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2024 Midyear Outlook | Volume 24, Issue 2

From the Editors

In our *2024 Private Equity Outlook* issued at the beginning of the year, we viewed the year ahead with "guarded optimism." From the vantage point of the third quarter, that perspective has been borne out. Private equity M&A deal activity in the United States has gathered steam, and while the market in Europe is still finding its stride, sponsors investing there are finding opportunity in certain sectors and market niches. The robust secondaries market continues to fill the gap where attractive exit opportunities are not available via the IPO market or third-party sales. Positive momentum on the dealmaking front is in turn giving sponsors hope that the fundraising environment may begin to warm.

But if market conditions are gradually becoming more stable (and favorable), the regulatory and enforcement environment is another matter. ESG-related regulations in the EU and UK are an ever-evolving landscape, while in the United States they provide the stage for

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"I guess everyone wins a gray medal?"

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increasingly polarized legislative battles. At the end of June, the U.S. Supreme Court issued two decisions with the potential to significantly upend the regulatory and enforcement environment: one holding that courts no longer must defer to an agency's interpretation of regulations, and the other calling into question the SEC's ability to pursue penalties through its in-house administrative proceedings. Both decisions promise to bring uncertainty and unintended consequences.

We hope you find the *2024 Private Equity Report Midyear Outlook* to be a useful summary of the many forces shaping the market as you set your agenda for the remainder of the year.

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The fundraising market is beginning to benefit from the improved financial conditions that have slowly brought dealmakers back to the table. Transactional markets—particularly in the U.S. and Europe—gradually began to thaw over the first half of 2024, and there is a cautious optimism that the uptick in deal activity will persist throughout 2024 and accelerate in 2025. That outlook gives fund sponsors and investors hope of unlocking liquidity and is creating a bit of momentum for new funds across asset classes. While raising capital is still taking longer than it did in 2020 and 2021, and remains challenging amidst macroeconomic uncertainty, the market is warming a bit—particularly for larger fund managers and funds targeting more than $1 billion.

To that end, we continue to see the private funds market concentrating in brand name mega funds where investors believe there is both opportunity and more certainty. While these funds are not immune to the challenges of this fundraising environment, they have weathered it better than most. That durability improves their outlook for the remainder of the year and beyond.

On the other hand, middle market and smaller firms continue to face prolonged capital-raising periods for funds launched over the past two years. A number of these firms have extended fundraising periods, offered or expanded fee reductions, and customized other offers to attract investors. Patience and creativity have been essential given the number of investors facing a liquidity crunch and reducing their private fund allocations or the number of managers they partner with.

In the first half of 2024, we also saw investors focusing on asset classes and sectors with countercyclical characteristics—or that would be too risky to pass up. Private credit funds continued to attract capital, offering a safe haven and an opportunity to achieve equity-like returns in today's "higher for longer" interest rate environment. Open-end credit funds have been particularly appealing as a source of more predictable liquidity, and many sponsors in the market have been very active in the space. In another vein, artificial intelligence (AI) is the opportunity no firm wants to miss. The technology is already so pervasive, and the transformational opportunity so evident, that sponsors throughout the private markets are trying to catch AI tailwinds that may boost their portfolios. That's made AI a very bright spot across the dealmaking and fundraising markets, from early-stage venture funds to later-stage growth and private equity funds.

We also continue to see strong interest in secondaries funds—perhaps not surprising, given that traditional exit routes have been so limited—and secondary exits have surged. The secondaries mega funds have been scaling, and managers continue to introduce new fund products, to capture a portion of this growing market.

Some sponsors are waiting for conditions to improve prior to launching new products in hopes of avoiding some of the market's current supply-and-demand imbalance. Others are moving more aggressively into retail capital, which presents an enormous opportunity for sponsors equipped to pursue it. We expect that trend to persist, and for sponsors to continue seeking new distribution channels that could unlock capital and provide a bulwark against future downturns.

While caution remains the theme of 2024, we are beginning to see optimism, opportunity and signs of liquidity in several areas in the market.

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The fund finance market continues to experience strong growth in 2024, driven by the ability of alternative lending sources with innovative financing products and structures to fill liquidity gaps of fund sponsors, while traditional fund finance lenders remain faced with balance sheet constraints and the aftershocks of the bank collapses of 2023.

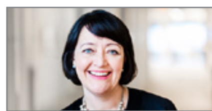
Major bank lenders continue to grapple with interest rate increases, regulatory changes in capital treatment and other macroeconomic events, forcing them to be much more selective about credit extensions to fund sponsors. At the same time, the appetite of sponsors for debt financing seems to be insatiable. The resulting competition for the limited bank balance sheet capacity available to the fund finance market continues to fuel substantial demand for alternative liquidity providers and bespoke financing solutions. With this demand comes opportunity, and the growth and expansion of the fund finance lender base and product offerings witnessed in 2023 showed no sign of letting up during the first half of 2024.

Subscription facilities remain a staple for many fund sponsors, and demand for capital call-backed credit continues to grow year after year. The use of asset-based leverage continues to expand beyond credit and secondaries funds and across a broader range of fund investment strategies, particularly private equity funds. We're also seeing fund sponsors deploy NAV solutions up and down the capital structure of their fund platforms. Sponsors are turning to these asset-based financing products to consummate acquisitions, to purchase portfolio company debt and, with growing scrutiny, to make distributions to limited partners.

The increased use of NAV facilities, particularly when asset-backed leverage is used to fund distributions or to support a struggling portfolio, has fueled some concern within the investor community. Although the Institutional Limited Partners Association (ILPA) has not criticized NAV facilities as fervently as it had initially criticized subscription credit facilities a few years ago, the group has recommended that fund sponsors disclose the rationale and key terms of NAV facilities and engage investors for consent to use NAV facilities when clear authorization is lacking. ILPA has also called for sponsors and investors to adopt language in fund documents that sets guardrails around permissible uses of NAV-based facilities going forward.

Sponsors also continue to raise capital from insurance companies and similar investors. While 2023 had seen a slowdown in activity in the face of market conditions and uncertainty over regulatory developments, we expect rated feeder structures and other structured products to continue to evolve and develop through 2024.

Private Funds Transactions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The secondaries market has been seeing an uptick in venture capital, credit and strip sale continuation fund transactions—and the growing popularity of these transactions has prompted existing co-investors to seek additional protections.

Venture Capital Continuation Fund Transactions

The venture capital GP-led secondaries market has picked up momentum, as investors seek liquidity amidst a slow market for IPOs and traditional M&A exits. While there were a few noteworthy VC continuation fund transactions in 2022 and 2023, 2024 has been characterized by a significant uptick in activity. We expect this trend to continue, as the last 12 months have seen existing sponsors in the VC secondaries market close funds significantly larger than their predecessor funds and new sponsors enter this part of the secondaries market. As before, pricing remains a challenge, however, as the bid-ask spread for VC assets continues to be one of the widest of all asset classes in the secondaries market. There has also been an increase in VC secondaries funds designing bespoke liquidity solutions for founders, employees and other early investors in VC-backed companies, providing those funds an additional avenue for accessing investment opportunities in target companies. For example, a fund may enter into a financing arrangement with such individuals secured by a pledge of securities in the target company in return for a negotiated minimum return coupled with an incentive payment at the time of an IPO or sale of the target company.

Credit Continuation Fund Transactions

While there has been considerable discussion over the last couple of years regarding the impending rise of the credit GP-led secondaries market, activity during much of that period was overwhelmingly concentrated in traditional portfolio deals and NAV loans. However, the last six months has seen several significant credit continuation fund transactions come to market. Credit secondaries transactions will typically involve a highly diversified portfolio that is principally comprised of numerous debt investments and a comparatively small number of post-reorganization equity positions. Legacy LP selling volume is difficult to predict at this stage, but anecdotally, legacy LP interest in liquidity with respect to credit portfolios has been somewhat muted in comparison to single-asset equity continuation fund transactions, where legacy LP selling volume has generally remained in the 80%–90% range for a number of years.

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Private Funds Transactions

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Strip Sale Continuation Fund Transactions

Over the last 12 months, there has been a notable uptick in strip sale transactions, that is, transactions in which a sponsor causes the selling fund to sell only a portion of one or more existing portfolio investments to a continuation fund. Typically, in a strip sale transaction, there is no rollover or reinvestment option offered to legacy LPs and the sponsor will seek to align the legacy fund's and continuation fund's exits from the commonly held portfolio investments. Particularly when sponsors are not concerned about an impending end of the legacy fund's term or about a lack of go-forward capital to support portfolio investment growth, strip sale transactions provide one way to boost the legacy fund's Distribution to Paid-In Capital ratio—and do so more quickly than typical continuation fund transactions due to the absence of an LP election process.

Co-investors in Continuation Funds

The treatment of co-investors in LP election processes for continuation funds remains an issue for negotiation between sponsors and co-investors. Many sponsors have been unwilling, at the outset of a co-investment, to take a position on whether co-investors would be given the option to either exit, to maintain the status quo (i.e., remain invested through a fee and carry-free co-invest vehicle) or to subscribe to a continuation fund with different economics. Instead, those sponsors have preferred to retain for themselves the right to decide at the time they undertake the continuation fund transaction whether to "drag" the co-investors along or to offer them an option to cash out. Co-investors, on the other hand, would like more certainty at the outset regarding their options in the event a continuation fund is organized, including the ability to preserve the economics they have under the terms of the original co-investment. Market terms on this point remain in flux.

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In notable contrast with the tepid environment that characterized most of 2023, the debt markets in 2024 started strong and kept going from there, making the first half of the year one of the busiest periods of financing market activity in several years. Loan market issuance for the first half of the year totaled $727 billion, eclipsing the prior first-half peak set in 2017.

Most of the debt issuance in the first half of the year consisted of opportunistic transactions, such as refinancing, repricing and dividend recap transactions not tied to M&A activity. For well-performing companies, the existing market environment has provided an opportunity to refinance or reprice higher-cost debt with new, lower-cost debt. This was particularly beneficial for companies that had issued debt during the high rate environments of 2022 and 2023. PitchBook LCD notes that approximately 29% of the entire leveraged loan asset class was repriced in the first half of 2024. Many companies facing debt maturities in the next few years also took advantage of today's active markets to address this maturity wall by refinancing with new, longer-dated debt.

The strength of the syndicated loan market has brought some credits back from the private credit market. Losing market share to syndicated lenders and with substantial dry powder, private credit lenders have had to agree to repricing transactions, along with incremental financings and delayed draw facilities, in order to keep their capital invested. There remains a healthy balance between the syndicated and private debt markets, and we expect that savvy private equity sponsors and borrowers will consider both options as part of obtaining the best available financing terms.

In addition, the current market environment has seen a shift back to more borrower-friendly covenant terms, with some syndicated deals achieving success without needing to reflect investor comments or make meaningful modifications to the terms reflected in posted debt agreements.

We expect current market conditions to continue in the second half of 2024. Activity levels may decrease, if only due to the sheer number of deals completed in the first half of the year. The U.S. presidential and congressional elections and resulting macroeconomic uncertainty may also cause some opportunistic transactions to be delayed to Q1 2025. Meanwhile, M&A activity appears to be slowly increasing, and acquisition-related issuance should play a larger role in the debt markets going forward.

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The first half of 2024 has brought an uptick in U.S. private equity M&A deal activity. Although the number of completed deals remains below that of 2021 and early 2022, what we have seen so far of 2024 would have been considered healthy deal activity in prior periods.

Buyers and sellers are closer, in general, to a meeting of the minds on price than they have been in some time, even if interest rates continue to present a challenge to PE buyers in modeling attractive returns at a price that will motivate a seller. Debt financing has been reasonably available, and the expectation that rates will remain where they are for at least the medium term—i.e., that we are in a "new normal"— has prodded parties into action and off the sidelines waiting for rates to drop.

Given elevated public equity valuations, take-private deal volume had fallen off considerably during the beginning of 2024 (despite certain mega deals, such as Silver Lake's agreement to take Endeavor private), with sponsors instead focusing on carve-out and add-on deals, but we have been seeing a resurgence of interest in take-privates in Q2. At the exit end of the life cycle, we are seeing sale processes initiated more frequently today than in the prior 18 months (including for some long-in-the-tooth assets), though with mixed results.

We continue to see a substantial number of continuation fund deals, which appear to have established themselves as a permanent part of the PE landscape. The combination of new third-party capital and continued control for the sponsor that these funds offer is particularly appealing in a still somewhat challenged dealmaking environment.

The regulatory environment remains a focus for market participants. While the threat of regulatory action isn't preventing deals from signing, the practical realities of dealmaking in an era of aggressive regulation can be seen in the amount of time and energy spent in negotiating terms such as efforts covenants, closing conditions and reverse termination fees.

Although 2024 has yet to unleash the torrent of activity some have hoped for, the war chests of dry powder held by sponsors, along with a period of relative stability in the debt markets, lead us to expect that the gradual increase in U.S. private equity M&A activity will continue. There is always the possibility of pre-election skittishness disrupting these generally favorable conditions, but so far we have not seen evidence of that bearing out.

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Despite early signs in the second half of 2023 that private equity M&A deal activity levels in Europe might be on a path to recovery, 2024 got off to a relatively slow start. Overall, private equity deal value in Europe in Q1 2024 decreased 37% compared to Q4 of last year and 20% compared to Q1 of last year. This sluggish deal environment was partly a result of subdued exit activity levels. Excluding Q2 2020—which brought the onset of the COVID-19 pandemic—Q1 2024 saw the lowest aggregate deal value derived from exits since Q1 2013.

Nonetheless, there are notable trends among the private equity M&A deals that have occurred. For example, sponsors continue their preference for build-and-buy strategies through smaller bolt-on transactions. This type of transaction accounted for 45% of deal value in Q1 2024, compared to the 10-year average of 28%.

An additional trend that has continued from 2023 is the increased appeal of public markets, which we reported on in our 2024 Private Equity Outlook. Q1 2024 saw three significant private equity backed IPOs: Galderma (€2 billion IPO backed by EQT, ADIA and GIC); Douglas (€890 million IPO backed by CVC); and RENK (€450 million IPO backed by Triton). With the exception of the Douglas IPO, whose shares soon dropped 19% below their listing price, these IPOs have performed relatively well. Shares in RENK almost doubled within two weeks after its IPO while shares in Galderma gained around 20% the day after its IPO and continue to trade above their listing price. While these positive performances might lead sponsors to give more attention to potential IPO exits, it is clear private equity still views such exits with significant caution, as was evidenced by Permira's last-minute decision to pull the plug on Golden Goose's IPO in June 2024.

Companies that have yet to accept institutional money—and which are typically still in the hands of founders or company employees—have emerged as popular targets for private equity investors. Deals involving this type of target accounted for 68% of deals by number in Q1 2024, compared to 58% of total deals by number in 2014. These companies are attractive acquisitions for a number of reasons. They often command lower purchase price multiples, which is particularly desirable in light of increased borrowing costs. They also allow investors to start with a clean slate, free of any issues or conflicting cultures introduced by prior owners. This trend has also been partly driven by the ability of companies to stay private for a longer period of time, possibly due to previously cheap debt, a greater array of funding sources (including from private equity and private credit), as well as the volatile public markets and low public market valuations of recent years, which have made going public a less attractive option for private companies.

The first half of 2024 continued to see heightened deal activity among sponsors themselves, including General Atlantic's acquisition of Actis, CVC's €2 billion IPO and, outside of Europe, BlackRock's acquisition of Global Infrastructure Partners. We covered the key drivers behind this trend here.

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M&A (Europe)

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On the other hand, Q1 2024 saw a reduction in the number and the aggregate deal value of take-private transactions. Nine companies were taken private in Europe in Q1 2024 with an aggregate deal value of €5 billion—€2.8 billion of which came from KKR's take-private of Encavis. Activity levels in the remainder of 2024 would need to pick up significantly to catch up to the levels recorded in 2023 (55 take-private transactions with €34 billion in aggregate deal value) and 2022 (43 take-private transactions with €56 billion in aggregate deal value). This trend has partly been the result of the notable increase in public company valuations, making such opportunities more sparse and more expensive to pursue.

Dealmaking has been resilient in the healthcare and IT sectors. Healthcare deal value increased 15% from Q4 2023 to Q1 2024, remaining largely constant compared to Q1 2023. About one in four European private equity M&A deals were in the IT sector, a higher percentage than in previous years. Further, we expect activity levels in the IT sector to continue to increase in the remainder of 2024, given the substantial valuation corrections that have taken place over the past two years and the continued appetite for AI-related deals.

As we had observed in the U.S., we also expect to see the popularity of continuation fund transactions to persist. The year 2023 saw record capital raising for secondary funds globally; the amount of capital available for investment in secondaries is now more than twice the amount deployed in the last 12 months.

Regulatory enforcement has remained quite active in Europe in 2024. When the EU's Foreign Subsidies Regulation (FSR) came into force last October, it was expected to catch 30–40 deals a year, with the focus largely on policing acquisitions by State-backed buyers. The reality has been quite different: As of the beginning of June, the European Commission had received 95 notifications, with around a third of those involving private equity acquirers. The changed enforcement environment raises considerations for sponsors regarding timing and disclosure, as well as questions about how LPs from sensitive jurisdictions may affect the approval risk profile. The Commission recently launched its first Phase II investigation under the FSR of an M&A deal—the acquisition of the Czech Republic's PPF Telecom by Emirates Telecommunications Group. This development is particularly notable given that the few prior in-depth (and self-reported) investigations had all related to procurement. Clearly, the Commission is taking enforcement seriously and we expect to see this continue.

In the UK, the Digital Markets, Competition and Consumers Act received royal assent in May 2024. The Act introduces a number of amendments to the UK competition regime, including higher merger control thresholds, new thresholds intended to catch so-called "killer acquisitions," as well as a new regulatory regime for digital markets. These changes are significant, as they will both implicate more deals and, in the tech sector specifically, may result in greater scrutiny of exits when the sale is to a strategic.

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M&A (Hong Kong)

In the first half of 2024, we have seen continuing pressure on sponsors to exit from investments which have reached their maturity. With the M&A market remaining muted, sponsors are adopting more creative solutions to provide liquidity to LPs, given that the traditional exit routes of trade sale and IPO are largely unavailable.

Continuation Fund Moving Towards M&A Terms

Continuation funds, which enable sponsors to retain ownership of an asset while offering liquidity to investors, have recently gained traction in Asia. Historically, Asian continuation fund transactions have utilized simple, short-form share purchase agreements (SPAs) to transfer the underlying assets from the existing fund to the continuation vehicle. This was because such transfer is an affiliate transfer by nature, and Asian lead LPs for continuation vehicles tend to rely on the alignment of their economic interests with the sponsors.

However, as the market matures in Asia, continuation fund SPAs have developed more sophistication, adopting terms previously only seen in arm's length M&A transactions. Notably, while lead LPs are willing to deploy their dry powder for good assets, they are still sensitive to pricing. On the other hand, sponsors are hesitant to accept a heavy discount for what they regard as quality assets. To bridge this valuation gap, parties are frequently relying on M&A purchase price mechanisms such as deferred payment or earn-out clauses. Representations and warranties insurance, which has become increasingly standard for traditional M&A transactions with a PE seller, is now often seen in continuation fund transactions as well to ensure a clean exit by the existing fund and provide protection for LPs of the continuation fund.

Renegotiation of Exit Terms

The challenges surrounding exits have also led to increased focus on the exit provisions of transaction agreements. Indeed, in the current environment, we observe that even parties with robust contractual rights in their existing transaction agreements are renegotiating those agreements with the aim of ensuring a commercially viable outcome, rather than solely relying on the provisions in the existing agreements, such as forced redemption if no qualified IPO occurs by a certain deadline.

These renegotiations may involve terms such as a buyback by the company and/or founder with installment payment plans, a request for additional board or observer seats or the appointment of financial controller roles to ensure the company is run in a financially prudent way, taking security over the company's assets and requiring the company to accommodate the lead investor's due diligence and other requests in a continuation fund transaction.

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M&A (Asia)

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Hong Kong Take-Privates

One seeming bright spot in the subdued M&A environment is the privatization of Hong Kong–listed companies. The prolonged underperformance of the Hong Kong stock market has led to increased appetite for undervalued assets, as bidders eye the enticing prospect of acquiring listed companies at a discount. Controlling shareholders have also shown increasing interest in delisting their companies and relisting later when valuation rebounds.

Hong Kong's take-private deal volume reached a four-year high of USD 3.3 billion in the first 4.5 months of 2024. Such deal volume has already exceeded that of all of 2023, and we expect activity to continue ramping up during the rest of 2024.

Among the take-private transactions, the consumer products sector stands out as a key area of focus, offering potential for long-term growth and value creation from established brands beyond immediate financial metrics. The proposed privatization of L'Occitane, a French-headquartered, Hong Kong–listed retailer of fragrances and home products, is the largest Hong Kong take-private transaction since Q4 2021.

M&A (Japan)

In Japan, private equity deal activity has trended upward for the last decade, with annual aggregate value (including exit) reaching a reported high of $50 billion in 2023—a figure bolstered by a number of take-privates that year. Although 2024 is not at that level, PE firms, including leading U.S. and domestic Japanese firms, are on the ground in search of deals. According to a recent Bain report, the number of GPs with a Japan office and whose most recent buyout/turnaround fund is at or above JPY 50 billion doubled between 2012 and 2024. Further, a large group of foreign investors are waiting in the wings.

There are several factors driving the development of PE transactions in Japan. Activist shareholders and others are increasing pressure on large Japanese corporations to maximize profitability by focusing on core business lines and selling non-core or unrelated assets. A growing number of small-to-midsized companies are facing succession issues as company founders look toward retirement. The Japanese government has encouraged M&A transactions through the guidelines it releases. (A notable example is provided by "Guidelines for Corporate Takeovers," published by the Ministry of Economy, Trade and Industry in August 2023, which describes how uninvited takeovers can enhance corporate value and secure shareholders' interests when conducted in a fair manner.) And the weak Japanese yen makes Japanese assets more attractive to overseas investors.

As U.S. PE firms ramp up their activities in Japan, they are faced with the need to comply with Japanese corporate, securities and other laws, and there are a handful of Japanese law firms that are well equipped to support complex cross-border PE transactions. At the same time, non-Japanese investors contemplating M&A activity in Japan may consider involving their international law firms—with their historical knowledge of the investor's requirements and acquisition practices outside of Japan—to assist local counsel with structuring, international tax, securities and other matters.

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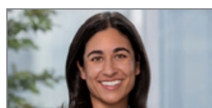

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Securities Settlement Cycle Moves to T+1

On May 28, 2024, the standard settlement cycle for most securities transactions was shortened from T+2 to T+1, as the amendments to Rule 15c6-1 adopted by the U.S. Securities and Exchange Commission became effective. According to the SEC, the shortened settlement cycle is intended to benefit investors by increasing operational and capital efficiency and by reducing the credit, market and liquidity risks arising from unsettled securities transactions.

While increased market volatility during the COVID-19 pandemic provided one impetus for the amendment, this recent development is part of a gradual contraction of the settlement cycle over the last 30 years.

Adapting to T+1

In a statement issued in May, SEC Chair Gensler cautioned that the "transition to a shorter settlement cycle may lead to a short-term uptick in settlement fails and challenges to a small segment of market participants." While widespread settlement fails have not materialized in light of the new settlement cycle, there is not yet a consensus among capital market participants regarding how the new cycle affects, in practical terms, a number of key settlement-related mechanics.

For example, the period for filing a final prospectus under Rule 424(b) of the Securities Act of 1933, as amended, is two business days after the earlier of the pricing date or the date of first use. Notably, such period could end after the settlement date on a T+1 settlement cycle. Under the T+2 settlement cycle, market practice for filing a final prospectus was typically to file on the morning of settlement. However, in recent T+1 transactions, some underwriters have insisted that the underwriting agreement include a covenant that the filing of the final prospectus be completed prior to the T+1 closing —in other words, earlier than required under Rule 424(b). In other transactions, the underwriting agreement did not contain such a covenant, and in those instances, the final prospectus supplement was not filed until after settlement.

Additionally, in order to avoid settlement issues or foot faults on closing documentation or SEC filing requirements, the amendments have brought renewed attention to the importance of early communication among the parties regarding their expectations of filing timelines and any intention to have an extended settlement period in reliance on Rule 15c6-1(d) of the Securities Act.

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Capital Markets

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Moving Forward

It is expected that most public equity transactions will abide by the T+1 settlement cycle, rather than agreeing to use an alternate settlement cycle. Notably, for trades that are effected after market close, T+1 occurs on the second day following the trade (e.g., for a trade that prices post-market Monday, T+1 settlement would be on Wednesday). Parties to debt offerings and more complex transactions are likely to continue to utilize Rule 15c6-1(d) to agree on longer settlement cycles, though it is possible that the debt market may shorten settlement periods over time as the market becomes accustomed to T+1 settlement.

Under the T+2 settlement cycle (and certainly under the prior T+3 regime), it was common practice to agree to closing documentation following pricing. However, the T+1 settlement cycle adds pressure to deal teams to ensure closing documentation is agreed to and execution mechanics are arranged in advance of pricing (and in certain circumstances, in advance of launch) to avoid issues with settlement.

Further, it is important for the deal team to consider whether certain established processes can be accomplished on a T+1 timeline. For example, the information required to complete and deliver stock powers with medallion guarantees, which many transfer agents require to transfer shares held in book-entry form, is often not available before the pricing of a transaction and will present challenges to obtain and deliver in one business day, unless advance arrangements are made.

It is expected that other non-U.S. jurisdictions (including the UK, Canada and the European Union) will move towards T+1 settlement in due course. Even so, until that happens—and even after, if some markets continue to operate on a T+2 cycle—market participants will be faced with the challenge of abiding by different settlement cycles. As such, cross-border market participants should keep a close eye on emerging trends in this area.

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There have been a number of key developments affecting UK tax law during the first part of 2024. The UK's general election took place on 4 July, with the Labour Party victory bringing an end to the 14-year period of Conservative Party governance. The lead-up to the election had implications for the tax policies of both parties, which may affect the taxation of fund sponsors as described below. In addition, there have been court cases and publications by HM Revenue and Customs (HMRC) concerning several significant areas of UK tax law, on which we offer some brief observations.

Abolition of "Non-Dom" Tax Regimes

The UK currently has certain long-standing tax regimes that benefit UK residents for whom the UK is not their permanent home (who are called "non-UK domiciled" or "non-dom"). In the UK's 2024 Spring Budget, the Conservative government announced significant changes designed to reduce the tax benefits of these regimes. According to Labour's manifesto, the new government appears likely to pursue substantially similar changes.

One such regime is the "remittance basis" of UK taxation, under which a non-dom can elect not to be subject to UK tax on their non-UK income and gains as long as they keep those amounts outside the UK, a benefit that can apply for at least the first 15 years following the individual's arrival in the UK. This regime has been used by foreign investment professionals who have come to the UK to work at investment funds, and it can be particularly relevant to the UK taxation of their co-investment (as well as other holdings).

From April 2025, it is expected that the remittance basis regime will be abolished and replaced with a new "foreign income and gains" (FIG) regime. Broadly, individuals arriving in the UK may pay no tax on their non-UK income and gains for the first four years, whether or not such amounts are brought into the UK, following which they will be taxed in the same way as other UK residents. However, Labour has indicated that it does not intend to implement some of the Conservatives' taxpayer-friendly transitional concessions, such as allowing for a 50% discount on the taxation of FIG for non-doms who do not qualify for the new FIG regime in the first year of the new regime's implementation.

Another current "non-dom" regime relates to UK inheritance tax (IHT): non-doms are not subject to IHT on their non-UK assets. This regime, too, has attracted foreign investment professionals to the UK due to the regime's benefits for estate-planning. Beginning April 2025, however, it is expected that after 10 years of UK tax residence, individuals will be subject to IHT on both their UK *and non*-UK assets. Moreover, under Labour it is expected that non-UK assets held in pre-2025 trusts will also be subject to IHT, which under current rules are protected and which the Conservatives had intended to retain as part of their transitional provisions.

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Tax (UK)

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Labour may seek to continue engagement with stakeholders, which the Conservatives had started prior to the election, regarding the abolition of these "non-dom" regimes, so we expect that it will be several months before final details of the new regimes and draft legislation will become available.

Taxation of Carried Interest

Of even greater relevance to the investment funds industry, Labour included in its manifesto a pledge to close the "loophole" under which in the private equity industry "performance-related pay is treated as capital gains." This is generally understood to refer to the taxation of carried interest at current capital gains tax rates. While there are currently few details on how this pledge would be implemented, Labour has indicated that it will consider different options and will consult with stakeholders before proposing draft legislation.

Recent UK Cases and Guidance

Miscellaneous income and partnership incentives. In its recent case against the Boston Consulting Group (BCG), HMRC successfully argued that a miscellaneous income tax charge should be applied to a partnership incentive plan that had sought to be taxed as capital gains. BCG paid its retiring professionals consideration for the sale of their interests in BCG's UK trading partnership; the amount of the consideration was determined by reference to the growth of BCG's global business. The Court held that the consideration for this sale should be taxed as income and not as capital gains largely because the shares in the global group (the benchmark by which the consideration was determined) were not owned by the partnership, but rather by its parent, and so did not comprise capital assets of the partnership. Notably, the Court's reasoning that the various conditions for miscellaneous income had been met suggests how the miscellaneous income charge could evolve from its historically limited usage to much broader application.

The decision also continues a trend of HMRC success with the miscellaneous income tax charge that was established in recent years by the cases of Odey, HFFX and *Bluecrest (PIP/IP)*, which all concerned partnership incentive plans of asset managers. Investment managers should now be on notice as to the ease with which the courts can impose an income tax charge on amounts derived from trading partnerships (including in the asset management space).

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Salaried members. In February, HMRC unexpectedly published new guidance relating to the salaried member rules, a regime whereby individuals who are members of a limited liability partnership (LLP) will be considered *employees* of that LLP for UK tax purposes, rather than "genuine" self-employed members, if certain conditions are met. Being treated as self-employed typically brings with it a significant reduction in national insurance contributions. One way to secure treatment as a genuine member is to satisfy Condition C of the rules, which involves ensuring that a member's overall capital contribution to the LLP is equal to at least 25% of the fixed remuneration the taxpayer reasonably expects to receive in each tax year. The new guidance states that arrangements permitting members to periodically "top up" their capital contributions to enable them to remain above this threshold may run afoul of anti-avoidance provisions in the salaried members rules and may, therefore, be inadequate for purposes of Condition C. While this new interpretation of Condition C and the anti-avoidance provisions remains to be tested before the courts, investment managers whose UK business is structured through LLPs should be aware of HMRC's change in practice.

Loans made for an unallowable purpose. HMRC have won a number of victories in the Court of Appeal this year in cases involving cross-border business acquisitions that were funded, in part, with loans made by UK resident companies that the Court found had an "unallowable tax avoidance purpose" (see *JTI, BlackRock HoldCo 5* and *Kwik-Fit Group*), with the result that interest paid on these loans was not deductible for UK tax purposes. These cases have generally involved fact patterns in which the presence of the relevant UK company and its loan-funding did not have a clear purpose (other than to generate UK tax deductions) and, as such, the results are unsurprising. Investment managers should note, particularly in relation to the structuring of portfolio investments, HMRC's willingness to scrutinise and challenge intra-group financing involving UK company loans in international structures.

CFIUS

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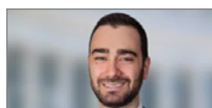

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The Committee on Foreign Investment in the United States (CFIUS) continues to actively review and investigate cross-border transactions implicating U.S. businesses, including those that involve private equity sponsors. In considering CFIUS's activity so far this year, we observe four key trends:

1. **Increased Attention on Foreign Limited Partners.** Starting last year and continuing into 2024, CFIUS has made clear its intent to request information about passive non-U.S. limited partners for its national security reviews and investigations of private equity transactions. Such information can include the limited partner's identity and governance and transaction rights—regardless of whether such information is subject to confidentiality restrictions. CFIUS initially signaled its increased interest in such information by updating guidance in 2023 to address direct and indirect investors in transactions, and in practice, CFIUS's gathering of information about non-U.S. limited partners is now an expected part of a CFIUS review or investigation, particularly where that limited partner is owned by a foreign government.

2. **Increased Focus on Compliance and Enforcement.** In April 2024, the U.S. Department of the Treasury released a proposed rule that would meaningfully strengthen and expand CFIUS's existing compliance and enforcement functions. If adopted, the amendments would grant CFIUS enhanced authority to gather information about transactions, mitigate the national security risks of transactions, and penalize those that violate CFIUS rules or obligations. Such enhanced authority could require more transaction parties than ever before to interact with CFIUS and be subject to potential CFIUS penalties, even if such parties are only indirectly involved with the transaction CFIUS is reviewing. A more detailed analysis of the proposed rule is available here.

3. **Possible Increased Congressional Oversight.** In June 2024, U.S. Representative Zach Nunn of Iowa introduced the bipartisan Foreign Investment Transparency and Accountability Act to strengthen congressional oversight of CFIUS. If passed, the bill would require CFIUS to justify to Congress when a foreign investment is flagged by CFIUS as a transaction of potential national security concern but then is not subsequently reviewed. The stated purpose of the bill is to increase CFIUS's transparency and accountability, but such congressional oversight could well be a starting point for further statutory changes to the CFIUS process. Such legislative attempts to alter the CFIUS process are not uncommon, but given the current geopolitical environment and increased scrutiny by lawmakers of the national security implications of cross-border commerce, we expect such proposals will be introduced with greater frequency.

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CFIUS

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4. **Increased Politicization.** Congress's continued interest in CFIUS and bid for increased oversight has—perhaps not surprisingly—been accompanied by a greater politicization of the CFIUS process. The high-profile potential sale of U.S. Steel to Japan's Nippon Steel is a prominent example of such increased politicization. The sale has been opposed by the United Steelworkers union, and politicians have seized on the symbolism of a storied American steel company coming under foreign ownership—all against the backdrop of a presidential election and with the company in question based in the battleground state of Pennsylvania. More than 50 lawmakers signed a letter to President Biden requesting that his administration undertake a comprehensive review of the sale. Other lawmakers have gone further, calling for CFIUS to block the sale, citing steel's importance to both the American economy and military. While the sale may indeed have national security concerns, CFIUS has traditionally guarded its objectivity, focusing solely on national security issues and leaving political considerations aside. The outcome of the likely CFIUS review of the U.S. Steel sale will shed light on how CFIUS may navigate political headwinds in the future.

With the enhanced interest and attention paid to foreign investment in the United States, CFIUS has become increasingly relevant to all types of transactions. Congressional and political forces are now putting more pressure than ever on CFIUS to comprehensively review transactions, even when national security is not a primary concern. Accordingly, private equity sponsors should monitor CFIUS-related regulatory changes and guidance to stay up to date on the potential CFIUS implications of their transaction activities.

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As we move into the second half of the year, the fate of the Federal Trade Commission's final rule to ban most noncompetes, set to take effect September 4, 2024, remains highly uncertain. (Our Debevoise In Depth on the FTC's final rule can be accessed here.) On the same day in April that the final rule was promulgated, Ryan LLC, a Dallas-based tax services and software provider, filed legal challenges to the enforceability of the rule in the Northern District of Texas, with the U.S. Chamber of Commerce and other business groups also filing suit and permitted to intervene as plaintiffs. On July 3, the district court granted a preliminary injunction staying the rule's enforcement—albeit only for the specific plaintiffs who challenged the rule—and indicated that it will issue a final decision on the merits of the case by August 30, 2024. (On July 23, in a parallel suit filed in the Eastern District of Pennsylvania by ATS Tree Services, LLC, a tree care company, the court declined to act.)

The Texas federal court's decision casts serious doubt on whether the FTC's rule will ever become effective. In granting the preliminary injunction staying the rule, the district court held that the plaintiffs are likely to succeed on the merits of their case, including on their argument that the FTC lacks authority to promulgate the rule. The court's decision on the merits could include vacating the rule, which would prevent enforcement of the rule throughout the country. And, of course, the decision at the district court level will be subject to appeal, including up to the Supreme Court. If the Texas federal court does vacate the rule, then the effective date of the final rule will likely be stayed throughout the appellate proceedings and will only become effective if an appellate court reverses the district court's decision on the merits.

Advice for Employers

Given that there is still a possibility that the final rule could still take effect (including, potentially, on its original effective date of September 4, 2024), we recommend that employers continue to prepare accordingly. This includes:

- continuing to audit current noncompete programs, including for the purpose of identifying who may be subject to a noncompete that would be rendered invalid on the effective date of the rule;
- preparing notices to be sent to current and former covered employees with noncompetes if the rule takes effect;

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- continuing to enhance trade secret protections beyond the use of noncompetes; and
- considering compensation changes and alternative arrangements, including garden leave arrangements, repayment agreements, retention bonuses or longer vesting periods for long-term awards (e.g., cliff-vesting or back-loaded schedules).

In their preparations, employers should also consider the state law landscape, which has been a source of significant change as more states direct greater attention to their own public policies in the areas of competition and worker mobility. These policy developments have to date only been in one direction—making noncompetes harder to enforce—and the invalidation of the FTC final rule may well result in even more such action at the state level.

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The first half of 2024 saw two developments regarding SEC enforcement that have particular importance for the private equity industry: the U.S. Supreme Court's ruling in *SEC v. Jarkesy* regarding the SEC's in-house administrative proceedings, and the settled enforcement action by the SEC against J.P. Morgan Securities for violating SEC whistleblower anti-impediment rules.

SEC v. Jarkesy

On June 27, 2024, the U.S. Supreme Court issued its highly anticipated ruling in *SEC v. Jarkesy*, holding in a 6-to-3 ruling authored by Chief Justice Roberts that the Seventh Amendment right to a jury trial precludes the SEC from pursuing penalties for securities fraud violations through in-house administrative proceedings in which an administrative law judge (ALJ) makes factual findings.

In 2013, the SEC instituted administrative proceedings against George Jarkesy and his investment adviser, Patriot28, in connection with two hedge funds advised by Patriot28, alleging that Jarkesy and Patriot28 violated the antifraud provisions of the federal securities laws through various misrepresentations to investors. After an ALJ found for the SEC, both respondents petitioned the Commission for review (which operates as a *de novo* appeal of the ALJ's decision). After six years, in 2020, the Commission affirmed the ALJ's finding; the SEC then imposed cease-and-desist orders on Jarkesy and Patriot28, ordered Jarkesy and Patriot28 to pay a $300,000 penalty and Patriot28 to pay disgorgement of more than $680,000, and prohibited Jarkesy from further involvement in the securities industry.

Jarkesy and Patriot28 appealed the Commission's agency's decision to the U.S. Court of Appeals for the Fifth Circuit, which ruled in the two respondents' favor, holding, among other things, that in the SEC's administrative proceedings, Jarkesy and Patriot28 were deprived of their constitutional right to a jury trial. The SEC appealed the Fifth Circuit's decision to the U.S. Supreme Court, which granted *certiorari*.

On June 27, 2024, the Supreme Court affirmed the Fifth Circuit ruling, holding that Jarkesy and Patriot28 had been deprived of their right to a jury trial. The majority opinion pointed to prior holdings that the right to a jury trial extends to statutory claims that are "legal in nature," which the Court then determined the SEC's civil monetary penalties to be, since their purpose is to punish and deter the wrongdoer rather than to make the victim whole.

The implications of this ruling are significant for the securities industry and administrative agencies in general (including, potentially, for Self-Regulatory Organizations, such as FINRA, that have in-house administrative hearing functions). Although the *Jarkesy* decision itself only concerned the constitutionality of litigating alleged *fraud* violations before an ALJ, the Supreme Court's reasoning with respect to monetary remedies certainly calls into doubt the ability of the SEC to obtain civil penalties in an administrative proceeding for *any* violation of the federal securities laws.

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SEC Enforcement

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As a practical matter, we expect that the Commission will continue to bring all litigated enforcement matters in federal district court, as it has for several years (with certain narrow exceptions where district courts lack jurisdiction). Any such administrative proceedings likely will be challenged under *Jarkesy* on Seventh Amendment grounds (as well as on other grounds in the Fifth Circuit's decision on which the Supreme Court did not rule).

Whistleblower Anti-impediment Rules

In January 2024, the SEC ordered J.P. Morgan Securities (JPMS) to pay an $18 million civil penalty for including a provision in its release agreements with retail clients in which the clients "promised not to sue or solicit others to institute any action or proceeding against JPMS arising out of events concerning" their accounts. (See our prior client alert regarding the JP Morgan settlement here.) Although the agreements expressly permitted JPMS clients to respond to inquiries made by the SEC or any other government or self-regulatory entity, the agreement did not include a provision that expressly permitted clients to voluntarily report information to SEC staff without risking legal action. The SEC determined that the absence of explicit language protecting whistleblowers with respect to the confidentiality requirements was a violation of Rule 21F-17(a) of the Securities Exchange Act of 1934, which prohibits impeding individuals from reporting potential securities law violations to the SEC. Notably, the ruling expands the focus of the SEC's whistleblower protections beyond employees to include investors.

Given this broadening of focus—not to mention the current SEC sweep underway to assess adviser compliance with Rule 21F-17(a)—private equity firms and their holding companies (whether public or private) should review documents across their businesses to make sure that they appropriately carve out whistleblowing activities from their confidentiality and other restrictions. Such documents may include:

- employment-related agreements (e.g., employment agreements, separation agreements, confidentiality agreements, restrictive covenant agreements, equity agreements);
- consulting agreements;
- confidentiality agreements/NDAs with individuals;
- policies (e.g., compliance manuals; codes of conduct; employee handbooks);
- training materials;
- brokerage customer and advisory client releases/settlement agreements; and
- limited partnership agreements and other forms of investor agreements.

Recent actions underscore the need to avoid even the appearance of impeding whistleblowing through impermissibly restrictive language, conflicting terms, or the lack of explicit whistleblower protections and assurances. Companies also should consult with counsel regarding the most effective way to address any existing or past agreements or other documents that could be read to prohibit or otherwise have a chilling effect on an individual's ability to provide information to or communicate with the SEC or other government agencies.

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On June 28, the U.S. Supreme Court, in *Loper Bright Enterprises v. Raimondo* ("*Loper*"), overturned "*Chevron* deference," the 40-year-old precedent that instructed courts to defer to a federal agency's interpretation of ambiguous federal statutes as long as the agency's interpretation was reasonable. Based upon the decision, courts instead must make an independent judgment as to whether an agency's actions are statutorily authorized.

The *Loper* ruling has significant implications for the private funds industry, affecting both SEC rulemaking at the firm level and the regulatory environment in which portfolio companies operate.

Firm-Level Implications

Recently, the SEC has relied heavily on *Chevron* deference to pursue an expansive view of its powers under the Dodd-Frank Act, the Investment Advisers Act and other federal securities laws. With the arrow of *Chevron* deference no longer in the SEC's quiver, the private funds industry can be expected to redouble its pushback (whether in the public comment process or in litigation) against new rules and rulemakings that reflect that expansive stance, including the Climate Disclosure Rule, the Safeguarding Rule and the Predictive Data Analytics Rule. Litigation against the SEC's new rules primarily has occurred in specific venues traditionally sympathetic to industry arguments; following *Loper*, the universe of potential venues may expand.

Moving forward, the SEC likely will need to take a fresh look at the bases for the rules it has proposed or re-proposed to better withstand legal challenges on the basis of broad statutory interpretation. The elimination of *Chevron* deference may thus slow the rapid pace of new SEC rules affecting private funds.

Portfolio-Level Implications

At the portfolio company level, the abolition of the *Chevron* doctrine can be expected to facilitate lawsuits challenging a wide range of actions by federal agencies on the grounds that they are not authorized by the applicable statute. Below are just a few examples where the statutory authority of agencies may be challenged:

- Companies that develop artificial intelligence or incorporate it into their operations or products may challenge the Biden administration's efforts to develop regulations to limit or curtail the use of AI.
- Healthcare companies may challenge rules issued by the Centers for Medicare and Medicaid Services aimed at the provision of care (e.g., rules aimed at setting minimum staffing levels for skilled nursing facilities).

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U.S. Regulatory

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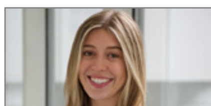

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- Companies that are subject to extensive regulatory oversight by the Environmental Protection Agency, including those in the energy and manufacturing industries, may challenge environmental regulations on the basis that they are not statutorily authorized and (where relevant) impose the types of significant economic burdens that implicate the "major questions doctrine."
- Companies in a variety of industries may consider using *Loper* to challenge efforts by the Biden administration to implement regulations that affect employer-employee relations (providing, for example, another line of attack against the Federal Trade Commission's attempt to bar certain noncompete agreements, depending on the outcome of current litigation).
- Pharmaceutical and medical device companies may challenge rules issued by the Food and Drug Administration based on a lack of clear statutory authority. For example, it may now be easier for clinical laboratories to challenge FDA's rule subjecting Laboratory Developed Tests to regulation as "devices" under the Federal Food, Drug, and Cosmetic Act.

But while *Loper* will present companies in regulated industries with the opportunity to challenge regulations, many regulated companies may also find that they are negatively affected by the destabilization in the regulatory environment brought about by the ruling's consequences:

- As the interpretation of laws governing regulatory authority shifts to the courts, there may be circumstances where judges who lack technical sophistication issue rulings that are impractical or unworkable.
- Different courts may take different positions with respect to the same regulation, potentially creating an environment where regulations are not evenly applicable across jurisdictions—a possibility *Loper* recognizes.
- Companies that have invested significant resources to comply with certain regulatory requirements may now find that those regulations face an increased risk of being invalidated in court.
- Corporate defendants who base their litigation strategy on their compliance with applicable government regulations risk plaintiffs arguing that those regulations are invalid—and therefore the defendant's compliance is irrelevant.

In light of these developments, investors should carefully consider how their litigation and business strategies should change in light of *Loper*. Experienced regulatory and litigation counsel may be of valuable assistance in considering whether, for example, it may now be possible to challenge unfavorable regulations or whether business strategies should be altered in light of potential regulatory challenges.

U.S. Funds Regulatory

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The first half of 2024 has seen several important developments in the U.S. regulatory landscape, including the striking down of the Private Fund Adviser Rules and SEC sweeps regarding the Marketing Rule. We summarize these developments below.

Private Funds Adviser Rules Vacated

On June 5, 2024, the U.S. Court of Appeals for the Fifth Circuit unanimously struck down the controversial Private Fund Adviser Rules that would have radically changed the SEC's historical disclosure-based approach to the regulation of private fund advisers.

As discussed at length in our client alert, the court's decision was based solely on its holding that the SEC did not have the authority under Advisers Act section 211(h) and section 206(4) to promulgate the rules. The court held that section 211(h) "has nothing to do with private funds" because it applies to "retail customers" only. The court also found that the rules were not supported by the SEC's general antifraud authority under section 206(4) of the Advisers Act because the SEC had not articulated a "rational connection" between fraud and any part of the rules. Given its holding that the SEC exceeded its authority, the court did not opine on the industry's arguments that (i) the SEC failed to provide the public a meaningful opportunity to comment on the adopted rules, (ii) the rules are arbitrary, capricious and otherwise unlawful and (iii) the SEC did not perform an adequate cost-benefit analysis. It is unclear at this time whether the SEC will appeal the decision or abandon this rulemaking.

While the full impact of the decision remains to be seen, the SEC's focus on private funds is likely to continue. The deadline for the SEC to seek a rehearing of the Fifth Circuit decision has passed, although the SEC has until September 3, 2024 to appeal to the U.S. Supreme Court. Even if the SEC does not seek to appeal the decision or to re-propose a version of the Private Fund Adviser Rules, the principles behind the rules remain indicative of the SEC's views on many industry practices and potential areas of focus for Advisers Act exams and enforcement going forward. Parts of vacated rules may also continue to surface as investor requests in negotiations.

Private fund advisers should be prepared to address investor requests that reflect certain principles underlying the Private Fund Adviser Rules. However, we think it is appropriate for private fund advisers to put on hold more comprehensive efforts to comply with the substance of the rules, pending developments in the appeals process or other SEC rulemaking.

The SEC's Spring 2024 Regulatory Agenda includes a target date of October 2024 for final rules with respect to the proposed Cybersecurity Risk Management Rule and Outsourcing Rule, as well as for re-proposing the Predictive Data Analytics Rule, each of which would apply to private fund advisers and relies at least in part on section 211(h) as authority for the rulemaking. The industry groups that brought the Private Fund Adviser Rules litigation recently submitted a letter to the SEC encouraging the regulator to withdraw these three proposals, indicating that if adopted they could face similar legal challenges. It is also unclear whether any of the court's conclusions will be read to apply to any *existing* Advisers Act rules or SEC interpretations.

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U.S. Funds Regulatory

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Marketing Rule

The SEC's Marketing Rule sweep continues to result in enforcement activity. On April 17, 2024, Division of Examinations released a new risk alert on the Marketing Rule—its third since the rule's May 4, 2021 effective date—which summarizes some of the deficiencies observed during the sweep.

The risk alert closely follows the April 12, 2024 announcement of settled charges against five registered investment advisers for Marketing Rule violations. The SEC's orders found that each of the five advisers failed to comply with Marketing Rule requirements by advertising hypothetical performance to the general public on their websites without adopting and implementing policies and procedures reasonably designed to ensure that the hypothetical performance was relevant to the likely financial situation and investment objectives of each advertisement's intended audience. Four of the five registered investment advisors received reduced penalties because of the corrective steps they undertook before being contacted by the SEC staff. The SEC also found that one of the five additionally committed a much longer list of rule violations, including making false and misleading statements in advertisements, advertising misleading model performance, being unable to substantiate performance, failing to enter into written agreements with people it compensated for endorsements, committing recordkeeping and compliance violations, and making misleading statements about its performance to a registered investment company client, which, in turn, were included in such client's prospectus.

The settled charges against those five registered investment advisors were preceded by Marketing Rule-related enforcement actions against nine other registered investment advisers settled in September of last year. Again, the SEC's orders found that each of the advisers advertised hypothetical performance to mass audiences on their websites without having the required policies and procedures. In addition, two of the advisers failed to maintain required copies of their advertisements.

More recently, on June 14, 2024, the SEC settled another Marketing Rule enforcement against a registered investment adviser, this time for performance advertising that was misleading and not fair and balanced. The adviser was found to have presented performance returns that were experienced by a single investor without disclosing that such investor's elevated performance was due to participation in IPOs in which many other fund investors did not participate.

We encourage all registered investment advisers to review their Marketing Rule policies and procedures in light of these enforcements and the new Risk Alert.

European Funds Regulatory

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A number of significant EU regulations came into effect in the first half of 2024, with others slated for the remainder of the year. We summarize them below:

AIFMD II

On 26 March 2024, the European Commission published amendments to the Alternative Investment Fund Managers Directive (AIFMD). These amendments, known as AIFMD II, entered into force on 15 April 2024. The changes include a new pan-European regulatory framework for the management of funds engaging in loan origination. The new framework introduces a specific regime for these managers and funds, including diversification limits, risk retention rules and leverage restrictions, with significant impact on funds that focus on loan origination.

Member States have two years from 15 April 2024 to transpose AIFMD II into national laws.

European Sustainability Reporting Standards (ESRS)

On 31 May 2024, the European Financial Reporting Advisory Group (EFRAG) published Implementation Guidance for reporting in line with the European Sustainability Reporting Standards (ESRS), which are being introduced under the Corporate Sustainability Reporting Directive (CSRD) that entered into force on 5 January 2023 and which must have been transposed into national law by 6 July 2024. The guidance relates to materiality assessment, value chain and ESRS datapoints—areas EFRAG widely considers to be the most challenging aspects of ESRS implementation.

Although EFRAG's guidance is non-binding, it is expected to be widely adopted by industry. However, if there is a conflict between the EFRAG guidance and the ESRS, the latter will take precedence.

Corporate Sustainability Due Diligence Directive (CSDDD)

On 24 May 2024, the Council of the European Union formally approved the Corporate Sustainability Due Diligence Directive (CSDDD). The regime introduces human rights, environmental and governance due diligence obligations for large companies' and their subsidiaries' operations, and in their "chain of activities" (supply and distribution chains). Broadly speaking, the CSDDD applies to large EU companies and non-EU companies whose EU turnover exceeds EUR450 million. The CSDDD further requires companies to adopt climate change mitigation plans aligned with the Paris Agreement and mandates EU member states to establish supervisory authorities to investigate and impose penalties on non-compliant companies.

The CSDDD will enter into force on 25 July 2024. Member states will have two years to adopt the CSDDD in national law. However, transitional provisions allow for staggered implementation, starting from three years from its entry into force.

For further details, please see this Debevoise In Depth.

SFDR Regulatory Technical Standards (RTS)

On 23 January 2024, the European Parliament published a Scrutiny Paper on the final report published by three European Supervisory Authorities on 4 December 2023

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European Funds Regulatory

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proposing amendments to the RTS under SFDR Level II. The changes include new mandatory and opt-in social principal adverse impact (PAI) indicators, changes to the existing PAI framework and to the "do no significant harm" test.

The Commission has not made any progress on this yet. Once notified, Parliament will have three months (which can be extended up to six months) from the date of notification to object to it.

For further details, please see this Debevoise In Depth.

ESMA Guidelines for ESG and Sustainability-Related Fund Names

On 14 May 2024, the European Securities and Markets Authority (ESMA) published its final report regarding "Guidelines on funds' names using ESG or sustainability-related terms." The Guidelines establish four categories of terms used in fund names: (i) transition-, social-, and governance-related terms; (ii) environmental- or impact-related terms; (iii) sustainability-related terms; and (iv) a combination of the above. The Guidelines also introduce certain minimum requirements, such as a minimum percentage commitment to promote environmental and/or social characteristics or to make sustainable investments and applying a prescribed exclusion list.

The Guidelines will apply three months after they have been translated into all EU official languages and published on ESMA's website (the "Effective Date") to fund managers of funds incorporated after the Effective Date. There are no grandfathering provisions. Fund managers of funds existing before the Effective Date benefit from an additional transitional period of six months from the Effective Date.

For further details, please see this Debevoise Update.

ESG Ratings Regulation

In February 2024, the Council and Parliament reached a provisional agreement on the proposal for a regulation on environmental, social and governance (ESG) rating activities. The proposed regulation provides for authorization and supervision by ESMA of third-party ESG rating providers, management and prevention of conflicts of interests, minimum transparency requirements and passporting of third-country rating providers.

In its current form, the regulation will apply 18 months from the date of its entry into force, which is expected shortly.

UK Sustainability Disclosure and Labelling Regime

The FCA's Sustainability Disclosure and Labelling Regime comes into effect this year. The regime introduces, for UK managers of UK funds, disclosure requirements for funds that use ESG terms in the naming or marketing of a product; those disclosure requirements come into effect on 2 December 2024. In addition, UK firms will have to adhere to the FCA's new anti-greenwashing rule when making sustainability claims, and ensure that the claims are fair, clear and not misleading. Finally, to help guide consumers, the FCA is introducing four labels, along with their criteria, that can be used on sustainability investment products: Sustainability Impact, Sustainability Improvers, Sustainability Focus, and Sustainability Mixed Goals. Firms can begin using labels with accompanying disclosures from 31 July 2024 onwards.

ESG

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The first half of the year has witnessed significant ESG-related regulations in the EU and United States, a proliferation of both anti-ESG and pro-ESG laws at the U.S. state level, and increased targeting of greenwashing by regulators and private litigants, especially in Europe. We highlight below several of the most important ESG developments for the private equity industry.

Climate Disclosures

United States

SEC Final Climate Rule, Legal Challenge and Stay

On March 6, 2024, the SEC adopted a long-awaited climate disclosure rule requiring nearly all SEC registrants to disclose extensive climate-related information. The Rule seeks to facilitate the disclosure of "complete and decision-useful information about the impacts of climate-related risks on registrants" and improve "the consistency, comparability, and reliability of climate-related information for investors." (Please see our in-depth analysis of the Rule and considerations for private equity sponsors.)

The rule was quickly challenged by various state attorneys general and energy companies. Shortly thereafter, on April 4, the SEC voluntarily stayed the Rule. That same month, a bill was introduced in the U.S. House of Representatives seeking to overturn the Rule. The future of the Rule is uncertain.

California Climate Laws

California is now implementing the climate-related laws it passed in 2023.

The Voluntary Carbon Market Disclosures Act (AB 1305) took effect on January 1, requiring businesses marketing or selling voluntary carbon offsets within California to disclose certain information online. AB 1305 further requires disclosures from entities claiming that they, a related entity or a product is carbon neutral.

The Climate Corporate Data Accountability Act (SB 253) requires entities that do business in California and have annual revenues greater than $1 billion to disclose their value chain greenhouse gas emissions. The Climate-Related Financial Risk Act (SB 261) requires entities that do business in California and have annual revenues greater than $500 million to disclose their climate-related financial risks and measures adopted to mitigate those risks. The first reports under SB 253 and SB 261 are expected in 2026 for activities conducted in 2025, meaning that companies in scope will be required to gather relevant data starting in 2025. However, there have been recent indications the compliance deadlines under the two laws may be extended by a year or more. The California Air Resource Board (CARB) is responsible for overseeing both laws and is developing implementing regulations. CARB is also defending a lawsuit alleging that the laws violate the U.S. Constitution's prohibition against compelled speech and the Commerce Clause and are precluded by the federal Clean Air Act.

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Europe

The EU continues to develop its Green Deal by passing the Corporate Sustainability Due Diligence Directive (CSDDD) and implementing the Corporate Sustainability Reporting Directive (CSRD).

CSDDD: On May 24, the EU Council formally approved the CSDDD, which sets mandatory obligations for large companies to identify and address human rights and environmental issues across their value chains. It further requires companies to adopt climate change mitigation plans to align with the Paris Agreement and mandates EU member states to establish supervisory authorities to investigate and impose penalties on noncompliant companies. The CSDDD will be phased in gradually between 2027 and 2029.

CSRD: On January 1, the European Sustainability Reporting Standards (ESRS), a key part of the CSRD, took effect. The CSRD requires EU companies and certain non-EU companies to make detailed disclosures in accordance with the ESRS. However, in order to give companies more time to prepare, the EU postponed the adoption of additional, sector‑specific ESRS standards from June 2024 to June 2026. Private equity firms may want to take advantage of the extension to start actively preparing for CSRD requirements. (For more insights, please see our in-depth article.)

Greenwashing

As legislation encouraging climate-related disclosures continues to proliferate, regulators across the globe have stepped up efforts to eliminate greenwashing from reporting, highlighting the need for firms to ensure their ESG disclosures are accurate, complete and evidence-based.

On May 31, the UK Financial Conduct Authority's anti-greenwashing rule and accompanying guidance entered into force. The rule requires firms to ensure that any reference to the sustainability characteristics of a product or service is fair, clear and not misleading. On May 14, the European Securities and Markets Authority released guidelines on the use of ESG and sustainability-related terms in investment fund names within the EU. The guidelines require funds using sustainability terms in their fund names to have at least 80% of their investments meet environmental or social characteristics or have sustainable investment objectives. The guidelines also introduce rules for funds using transition-related terms, such as "improving," "progression," or "transformation," which imply a positive evolution toward sustainability goals.

Consumers and activists are also challenging misleading statements in court. On January 9, Investors for Paris Compliance, a climate activist group, sued five large Canadian banks alleging that they misled investors through their use of terms such as "sustainable finance." The complaint asserts that the banks lacked adequate disclosures concerning their carbon emissions and that their "sustainable finance" actually had the potential to increase GHG emissions.

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ESG

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ESG Polarization

In the United States, the polarization of ESG sentiments continues, with nearly every state having introduced either pro- or anti-ESG legislation. In many cases, bills that stalled in the 2023 legislative sessions are being reintroduced. (Please see our tracker of state-level ESG laws and regulations here.)

Some U.S. states have stepped up enforcement of anti-ESG laws. On January 26, the Texas Attorney General announced that Texas would prohibit Barclays from participating as an underwriter in the state's municipal bond market because the bank did not adequately respond to requests for information related to its ESG policies. On January 31, Florida Governor Ron DeSantis announced that Florida intends to bring enforcement actions for violations of Florida's anti-ESG legislation.

At the same time, Oklahoma is considering rolling back its anti-ESG laws. On April 11, the Oklahoma House of Representatives' Rules Committee unanimously approved a new bill, SB1510, which would curtail the application of Oklahoma's Energy Discrimination Elimination Act (EDEA). Under the EDEA, which was passed in 2022, contractors with Oklahoma municipalities and state agencies must provide a written verification that they do not boycott energy companies. On May 7, an Oklahoma District Court granted a request for a temporary injunction halting the application of the EDEA.

Real Estate

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Despite continued frustration with lingering high interest rates, the second half of 2024 may well see a rise in real estate transaction volume. Some real estate players have begrudgingly accepted higher interest rates and have modified their behavior accordingly, with sellers making price cuts to facilitate transactions and borrowers turning to alternative capital and debt sources. Indeed, the inefficiencies in the primary lending market combined with liquidity constraints may be a source of opportunity for private equity investors. In any event, the greater availability of alternative capital coupled with price reconciliation by sellers may lead to growth in transaction volume, relative to 2023 lows.

In recent months, **single-family home rentals** have provided some cause for excitement within the real estate industry. With rental rates having climbed nearly 3.4% across the country from March 2023 to March 2024, many younger tenants still cannot afford to purchase homes and are instead choosing to upgrade to larger rentals. This "new American dream" has led to the construction of over 80,000 build-to-rent homes this year, a 16% increase over the previous 12-month period. Leading build-to-rent developers expect this demand to continue.

The apartment outlook likewise appears relatively healthy following record completions in 2023 and with nearly one million units still in the pipeline for 2024. In the Class A space, soft rent growth and slight increases in vacancy rates have led

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to larger and more frequent rent concessions by luxury product operators. That said, current Class A rents still far exceed pre-COVID rents and will likely continue to do so. With record supply deliveries incoming in 2024, investors can expect mild but stable growth in the sector.

Office sector activity remains mixed and characterized by valuation compromises, with Class A product continuing to perform while less flashy properties sell at steep discounts. Over the last few years, value-oriented investors have tended to avoid office opportunities due to greater work-from-home activity and an unwillingness to deploy alternative capital in this sector. Now, as work-from-home habits have finally stabilized, and with more than $200 billion of outstanding office loans set to mature by the end of 2024, some opportunistic investors are beginning to take advantage of deeply discounted office buildings facing heightened vacancy rates. The coming months may see lower valuations in the office sector and may present attractive opportunities to investors with greater risk tolerance.

Meanwhile, e-commerce sales have driven growth for **industrial assets**. Data centers are quickly becoming the sweetheart of the industrial sector, as average rental rates rose substantially over the past eight months. As the critical infrastructure supporting the AI ecosystem, and given that AI is still in its infancy, data centers will very likely continue to see strong demand through 2024 and beyond. This asset class does face some sustainability headwinds, though, as AI infrastructure is expected to double the demand on global electricity by 2030. Heading into 2024, investors who can reconcile demand with sustainability via renewable energy or other technology will be poised for long-term success.

Although e-commerce sales have cannibalized market share from traditional retail, **strip malls**, **grocery-anchored shopping centers and restaurant retail** have all continued to benefit from the growth in remote work arrangements following COVID, with food service leases becoming the largest category of all new leases for the first time since 2007.

In sum, the first half of 2024 has had some bright spots after a prolonged period of challenges. The second half of the year may see increased transaction volume, heightened optimism for and interest in niche investments, and greater activity in the industrial sector. Ultimately, investment opportunities in commercial real estate in the second half of 2024 will continue to be heavily influenced by the monetary policy of the Federal Reserve and investors' appetite for risk.

Restructuring

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As predicted in the *Debevoise 2024 Private Equity Outlook*, restructuring activity in the first half of the year has kept pace with the relatively elevated levels observed through the latter half of 2023. Although the drumbeat of recession forecasts has abated, market expectations for interest rate cuts likewise remain unrealized, which continues to put pressure on highly leveraged borrowers—both because of liquidity challenges and because it is more difficult to refinance at maturity in the current credit environment. These considerations, together with certain industry-specific performance issues, have resulted in steady restructuring activity.

The vast majority of restructuring transactions (approximately 79%) continue to occur out of court, as all parties in interest—including lenders—appear focused on avoiding the costs and uncertainties associated with in-court proceedings. Distressed exchanges are the most common form of liability management transaction; for example, S&P reports that they cause a majority of all defaults. This trend is worth monitoring since, historically, distressed exchanges' share of total defaults has decreased as default rates rise.

Recently, bankruptcy courts in the Southern District of Texas issued two rulings on prepetition liability management transactions that may affect the negotiation and structure of such transactions in the future. In *Robertshaw US Holding Corp.*, the bankruptcy court granted a motion for declaratory judgment clearing the sponsor and participating lenders of liability for their participation in a prepetition amend-and-paydown transaction. The court did find that the debtor technically breached the prepetition credit agreement, but held that the non-participating lender's remedy under the credit agreement was to file a proof of claim for direct (money) damages rather than for any equitable relief. In contrast, in *Wesco Aircraft Holding Corp.*, the bankruptcy court found that the non-pro-rata secured uptier transaction violated the terms of the indenture and declared that "all rights, liens and interests" of the non-participating lenders survived the transaction.

The disparate outcomes of these two cases show that courts are examining the relevant agreements and circumstances for liability management transactions on a case-by-case basis, and strongly suggest such transactions will be heavily scrutinized and, likely, litigated. In order to mitigate litigation risk, sponsors have started retaining their own counsel to represent them through the entire course of liability management transactions and any subsequent challenges. This helps sponsors craft a record reflecting their role and decision-making processes before any litigation, thereby materially improving their defenses against potential future claims.

The Supreme Court has also rendered a number of opinions that may affect the restructuring landscape. Perhaps the most notable of those was the decision in *Harrington v. Purdue Pharma L.P.*, on June 27, 2024, holding that bankruptcy courts lack the authority to grant nonconsensual third-party releases outside the narrow confines of section 524(g) of the Bankruptcy Code. Importantly, this decision expressly does not apply to claims asserted against a sponsor by a portfolio company, or to derivative claims like breach of fiduciary duty or fraudulent transfer claims. That said, the decision removes

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Restructuring

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at least one tool traditionally used to manage direct claims by creditors of portfolio companies. In light of this ruling, when a bankruptcy filing is necessary, sponsors would be well advised to carefully consider which entities to file and how to structure the plan of reorganization to minimize the risk of follow-on litigation with parties seeking to extract nuisance value.

The Supreme Court also held in *Kaiser Gypsum Co*. that insurance providers qualify as "parties in interest" under Bankruptcy Code section 1109(b). As a result, an insurer "may raise and may appear and be heard on any issue" in a Chapter 11 case even if a proposed plan of reorganization neither increases its prepetition obligation nor impairs its contractual rights. This decision could complicate the resolution of complex multi-party cases, particularly mass tort cases, which themselves remain subject to legal uncertainty as courts consider whether the use of certain transaction structures, such as divisive mergers, is permissible.

Looking ahead, we believe the increased use of net asset value (NAV) financing by fund sponsors to meet additional liquidity needs and as an alternative to traditional exits should be monitored carefully. When evaluating NAV loan terms, as when evaluating portfolio company financings, we believe sponsors would be wise to negotiate for terms that provide them maximum flexibility to respond to a potential black swan event.

Banking/Financial Services Sector

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For many years, the banking sector and private equity were viewed as competitors in the financial services arena. However, a combination of regulatory factors (such as proposed increases in capital requirements) and industry factors (including the bank failures of the spring of 2023, high interest rates affecting bank bond portfolios and the stress on bank loan portfolios) increasingly have banks turning to private equity for solutions—a development which presents private equity with new opportunities for returns. And though the banking industry is heavily regulated, there exist many possibilities for private equity investors outside of the regulatory perimeter, as illustrated below.

Minority Equity Investments in M&A and Restructurings. Private equity investors' direct investments in banks are typically restricted by law to less than 25% of the voting stock of a bank. However, this still provides ample opportunity for private equity involvement, as was seen in the March 2024 $1 billion investment that several private equity firms made in New York Community Bancorp as part of NYCB's recapitalization. Private equity firms are also making equity investments to facilitate a bank's acquisition of another bank by "filling the hole" for the acquiring bank. For example, private equity firms made a $400 million investment to facilitate Banc of California's acquisition of PacWest, which was significantly affected by the failure of Silicon Valley Bank. That was followed by a $175 million private equity investment in connection with the merger of FirstSun Capital Bancorp with HomeStreet.

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Banking/ Financial Services Sector

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Purchase of Loan Portfolios and Other Assets. Private equity investors have also recently purchased loan portfolios and other assets from banks preparing for deals or seeking to exit certain portfolios or businesses, either to reduce capital charges or to simplify their operations as they address supervisory and market scrutiny. For example, as Capital One and Discover work toward regulatory approval of their proposed merger, Discover announced the sale of $10 billion of its student loan portfolio, which had contributed to supervisory issues, to a group of private equity firms. Similarly, Truist sold its insurance brokerage, valued at $15.5 billion, to a group of private equity firms as it seeks to focus on its core banking activities.

Synthetic Risk Transfers. Recently, U.S. banks, following a practice that has long been common in Europe, have been issuing instruments such as credit-linked notes to synthetically transfer credit risk from their balance sheet to private equity firms and other investors that are seeking greater private credit exposure. Due to greater regulatory clarity, these transactions will continue to grow in the United States, where they now total about $17 billion annually (compared with nearly $200 billion in Europe), presenting new opportunities for private equity investors.

Joint Ventures with Banks to Fund Loans. As the private credit space expands, joint ventures with banks enable private equity firms to tap into existing relationships between banks and their clients, while allowing banks to service their clients without taking on high capital charges. This trend can be seen across the U.S. banking industry, from midsized regional banks to national giants. For example, Webster Financial Corporation, a $76 billion banking organization, earlier this month announced a private credit joint venture with a private equity firm, and it has been reported JPMorgan Chase is seeking private equity partners for a similar venture.

Consortium Deals. Although, as discussed above, the size of a direct investment in a bank by an individual private equity firm is limited by law, firms often participate in consortium deals with other investors to acquire banks such that no one investor “controls” the bank for regulatory purposes. As an example, last year, TIAA sold its bank subsidiary, which now has nearly $38 billion in assets, to a consortium of five private equity firms, with each firm having a noncontrolling interest in the bank.

Pressures on the banking industry as it adapts to changing regulatory and market conditions create ample opportunities for private equity investors seeking exposure to traditional banking assets. Our involvement and significant experience in both the private equity and banking industries provide us with a broad prospective on identifying and executing on these prospects.

About the Debevoise Private Equity Group

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

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