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2020/2021 Private Equity Year-End Review and Outlook | Volume 20, Issue 4

From the Editors

2020 was a year of remarkable resilience for the private equity industry. After every aspect of the industry was upended in the second quarter, sponsors, investors and their advisors quickly adapted, factoring pandemic-related risks into their assessments and settling into a new normal for their business operations. To appreciate the extent of the industry's agility, contemplate the strong M&A market, the stronger IPO market and the banner year for secondary fundraising and LBO financing—and then consider how unlikely those conditions seemed at the start of the pandemic.

To be sure, there are many unknowns on the long road toward economic recovery. Beyond market conditions, further uncertainty comes from tax policy, regulation and enforcement. The tremendous cost of fighting the COVID-19 pandemic and shoring up battered economies has governments reexamining their tax codes. A new administration in Washington will likely bring more aggressive enforcement of financial, environmental and workplace regulations. In Europe, while funds and investors are generally well prepared for Brexit, the effects of the new EU regulations regarding ESG disclosure remain to be seen.

We hope that you will find the *2020-2021 Private Equity Year-End Review and Outlook* to be a useful summary of the uniquely challenging year behind us and a helpful guide in strategizing for the year ahead.

"New month everybody! Who wants to turn the calendar page?"

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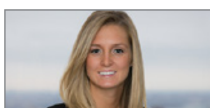
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Although the first half of 2020 saw an increase in fundraising (as compared to 2019), with the benefit of hindsight, this growth can largely be attributed to established sponsors raising megafunds which were launched prior to the COVID-19 pandemic. Both the number of funds closed and capital raised decelerated sharply over the course of the first three quarters of 2020, making it the lowest fundraising period for closed-end funds in the past few years. This slowdown is in part a result of the economic uncertainty caused by the pandemic; however that is only part of the narrative. The number of fund closings on a year-to-year basis has been in a steady decline over the past five years, which is a trend that continued in 2020. In addition, 2019 had a large number of megafund closings, with only a few continuing fundraising into 2020. However, if the larger funds in the market close at their expected target sizes, the fourth quarter of the year would bring 2020's fundraising total up to levels consistent with the past few years (although still less than the amounts raised in 2019).

Continuing travel restrictions present unique challenges to newer fund managers and their ability to attract first-time investors as in-person due diligence remains inadvisable. We have continued to see investors seek out larger sponsors with established track records, resulting in increased fund sizes for the funds that have successfully closed over the first three quarters of the year. Institutional investors are continuing to prioritize their existing sponsor relationships, a trend we expect to continue into 2021.

Despite lockdowns occurring all over the world, we have seen institutional investors, including even sovereign wealth funds and public pension funds, adapt quickly and continue to make commitments, shifting to virtual investment committee and board meetings to approve investments. Many more funds have moved towards rolling closings than we have seen in the past, with an increased premium placed on the ability to quickly close on investors given the uncertainty and volatility of the market.

As expected, the meaningful increase in credit-focused funds has continued through the end of 2020. Traditional private equity sponsors with established track records and relationships with institutional investors able to execute quickly have continued to enter the market. There has also been an evolution of existing credit products to become even more sophisticated—for example, flexible opportunistic credit funds with broad mandates to capitalize on dislocations and traditional junior debt products expanding to unitranche. Additional information about some of the key tax and regulatory issues facing credit fund sponsors (particularly in Luxembourg) can be found here.

Finally, another trend we have continued to see is the increased focus from private equity sponsors on tapping into insurance company capital, both through investments by private equity firms in insurance and reinsurance companies and through customized structuring, such as rated note issuers, to attract insurance company investors to investments in private equity and private credit funds on a risk-based capital-favorable basis. For additional background about the intersections between the private equity and insurance markets, please see here.

Secondaries

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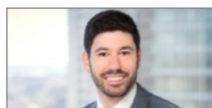

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2020 was a tale of two halves for the private fund secondaries market. The secondaries market entered 2020 fresh off several successive record years of transaction volume and with an eye towards continued expansion. After a promising start to Q1, the COVID-19 pandemic, and associated widespread public health measures and restrictions, swiftly overtook the secondaries market, which came almost to a halt by late March 2020.

The second quarter in particular was quiet. Secondaries buyers were skeptical that historical financial statements were able to effectively price in the impact of the pandemic on asset values, given the immediacy of the crisis. Likewise, sponsors and limited partners that may have been considering availing themselves of the secondaries market, generally pressed pause on their plans in order to take stock of the impact of the economic shocks on their portfolios and the general pricing environment. A handful of pre-pandemic deals managed to get over the line in Q2, including a small number of GP-led transactions, in particular in the NAV and preferred equity financing corners of the market, but secondaries market activity on the whole dropped more than 50% at the end of H1 2020 as compared to H1 2019.

However, the secondaries market roared back to life in Q3, with seasoned secondaries professionals telling us that the period since August 2020 has been the busiest of their careers. GP-led transactions, and specifically single-asset transactions, led the way. Some of these transactions were the result of pre-COVID-19 trade sales that were initially thwarted by the pandemic and later revived as GP-led transactions; others were motivated by dislocated business plans or the desire for a longer runway with specific assets. From a secondaries buyer perspective, GP-led transactions, and single-asset transactions in particular, are more straightforward to diligence and price as compared to traditional LP interest transactions, where a diversified underlying portfolio and lack of recent or real-time financial information pose significant challenges in choppy economic waters. Momentum for these deals has continued to build through the fourth quarter.

So what did 2020 demonstrate about the secondaries market, and what might that portend for the year ahead?

The secondaries market is resilient: The surge in GP-led transactions in H2 2020 builds on the growth of this part of the secondaries market over the past several years —but it represented a massive acceleration of this trend. While GP-led transactions comprised about 30–35% of overall secondaries transaction volumes in 2019 (with LP interest trades comprising 65–70%), observers have told us that when all is said and done in 2020, they expect those positions nearly to invert. While it is likely that outsized proportion of GP-leds relative to traditional LP trades in the overall secondaries market in 2020 was the result of the unique circumstances of the past year, the ability of the secondaries market as a whole to pivot to alternative transaction types, including GP-led continuation funds, NAV and preferred equity structures, GP-led strip sales and other structures, demonstrates the resilience of the market and the players in it in times of macroeconomic disruption and uncertainty.

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Secondaries

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The secondaries market is growing its supply to meet growing demand: Despite the pandemic, 2020 was a record year for secondary fundraising, with more capital raised for secondaries strategies through the first three quarters than in any prior year. The market also saw important new entrants, such as secondaries funds backed by asset managers who traditionally have not had a secondaries focus, as well as the continued proliferation of entrants bringing a niche focus, such as funds dedicated to single-asset or concentrated portfolios, credit and infrastructure transactions. At the same time, the growth in private equity fundraising and deal-making over the past decade means that the potential supply of transactions to the secondary market grows with each passing year. The secondaries market has built up the dry powder, specialized know-how and experience to address the needs of its increasingly complex transactional market.

The secondaries market continues to innovate: As noted above, secondaries players devoted more attention to alternative transaction types in 2020. With the minds of the industry focused on these alternatives approaches, we saw increasing adoption in secondaries transactions of deal technology from other aspects of the broader private equity market including a revived focus on material adverse change clauses, preferred equity financing structures and increasing usage of representation and warranty insurance. We expect that cross-pollination from other sectors (particularly with the increasing prevalence of new specialized players) to continue and expand in the year ahead.

Fund Financing

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Although the pace of fundraising slowed down in 2020, the fund finance market has held up tremendously through the pandemic. At the beginning of the year, the market was buoyant with more demand from funds for capital call lines that was met by more lenders entering the market. With the onset of COVID-19, fund-level facilities became an important source of liquidity—not only as a defensive measure but also to provide back-leverage and otherwise take advantage of opportunities created by market disruption. Pricing increased modestly, but we saw no defaults from investors, and sub-lines (even for SMAs) continued to be raised at a good pace. Funds also continued to increase and/or extend their sub-lines, sometimes even past the fund's investment period. Also, while some lenders stepped back somewhat because of increased usage of these facilities, we saw that trend reverse later on in the year.

We also saw more innovation in fund-level financings, with more and more bespoke fund finance products.

ESG mechanics were added to subscription line facilities—the first deal of any significant size and scope being a deal on which we advised a private equity sponsor on a EUR 2 billion-plus facility with a broad club of lenders. In ESG facilities, the sponsor gets a step-down in the margin if it meets certain pre-agreed ESG metrics. ESG financings remain a source of focus as LPs encourage GPs to set ambitious ESG targets, and GPs themselves look to do more.

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Fund Financing

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There was also significant interest in "concentrated NAV facilities" for private equity sponsors this year. While NAV facilities for secondaries and credit funds continued apace, 2020 saw an increased interest in NAV facilities secured by portfolio companies. Proceeds were used to shore up liquidity for COVID-19-impacted portfolio companies, make follow-on investments or make distributions to create recycled capital. We expect this area of the market to continue to grow beyond 2021.

We also saw more interest in raising fund-level financing by tapping insurance capital in transactions structured to take into account the risk-based capital regime to which insurers are subject. Private equity sponsors are increasingly interested not only in bilateral investments from insurance companies and others but also in issuing "rated" structured products in the market.

M&A (U.S.)

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The second half of 2020 saw the mid-year detour to private investments in public equity (PIPES) and rescue financings yield to a resurgent M&A market as the reopening of the finance markets allowed for derailed sale processes to be resumed and deal volumes to increase. Deal principals and advisors became more accustomed to transacting on Zoom, with principals traveling for diligence on a targeted basis, given continued COVID-19 risk.

The capital markets special purpose acquisition company ("SPAC") fund-raising phenomenon of recent years that accelerated early in 2020 began generating actual M&A deals, with an increasing number of sponsors electing to "exit" portfolio investments through mergers with SPACS. In doing so, they accepted the potential risks and rewards of monetization over time rather than through an immediate cash sale. As we move into 2021, we believe SPACS will continue to constitute a major force in the M&A deal market. We also suspect, however, that some number of SPAC sponsors may find that there are fewer target companies in particular industries that are truly ready for "prime time," living life as a public reporting company, than they may have anticipated.

In terms of sector focus, we believe that software, IT hardware and healthcare will continue to dominate in 2021. Everyone will also be watching for deal opportunities in infrastructure services, as the long-anticipated bipartisan support for infrastructure funding potentially becomes reality.

We anticipate an increasing number of carve-out deals in 2021, as strategies emerge from the pandemic with an increased focus on their core businesses, and a desire to shed business units that divert management focus. Lastly, keep an eye out for an increasing number of "continuation" deals, with sponsors transferring portfolio companies in older funds to successor funds, rather than fighting for attention in a sale market that is going to be quite crowded given the backlog caused by COVID-19 earlier in the year.

In sum, prospects for US deal activity going forward seem strong as we head into 2021, in a remarkable improvement from the sentiment six months ago, particularly with widespread vaccination on the short-to-medium-term horizon in the United States.

M&A (Latin America)

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The region's economies were materially impacted by the pandemic in 2020. The M&A market essentially ground to a screeching halt during the first half of the year but then partially recovered in Q3 and Q4 as the appetite of the more aggressive domestic and foreign investors was whetted by distressed assets becoming available at bargain-basement prices denominated in deeply devalued currencies. During the second half of the year, interest developed in start ups in technology, particularly fintech, and healthcare opportunities and players adapted to "digital deal-making." The partial recovery was also aided by the opening of a rare exit window through the capital markets. IPOs have become hot as historically low interest rates increasingly drive local retail investors to search for yield. While foreign private equity investors have not been particularly active in the region in 2020, we are observing growing interest in investments in infrastructure, education and healthcare.

The outlook for 2021 remains challenging. Growth projections for Brazil, for instance, have been recently pared back by the OECD to 2.6% from 3.6% p.a. as economists are concerned that the fiscal vulnerabilities of the country have been exacerbated by the governmental actions taken in response to the pandemic and the slow pace of the structural reforms that are needed. Extreme uncertainty will continue to be the dominant theme until it is clearer when the region can return to a more "normal" scenario. Nevertheless, we expect that there will be a number of good opportunities for savvy investors.

We remain optimistic about the potential of the region for private equity and institutional investors in Latin America for the following reasons:

- *First,* we would expect that, as the global economy rebounds, the region's local economies should experience a classic commodity-driven cyclical recovery;
- *Second*, the opening of the local capital markets in Latin America prompted by low interest rates should continue particularly in the first half of the year and will provide a better path to exit for private equity players; and
- *Third*, for so long as the local currencies remain deeply devalued, dollar-based investors may be able to generate high returns.

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Numerous challenges have of course been faced by the European private equity market in 2020. The outbreak of COVID-19, and the ensuing uncertainty and related volatility that followed, brought deal volumes down in the second quarter of the year but also encouraged dealmakers to utilize their creativity. As an example, May saw the first major "PIPE" (private investment in public equity) deal in the United Kingdom for over a decade, mirroring a flurry of PIPEs in the United States structured primarily to address an increase in demand for liquidity at the onset of the pandemic.

As dealmakers became more adept at assessing COVID-19-related risks and its direct and indirect impact on assets, the second half of the year saw somewhat of a resurgence in activity, primarily targeted at businesses in sectors that demonstrated long-term resilience during the pandemic; TMT and healthcare have continued to attract significant investment.

The GP-led secondaries market, which was similarly subdued by the onset of the pandemic, is buoyant again and looks likely to continue to be so into 2021.

Record levels of "dry powder" remain available to private equity dealmakers, which, coupled with historic low interest rates and government-backed schemes to support business and individuals, is likely to encourage and support a favourable climate for private equity investments.

The key challenge for dealmakers may ultimately be one of timing. Volatility appears to be here to stay, and further uncertainty is likely to lie ahead with the implementation of Brexit and the inauguration as U.S. President of Joe Biden both falling early in 2021.

Question marks also remain as to whether companies in the most COVID-19-vulnerable industries (such as hospitality, retail and travel) can survive long enough to see a turnaround in fortunes. As a result, distressed M&A is likely to become a more prominent feature of the market (we have seen already a number of examples of this). Consolidation in those industries most heavily hit by the pandemic is also likely to continue. Carve-outs of non-core assets or inefficient business units are also likely to be a feature of the market in the year ahead, as companies look to continue to shore up their balance sheets and prepare for continued recessionary pressures. This of course presents opportunities for private equity.

Finally, as noted in our 23 November 2020 Client Update, the UK government has recently published draft legislation that comprehensively reforms the UK's foreign investment rules, introducing a hybrid system of mandatory and voluntary notifications on grounds of "national security" similar to that in the United States and Germany. The effect on private equity buyers is still uncertain, but where a substantive review is mandated, additional regulatory disclosures concerning the buyer and the transaction terms are likely to be required to be made and deal timetables extended as a result.

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Consistent with global trends, private equity M&A activity in Asia experienced a noticeable slowdown in 2020 due to the COVID-19 pandemic. Not surprisingly, lockdowns and social distancing have adversely affected deal-making in previously popular sectors such as consumer and construction. The technology, media & telecom ("TMT") sector, however, has been a standout performer this year. In Asia, TMT M&A accounted for approximately 20% of total M&A deal values in the first three quarters of 2020, which was a larger share of overall deal activity compared with other regions. This evidences investors' continued eagerness to participate in the development of Asia's technology and digital ecosystem, which has thrived during the pandemic and continues to offer significant long-term growth opportunities.

Notable TMT sector transactions in Asia this year included the US$7.6 billion take-private of Chinese online classifieds company 58.com, led by Ocean Link, Warburg Pincus and General Atlantic, which is the largest private equity M&A transaction in Asia to date. The largest growth equity transaction in Asia to date is the US$1.7 billion financing of Full Truck Alliance, China's largest online B2B marketplace for commercial freight, led by SoftBank Vision Fund, Sequoia, Permira and Fidelity.

As we have noted previously in the 2020 Midyear Review & Outlook issue amidst the Luckin Coffee accounting scandal and heightened geopolitical tensions, there has been (and likely will continue to be) a significant number of de-listings and "take-private" transactions involving U.S.-listed Chinese companies. Most (if not all) of these companies currently are not able to be in full technical compliance with the relevant audit inspection requirements promulgated by the U.S. Public Company Accounting Oversight Board ("PCAOB") due to potential conflicts with China's state secret laws. With the passage of the Holding Foreign Companies Accountable Act ("HFCAA") by the U.S. Congress in 2020, and assuming HFCAA is signed into law by the President, U.S.-listed Chinese companies will be required to comply fully with the applicable PCAOB requirements within three years or face potential suspension of trading from U.S. stock exchanges. At the same time, U.S.-listed Chinese technology companies, such as Alibaba, JD.com and NetEase have conducted secondary listings in Hong Kong, and we expect other companies to consider or pursue similar plans.

U.S. Capital Markets

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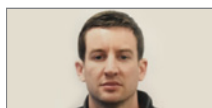

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Market Resiliency Shows Through Strength of Both IPO and High-Yield Offerings

As the financial markets continue to navigate the uncertainties of COVID-19, initial public offerings ("IPOs") have proceeded largely unfazed by the global pandemic. Indeed, investors were treated to a strong IPO market in 2020, particularly the second half, and should expect the start of 2021 to remain robust, with such anticipated offerings as Robinhood and Instacart rumored to be in the queue. Private equity firms are not looking to be forgotten either—eager to debut their portfolio companies to the market at attractive valuations with 13 PE backed IPOs in the first half of 2020 alone. Q3 2020 saw a record shattering 165 IPOs—the strongest quarter for U.S. exchanges since the Global Financial Crisis—and Q4 has been active with high profile market entrants such as DoorDash and Airbnb. With U.S. markets at or near all time highs, we expect growth stocks, in particular technology and healthcare, to continue to drive non-SPAC IPO activity in 2021.

Special Purpose Acquisition Companies ("SPACs") have likewise witnessed a roaring resurgence. Developing a reputation in the 1980s as penny-stock frauds, it was relatively recently that they have managed to reinvent themselves. That is, investors today will find SPACs underwritten by such investment banks as Deutsche Bank, Goldman Sachs and Credit Suisse. Indeed, while 2020 was a surprisingly good year for IPOs, it was at least as good for SPACs—with 200 SPACs raising a near $64 billion as of December. Private equity firms, moreover, appear to be capitalizing on the trend, with numerous firms jumping in, including Apollo and TPG.

High-yield bond issuance in leveraged buyout financing has also shown a marked increase, considering it all but dried up earlier this year as the pandemic gripped financial markets. The Federal Reserve's unprecedented support, moreover, to backstop the bond market has played an important role in boosting investor demand and reducing the cost of bond capital relative to bank capital. In October alone, leveraged finance volume to fund leveraged buyouts, including high-yield bonds, increased to $11 billion, a four month high. Indeed, high-yield bonds have comprised a larger share of overall leveraged finance activity than in previous years. As of October, high-yield bonds have accounted for a third the value of total leveraged finance issuances across North America and Europe, up from 24.7% in 2019 and only 13.1% in 2018. And, as of November, high-yield issuance volume moved above $400 billion, an unprecedented total that flattened the prior annual record of $354 billion, set in 2012.

SEC Overhauls Securities Offering "Integration" Framework

In November, the SEC eased the rules governing exempt offerings, otherwise known as "private placements" in an attempt to balance the promotion of capital formation and ease of access to investment opportunities with investor protections. Among the most significant of the changes were the amendments to long-standing integration considerations, including replacing the five-factor integration test, shortening the six-month integration safe harbor under Regulation D to a 30-day integration safe harbor across a variety of different offerings, and codifying that offers and sales made pursuant

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U.S. Capital Markets

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to an employee benefit plan will not be integrated with other offerings. Given issuers' need to access funds in order to continue their operations during the pendency of a public offering, these changes will be of particular importance for pre-IPO issuers during late-stage private capital raises.

SEC Proposes Amendments to Employee Compensation Issuances

November also witnessed the SEC proposing a series of amendments aimed at modernizing Rule 701 and Form S-8 to reflect recent trends in compensatory practices. These amendments, more specifically, would lower the compliance and disclosure costs to non-reporting issuers that rely on, or seek to rely on, the Rule 701 exemption, and expand the scope of certain workers in the "gig economy" who would be eligible to receive compensatory securities under Rule 701 or on a Form S-8 registration statement.

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COVID-19

The UK's and EU's economic and tax policies in 2020 were significantly affected by governments' response to COVID-19. However, with the UK's forecast budget deficit for 2020–21 having been increased from £54.8 billion in March to £394 billion in November (far exceeding the previous record for a peacetime deficit) as a result of policy measures and adverse effects on the economy relating to COVID-19, it seems possible that the UK may seek to implement a revenue-raising tax policy in the medium-term. This may turn out to be one of the longer-lasting legacies of the pandemic, and makes recent tax policy papers all the more interesting reading.

UK's Tax Regime for Holding Companies

The UK Government is conducting a wide-ranging review intended to ensure that the UK is an attractive jurisdiction for fund and investment holding structures. A recently-published report relating to one aspect of this, the anti-hybrid rules, can be seen as encouraging for the private equity industry. The Government appears to have taken on board industry feedback regarding the UK regime's shortfalls (in particular, compared to Luxembourg) and proposed:

- A *de minimis* threshold such that investors holding less than 10% in a fund partnership should not be treated as "acting together" with other partners. This removes minority fund investors from the scope of the UK anti-hybrid rules.
- A *de minimis* threshold such that investors with less than 5% in the equity of an entity should not be treated as "acting together" with that entity. This should remove many debt investors (who often hold small equity stakes) from the scope of the UK rules.
- Other improvements to clarify that tax-exempt investors should not give rise to hybrid mismatches and to recognize that certain apparent mismatches in fund structures (especially those with U.S. investors) do not cause any mischief.

Together, these welcome changes should significantly simplify sponsors' task when evaluating the UK anti-hybrids rules.

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UK Tax

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Capital Gains Tax

The UK's Office of Tax Simplification ("OTS") published a report, in November, regarding the future of the UK's capital gains tax ("CGT") regime. While the terms of reference of the OTS's report did not include policy-making, the contents have resulted in some speculation around the alignment (upwards) of CGT rates with income tax rates and otherwise curbing the distortive effect of the difference in rates (including in the context of employee incentive schemes). It remains to be seen whether the Government will make policy along these lines, which would be unfavorable to the UK private equity industry (and, arguably, in contrast to the "holding companies" review).

Carried Interest

In relation to carried interest, we note that there still remain areas of ambiguity following the swathe of rule changes in this area that have been in effect since 2016. Recent updates to guidance on the "disguised investment management fee" rules leave a number of questions unanswered; there is still no guidance on the "income-based carried interest" rules; and we await HMRC's views on a key issue around non-UK (in particular, U.S.) carry recipients' ability to claim double tax relief on carried interest. At this uncertain time, private equity firms should seek ongoing counsel on behalf of their UK-based principals if affected by these provisions.

Brexit

The UK and the EU successfully negotiated a trade deal to govern their relationship following the Brexit transitional period (which ended on December 31, 2020), but its terms do not permit the UK to benefit from certain important EU tax regimes. In particular, private equity firms whose investment structures include UK and EU companies should be aware that, as of January 1, 2021, they no longer benefit from the EU Directives that previously facilitated tax-neutral treatment of UK-EU cross-border mergers, that removed withholding taxes on interest and royalties, and that removed withholding taxes and income tax on dividends, paid between a UK company and a group company in an EU member state.

Separately, in a surprising (but cautiously welcomed) development, the UK Government revealed legislation, immediately after concluding the trade deal, to significantly reduce the scope of the EU's DAC6 regime (see below) insofar as it applies to UK persons. However, since many UK-based private equity firms will invest in the EU or use EU-based fund or holding structures, it could be that such firms will experience only a limited easing of the compliance burden by virtue of this development.

DAC6

Finally, it is worth flagging that private equity firms, their portfolio companies and their advisers should be paying close attention to new, EU-wide mandatory rules on disclosing tax information in relation to cross-border arrangements (DAC6). After some delays relating to COVID-19, this extensive tax reporting regime requires first reports to be made across the EU (and limited reports to be made in the UK: see above) by January 30, 2021 or February 28, 2021 as appropriate (the latter deadline being in respect of all reportable transactions where the first step in implementation took place since June 25, 2018). We recommend that you urgently seek advice if you invest in the EU and are unsure as to your preparedness to comply with this unusually broad regime, which is backed by material penalties for non-compliance.

U.S. Tax

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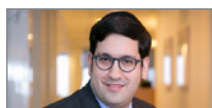

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In the wake of the Tax Cuts and Jobs Act of 2017, taxpayers are still adapting to the new U.S. tax landscape. However, taxpayers may once again need to adjust to new tax rules if the incoming Biden administration is able to pass its proposed tax policies. Of course, the possibility of significant tax reform will depend on the Georgia Senate runoff elections in January 2021, as Democrats may face roadblocks to passing tax legislation in a Republican-controlled Senate.

During the presidential campaign, the Biden administration outlined a series of potential changes to the tax code. Proposals include returning the top individual tax bracket to the pre-2017 rate of 39.6% while limiting itemized deductions to 28%, uncapping the social security tax of 12.4% on income over $400k, increasing the corporate tax rate on domestic income to 28% and increasing the effective corporate tax rate on active foreign income to 21%, by reducing the global intangible low-taxed income ("GILTI") deduction to 25%. The reduction in the GILTI deduction, together with the availability of the foreign-derived intangible income, or "FDII," deduction and new tax credits that the Biden administration may add, could push U.S. multinationals to move operations onshore. However, the increased corporate and GILTI tax rates may lead private equity and other financial buyers to utilize an offshore parent when structuring a carve-out from a multinational with material non-U.S. operations.

The Biden administration has also signaled that it may seek to eliminate the preferred capital gains rate for individuals with $1 million or more of taxable income and impose an estate tax (or preclude estate beneficiaries from getting a fair market value step-up). Finally, there is the ever-present specter of taxing all carried interest at ordinary rates.

Taxpayers should carefully monitor whether any tax changes will be effective for 2021 or 2022 and plan accordingly. If legislation to increase tax rates materializes, taxpayers may want to sell assets before such legislation is effective.

If Congress does enact legislation to tax carried interest at ordinary rates (or otherwise changes the taxation of capital gain), carried interest holders should consider whether (consistent with the restrictions in the underlying fund document) they can accelerate the recognition of income on their carry before the change. Although there are possible structures to accelerate gain without fully disposing of the carried interest, careful structuring is paramount.

While the future U.S. tax landscape remains uncertain, attentive taxpayers should be able to prepare and plan for any changes to put themselves in the best position going forward.

Healthcare

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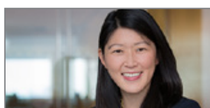

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While healthcare and life sciences companies were affected by the 2020 pandemic in many of the same ways as other companies, they also confronted a variety of unique challenges. Many providers, for example, had to adapt to a new remote care paradigm, including new reimbursement rules for telemedicine visits. Hospitals had to contend with an influx of COVID-19 patients and a corresponding reduction in surgical procedures, while nursing homes struggled to protect their patients from the emerging pandemic. Pharma companies grappled with producing vaccines and treatments in record time, while healthcare and medical device companies explored ways to develop and/or expand distribution of COVID-19 diagnostics and personal protective equipment.

At the same time, a number of subsectors thrived in the face of the pandemic. Telehealth, for example, attracted substantial investment interest this year as its use burgeoned throughout the pandemic; the concomitant easing of regulatory hurdles further drove its enormous growth. One of the larger transactions of the year—Teladoc's $18.5 billion acquisition of Livongo Health—demonstrates the vast potential of virtual treatment. Contract Development and Manufacturing Organizations ("CDMOs") also continue to attract impressive multiples in this environment.

Although the health insurance industry has, generally, benefited from deferrals and cancellations of treatment, benefits to plans may be mitigated by decreases in medical loss-ratios to account for net claims reductions. Further, the industry may have to brace itself for 2021, which could bring a resurgence of delayed treatments as vaccines become widely available and society gradually returns to normalcy.

Continuing its impressive growth trend, the mental and behavioural health sector has done well again this year, capitalizing on individuals' needs to combat loneliness and depression during lockdowns. Therapy in these areas is more conducive to virtual interaction than some other areas. Artificial intelligence has been another area of development in 2020, particularly as it relates to diagnostics, drug discovery, and clinical trials.

We have also seen significant M&A activity in the healthcare technology and information technology sectors, particularly by private equity buyers. And finally, the biotech sector continues to surge, with a continuing emphasis on cancer-related and rare disease therapies, including Gillead's $21 billion acquisition of Immunomedics and AstraZeneca's recently announced $39 billion acquisition of Alexion.

Several other themes that have evolved over the past few years continue to shape the industry in 2020 and will likely continue to do so into the future. The growing focus on value-based care and its effects on the practice of medicine and reimbursement mechanics have not abated, and recent changes to the anti-kickback statutes will make innovation in this area easier to achieve. Pressure on drug prices has continued with the Trump Administration's executive orders addressing most favored nation pricing for Medicare Part B drugs and transparency in hospital pricing, and the Biden

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Healthcare

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Administration has doubled-down with its promise to empower the Centers for Medicare and Medicaid Services to use its considerable leverage to negotiate directly with drug companies. Assuming the Supreme Court does not rule that the Affordable Care Act is unconstitutional, the Biden Administration may address gaps in the law and perhaps propose a public option, all of which may increase demand for medical services and products.

The year also saw an increase in less traditional transactions across the healthcare space, including during the short-lived PIPE explosion, mergers with special purpose acquisition vehicles, or SPACs, often backed by private equity sponsors, venture capital-type investment in behavioral health, telehealth and other sectors, and a swelling of IPOs. We expect many of these trends to continue into 2021, providing both competition to private equity investment as well as new avenues for sponsors to explore.

Although by any measure healthcare deal activity is down from last year, to date in 2020, despite COVID-19-related headwinds, investment in healthcare and life sciences businesses by private equity and venture investors is the highest of any industry other than information technology and industrials. However, life sciences M&A is at a 10-year nadir, and both the number and value of healthcare deals are at the low end of the range over the past five years.

Looking ahead, as the emergency abates and a new administration takes office, a fundamental question is whether society will resemble its pre-pandemic state or if it has been permanently altered. From a healthcare and life sciences perspective, we expect that the regulatory environment that has enabled the extraordinary growth of telehealth and healthcare technology will not revert to pre-COVID-19 restrictions. Pharma will likely continue to seek scale and innovation through acquisitions, while services companies and providers will need to be agile to adjust to an uncertain future. Much will likely depend on the outcome of the senatorial elections in Georgia as many initiatives will require congressional approval. Dealmakers, particularly private equity, will also need to be agile, and should expect a somewhat less friendly deal environment in the healthcare space. There is currently considerable suspicion of consolidation and sponsor-backed acquisitions in this space, and the nomination as Secretary of Health and Human Services of Xavier Becerra, who as Attorney General of California has been sceptical of acquisitions of healthcare companies, will not be comforting to those seeking to invest in the sector.

U.S. Employee Benefits & Executive Compensation

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Continue to Keep an Eye on Worker Classifications

While the COVID-19 pandemic dominated employment-related legislation, litigation and enforcement in 2020, this year saw meaningful changes in worker classification issues, which are likely to continue in 2021 under the Biden-Harris administration (likely, in an employee-favorable direction). Because worker misclassification can result in extra employer liabilities for back pay and benefits, including penalties, this will continue to be an important issue of compliance and transaction diligence for companies in the United States, including private equity firms and their investments.

Worker classifications, particularly in the gig economy, continued to be the subject of debate in 2020, with California leading the way on legislation. California Assembly Bill 5 ("AB5") took effect on January 1, 2020 and made it more difficult for companies in California to classify workers, including gig workers, as independent contractors by presuming they are employees unless they perform work outside the usual course of the company's business (the so-called "ABC test"). However, this controversial law was scaled back by a California voter ballot in the November election—California Proposition 22— that expressly carves out app-based transportation and delivery drivers from AB5 (who were many of the gig workers the California law had intended to reclassify as employees) by defining them as "independent contractors" and not employees. Legislators in New York and other states have been considering bills similar to California's AB5 to force more employers to classify workers as employees, but those bills have been delayed by the pandemic. By contrast, at the federal level, the Department of Labor proposed a rule in September 2020 and a substantially similar final rule on January 6, 2021 that would make it easier to classify workers as independent contractors. For a summary of this proposed DOL rule, please see here. President-elect Biden, however, promised in his campaign to "aggressively pursue employers who violate labor laws, participate in wage theft, or cheat on their taxes *by intentionally misclassifying employees as independent contractors*" and he has supported enacting the Protecting the Right to Organize Act, which is similar to California's ABC test. Therefore, President-elect Biden's administration may withdraw the Department of Labor's final rule before it takes effect on March 8, 2021.

Similarly, the Biden-Harris administration is likely to take a pro-worker approach to other labor and employment issues in 2021, including overtime classifications under the Federal Labor Standards Act, federal minimum wage, joint employer liability and paid leave. However, it is unlikely that we will see any meaningful movement on such measures until later in 2021 given other urgent priorities of the new administration, and, as with other issues, the extent of these initiatives may depend on whether Democrats gain control of the Senate. One thing is clear: issues of worker classification are not settled, and companies should remain alert for legal developments to the use of independent contractors, as well as which workers are eligible for overtime.

CFIUS Reform

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Heightened Attention to CFIUS: Notable Developments in 2020

For private equity fund sponsors, the completed implementation by the Committee on Foreign Investment in the United States ("CFIUS") of the provisions of the Foreign Investment Risk Review Modernization Act ("FIRRMA") brought both good and less-good news.

FIRRMA's Impact on Fund Sponsors

Principal Place of Business of Fund Is Controlling. As to good news, transactions by a U.S.-based fund sponsor using a Cayman (or other offshore) vehicle are not, by virtue of making use of an entity organized abroad, within CFIUS jurisdiction. This new clarity is provided by the definition of a "foreign entity" being tied, in part, to the location of its "principal place of business," which is newly defined. An investment fund's principal place of business is the primary location where the general partner ("GP") directs or controls its activities. The foreign vehicle is, then, not considered "foreign" to the extent that the "nerve center" is inside the United States (a limited exception applies if the fund has made a recent U.S. or foreign government filing stating that its principal place of business is outside the United States). The principal place of business clarification will not, however, be helpful if either the GP is, or if it is controlled by, a foreign person or if the fund is primarily managed from outside the United States.

Expansion to Non-Controlling Investments in TID U.S. Businesses. On the downside, FIRRMA expands CFIUS's jurisdiction to include non-controlling investments (of any size) by a foreign person in a "T[echnology]I[nfrastructure] D[ata] U.S. business" if that person is accorded any one of three "trigger rights." A TID U.S. business includes (i) a business that produces, designs, tests, manufactures, fabricates or develops a "critical technology" (defined, in most relevant part, by whether the technology is subject to U.S. export controls – see further discussion below); (ii) performs certain functions with respect to "critical infrastructure"; or (iii) maintains or collects "sensitive personal information" of U.S. citizens (which includes insurance-, financial- or health-related data subject to a general threshold of data from at least a million persons collected or maintained during a 12-month period). The trigger rights are: (i) access to material non-public technical information; (ii) a board or board observer seat; or (iii) involvement in substantive decision-making regarding the TID U.S. business. This expansion of CFIUS's jurisdiction to non-controlling investments (called "covered investments") by foreign funds and GPs, however, can be meaningful if and to the extent that they do acquire any of the trigger rights.

Investments by Passive Foreign LPs Are Outside CFIUS Jurisdiction. As to foreign limited partners ("LPs"), in a couple of ways, FIRRMA and the regulations recognize the benefit to U.S. businesses of being able to take in foreign capital assuming that the investment raises no national security concerns. First, because and to the extent that LPs typically are not accorded one of the three trigger rights, their non-controlling investments will not be considered "covered investments." Second, FIRRMA and the regulations establish an investment safe harbor for foreign LPs that invest in an

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"investment fund" that is exclusively managed by a U.S. general partner (or equivalent), if the LPs are not accorded any of the trigger rights and their participation rights in the limited partner advisory committee ("LPAC") are limited. To ensure the availability of this safe harbor and confirm that foreign LPs' investments are not otherwise covered investments, sponsors' limited partnership agreements increasingly provide that LPs are not accorded any of the trigger rights, have limited rights on an LPAC and, in any event, do not have any control over the GP or the fund.

Excepted Investors. CFIUS also has established a more favorable regime with respect to non-controlling investments by "excepted investors." These are investors based in, and whose directors and shareholders are from, "excepted foreign states" (only Australia, Canada and the United Kingdom, until at least February 2022). Their non-controlling investments in TID U.S. businesses are not "covered investments" and, therefore, they will be outside CFIUS's jurisdiction.

Other Important Developments

- **Mandatory Filings.** In October, CFIUS issued final rules as to when a filing is mandatory in connection with a foreign person acquiring control of, or making a covered investment in, a "critical technology" TID U.S. business. A filing is now mandatory if a "U.S. regulatory authorization" (an individual license) would be required to export, re-export, transfer (in-country) or retransfer an investment target's "critical technology" to any of the countries of the acquirer, its parents and any holders of a 25% voting interest in those entities. For non-U.S.-based PE sponsors (or for LPs that are accorded a trigger right), increasing familiarity with export controls may well become the norm.

- **Foreign Government Interest.** A filing also is mandatory if a foreign person in which a foreign government has a "substantial interest" itself acquires a substantial interest in a TID U.S. business. The impact of this requirement, however, is limited in the case of investment funds because interests of the foreign government are relevant only to the extent that the foreign government holds a 49% or more voting interest in the general partner (or equivalent) itself (i.e., not the fund).

- **Expansion of Critical Technologies to Include "Emerging" and "Foundational" Technologies.** The Export Control Reform Act ("ECRA") directs the U.S. Department of Commerce to establish appropriate export controls for "emerging" and "foundational" technologies. Any such technologies identified by the Commerce Department are considered "critical technologies" for purposes of CFIUS's regulations. In October 2018, the Commerce Department issued an advance notice of proposed rulemaking ("ANPR") seeking public comment on criteria for defining and identifying emerging technologies and, in August 2020, it issued an ANPR with respect to foundational technologies. No final regulations or other guidance has yet been published. In the

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meantime relevant interdepartmental working groups continue to consider the issue, and certain, limited technologies have been identified as "emerging technologies" pursuant to the United States' participation in the Wassenaar Agreement, which requires member states to adopt certain export controls.

- **Short-Form Declarations.** With the new regulations implementing FIRRMA's provisions that establish the filing of a short-form declaration as an alternative to a full-blown notice, CFIUS's review of a transaction could be complete by no later than 30 days from the filing date. (By contrast, the process of drafting a notice, filing the draft with CFIUS for its comments, filing the final notice and CFIUS's review can take as long as five months.) A cautionary note, however, is that, notwithstanding the speediness of a CFIUS response, it could ask the parties to submit a full notice, in which case the submission of a declaration would have delayed the review process.
- **New Enforcement Function.** FIRRMA provided CFIUS with additional support for an enforcement function, and CFIUS announced its new Office of Investment Security Monitoring & Enforcement this summer. In addition to providing a tip-line on its website, CFIUS has launched numerous reviews of completed transactions, particularly where the foreign investor was Chinese or, in some cases, Russian.
- **Effect of FIRMMA and Heightened CFIUS Review.** Many observers looked to CFIUS's annual report to Congress of data for both 2018 and 2019 to see if trends are emerging in the post-FIRRMA regulatory landscape. The data reflect the growing trade tensions between China and the United States, with Chinese acquirers declining in both years and, in 2019, falling from the top spot for the first time since 2011, replaced by Japanese investors.

Looking forward to 2021, we do not anticipate any meaningful change in CFIUS's regulations and the new year will bring further familiarity with the new regulatory structure. We expect the bipartisan concerns that drove FIRRMA's adoption, including a distrust of the Chinese government and preservation of U.S. technological ascendency, to continue under President Biden. That noted, we expect that the tone of senior U.S. officials regarding the issues within CFIUS's purview will change under the new administration.

U.S. Regulatory

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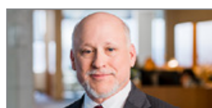

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Despite the COVID-19 pandemic, the Securities and Exchange Commission ("SEC") in 2020 finalized a number of regulatory proposals applicable to private fund managers.

In August 2020, the SEC adopted, substantially as proposed and effective December 8, 2020, its final amendments to the definition of "accredited investor" under the Securities Act of 1933 ("Securities Act"). The final amendments provide additional flexibility for natural persons to qualify as accredited investors outside of the asset, net worth and income thresholds that historically served as a proxy for a natural person's ability to participate in exempt offerings. Private fund sponsors should update subscription and offering materials to reflect the new and updated categories as they may increase opportunities for employees of private fund sponsors to invest in the sponsor's private funds and provide family offices with greater flexibility in structuring their investments in private funds and other private issuers.

In October 2020, the SEC adopted its final amendments applicable to funds registered under the Investment Company Act of 1940 ("Investment Company Act") in connection with the regulation and use of derivatives and certain other transactions. In particular, new rule 18f-4 permits registered mutual funds (other than money market funds), exchange-traded funds, registered closed-end funds, and business development companies ("Registered Funds") to enter into derivatives transactions and certain other transactions notwithstanding the restrictions under section 18. Of note to private funds, the rule permits a Registered Fund to apply a flexible "asset coverage" approach rather than the more restrictive value-at-risk limits to its "unfunded commitments" (including investments in private funds), subject to conditions tailored to these transactions.

In November 2020, the SEC adopted its final amendments to simplify, harmonize and improve certain aspects of the exempt offering framework under the Securities Act. The amendments most applicable to private funds include changes that *(i)* simplify the analysis of whether offerings must be integrated by replacing the current patchwork of rules and guidance with one general principle of integration and four safe harbors, one of which allows for the commencement of an offering 30 business days after the termination of another offering without integration; *(ii)* reaffirm guidance on an issuer's requirements to take reasonable steps to verify that purchasers are accredited investors for purposes of Rule 506(c) offerings; and *(iii)* harmonize certain disclosure requirements for non-accredited investors in Rule 506(b) offerings.

This month, the SEC adopted a new rule under the Investment Company Act addressing the requirements for determining the "fair value" of securities owned by Registered Funds when market quotations are not readily available. While the new rule is not applicable to private funds, it remains to be seen whether some of the concepts reflected in the rule (particularly with respect to valuation risk) will impact the views of the Office of Compliance Inspections and Examinations ("OCIE") on private fund valuation practices.

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Shortly before this publication, the SEC adopted a new investment adviser "Marketing Rule" under Rule 206(4)-1 under the Investment Advisers Act of 1940 ("Advisers Act") that will replace the existing advertising rule and cash solicitation rule. The Marketing Rule is a radical revision of the existing marketing and advertising rules and introduces an entirety new framework under which investment advisers will market their services and products (including private funds). Given these changes, we expect significant interpretative issues to arise concerning the Marketing Rule's application. The effective date of the Marketing Rule will be no earlier than September 2022, giving investment advisers at least an 18-month transition period.

Despite the COVID-19 pandemic, the SEC also provided registrants guidance on a variety of compliance matters. Consistent with its 2020 priorities, which cited private equity funds as an explicit priority, OCIE issued a number of risk alerts providing guidance of interests to private fund managers. In August 2020, OCIE outlined its recommendations to registrants on operational, technological, and commercial challenges due to the effects of COVID-19. While the August 2020 risk alert included topics that are more applicable to private fund managers with retail clients (like the protection of investors' assets), OCIE is likely to continue focusing on private fund managers' evolving practices, disclosures and any related changes caused by the COVID-19 pandemic. We also expect OCIE to continue to be focused on matters relating to cyberattacks and information security, a focus of a September 2020 OCIE risk alert. Most recently, in November 2020, OCIE highlighted the most commonly cited deficiencies it has observed in examining registered investment advisers relating to Rule 206(4)-7 under the Advisers Act. While OCIE did not identify any new risks or findings, OCIE Director Peter Driscoll in separate remarks emphasized the deficiencies that arise when a Chief Compliance Officer lacks sufficient authority and resources.

While the priorities and focus of the SEC over the next four years will remain uncertain in the short term, the SEC is likely to continue focusing on private equity advisers. Additionally, we expect the SEC to review the exemptive relief orders under the Advisers Act and the Investment Company Act granted during the course of 2020 as a response to the COVID-19 pandemic, which have received positive feedback from registrants. In particular, market participants have requested making permanent the flexibility granted to Registered Fund boards with respect to approving certain actions without the need of an in-person meeting and vote.

European Regulatory

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Brexit

Brexit will finally take effect at 11pm GMT on 31 December 2020, when in financial services terms UK-based firms will cease to benefit from EU "passporting" rights. For most firms, there will be no dramatic consequences, and – we hope – no unexpected consequences, with firms long since having put in place alternative structures to manage their EU business.

For EEA firms operating in or passporting into the UK, the FCA has put in place a "temporary permissions regime," enabling EU firms to continue operating in the UK into 2021. EU states have not generally extended similar transitional relief.

Financial services have not been a particular focus of the UK-EU Trade Deal, with the expectation that UK firms will rely on the existing regimes for "third country" firms to access professional clients in various EU financial services Directives. As it has turned out, there has been little progress in implementing the equivalence decisions required for the third country regimes to apply, with now considerable doubt as to whether those regimes will apply (at least in favor of the UK) at all. In practice, few firms have planned for the impact of Brexit in reliance on the prospective third country regimes.

ESG

2020 has been an important year for environmental, social and governance ("ESG") factors. Two pieces of legislation relating to fund managers' integration of ESG factors in their investments will come into force in the next two years, starting in March 2021, namely the Sustainable Finance Disclosure Regulation (the "Disclosure Regulation") and the related Taxonomy Regulation. These regulations will require larger fund managers to incorporate ESG considerations into their investment management decisions, and to explain and disclose to investors (as well as the public at large) how they do so. Other managers will need to follow the extensive checklists in the Disclosure Regulation when disclosing their approach to ESG, both to investors and to the public at large.

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

AIFMD Review

The European Commission (the "Commission") plans to publish its long-awaited legislative proposal to amend the AIFMD in Q3 2021, with a public consultation now open. The scope of the consultation is wide, leaving the parameters of the review open, although it is not generally expected that the Commission will propose significant changes to AIFMD. It is worth noting though that a letter from ESMA to the Commission in August 2020 in relation to the AIFMD raised a number of important points, such as the heavy reliance by AIFMs on delegation and secondment arrangements, as well as the use of host AIFMs, suggesting clarification on the "maximum extent" of such arrangements and the substance required for EU AIFMs. For AIFMs that currently rely on delegation to firms outside the EU, this is an important area to watch.

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Pre-marketing

In Germany, the Ministry of Finance recently published the long-awaited draft rules implementing (among other things) the Cross-border Distribution of Funds Directive, which amends AIFMD to create an EEA-wide approach to pre-marketing. "Pre-marketing" refers to distribution-related activities that can be conducted without having obtained marketing approval.

The German rules make non-EU funds and managers subject to the same rules regarding pre-marketing as EU funds, to the extent marketed in Germany. German and non-EU AIFMs and EU AIFMs marketing non-EU AIFs will be required to document their pre-marketing efforts and notify the German regulator BaFin. EU AIFMs marketing EU AIFs will have to notify their home state regulator.

SEC Enforcement

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Following the 2020 election results, the change in administration and SEC leadership will almost certainly result in some shift in enforcement priorities. While the last four years have been largely focused on "Main Street" retail investors, prioritizing exams and cases involving retail investors directly impacted by fraud, the new SEC Chair will likely place a higher priority and focus on financial institutions and aggressive market structure and asset management cases, including cases involving private funds.

The selection of a new SEC Chair will set the tone. While confirmation will require consensus from both parties given the closely divided Senate, we expect the incoming SEC Chair to adopt an aggressive enforcement stance, particularly against financial institutions. We accordingly expect the incoming SEC Chair to select an Enforcement Director who will pursue an ambitious agenda, including charging cases aggressively and seeking significant monetary remedies and sanctions.

In light of this, we expect an increase both in examination referrals to enforcement and in enforcement actions. Democratic-appointed SEC Chairs tend to view a public enforcement action with penalties and other sanctions both as the appropriate resolution for violations and as a deterrent for the broader registrant population. As a result, while the last four years have seen the exam staff view registrant self-remediation as means to resolve exam deficiencies, a new SEC Chair will likely encourage more referrals to enforcement even where a registrant has taken remedial steps. A new SEC chair is also likely to request and receive an increased budget, thereby increasing overall headcount that will result in increased investigative activity levels, which in turn leads to more enforcement actions as those investigations come to fruition.

A new SEC Chair will likely focus on investigating and charging systemic cases against large financial institutions, issuers, private funds and pension funds. While the agency post Dodd-Frank has had an aggressive private funds examination program, we expect even more robust examinations, particularly for managers with significant assets under management and managers that have never been examined. Many private fund managers have been extremely active during the COVID-19 pandemic, which has presented interesting and unique investment opportunities; we expect the

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SEC Enforcement

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exam staff to focus on those registrants in particular. More generally, we expect the SEC staff to continue its scrutiny of fee and expense allocation, conflicts disclosures, valuation, allocation of investment opportunities, and relationships with affiliates. Other developing areas that are unlikely to recede include cases involving ESG (*e.g.*, are investments consistent with ESG disclosures?) and COVID-19 disclosures (*e.g.*, are performance risks adequately disclosed?).

We believe the new administration will likely seek even more significant monetary relief in enforcement actions. In addition to supporting the trend of increasing civil penalty levels, including in financial reporting cases, the SEC's new leadership will be armed with newly enacted statutory authority to seek and impose disgorgement of unjust enrichment. On January 1, 2021, Congress passed the National Defense Authorization Act for Fiscal Year 2021, which arguably frees the SEC from the limitations on disgorgement imposed by *Liu v. SEC*. Congress also created a bifurcated statute of limitations for disgorgement (five years for negligent fraud and ten years for intentional fraud). The bifurcated limitations period may have a number of unintended consequences, including incentivizing "overcharging" conduct and making settlements with the Commission more difficult for asset managers.

Finally, with the recent amendments to the whistleblower program adopted this fall, and the agency's establishment of an expedited claims review process, we expect tips to continue rising and awards to continue flowing from the SEC.

Europe Business Integrity

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The legislative trend towards requiring increased disclosure and diligence of ESG risks and impacts continues apace. The EU's legislative initiatives highlighted in the 2020 Midyear Review and Outlook issue, and laid out below, have continued to develop over the last six months. Many of these initiatives will, or are predicted to, come into force in 2021. The initiatives reflect the EU's international commitments, including under the Paris Agreement on combating climate change and its commitment to implement the 2030 Sustainable Development Agenda in full; they represent an attempt to funnel finance flows and direct business interests to promoting these commitments, including climate adaptation and mitigation, biodiversity, and a concern to avoid adverse impacts on human and labor rights and other social and governance concerns.

Sustainable Disclosure and Taxonomy Regulations. From 10 March 2021, fund managers, financial advisers and many other regulated firms in the EU, as well as non-EU fund managers marketing their funds in the EU, will have to consider and report on how sustainability risks are part of their investment decision-making process, and for certain larger entities, how they consider the adverse impacts of their decisions. The Disclosure Regulation also attempts to place some criteria and benchmarking around what constitutes a "sustainable" investment, including mandating the publication of information that will assist customers to compare financial products. Read together with the Taxonomy Regulation, the Disclosure Regulation also imposes criteria around what

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Europe Business Integrity

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constitutes an "environmentally sustainable" product. However, the supplementary technical guidance, which will provide much of the detail around the criteria and was slated to be published in December 2020 deadline, has been delayed. As a result, the first disclosures will be made without technical guidance. We rolled out a series of in-depth webinars on these Regulations in October and November 2020, available here.

Mandatory Human Rights Due Diligence Law and Conflict Minerals Regulation. As of 1 January 2021, the Conflict Minerals Regulation will require EU importers of tin, tantalum, tungsten and gold from conflict-affected and high-risk areas to carry out due diligence on their supply chain. This will be relevant to fund clients when diligencing investments that directly or indirectly engage this sector, including, for example, many consumer electronic products and the automotive, aerospace and medical industries. Of broader application, and as foreshadowed in the MYRO, the EU announced that, in 2021, it would put in place a mandatory human rights due diligence law that will apply across sectors, and—despite the name—require that entities diligence a broad range of ESG risks and impacts. It will apply not only to EU entities, but more generally to entities whose goods and services enter the EU. The proposal reflects a perceived wish for greater certainty and a frustration with the perceived lack of effectiveness of voluntary standards. On 11 September 2020, the European Parliament's Committee on Legal Affairs published a report containing recommendations and draft provisions for that legislative proposal. The proposed legislation envisages a variety of penalties for businesses that fail to assess and prevent adverse human rights and environmental impacts.

The United Kingdom. The UK's relationship with the EU post-31 December 2020 remains uncertain, as does the ESG legislation that the UK may adopt post-Brexit and how this will relate to the EU's initiatives. However, the UK has taken certain proactive steps in adopting and strengthening its own domestic ESG disclosure and diligence framework. As reported in the MYRO, the UK put in place a review process to strengthen the effectiveness of the Modern Slavery Act (MSA), including of section 54, which requires larger businesses publish an MSA statement setting out the steps taken in their business and supply chains to combat modern slavery. Following a consultation, the government has set out various changes it intends to make to the MSA and accompanying guidance, including specified areas that businesses must report on in their statements and implementing stronger penalties for noncompliance. In August 2020, the UK proposed legislation targeting the use of products resulting from illegal deforestation and mandating supply chain due diligence in the sector. It has been suggested that the diligence obligation might extend to entities financing operations, as well as those conducting them. Finally, in November, the UK announced a roadmap for implementing a mandatory system of climate-related financial disclosures would come on stream within the next 3-5 years, alongside a new "green taxonomy," which will derive the majority of its content from the EU's Taxonomy, and will provide a framework to determine what is, and is not, environmentally sustainable.

U.S. Business Integrity

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Environmental Initiatives in the Biden Administration

Private equity firms and their portfolio companies will need to consider the impact of the Biden administration's anticipated environmental initiatives.

Climate Change. President-elect Biden intends to rejoin the Paris climate change accord and require many U.S. companies to reduce their greenhouse gas ("GHG") emissions. As a divided U.S. Congress is unlikely to pass comprehensive climate change legislation, President-elect Biden is expected to use executive action to re-impose certain Obama-era climate change policies, though he also may seek more ambitious reductions in GHG emissions. Although the initial executive orders likely will target the coal and energy industries, future orders undoubtedly will impact other industries.

Increased Enforcement. The Biden administration is expected to prioritize the enforcement of federal environmental laws. This includes expected enforcement by the Environmental Protection Agency and Department of Justice involving laws such as the Clean Air Act and Clean Water Act. Federal authorities are expected to seek harsher penalties for environmental violations and may bring enforcement actions for infractions that the Trump administration did not prosecute.

Environmental Justice. Likewise, President-elect Biden has pledged to prioritize environmental justice in order to address soil and groundwater contamination, air and water pollution and other environmental concerns disproportionately affecting minority and low-income communities. Such matters often involve landfills as well as heavily contaminated sites and factories emitting harmful pollutants into the environment. President-elect Biden said he would establish a new Environmental and Climate Justice Division within the Department of Justice that would enforce environmental justice issues. The new administration likely will increase regulatory oversight of permits seeking to emit pollutants in these communities. In addition, the cost of cleaning up soil and groundwater contamination in these communities may increase as federal authorities pursue more comprehensive investigations and stricter cleanup requirements. Biden administration initiatives on environmental justice also could trigger lawsuits from governmental authorities, nongovernmental organizations and private parties against companies responsible for contamination in these communities.

Impact on Private Equity. Private equity firms will need to evaluate the impact of these new environmental requirements on potential investment targets as well as their portfolio companies. For example, due diligence should include an assessment of any costs to comply with new climate change laws, address increased enforcement of environmental laws, and remediate any contamination under stricter cleanup requirements. In addition, sponsors should monitor the potential impact of new environmental initiatives on their portfolio companies, including relating to environmental justice. While the full extent of the Biden administration's ultimate environmental initiatives of course is currently unknown, private equity firms should consider how to best position themselves to adapt to the new requirements. As an increasing number of private equity firms consider Environmental, Social and Governance ("ESG") issues in their investments, they will need to consider the likely impact of the Biden administration's anticipated environmental initiatives.

Data Strategy and Security

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Private equity firms face a wide range of cybersecurity and data privacy threats. They are, for example, a significant target of email compromises designed to divert wire transfers and to steal other sensitive information. These incidents often involve careful selection of individual executives and well-researched "spear-phishing" emails to key individuals involved in authorizing or initiating wires or handling accounts payable. Depending on the likelihood that personal information in the mailbox was accessed or acquired by the attacker, the firm may have mandatory breach notifications to individuals and regulators, in addition to any monetary losses associated with misdirected wires.

Ransomware also remains a threat to PE firms, and their portfolio companies in particular have been heavily targeted lately by leading ransomware groups, which are often sophisticated attackers who disrupt operations and, increasingly, take a copy of sensitive data that they threaten to post publicly as added leverage to try to force the company to pay a ransom. There is also evidence that ransom groups are timing some of their attacks to coincide with business transactions involving a PE firm or a portfolio company in order to maximize pressure on the victim. Ransom demands were routinely well into seven figures, and eight figure demands were not uncommon during 2020. One leading forensic vendor reported that their investigation of ransomware incidents was up 400% in 2020. Meanwhile, on October 1, 2020, the U.S. Treasury Department and FinCEN each issued advisories warning companies of sanctions risks associated with ransom payments, requiring victim companies and the vendors assisting them to exercise caution and diligence related to any such payments.

At the same time, regulators are becoming increasingly savvy on cybersecurity and data privacy issues as they give higher prioritization and invest more resources. Their examinations of firm cybersecurity programs are now holistic in nature, ranging from an often granular review of technical controls all the way to governance issues at the senior management and board levels. For example, the expectations of the SEC and FINRA regarding the management of cybersecurity and data privacy risks is steadily increasing, with industry standard best practices increasingly solidifying as requirements. Issues such as operational resilience (including not only backup systems but dependencies on third parties that could disrupt operations in the event of an incident), third-party risk management, access controls, data governance, and cloud migration are all top of mind for cyber and privacy regulators. As examples, during 2020, the SEC's Office of Compliance Inspections and Examinations issued cyber and data privacy risk alerts on operational resiliency (January), ransomware (July), and compromised credentials (September).

The growing magnitude of the cybersecurity and data privacy risks to PE firms and their portfolios has led firms to give high priority to these issues, in keeping with broader trends across other sectors. Increasingly, firms are also prioritizing these issues in due diligence for their acquisitions, realizing that discovering after the transaction that an historical data breach has occurred or that crown jewel IP of the target has been stolen by hackers is a costly endeavor. As PE firms become better at managing their own cyber and privacy risks, they are also sharing lessons learned with, and promoting a more comprehensive approach to these issues by, their portfolio companies.

U.S. Intellectual Property

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Supreme Court Win Extends Trademark Protection to Domain Names

In June 2020, the United States Supreme Court issued an important decision recognizing the ability of brands to protect and register their domain names as trademarks if consumers understand that the domain names are associated with one company. More specifically, the Supreme Court held that Debevoise client Booking.com B.V. had the right to register its eponymous domain name, BOOKING.COM, as a trademark, precisely because it had become known by so many consumers as belonging uniquely to Booking.com.

The U.S. Patent and Trademark Office ("USPTO") had taken the position that there is a per se bar against registering or protecting domain names consisting of a generic term, like "Booking," along with an addition of a generic top-level domain, like ".com." Under the USPTO's view, domain names like hotels.com, law.com, weather.com and wine.com cannot be protected as trademarks because the addition of the top level domain does nothing to indicate that the name is associated only with one company, as contrasted to lots of companies. More generally, the USPTO suggested that the combination of two generic elements – in that case, "Booking" for websites that allow consumer to book travel, and ".com," which indicates that the domain name is a commercial website – are no more than the sum of its two generic parts.

On behalf of Booking.com, we and our co-counsel argued that the USPTO's decision was legally and factually flawed. Legally, the combination of two generic elements may well create powerful brands, as the Federal Circuit previously held in the Pretzel Crisps case (in which Debevoise also represented the winning party). For example, American Airlines and Citibank are famous, protectible trademarks, even though their constituent elements are generic terms. Factually, the USPTO was wrong because consumers know that the Booking.com services come from one company, and that other travel websites are not known generically as booking.coms.

The Supreme Court agreed, in an 8-1 decision authored by Justice Ginsburg (sadly, her last decision for the Supreme Court). The Supreme Court rejected the USPTO's position, holding that whether BOOKING.com is generic "turns on whether that term, taken as a whole, signifies to consumers the class of online hotel-reservation services." More generally, the Supreme Court made clear, in assessing whether any mark containing generic terms is generic, the USPTO must consider the meaning of the trademark as a whole to consumers, rather than the meaning of its individual, constituent parts.

Why is this ruling significant for private equity portfolio companies? Because, for many portfolio companies, domain names can function as much more than simply web addresses. Instead, they can be understood by consumers as identifiers of *specific* brands' goods and services. Wine.com, for example, is not simply a generic reference for any website that sells wine; rather, consumers know that wine.com is a brand name for a specific company that sells wine. Protecting these trademarks – both through registration and, if necessary, enforcement actions – is critical to maintaining the value

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of the brand and prevent bad actors from offering competing services under confusion websites or stores using the same or similar names.

The principles confirmed by the Supreme Court have applicability well beyond domain names. Many businesses have brands that are comprised of generic terms. That is why companies such as Salesforce, Home Depot, BodyArmor, Ancestry.com, Cars.com and Wine.com supported our position with amicus briefs before the Supreme Court. If the Supreme Court had accepted the USPTO's position, registrations of hundreds of trademarks comprised of arguably generic elements could have been at risk of cancellation.

Debevoise was honored to represent Booking.com B.V. in this case. We regularly advise clients on these issues, including how best a brand can position itself to protect its web address or other names through trademark rights. The ruling affirms that the consumer is king when it comes to brand names, and underscores the importance of consumer perception evidence for those seeking to register arguably generic or descriptive terms as trademarks.

U.S. Restructuring

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Restructuring in 2020 was defined by the pandemic and private equity's response thereto. As COVID-19's global shock impacted both business operations and consumer behavior, many portfolio companies faced sudden, dramatically negative shocks to liquidity and revenue. Private equity sponsors swung into action, conducting portfolio-wide reviews to make sector- and company-targeted predictions as to the scope and timing of pandemic-related impacts, and to identify and address the businesses that would experience true distress. Aided by low interest rates and federal policy to encourage lending, sponsors moved quickly in the late spring and early summer to improve liquidity (through revolver draws, new borrowing, private investment in public equity ("PIPE") transactions, or direct sponsor assistance) and relieve covenant pressure (through waiver and amendment transactions) and provide runway for many portfolio companies to bridge toward an eventual macroeconomic recovery.

For businesses and sectors that were already distressed entering 2020, however, the pandemic and related global economic shocks often proved ruinous. In the troubled retail, consumer products, and oil-and-gas sectors, in particular, lenders in top-heavy capital structures were hesitant to permit additional liquidity or provide covenant relief without more comprehensive restructuring, leading to a wave of defaults and, in many cases, bankruptcy.

The year 2020 also witnessed a surge in new and creative liability management transactions that permitted troubled companies to amend their debt covenants, increase borrowing capacity, or extend debt maturities, but sometimes spawned controversy. In addition to more traditional spin-offs or carve-outs to protect the value of better

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performing divisions, 2020 saw a wave of majority/minority splits among lender groups, where a majority group of lenders would enter into a debt amendment or restructuring transaction granting the borrower necessary relief, in exchange for providing disproportionate value to the majority group relative to other debtholders (including the non-participating minority within their same tranche of debt). For sponsors and their portfolio companies, the enhanced ability to avoid defaults and increase liquidity of a challenged borrower has come at the risk of expensive and distracting litigation brought by minority debtholders against not only the majority lender groups but also the borrower and its directors. The reception of courts to these non-pro rata transactions may well dictate whether this trend continues in 2021 and beyond.

Looking ahead, the promise of multiple COVID-19 vaccines and the glimmers of an improved economy offer hope for troubled portfolio companies and their private equity sponsors, but significant risks remain. The need for companies to deliver audited financials in the first four months of 2021 may lead to misses in financial covenants or going concern qualifications, which may drive a new round of amendment discussions with less-forgiving lender groups. Looking further ahead, the new borrowing that provided a liquidity lifeline in the first half of 2020 added leverage that must be managed and, in certain cases, may be more than a recovering business can bear. We expect that sponsors will be busy reviewing and advising their portfolio businesses on balance sheet challenges like these, as we all adjust and adapt to the uncertainties along the path toward economic recovery.

U.S. Real Estate

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In a year of unprecedented market disruption driven by a global pandemic, a great deal of uncertainty remains in the real estate industry heading into 2021. Investment strategies that were successful in prior economic downturns have proven difficult to replicate in the current environment, creating novel challenges for investors as they navigate through what a "new normal" means for the industry going forward.

Fundraising efforts in the second and third quarters proved strong and signaled potential for an upswing in transactions as institutional investors aimed to take advantage of distressed situations. However, the disconnect between discounts sought by investors, and the pricing to which sellers were willing to agree, stalled the market for much of the year. It will be interesting to see what happens in the coming months as debt forbearance agreements expire and retail and hospitality assets increasingly succumb to the burdens imposed by government-mandated closures and restrictions.

By contrast, some sectors have continued to flourish despite the trouble experienced by others. Life science-focused real estate, for instance, has been a bright spot in the commercial sector with office landlords hoping that the rising demand for laboratories and research space can help fill the gap left by decreasing demand from more traditional users of office space. In addition, growing consumer consumption of streaming services during the lockdowns has spurred an uptick in data center acquisitions globally and paved the way for related development deals in anticipation of the 5G cellular network rollout.

Notably, the expansion of distribution hubs and logistics centers (already well underway due to the influential rise of e-commerce) has endured – and is soaring – amid the pandemic; the largest logistics deal by value closed before the year's end, symbolic of the prevailing trend to expand such portfolios. Now their ever-growing presence, coupled with a waning appetite for urban living, has propelled new multifamily investment activity in some unexpected secondary and tertiary markets. Multifamily investors following renters to these markets may not be unusual in light of a recession, but changing attitudes of renters could outlast the pandemic, enabling such an opportunistic approach to outperform value-add strategies in primary markets, such as New York and California, where state legislatures have recently passed tightened rent control laws. Similar motivating factors have also driven substantial acquisitions of single-family homes as investors bet on home-rental operations for the long term.

While the November announcement of multiple vaccines producing highly encouraging results is undoubtedly welcome news for the real estate industry after suffering major declines this year, a bullish reaction is likely a bit premature. For one, moments of uncertainty may arise before the vaccine becomes widely available. Further, the aftereffects of the recession could have an impact on property income for years to come in response to, for example, the feasibility of remote work and the potential for decreasing real estate footprints by traditional office tenants and the relative ease and convenience of online shopping. Perhaps, then, the takeaway should be a cautious optimism that the worst of the pandemic's ramifications on the real estate industry are behind us.

About the Debevoise Private Equity Group

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

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

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