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From the Editors

Like much of the economy, the private equity industry has shifted into a lower gear in the face of high interest rates, market uncertainty and ongoing geopolitical turbulence. Even so, the work of structuring deals, tapping into capital markets, and managing regulatory and technological change continues—and is arguably even more important to the bottom line in a lower-growth environment.

The Spring 2023 Private Equity Report probes important trends unfolding on each of these fronts. We hope you find it a useful resource for managing risk and seizing opportunity.

Carve-Out Deals Today: Overcoming Complexity and Unlocking Value

The potential of carve-out acquisitions to unlock value in underinvested businesses has been long known. But the process of extracting a business unit from its parent, with all necessary financial information, assets, employees and data intact—and while under considerable time pressure—can be exceptionally complex and test the skills of even the most experienced deal teams. Here we present a systematic review of the key dimensions of carve-outs, along with their major considerations.

Spring Roundup of Crucial U.S. Regulatory Developments

As we approach the middle of the year, the SEC continues its brisk rulemaking pace. Its proposal to replace the Custody Rule with the Safeguarding Rule would expand coverage to include a wider range of assets, account for industry changes that have occurred since 2009 and much more closely regulate the adviser-custodian relationship. In addition, proposed amendments to Form PF have been adopted, and the Cybersecurity Rule Proposal comment period has been reopened.

The Up-C Goes to Court: Managing the Emerging Risks of an Advantageous Tax Structure

The Umbrella Partnership Corporation, or "Up-C," has become an increasingly popular way for sponsors of LLC portfolio companies treated as partnerships for tax purposes to access the public securities markets

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while preserving many of the tax efficiencies of a traditional partnership ownership model. However, care must be taken, as the Up-C has also attracted the attention of the plaintiffs bar and minority investors alleging the structure allows conflicts of interest and unfair allocation.

Generative AI: Risks and Considerations for Private Equity

The release of powerful generative AI tools has prompted private equity, like virtually every other industry, to imagine the possibilities for automating a wide range of tasks. But generative AI also brings with it a host of regulatory, quality control and third-party management risks. By establishing appropriate risk-based policies, procedures and guardrails, private equity firms can more safely manage their use of this technology as it becomes more prevalent and more powerful.

"Honey, why is the toaster trying to convince me that all of this new A.I. stuff is nothing to worry about?"

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SPOTLIGHT

Carve-Out Deals Today: Overcoming Complexity and Unlocking Value

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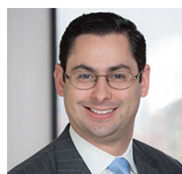
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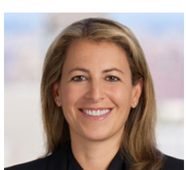
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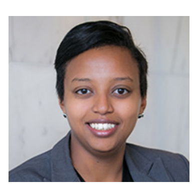

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Savvy private equity buyers have long known that carve-out transactions can be a powerful tool for unlocking value from often under-invested businesses. And although the number of carve-out transactions in the market today is likely to be affected by the same macro forces currently dampening the broader M&A market, we expect that large corporates will continue to look to divestitures as a means to raise capital, shore up losses or focus their resources on core businesses and strategies. Today's carve-out deals are often marked by two recurring elements that could be in opposition: the complexity inherent in this type of transaction and the speed with which corporate sellers want to move to effect the transaction; managing both is critical for minimizing deal risk.

Complexity may be introduced in several ways. The deal might require carving out decentralized international operations or separating business units in a regulated industry. Or the carve-out may be predicated on a contemporaneous flip of a portion of the acquired business to a third-party buyer. In some cases, a private equity buyer may pursue two businesses for sale by two different owners with a view toward combining them; when one (or both) of those businesses is a carve-out, integration challenges are magnified, particularly when the carve-out business does not have its own management team or is not operationally self-sufficient.

Then there is speed. The race to deal execution in many deals today increases the pressure on buyers to get a handle on the complexities raised by a carve-out in a highly compressed period of time. In competitive situations, buyers may find themselves squeezed by tight deadlines or constrained by limited access to management and diligence.

With these considerations in mind, this article will discuss some of the deal execution considerations for private equity sponsors doing carve-outs in today's market:

1. Defining the Transaction Perimeter

At the core of any carve-out is the need to define the perimeter of the business being sold, identify the assets that comprise it and scope the related liabilities that will be assumed. These variables become more challenging to determine if the business has not been operated as a separate division or if it is deeply intertwined with the corporate parent's operations.

A buyer will need to thoroughly understand the scope of shared services between the corporate parent and the divested business (*e.g.*, back-office functions like treasury, tax, legal and HR), how the cost of those shared services has historically been charged or allocated to the divested business

and the costs of replacing those services going forward. A buyer will also need to conduct due diligence on the extent of shared facilities, personnel, contracts and other assets and then assess the impact of the carve-out on costs and operations when those facilities, assets or people either transfer with the divested business or remain with the seller and need to be replaced. Close coordination between the buyer and the management team is critical to this diligence, although naturally hampered by the fact that management is still operating in sell-side mode prior to signing when the buyer is negotiating these terms in the purchase agreement.

A key provision in any carve-out purchase agreement is the "sufficiency of assets" representation, in which the seller represents that the buyer is acquiring all of the assets necessary to conduct the business in the manner in which it has previously been conducted, subject to specified exceptions. Needless to say, understanding the exceptions is a critical component of a buyer's due diligence. Often today, a buyer's only remedy for a breach of this representation is under a representation and warranties insurance policy—if one is obtained.

The transition services agreement or other transitional arrangements (such as transitional supply agreements and transitional license agreements) can temporarily fill any post-closing gaps. But even with those agreements in place, it is often necessary for the buyer to do some pre-closing work to ready the business for operating on its own, such as standing up an ERP system, entering into new vendor contracts or building out the management team or back-office functionality not provided under the transition services agreement. Parties to carve-out transactions benefit from early and deep engagement in identifying services that will need to be provided to or by a divested business, assessing the mechanics and personnel necessary to provide such services and negotiating both the service fees and the length of time for which the transition services will be needed. It is also important to consider potential limitations that may prevent or constrain provision of certain services to non-affiliates, including third-party vendor consents and regulatory limitations.

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2. Financing

Historically, companies did not always prepare comprehensive financials for their component businesses. As a result, when a company decided to divest an operating unit, the unit was unlikely to have stand-alone financials. In recent years, accounting standards and disclosure practice have led segment reporting by public reporting companies to become more stringent and, as a result, public sellers are more likely to have comprehensive financials for a division being divested. In addition, even if there is no public segment reporting, in well-run auctions, carve-out financials will have been completed in advance of approaching potential buyers.

But even with these market practices and evolving accounting standards, buyers seeking to finance a carve-out acquisition often find themselves with insufficient financials to pursue their desired financing. When this occurs, it is often because the precise scope of the business being sold changed during the negotiations, so that the financials produced for the auction no longer match the actual assets and liabilities that will be acquired. New financials can usually be produced, given sufficient time and management attention, but the needed resources may be in short supply in a fast-moving sale process.

In any event, the unavoidable reality for many buyers is that some combination of audited and unaudited financials of a target business will be needed in order to obtain debt financing. It is also generally true that the more comprehensive the financials that are available, the more financing alternatives there will be and, in the end, the more likely that the buyer can pursue the financing structure of its choice.

A marketing of high-yield bonds is likely to require more disclosure of financial information and to a higher accounting standard than other forms of financing. These bonds are typically sold to investors in a transaction exempt from the registration requirements of the Securities Act of 1933, pursuant to the "Rule 144A safe harbor" provision. For an offering to be eligible for this safe harbor, an issuer must satisfy certain informational requirements, including providing the "issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financials for such part of the two preceding fiscal years as the issuer has been in operation (the financials should be audited to the extent reasonably available)."

Notwithstanding the apparent flexibility of the rule, under customary market practice, a high-yield offering under Rule 144A is modeled on a public offering of comparable securities, which would typically include two years of audited balance sheets, three years of audited statements of income, changes in stockholders' equity and cash flows, and two additional years of selected financial data, all as required under Regulations S-X and S-K of the Securities Act of 1933.

While market practice allows for deviation from this standard in cases where the full package of financials is not available, it is uncommon for disclosure to include fewer than two years of audited financials. If at least two years of audited financials and unaudited interim financials for the target business cannot be provided within the contemplated time frame for the closing of the transaction, a buyer risks losing the option of tapping the high-yield bond market and may instead need to obtain alternative financing that in some cases could be more expensive and less flexible. If the buyer is faced with that prospect, however, there are several possible options:

Push the Seller. Given the potential impact that not having financials has on a buyer's cost of capital and on the portfolio company's post-closing operating flexibility, before pursuing other financing options, a buyer should probe assertions that the necessary financials are not available or cannot be produced on an acceptable timeline. Depending on the dynamics of the sale process, it may be useful to share with the seller the projected impact of these increased costs on the value of the target business to the buyer. In the end, a more costly financing is a shared problem, and there can sometimes be a shared solution.

Push the Arrangers. If, even after probing the situation and looking for solutions, the financials necessary for a customary marketing of high-yield bonds will not be available in time, a buyer should still consider pressing its prospective arrangers to provide bridge commitments supporting the bond offering. As noted above, as a technical matter, the Rule 144A safe harbor information requirements are more lenient than customary market practice. Therefore, an offering supported by less financial disclosure (*e.g.*, only one year of audited financials) may still comply with Rule 144A, as long as applicable antifraud rules and regulations can be satisfied. Given the unusual nature of this type of bond offering, though, it may be difficult to predict market appetite and, as a result, potential arrangers are likely to be resistant to underwriting a bridge on this basis—or at pricing that would be attractive to the buyer. However, given the right circumstances, including an attractive credit and a competitive "bake-off," it may be feasible.

Second Lien Financing. Depending on the size of the financing shortfall, a sponsor could consider a syndicated or privately placed second lien financing. These types of financings are likely to be more expensive, and the related covenants might be more restrictive than could be obtained in a traditional high-yield offering. However, as compared to a high-yield offering, a second lien financing will provide greater flexibility to refinance or repay the junior portion of the capital structure. A buyer will need to take into consideration both the direct incremental costs and the potential impact of lost operating flexibility of these financings.

Unitranche Financing. A buyer could consider avoiding debt marketing altogether and pursue a unitranche financing. This type of financing is likely to be more expensive than a non-flexed syndicated financing, and the related covenants are likely to be more restrictive than could be obtained in a traditional syndicated capital structure, including the possibility of having a financial maintenance covenant. A buyer will

need to take into consideration both the direct incremental costs and the potential impact of lost operating flexibility of a unitranche financing. Because of the immense growth in this space over the last several years, supply in this market can provide a solution for large cap deals in a manner not possible only a few years ago. For carve-outs involving targets in the software business, a unitranche financing may also present an opportunity to obtain a loan that is based on the company's recurring revenue rather than EBITDA.

Seller Paper. Whether in the form of debt or equity, seller paper can be a possible bridge until the necessary financials can be produced and a customary 144A bond offering can be made. Obviously, this option is likely to be unattractive to the seller, but a buyer may well argue that the seller should bear some responsibility for the lack of requisite financials and play a role in resolving the issue. The availability of this alternative will depend on the dynamics of the given sale process. The cost of and flexibility of covenants, if any, in seller paper will depend on the negotiating leverage of the parties and, therefore, will differ on a case-by-case basis.

None of these alternatives is as good as having full financing optionality, and carries its own particular cost-benefit analysis. However, when confronted with a carve-out acquisition in which customary financials will be unavailable to execute an optimal financing, one of these alternatives might prove to be a workable solution for a buyer.

3. Employee Separation

The degree of complexity involved in addressing legal issues associated with human resources (HR) matters in carve-outs will depend on a number of factors, including the extent that the divested business's employees and compensation and benefit plans are mixed in with other businesses or operations of the seller.

At the more complicated end of the spectrum are situations where employees of the divested business are entangled within seller's other business units: employees are shared with other business units, paid under seller's general compensation plans and receive benefits under seller's general benefit plans. Disentangling the employees and standing them up in a new business entity requires significant diligence and pre-closing preparation to:

(i) develop and implement a methodology to identify which shared employees will transfer with the divested business;

(ii) determine when the buyer will need to replace benefit plans and payroll, or if seller will provide temporary post-closing coverage of business employees for a negotiated fee; and

(iii) allocate assets and liabilities relating to the divested business employees (*e.g.*, in defined benefit pension plans, retiree medical coverage, forfeited equity, bonuses, severance and other compensation and benefit items).

From an HR perspective, carve-outs are simpler if the divested business is already operating as a stand-alone group, with a subsidiary in this group directly employing all business employees who are dedicated exclusively to the business, including non-U.S. employees. Sometimes, in anticipation of a sale, a seller will stand up a business in a subsidiary group, which will spare a PE buyer the efforts and costs of disentangling the business from the seller (although it will likely require diligence to confirm that all business employees have been properly transferred there, and that compensation and benefit plan liabilities and assets have been appropriately allocated).

Location of the employees is another factor that can increase the complexity of a carve-out and require substantial advance planning. This is particularly true if employees are distributed globally in countries that have specific regulatory requirements applicable to the treatment of employees in these transactions or in countries where works council and union consultations are required.

Key HR questions that arise in carve-outs include:

a) Which employees are being transferred with the business (*e.g.*, can a PE buyer select employees it wants, or will a fixed methodology be used)? Do any employees have a legal "right" to transfer (as is the case in certain non-U.S. jurisdictions)?

b) What is the process for transferring business employees? Will the transfer occur automatically, or will

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the buyer need to make individual offers to employees (which can be a time-intensive and costly process)?

c) What compensation and benefits will a buyer be required to offer to employees and provide, and for what period? Are there any compensation or benefits items that a PE buyer would refuse to assume or continue?

d) What benefit plans will be available to the business employees at closing of the PE buyer's acquisition?

   1) An acquired business may have standalone benefit plans and payroll that will transfer with the business. Otherwise, a PE buyer needs to establish new benefit plans.

   2) If new plans cannot be set up before closing, a seller may allow the acquired business employees to continue in the seller's benefit plans and payroll for a transition period, or a PE buyer may need to use a third-party PEO to provide employee benefits until it sets up new plans. Both alternatives could be costly.

A carve-out buyer and its advisors should carefully analyze the aggregate dollar value and holders of outstanding seller equity or cash long-term incentive (LTI) awards of the business's employees at the closing, as well as the treatment of those awards in connection with the transaction. If employees forfeit unvested awards, a seller may seek to require a buyer to make up those awards. A buyer will also want to identify and quantify liabilities of change-of-control, retention or enhanced severance arrangements (*e.g.*, during a preset post-closing period) and include these amounts in consideration of overall transaction value.

Defined benefit pension plans are also of particular interest to PE buyers in carve-outs. Typically, a PE buyer will not be interested in continuing or mirroring any defined benefit pension plan or retiree medical plan that seller had offered due to the variability of such plans' funding obligations and service costs. As a result of the carve-out, business employees may forfeit anticipated benefits in a seller's defined benefit pension plan because their transfer to the buyer will be considered an employment termination that cuts off service credit and eligibility for levels of benefits. Government regulators can try to demand that a seller contribute additional cash to an underfunded benefit plan as a result of the carve-out acquisition, and the seller may try to push all or part of that cost on the buyer. In the United States, if the business employees participate in union multiemployer pension plans, withdrawal liabilities from the plan could be triggered unless the buyer agrees to stand in for the seller in the multiemployer pension plan and continues to contribute going forward.

4. Intellectual Property

Carve-outs can raise particularly thorny issues regarding the allocation and sharing of intellectual property (IP) assets:

IP Allocation – Often, it is possible to allocate IP assets just like other assets, but a default allocation standard may not always be feasible for IP. The intangible nature of IP can make it difficult to conclusively identify all IP assets used in the divested business and the relative use of such IP among the seller's businesses. Adopting an allocation standard that does not account for these unknowns could result in inadvertently transferring IP assets to a divested business (or vice-versa). Therefore, specificity in identifying IP assets, coupled with buyer-favorable transition services and licensing arrangements, may be used to supplement any default allocation standard.

Treatment of Shared IP – Regardless of the standard applied to the allocation of IP assets, there will be certain IP assets (whether identified or unknown) that are allocated to one business but that will continue to be used, or will be planned for use, by the other. Such shared IP can create a complicated web of entanglements and should be addressed carefully in deal documents. In some cases, parties are willing to agree to broad,

perpetual one-way licenses or cross-licenses ensuring that the other business has freedom to operate with respect to shared IP. In other cases, however, commercial and competitive considerations require a more specific identification of IP assets subject to the license and more narrowly scoped license rights flowing between the parties. This is particularly the case for patents, trade secrets and know-how, but heightened attention should be paid to the licensing arrangements for all shared IP assets, including trademark and brand rights allocated to one party that are necessary or desirable for short-term or long-term use by the other party post-closing. Parties should also take into account go-forward matters, such as ownership and licensing of a party's improvements to any licensed IP.

Commercial Arrangements – Arrangements for shared IP rights may also be necessary in carve-outs where there will be ongoing commercial dealings between the seller and the divested business after closing. For example, a seller that retains manufacturing capabilities and plans to supply components to a divested business post-closing might consider retaining all rights in manufacturing-related IP for such components and excluding this IP from any post-closing license to the divested business. This arrangement might also provide the divested business with certain benefits, such as a reliable source of goods and no need to stand up new operations and relationships immediately after closing. Where circumstances exist that make such arrangements advisable, the parties can consider mechanisms to ensure that the party without ownership or license rights in relevant IP is not disadvantaged, such as an obligation on the seller to assist the divested business in transitioning to an alternate source of supply upon termination or expiration of the commercial arrangement.

5. Data Separation

Data migration and data protection matters are becoming a greater focus in carve-out transactions—and for good reason. From a business and a legal perspective, the buyer and its advisors need to diligence which data should be transferred or otherwise made available post-closing to the divested business. Will the divested business have historical pricing or cost information relating to its customers or vendors? Will it retain know-your-customer records or other books and records relating to its customers? Will it have historical personnel records? What restrictions will there be on transferring or providing access to such information when the business is no longer part of the parent?

Just as with the employee service and IP matters discussed above, parties should assess the nature of data that will be transferred or shared in the carve-out. The sizeable risks associated with violating data protection laws and contractual obligations, as well as data breaches and business continuity matters, all warrant careful attention. Depending on the data at issue, it can be important to conduct a thorough review of binding obligations regarding that data, including confidentiality obligations and restrictions on, or best practices for, transferring or sharing such data. The transaction documents—most likely the transition services agreement—should clearly establish the parties' respective responsibility for compliance and remediation of any potential data breaches or other cybersecurity incidents and should clearly allocate liability for any resulting claims and damages.

6. Tax Considerations

As noted above, today's carve-out deals are often multi-jurisdictional. These types of carve-outs require the buyer to work closely with tax advisors experienced with carve-out transactions to ensure that it satisfies all local tax obligations arising from the transaction. There are three primary types of local transactional tax obligations to consider in a carve-out:

Transfer Taxes – A number of jurisdictions will impose a one-time, non-refundable tax on the transfer of certain types of assets, most notably real property. Generally, transfer taxes are based on the gross purchase price attributable to the relevant assets.

Value-Added Taxes – Certain jurisdictions impose a value-added tax on asset sales, though such transactions may qualify for an exemption. For example, many jurisdictions will exempt the sale of a going concern from value-added tax, though the application of any such exemption is very fact-specific and

requires close coordination with tax advisors. Similar to a transfer tax, a value-added tax is typically imposed on a gross basis. Unlike a transfer tax, however, a value-added tax often is refundable to the buyer or available to offset future payments of value-added tax, though receipt of such benefit may take a number of years depending on the relevant jurisdiction and the divested business's sales therein.

Indirect Capital Gains Taxes – Certain jurisdictions tax capital gains attributable to the sale of companies operating or formed within that jurisdiction. Unlike a transfer tax or value-added tax, an indirect capital gains tax is customarily based on the seller's gain from the sale attributable to the relevant jurisdiction rather than the gross purchase price paid by the buyer. As a result, some of the information necessary to calculate this tax may not be available to the buyer.

Depending on the jurisdiction, the buyer or the divested business itself may be primarily liable or secondarily liable (including as withholding agent) for each of these taxes. The buyer should address the sharing of each of these taxes in the applicable acquisition agreement, as each tax is often treated differently.

7. Insurance and Risk Management

Insurance for most divisions and subsidiaries is typically placed at the corporate level, and in a carve-out, a buyer typically will need to put an entirely new insurance program in place effective as of the closing. This process usually requires the expertise of professional risk managers and outside counsel. As an initial step, the coverage that has historically been applicable to the divested business's operations should be carefully reviewed. The buyer should conduct an in-depth analysis of the necessary risk transfer for the new stand-alone company (including appropriate limits) and projected costs, which may be significantly different without the premium efficiencies realized by the parent as part of parent's larger corporate program.

The primary goal is to avoid any gaps in coverage by ensuring the new stand-alone insurance dovetails with the previous parent policies. If the seller does not retain liability for pre-closing occurrences, the buyer should seek full access to any "occurrence based" policies at the corporate level applicable to pre-closing occurrences of the divested business, as new stand-alone occurrence policies will not cover pre-closing occurrences. With respect to any "claims-made" policies accessible to the divested business prior to closing, the buyer may want to procure "tail coverage" at closing, which would cover the divested business's claims made post-closing for pre-closing wrongful acts of the divested business for a set period of years. This tail coverage should also cover wrongful acts that span the closing, as the business's new stand-alone claims-made policies will not cover claims involving pre-closing wrongful acts. Alternatively, the buyer could seek access to the seller's claims-made policies for claims involving pre-closing acts.

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8. Getting it Done: Deal Management

When approaching a carve-out, private equity buyers face a large number of complicated, intersecting workstreams, including the need to: (i) develop an optimal tax structure for the business; (ii) establish entities to acquire the assets; (iii) obtain corporate, tax and other operational registrations, licenses and permits the entities need in order to conduct business; (iv) open bank accounts and transfer funds to entities, whether as required by local law in connection with entity formation or for general operating purposes; and (v) if not provided pursuant to a transition services agreement, enter into leases and other contracts with vendors whose services are necessary to operate the business (*e.g.*, payroll, enterprise resource planning software). Many of these steps must be executed in a particular sequence (for example, a buyer won't be able to open a bank account before the entity has been formed), making sequencing and timeline management critical in the pre-closing period.

When a carve-out involves foreign jurisdictions, complexity can be magnified due to a number of factors. These may include: (i) difficulty in obtaining regulatory approvals or forming a new entity expeditiously; (ii) enhanced corporate formalities, such as requirements for original or certified documents (or even fingerprints); (iii) the need to negotiate local acquisition agreements to establish the allocation of the purchase price among foreign operations for tax purposes and satisfy local conveyancing and filing requirements; and (iv) the lack of familiarity by local authorities with private equity buyers generally.

In addition, local law in the covered jurisdictions could impose additional regulatory requirements, create successor liability considerations that may not be consistent with the negotiated deal between the parties and raise other tax and employee-related issues. The time necessary to address these issues has the potential to lengthen either the pre-signing or the signing-to-closing timeline or increase the possibility of deferred closings.

As soon as possible, the private equity buyer and its advisors will need to establish a detailed plan for standing up the business. Doing so requires close coordination and collaboration between a buyer's and seller's advisors on a range of levels: at the level of the overall transaction, at different functional levels and at the local country level, if foreign assets are involved. The plans should not only identify the broad categories of steps that need to take place before closing but also specify the inputs required before a particular workstream can commence and the anticipated timeline for obtaining those inputs and for completing the workstream once begun.

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Establishing timelines will undoubtedly involve the use of imperfect estimates. The parties and their advisors should understand the assumptions on which these estimates are built, as well as the impact on other aspects of the transaction if those timelines are not met. The parties and their advisors should be aggressive in their efforts to meet—and, if possible, beat—timelines; any cushion achieved on one portion of the timeline could potentially offset missed timeline targets elsewhere in the separation process. Where appropriate, contingency plans should be identified to mitigate downstream impacts if timeline assumptions are not met. For example, if a new buyer entity is not operationally ready in a certain jurisdiction by closing, are there workarounds under the transitions services agreement or under third-party vendor agreements? Is a deferred closing in that country feasible? Ultimately, the parties and their advisors will need to maintain open lines of communication throughout the sign-to-close process in order to overcome these obstacles.

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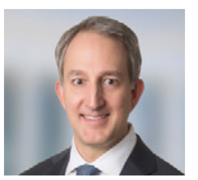
Spring Roundup of Crucial U.S. Regulatory Developments for Private Equity Sponsors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The Securities and Exchange Commission (the "SEC") continued its rapid rulemaking pace in the first quarter of 2023 with three developments discussed below: proposing watershed amendments to the Custody Rule under the Investment Advisers Act of 1940, as amended (the "Advisers Act"); adopting amendments to Form PF proposed in January 2022; and reopening comments on its proposed cybersecurity rule. Looking ahead, we anticipate that sometime in the early summer, the SEC will adopt the so-called "Private Funds Rules" proposed in February 2022—the most consequential rulemaking applicable to private fund advisers since Dodd-Frank—and later this year adopt new cybersecurity rules, rules relating to ESG disclosure and service provider outsourcing rules applicable to private fund advisers.

In Watershed Move, the SEC Proposes to Replace the Custody Rule with New "Safeguarding Rule"

In February 2023, the SEC proposed new rule 223-1 (the "Safeguarding Rule") under the Advisers Act, which would replace the long-standing rule 206(4)-2 (the "Custody Rule") and would impose substantial compliance burdens on registered investment advisers. As proposed, the Safeguarding Rule would broaden the application of the current Custody Rule to cover a wider range of assets and would also regulate more acutely the relationship between an adviser and a custodian.

The Safeguarding Rule also introduces a number of significant amendments that, according to the SEC, account for changes in technology, advisory services and custodial practices that have occurred since the Custody Rule was last amended in 2009 and that the SEC predicts will enhance investor protections. Among other things, the Safeguarding Rule would:

Expand custody beyond "funds and securities" to all client "assets." Covered assets would include real estate and other physical assets, (presumably) loan agreements and digital assets, such as cryptocurrency (in line with the SEC's broader efforts to regulate this asset class).

Discretionary authority would result in "custody." The amendments would specifically include "discretionary authority" within the definition of custody, a change that could have implications for SMA relationships and CLO collateral managers. This development is contrary to existing interpretations

of the Custody Rule, which do not consider discretionary trading of delivery-versus-payment ("DVP") assets to result in custody. Under the Safeguarding Rule, DVP trading could qualify for limited relief from the rule's requirements, but only if an adviser's discretionary authority is limited to trading DVP assets, in which case the adviser can avoid a surprise examination (but would otherwise be subject to the Safeguarding Rule's requirements).

Expand the scope of privately offered securities but narrow the exception. The amendments would expand the exception to include privately offered securities and physical assets. However, the exception that would allow an adviser to avoid holding such assets with a qualified custodian and undergoing a surprise examination of those assets would depend on the adviser's ability to demonstrate that such assets cannot be recorded and maintained by a custodian in the manner that would be required by the new rule. In that case, the adviser would need to, among other things, safeguard the assets and enter into an agreement with an independent public accountant to verify the purchase or sale of any such asset within one business day of such transaction. The SEC explicitly stated that (i) crypto securities transferred via a public, permissionless blockchain evidenced through public keys or wallet addresses would not qualify for the exception, and (ii) crypto assets that are not securities would not qualify because they are neither privately offered securities nor physical assets.

> Looking ahead, we anticipate that sometime in the early summer the SEC will adopt the so-called "Private Funds Rules" proposed in February 2022—the most consequential rulemaking applicable to private fund advisers since Dodd-Frank—and later this year adopt new cybersecurity rules, rules relating to ESG disclosure, and service provider outsourcing rules applicable to private fund advisers.

Require written agreements for new qualified custodians. All registered investment advisers would be required to enter into agreements with qualified custodians and would need to obtain, in writing, reasonable assurances from those custodians that the custodian will, principally:

1. exercise due care in discharging its duty as a custodian and will implement appropriate measures to safeguard client assets from theft, misuse, misappropriation or other similar types of loss;
2. indemnify the client against the risk of loss in the event of the custodian's own negligence, recklessness or willful misconduct (and will have the necessary insurance arrangements in place to protect the client);
3. clearly identify the client's assets as such, hold them in a custodial account and segregate them from the qualified custodian's proprietary assets and liabilities; and
4. not subject client assets to any right, charge, security interest, lien or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to or authorized in writing by the client.

Require segregated accounts for banks and savings associations. The above segregation of client assets would require custodians to hold client assets in a special account designated to protect such assets from creditors of the bank or savings association in the event of insolvency or failure of the bank or savings association. Although there was initially fiery pushback from the banking industry regarding this aspect of the rule proposal, the SEC is unlikely to entertain those objections in light of recent high-profile bank failures.

Additionally, the Safeguarding Rule would (i) amend Form ADV to align investment advisers' reporting obligations with the new requirements under the proposed Safeguarding Rule and (ii) amend the recordkeeping rule to require advisers to keep additional, more detailed records of trade and transaction activity and position information for each client account of which it has custody.

Adoption of the Safeguarding Rule as proposed would mean substantial new compliance costs for both

registered investment advisers and qualified custodians. In addition, model custodian agreements would need substantial revisions in order to reflect the increased regulatory burdens on custodians and to introduce registered advisers as parties to the agreement. This aspect of the Safeguarding Rule continues the SEC's trend of requiring registered investment advisers to rewrite existing agreements with third-party service providers. Finally, it is unclear whether existing Custody Rule guidance could be applied to the new Safeguarding Rule.

The SEC is seeking comment from the public on the proposal, including responses to nearly 300 specific questions included in the Release. The proposed compliance transition period following adoption of the rule would be one year for large advisers with more than $1 billion in regulatory assets under management and 18 months for advisers with under $1 billion in regulatory assets under management.

SEC Adopts Amendments to Form PF

On May 3, 2023, in the first of what may be a number of new rules that will reshape the regulatory framework applicable to private fund advisers, the SEC adopted amendments to Form PF applicable to private equity fund advisers (and other private fund advisers). On a positive note, the final version of the rule relaxed many of the more onerous proposed requirements.

Notable aspects of the new rule applicable to private equity fund managers include an obligation for ***all*** private equity fund advisers to report specific events on a ***quarterly*** basis, including adviser-led secondary transactions, removal of a fund's general partner and investor elections to terminate a fund or an investment period. As originally proposed, these events would have been required to be reported within one day of occurrence.

The final rule also requires ***large*** private equity fund advisers to report specific information on an ***annual*** basis, including GP and LP clawbacks, certain fund-level borrowings, events of default, fund strategy by percentage of deployed capital and bridge financing to controlled portfolio companies. Notably, the final rule did not amend the definition of "large private equity fund adviser" to include advisers with more than $1.5 billion AUM, as proposed. Instead, the SEC chose to maintain the current threshold of $2.0 billion AUM.

The compliance dates for the new reporting requirements differ. ***Current event reporting*** will be required ***six months*** after publication of the final rules in the Federal Register, while the new ***annual reporting*** obligations begin ***one year*** after publication of the final rules in the Federal Register.

SEC Reopens Cybersecurity Rule Proposal Comment Period

Additionally, on March 15, 2023, the SEC reopened the comment period for the proposed cybersecurity risk management and cybersecurity-disclosure rules for registered investment advisers. If adopted as proposed, the rules would include a requirement to confidentially report certain cybersecurity events to the SEC.

The initial comment period ended on April 11, 2022. The new comment period expires on May 22, 2023. For more information on this proposal, please see our Four Takeaways from the rule proposal here.

Looking Ahead

We anticipate sustained regulatory activity for the second half of 2023, with the SEC slated to propose additional rules affecting the private fund industry, including 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 increased examination of private fund marketing as a result of the new Marketing Rule and continued private fund examination and enforcement efforts.

The Up-C Goes to Court: Managing the Emerging Risks of an Advantageous Tax Structure

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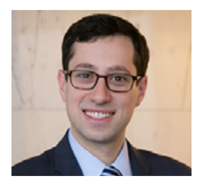
Partner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I. Introduction

Attacking a favorite IPO transaction structure used by the private equity industry—the Umbrella Partnership Corporation, or "Up-C"—has become an emerging trend in the plaintiffs' bar and one that all sponsors should have on their radar. Numerous sponsors and their funds have used the Up-C structure in IPO transactions in recent years, both for their portfolio companies and for themselves—and for good reason. The Up-C allows investors in an LLC that is treated as a partnership for tax purposes to access the public securities markets by taking the company public while preserving many of the tax efficiencies of a traditional partnership ownership model. Moreover, when those investors eventually liquidate their partnership units, they sell them to the public company in exchange for (i) public shares on a 1:1 basis (which are then sold for cash) plus (ii) additional cash consideration equal to a portion (usually 85%) of the cash tax savings realized by the public company attributable to those units in future years through a contract called a Tax Receivable Agreement (TRA).

Although many investors appreciate the opportunity to invest in these newly public companies, as with any evolving deal structure, increased use brings increased scrutiny. So it is that, as Up-C investments have matured, the structure increasingly has been challenged by minority investors contending that the Up-C model permits pre-IPO investors to "double dip" on cash distributions made by the business and unfairly capture tax benefits that should inure ratably to the public shareholders. Some of these minority investors have turned to litigation as a means of addressing perceived inequities in the Up-C model. Ironically, in a shift from typical stockholder suits, in the Up-C context, companies that are performing well at or post-IPO are targeted for litigation. Instead of suing to recover for losses, investors—or, rather, their lawyers—bring suit alleging the appearance of conflicts and unfair allocation of the upside resulting from the cash tax savings that the structure affords.

This inversion in risk profile, and the attack on a common and advantageous tax structure, make the Up-C litigation trend one worth watching closely. To aid investors, we offer the following primer, in which we first describe the common features of an Up-C IPO transaction and the Up-C ownership model, and then analyze recent lawsuits involving Up-Cs. We focus in particular on portfolio company litigation, and the particular challenges to post-IPO cash distributions made by Up-Cs and the impact and unwinding of TRAs entered into in connection with Up-C IPO transactions.

II. Structure and Benefits of Up-C IPOs

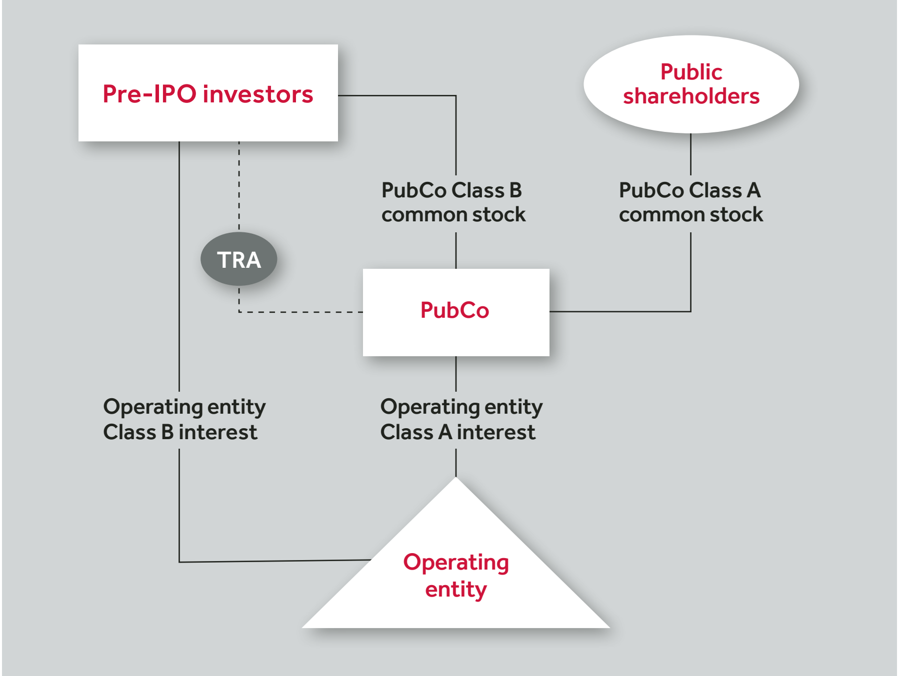
As many in the industry have long recognized, Up-Cs can offer important advantages when taking an investment public. Private equity funds often hold their investments in portfolio companies via structures that are treated as pass-through entities for U.S. tax purposes, like limited partnerships or limited liability companies. In a traditional portfolio company IPO, pre-IPO investors experience no shift in the company's tax status in connection with the IPO—it is a corporation before and after. However, for a portfolio company treated as a partnership for tax purposes, the sponsor has a choice of whether to incorporate the company to take it public or instead to go public via an Up-C structure. If the company is incorporated, it becomes a traditional corporation subject to corporate entity level taxation, and pre-IPO investors lose the benefit of the pass-through status. In addition, it is generally not possible for pre-IPO investors to deliver a stepped-up tax basis to the company on a sale of interests, meaning there is no possibility for realizing the enhanced value that may come from a TRA. A key appeal of the Up-C structure is its ability to preserve some of the benefits of partnership status for pre-IPO investors, and the value enhancement of a TRA, while inviting public investment.

In an Up-C IPO, the sponsor creates a holding company ("PubCo"), which is named the managing member of—and thus controls—the operating pass-through entity and is capitalized by units of the operating entity representing typically between 30-40% of the economic interest in such entity (which PubCo acquires with the proceeds of the IPO). Pre-IPO investors retain units in the operating entity representing the remaining 60–70% economic interest in such entity. The operating entity continues operating the underlying business and holding its principal assets.

In the IPO, PubCo issues two types of shares: (1) Class A common stock, which is issued to public investors and carries the economic entitlements of ownership in PubCo but only a small percentage of voting rights; and (2) Class B common stock, which is issued to pre-IPO investors and carries a majority of the voting rights in PubCo, but no economic rights (as these investors continue to hold their economic interests via units in the operating pass-through entity).

PubCo and the pre-IPO investors also typically enter into two agreements in connection with the IPO. First, they enter into an exchange agreement allowing pre-IPO investors to exchange their units in the operating company for cash or shares of Class A common stock, typically on a 1:1 basis. Second, pre-IPO investors and PubCo enter into a TRA entitling pre-IPO investors to a percentage of any tax benefit derived by PubCo from the Up-C structure following a sale of the pre-IPO investor's units to PubCo (typically 85% of the realized cash tax benefits derived by PubCo in the future, usually paid out for all practical purposes over the following 16 years). Such benefits are generated by a stepped-up tax basis in its assets that PubCo acquires from the pre-IPO investors – it is a separate tax asset that is created in the exchange, with benefits split between PubCo and the pre-IPO investors. The TRA also typically provides for a lump sum payment to pre-IPO shareholders in the event of a change in control transaction, calculated based on certain valuation assumptions.

The following figure illustrates the resulting structure after consummation of the Up-C IPO :



In addition to payments under the TRA, pre-IPO shareholders also benefit from continuing to hold their economic interest at the operating entity level, which remains a pass-through entity for those investors not subject to corporate tax (although their exchange price is tied to the public share price, which presumptively is burdened by the corporate tax paid by PubCo).

III. Litigation Challenges to Up-C Structures

For all the benefits the Up-C IPO offers to investors, the structure has not been without its critics. As illustrated above, after completion of the Up-C IPO, pre-IPO investors remain in effective control of the underlying business through their voting control over PubCo (provided that such investors have not elected to exit the investment altogether). The separation of these investors' voting interest at the PubCo level from their economic interest at the operating entity level, however, increases risk that decisions made at one level or the other could be subject to challenges that pre-IPO investors are attempting to disproportionately benefit themselves over public shareholders. Such structural risks attendant to the Up-C form mean that, unless the board implements procedural protections for minority shareholders, pre-IPO investors' governance decisions are likely to be reviewed under the strict "entire fairness" standard of review.

Garfield v. Blackrock Mortgage Ventures, LLC, et al. (Del. Ch.), Case No. 2018-0917, a case involving an effort by BlackRock and Highfields Capital to exit an investment that they had taken public via an Up-C IPO, exemplifies these risks. There, the plaintiff, a minority shareholder in the PubCo, sued to challenge the exit transaction and the Chancery Court held that it was subject to entire fairness review because the pre-IPO investors constituted a control group and were differently situated from minority shareholders with respect to the exit.

More recently, litigation involving Up-C structures has arisen in two other areas of interest for private equity sponsors: (1) the operating entity's payment of dividends or other cash distributions in the post-IPO period and (2) early termination of TRAs, as PubCos undergo further change-in-control transactions or pre-IPO investors seek to terminate their TRAs early as part of larger restructuring transactions.

> Attacking a favorite IPO transaction structure used by the private equity industry—the Umbrella Partnership Corporation, or "Up-C," —has become an emerging trend in the plaintiffs' bar and one that all sponsors should have on their radar.

A. Distributions

One area in which the complexity of the Up-C structure has spawned litigation is the payment of dividends or other distributions by the operating entity. Because pre-IPO investors control the decision regarding whether and when the operating entity will distribute excess cash to unitholders, some minority PubCo shareholders have attempted to challenge these distributions as self-interested transactions.

In particular, operating company dividends have been challenged as inequitable "double dipping" transactions that unfairly benefit pre-IPO shareholders. The "double dip" theory is usually presented as follows: When the operating company pays a dividend, cash is distributed (1) directly to pre-IPO shareholders on account of the units representing their economic interests in the operating company and (2) to PubCo on account of its units representing the remaining economic interest in the operating company. Dividends received by PubCo are then typically held as cash on its balance sheet to the extent that they are not needed to pay corporate taxes. Although such distributions are pro rata among the unitholders of the operating partnership, because pre-IPO investors have the right to exchange their units in the operating company for Class A shares in PubCo, they arguably benefit twice from the dividend—once at the operating company level in the form of cash from the dividend and again at the PubCo level in the form of cash on PubCo's balance sheet from the dividend. Claims that these dividends constitute breaches of the fiduciary duty of loyalty are bolstered by the fact that pre-IPO investors remain in effective control of all of the relevant corporate decisions through their voting control over PubCo.

At least one lawsuit has been filed in the Delaware Court of Chancery espousing this "double dipping" theory of liability in connection with operating company dividends: *Schumacher v. Mariotti*, Case No. 2022-0051 (Del. Ch.). Defendants have moved to dismiss on several grounds, including that shareholders were fully informed of the Up-C structure and its potential consequences before purchasing their shares. The Chancery Court will hear argument on the motion in July 2023.

B. Early TRA Termination

Another feature of Up-C transactions that presents litigation risks is early termination of TRAs. Such contracts typically pay out most of their value in the first 16 years following an exit by a pre-IPO investor, including a sponsor. The 16-year period in most cases will extend well past the termination date of most closed-end funds. As a result, sponsors understandably look for options to monetize their TRA rights before the end of the contract's lengthy term. While a relatively nascent market exists to purchase TRAs, the buyer of the TRA has in certain cases been the related PubCo itself.

As noted above, TRAs are subject to multiple contingencies. For example, the PubCo may incur tax liability such that it benefits from a step up in tax basis made possible by the Up-C structure—and thus trigger an obligation to make payments to pre-IPO investors under the terms of the TRA. Or, certain change-in-control transactions may be beneficial in light of the fact that they also may trigger payments to pre-IPO investors under TRAs. Both of these contingencies recently have spawned shareholder litigations arising from typical Up-C structures.

For example, *IBEW Local Union 481 v. Winborne*, Case No. 2022-0497 (Del. Ch.), concerns an effort by KKR and Silver Lake to monetize rights under TRAs after they had otherwise exited their investment in GoDaddy Inc. There, plaintiffs filed a shareholder derivative action seeking to challenge GoDaddy's $850 million buyout of the TRAs entered into in connection with GoDaddy's April 2015 Up-C IPO. Plaintiffs alleged that the price of the buyout was excessive and constituted a breach of the duty of loyalty in light of the fact that directors affiliated with KKR and Silver Lake remained on the board. The decision whether to agree to the buyout was not submitted to shareholders for approval, and GoDaddy had never earned taxable income (rendering it possible that it would not trigger payments to the sponsors under the TRA for an extended period). Defendants have moved to dismiss on several grounds, including that the board's formation of a special committee to negotiate the buyout entitles it to the deference of the business judgment rule. The Chancery Court will hear argument on the motion to dismiss at the end of May 2023.

Similarly, in *Pullan v. Skonnard*, Case No. 2021-0043 (Del. Ch.), plaintiffs filed a shareholder derivative action seeking to enjoin a take-private transaction, a component of which included a $127 million payment to Pluralsight's private equity sponsors under an amendment to the terms of a TRA entered into in connection with Pluralsight's May 2018 Up-C IPO. Plaintiffs alleged that the take-private transaction should be enjoined because the board was conflicted with respect to the negotiation of amendments to the TRA and that the disclosures in connection with proxy solicitation for the transaction were insufficient. Plaintiffs dropped their motion to preliminarily enjoin the transaction after defendants agreed to limited document discovery and voluntarily dismissed the case in January 2023 after receiving additional disclosures in connection with the same.

IV. Looking Ahead

Every structure comes with risk, and the Up-C structure is no exception. The Up-C structure allows investors to address complex problems involving the intersection of tax, capital markets and M&A, and its advantages continue to outweigh its drawbacks for most deals. But, as with many creative solutions to complex problems, additional risks are emerging over time. We are closely monitoring this evolving landscape, as litigious shareholders and their counsel are beginning to target features typical of Up-C structures and the Delaware Chancery Court is poised to provide additional guidance in these areas in the *Schumacher* and *Winborne* cases scheduled to be heard this summer. Sponsors should be alert to these developing issues as they begin strategizing their exits from investments in Up-C structures and wind-downs of TRAs entered into in connection with such transactions. Strong arguments exist to defend Up-C structures and TRA payouts, but each case is different, and sponsors are well-advised to be prepared for possible future challenges.

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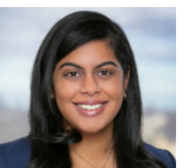

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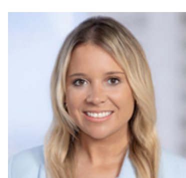

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Generative AI: Risks and Considerations for Private Equity

The last few months have seen a rapid increase in the availability of AI tools, such as ChatGPT, Bard and Claude, that can generate content including text, images, video and code. These generative AI tools include models that have been trained on large datasets of existing content, learning the features of that content to create something new.

Within private equity firms and their portfolio companies, generative AI can be applied to an enormous range of use cases: analyzing data, drafting content and code, creating marketing materials, conducting research or diligence, creating efficiencies in operations and analyzing financial performance, to name just a few. The range of use cases presents, in turn, a range of risks that may vary significantly based on context. For example, generative AI used to translate an internal communication poses a very different risk than if it is being used to translate an investor communication.

It is therefore important for private equity firms to consider and manage the risks associated with generative AI when assessing their own operations, as well as when considering the risks and value propositions of their current and prospective portfolio companies. Acknowledging these risks and establishing policies, procedures and effective controls to mitigate them will benefit firms seeking to make the most of this new technology.

Risks and Considerations

Regulatory Risk

The AI regulatory landscape is changing quickly as lawmakers and regulators work to keep pace with this rapidly evolving technology. There are already some AI-specific regulations in place that could be implicated by the use of generative AI. For example, New York City's Automated Employment Decision Tool Law, which becomes effective on July 5, 2023, imposes onerous audit and disclosure requirements on employers that use certain types of tools in employment-related decisions. Some privacy laws also address AI through provisions regarding automated decision-making. For example, the Virginia Consumer Data Protection Act requires individuals to be provided with a right to opt out of "profiling in furtherance of decisions that produce legal or similarly significant effects."

Privacy, Confidentiality and Intellectual Property

Sharing information with generative AI tools can pose many of the same risks that are associated with sharing confidential, sensitive or personal information with any third party.

Privacy Risk: Depending on the nature of the personal information being shared with generative AI tools, firms and portfolio companies may be required to update privacy policies, provide notices to clients or investors, obtain their consent and/or provide them with opt-out rights, etc. Privacy laws that provide limitations on disclosure of personal information to third parties, including state privacy laws like the California Consumer Privacy Act and sector-specific privacy laws like Regulation S-P, should be considered when inputting data into generative AI tools. It may also be important to consider the privacy policies and terms of conditions of the companies that offer these generative AI tools, like OpenAI, to ensure compliance with any obligations.

Disclosure Risk: For private equity firms using generative AI, fund governing documents and agreements may limit how client or investor data can be used or shared and the ability of the firm to input that data into a generative AI tool. For example, governing documents and agreements may impose restrictions on the firm's ability to share investors' or clients' confidential information with third parties or the sharing of certain client or investor data with ChatGPT may exceed stipulated purposes for which collected data may be used. Additionally, any use of AI for investment decision-making or modeling should be adequately disclosed in fund documents and should be consistent with the adviser's stated investment approach.

Confidentiality Risk: Some generative AI models may use input data to further train the AI. Therefore, inputting confidential investor or client data or other proprietary information runs the risk of that information becoming available to other users of the same tool (including, perhaps, competitors).

Intellectual Property Risk: Content created by generative AI may not be protectable by copyright. Additionally, users should consider any intellectual property restrictions on training or input data.

Output Issues

Quality Control: As impressive as it is, generative AI can produce inaccurate results. For example, ChatGPT may provide incorrect information on potential investments (such as portfolio companies), sectors and market trends. Because it is a language model, it may struggle with computational tasks depending on how the prompt is phrased. These risks are magnified where firms or companies use generative AI for critical business operations but can be mitigated by ensuring that a human with appropriate expertise reviews any output prior to use.

Transparency: Using content created by generative AI without clear disclosures may pose litigation (*e.g.*, claims of unfair or deceptive practices) and reputational risk.

Vendor Management

Many of the risks discussed above also apply to third-party service providers who may seek to use generative AI to compete and control costs where possible. For instance, quality control risks may arise where a vendor uses generative AI to produce deliverables without human intervention. Likewise, confidentiality risks may arise where vendors have privileged access to data and use generative AI tools to process that data. Firms should consider the need to diligence their third-party vendors' use of generative AI and contemplate taking measures to control such risks in vendor agreements, where possible.

Policies, Procedures, and Guardrails

Because of the growing availability of generative AI technology such as ChatGPT, it will be important for private equity firms to understand how AI is being used both in their organizations and at their portfolio companies, including under what circumstances, and with what guardrails. The risks posed by using ChatGPT to draft trivia questions for team-building events are very different from the risks of using ChatGPT to generate investment advice for clients. Higher-risk use cases should receive more scrutiny and may require revisions or expansions to disclosures.

An effective AI risk management program will allow firms to safely adopt and oversee the use of new AI technologies as they become available. Risk management programs may include creating a cross-functional committee that oversees an AI program or implements other means for establishing overall accountability;

For use cases that require input of sensitive or confidential information, firms and portfolio companies should consider licensing a closed-loop instance of a generative AI tool, whereby data inputs are not accessed by the licensor or added to the tool's general training set.

providing appropriate policies, procedures and training to personnel using AI, particularly for higher-risk uses; documenting uses of AI and labeling content generated with the assistance of AI; and ensuring that the use of AI is fully disclosed as needed in regulatory filings. With respect to portfolio companies, firms should consider assessing and risk-ranking the companies' uses of generative AI. For higher-risk uses (*e.g.*, where a company's use of generative AI is central to its business or may receive heightened regulatory interest), firms may want to consider providing benchmark policies, procedures and guardrails for the companies' uses of generative AI.

However, establishing a comprehensive AI risk management program is time-consuming and resource-intensive. Even implementing a ChatGPT policy may be difficult without (1) adequately assessing which use cases should and should not be allowed (and, if allowed, what restrictions, if any, should apply) and (2) developing the policies and procedures needed to administer their desired policy.

While working on a longer-term approach to AI, there are guardrails that firms and their portfolio companies can implement as a first step, such as:

Monitoring input. To address privacy and confidentiality concerns, firms and portfolio companies may consider implementing a proxy server to monitor what information is being shared with generative AI tools. Inputs could then be reviewed to ensure that no sensitive or confidential information is being shared and, if needed, take appropriate action to block access.

Using beta testers. One way to limit risk is to allow only a designated set of individuals to have access to generative AI tools. These beta testers could be provided training on risks and considerations like confidentiality risks, prohibited inputs, quality control and reputational risk. All proposed use cases could then be sent to the beta testers to review and assess. The beta testers could then make recommendations to a committee as to whether the use case should be approved based on the benefits or risks posed. Firms and portfolio companies could also consider establishing an internally accessible resource that documents approved or prohibited uses, which would allow employees to know which uses have been approved.

Licensing. For use cases that require input of sensitive or confidential information, firms and portfolio companies should consider licensing a closed-loop instance of a generative AI tool, whereby data inputs are not accessed by the licensor or added to the tool's general training set. By setting up a private instance, firms and portfolio companies may be able to reduce many of the confidentiality risks associated with use of the public versions of these tools.

Generative AI tools have the potential to create many efficiencies across business lines—in investing, marketing and more. Implementation of policies, procedures and guardrails now can allow a firm to take advantage of these benefits without exposure to undue risk both for current technology and for new tools as they become available.

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