulation governs the EU's initiative to establish a comprehensive classification system of economic activities considered to be environmentally sustainable, such as generation of energy from renewable sources or low carbon emitting manufacturing. The Taxonomy also introduces disclosure requirements for financial services firms regarding environmentally sustainable activities conducted by their investments and disclosure requirements for large EU "public interest" companies regarding their own economic activities. Reflecting the EU's plan to achieve carbon neutrality by 2050, the Taxonomy Regulation (and associated technical screening criteria) initially focuses on six specific climate change issues. The Taxonomy Regulation came into effect on 1 January 2022 regarding the first two issues (climate change mitigation and climate change adaptation), with the four remaining objectives included starting 1 January 2023.

The Taxonomy Regulation is expected to play a substantial role in asset allocation decisions in EU capital markets. EU policy makers will use it as the basis for directing capital flows toward environmentally sustainable activities, including encouraging investment in financial products that meet EU-wide standards regarding investment in environmentally sustainable projects and companies. EU authorities are also expected to use the Taxonomy to determine the environmental risk of a particular asset; in addition, the Taxonomy will form the basis of bank capital requirements that are linked to environmentally beneficial assets. The Taxonomy will cover more economic activities over time and it is likely that compliance by companies with the Corporate Sustainability Due Diligence Directive will be linked to alignment of their activities with the Taxonomy Regulation. For example, the Complementary Climate

Continued on page 21

European Funds Regulatory

Continued from page 20

Delegated Regulation has been adopted by the Commission and, if accepted by the Council and Parliament, will allow certain gas and nuclear-related activities to qualify as environmentally sustainable beginning on 1 January 2023.

With a taxonomy in place for environmental issues, attention is being turned to the social component of ESG. The EU intends to introduce a taxonomy regulation for social investments (a "Social Taxonomy"), which will define a set of social objectives, the types of activities that contribute to those objectives and provide criteria (such as quantifiable thresholds) for the activity to make a substantial contribution to the objective. To that end, a Final Report on Social Taxonomy was published in February 2022.

ESG

Andrew M. Levine
Partner—New York
amlevine@debevoise.com

Stuart Hammer
Counsel—New York
shammer@debevoise.com

Ulysses Smith
ESG Senior Advisor—New York
usmith@debevoise.com

Merryl Lawry-White
Associate—London
mlawrywhite@debevoise.com

Sophie Michalski
Trainee Associate—London
smichalski@debevoise.com

The first half of 2022 has seen a significant number of regulatory developments in the United States, the EU and the UK regarding ESG-related disclosure and enforcement, which we review below.

SEC ESG and Climate-Related Disclosure Proposals. On May 25, 2022, the U.S. Securities and Exchange Commission proposed new disclosure requirements for ESG-focused funds. The new requirements would apply to registered funds and investment advisers that factor in ESG considerations when selecting investments or include ESG as part of their overall investment strategy.

Generally, the proposals would require more specific disclosures in annual reports, fund prospectuses, adviser brochures and other disclosures describing how the fund or adviser incorporates ESG factors into its investment portfolio or process. The proposals would also extend the investment company "names rule" under the Investment Company Act of 1940 to ESG registered funds, so that a registered fund using ESG terminology in its name (*e.g.*, "sustainable," "responsible," "green," etc.) would be required to invest 80% of its assets consistent with that focus. (In addition to our In Depth look at what the proposals mean for private fund advisers, which can be found here, see further discussion in the U.S. Funds Regulatory section above, as well as a recent short video conversation as part of our *Private Equity in Focus: SEC Recap* series.)

In addition, on March 21, 2022, the SEC released proposed rules on the "Enhancement and Standardization of Climate-Related Disclosures for Investors." These proposed rules would apply to SEC registrants (i.e., firms with securities registered under the Securities Exchange Act of 1934) and add new (and often prescriptive) climate-related disclosure requirements to Regulation S-K, which primarily governs qualitative disclosures, and Regulation S-X, which governs financial statements.

Specifically, the March proposal would require disclosure related to three issues:

1. *Greenhouse Gas (GHG) Emissions:* Registrants would be required to disclose all Scope 1 (direct) and Scope 2 (indirect) emissions. Most registrants would also be required to

Continued on page 22

ESG

Continued from page 21

disclose Scope 3 emissions—those emissions that occur outside the organization but within its value chain—if those activities are either material or included in registrants' GHG reduction goals. Scope 3 emissions would be subject to a safe harbor limit, including an exemption for smaller registrants and a delayed compliance date.

2. *Risk-Management Processes:* Registrants would need to describe their processes for identifying, assessing and managing climate-related risks.

3. *Transition Plans:* If registrants have a transition plan, they would have to describe the plan (including relevant metrics), discuss how they plan to mitigate or adapt to risks and provide annual updates.

(For additional information on this 500+ page rule proposal, please see our Debevoise Update.)

"Greenwashing" Enforcement. On April 28, 2022, the SEC announced charges against Vale S.A., a Brazilian-based mining company, alleging violations of federal anti-fraud and reporting provisions under the Securities Exchange Act of 1934 and the Securities Act of 1933. The SEC claims that Vale "ma[de] false and misleading claims about the safety of its dams prior to the January 2019 collapse of its Brumadinho dam," which resulted in the deaths of 270 people and caused significant environmental and social damage, as well as the "loss of more than $4 billion in Vale's market capitalization." This is the first known action to be brought by the SEC Enforcement Division's Climate and ESG Task Force, which was established in March 2021 to focus on "greenwashing"—misstated or exaggerated statements by firms regarding their ESG-related commitments or practices.

The action against Vale was followed in May by the ESG Task Force's second known case, in which the SEC entered into a settlement agreement with a Bank of New York Mellon subsidiary, BNY Mellon Investment Advisor, Inc., for making "material misstatements and omissions… concerning the consideration of [ESG] principles to make investment decisions for certain mutual funds" contrary to Section 206(4) of the Investment Advisers Act of 1940, and Section 34(b) of the Investment Company Act of 1940. The settlement agreement included a $1.5 million penalty, as well as a censure and cease and desist order.

The United States is not the only jurisdiction cracking down on greenwashing. On May 31, 2022, BaFin, Germany's financial watchdog, raided the Frankfurt offices of Deutsche Bank and Deutsche Bank's asset management group, DWS, in connection with the latter's alleged greenwashing. Last year, DWS's former Chief Sustainability Officer alleged that the company inflated its ESG credentials by claiming that hundreds of billions of dollars in assets it was managing were "ESG integrated," despite a lack of action by fund managers. The allegations led to separate investigations by the U.S. Department of Justice, SEC and BaFin last year; these investigations are believed to be ongoing.

SEC 2022 Examination Priorities. In another indication of the SEC's keen focus on ESG-related issues, the SEC's Division of Examinations included ESG as a stand-alone

Continued on page 23

ESG

Continued from page 22

priority for the first time in its 2022 Examination Priorities report. This signals that in conjunction with the SEC's ESG-related rulemaking, as well as the activities of the SEC's Enforcement Division, the Division of Examinations will be scrutinizing firms' public disclosures for instances of greenwashing. (Our In Depth discussion of the 2022 Examinations Priorities report can be found here.)

Environmental Justice. In May 2022, DOJ created the Office of Environmental Justice and announced a new enforcement strategy to guide DOJ attorneys pursuing environmental justice cases. DOJ's focus on environmental justice likely will result in additional actions against companies for violations of environmental laws affecting minority and low-income communities. Environmental justice was a core tenet of the Biden presidential campaign, which promised to remedy the disproportionate impact of environmental issues on minority and low-income communities and to punish polluters responsible for public health issues in those communities. Such actions could harm the reputation of alleged violators and tarnish their ESG profiles.

UK TCFD Implementation. The UK's Financial Conduct Authority's Listing Rules have required certain companies and limited liability partnerships to make disclosures in accordance with the Task Force on Climate-Related Financial Disclosure (TCFD) recommendations on a "comply or explain" basis. The disclosures should cover how climate change is addressed in corporate governance, the impacts of climate change on strategy, how material climate-related risks and opportunities are managed, and the performance measures and targets applied in managing these issues.

From April 6, 2022, the disclosure requirements were extended to certain UK companies that have more than 500 employees and meet at least one of the following three criteria:

- a turnover of more than £500 million;
- are publicly traded, with transferable securities trading on a UK-regulated market (such as the LSE's main market); or
- are banking companies or insurance companies.

For more information, please see our In Depth discussion here.

SFDR Developments. The Sustainable Finance Disclosure Regulation (SFDR) sets out the content, methodology and presentation for disclosure of sustainability-related information by financial market participants. On April 6, 2022, the European Supervisory Authorities (ESAs) produced the final Regulatory Technical Standards (RTS), including the templates for disclosure by funds within Article 8 or Article 9 of the SFDR. The RTS are subject to final approval by the European Parliament and Council. On May 13, 2022, the ESAs published a set of questions that they recently posed to the European Commission regarding interpretation of the SFDR and EU Taxonomy for sustainable activities. (For more information, please see our Debevoise Update here.)

Continued on page 24

ESG

Continued from page 23

On May 31, 2022, the European Securities and Markets Authority published a supervisory briefing on best practices for disclosures under the SFDR. The briefing aims to combat greenwashing by investment funds to align their supervision with sustainability features across the European Union. More broadly, the briefing marks a more active approach by national authorities regarding SFDR compliance, and we expect more audits of SFDR disclosures and enforcement actions in Europe going forward. (For more information, please see our In Depth discussion here.)

EU Directive on Corporate Sustainability Due Diligence. On February 23, 2022, the European Commission issued its long-awaited Draft Directive on Corporate Sustainability Due Diligence. The Draft Directive applies to certain EU and non-EU companies with either more than 500 employees and net turnover of more than €150 million worldwide (Group 1 Companies) or more than 250 employees and net turnover of more than €40 million worldwide that generate at least 50% of that turnover in certain "high-risk" sectors (Group 2 Companies). The definition of a "high-risk" sector is based on existing sectoral OECD due diligence guidance.

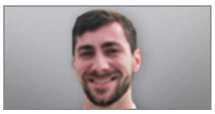
If adopted, the Draft Directive will require Group 1 and Group 2 companies to conduct corporate due diligence that identifies, prevents and mitigates adverse human rights and environmental impacts by the company and its subsidiaries through established business relationships in their value chains. It addresses directors' duties regarding the establishment and oversight of these due diligence requirements. The Draft Directive also clarifies that a director's duty to act in the best interests of the company extends to considering sustainability matters, including the short-, medium- and long-term consequences of decisions on human rights, the environment and climate change.

Additionally, the Draft Directive establishes an enforcement regime that includes both regulatory sanctions and civil liability for companies that fail to meet the Draft Directive's requirements. (For more information, please see our In Depth discussion here.)

Real Estate

Nicole Levin Mesard
Partner—New York
nlmesard@debevoise.com

Malina Welman
Associate—New York
mwelman@debevoise.com



Matthew Mrozek
Law Clerk—New York
mmmrozek@debevoise.com

When the rapid onset of the pandemic triggered sudden shifts in where and how Americans wanted to live and work, real estate investors quickly adjusted their investment strategies to meet the demand for greater space at home, more remote working flexibility and expanded online shopping capability. Consequently, warehouses, last-mile logistics centers and single-family homes outside metropolitan centers significantly outperformed other asset classes, such as hospitality and retail, in what many believed represented a long-term realignment of real estate portfolios.

However, as pandemic-related restrictions continue to be lifted across the country, lifestyle preferences are shifting once again, thereby putting pressure on those classes that were poised to be consistent bright spots in the market. In fact, commercial real estate sales reportedly decreased more than 15% compared to figures in 2021, ending a more than year-long growth streak. As investors contemplate strategies that align with the new direction of the market, mounting skepticism as to where to turn next is palpable. Not only are there concerns with the impact of rising interest rates driving up the cost of borrowing, but investors are also now feeling pressure to lock in opportunities that can withstand a down economy as threats of a looming recession grow in the wake of record inflation. One opportunity with the potential to withstand these stressors can be found in affordable housing.

Mission-driven investment focused on quality affordable housing has steadily gained traction over the last decade in parallel with the growing popularity of socially-responsible ESG initiatives backed by Wall Street. An overwhelming demand for more affordable housing in expensive cities like New York and San Francisco, coupled with tax subsidies and government incentives, such as Low Income Housing Tax Credits, Section 8 vouchers and other local tax abatement programs, have together afforded investors and operators both stability and profitability while also achieving social good. With greater volatility in the current market, some of the largest institutional investors are now also entering the affordable housing arena to leverage an asset class well-suited to turbulent economic times given the inelastic demand, consistent cash flows and occupancy rates that reliably outpace market-rate housing.

Nevertheless, investors and sponsors should be mindful of the risks associated with investment in this space, though they are relatively low in comparison to the unregulated market. Interest rate risk, for example, is always baked into underwriting assumptions regardless of the property type, but the potential of decreasing property values can more acutely affect affordable housing investors because of the stabilized nature of these assets. The more critical threat, however, that can upend investors' appetite altogether concerns the longevity and availability of public sector subsidies.

Without these government incentives meant to enable the long-term maintenance of affordable rents and the purchase of land in high-rent urban areas, the private market for affordable housing development could shrink significantly, reversing laudable strides that have been made in addressing the severe housing shortage. Such concerns are

Continued on page 26

Real Estate

Continued from page 25

currently being realized in New York City. In June 2022, the City's longstanding 421-a tax abatement program, which has been utilized in more than two-thirds of the City's affordable housing units built in the last decade, expired without a ready replacement, leaving already anxious investors in a holding pattern. While the fate of 421-a (or any potential successor program) remains in limbo, investors in this space may find greater certainty beyond the country's largest urban areas, such as the Sun Belt region, where cheaper land and building materials offer attractive opportunities to build needed affordable units in these quickly densifying areas. Notwithstanding the potential challenges in the affordable housing market, the relative stability of this asset class makes it one worth exploring as the economy braces itself for a potential recession.

Restructuring

M. Natasha Labovitz
Partner—New York
nlabovitz@debevoise.com

Sidney P. Levinson
Partner—New York
slevinson@debevoise.com

Michael C. Godbe
Associate—New York
mcgodbe@debevoise.com

Sigan Chen
Summer Associate—New York

After a largely quiet 2021, 2022 has already emerged as a more active year for restructuring. A multitude of factors are converging to produce rapidly shifting market conditions: an aging credit cycle, persistent inflation, tightening monetary policy, continued supply-chain issues and geopolitical uncertainty. On top of these developments, a number of upcoming, far-reaching legal decisions signal the potential for further turbulence ahead.

The maturation of the expansionary stage of the credit cycle—one of the longest on record—has become more readily apparent. Lenders have become increasingly inquisitive, resulting in longer delays in closing and pressure on rates. Market wariness is exacerbated by the Fed's hawkish stance to combat inflation, which is expected to result in continued interest rate increases and reductions in the Fed's balance sheet holdings. In the coming months, these policy decisions could further impair efforts to raise new funds in capital markets as a confluence of looming maturities, covenant defaults and liquidity constraints rattle already-skittish lenders. In the short term, we may see an uptick in restructuring transactions as sponsors accelerate plans to address maturities and other runway obstacles in anticipation of increasingly tight credit markets.

On the mass-tort front, bankruptcy practitioners and distressed investors await decisions in a pair of potentially transformative circuit-level cases. In *Purdue Pharma*, the Second Circuit will address whether a chapter 11 plan can provide third-party releases to non-debtors, a decision that could reverberate beyond tort-related restructurings. In *LTL Management*, the Third Circuit will consider whether a solvent entity (in this case, Johnson & Johnson) may use a spin-off or demerger transaction to ringfence liabilities into a subsidiary that files for chapter 11 while the non-troubled operating business avoids bankruptcy entirely. Regardless of how the circuit courts rule, however, we expect that bankruptcy will continue to be a useful tool for addressing mass tort liability because, as Bankruptcy Judge Michael B. Kaplan explained in a lower court decision in the J&J case, "[t]he bankruptcy courts offer a unique opportunity to compel the participation of all parties in interest (insurers, retailers, distributors, claimants, as well as Debtor and its affiliates) in a single forum with an aim of reaching a viable and fair settlement."

Continued on page 27

Restructuring

Continued from page 26

In the meantime, litigation has continued regarding the propriety of "uptier" liability management transactions in which a majority group of lenders enter into a debt amendment granting the borrower necessary relief and new-money financing while giving the majority lender group lien-priority over other debtholders. In *Serta Simmons*, the Southern District of New York found that claims brought by lenders excluded from an uptier transaction were plausible enough to survive a motion to dismiss. Meanwhile, in the New York Supreme Court Commercial Division, TriMark USA failed to have the lawsuit against it dismissed and ended up settling with minority lenders. That court is now considering whether to dismiss similar claims brought by plaintiffs in *Boardriders*. In contrast, in *TPC Group Inc.*, the Bankruptcy Court for the District of Delaware recently dismissed the plaintiffs' claims brought in connection with a somewhat similar transaction. The persistent threat of litigation seems to have done little to diminish the appetite for uptier liability management transactions, judging by recent transactions consummated by aerospace supply chain manager Incora and Envision Healthcare.

Insurance

Marilyn A. Lion
Partner—New York
malion@debevoise.com

E. Drew Dutton
Partner—New York/Hong Kong
eddutton@debevoise.com

Marshal L. Bozzo
Counsel—New York
mlbozzo@debevoise.com

Thomas A. DeMarzo
Associate—New York
tademarzo@debevoise.com

Last fall, the Financial Stability (E) Task Force of the National Association of Insurance Commissioners (NAIC) charged the NAIC's Macroprudential Working Group with coordinating with state regulators and other interested parties in an effort to provide further clarity to regulators' questions and considerations concerning the growing number of complex transactions involving insurers and private equity firms. In response, the Working Group prepared a draft list of "Regulatory Considerations Applicable (But Not Exclusive) to Private Equity (PE) Owned Insurers" (the "Regulatory Considerations"), which subsequently underwent multiple rounds of revision and exposure for comment.

On June 27, 2022, the Task Force and Working Group adopted the revised list of Regulatory Considerations, a copy of which is available as Attachment B to the joint meeting materials here.[1] On July 21, 2022, the NAIC Financial Condition (E) Committee adopted the Regulatory Considerations and voted to send the Regulatory Considerations to the NAIC Executive (EX) Committee.

A summary of the Regulatory Considerations may be found in our *2021/2022 Private Equity Year End Review and Outlook*. The Regulatory Considerations include the following regulator discussion result, which was described as essentially a 14th consideration:

> [R]egulators discussed a desire to meet with various industry representatives to discuss the incentives behind private equity ownership of insurers and conversely the concerns other industry members may have with such ownership. Regulators believe the insights from these conversations will benefit their ability to monitor and, when necessary, contribute to the work occurring in the various NAIC committee groups regarding these considerations.

Continued on page 28

1. Although the posted version of the Regulatory Considerations states that "The proposed regulator responses are exposed for a 45-day comment period," that notation was from before the June 27, 2022 meeting, and such comment period has passed.

Insurance

Continued from page 27

The Regulatory Considerations highlight insurance regulators' view that they need additional information regarding certain transactions involving insurers, including those between minority investors and insurers. States' insurance holding company acts and regulations (which are substantially similar to the NAIC models) have always provided approval, non-disapproval and notification rights regarding controlling and affiliated parties based on "control," which is generally presumed at direct or indirect ownership of 10% or more of the voting securities of an insurer, although control can also be found in other ways and based on a combination of factors (indicia of control), including by contract or otherwise. As we discussed here, on April 19, 2022, the New York State Department of Financial Services issued Circular Letter No. 5 to all New York-domiciled insurers and other interested parties describing how DFS interprets "control" under the New York insurance law for transactions with insurers. The Regulatory Considerations note that the Circular Letter was distributed to Working Group members and interested regulators.

The Regulatory Considerations do not present substantive rules or regulations but rather present principles and some discussion of them for further work to be done by other NAIC working groups and task forces. Also, the inclusion of an item in the Regulatory Considerations does not mean that the NAIC or state insurance regulators necessarily will take action on that item, and it is too early to determine whether the Regulatory Considerations will result in significant changes to current regulatory requirements and processes. Rather, the Regulatory Considerations reflect regulators' focus on the increasing complexity of transactions in recent years (including, as the document's title suggests, transactions not involving private equity) and an inquiry into whether current documentation and disclosure requirements adequately enable regulators to identify and assess risks of insurers. Such risk assessment is part of insurance regulators' role in monitoring and regulating insurer solvency.

To the extent regulatory changes are identified from further work to be done based on referrals in the Regulatory Considerations by the various NAIC groups of regulators, such changes could include amendments to the analysis handbooks that regulators use or even the development or amendment of model laws or regulations (such as the insurance holding company acts or regulations), which in turn would need to be adopted by the states to become effective. It is worth noting that any interested parties who have not had an opportunity to comment on the Regulatory Considerations will have the opportunity to comment on further work at the NAIC to carry out the referrals.

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 400 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 2021

International Arbitration, Fund Formation, M&A, White Collar

Law 360

GROUPS of the YEAR 2020

Investment Management, Intellectual Property

British Legal Awards

BANKING AND FINANCE TEAM OF THE YEAR, 2020

Private Equity International Awards Hall of Fame

20 PEI AWARDS across North America, EMEA & Asia since 2001

Chambers USA Awards for Excellence

Law Firm of the Year International Arbitration

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