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From the Editors

The year 2022 saw the storm clouds that had been gathering over private equity finally erupt, with broad macroeconomic and geopolitical uncertainty, high interest rates and a (largely) aggressive regulatory environment signaling an end to the highly favorable conditions that previously survived even the pandemic. The list of challenges is daunting. Debt for financing deals is harder to come by, and the IPO market is unwelcoming. Tougher rules relating to national security concerns, as well as sanctions in response to Russia's war with Ukraine, have put a damper on cross-border investment, particularly in China. U.S. regulatory authorities continue to heavily scrutinize PE transactions and put private funds under a microscope—a trend that shows no sign of abating. In renewable energy, governments are often inhospitable to private investment even while seeking to promote decarbonization.

As always, however, the private equity industry's greatest assets are its resilience and innovation. In the face of less-available capital, sponsors have become more creative in their deal structuring. Sponsor-led

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"I think we are finally ready to buy a house! What's the market like?"

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secondaries, including continuation funds and funds of funds, have become more common. PE firms are also turning more frequently to co-investors to co-underwrite or warehouse deals as well as for follow-on capital for add-on acquisitions. And with many exits from portfolio companies delayed, sponsors are using back leverage loans and NAV facilities to provide limited partners with liquidity.

The 2023 Private Equity Outlook issue summarizes these developments as they have unfolded in different corners of the private equity world. We hope that you will find this to be a useful guide to the year ahead as you refine your own strategies in this dynamic time.

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Fundraising

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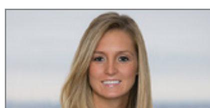

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While private equity fundraising throughout the first half of 2022 kept pace with the record levels of 2021, the second half of the year brought a slowdown that is expected to result in annual totals below those of last year. Despite this decrease, the number of sponsors actively fundraising remained high, giving many traditional institutional investors the option of being selective when making their allocations. As a result, the fundraising experience differed significantly among sponsors in 2022.

Larger sponsors and mega-funds continued to dominate the market as investors prioritized established sponsor relationships, leading many other sponsors, particularly middle market and smaller firms, to postpone final closings into 2023 in the hopes of receiving a share of the new year's capital allocations. We believe the trends favoring larger sponsors will continue, and as a result, we expect numerous mega-fundraises to occur or be concluded in 2023. To help ensure that they reach these loftier targets, sponsors are continuing to expand their marketing efforts to international investors, including sovereign wealth funds and high-net-worth retail investors (whose participation in the private equity market is expected to grow significantly in the next decade).

Sponsors are also continuing to explore the secondary market and strategies such as tender offer plus staple deals to facilitate and supplement fundraising. We expect the use of continuation funds to persist, enabling sponsors to provide liquidity to their investors while still retaining control of portfolio companies that sponsors believe have further value-creation potential in the current market environment.

The increased regulation of private equity funds—in particular, the SEC's implementation of the new marketing rule in November—presented additional challenges and costs to sponsors in the second half of 2022. However, we expect the new marketing rule's impact on fundraising to be limited, as sponsors have had time to devise compliance approaches, that will continue to be refined in the new year.

Finally, the global economic environment remains uncertain. Rising interest rates and Europe's energy crisis could further drive down global public equity markets, which may cause institutional investors to reduce their PE allocations in 2023. Conversely, countervailing factors, such as the slowing pace of interest rate hikes and the rejuvenation of global supply chains, might lead to increased investor optimism. In any event, we expect sponsors to continue to develop and test innovative fundraising strategies and to focus on solidifying their track records to remain competitive in the fundraising market.

Private Funds Transactions

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Continuing the trends of early 2022, secondaries market activity during the second half of 2022 was colored by market volatility fueled by inflation and increased borrowing costs. While acceptance of new market realities narrowed the gap between seller and buyer asset pricing expectations and led to an uptick in deal volume to close the year, challenging economic headwinds kept the secondaries market from reaching the deal volume that many had anticipated. At the same time, a tight fundraising environment continued to present challenges to those trying to fill out the investor syndicates necessary to close a number of the larger GP-led secondary transactions that made their way to market during 2022.

In response, sponsors of single-asset GP-led transactions increasingly sought (and frequently got) greater flexibility in deal syndication. For example, it has become more common for sponsors to address first closing equity shortfalls through the use of multiple closings and cross-fund equity financing, in which the sponsor's affiliated funds bridge the initial closing equity gap, often temporarily and in anticipation of further third party syndication. Such flexibility, however, can be a double-edged sword, as such sponsors must manage a more involved conflicts analysis and approvals process (where affiliated funds are involved on the buy side), a more complex investor election process (where liquidity election cut-back mechanisms must be pre-baked) and potentially difficult discussions with company management (who may not get, or may need to wait for, the level of liquidity desired).

To simultaneously address existing investor demands for liquidity and fundraising shortfalls for new products in this challenging environment, more sponsors considered and utilized full-fund recapitalizations, and tender offers with stapled commitments to new funds from secondary buyers. These "distressed" situations continue to afford secondary buyers comparatively more leverage in negotiations with sponsors, evidenced by the increasing prevalence of subordination of sponsor returns in favor of new money, enhanced oversight of asset dispositions and the use of deferred consideration to existing investors seeking liquidity.

While constraints in the leveraged financing market have led to an overall slowdown in private equity buyouts, co-investors have seized new opportunities to fill funding gaps and take on more active roles. With it often taking longer to reach desired target sizes in raising new funds, sponsors have increasingly turned to co-investors that have dedicated co-investment strategies, more capital to deploy, and the ability to handle more complex transactions to co-underwrite or warehouse deals—for example, where a sponsor wants to close a deal before it has fully raised a new fund or before it can syndicate a deal to other co-investors who may take longer to approve an investment. Sponsors are also increasingly turning to co-investors for follow-on capital to fund add-on acquisitions by portfolio companies (which sponsors may have traditionally funded with debt financing) or for working capital or to repay existing debt. In follow-ons where the sponsor's main fund is investing less money and co-investors are investing more, the line between co-investments and secondaries has blurred. As a result, co-investors are increasingly grappling with the same issues that apply to continuation fund transactions, including managing conflicts of interest, information asymmetry, acquiring new securities in a portfolio company at a different valuation than the sponsor's entry

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Private Funds Transactions

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valuation, and different investment horizons. As co-investments have become more complex, the long-standing dynamic of co-investors passively investing and divesting at the same time and on the same terms as the sponsor has also evolved.

As market disruption and liquidity challenges drive a shift in deal dynamics, private fund transaction terms are adapting adroitly. We expect to see this trend continue as we help our clients develop novel and bespoke solutions in a challenging deal market.

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Despite the slowdown in fundraising, demand for fund-level financing remained strong in 2022. At the beginning of the year, the market was buoyant with strong demand from funds to fill their liquidity needs. As the year progressed, bank lenders that traditionally have been major players in the subscription finance market responded to a series of macroeconomic events—including the increase in interest rates and regulatory changes in capital treatment—by becoming more selective with extensions of credit.

Many lenders that deployed large amounts of capital in previous years have also been looking to reduce exposures to a single product and adjust their balance sheets. As a result, we saw increased focus on syndication efforts, via assignment or participation. Lenders are also looking to readjust their balance sheet exposures by means of swaps, financial guarantees or other similar transactions. Accordingly, market players have been revisiting the relevant provisions in their facility documents to accommodate such processes.

In addition to subscription facilities, we saw the continued popularity of back leverage loans and use of NAV facilities by buyout funds. With the leveraged finance markets disrupted, sponsors increasingly turned to these products to consummate acquisitions, purchase portfolio company debt and make distributions to limited partners in view of delayed exits from portfolio companies. Conditionality for these structures also continues to evolve, with some lenders willing to consider providing these facilities with limited conditions similar to that for opco-level facilities. We also saw more alternative fund finance credit providers offering these facilities.

Sponsors also continued to raise capital from insurance companies and similar investors. Rated feeder structures and other structured products such as collateralized fund obligations continue to evolve and develop—an aspect of the market in which we have had significant involvement. We expect innovation in the fund finance market to continue so long as sponsors have unmet liquidity needs.

Leveraged Finance

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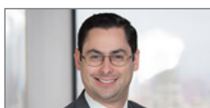

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The close of 2022 marked the end of a tumultuous year for the financing markets. With robust activity early in the year followed by large periods of near inactivity, 2022 will be most remembered for the financings associated with several mega LBOs including Twitter, Citrix and Nielsen, among others.

In the first months of the year, we saw a number of large LBOs signed that were backed by multibillion dollar financing packages. While these deals were signed prior to (or shortly following) the commencement of the Ukrainian war, the Fed's aggressive rate increases and the resulting deterioration in the credit markets, those disruptions did not prevent these transactions from closing in the second half of the year. The terms on which the transactions were committed (including the "market flex" terms) thus reflected the exuberant market conditions of early 2022 rather than the very different reality that characterized the final three quarters of 2022. Not surprisingly, investors were reluctant to purchase the debt on those earlier terms, leading banks and sponsors to restructure a number of these deals. In many cases, the banks ultimately had to fund the committed financing off of their own balance sheets where a successful syndication could not be achieved without the banks bearing significant losses.

With the deterioration in traditional capital markets, 2022 also saw an increasing number of sponsors seeking to finance M&A activity using novel fund finance and alternative financing structures. These include "back-leveraged" facilities and PE net asset value facilities. Because these facilities are supported by the creditworthiness of the private equity sponsor and its fund assets, the underwriting process is less dependent on the entity being acquired, and pricing can be more favorable than traditional leveraged loans or high-yield debt. Notably, in several cases, borrowers were able to arrange for these facilities on a committed basis and subject only to "SunGard Conditionality," thus allowing these facilities to be presented to sellers as part of the overall financing package for an acquisition or for borrowers to be comfortable providing a larger equity commitment to the sellers, which backstops these facilities.

CLO activity has become a barometer for the overall health of the leveraged finance market. While 2021 was a record year for such activity, 2022 presented significant headwinds. Many market commentators are predicting that CLO activity will experience modest declines in 2023 amid continuing rising interest rates, inflationary pressures and geopolitical tensions. CLO formation will also be challenged by the more conservative management of capital by banks to ensure compliance with regulatory capital reserve requirements. Decreased CLO activity will likely result in less new loan issuance and a more conservative approach by banks underwriting committed financings.

The year 2023 will bring a dynamic environment for both existing debt issuers and new issuance. For existing issuers, we expect more liability management transactions as issuers struggle to refinance existing indebtedness and face increased capital costs due to benchmark interest rates at levels not seen since before the global financial crisis. On the new issuance front, there are signs that debt capital markets are beginning to reactivate. This trend should continue throughout the first quarter of the year, as inflationary pressure tempers, interest rate increases slow and M&A deal-making activity returns. Nonetheless, uncertain macroeconomic factors, including a potential standoff on the U.S. government debt ceiling, may result in increased volatility and drive a need for issuers to be opportunistic.

M&A (U.S.)

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The U.S. M&A story of the second half of 2022 was a continued slowdown in traditional LBOs, caused primarily by further dislocations in the debt financing markets. Several large bank lenders were forced to hold debt from prominent deals that had signed earlier in 2022 on their balance sheets when the debt could not be sold at acceptable prices; those lenders largely closed up shop in the second half of the year, leaving direct lenders with an opportunity to take a more prominent role in the markets. However, as continued uncertainty and fears of a recession weighed down broader markets, these direct lenders were increasingly hesitant to write substantial checks for individual credits, making debt for larger deals hard to come by. In addition, the sale processes that took place showed little change in seller valuation expectations compared to the past several years, even though buyers were facing much more expensive debt—when they could get debt at all. The divergence between seller expectations and buyer reality made it difficult to achieve a meeting of the minds on price. It will be interesting to see in 2023 if sellers decide this is the "new normal" or instead elect to continue to hold assets on the sidelines in the hope of further recovery in the debt markets.

We did see some sponsors get creative on the buy-side to get deals done, including by seeking to acquire two companies at once and combining them, by buying businesses with low or no leverage and planning to add debt later, or leaning on co-investors to write sizable equity checks. In addition, carve-out transactions with PE buyers were plentiful (relatively, at least), as corporate sellers looked to batten down the hatches and sell non-core assets. We will surely see sponsors continuing to sharpen their pencils in 2023, as they look to put to work ever-increasing stocks of dry powder in the midst of a challenging environment.

Given difficulties in traditional sale processes, we saw sponsors increasingly use fund-to-fund and continuation fund transactions as a way to obtain liquidity for LPs, while allowing their more-recent funds to obtain interests in attractive assets. We expect to see sustained focus on these transactions in 2023.

The end of 2022 saw some notable take-private transactions by PE firms; given depressed public equity valuations, we expect these deals to be a continued source of deal flow for PE in early 2023. In terms of potential targets, there are a number of companies that went public through SPAC mergers during last year's boom that are now trading well below the valuations in those deals and could be candidates for take-privates, though many of those companies tend to have negative cash flows, making them less attractive for PE firms.

We would be remiss if we didn't mention the continued focus by U.S. antitrust authorities on private equity acquisitions, particularly in the context of potential roll-ups. This has led to heightened focus from practitioners on risk allocation provisions in acquisition agreements. With no sign of a letup by the FTC and DOJ, we expect this area to require continued attention.

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In 2022, private equity in Europe faced a difficult set of conditions, marked by currency volatility, fiscal volatility and rising inflation and interest rates. The third quarter of the year saw quarter-over-quarter decreases in cumulative private equity deal value and deal count of 31.6% and 9.6%, respectively; cumulative exit value for 2022 is expected at €300 billion, down from €430 billion in 2021.

Current macroeconomic conditions have favored private equity deal-making in the business services and products sector, which accounted for 37.8% of all deals from Q1 to Q3 2022, the highest level since 2006. As predicted in our 2022 Private Equity Midyear Review and Outlook, private equity deal-making in the consumer services and products sector suffered given the reduction in consumer spending, with a 52.2% decrease in year-on-year cumulative deal value in Q3 2022.

We expect to see M&A activity driven by the pursuit of decarbonization to remain strong in 2023. Rising energy prices in Europe as a result of the war in Ukraine and record profits earned by energy companies may lead to greater investment in companies focused on renewable energy to mitigate future supply issues and to bolster long-term decarbonization transition capabilities. In September, for example, EIG acquired 25% of Repsol's global upstream business for US$4.8 billion, providing Repsol with additional capital to help it reach its goal of net zero emissions by 2050.

We also expect deal timelines to lengthen. In response to macroeconomic conditions, buyers may take longer to conduct due diligence and be even more focused on the terms they seek to negotiate, which may result in valuation gaps. To bridge those gaps, we may see more creative deal-structuring, including carefully designed earn-out mechanics. In response to higher interest rates, we expect greater creativity to keep existing lower fixed-rate debt in place.

Take-privates continued to be a theme in 2022, driven by the general fall in share prices and the substantial amounts of dry powder private equity houses continue to have available. The weakening of the pound sterling has made UK-listed targets particularly attractive. The acquisition of Biffa, one of the UK's largest waste management companies, by Energy Capital Partners, is just one example. Even so, private equity deal-making levels in the UK and Ireland, typically the highest in Europe, fell below activity levels in France and Benelux in Q3 2022, possibly as a result of political turmoil in the UK during Liz Truss' short-lived premiership.

In contrast to take-private activity, the market for carveouts slowed significantly in 2022. Looking ahead, carveout activity levels may pick up, given that the rise in interest rates combined with anticipated reductions in consumer spending may lead to large corporations disposing of non-core or under-performing assets to strengthen their balance sheets. In June 2022, for example, Unilever completed the disposal of its tea business, ekaterra, to CVC for €4.5 billion.

GP-led secondaries continue to grow as a viable exit path for many older investments where a third-party exit is seen to be less desirable. We expect this trend to continue in 2023, especially once LP expectations on valuation start to settle.

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M&A (Europe)

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Looking further ahead, two events may significantly affect the market. First, in December we saw China dramatically abandon its zero-Covid policy and announce that its borders will be open to international travellers from January 8 for the first time in almost three years. This will have a notably positive impact on consumer, tourism and luxury goods sectors as Chinese consumers look to travel and spend abroad. Second, any reduction of the high energy and commodity prices brought about by the war in Ukraine may ease inflationary pressures. In November, inflation in the UK fell to 10.7%, down from a 41-year high of 11.1% in October; many economists believe that the rate of inflation may have passed its peak in the UK.

Recent years have also seen growth in the importance and prevalence of regulatory regimes regarding foreign investment, partly driven by Covid-19, with regulators taking a more aggressive approach to restricting investments by foreign entities in an expanding number of sectors deemed to have national security implications. As a result, the regulatory review of transactions involving foreign investors has become considerably longer and more unpredictable. For example, in November 2022, over a year after China-backed Nexperia completed its acquisition of the UK's largest semiconductor manufacturer, Newport Wafer Fab, the UK government ordered Nexperia to unwind its purchase on national security grounds under the National Security and Investment Act 2021 (NSIA). The action represented the UK government's first use of NSIA's "lookback" powers to call in a transaction that closed before the regime entered into force in January 2022.

Alongside more countries introducing regimes governing the national security aspects of foreign investment (25 of 27 EU Member States have now either implemented or are planning new laws in this area), many of those with existing regimes are enhancing them further. For example, several jurisdictions (including Austria, Denmark and Spain) have expanded their powers over non-controlling minority acquisitions such that even passive minority interests (*e.g.*, LP investments in fund structures with limited governance rights, fund-to-fund restructurings and secondary deals) in targets considered to have national security importance may trigger regulatory review. It is therefore more important than ever to assess the potential applicability of foreign investment rules in any transaction and, crucially, at an early stage in the process.

While a significantly higher number of jurisdictions already have merger control rules in place, there continue to be important developments which need to be kept in mind. For example, in March 2021, the European Commission adopted its new policy whereby it will, in certain circumstances, encourage and accept referrals from Member States of "any concentration," even where the merger falls below EU and national jurisdictional thresholds. The test case for this has been Illumina's acquisition of GRAIL, which completed in August 2021. While subject to appeal, the General Court's endorsement of the European Commission's approach is likely to encourage use of the referral mechanism, meaning merging parties must carefully consider whether their transaction may be subject to scrutiny. As a result, we expect purchasers to be increasingly asked to make "hell or high water" commitments to satisfy any regulatory conditions to the merger.

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M&A and private equity investment activity in the APAC region generally slowed in 2022. While some of this slowdown can be attributed to rising interest rates throughout much of the region and worries about the trajectory of the global economy, developments involving China have driven much of the shift, including the significant impact of prolonged lockdowns on China's economy stemming from the government's zero-Covid policies. Although China began rapidly relaxing those policies in December and also announced measures to bolster the economy, including providing rescue packages to the slumping real estate sector and a shift in tone toward big tech companies, spiraling Covid caseloads in China will likely continue to cause business disruptions in the short term.

In addition to a challenging domestic environment, China is also facing external headwinds. In particular, the U.S. government has increasingly tightened regulatory and other restrictions on China's tech sector, as well as limiting access to cutting-edge chip components and machinery. The impact of these restrictions on the M&A market has been clear: between January 2020 and October 2022, the share of M&A deal value in China involving foreign investors slid from 52.7% to 33.5%. In response, the Chinese government quickly stepped in, filling the void with money from State-owned investment funds in an effort to make the country's business environment more self-reliant.

Looking outside of China, deal activity in Australia and New Zealand decelerated in the second half of the year, although overall activity remains high. In addition, Southeast Asia and India saw a rise in M&A activity. Notable transactions include Bain Capital's US$3 billion acquisition of Evident Corporation, an optical technology company focusing on life sciences and industrial markets, and TPG Capital Asia's $1.4 billion majority investment in iNova Pharmaceuticals, a consumer healthcare and medical products company.

Exits through IPOs decreased significantly compared to 2021, particularly for overseas listings of Chinese companies. This trend may reverse during 2023, following the deal China struck in August allowing the U.S. Public Company Accounting Oversight Board to inspect the records of U.S.-listed Chinese companies, and public confirmation in mid-December by the agency that it has secured that access. This development could potentially end the decade-long standoff between Washington and Beijing over this issue, thereby easing the threat of approximately 200 Chinese companies being delisted from U.S. stock exchanges. On the other hand, SPAC mergers as an exit alternative have not gained significant transactions in the region.

Faced with a rocky exit environment, continuation funds have attracted increasing interest from market participants. Four GP-led continuation funds were completed in the APAC region in 2022 (compared with two in 2021), including a US$1.45 billion single-asset continuation fund for Ssangyong C&E Co. Ltd., a leading Korean cement maker. Heading into 2023, a number of continuation fund deals are in the pipeline.

M&A (Latin America)

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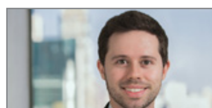

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Central Banks of major Latin American countries began tightening monetary policies across the region earlier than their peers in the United States and Europe. As a result, interest-rate hikes initiated in 2021 or in the first part of 2022 brought about lower valuations and a general decrease in deal value across the region in 2022. This trend has particularly affected venture capital activity, which has grown exponentially in the region for the past several years. Deal volume in 2022, however, remained relatively strong when compared to pre-pandemic levels, especially in the second half of the year, propelled in part by high commodities prices and resumption of post-pandemic activity. M&A transactions were mostly smaller in size and involved more strategic than financial investors.

Politically, while economies in Central America and Peru continue to struggle, Chile, Colombia and Brazil successfully elected new governments in 2022. Election results in these countries consolidated a significant shift from right to left-leaning governments in the region, although political pundits predict the opposite trend in Argentina's upcoming 2023 election and elsewhere. Whether new leaders will alter or further improve recently implemented investor-friendly policies in the region remains to be seen.

Overall, we expect growth in private equity M&A activity in the region to be moderate this year, in light of macroeconomic conditions and global geopolitical instability. The escalation of political tensions between the United States and China, the Ukrainian war in Europe, rising interest rates in developed economies, and different approaches to international policies across the region will likely continue to affect capital raising. While some of these factors may increase the urgency of further integrating economies within Mercosur and progressing its commercial agenda with the European Union and other advanced economies in the short-term, they also create difficulties. Despite these challenges, there are a few reasons to remain cautiously optimistic about the region's deal activity in 2023:

- Increased digitalization, untapped consumer markets and further industry consolidations in the technology, education and healthcare spaces will continue to offer opportunities for savvy private equity sponsors willing to commit capital in the long run. While capital raising may become more challenging, sponsors active in the region still have a great deal of dry powder to deploy.
- The persistent need to upgrade infrastructure, the integration of ESG factors in investment theses and the expectation that Brazil may take a more prominent role in renewable energy on the global stage may further propel the logistics and energy sectors, a trend that we have observed in 2022 and that is likely to continue.
- Given the limited prospects for public equity offerings and higher cost of capital generally, companies will continue to tap into private equity capital to fund their operations, and private equity sponsors may look to exit earlier investments through private sales.
- If lower valuations of public companies continue in 2023 and local currencies remain devalued, take-private transactions backed by private equity sponsors may offer attractive entry or expansion opportunities.

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Reinvigorated Antitrust Enforcement of Interlocking Directorate Violations

Over the past several months, the Department of Justice's Antitrust Division and the Federal Trade Commission have indicated their intent to reinvigorate enforcement of the Clayton Act's prohibition against "interlocking directorates," situations where a person simultaneously serves on the board of two or more competing corporations. In April, for example, Assistant Attorney General Jonathan Kanter expressed the DOJ's intent to apply the "bright-line rule" against interlocking directorates beyond the merger review process. This fall, there were reports of the DOJ sending letters and civil investigative demands to companies, private equity firms and investors requesting information about their board composition; shortly thereafter, the DOJ's concerns regarding interlocking directorates between five pairs of companies led to the resignation of seven directors. Although those companies and directors were able to unwind the interlocks in question by resigning without admitting to liability, the action by the government forewarns of greater enforcement in this area. Meanwhile, in November, the FTC issued a policy statement that expressly lists interlocking directorates as a method of unfair competition subject to enforcement under Section 5 of the FTC Act, even if not covered by the literal language of the Clayton Act, as conduct that "violates the spirit of the antitrust laws."

While historically interlocking directorates received less attention, in this new enforcement environment, the issue calls for increased attention for private equity firms when considering the corporate governance of their portfolio companies.

The Prohibition against Interlocking Directorates

Subject to certain *de minimis* exemptions, U.S. antitrust laws prohibit a "person"—an individual or a company—from simultaneously serving as a director or officer of two competing corporations. This prohibition can be triggered, regulators contend, even when a company has two different employees sitting on the boards of competing companies. A finding of competitive injury is not required for enforcement actions to be taken against an interlocking directorate. The prohibition is prophylactic, designed to prevent unlawful collusion and sharing of competitively sensitive information through a person sitting on competitors' boards.

Historically, the FTC and DOJ have taken action against interlocks in the context of pre-merger investigations during Hart-Scott-Rodino review. These agency actions typically have been resolved through consent decrees between a company and the FTC or DOJ that remove the offending interlock by requiring a director to resign or by implementing safeguards that effectively eliminate the interlock in any area of competitive overlap. In cases where the government has identified a "cognizable danger of recurrent violation," it also has sought prospective injunctive relief, such as barring corporate defendants from having common directors or placing directors at certain companies for several years. For example, the DOJ required Tullett Prebon Group to restructure its proposed $1.5 billion acquisition of ICAP's hybrid voice brokerage business such that ICAP obtained neither post-acquisition ownership interest in Tullett Prebon nor any right to appoint board members to Tullett Prebon. Similarly, after the DOJ challenged

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Antitrust

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CommScope's acquisition of Andrew Corp. due to Andrew Corp.'s holdings in Andes, a competitor of CommScope, CommScope agreed to divest its holdings and forfeit its investor rights in Andes, including the right to appoint certain board members.

With the government signaling its intent to pursue interlocks outside of the HSR review process, companies can expect actions of this type to form a more frequent part of the enforcement landscape.

What Should PE Firms Keep in Mind?

Regulators are making good on their commitment to seek out interlocking directorate violations as part of their broader toolbox to promote robust competition, and there is no reason to expect this trend to shift.

PE firms should assess the composition of the management teams and boards of their portfolio companies—with a particular focus on portfolio companies with overlapping or potentially competing businesses—and obtain counsel to minimize risk and uncertainty in this area. PE firms may also consider annually reviewing other director or officer positions held by independent board members at their portfolio companies.

International Economic Sanctions

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When Deputy Attorney General (DAG) Lisa Monaco declared sanctions the "new FCPA (Foreign Corrupt Practices Act)" in a moderated discussion in April 2022, a new level of commitment to sanctions enforcement by the Department of Justice (DOJ) was made clear. The announcement came at a time of increased geopolitical tension and followed Russia's invasion of Ukraine, which resulted in unprecedented and extensive sanctions and export controls imposed against Russia. At the same time, the announcement appeared to reflect a broader shift in U.S. enforcement policy. In light of the FCPA's extensive impact on corporate enforcement and compliance efforts on a global scale, it is important for private equity firms and operating companies to understand the interplay between anti-corruption and sanctions and export controls enforcement, and the broad implications of DOJ's new enforcement focus.

Brief Overview of the FCPA and Sanctions and Export Controls Enforcement

The FCPA, which establishes a crucial area of enforcement for the U.S. government, prohibits corruptly giving anything of value to non-U.S. government officials to obtain or retain business. The DOJ and the U.S. Securities and Exchange Commission (SEC) have joint FCPA enforcement authority and cooperate with enforcement authorities worldwide. Since the FCPA's enactment in 1977, monetary penalties imposed through FCPA enforcement have surpassed $24 billion, which includes penalties assessed by the U.S. authorities and by non-U.S. authorities that were credited by the U.S. authorities, with the majority of those penalties assessed in the last decade. In recent years, there has also been considerable expansion in anti-corruption enforcement in other jurisdictions, including France and the United Kingdom.

Sanctions and export controls laws differ from the FCPA, in addition to their substantive focus, in that they do not require a showing of "corrupt" intent. In other words,

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International Economic Sanctions

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sanctions and export controls violations can be enforced on a strict liability basis. In the United States, the Office of Foreign Assets Control of the Department of the Treasury (OFAC) and the Bureau of Industry and Security of the Department of Commerce (BIS) have administrative enforcement authority over sanctions and export controls violations, respectively. DOJ can take criminal action against intentional or willful violations. Sanctions and export controls regimes in other jurisdictions, including the United Kingdom and the European Union, often are analogous to U.S. regulations, but with certain important differences.

Recent Developments

There have been two overarching developments in the sanctions and export controls enforcement space in the aftermath of Russia's invasion of Ukraine. First, the United States and its allies rapidly enacted broad sanctions and export controls against numerous entities and individuals with ties to Russia, across different industries. In addition to the preexisting mechanisms for enforcing those sanctions, authorities in the United States and elsewhere have established task forces and increased resources dedicated to sanctions and export controls enforcement. In the United States, the KleptoCapture Task Force, an interagency law enforcement group dedicated to enforcing the measures taken in response to Russia's invasion, has been a prominent example of the new enforcement era. The Task Force's noteworthy coordinated actions include the seizure of a $45 million airplane owned by Russian energy company PJSC Lukoil.

Second, there is growing international cooperation on sanctions and export controls. In March 2022, officials from Australia, Canada, the European Union, Japan, the United Kingdom, and the United States announced the launch of the Russian Elites, Proxies, and Oligarchs (REPO) Task Force, which by June had blocked or frozen more than $30 billion of sanctioned assets.

Overlap Between FCPA and Sanctions and Export Controls Enforcement

As DAG Monaco further highlighted in a June address, there is growing overlap between corporate crime and national security. It is therefore not surprising that there are similarities in enforcement trends of the two areas. Both FCPA and sanctions enforcement target a variety of industries, as evidenced by the expansion of sanctions beyond the banking sector and into areas such as energy, luxury goods, and new investments. In addition, like fighting corruption, sanctions and export controls enforcement is no longer just a U.S. concern: both enforcement areas involve extensive cooperation and coordination on a multinational level. The work of the REPO Task Force in particular demonstrates the evolution of a "multilateral enforcement regime" in the sanctions and export controls space.

Finally, as DAG Monaco noted, both FCPA and sanctions and export controls enforcement policies reinforce the value of compliance efforts by rewarding companies that "develop the capacity to identify misconduct within the organization, and then come forward and voluntarily disclose" that misconduct to the enforcement authorities. Analogous to the corporate enforcement policy developed by DOJ's FCPA Unit,

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International Economic Sanctions

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DOJ's National Security Division, OFAC, and BIS have established policies that credit companies for voluntarily disclosing potential violations and cooperating with the agencies on ensuing investigations.

Looking Ahead

The interplay between FCPA and sanctions and export controls enforcement will have broad implications for businesses. For example, sanctions imposed pursuant to the Global Magnitsky Human Rights Accountability Act, initially focused on human rights abusers, have expanded to target those alleged to have engaged in "significant corruption." Sanctions designations have been used to target alleged bribe recipients or alleged bribe-giving intermediaries who are outside the reach of the FCPA, either due to jurisdictional reasons or because of the substantive limitations of the FCPA, which focuses on those giving bribes rather than those receiving them. Even outside of the Magnitsky Act sanctions, efforts of sanctions enforcement authorities such as those of the KleptoCapture Task Force are often described as fighting "corrupt oligarchs," suggesting another potential area of crossover between FCPA and sanctions enforcement. Those risks are heightened by the fact that the businessmen with ties to Russia who may be subject to, or at risk of, sanctions were previously deeply integrated in the global markets, doing business with many Western counterparties.

In light of the new and evolving enforcement landscape, companies need to consider not only the FCPA but also sanctions and export controls risks when developing compliance programs. Companies should expect that any business connections with currently or previously sanctioned parties will likely be closely scrutinized by enforcement authorities, both from FCPA and sanctions and export controls perspectives. Businesses should also keep abreast shifting national security priorities of the United States and other jurisdictions, as those priorities are likely to drive enforcement in the future.

CFIUS

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In 2022, the most notable developments for the PE industry regarding the Committee on Foreign Investment in the United States were the issuances of (i) a new Executive Order identifying additional national security factors for CFIUS reviews and (ii) formal Enforcement and Penalty Guidelines for noncompliance with mandatory notification requirements or mitigation measures. For sponsors seeking foreign-sourced capital through fund raises, co-investments or otherwise to fund acquisitions and investments in U.S. businesses, as well as for sponsors seeking to sell U.S. businesses to "foreign persons," the Executive Order and Guidelines highlight the need to be mindful of CFIUS's jurisdiction to review and address national security concerns with respect to acquisitions and investments in U.S. businesses by foreign persons. We review these two developments below.

Executive Order 14083 – National Security Factors

The CFIUS statute identifies national security factors to be considered in reviewing transactions and gives the President the discretion to apply additional factors. On September 15, the Biden administration did just that, with Executive Order 14083.

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CFIUS

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Of perhaps greatest interest is the continuing focus on whether a transaction involves a U.S. business with ***access to U.S. persons' sensitive data*** and whether the foreign investor (or their third-party ties) has the ability to exploit such information to the detriment of national security. An additional factor that substantially broadens the scope of national security concerns is the transaction's ***effect on the resilience and security of critical U.S. supply chains***, both within and outside the defense industrial base. Furthermore, a pattern or practice ***of multiple acquisitions or investments in a single sector*** or in related manufacturing capabilities, services, critical mineral resources or technologies may be scrutinized. Two other important factors are:

- a transaction's ***effect on U.S. technological leadership*** in areas affecting U.S. national security, including microelectronics, artificial intelligence, biotechnology and biomanufacturing, quantum computing, advanced clean energy and climate adaptation technologies; and whether: (i) the transaction could reasonably result in future technology advancements and applications that could undermine U.S. national security; and (ii) a foreign person involved in the transaction has ties to third parties that may pose a threat to U.S. national security; and
- whether a transaction may provide a foreign person (or their third-party ties) with access to conduct ***cyber intrusions or other malicious cyber-enabled activity***.

Also noteworthy is the more intense focus on whether the foreign person has "ties" to third parties who might be viewed as raising national security concerns, such as joint venture partners in China or Russia.

Enforcement and Penalty Guidelines

On October 20, the Department of the Treasury, as Chair of CFIUS, released the first-ever Enforcement and Penalty Guidelines, which, while nonbinding, provide information about how CFIUS assesses violations of the laws and regulations that govern transaction parties and breaches of CFIUS mitigation agreements.

The Guidelines outline three categories of acts or omissions that may constitute a violation: (i) failure to timely submit a mandatory declaration or notice; (ii) noncompliance with CFIUS mitigation agreements, conditions or orders; and (iii) material misstatements, omissions, or false or materially incomplete certifications filed with CFIUS. Like many other civil regulatory enforcement frameworks, the Guidelines provide aggravating and mitigating factors to assist CFIUS in its determination of an appropriate penalty outcome for particular violations.

Capital Markets

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The SEC took several actions of particular note in 2022, which we review below.

Postponed Application of Rule 15c2-11 to Fixed-Income Securities

On November 30, the SEC issued a no-action letter delaying the enforcement of Rule 15c2-11 as it applies to the quotation of fixed-income securities. Rule 15c2-11 requires a broker-dealer that wishes to publish a quotation for securities in a quotation medium other than a national securities exchange to first establish that certain current information about the issuer is publicly available. In 2021, the SEC interpreted Rule 15c2-11 to apply to fixed-income securities and introduced a phased compliance regime. Under Phase 1 of the compliance regime, which was set to expire on January 3, 2023, regular practices required for securities to trade among qualified institutional buyers under Rule 144A were deemed to satisfy Rule 15c2-11 (*i.e.*, it was sufficient for an issuer of Rule 144A securities to undertake to make certain financial information about the issuer available to current and prospective investors on request).

In its November no-action letter, the SEC effectively extended Phase 1 through January 4, 2025, a two-year extension of current market practice. Further, the SEC confirmed that where securities are fully and unconditionally guaranteed, information concerning the guarantor (and not strictly the issuer) may be relied upon in satisfaction of Rule 15c2-11. The SEC's no-action letter was a welcome relief for market participants, particularly in the 144A bond market, who had been cautioning the SEC of the expected market turmoil upon the expiration of Phase 1.

Adoption of Rule 10b5-1 Amendments

In December, the SEC adopted amendments to Rule 10b5-1 that impose significant conditions on the availability of the affirmative defense to insider trading liability under Rule 10b5-1(c)(1), in addition to creating new disclosure requirements related to trading activity of corporate insiders and expanding reporting obligations for issuers and corporate insiders. Large stockholders and corporate insiders of public companies considering using trading plans that comply with Rule 10b5-1 to purchase or sell shares should be aware of the added conditions to the availability of Rule 10b5-1's affirmative defense, which include: (1) mandatory minimum cooling-off periods between entry into a trading plan and execution of the first trade, (2) certifications by directors and officers that they are not aware of any material, nonpublic information about the issuer at the time of entry into a trading plan, (3) a prohibition on overlapping plans, and (4) a requirement to act in good faith when entering into, modifying or canceling a trading plan. The amendments will take effect on February 27, 2023.

Adoption of the Universal Proxy Card

Pursuant to rules adopted by the SEC in November 2021, universal proxy cards will be required in contested director elections beginning in the upcoming proxy season. The rules require registrants to use a proxy card that includes both the registrant's nominees and the dissident stockholder's nominees, allowing stockholders to vote for a combination of candidates from either director slate as if they were attending

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Capital Markets

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the stockholder meeting in person. The rules could increase the odds of a successful dissident nomination by allowing shareholders to "mix and match" their vote rather than voting for either the management or dissident slate in full. Even controlled public companies could face dissident shareholders taking advantage of these new rules, even if just as a nuisance or to increase bargaining leverage in an activist campaign.

The new rules include additional disclosure requirements that public companies should keep in mind as the 2023 proxy season approaches. Among the added obligations is the requirement that the registrant include the fact that there has been a stockholder nomination, file a preliminary proxy statement and refer to the dissident stockholder's proxy statement, and include the recommendation of the nominating committee and/or board on how to vote on the dissident stockholder's nominee(s).

In anticipation of the use of the universal proxy rules by dissident stockholders, public companies should also consider updating their advance notice bylaws to ensure adequate information about any dissident nominee is provided to the company.

Proposed New SPAC Rules (Alongside the Effects of Excise Tax)

In the 2022 Midyear Review and Outlook, we highlighted the SEC's proposed new rules and amendments regarding de-SPAC transactions. Since then, additional trends have emerged as the SPAC market continues to struggle.

First, likely as a result of the SEC's proposed changes, which, if adopted, would add significant enhanced liability (as well as increased due diligence costs) for participants in de-SPAC transactions, an increasing number of investment banks have been withdrawing as financial advisors, placement agents or other advisory roles in such transactions and disclaiming any responsibility for the de-SPAC registration statement pursuant to Section 11(b)(1) of the Securities Act, a previously very rare event. Such a termination can itself cause further delay and additional scrutiny of the transaction from the SEC.

Additionally, the threat of the new excise tax imposed under the Inflation Reduction Act of 2022 led some SPACs to wind up before year-end (earlier than required by their organizational documents) if no de-SPAC transaction was imminent. Recent guidance from the IRS has clarified that the excise tax will not apply to SPAC liquidations but will impose a 1% tax on domestic SPACs that redeem stock pursuant to its investors' redemption rights in connection with the stockholder vote required for any de-SPAC transaction. This will be an added cost on de-SPAC transactions subject to the Act, which may be significant if redemption rates continue to be very high.

These trends, as well as continued difficulty securing PIPE financing, have led to a significant number of delayed or terminated de-SPAC transactions that may pave the way for private equity buyers to fill the void left by SPAC acquirors. Further, many recently closed de-SPAC transactions have seen share prices drop far below their $10 IPO price, potentially attracting "take-private" offers.

Tax (U.S.)

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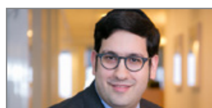

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The new year brings an opportunity to review recent changes and proposed changes to tax law. Three notable areas are the Inflation Reduction Act, partnership secondary liability for certain fund transfers and proposed regulations on how "domestically controlled" REITs are defined, each discussed below.

Inflation Reduction Act

The Inflation Reduction Act, enacted on August 16, 2022, introduced two new taxes. First, the Act introduced a 1% excise tax on certain share buybacks that occur on or after January 1, 2023. Second, the Act created a new 15% corporate minimum tax on book income for certain large corporations, applying to tax years starting on or after January 1, 2023. The IRS also recently released guidance on these new taxes, under which the IRS provided some relief for SPAC liquidations from the 1% excise tax but extended its reach to certain tax-free corporate acquisitions where sellers receive cash or other property. The IRS guidance also provided initial guidance on the complex 15% corporate minimum tax on book income, wherein the IRS excluded certain book-tax differences that the IRS views as being inconsistent with tax policy (*e.g.*, book gain from certain tax-free reorganizations and book income from cancellation of indebtedness that qualifies for the bankruptcy or insolvency exception from cancellation of indebtedness), with a promise to provide additional guidance to tackle book-tax differences arising from mark-to-market accounting rules. (For more information, *see* the Debevoise In Depth on the Inflation Reduction Act and IRS guidance).

Partnership Secondary Liability

As part of a planned phase-in, partnerships will bear secondary liability for withholding taxes under Section 1446(f) of the Code for transfers of partnership interests that occur on or after January 1, 2023. Section 1446(f) withholding arises when a non-U.S. partner in a partnership that is engaged in a U.S. trade or business transfers its partnership interest. This can occur, for example, when a fund owns a U.S. pass-through portfolio company and a non-U.S. partner does not make its investment through a blocker corporation. The transferee of the fund interest is primarily liable to make the necessary withholding unless the transferee receives appropriate certificates from the transferor or the fund demonstrating that no withholding is required. A U.S. transferor can readily demonstrate that no withholding is required by providing a W-9. Where the fund does not own any U.S. pass-through companies (for example, a fund that only invests in corporations or a parallel fund that used blockers for such pass-through companies) and a non-U.S. transferor has three years of Schedule K-1 statements, the transferor may provide a certificate to avoid withholding. In the event that the transferor does not have three years of Schedule K-1 statements, the transferor and transferee will need to look to the fund to provide a certificate. While these rules have been in effect since 2018, until now a fund that did not provide a certificate had no secondary liability on withholding. However, starting January 1, 2023, the fund will be required to withhold distributions from the transferee if the transferee fails to withhold or receive appropriate certificates. Fund sponsors should consider obtaining confirmation that the transferee has either withheld the correct amount or established an exemption from withholding.

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Tax (U.S.)

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"Domestically Controlled" REITs

Recent IRS proposed regulations clarify how the "domestically controlled" REIT test is calculated, in a change from how many in the market have been calculating this in the past. Foreign owners of U.S. real estate and U.S. corporations with significant real estate assets are generally subject to U.S. tax on disposition, but they are generally not subject to tax on the sale of a "domestically controlled" REIT, which is a REIT 50% or more owned "directly or indirectly" by U.S. persons. Under the IRS proposed regulations, the rule would look through REIT owners that are domestic corporations with significant foreign ownership. As such, these rules may impact certain private REIT transactions and existing REIT structures relying on domestic blockers with significant foreign ownership to satisfy the "domestically controlled" REIT test for the underlying REIT.

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For the investment fund industry, the most important development in the United Kingdom in 2022 was the long-awaited introduction of the Qualifying Asset Holding Company (QAHC) regime, which came into effect in April. This regime makes it possible to establish tax-efficient holding companies in the United Kingdom, through which funds and certain other types of investors may hold investments with minimal tax leakage and with repatriation of gains in capital form. However, the term "qualifying" is critical, as a holding company seeking to be covered by the regime must meet specified criteria, most notably on a minimum ownership threshold by certain categories of eligible owners. Funds seeking to establish a QAHC must navigate requirements to be regarded as "qualifying funds" in order to secure eligible owner status.

We expect to see amendments in the near future to deal with the complexities and uncertainties that remain in the legislation (although some issues may take some time to address). For example, in response to comments from the fund industry, draft provisions have already been released to remedy an issue relevant to Delaware limited partnerships. Previously, these vehicles would have been ineligible to use one of the most favorable tests to determine status as a "qualifying fund," because, technically, they are "bodies corporate" under UK law. The new proposals will allow them to use this favorable test and will apply retrospectively from the inception of the regime.

While it is still in its early days, the QAHC is a useful addition to holding company options for investment funds and His Majesty's Revenue & Customs (HMRC) are committed to making the regime a success and are keenly receptive to input from industry regarding the rules and their implementation.

Beyond the QAHC, the United Kingdom saw changes in its wider tax regime during 2022. Proposals in early autumn for significant tax reductions were quickly quashed, giving way to tax increases taking effect beginning April 2023. The most notable of these is an increase in the corporation tax rate from 19% to 25% for large companies. In addition, while ordinary income tax rates remain the same, the threshold above which the additional rate of 45% is paid will fall from £150,000 to £125,140. Furthermore, the capital gains and dividend

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Tax (UK)

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tax-free allowances for individuals will be lowered to £6,000 (from £12,300) and £1,000 (from £2,000), respectively. In addition, the United Kingdom remains committed to early implementation of the OECD proposals to introduce a global minimum tax, with draft legislation being published last summer and expected to be formally introduced in the spring.

Currently, there are no further proposed changes specifically directed at investment funds or their managers. However, as was indicated in case law in 2022, HMRC continue to show significant interest in fund structures and management teams. We expect more of the same in 2023, with anti-abuse provisions, the application of certain UK income tax rules to partnerships (including to transactions involving partnership capital) and the interpretation of "purpose" tests being likely regulatory priorities. HM Treasury's review of the UK funds regime, released in 2020, is also now generating some activity, with HMRC establishing working groups addressing key points of focus.

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State laws governing noncompetes continued to evolve in 2022 as more and more states enacted legislation to limit their use. In 2023, however, the focus will be on rulemaking at the federal level. On January 5, 2023, the Federal Trade Commission (FTC) proposed a new rule that, if finalized, would ban post-employment noncompete agreements with any worker. The proposed rule would also require employers to rescind existing noncompetes and provide individualized notice of this rescission to current and former employees. Employers would likewise be barred from representing to an employee that the employee is covered by a noncompete clause. The proposed rule would also impact seller noncompetes, prohibiting post-employment noncompetes with seller-employees who owned less than 25% of the business entity at the time they entered into the noncompete.

The FTC's proposed rulemaking follows President Joe Biden's July 2021 executive order urging the FTC to ban or limit noncompete agreements. The rulemaking also comes on the heels of recent FTC and state Attorney General enforcement actions with respect to noncompetes. The proposed rule is based on a preliminary finding by the FTC that noncompetes constitute an unfair method of competition and therefore violate Section 5 of the Federal Trade Commission Act.

Any final rule would supersede the ever-changing patchwork of state laws governing noncompetes, except to the extent any state law provides greater worker protections than the FTC's final rule. However, the ultimate scope of any final rulemaking by the FTC on noncompetes remains to be seen, as the proposed rule is subject to a comment period that runs until March 20, 2023. The effective date of the final rule would be 60 days after the final rule is published in the Federal Register, and the compliance date would be 180 days after that publication. Were the FTC to adopt the categorical ban on noncompetes as proposed, we expect legal challenges to its enforcement on jurisdictional and constitutional grounds.

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Given the amount of legislative and regulatory activity at both the state and federal levels regarding noncompetes, it is important for employers to stay ahead of legal developments in this area. Given that some states already ban noncompetes for low-wage earners and we expect that trend to continue, we recommend that employers avoid entering into noncompete agreements with low-wage earners without a compelling business reason for doing so. We also recommend that employers focus on enhancing trade secret protections beyond the use of noncompetes and begin to consider compensation tools that may be used to strengthen employee retention if the rule is adopted in some form.

Finally, we recommend that employers that are or likely will be before the FTC in other contexts (such as a Hart-Scott-Rodino merger review) be aware of, evaluate and consider proactively modifying their use of noncompetes. If such employers are using noncompetes broadly, the FTC may hold up their mergers or subject them to separate post-closing investigations.

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The U.S. Securities and Exchange Commission continued to focus heavily on private fund advisers this year, bringing a number of enforcement actions aimed at fund managers' fees and related disclosures and engaging in sweep investigations designed to boost compliance with technical books-and-records and filings requirements.

In September, for example, the SEC brought charges against Hudson Advisors LP and Lone Star Global Acquisitions for failing to disclose that the ancillary and underwriting fees charged to the funds they managed included the cost of the anticipated U.S. income tax liability of Hudson's founder due to Hudson's income from those fees. (The founder's tax liability stemmed from Hudson's formation as a limited partnership.)

The SEC's action is notable because in 2018, prior to any contact from SEC staff, Hudson and Lone Star undertook an internal review of fee practices and disclosures, identified and terminated the practice at issue (of which Hudson's owner was unaware), reimbursed the funds $64.7 million, and disclosed the issue to the LPACs. However, the extent of the remediation apparently did not fully satisfy the staff, and the order provided for an additional $3.8 million in remediation to the funds, along with a significant $11.2 million penalty. The case thus further demonstrates the SEC's more aggressive enforcement posture toward private fund managers—even when managers proactively identify, disclose and remediate a material compliance issue.

Also in September, the SEC charged Energy Innovation Capital Management, an exempt reporting adviser, with charging excess management fees in advising two venture capital funds. This action is part of the ongoing scrutiny by the Enforcement Division's Asset Management Unit of fund documents that provide for the management fee base to be lowered following particular dispositions of fund assets (such as write-offs or partial dispositions), particularly in the post-commitment period. Given the SEC staff's continuing focus on this issue during exams, private fund managers that include such provisions in fund documents should ensure that the fee calculations track those provisions and that the calculations are accurate.

In June, the SEC settled an action against Energy Capital Partners Management LP for failing to disclose (or obtain LPAC approval for) an arrangement by which third-party equity consortium co-investors would not pay their pro rata share of expenses related to a credit facility used to finance a particular transaction, with the co-investors' portion instead being allocated to the funds. The amount of money at issue was clearly immaterial to the transaction and presumably necessary to close the deal (*i.e.*, in the funds' best interest). The case shows the SEC's continued aggressive posture toward expense allocation issues, notwithstanding Commissioner Hester Peirce's dissenting vote.

Finally, the Enforcement staff is conducting several ongoing sweeps of various technical violations of the federal securities laws that will almost certainly result in enforcement actions in the coming year and beyond. Specifically, the staff's sweep of off-system communications that resulted in large fines against 11 banks this year is now focused on private fund managers and others. In addition, the Enforcement staff is conducting sweeps looking at late or other "foot fault" Schedule 13D and Form 4 filings.

U.S. Funds Regulatory

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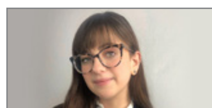

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As predicted, 2022 saw the most intense regulatory activity by the Securities and Exchange Commission in the private funds space since the Dodd-Frank reforms of 2011. The SEC issued a number of unprecedented and far-reaching proposed rules during the year that, if adopted, have the potential to reshape the private fund industry. We highlight the key proposals and actions below. The year also saw the SEC's Marketing Rule—applicable to registered investment advisers—take effect in November, with implications for everything from fund performance presentations to a sponsor's relationship with placement agents and required comprehensive rewriting of fund marketing materials and compliance procedures.

We do not expect the SEC to ease up in 2023, as it looks to adopt many of the proposed rules, begin a comprehensive sweep of marketing practices (likely in the first quarter of 2023), and continue its normal (read: aggressive) examination and enforcement efforts related to private fund sponsors. Combined with the fact that Congress approved and President Biden signed into law a 2023 fiscal year budget for the SEC of $2.2 billion (an increase of $210 million over the 2022 budget) to allow the SEC to hire even more staff, 2023 may be an even busier regulatory year than 2022 for the private fund industry.

The Year 2022 – The First Half

Form PF

On the heels of a speech by SEC Chairman Gary Gensler to the Institutional Limited Partners Association (ILPA) in November 2021 calling for increased competition and transparency in the private funds industry, the SEC on January 26 proposed amendments to Form PF that would require private fund advisers to notify the SEC within 24 hours of any of the following: (i) the completion of an adviser-led secondaries transaction; (ii) the implementation of general partner or limited partner clawbacks; or (iii) certain LP elections to terminate the fund or the general partner. The Form PF Proposal would also lower the reporting threshold for private fund advisers from $2 billion AUM to $1.5 billion and require new reporting in regular quarterly and annual reports of, among other things, fund strategies, fund borrowings, events of default, and portfolio company restructurings and financings. We anticipate that the SEC will look to adopt this proposal sometime in the second quarter of 2023.

Private Fund Regulation

On February 9, the SEC published its most far-reaching—and controversial— proposal of the year, which seeks to regulate substantive contractual terms applicable to private funds and impose certain disclosure requirements (the "Private Funds Proposal"). Both of these components will significantly impact the operation and economics of private funds and have the effect of placing the government's thumb on the scale of private party negotiations. In proposing the new rules, the SEC focused on a perceived lack of investor transparency and its concern that investors may be unable to compare economic terms across funds. In addition, the SEC essentially identified certain conflicts of interest as unacceptable by singling out and prohibiting certain fund terms.

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Certain of the substantive requirements apply to all advisers to private funds rather than to only registered advisers, including:

- *Prohibitions on certain indemnities* that would limit the adviser's liability for breach of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness in providing services to the private fund.
- *Restrictions on carveouts from GP clawback provisions* relating to taxes paid or deemed paid for distributions.
- *Prohibition on certain fees and expenses* charged to private funds (including for advisers' regulatory, compliance and examination costs and for services not provided).
- *Prohibition on non-pro rata cost allocations* related to a fund's portfolio. This may impact advisers' ability to structure co-investments.
- *Side letter terms* that would prohibit private fund advisers from providing preferential terms to certain investors, such as information rights about portfolio holdings, and prohibit certain other preferential treatment unless disclosed to all current and prospective investors.

The following requirements would only apply to registered advisers:

- *Adviser-Led Secondaries:* Registered advisers would be required to obtain and distribute a fairness opinion to investors in connection with adviser-led secondaries.
- *Quarterly Statements:* Requires registered advisers to provide fund investors with quarterly financial statements within 45 days after the end of each quarter.
- *Annual Audit Requirement:* Mandates year-end audits for all private funds advised by the adviser and imposes certain SEC notice requirements on the auditor.
- *Written Annual Compliance Review Requirement:* Would require registered investment advisers' annual compliance reviews to be documented in writing.

As we noted in our client alert on the Private Funds Proposal:

- The Private Funds Proposal represents a dramatic shift for the SEC, which has administered and enforced a largely disclosure-based regime applicable to private fund advisers. In particular, it marks a significant change in rulemaking under the Investment Advisers Act of 1940, which historically has favored principles-based regulation over prescriptive requirements.
- The Private Funds Proposal also represents an attack by the SEC on the treatment of private funds under the Investment Company Act of 1940 (the "1940 Act"), which exempts private funds (and their investment advisers and other affiliates of a private fund) from the very type of disclosure and conduct-based regulation that the proposed rules would introduce.
- Notably, the Private Funds Proposal prohibits tax-related carveouts from GP clawback provision, and would prevent advisers from seeking certain indemnities from funds, thus imposing a higher standard of care. These elements of the proposed rules in particular have the potential to cause a shift in preference away from traditional private fund, in favor of pledge funds and single-asset structures.

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- Due to the absence of any grandfathering provisions in the Private Funds Proposal, the proposed rules will seemingly apply to all private funds on the date the rules come into effect. Given the far-reaching impact of the Private Funds Proposal, a large number of fund advisers may find that their existing negotiated agreements are suddenly out of compliance. Advisers may respond by terminating existing funds early and raising new funds with compliant terms, increased cost, and renegotiated side letters. The resulting disruption in the markets could also significantly impact the dry powder available and the management of existing investments and co-investments, and could severely diminish investor returns and affect the operations of portfolio companies.

We anticipate that the SEC will look to adopt the Private Funds Proposal in the spring of 2023, although given the transformative nature of the rules, we expect some manner of legal challenge to the rules based on the SEC's lack of authority to adopt such rules, a failure to consider alternatives and an incomplete cost-benefit analysis as required by federal law, which likely will delay implementation of any final rules.

Cybersecurity

On February 9, the SEC also released proposed rules addressing cybersecurity risk management, incident reporting, and disclosure for RIAs and funds (the "Cybersecurity Proposal"). The Cybersecurity Proposal promulgates an entirely new cybersecurity regulatory regime for registered advisers to private funds, requiring an expansion of cybersecurity risk management practices to cover all systems and data for such entities. If adopted, the Cybersecurity Proposal would impose internal control, reporting and disclosure requirements:

- *Internal Controls:* The Cybersecurity Proposal requires investment advisers to adopt and implement policies and procedures that are "reasonably designed" to address cybersecurity risks.
- *Reporting:* The Cybersecurity Proposal would also require advisers to report certain cybersecurity-related incidents to the SEC within 48 hours.
- *Disclosure Requirements:* The Cybersecurity Proposal also adds disclosure of cybersecurity-related risks and incidents to Form ADV.

We anticipate the SEC taking action on this proposal sometime in the spring of 2023.

ESG

On May 25, 2022, the SEC issued proposed rules regulating ESG-related disclosures for investment advisers. The ESG Proposal seeks to address the concern of greenwashing, a practice in which an investment adviser overstates or misrepresents the environmental factors considered in its portfolio selection. It also aims to clarify what the SEC believes is confusion surrounding ESG products. The ESG Proposal would therefore require an adviser to classify each 1940 Act fund advised by an adviser and investment strategy offered by the adviser into one of three categories with particular disclosure requirements in 1940 Act fund documents and in Form ADV, depending on the ESG category:

- *Integration funds or strategies*, which consider one or more ESG factors alongside non-ESG factors, where ESG factors are no more significant than non-ESG factors.
- *ESG-focused funds or strategies*, which focus on one or more ESG factors by using them as a significant or main consideration in selecting investments or in their engagement strategies with portfolio companies.

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- *Impact funds or strategies*, a subset of ESG-focused funds or strategies that seek to achieve specific ESG impacts.

The ESG Proposal also adds other ESG disclosure requirements to Form ADV.

We anticipate the SEC taking action on this proposal in the fall of 2023.

The Year 2022 – The Second Half

The SEC's ambitious rulemaking pace slowed down considerably during the second half of the year. Further guidance on the implementation of the Marketing Rule, which became effective November 4, was notably absent, forcing many sponsors to grapple with a host of interpretive and implementation questions in the run-up to the compliance date and in subsequent fundraising efforts. On September 19, the SEC's Division of Examinations published a risk alert previewing anticipated review areas in examinations of advisers under the new Marketing Rule, which we expect will commence in the first quarter of 2023. Private fund advisers should therefore be prepared for a Marketing Rule compliance sweep, with potentially further SEC "guidance" in the form of risk alerts and deficiency letters, following sometime thereafter.

Outsourcing

On October 26, the SEC released a proposal addressing the perceived risk resulting from investment advisers outsourcing certain core functions to third-party or related service providers. If adopted, the Outsourcing Proposal would require private fund advisers to (i) perform due diligence before engaging certain service providers; (ii) monitor service providers on an ongoing basis; and (iii) provide information on the adviser's use of service providers in Form ADV. We anticipate the SEC acting on this proposal sometime in the second half of 2023.

ERISA

On November 22, the Department of Labor issued a final regulation that permits ERISA fiduciaries to take into account ESG factors when making certain investment decisions. This reversed earlier Trump administration guidance, which required ERISA fiduciaries to make investment decisions solely based on "pecuniary" factors. Under the ERISA Rule, fiduciaries will employ a principle-based approach determining factors relevant to a risk and return analysis. Such factors may, but are not required to, include the economic effects of climate change and other ESG factors.

Looking Forward

We expect a busy 2023 for regulatory matters, perhaps even busier than 2022. In addition to the potential adoption, in some form, of the proposals noted above—and legal challenges to the Private Funds Proposal—we anticipate the SEC proposing additional rules affecting the private fund industry, including amendments to the rules related to the custody of client assets, amendments to Regulation D and Form D (presumably to require issuers and sponsors to provide additional information about their offerings), and changes to the determination of "holders of record" for purposes of counting investors in private issuers. We also expect, as noted above, increased examination of private fund marketing as a result of the new Marketing Rule, and continued private fund examination and enforcement efforts.

European Funds Regulatory

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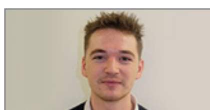

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In the European Union, 2022 was a key year for Environmental, Social and Governance (ESG) regulations, as fund sponsors invested time and resources responding to the coming into effect of the Sustainable Finance Disclosure Regulation (SFDR) in 2021 and the EU Taxonomy in 2022. Many fund sponsors moved from minimum standards of disclosure to so-called Article 8 classification, reflecting the trend toward financial products that promote environmental and/or social characteristics. However, some uncertainties regarding the regulations' requirements remain. In response, the European Commission and national regulatory authorities issued guidance on SFDR and the EU Taxonomy during 2022, shedding some light on pressing issues in the application of the ESG rules.

The EU Taxonomy is generally recognized as an achievement given the classification standardization of economic activities contributing to environmental objectives according to scientifically based criteria. However, some aspects of the EU Taxonomy remain controversial—such as, for example, the decision to include criteria enabling fossil gas and nuclear energy to be considered green activities. Interestingly, during 2022, the SFDR has largely become viewed as a labelling regime rather than a disclosure regulation (as originally intended).

Some European jurisdictions, concerned with the mis-selling of "green" investments to retail investors, are establishing regimes to target greenwashing. The United Kingdom's Financial Conduct Authority published a Consultation Paper that introduces a concrete "labelling" regime for funds wishing to market to retail investors as green. Other EU national jurisdictions, including Germany and France, followed suit. Greenwashing is also a key priority for the European Securities and Markets Authority, which launched a consultation on guidelines for the use of ESG or sustainability-related terms in fund names. In addition, the European Supervisory Authorities published a call for evidence on greenwashing to gather input on the key features, drivers and risks associated with greenwashing and to collect examples of potential greenwashing practices. It seems that the SFDR, rather than representing the last word on greenwashing, has instead led to further discussion on the matter, driven by the substantial amount of disclosure the regime requires.

Last year also saw the publication of the Corporate Sustainability Reporting Directive (CSRD) in the EU. While the framework is now very much at the early stage, with requirements to be phased in from January 2024, the CSRD substantially widens the scope of companies subject to sustainability-related reporting obligations while expanding and standardizing the type of information to be reported.

A draft of the Directive on Corporate Sustainability Due Diligence (CSDDD) was also published in 2022. If adopted, the draft Directive will require companies under its purview to conduct corporate due diligence that identifies, prevents and mitigates adverse human rights and environmental impacts by the company, its subsidiaries and business relationships in their value chains. Both the CSRD and CSDDD will affect in-scope companies both within and outside the EU.

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Further, proposed changes to the Alternative Investment Fund Managers Directive (AIFMD), which sets the regulatory framework for the marketing and management of funds in the EU, were the focus of much discussion in 2022 following their publication in the previous year. The revisions will likely set out specific product rules on loan origination funds and also introduce enhanced rules on reporting on delegation and on fees and expenses. The new rules would have to be transposed into national law before becoming directly applicable, likely in 2025.

ESG and the AIFMD revision are likely to remain high on the EU's regulatory agenda in 2023.

ESG

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The past year saw numerous regulatory and other governmental actions regarding ESG in both the United States and the EU, which we summarize below.

U.S. Securities and Exchange Commission

Goldman Sachs settled with the SEC. On November 22, the U.S. Securities and Exchange Commission ("SEC") settled charges with Goldman Sachs Asset Management relating to three portfolios marketed as ESG investments. With respect to two funds and one separately managed account, the SEC found that, for a period, Goldman lacked written policies or procedures regarding incorporating ESG factors into the investment process prior to the securities' selection for portfolios. The SEC further found that, once written ESG policies and procedures were in place, Goldman inconsistently followed them. Without admitting or denying the SEC's findings, Goldman Sachs paid a $4 million penalty and agreed to a cease-and-desist order and censure.

State-Level Developments

Several significant ESG-related regulatory developments occurred in the past year at the U.S. state level. Debevoise has developed a tracker for these developments, which can be accessed here: State-Level ESG Developments tracker. We highlight a number of key developments below:

Florida took steps to eliminate ESG considerations from state pension investments and withdrew $2 billion from BlackRock management, citing ESG investment concerns. On August 23, Florida Governor Ron DeSantis and Trustees of the State Board Administration (SBA) passed a resolution updating the fiduciary duties of the SBA's investment fund managers and advisers, and prohibiting ESG considerations in Florida's pension investment management strategies. The resolution stated that investment decisions "must be based only on pecuniary factors [which] do not include the consideration of the furtherance of social, political, or ideological interests." On December 1, 2022, Florida Chief Financial Officer Jimmy Patronis announced that the state would remove $600 million of short-term investments from BlackRock's management. The

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State Treasury further directed Florida's custody bank to freeze $1.43 billion of long-term securities, with the intention of reallocating the funds to other money managers by 2023. The announcement included claims that BlackRock has taken an "undemocratic" and "ideological" approach to its investments. This is the largest known divestment of state funds motivated by anti-ESG sentiments.

Asset managers testified before Texas State Senate committee on ESG practices. On August 24, Texas Comptroller Glenn Hegar announced a list of 10 financial companies deemed to "boycott energy companies." Less than three months later, a Texas Senate committee issued a subpoena to representatives from some of the world's largest asset managers for information on their ESG policies and practices. The asset managers testified on December 15 before a senate committee in Marshall, Texas regarding their role in federal rulemaking on ESG standards, the effect of the companies' ESG policies on state public pension investments and their advising policies on risk/return for clients, among other topics. Vanguard, the world's second-largest asset manager, was absent from the hearing following its December 7 decision to withdraw from the Net Zero Asset Managers initiative, a coalition of international asset managers committed to limiting global temperature rise and supporting the goal of fund firms reaching net zero greenhouse gas emissions by or before 2050. Vanguard indicated that it based its exit on a need for greater independence, clarity for its investors and freedom from investment restrictions.

Democratic state attorneys general and BlackRock responded to Republican criticism of ESG investing. On August 4, 2022, 19 Republican state attorneys general sent a letter to BlackRock criticizing the fund manager's alleged prioritization of ESG investment criteria over return on investment in managing state pension funds, potentially in violation of state and federal laws. In particular, the attorneys general maintained that BlackRock may have breached its duty of loyalty to investors for its alleged failure to invest state pensions with the undivided commitment to financial return. BlackRock responded on September 6, asserting that the Republican attorneys general had made inaccurate statements regarding BlackRock's motive and process for engaging in ESG investments. BlackRock defended itself as a "leading fiduciary asset manager" and asserted that "BlackRock's belief that climate risk poses investment risk is backed by [BlackRock's] publicly available research." On November 21, D.C. Attorney General Karl Racine and 17 other Democratic state attorneys general addressed the Republican claims in their own letter to Republican senators and members of Congress. The Democrats' letter emphasized that ESG factors "are like any other material factors" and that consideration of ESG factors is itself part of "prudent investment decision-making." The letter also suggested that state pension funds consider ESG factors in an effort to encourage positive financial results and protect state employees' savings against "foreseeable risks."

Miscellaneous

The U.S. Department of Labor released its final ESG rule for ERISA Plans. On November 22, the Department of Labor announced the reversal of a rule enacted under former President Donald Trump that implicitly restricted ESG offerings. Under the

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new rule, ERISA fiduciaries may now consider ESG factors in the process of investment selection for pension funds. The final regulation reiterates the well-established policy that an ERISA fiduciary "may not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits under the plan to other objectives." Neither may an ERISA fiduciary "sacrifice investment return or take on additional investment risk to promote benefits or goals unrelated to interests of the participants and beneficiaries." However, the rule also expressly permits a fiduciary's consideration of ESG in the context of risk return factors, subject to the fiduciary's duties of loyalty and prudence. The change reflects the DOL's stance under President Biden. The final rule will come into effect on January 30, 2023. (Find more information about the final rule in the firm's November 29 client update.)

Europe

European Securities and Markets Authority began consultation on guidelines for use of ESG terms in fund names. The European Securities and Markets Authority invited comments on proposed guidelines on the use of ESG and sustainability-related terms in fund names. ESMA Chair Verena Ross said the initiative was driven in part by transparency concerns, "tackling the risk of greenwashing," and investor protection against "unsubstantiated or exaggerated sustainability claims." ESMA proposed the introduction of minimum thresholds to align the use of ESG or sustainability-related terms in a fund's name with its investment characteristics and objectives. If a fund uses any ESG-related term in its name, at least 80% of its investments should be used to meet the environmental or social characteristics or sustainable investment objectives in accordance with the binding elements of the investment strategy under the Sustainable Financial Disclosure Regulation. Of the 80% devoted to ESG objectives, 50% of the fund's investment should be devoted to sustainable investments as defined by the SFDR if the fund contains a sustainability-related term within its name. ESMA has outlined the preferred format of responses to its proposal here and will consider all comments received by February 20, 2023.

EU member states reached a political agreement on the world's first major carbon border tariff. On December 13, the EU agreed to implement the world's most significant carbon border tax in an effort to steer the European economy toward carbon neutrality by 2050. The scheme will require companies importing polluting goods into the EU to buy certificates to cover emissions. The law initially will tax imports of iron and steel, cement, fertilizers, aluminum and electricity, and eventually will extend to other goods. Dutch politician and lead carbon tax negotiator Mohammed Chahin stated that the tax "is one of the only mechanisms we have to incentivize our trading partners to decarbonize their manufacturing industry." The plan likely will be implemented by October 2024 and allow for a transition period until 2026 or later.

ESG Regulatory Trends in Asia

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The last few years have seen rapid growth in the number of environmental, social and governance guidelines in the APAC region. While ESG regulatory regimes in the region are not yet as advanced as in the United States and Europe, we expect APAC regulators will continue to develop ESG regulations to increase scrutiny of green funds and provide investors with enhanced ESG data.

For example, Hong Kong, Singapore and Japan have rolled out ESG disclosure requirements for listed companies (although compliance is mostly on a voluntary or "comply or explain" basis). The Hong Kong Stock Exchange has imposed additional mandatory disclosure requirements relating to the governance, reporting structure and the reporting boundary of listed issuers. India has built on its current disclosure recommendations by requiring a new Business Responsibility and Sustainability Report from the 1,000 largest listed companies by market capitalization. In Japan, large companies and those listed on the Tokyo Stock Exchange's Prime Market have been required to make climate-related disclosures since April 2022; this requirement will eventually expand to cover all companies that submit annual securities reports. In South Korea, the Financial Services Commission lowered the total asset threshold at which companies must make mandatory filings of corporate governance disclosures from KRW 2 trillion to KRW 1 trillion.

In line with global efforts to manage climate-related risks and combat greenwashing, many APAC countries and regions have also made steady progress in promulgating requirements and guidelines applicable to green funds. The Securities and Futures Commission in Hong Kong has required green funds to disclose their ESG focus, investment strategy, asset allocation, reference benchmark, additional information and risks, with heightened disclosure requirements for climate-focused funds. Similarly, the Monetary Authority of Singapore has rolled out ESG-specific requirements for fund naming, prospectus disclosures and periodic reporting, which took effect on 1 January 2023. In Japan, the Financial Services Agency has issued guidance that asset managers selling ESG- or Sustainable Development Goal-Related products should explain how the products satisfy the characteristics of those designations, with concrete metrics to enhance transparency for customers.

Although the current requirements and guidelines currently applicable to green funds largely center around disclosure and reporting, we expect heightened and more stringent regulation of green financial products by APAC regulators as more and more capital flows into ESG investments.

With ESG set to remain in regulators' spotlight, funds looking to equip themselves for successful exits should look beyond compliance and regulatory reporting and prioritize two tasks: (i) identifying new investments with a clear ESG focus with the potential to generate both positive impact and robust returns, and (ii) ensuring that the funds' due diligence processes and controls adequately cover ESG issues. Post-acquisition, funds should work closely with their portfolio companies to make sustainability and governance part of the benchmark of financial performance, seek advice from specialists on regulatory and risk management issues, and develop ESG programs focused on creating long-term value.

Intellectual Property

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Protecting Software as a Trade Secret

A company's most valuable asset may be its proprietary software. This point was underscored in October, when Versata Software landed a $105 million verdict against a licensee for reverse engineering Versata's proprietary vehicle component configuration software. While many developers seek to protect their software by copyrighting their source code, trade secret protection provides advantages over copyrighting, including no registration requirement or filing fees, and the ability to keep code—and possibly even functionality—secret from competitors. We regularly counsel clients on the requirements that go along with protecting software as a trade secret, which recent court decisions have helped to clarify.

What is protectable? Companies regularly protect their source code as a trade secret—although doing so precludes disclosing that code in a copyright deposit. (Instead, the copyright office permits the owners of trade secret code to submit only portions of the code or to redact trade secret portions.) Furthermore, in *Turret Labs USA, Inc. v. CargoSprint*, LLC, No. 21-952, 2022 WL 701161 (2d Cir. Mar. 9, 2022), the Second Circuit suggested that "a computer software's functionality" can be a trade secret, even if that functionality "is made apparent to all users of the program."

To be a trade secret under the federal Defend Trade Secrets Act (which mirrors most states' laws), however, information cannot be "readily ascertainable through proper means." And the Third Circuit has found that, where "reverse engineering is so straightforward that the distribution of a product is itself akin to a disclosure," information is not a trade secret. *Mallet & Co. Inc. v. Lacayo*, 16 F.4th 364, 388 n. 31 (3d Cir. 2021). Thus, developers should consider whether their software functionality can be readily replicated before relying on trade secret protection.

How to keep it secret? To qualify for trade secret protection, owners must take reasonable measures to keep information secret. In *Turret Labs*, Turret alleged that an entity had improperly gained access to Turret's proprietary software. The Second Circuit, however, affirmed the dismissal of Turret's misappropriation claims, holding that Turret failed to adequately plead reasonable measures. The court found that, where a trade secret consists of a software's functionality, "the reasonableness analysis will often focus on who is given access, and on the importance of confidentiality and nondisclosure agreements to maintaining secrecy." Turret protected its purported trade secrets by keeping servers in monitored cages and limiting access to the software to those with usernames and passwords. But the Second Circuit found these security measures were "largely irrelevant" since Turret had authorized Lufthansa Cargo Americas to grant end users access to Turret's software without requiring Lufthansa to limit "access only to legitimate freight forwarders bound by confidentiality agreements."

To ensure compliance with the reasonable measure requirement, owners should consider:

- requiring third parties to sign written confidentiality agreements before providing demonstrations or trials of software;
- drafting licenses to ensure that all users are bound by confidentiality requirements;
- marking any visible parts of software as confidential; and
- restricting access to those who need to use software, and logging who uses it.

By selecting the appropriate information to protect and taking measures to maintain its secrecy, trade secret law can offer additional protection for a company's most valuable assets.

Real Estate

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The headline factor for real estate in 2022 has been the same as that for many other sectors—persistent inflation around the world leading to interest rate increases from the Federal Reserve and other central banks. As lenders have followed suit, real estate transaction volume has cooled, and the combination of higher rates and rising prices for building materials has slowed construction activity. Banks have shied away from real estate lending in recent months as uncertainty around the U.S. economic outlook continues. Fundamentals in industrial, retail and hotels remain strong for now, but real estate investors will need to be creative in sourcing opportunities and flexible in managing debt moving forward.

Multifamily stabilized occupancy has remained high in 2022, though rent growth began to slow in the later months of the year. The Single-Family Rental (SFR) market also decelerated, though a tight job market will likely keep residential demand strong for the near term. Investors purchasing stabilized residential assets will be well-positioned to capitalize on strong housing demand even given higher interest rates, though developers will have to continue to contend with higher building costs. If land costs continue to rise, developers and investors may find that moderate residential rent growth will not provide sufficient returns. Federal and/or state efforts to reduce burdensome regulations and expand housing supply may create additional opportunities for investors to tap into heavy demand.

Trades have been down among office buildings, where even large market players have accepted foreclosures on core assets. Office occupancy has seemingly settled in at a lower level than before the pandemic, as hybrid and fully remote working models become a permanent part of the landscape. Encouraged by municipal governments, investors have begun to convert office properties into residential spaces despite the inherent structural difficulties. Even established players in the office market have sought to marshal investor funds toward residential redevelopments, which could provide an avenue toward relieving housing affordability pressures.

In the fund space, public REIT stocks struggled in 2022 after a solid 2021. Non-Traded REITs (NTRs), whose asset values are based on appraisals instead of a public share price, have outperformed public REITs, though some NTRs have recently signaled weakness by capping investor redemptions. Investors are likely to take liquidity where available and may seek to further liquidate NTR positions because they cannot easily liquidate closed-end fund positions. If redemptions stay high in 2023, fund managers may be forced to sell assets in order to raise the necessary cash, placing additional downward pressure on prices.

The outlook for real estate in 2023 seems to be apprehensive but selectively optimistic, with areas of both strength and concern. If the Fed slows its pace of interest rate increases in early 2023, real estate transactions and construction activity might return to levels seen earlier in 2022 fueled by easier access to debt capital. If the economy continues to be overheated, however, 2023 could be a continuation of late 2022, with slower transaction volumes and a greater number of foreclosures and deeds-in-lieu, particularly for office properties.

Restructuring

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While low interest rates and open capital markets led to relatively little restructuring in early 2022, activity picked up notably in the autumn as a rising interest rate environment and tightening money supply required companies and investors to reevaluate their approach to distressed situations.

As in past cycles, climbing interest rates and the resulting unavailability of cheap capital have made it more difficult for highly levered companies to secure new capital or refinance debt. Businesses with floating-rate debt face increased debt service obligations, with highly levered companies in particular struggling to grow revenue to match these increased costs, particularly in light of supply chain stress, inflation and other macroeconomic disruptions. Consumer-facing businesses may soon face added strain as COVID stimulus phases out and consumers begin to feel the bite of inflation, potentially changing spending patterns and further straining business revenue. This confluence of factors has resulted in increased workout activity, but, except for certain industries, much of that activity remains out of court, as business Chapter 11 filings remain historically low.

A notable exception to the out-of-court workout trend is in the cryptocurrency sphere. There, 2022 saw a cascade of Chapter 11 filings, including by crypto "bank" Celsius Network and brokerage service Voyager Digital in July, followed by filings in November for crypto exchanges FTX, FTX.US and BlockFi. All told, these crypto-industry defaults have resulted in billions of dollars of frozen or lost value, although there has thus far been limited spillover into the broader U.S. and international economy, and it remains to be seen whether such a contagion will occur.

Mass tort liabilities are another area of steady in-court restructuring activity, with Hess Corp. and 3M Technologies filing high-profile bankruptcies in 2022 to resolve pending tort litigation. Looking ahead to 2023, the mass-tort landscape may shift based on decisions in potentially transformative circuit-level cases: the Second Circuit is considering the future availability of third-party releases in the context of the Purdue Pharma case, and the Third and Fourth Circuit both have pending cases regarding a solvent entity's use of 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. Regardless of the outcome, however, we expect that Chapter 11 will continue to be an important mechanism for addressing litigation claims in a streamlined way that is fair to all claimants.

In other litigation news, out-of-court liability management transactions involving disparate treatment for majority and minority lenders (such as the "uptier" and "dropdown" liability management moves that were increasingly common in post-pandemic financing) have faced ongoing litigation challenges, and now these so-called "lender on lender violence" transactions may be on the downswing. In part, this may result from recent court decisions that have been generally favorable to the minority lenders, including suits involving lenders to mattress manufacturer Serta Simmons and surfwear company Boardriders. In addition, the advancing credit cycle and rising-rate environment has also created more opportunities for distressed investors to find attractive high-yield returns in deals that are open to all lenders, not just a few.

As we look ahead to 2023, the scope and nature of restructuring activity will be largely determined by the capital markets generally. If interest rates continue to rise, we anticipate a much more challenging environment for out-of-court liability management, and a related increase in Chapter 11 activity.

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Renewable Energy

The global shift toward renewables accelerated sharply in 2022, driven by the continuing transition to clean energy and the energy crisis arising out of the war in Ukraine. The International Energy Agency now estimates that renewable energy will grow by 2,400 GW over the next five years, a 30% increase from last year's forecast, and become the largest source of electricity by 2025. In the first half of 2022 alone, private equity and venture capital investors poured almost US$12 bn into renewable energy projects, compared to US$15 bn over the full year of 2021.

Nevertheless, much remains to be done to achieve net zero by 2050. In particular, the International Energy Agency forecasts that renewables will need to constitute at least two-thirds of the total energy mix.

Against this background, it is unsurprising that opportunities for renewable energy investors abound. For example:

- In the United States, the new Inflation Reduction Act is expected to drive investment in clean energy of more than US$360 bn through a combination of tax incentives, grants and other funding mechanisms.
- In order to meet international climate obligations and end the EU's reliance on Russian fossil fuel, in May 2022, the European Commission proposed the REPowerEU plan, which would increase the EU's renewable energy consumption from 40% to 45% by 2030.
- Both the Indian government and the Chinese government (in its new 14th Five-Year Plan) have set ambitious renewable energy targets that are estimated to double each country's renewable capacity expansion over the next five years.
- Coming out of COP27, the Africa Just and Affordable Energy Transition Initiative aims to increase the generation of renewable electricity across Africa by 25% by 2027 and create an energy sector centered on renewables by 2063 (as we reported here).

As is often the case, however, great opportunity has been accompanied by significant risk as governments have continued to target renewables investments in 2022. For example:

- The UK government imposed a revenue cap on renewable energy producers in October's Energy Prices Act 2022 and then adopted plans to introduce a five-year levy of 45% on profits of certain renewable electricity generators.
- The EU Council agreed to impose a temporary market revenue cap of €180/MWh on inframarginal energy production, which includes renewable energy.
- The Mexican Supreme Court failed to reach the supermajority required to declare President López Obrador's Reform Act unconstitutional, a development that (as we reported here) significantly harms renewable energy investors by prioritizing energy produced by the state-owned energy company at the expense of private power contracts and permits. However, the application of the Act remains suspended by a number of court injunctions, and the Act could still be declared unconstitutional by the Chambers of the Supreme Court (which are not subject to the supermajority voting requirement).

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International Arbitration

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Further, the renewables sector is no stranger to disputes driven by rollbacks of regulatory incentives. For example, as we discussed here and here, investors have brought more than 50 investment-treaty claims against Spain in response to its rolling back of solar energy subsidies. Investors seeking to take advantage of opportunities in the renewables sector thus should bear in mind the possibility that regulatory or legislative incentives—such as the Inflation Reduction Act—may be rolled back or weakened as a result of unforeseen shifts in the political or legal environment.

A key way to manage these risks is through contractual protections, including robust dispute resolution clauses structured to optimize the chances of success in future disputes. A comprehensive approach that takes into account applicable investment treaties—which set the standard by which the host State must treat foreign investments and provide investors with a neutral international forum in which to seek relief when suing the host State in its own courts is not a viable or attractive option—can also be vital to protecting private equity investments in renewables, as we discussed here. Working with outside counsel having specialized experience with these issues can help private equity firms successfully protect their international investments.

Healthcare

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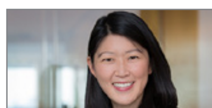

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Investor Outlook for Telehealth Services

The COVID-19 pandemic spurred a boom in the adoption of telehealth services that is expected to continue unabated. Not surprisingly, this sector has attracted considerable attention from investors, with venture capital investment in digital health (which includes telehealth, as well as health IT, wearable devices and other areas) tripling from 2017 to 2020.

At the start of the pandemic, federal and state lawmakers temporarily eased regulatory burdens to facilitate the growth of telehealth services. On the federal level, the relatively flexible regulatory environment created at the start of the pandemic is expected to continue for the foreseeable future. On December 23, 2022, Congress passed the Consolidated Appropriations Act of 2023, which extends through the end of 2024 the easing of a number of restrictions on telehealth services for Medicare beneficiaries instituted during the COVID-19 public health emergency. This enactment maintains the removal of geographic requirements and the expansion of originating sites for telehealth services, expands the list of practitioners eligible to furnish telehealth services, and expands telehealth services for Federally Qualified Health Centers and Rural Health Clinics. Of course, these changes are not permanent. If the extension expires at the end of 2024, the federal system would revert largely to its pre-pandemic form. That said, given the strong support for telehealth services, it seems unlikely that Congress would let all of the pandemic-era telehealth waivers expire in the foreseeable future.

At the state level, many jurisdictions have enacted payment parity laws that generally require private insurers to reimburse telehealth and in-person services at the same rate.

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Healthcare

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As of the end of 2022, 21 states (including California) have enacted permanent payment parity laws, with another five passing temporary ones.

Dramatic expansion of any industry combined with relaxed regulatory requirements often brings bad actors—with regulators and law enforcement not far behind. For example, in July of 2022, the U.S. Department of Health and Human Services' Office of the Inspector General issued a Special Fraud Alert advising practitioners to exercise caution in transacting with telemedicine companies. This followed the U.S. Department of Justice's announcement of a national enforcement action in which it brought criminal charges against 36 defendants in 13 federal district courts for upwards of $1.2 billion in alleged fraudulent telemedicine, cardiovascular genetic testing and durable medical equipment schemes. The U.S. Drug Enforcement Administration has also investigated telehealth companies in connection with possible violations of the Controlled Substances Act. Regulatory scrutiny will likely extend beyond clear-cut cases of fraud to include more general compliance enforcement, with a particular focus on kickbacks, overuse and interstate licensing issues. All healthcare investors—not just those directly involved in telehealth or healthtech—thus need to carefully monitor the ongoing evolution of telehealth regulation and enforcement.

Insurance

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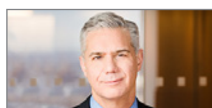

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As previously reported in our 2022 Private Equity Midyear Review and Outlook, insurance regulators continue to take an interest in PE ownership of insurers, with the National Association of Insurance Commissioners adopting in July its "Regulatory Considerations Applicable (But Not Exclusive) to Private Equity (PE) Owned Insurers." The Regulatory Considerations prompted numerous ongoing referrals to various NAIC working groups, reflecting the regulatory appetite for increased transparency into related-party transactions and PE owners' holding company structures, as well as improved regulatory tools to better assess the riskiness of complex transaction structures.

For example, as discussed in our December review of the 2022 NAIC Fall National Meeting, the NAIC Group Solvency Issues (E) Working Group is developing a proposal to request more information from Form A applicants, including information regarding the acquirer's economic goals, dividend expectations and ability to provide additional capital support in the future. The Working Group also formed a drafting group tasked with identifying scenarios in which owners (directly or indirectly) of less than 10% of the voting securities of an insurer may be deemed to have "control," through, for example, board representations, non-customary minority shareholder rights, restrictive investment management agreements, or excessive control or discretion over investment strategies. (As we discussed here, on April 19, the New York State Department of Financial Services issued Circular Letter No. 5 to all New York-domiciled insurers and

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Insurance

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other interested parties describing how DFS interprets "control" under the New York insurance law for transactions with insurers.)

Several changes made earlier this year stemming from the Regulatory Considerations are already effective as of 2022 year-end reporting. For example, the Statutory Accounting Principles (E) Working Group adopted revisions to Statement of Statutory Accounting Principles 25 (Affiliates and Other Related Parties) to clarify related-party and affiliate investment disclosures. These adoptions build upon Schedule Y, Part 3, a new financial statement schedule that became effective for 2021 year-end reporting and that requires the identification of all investors with holdings in the applicable insurer or insurance group in excess of 10% of its equity interests, regardless of any disclaimers of control or affiliation.

Another concern of regulators is that the rising interest rate environment has increased the likelihood that reporting entities will move to a net negative interest maintenance reserve (IMR) position from the sale of fixed-income instruments. Under current statutory accounting principles, negative IMR is not an admitted asset, and so net negative IMR-positioned insurers must record a non-admitted asset, thus lowering the insurer's surplus and risk-based capital.

Data, privacy and the use of artificial intelligence in the insurance industry was another major theme of the 2022 NAIC Fall National Meeting. A number of NAIC groups are concerned about implicit bias in artificial intelligence, which is increasingly being used by insurers for underwriting and other purposes, as well as for big data and consumer privacy protections. Going forward, we expect regulators to keenly focus on ways to address such perceived inequities in the insurance industry.

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