Debevoise & Plimpton

The Private Equity Report Quarterly

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From the Editors

As 2022 nears its midpoint, the ability of the private equity industry to adapt to change is coming into play on multiple fronts. As the combination of inflation, geopolitical instability and changes in monetary policy point to a likely turn in the credit cycle, sponsors and portfolio companies are preparing for a more challenging capital environment. The more aggressive approach by the DOJ and FTC to antitrust issues has brought increased scrutiny of the divestiture acquisitions that comprise an important component of private equity dealflow. Meanwhile, the SEC has been issuing a steady steam of proposed rules that would significantly alter everything from cybersecurity reporting requirements to the allowable commercial terms for private fund advisors. (There is, however, a welcome regulatory development coming out of Westminster, as the United Kingdom implements its new Qualifying Asset Holding Company regime.)

As always, sponsors continue to adapt to new opportunities for both capital and investment. Funds are using innovative rated note structures to access capital from yield-hungry insurance companies, while holding companies are turning to pre-capitalized trust securities as a leverage-neutral, covenant-lite funding source. On the investment front, new frontiers are being explored, as funds look to the opportunities presented by the privatization of activities in space and the growth of space-based technologies. And the rise of non-fungible tokens is bringing a new arena for IP assets—and where those assets need to be protected.

We hope that you find the Spring 2022 Private Equity Report to be a useful review of some of the key issues now on the private equity agenda.

- **Navigating the Dynamic World of Antitrust Divestitures** When a business needs to be divested before a merger to address antitrust concerns, sponsors increasingly fill the role of buyer. Increased skepticism of M&A from Washington, however, has resulted in a more challenging environment, which needs to be navigated with care.
- **The Financing Flexibility of P-Caps** Although less well known than other forms of contingent capital, pre-capitalized trust securities have become increasingly popular. Along the way, issuers may want to weigh a number of structuring options and must also consider costs, possible refinancing risk based on market conditions and the fixed maturity of any notes that are issued.
- **Spring Roundup of Critical U.S. Regulatory Developments for Private Equity Sponsors** In February, the SEC proposed extensive new rules that, if adopted, would substantially affect private fund advisers—even those that aren't registered investment advisers. In addition to these

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proposed rules, which would require specific disclosures and prohibit certain commercial terms, other proposed changes affect Form PF and disclosure and investor protections around SPAC IPOs.

- **How Private Equity Firms Can Prepare for the SEC's Proposed Cybersecurity Rules** The SEC's proposed rules for cybersecurity risk management, incident reporting and disclosure for registered investment advisers and funds reflect the priority that the agency is placing on cybersecurity. The proposed rules will also introduce an entirely new set of regulatory concerns, with ramifications across affected organizations.
- **A Close Look at the UK's New "Qualifying Asset Holding Company" Tax Regime** The United Kingdom has long been hampered by its lack of a competitive, coordinated holding company regime. The new qualifying asset holding company (QAHC) regime aims to correct that shortfall. Funds wishing to qualify as a QAHC must meet several eligibility conditions, some of which will require monitoring throughout the life of the fund.
- **Innovative Rated Note Structures Spur Insurance Investments in Private Equity** Rated note structures are a powerful vehicle to connect insurance companies and funds. However, they require careful structuring and the consideration of several variables. Both issuers and buyers also need to keep an eye out for possible changes in how the notes are treated under accounting principles.
- **Credit Markets in Uncertain Times: Hope for the Best, but Prepare for the Worst** A confluence of factors is making it more likely that the decade-long expansionary phase of the credit cycle is coming to an end. There are steps that sponsors and portfolio companies can take now to manage the possibility of increased costs through capital contraction, deal execution risk and post-transaction litigation risk.
- **Funding the New Space Race: Risks and Opportunities for Sponsors and Investors** The exponential growth in privately funded space activities is a reflection of the vast opportunities investors see in this area. However, pursuing those opportunities also means navigating a number of concerns, including regulatory risk, collision risk, liability risk and security risk.
- **Understanding NFTs: Key IP Considerations for Issuers, Owners and Investors** Just when everyone had gotten used to the idea of cryptocurrency, the rise of non-fungible tokens introduced another digital asset of which to keep track. NFTs bring with them considerable IP issues for portfolio companies that are brand owners—even if those companies themselves steer clear of NFT marketplaces.

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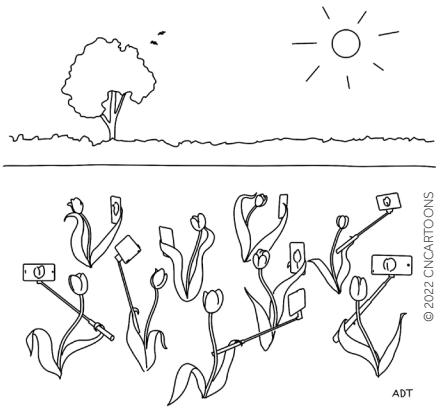

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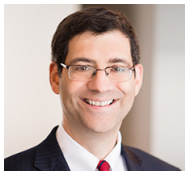
Navigating the Dynamic World of Antitrust Divestitures



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When the Federal Trade Commission ("FTC") or Department of Justice ("DOJ") believes a merger or acquisition will have anti-competitive effects, it typically either attempts to block the transaction outright or conditions approval of the transaction on the transaction parties' acceptance of behavioral or structural remedies.

Historically, the FTC and DOJ preferred structural remedies over behavioral ones. Behavioral remedies, in which the parties agree to restrictions designed to prevent anticompetitive behavior by the combined company, require ongoing conduct limitations and monitoring, if not active policing by the agencies. On the other hand, structural remedies, which often involve the divestiture to a third party of the product or business held by the buyer or target that when combined with the other party's business raises anticompetitive concerns, represent a one-time fix by changing the competitive landscape.

Private equity sponsors have increasingly played a role in facilitating the structural remedies needed to allow combinations to take place. To take one recent example, when United Healthcare wanted to acquire Change Healthcare but needed to sell its ClaimsXten business to address the acquisition's antitrust concerns, it was TPG that won the auction—beating out, so market rumor has it, several other sponsors in the process.

However, even structural remedies are facing increasing skepticism from the antitrust agencies, as part of a larger hostility from Washington toward mergers and acquisitions. As Jonathan Kanter, the Assistant Attorney General for the DOJ's Antitrust Division, recently wrote, "merger remedies short of blocking a transaction too often miss the mark…. Complex settlements, whether behavioural or structural, suffer from significant deficiencies."

Why the hostility? In part, it derives from the concern that the divestiture buyer may not be a successful competitor to the divesting business. For instance, the FTC approved Hertz's $2.3 billion acquisition of Dollar Thrifty Automotive Group in May 2013, on the condition that the combined company sell a small rental car operator, which it did to Macquarie Capital. Within months, the distributed business filed for Chapter 11 bankruptcy protection.

There are many reasons a divested business might fail. The divestiture buyer may not have the resources, experience, infrastructure or understanding of the business to make a serious go of it. Moreover, there is no certainty that the divestiture buyer will want to continue expending resources on the business, and may simply get distracted. When a buyer uses the divested asset ineffectively, it results in "concentration creep," a result the antitrust authorities like to avoid.

Despite the hostility, divestitures continue to be a critical means of resolving antitrust concerns. Merger partners and prospective divestiture buyers need to be able to navigate through the stormy waters of regulatory skepticism and to be prepared to evade the occasional rogue wave.

Proposed divestiture buyers must be ready to be closely scrutinized. The authorities will want to delve deeply into the proposed buyer's business plan, financing and funding structure. More recently, the agencies have also focused on ensuring that the proposed buyer has sufficient time, access to the seller's management and adequate information to conduct thorough due diligence. As the parties plot the overall timeline for their transaction, they need to keep this in mind—both the seller and the proposed buyer of a divested business or asset will want to treat the divestiture in much the same way transacting parties treat any sale of a business or asset, but the seller in this context may want to work harder to find ways to share privileged, confidential or sensitive information with the proposed buyer, because if it doesn't do so in the first place, the reviewing agency may well require it to do so later.

There is also a growing focus by the DOJ and FTC on ensuring a smooth transition upon the sale of the divested business. While the regulators have always expected there to be robust transition services agreements in place, the agencies will likely place increased emphasis on those agreements, ensuring they include back-office functions like IT services and are sufficient in scope and time to provide for the divestiture buyer's long-term success. In the same vein, underscoring a greater recognition of the importance of attracting and retaining customers and stepping into third-party arrangements, one can expect the reviewing agency to insist that the seller provide the divestiture buyer greater access to customers earlier in the process and greater assistance to secure necessary contractual assignments and approvals.

Sponsors that look to acquire businesses that are divested as part of structural remedies need to be prepared for greater scrutiny on several fronts from the government.

While the agencies have for some time expressed their preference for upfront buyers of businesses in certain industries over hold separate arrangements, more recently, regulators have pressed merger partners proposing a divestiture remedy to identify at least three potential "interested and approvable" divestiture buyers. Moreover, the authorities are likely to require the use of agency-approved monitors in more and more deals involving divestitures, who will oversee the operations of the divestiture buyer with respect to the divested business, including compliance with the divestiture order. Certain industries—pharmaceuticals in particular—tend to be more on the government's mind when considering the use of a monitor.

Indeed, healthcare and life sciences transactions are generally attracting heightened regulatory and Congressional scrutiny—and all the more so when those transactions include private equity buyers. Merger partners in these industries should tread particularly carefully in dealing with the antitrust authorities, and expect the unexpected. Knowing, for instance, that the FTC may insist that merger partners in pharma transactions divest the easier to divest product may make the process smoother and less frustrating.

Another recent development for divestiture buyers to note is the FTC's return to the use of prior approval provisions built into divestiture orders. These provisions generally give the FTC authority to approve or disapprove any sale by the divestiture buyer of the business or assets that were divested, or any portion of them. The provision may last for up to 10 years, and would be triggered even if the sale would not have otherwise required an antitrust filing—and the

FTC could disapprove any such sale even if there were no antitrust issue with the acquirer's acquisition of the business or assets in itself. For instance, to complete its proposed acquisition of Novitium Pharma, ANI Pharmaceuticals agreed to divest two generic drug products to Prasco. The divestiture order requires Prasco to obtain prior approval before selling or licensing any FDA authorizations for the divested assets for three years, and for seven years thereafter requires it to obtain prior approval before selling or licensing any FDA authorizations for the divested assets to anyone who owns, or is seeking approval for, an FDA authorization to manufacture or sell a divested product's therapeutic equivalent.

Given the highly dynamic antitrust landscape, managing the process and coordinating interactions among the regulators, the merger partners and the potential divestiture buyers are of paramount importance. The agencies have found divestiture buyers to be reluctant to raise concerns with the agency staff or monitors, and consequently, regulators will be looking for frequent and open communication among all players. The divestiture seller must keep in mind that a divestiture buyer often has two bites at the apple: in its negotiations with the seller and again during the agency review. The regulators insist that the contract include provisions that allow them to modify the contract, and in the event concerns are raised during the divestiture process, the agencies may require the divestiture of additional assets or contractual provisions that are even more protective of the divestiture buyer than those the buyer negotiated for itself.

In addition to coordinating among all parties and working out when best to introduce potential divestiture buyers to the regulators, merger partners may want to understand what interactions a potential divestiture buyer has had with the regulators in the past—not only as a party to a transaction but also as an industry player contacted by the authorities in connection with the current underlying transaction or a prior transaction. An industry participant contacted by the agencies during the investigation should be careful not to overplay its hand in complaining about the merger's potential effects if it wants to show up later as a potential divestiture buyer. Companies who might see themselves as possible divestiture buyers should take care as to what they say if asked to provide views on a particular pending transaction.

In short, be patient. Whether the sponsor is a merger party or potential divestiture buyer, recognize that the process takes time, and the authorities are increasingly focused on ensuring the divestiture buyer's enduring commercial and competitive success. And keep in mind that if the regulators do not believe the proposed remedy sufficiently addresses their concerns, they may go to court to challenge the transaction, further lengthening the process. Here are a few suggestions for sponsors that may help in reaching agreement without being pulled into litigation:

- Have counsel engage with the regulators as early as practicable.
- Be able to demonstrate a track record of successful growth of portfolio companies, especially for carve-outs and in the industry in question.
- Be prepared as a divestiture buyer to provide as much detail as possible as to how the divested business will be operated (including composition of the proposed management team) and to provide details regarding the expected hold period and exit strategy.
- Consider, if it makes sense from an investment perspective, partnering with a strategic company in the relevant industry and involving that company in interactions with the antitrust authorities.
- Ensure that the business plan for the divested business includes details of the growth of the business and how it will meet debt obligations under a variety of scenarios.

Divestitures are under increasing scrutiny, but they are often the only way to solve competitive concerns, and despite the skepticism, divested businesses have more often than not become successful competitors. They can also present excellent opportunities for the sponsor that is prepared to manage the agency review process to a successful conclusion.

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The Financing Flexibility of P-Caps

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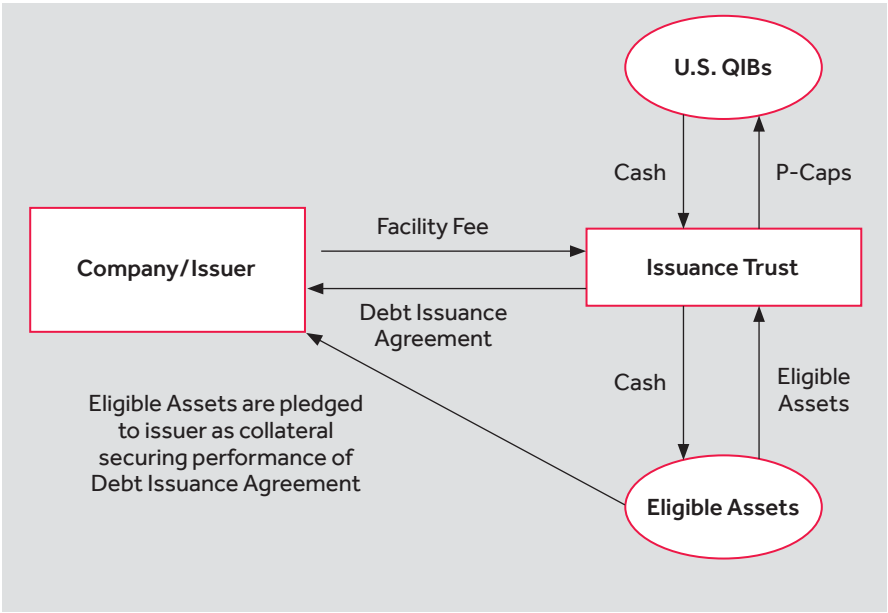
Companies use contingent capital facilities to supplement existing capital resources, improve funding diversification and enhance financial flexibility through immediate access to committed capital. Contingent capital can take many forms, with revolving credit facilities being one obvious example. A less well-known capital markets contingent capital product, pre-capitalized trust securities ("P-Caps"), have some features similar to those of a revolving credit facility, but can be much longer dated with less counterparty risk. In this article, we provide a brief introduction to P-Caps, including the potential benefits and considerations.

The P-Caps Structure

Generally, in a P-Caps transaction, the company creates a new Delaware statutory trust. That trust issues trust securities to qualified institutional buyers in a Rule 144A offering. The proceeds from the issuance are invested by the trust in a portfolio of principal and interest strips of U.S. Treasury securities ("Eligible Assets") that, together with the facility fee described below, matches the expected payments on the trust securities. The basic structure is depicted below:



Concurrently with the issuance of the trust securities, the trust enters into a facility agreement with the company. The facility agreement provides the company with an issuance right (the "Company Issuance Right") that permits the company, at its option, to issue senior notes to the trust and require the trust to purchase such senior notes with an equivalent amount of the Eligible Assets. The company

is required to exercise the Company Issuance Right in full upon certain automatic or mandatory triggers, including events of bankruptcy, certain payment defaults or if the company's consolidated net worth falls below a threshold amount. In return for the Company Issuance Right, the company pays the trust a facility fee. The facility fee, together with the income from the Eligible Assets, is equal to the coupon on the trust securities.

The trust securities are typically rated in line with the company's senior notes rating and are designed to mimic an investment in those notes, providing investors a risk profile equivalent to a direct investment in the company's senior debt.

If the company wants to exercise the Company Issuance Right and receive the Eligible Assets, it delivers a notice to the trust. Assuming a full exercise of the Company Issuance Right, the trust's sole assets will be the company's senior notes. Most P-Caps facilities permit the company to exercise the Company Issuance Right in part, in which case the company would issue a portion of the contractually agreed maximum aggregate amount of senior notes to the trust and receive the equivalent amount of Eligible Assets. The trust's assets would then comprise the remaining Eligible Asset and the senior notes that were issued. The facility fee on the unissued senior notes, the coupon on the senior notes and the income from the remaining Eligible Assets would provide sufficient funds to pay the coupon on the trust securities.

Structuring Options

The basic P-Caps structure described above can be modified to provide the company with additional flexibility and optionality. Structuring options in existing P-Caps facilities have included the following features:

- **Refreshability.** Recent P-Caps structures have allowed the company to draw on the facility, repay the facility and then re-borrow as frequently as it would like during the life of the facility. This is made possible by the inclusion of a repurchase right that allows the company to repurchase any or all of the senior notes then held by the trust, in exchange for Eligible Assets that the company holds or purchases in the market.
- **Assignability.** Another modification allows the company to direct the trust to grant the Company Issuance Right to one or more assignees of the company, typically direct or indirect subsidiaries of the company. Upon exercise of the Company Issuance Right, the company would issue its senior notes to the trust, but the trust would deliver the Eligible Assets to the assignee. This feature may be useful if there is a desire to move capital into a regulated subsidiary (*e.g.*, a regulated insurance company or bank) in advance of a bankruptcy filing by an unregulated holding company.
- **Pledge.** In other P-Caps transactions, primarily in the non-insurance space, the Eligible Assets have been pledged to lenders to fully collateralize the company's letter of credit facility. The pledge would be enforceable by the lenders, and the Company Issuance Right triggered, upon the occurrence of an event of default under the letter of credit agreement.

P-Caps are a reliable, pre-emptive tool a company can employ to prepare for unforeseen stress events, closed market windows, opportunistic M&A funding or other liquidity needs.

Benefits

There are several key benefits of P-Caps compared with other sources of capital:

- **Leverage Neutral.** Until the senior notes are issued to the trust, the P-Caps are not reflected on the company's balance sheet and not included in the company's financial leverage. The off-balance sheet nature of the P-Caps structure enables the company to proactively prepare for contingencies, while ensuring the company does not advertise an artificially inflated leverage level or breach any leverage-related financial covenants prior to issuance.
- **Rating Positive.** Rating agencies generally view P-Caps as a credit positive because they improve the company's access to liquidity, especially in times of stress. In addition, the trust securities are typically rated in line with the company's senior notes as investors are in effect investing in the senior credit of the company.

- **Standby Credit.** The immediate liquidity offered by P-Caps provides for a reliable source of financing during a stress event. P-Caps are a form of standby credit which is available prior to maturity regardless of market windows, broader economic conditions or issuer specific events. This is significant, as other avenues of capital may be unavailable or prohibitively expensive during a liquidity shortfall. For example, in contrast to a revolving credit facility, there is no counterparty risk when the company wants to draw on the facility because the Eligible Assets are on hand with the trust and the trust is contractually obligated to provide the Eligible Assets, in exchange for the company's senior notes.
- **Tax.** The company will receive a net tax deduction equivalent to the amount of the facility fee payable by the company to the trust while the facility is undrawn. The tax deduction offsets the facility fee, which helps reduce the overall cost of the P-Caps.
- **Long-Dated.** Issuances of P-Caps have been for 10, 20 and 30-year maturities. These are significantly longer maturities than the typical revolving credit facility.
- **Covenant-Lite.** The trust securities and the underlying senior notes have few, if any, covenants. To the extent that these facilities do include restrictive covenants, they typically mirror the covenants in the company's other senior indebtedness.
- **Use of Proceeds.** If the contingent capital facility is drawn, the company receives the Eligible Assets, which are expected to be liquid securities, and does not have any restrictions on its use of the Eligible Assets. The Eligible Assets can be held as U.S. Treasury strips or converted into cash for immediate use.

Considerations

The benefits of the P-Caps should be weighed against the following considerations:

- **Cost.** The company is required to pay the facility fee even if the facility is undrawn, resulting in ongoing costs in excess of a typical revolving credit facility undrawn commitment fee. There are also additional transaction costs related to monetizing Eligible Assets when the Company Issuance Right is triggered and sourcing Eligible Assets to refresh the facility if it is drawn and repaid.
- **Fixed Maturity.** If the Company Issuance Right is exercised and the senior notes are issued to the trust, the senior notes will need to be repaid or refinanced at maturity, which is fixed regardless of when the Company Issuance Right is exercised, subjecting the company to eventual refinancing risk based on market conditions.
- **Credit Risk of Company.** As noted above, the facility automatically or mandatorily triggers after the company goes into bankruptcy or defaults, or if the company's net worth declines below a specified threshold. While this automatic issuance of senior notes would immediately increase the company's liquidity, it also increases its outstanding indebtedness, which would be treated *pari passu* with the company's other existing senior indebtedness.
- **P-Cap Pricings.** The coupon the company pays on the P-Caps is generally slightly higher than the interest rate paid on the company's revolving credit facility, which reflects the structured nature of the product, the longer-dated maturity and the company's typical senior notes pricing.

Final Thoughts

There have been a limited number of P-Caps transactions over the last 10 to 15 years, and those transactions have been executed primarily by insurance companies. However, more recently, companies in the energy sector have taken advantage of the structure, and it is fair to say that the structure is industry agnostic. P-Caps are a reliable, pre-emptive tool a company can employ to prepare for unforeseen stress events, closed market windows, opportunistic M&A funding or other liquidity needs.

P-Caps can be an effective, supplemental source of liquidity and capital that provides a company with long-dated flexibility and for the right company is a great addition to the company's capital structure. We would be happy to discuss the structure and the related costs and benefits with any interested issuer.

Debevoise & Plimpton

Spring Roundup of Critical U.S. Regulatory Developments for Private Equity Sponsors

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As expected, 2022 has already seen unprecedented regulatory activity by the Securities and Exchange Commission ("SEC") related to the private equity fund industry, with at least one rule proposal affecting the industry being released each month this year. Much of that activity has centered around the five areas of Chair Gary Gensler's agenda that we highlighted in our 2021/2022 Private Equity Year-End Review and Outlook:

- **Amendments to Form PF:** On January 26, 2022, the SEC proposed significant amendments to Form PF, which we discuss further below.[1]
- **Updates to Rules Related to Private Fund Advisers:** On February 9, 2022, the SEC proposed extensive new rules that could substantially change the regulation of private fund advisers, also discussed below.
- **Climate Change Disclosure:** On March 21, 2022, the SEC proposed an extensive climate disclosure rule applicable to public companies. The proposed rule would add new climate-related disclosure requirements to Regulation S-K, which governs qualitative disclosures, and to Regulation S-X, which governs financial statements. If adopted, the proposed rule would constitute a significant expansion of SEC disclosure requirements related to climate change.[2]
- **Rules Related to Investment Companies and Investments Advisers to Address Matters Relating to Environmental, Social and Governance Factors:** New rules setting forth ESG-related requirements for investment companies and investment advisers are in the works and expected to be released in the second quarter of 2022.
- **Revisions to the Definition of Securities Held of Record:** This potential amendment to the definition of "held of record" for Section 12(g) of the Securities Exchange Act of 1934 (the "Exchange Act") could result in private fund portfolio companies and funds having to file public reports under the Exchange Act.

1. Amendments to Form PF to Require Current Reporting and Amend Reporting Requirements for Large Private Equity Advisers and Large Liquidity Fund Advisers, SEC Release No. IA-5950; File No. S7-01-22 (Jan. 26, 2022), *available at* https://www.sec.gov/rules/proposed/2022/ia-5950.pdf.
2. *See* Eric Juergens, Andrew M. Levine, Alison M. Hashmall and Ulysses Smith, SEC Issues Long-Awaited Proposed Climate Change Disclosure Rule (March 24, 2022), *available at* https://www.debevoise.com/insights/publications/2022/03/sec-issues-long-awaited-proposed-climate.

In addition, as discussed below, the SEC has proposed a new rule governing SPACs, and, as discussed elsewhere in this issue, a new rule regarding cybersecurity measures that registered investment advisers must implement. Further, the SEC intends to propose, or re-propose, rules targeting the exempt offering framework under the Securities Act of 1933 and rules specific to Regulation D under that Act.

Updates to Rules Related to Private Fund Advisers

On February 9, 2022, the SEC proposed extensive new rules that, if adopted, would substantially affect private fund advisers. Notably, many of the proposed rules, which would require specific disclosures and prohibit certain commercial terms, cover all advisers to private funds, rather than just registered investment advisers. In our view, the adoption of these rules may result in increased management fees, as private fund advisers seek to recoup the higher cost of compliance, insurance and reporting. Given that these proposed rules represent a significant shift in the regulation of private fund advisers, we expect them to generate numerous comments both in support and in opposition.

The proposed rules include the following prohibitions and requirements that would cover **all advisers** to private funds:

- **Prohibition of Certain Indemnities:** Investment advisers would be prohibited from seeking indemnification or from limiting the adviser's liability for breach of fiduciary duty, willful misfeasance, bad faith, negligence or recklessness in providing services to the private fund.
- **Restrictions on Carveouts from GP Clawback Provisions:** Tax-related caps on GP clawback provisions would be prohibited.
- **Prohibition on Certain Fees and Expenses:** Investment advisers would be prohibited from charging certain fees and expenses, including those associated with services not provided, an adviser's regulatory or compliance matters or an adviser's examinations and investigations.
- **Prohibition on Non-Pro Rata Cost Allocation:** The proposed rules would prohibit an adviser from charging fees and expenses related to portfolio investments on a non-pro rata basis among clients.
- **Prohibition on Borrowings from Private Funds:** Advisers would be prohibited from borrowing from, or receiving an extension of credit from, a private fund.
- **Prohibitions on Preferential Treatment (Side Letter Terms):** The proposed rules would prohibit private fund advisers from: (1) providing preferential terms to certain investors regarding information about portfolio holdings or exposures or redemptions from the fund and (2) providing other preferential treatment, including treatment that is sometimes required by state and local laws, unless disclosed to all current and prospective investors.

These prohibitions and requirements would only cover **registered investment advisers** to private funds:

- **Requirements Related to Adviser-Led Secondaries:** Before closing on an investment in an adviser-led secondary transaction, registered investment advisers would be required to obtain and distribute a fairness opinion to investors from an independent opinion provider. They would also be required to prepare and distribute a written summary to investors of material business relationships between the adviser and the opinion provider in the previous two years before closing.
- **Quarterly Statements:** Registered investment advisers would be required to provide fund investors with quarterly statements detailing information about the private fund's performance, fees and expenses within a certain timeframe (*i.e.*, within 45 days after the end of each quarter).
- **Annual Audit from an Independent Public Accountant:** Registered investment advisers would be required to distribute audited

financial statements annually and upon liquidation. Advisers would also need to enter into a written agreement with the independent public accountant overseeing the audit requiring the auditor to notify the SEC if the audit report contained a modified opinion. The agreement would also require the auditor to notify the SEC upon the auditor's termination, dismissal, resignation or removal from consideration for being appointed.

- **Written Annual Compliance Review:** The proposed rules would require registered investment advisers' annual compliance reviews to be documented in writing.

The comment period for this proposal originally ended on April 25, but it was reopened to 30 days from the related announcement's publication in the Federal Register. For more information on the above requirements, please see our key takeaways and comprehensive summary of the proposed rules here.

Amendments to Form PF

The proposed amendments to Form PF, which were adopted pursuant to the Dodd-Frank Act of 2010, would also affect private fund advisers, most notably by instituting one-day reporting requirements for certain key events and by establishing additional reporting requirements for a broader group of private fund advisers. The proposal also added requirements for large liquidity fund advisers. Taken as a whole, the Form PF proposal would add burdensome reporting requirements on private fund advisers without a corresponding increase in investor protection benefits. The proposals also do not appear to advance the systemic risk monitoring goals of the Dodd-Frank Act.

The comment period for the proposed rule ended on March 21. For more information on these amendments, please see here.

> Coupled with focused examination initiatives and continued enforcement of private fund advisers, 2022 will continue to be a period of intensified U.S. regulatory activity affecting private equity advisers and the investment management industry.

Amendments Relating to SPACs and de-SPAC Transactions

On March 30, 2022, the SEC proposed new rules and amendments to enhance disclosure and investor protections in initial public offerings by special purpose acquisition companies ("SPACs"). Of special note to private fund advisers are the amendments related to the status of SPACs under the Investment Company Act of 1940 (the "1940 Act"). Specifically, proposed Rule 3a-10 under the 1940 Act would provide a safe harbor exemption from the definition of "investment company" under Section 3(a)(1)(A) of the 1940 Act for SPACs that meet certain conditions.

The SEC has requested comment on the proposed rules by May 31, 2022 or 30 days after publication of the rules in the Federal Register, whichever is later. The proposed rules are subject to a 60-day public comment period. For more information on these amendments, please see our summary here.

Cybersecurity Rule Proposal

Additionally, on February 9, 2022, the SEC proposed rules related to cybersecurity compliance for registered investment advisers. They would include a requirement to confidentially report certain cybersecurity events to the SEC.

The comment period for the proposal ended on April 11. For more information on this proposal, please see our Four Takeaways from the rule proposal here.

Climate Change Disclosure Proposal

On March 21, 2022, the SEC released its long-awaited proposed rule applicable to public reporting companies on the "Enhancement and Standardization of Climate-Related Disclosures for Investors," which is intended to require "consistent,

comparable, and decision-useful information" on climate-related disclosures. The proposed rule would add new, often prescriptive climate-related disclosure requirements to Regulation S-K, which primarily governs qualitative disclosures, and Regulation S-X, which governs financial statements. In general, these disclosures would address various climate-related risks to the registrant's business, operations and financial condition, including disclosure of a registrant's greenhouse gas emissions. The proposed rule could affect public portfolio company investments of private equity funds (or private company investments that a sponsor intends to take public), as well as private equity managers that themselves are public companies.

The SEC had originally requested comment on the proposed rule by May 20, 2022 or 30 days after publication of the rule in the Federal Register, whichever is later, but extended it to June 17. For more information on these amendments, please see our summary here.[3]

As noted above, we expect the SEC to continue to propose (and re-propose) rules at a rapid pace throughout the remainder of the year. Coupled with focused examination initiatives and continued enforcement of private fund advisers, 2022 will continue to be a period of intensified U.S. regulatory activity affecting private equity advisers and the investment management industry.

3. https://www.debevoise.com/insights/publications/2022/03/sec-issues-long-awaited-proposed-climate.

Debevoise & Plimpton

How Private Equity Firms Can Prepare for the SEC's Proposed Cybersecurity Rules

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On February 9, 2022, the SEC released proposed rules relating to cybersecurity risk management, incident reporting and disclosure for registered investment advisers ("RIAs") and funds that would impose sweeping new cybersecurity obligations for RIAs to private equity funds. The proposals reflect the consistent priority that Chair Gary Gensler has placed on rulemaking, examinations and enforcement regarding both private funds and cybersecurity, as well as the Staff's observations that "certain advisers and funds" continue to "show a lack of cybersecurity preparedness, which puts clients and investors at risk." The proposed rules will significantly impact the private equity industry given the size and rapid growth of the sector. As Chair Gensler noted in his May 2021 congressional testimony, there are 18,000 private equity funds with over $5 trillion in assets under management, which represents a five-year growth rate of 116%.

The proposed rules are significant because they promulgate an entirely new cybersecurity regulatory regime for RIAs to private funds, requiring an expansion of cybersecurity risk management practices to cover all systems and data for such entities. While Risk Alerts from the SEC's Division of Examinations have provided guidance regarding cybersecurity-related issues during the past few years, and many RIAs have strengthened their programs in response to that guidance, the proposed rules set forth definitive requirements. If adopted, the proposed rules would require RIAs to private equity funds to implement cybersecurity risk management programs, new incident notification protocols and new disclosures. The notice-and-comment period for the proposed rules closed on April 11, 2022.

The proposed rules would thus increase the compliance obligations on RIAs to private equity funds and also increase regulatory risk due to new grounds for cybersecurity exam deficiency findings and enforcement actions. As such, RIAs to private funds should prepare now for the potential change in the regulatory landscape.

Key Requirements under the Proposed Rules

(1) Incident Reporting: Proposed rule 204-6 under the Investment Advisers Act of 1940 would require RIAs, "including on behalf of a client that is a registered investment company or business development company, or a private fund"

(collectively, "covered clients"), to report any significant cybersecurity incidents, which are defined as any event that:

1. "significantly disrupts or degrades the adviser's" or private fund client's "ability to maintain critical operations"; or
2. "leads to the unauthorized access or use of adviser information," resulting in substantial harm to the RIA or to a client or an investor in a private fund whose information was accessed.

RIAs, on behalf of themselves and their covered clients, must report to the SEC "promptly, but in no event more than 48 hours, after having a reasonable basis to conclude that a significant adviser cybersecurity incident or a significant fund cybersecurity incident had occurred or is occurring."

RIAs must use the new Proposed Form ADV-C for incident notification to the SEC. The notification must include a detailed description of the nature and scope of the incident and any disclosures about it. RIAs will be expected to update any previously submitted Forms ADV-C when there has been a material change in facts. The proposed rule states that submitted Forms ADV-C will remain confidential and not be disclosed to the general public.

(2) Cybersecurity Risk Management Policies and Procedures: Proposed Advisers Act Rule 206(4)-9 would require RIAs to private funds to adopt and implement policies and procedures that are "reasonably designed" to address cybersecurity risks. These policies and procedures need to address:

1. risk assessment practices;
2. user security and access;
3. preventing unauthorized access to funds; and
4. threat and vulnerability management and incident-response and recovery.

The proposed rules also require RIAs to private funds, on an annual basis, to:

1. review and assess the design and effectiveness of their cybersecurity policies and procedures; and
2. prepare a report describing the review, explaining the results, documenting any incident that has occurred since the last report and discussing any material changes to the policies and procedures since the last report.

Finally, the SEC's proposed amendments to Advisers Act Rule 204-2 would impose additional recordkeeping requirements on RIAs. Rule 204-2 would be amended to require RIAs to retain, among other items, a copy of their cybersecurity policies and procedures and of any Form ADV-C filed by the RIA under Rule 204-6 in the last five years.

(3) Disclosure Obligations for RIAs: The proposed rules would also amend Form ADV Part 2A for RIAs to include Item 20 ("Cybersecurity Risks and Incidents"), requiring disclosure of (a) cybersecurity risks and incidents that could materially affect the advisory relationship with current and prospective clients and (b) any significant cybersecurity incidents that have occurred within the last two fiscal years. The amendment would require that RIAs describe the cybersecurity risks that could materially affect the services they offer and how they plan to assess and address those risks. Under the proposed rules, the disclosures must include information about the likelihood that and extent to which the cybersecurity risk or incident:

1. could occur and what safeguards are in place to prevent it;
2. could disrupt or has disrupted the RIA's ability to provide services;
3. could result or has resulted in the loss or compromise of sensitive data; and

The proposed rules are significant because they promulgate an entirely new cybersecurity regulatory regime for RIAs to private funds, requiring an expansion of cybersecurity risk management practices to cover all systems and data for such entities.

4. has or could harm clients.

Additionally, Proposed Amendment 204-3(b) would require RIAs to deliver interim brochure amendments to clients if:

1. the RIA was subject to a cybersecurity incident after the dissemination of its brochure; or
2. the information already disclosed in its brochure about an incident materially changes based on new discoveries.

Key Takeaways

(1) Prepare for 48-Hour Breach Notice Deadline: RIAs may find it challenging to meet the 48-hour reporting timeline of the SEC's proposed rules. To meet the tight notification deadline and gain credibility with regulators, it is important for RIAs to have clear protocols for escalating incidents, drafting notifications and obtaining the necessary approvals. Specifically, RIAs should consider:

a) **Who Is Covered:** Confirming which advisory entities and private funds are subject to the new notification deadline and assessing which data, information systems and employees are associated with the covered entities.

b) **Who Is Responsible:** Determining the person responsible for notifying the SEC of the incident and who else must approve the notification. It may be prudent to designate multiple people for each of these roles.

c) **Prompt Escalation:** Determining which incidents may trigger the 48-hour notification requirement and therefore should be escalated to the persons responsible for the notification, as well as who should be making that escalation.

d) **Notification Template:** Creating a sample notification template that tracks the requirements of Form ADV-C so that the actual notification does not need to be drafted from scratch during an incident.

(2) Adopt, Implement and Test Policies and Procedures: The proposed rules expand RIA obligations regarding cybersecurity policies and procedures and delineate the expected elements of a cybersecurity risk and incident-response program, including user security and access, information protection, threat and vulnerability management, and cybersecurity incident-response and recovery. While preexisting policies and procedures may cover some of these components, RIAs must ensure that all of them are included. Moreover, it will be crucial to regularly test these cybersecurity policies and procedures to ensure sufficient implementation and compliance with the SEC's proposed rules—particularly since targeting policies and procedures violations by RIAs is a common SEC enforcement approach.

(3) Disclosures and Evidence Preservation: The proposed rules emphasize the importance of clear and accurate disclosures regarding cybersecurity risk and incidents to investors and the SEC, formalizing takeaways from the SEC's 2021 enforcement actions against Pearson and First American as well as the priorities emphasized by Chair Gensler's January 24, 2022 speech. Once they are enacted, the SEC likely will use the proposed rules to scrutinize cybersecurity-related disclosures and recordkeeping violations through exams and enforcement actions. RIAs should ensure that their disclosures are both accurate and supported by objective documentation, which will require analysis of privilege considerations.

(4) Incident-Response Planning: RIAs should review their incident-response and business continuity plans and consider testing those plans through tabletop exercises. Given that the proposed rules create obligations for RIAs to disclose cybersecurity incidents affecting private fund clients' systems or information, tabletop exercises can test how incidents are escalated and the engagement of all the relevant players in the incident-response process.

Debevoise & Plimpton

A Close Look at the UK's New "Qualifying Asset Holding Company" Tax Regime

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While the English limited partnership is an excellent fund vehicle option, the UK has lacked a competitive, coordinated holding company regime. This gap has led many funds, including several managed by UK teams, to locate their fund and holding structures outside the UK, notably in Luxembourg, where the combined regimes are more established and attractive. However, this strategy has become more challenging, as EU and other jurisdictions increase their scrutiny of holding companies' "substance," requiring funds to demonstrate, among other things, that the holding company was not set up in a particular jurisdiction purely to benefit from applicable tax relief.

The UK's new qualifying asset holding company ("QAHC") regime, which took effect on April 6, 2022, attempts to address these issues. Not only does it provide funds with a regime that is competitive with alternatives offered in rival European fund centers, but it allows UK-managed funds to easily meet any "substance" concerns, since the UK is a natural choice in which to locate the holding company of a UK-managed fund.

Below, we review the QAHC regime's key tax consequences and eligibility requirements.

1. Tax Consequences

There are several favourable tax consequences for companies that elect to be a QAHC. The most important of these are set out below.

Exemption from Tax on Capital Gains

A QAHC is not subject to corporation tax on gains arising from the disposal of shares (other than shares in UK "property-rich" companies that derive at least 75% of their value from UK real estate) and of overseas real estate. This is a significant improvement over the UK's complex participation exemption. It also avoids the need to consider participation requirements in other jurisdictions, such as those required for a Luxembourg holding company.

Abolition of UK Withholding Tax

Payments of interest by a QAHC are not subject to the usual 20% UK withholding tax. While the UK interest withholding tax rules already contain a number of exemptions, this provision will likely remove the administrative

burden and cost that might otherwise be incurred in meeting such other exemptions. Since the UK does not impose withholding tax on dividends, the QAHC holding company structure results in the complete absence of UK withholding tax.

Capital Gains Tax Treatment for Share Buybacks

A key feature of the QAHC regime is that it enables QAHCs to return value to investors through share buybacks. The UK's "distribution" rules and certain anti-avoidance rules, either of which could otherwise bring such returns within the charge to income tax, will not apply (with some exceptions). The full amount paid by a QAHC to a shareholder on a share buyback will be treated as capital and taxed within the capital gains tax regime. This feature will be of particular benefit to UK resident individual investors, including team members with carried interest or co-invest entitlements. Additionally, there will be no stamp duty or stamp duty reserve tax on the repurchase by a QAHC of its shares or securities.

Deductions Allowed for Profit Participating Debt

QAHCs may take a deduction for interest costs on profit participating loans. This will render the QAHC efficient for debt financing structures.

2. Eligibility Requirements

Unlike in other jurisdictions, where holding companies merely fall within the general law, companies seeking to qualify as a QAHC must meet several eligibility conditions. The most significant criteria include the following:

Residence

A QAHC must be UK resident. However, there is no requirement that the company be incorporated in the UK. Companies may be UK resident for tax purposes if incorporated outside the UK, but with their "central management and control" in the UK.

Ownership

The ownership condition limits the size of "relevant interests" that are held by "non-Category A investors" in a QAHC to 30%. Category A investors include a range of investors, such as pension funds, charities, authorised long-term insurance businesses and, most importantly, "qualifying funds" (which are discussed below in more detail).

The term "relevant interest" generally means that a person is beneficially entitled to the QAHC's profits or assets available for distribution or if they have voting power in the company in relation to "standard resolutions." The "relevant interest" provision includes various anti-abuse rules, including specific rules relating to carried interest.

Activity

The QAHC regime requires the main activity of the company to be the carrying on of an investment business. Any other activities of the company must be ancillary to the business and must not be carried out to any substantial extent. This requirement should be relatively simple for most private equity, credit and other private capital funds to meet, although credit funds have expressed some caution regarding loan origination, given that there is long-standing uncertainty as to whether loan origination by an investment fund is to be treated as a trading activity or an investment activity for UK tax purposes.

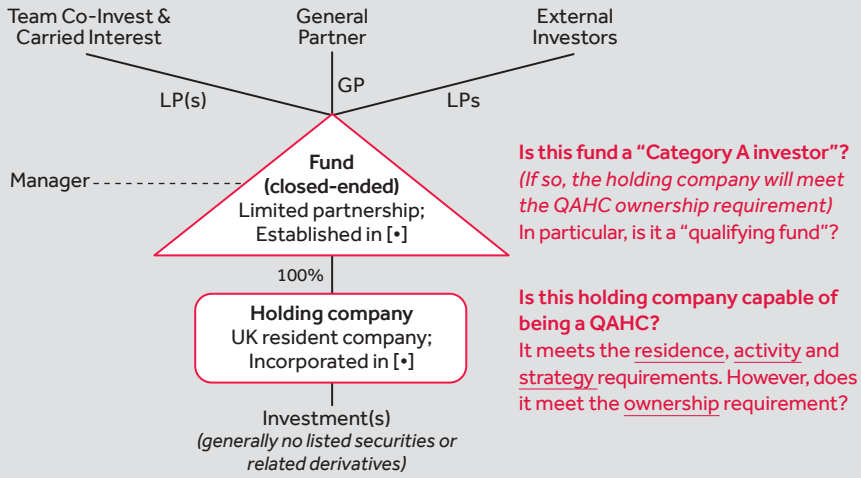
Investment Strategy

This condition requires that the investment strategy of the potential QAHC does not involve the acquisition of equity securities listed or traded on a recognised stock exchange or any other public market or exchange or other interests that derive their value from such securities. However, it should be noted that the strategy could involve the acquisition of listed equities for the purpose of facilitating a change of control of the issuer, so that it results in the securities no longer being listed or traded.

3. Qualifying Funds and Diversity of Ownership

As noted above, the ownership conditions for the QAHC regime will require fund sponsors' considering the regime for a wholly owned company to determine whether the parent fund is a Category A investor and, in particular, a "qualifying fund." Figure 1 (see next page) represents a typical structure.

Figure 1. Typical Fund/Holdco Structure



In order to become a "qualifying fund", a fund must be a collective investment scheme ("CIS") or an alternative investment fund ("AIF") which meets one of the following tests demonstrating "diversity of ownership": Most investment funds can expect to be either a CIS or an AIF (a principal difference between the two is that a CIS cannot be a "body corporate").

Genuine Diversity of Ownership ("GDO") Test

A fund which is a CIS may meet the diversity of ownership condition by relying on the GDO test. Broadly, if such a fund is able to demonstrate that it has marketed itself to a sufficiently broad investor base, it will meet the GDO test. Certain funds, such as separate managed accounts or small, parallel funds, may not be in a position to rely on this test because they are not widely marketed. It is not known why the GDO test was only extended to CIS funds, since there would seem to be no policy reason for, essentially, excluding funds that are "bodies corporate." Determining whether a fund is a "body corporate" involves a highly technical analysis of the vehicle's legal characteristics and this element represents an uncertain and, potentially, broad exclusion for certain common non-UK fund vehicles (albeit one for which there will often be a solution).

Non-Close Test

A fund, whether an AIF or a CIS, can also rely on the non-close test to prove diversity of ownership. Broadly, this involves demonstrating that the fund is "controlled" by more than five persons. Like the GDO test, this can probably be met by most widely held funds, but separate managed accounts and small funds may encounter issues. Unlike the GDO test (which, for close ended funds, is conclusively determined during the fundraising process), the non-close test requires monitoring throughout the life of the fund.

70% Controlled by Category A Investors Test

An AIF or CIS that is at least 70% controlled by Category A investors can meet the diversity of ownership condition in this way. This test may be suitable for certain funds such as sovereign wealth funds. Like the non-close test, this will require monitoring.

4. Conclusion

The introduction of the QAHC regime has generated considerable interest and represents a significant opportunity for the UK to regain its position as an attractive location for asset-holding vehicles. However, fund sponsors should consider their options carefully as some elements of the QAHC eligibility requirements may present challenges and the ownership criteria, in particular, will need to be examined in detail. Furthermore, certain tax reliefs relevant to a fund's investment structuring, such as reliefs established by EU directives, may only be available to EU holding companies. In addition, some EU countries, such as Spain, offer certain reliefs for domestic companies that are owned by entities domiciled in other EU countries. Nonetheless, the QAHC regime represents the most exciting development in UK investment funds law in many years and we anticipate that it will be used frequently.

Debevoise & Plimpton

Innovative Rated Note Structures Spur Insurance Investments in Private Equity

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As insurance companies look for opportunities to invest in a diversified portfolio of funds, and funds look for ways to access additional capital, there is increasing demand for innovative rated note structures. Such investments are typically structured as one or two tranches of rated debt supported by limited partnership interests in the underlying funds that comprise the investment portfolio and a tranche of equity commitments, which, as the first-loss tranche, is important for the ratings analysis. The past year has seen an increase in the use of such note structures, and we expect their popularity to continue to increase so long as market performance is strong and insurance regulators do not change the investment classification of the notes issued, or the loans incurred by, these structures.

This article reviews how these investments are typically structured, some important parameters that need to be determined in their structuring, the current regulatory environment and recent trends.

Key Characteristics

- **Basic Structure:** Structured notes obligations generally involve two entities: an issuer, which is a special purpose vehicle that issues debt and equity, and an asset holdco, which is a special purpose vehicle that is a direct subsidiary of the issuer and is the entity that holds the investment portfolio. The issuer then pledges its ownership interest in the asset holdco for the benefit of the noteholders.
- **Debt-Like Characteristics:** Insurance companies rely on the debt characterization of the structured notes obligations for their risk-based capital ("RBC") analysis. To support this analysis, the return on the debt is generally structured as regular interest payments and repayment of principal, subject to a priority of payments waterfall. The equity in the issuer gets the benefit of the upside once the scheduled debt payments have been made pursuant to the priority of payments.
- **Priority of Payments Waterfall:** Structured notes structures typically have long tenors (for example, 10–15 years). Because of this, a structured notes obligation that relies on market performance and is supported by alternative investments, which are inherently illiquid assets, requires some protection from economic downturns. Common terms used to provide that protection include:
  - Payment of interest is generally required only to the extent cash is available; otherwise, the interest is deferred until cash is next available in the priority of payments.

  - The amortization schedule is usually a target amortization schedule that requires amortization payments only to the extent cash is available in the priority of payments (with cumulative catch-up payments in subsequent periods).
  - Full repayment of the debt can be targeted within a relatively short period of time (*e.g.*, four–five years) based on modeled cash flows, but legal final maturity will often be set at 10–15 years to provide flexibility, in particular in case of an economic downturn.
  - Distributions are made to equity only once interest and target amortization have been paid in accordance with the target schedule. Distributions to equity are also generally subject to pro forma satisfaction of a loan-to-value ratio and, sometimes, a liquidity ratio.

- **Funding Capital Calls:** There are certain structural holes that the investors need to be prepared to either address in the documentation or, more commonly, accept as deal risk:
  - The debt and equity committed to the issuer is generally (but not always) equal to the LP commitments made to the underlying funds. If the underlying funds can call capital to pay fees and expenses in addition to the LP capital commitment, in the absence of adequate reserve, there is a possibility that there will not be sufficient cash available to fund a capital call to pay fees or expenses.
  - Many funds permit recycling of commitments. However, if the issuer has received a cash distribution from the underlying funds, and that cash is run through the waterfall, it is no longer available for recycling. The portfolio needs to provide sufficient cash into the structure to be able to cover these additional calls on capital.

In these cases, the issuer would become a defaulting LP if the investment portfolio does not generate sufficient cash to service these capital calls, thereby impairing the debtholders' collateral. It is therefore important to control when and how much cash leaves the structure.

- **Investment-Grade Rating:** Insurance companies rely on the investment-grade or quasi-investment-grade rating of the debt for their RBC analysis. If the debt is downgraded, the debtholders might request an Event of Default or a drawstop on unfunded commitments until the investment-grade rating is restored.

Critical Structuring Parameters

When structuring these investments, issuers must determine certain key parameters. We list three of them here, and discuss each in turn.

- Whether the investment portfolio will be set as of the closing date;
- Whether the commitments to the issuer will be funded in full on the closing date; and
- Whether the issuer will be consolidated with its parent's balance sheet and whether that parent has other obligations that subject the parent and its subsidiaries to covenants with which the structured notes obligations might conflict.

Setting the Investment Portfolio

The issuer needs to determine whether the asset holdco will have set the investment portfolio as of the closing date, or whether the asset holdco will build or adjust the portfolio after the closing date based on agreed investment guidelines. If the investment portfolio may change after the closing date, it is important to ensure the investment portfolio will be sufficiently diversified to support an appropriate rating. In addition, the issuer needs to be prohibited from committing more than the aggregate principal amount of debt and equity that has been committed to the issuer. Alternatively, noteholders will have to be comfortable that expected distributions on the underlying funds will be sufficient to fund capital calls for which no matching source of funding is identified at closing.

Funded or Unfunded Commitments
Another important parameter is whether the debt and equity commitments will be fully drawn on the closing date, or if there will be a delayed drawing schedule. Having some or all of the commitments unfunded as of the closing date presents additional considerations. There needs to be a comfort level regarding the creditworthiness of the debtholders and equity holders. Protections may be necessary to ensure the issuer receives the full draw amount needed, including defaulting noteholder provisions and GP or other parent support from the issuer or the underlying funds. Finally, the investment may need to come with drawing conditions such as a ratings downgrade or an LTV breach in the event the condition of the structured notes obligation has changed since the closing date. However, the matter of drawing conditions should be approached cautiously, as a drawstop may cause the issuer to become a defaulting limited partner with respect to some or all of the underling funds, thereby exacerbating the problem.

Balance Sheet Considerations
While the issuer of a structured notes obligation is a special purpose vehicle, the parent of the issuer may be a company that itself has debt obligations. If the parent is required to consolidate the issuer in its balance sheet, the covenants in the parent's debt agreements may extend to the parent's subsidiaries and must be considered to ensure that the debt issuance by the issuer does not conflict with those covenants.

The past year has seen an increase in the use of such note structures, and we expect their popularity to continue to increase so long as market performance is strong and the insurance regulators do not change the investment classification of the notes issued, or the loans incurred by, these structures.

Liquidity Facility

Many structured notes structures include liquidity support, in the form of a revolving facility provided by a third-party lender, that can be used to bridge a funding shortfall. These liquidity facilities are generally available to fund fees and expenses, interest on the debt tranches and, sometimes, capital calls from the underlying funds. While these liquidity facilities are rarely used, including a liquidity facility in the structure provides stability to the structured notes obligation by supporting the ratings analysis and reducing the possibility that the structure will fail.

Regulatory Treatment

The structure of structured notes obligations is based on the current RBC treatment of the notes' debt investments as debt investments. However, the National Association of Insurance Commissioners ("NAIC"), the standard-setting and regulatory support organization created and governed by state insurance regulators, has for a number of years been exploring changes to statutory accounting principles and securities valuation office ("SVO") procedures that could affect the reporting and capital treatment of structured notes obligations rated note feeder vehicles and similar structures. Currently, the NAIC is working on a principles-based approach to structured notes with the goal of settling on final rules by May 2023 with a January 1, 2024 effective date. We generally see the insurance company debtholders assume the risk of a change in law or of the structured notes obligation not achieving the desired capital or reporting treatment.

Recent Trends

- **Decoupling of debt and equity commitments:** While investors in some structured notes obligations are purchasing a vertical slice of the structure that includes both debt and equity, we are increasingly seeing structures that decouple the two. This strategy works well for insurance companies that wish to

invest in rated debt instruments but not the equity. The equity is then purchased by investors such as a balance sheet fund of the firm forming the structured notes obligation, family offices and other third-party investors attracted to the combination of levered exposure to multiple funds and the potential for high returns. While equity holders may be required to make an initial funding, often no further funding is required (subject to certain downside events such as a loss of rating for a period of time) until the debt has been funded in full. If the portfolio produces sufficient cash flows to service future capital calls, it is possible that the equity is never drawn again but still gets the benefit of excess cash distributions out of the system.

- **Equity Credit Support:** To the extent that equity commitments are not funded in full on the closing date, equity holders may be required to have an eligible rating or provide adequate credit support from a person with an eligible rating. This credit support frequently takes the form of a parent guaranty, a letter of credit or a cash collateralization, in each case for the full amount of the equity commitment. This credit support not only supports the ratings analysis, but also provides comfort to the debtholders that the equity holders will fund when required to do so under the terms of the transaction documents.

Conclusion

In the current market environment, we expect to see more private equity firms and insurance companies develop and invest in these structures to maximize their access to liquidity and as a new investment opportunity. We also expect further innovations as market participants react to regulatory and other developments.

Debevoise & Plimpton

Credit Markets in Uncertain Times: Hope for the Best, but Prepare for the Worst


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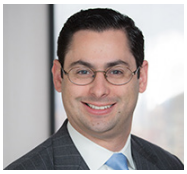
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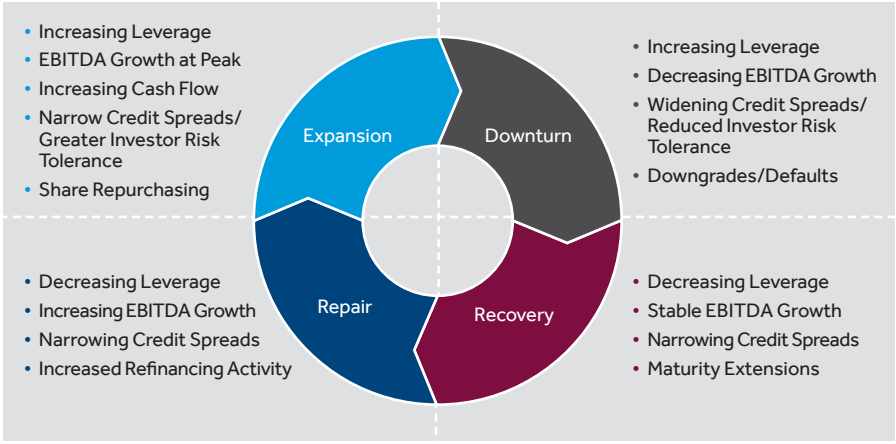
Current events, including inflation, tightening monetary policy, rapidly shifting geopolitical conditions and an aging credit cycle, are coalescing to increase transactional risk in credit markets. The aging credit cycle can bring particular challenges to finance and M&A transactions. Although economic crystal balls remain cloudy, there are steps that private equity sponsors and their portfolio companies can take to prepare should the credit cycle turn from expansion to downturn in the near- to mid-term (see illustration). In this article, we discuss three of the challenges such a turn in the credit cycle would bring—increased costs through capital contraction, deal execution risk and post-transaction litigation risk—as well as best practices that, while generally prudent in any phase of the credit cycle, take on increased importance during mature expansionary periods and the transition to a downturn.



It is helpful to begin with some historical perspective. The current credit cycle has had one of the longest expansionary phases on record—lasting over a decade. For comparison, the National Bureau of Economic Research reports that the historical average length of an entire credit cycle is less than six years. As a credit cycle nears or enters the transition from its expansionary phase to a downturn, new challenges and opportunities arise. On the one hand, the cost of capital typically increases and may constrain new deal activity, the availability of (re)financing opportunities and the profitability of existing and planned investments. On the other hand, destabilized markets may offer particularly attractive investment and acquisition opportunities for courageous and adaptable investors. Investing in a late-stage market may carry a potential for strong return, but also increased risks. These risks, however, can be mitigated through advance planning and attention to detail.

Capital Contraction

In the expansionary phase of a credit cycle, overall low interest rates and a glut of investable cash put pressure on lenders to generate or maintain higher yields, incentivizing lenders to take on (or stay in) ever-riskier investments in search of the desired rate of return. When the credit cycle rolls into a downturn, conditions begin to support higher yields on relatively less risky investments. Lenders become less incentivized to support stressed credits, instead seeking either a return of capital that can be deployed on better terms elsewhere, or a more comprehensive restructuring that will reset a capital structure on higher-yield terms reflecting the new credit market. This market tightening has implications both for new capital commitments (including refinancings) and for managing existing debt facilities.

New Capital Commitments and Refinancings. New and recommitted capital is more expensive and harder to come by in a downturn. As noted above, lenders have more options for higher-yield investments. Even lenders that want to invest may be limited by internal or regulatory criteria for deploying credit into highly leveraged situations, like CLOs that are constrained by investment guidelines from deploying defensive capital to aid distressed credits. Moreover, arranging banks may price in balance sheet or clawback risk associated with the increased danger of failed syndications. In a tightening credit market, lenders can and will demand more onerous covenant packages, which in turn limit borrowers' operational flexibility and create more opportunities for default. Particularly in transactions with a distribution to equity, financings face enhanced litigation risk. For example, creditors in bankruptcy may challenge dividends funded by debt proceeds as constructively fraudulent, claiming that the borrower was insolvent or rendered so by the transaction. The Payless Shoes and KB Toys bankruptcies provide cautionary tales.

Alternatively, lenders that are excluded from the opportunity to participate in a potential liability management transaction may subsequently seek to challenge that transaction, as a fraudulent conveyance or otherwise. This tail risk may be enough of a reason for lenders to shy away from a deal. All of this suggests that transaction activity will slow and returns to equity will decrease from expansion-period levels. Such conditions help drive the deal execution and litigation risks addressed further below.

Managing Existing Debt Facilities. A contracting credit environment also narrows borrowers' options when trying to manage discrete liability issues like maturities, financial covenants and basket capacity. Lenders are more likely to scrutinize covenant compliance and look for opportunities to require new capital infusions and other material accommodations for amendments that would have been easily achieved in an expansionary environment. In such turbulent times, borrowers should think proactively about strategies such as:

- Tracking who owns the debt and when they acquired it, to keep an eye on evolving lender group motivations and behaviors tied to where debt is trading, and the possibility of different factions forming within a group.
- Enhancing liquidity through revolver draws before borrowing conditions become difficult to meet, or lenders themselves start to experience credit issues. Investing in covenant compliance training and materials to avoid foot faults and to educate legal, treasury and accounting personnel about potential weaknesses well in advance of defaults materializing.

Deal Execution Risk

Transactions closing at the turn of the credit cycle face two principal problems: (i) buyer's remorse in light of more challenging or changed macroeconomic conditions and (ii) difficulty in syndicating or closing financing. Sponsors and portfolio companies entering into transactions during an aging credit cycle can incorporate risk-allocation strategies to address these issues.

Sponsors and their portfolio companies on the buy-side should consider non-syndicated private credit financing to avoid execution risk, as well as the risk of price flex. Buyers should remain vigilant to continue to align the closing conditions in a purchase agreement and the requirements for funding financing

commitments to ensure that if they are obligated to close, their lenders are obligated to fund. Working capital adjustments reflecting increases in business volatility may also be worth negotiating.

Conversely, as sellers, sponsors and their portfolio companies should seek to reduce a buyer's optionality regarding closing the transaction. This can be accomplished by requiring a full equity backstop, as well as by watering down or eliminating closing conditions related to the go-forward business's solvency (regardless of what the financing papers say). Additionally, in anticipation of less certainty around economic trends between signing and closing, sellers should consider the possibility of a reduction in trade credit availability and its impact on ordinary-course operating covenants.

Although economic crystal balls remain cloudy, there are steps that private equity sponsors and their portfolio companies can take to prepare should the credit cycle turn from expansion to downturn in the near- to mid-term.

Post-Transaction Litigation Risk.

When parties close deals they later regret due to changed economic conditions, they may look to shift losses through litigation. Accordingly, portfolio companies and their directors should be prepared for a more litigious environment as the credit cycle ages.

Directors should be prepared for their actions to be scrutinized with the benefit of 20/20 hindsight, and board processes should be designed and documented accordingly. Boards should consider up-to-date information and professional recommendations before granting final approval of any deal closing to ensure that any shifts in market conditions do not undermine the business rationale for the transaction or compel a different recommendation to shareholders (if shareholder approval is required). Directors should consider different angles and test the professional advice they are given to ensure they are fulfilling their fiduciary duties. For example, the U.S. District Court for the Southern District of New York has allowed breach of fiduciary duty claims to proceed against directors who failed to consider the overall effects of a multistage transaction on the post-closing solvency of the company. Directors also should keep in mind that the enterprise value of financially distressed companies may break above equity, and their fiduciary duties may require them to consider the interests of creditors and other stakeholders when assessing potential transactions.

Similarly, boards and management should be mindful of communications and disclosures made to employees and other minority shareholders receiving equity in potential transactions. The likelihood of litigation increases when economic changes occur between signing and closing a deal if the relative risks borne by the parties no longer align with what is in public disclosures or communications. This risk is particularly acute in the turbulent conditions following a shift in the credit cycle and may require near-real-time updates to ensure recipients timely receive all information relevant to their investment decisions.

Transactions involving insolvent companies may be unwound or the proceeds clawed back under certain circumstances. For example, a debtor in bankruptcy may seek to unwind the transfer of assets or the incurrence of liabilities on the basis that it was insolvent at the time or was rendered insolvent by the deal, and that it received less than reasonably equivalent value in exchange (like the leveraged dividends noted above). A range of other insolvency-related litigation may also arise, including preference actions, efforts to recharacterize debt investments as equity or sale transactions as loans, and the judicial subordination of debt for inequitable conduct. Transactions can be structured to account for and mitigate such risks through a combination of financial opinions, corporate structure and market testing.

In light of rapidly shifting geopolitical and economic conditions, sponsors and their portfolio companies would be well-advised to prepare for the potential risks and corresponding opportunities associated with a change in the credit cycle.

Debevoise & Plimpton

Funding the New Space Race: Risks and Opportunities for Sponsors and Investors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Private-sector funding in space-related companies has increased tenfold over the last decade, topping $10 billion in 2021.[1] The exponential growth in privately funded and operationalized space activities is redefining the boundaries of a sector that was once the purview of States. This growing and transforming field of potential investments affects our private equity clients, providing both a multitude of opportunities—and, of course, attendant risks.

To provide an overview of the issues sponsors and investors need to consider, Catherine Amirfar, Co-Chair of Debevoise's International Dispute Resolution and Public International Law Groups, moderated a panel discussion on the "New Space Race: Risks and Opportunities" during Paris Arbitration Week in March 2022. The panel, which featured David Bertolotti (Eutelsat), Julien Cantegreil (SpaceAble), Chris Kunstadter (AXA XL) and Lynn Zoenen (Alpine Space Ventures), explored a series of topics, including private capital opportunities, key investment risk factors, the role of insurance and data in mitigating risks and the potential for disputes. A recording of the session is available here; key takeaways include the following:

Investment Opportunities

Technological advances are helping to lower launch costs, drive broader access to space and create investment opportunities in a range of sectors. Launch costs have fallen dramatically in recent years—from €30,000/kilo ten years ago to under €2,000/kilo today—and are expected to drop below €1,000/kilo by 2030. This trend is expected to continue, given the enhanced serial production of space technology, the production of reusable materials and lightweight systems and the proliferation of launch service providers ("LSPs").

At the same time that space-based activity has become more economically viable for private actors, technological developments are creating increasingly compelling business opportunities:

- Earth observation from space can enhance mapping, track weather, improve agriculture, mitigate natural disasters, support sustainable development and document human rights violations. In addition, space-borne data can be used to amplify other data from other sources—such as drone imagery, internet of

1. McKinsey & Company, "Space: Investment shifts from GEO to LEO and now beyond," 27 January 2022, https://www.mckinsey.com/industries/aerospace-and-defense/our-insights/space-investment-shifts-from-geo-to-leo-and-now-beyond.

things sensors and social media—to produce actionable commercial insights for pilots, fund managers and infrastructure managers and other front-line decision-makers.

- Internet connectivity outside of urban areas also offers significant investment potential. In addition to residential uses, extending connectivity also creates opportunities for the energy, forestry and shipping industries operating in remote areas.
- Long-term commercial activity in space is fueling a market for tools providing better situational awareness in space. As low Earth orbit becomes increasingly crowded, private actors need access to a precise and comprehensive pool of data of the orbit of space objects in order to calculate and mitigate collision risk.
- Space mining—the excavation of materials and minerals from asteroids and near-Earth objects—is also an area of rapidly growing interest. This market is expected to reach $3 billion by 2026, suggesting the potential for massive returns but requiring significant upfront investment.

Regulatory Risk

Activities in space are regulated by both national and international laws. This legal framework is still evolving, however, with gaps at the international level leading to overlapping standards, or an absence of regulation altogether, at the national level. Consider that current international treaties envisage three basic principles for space exploration: (1) *non-appropriation* (space is "the province of all mankind"); (2) *peaceful use* (no weapons of mass destruction in orbit or on celestial bodies); and (3) *state liability* (states bear liability for national activity in space). These principles, however, were established decades before the current rise of private commercial activity in space and are largely geared towards the competition between national space agencies that dominated early space exploration. Their aspirational approach does not address the day-to-day questions faced by private space actors like satellite operators or LSPs. International law standards that take into account enhanced activities in space are in development, but the negotiation of new treaties is a slow process.

In the meantime, national authorities must regulate space activities launched from within their territories. New laws can account for new types of space activities, but different legal systems provide different rules, which can lead to an uneven patchwork of regulations. In the absence of binding and cohesive legal rules that take into account the growth of private-actor activity, practical questions are therefore often left to industry-specific norms.

Collision Risk

Space is increasingly crowded. The European Space Agency states that there are currently more than 8,200 satellites in orbit, of which only 5,400 are still functioning; there may be as many as 100,000 satellites in orbit by 2030.[2]

In addition, space debris now accounts for more than 30,000 catalogued objects.[3] Increased military activity in space compounds this problem, as was recently demonstrated when Russian anti-satellite missile tests in November 2021 created a vast debris field, endangering not just satellites and other space objects but the safety of the crew of the International Space Station.

The increasing risk of collisions in space is therefore a pressing issue, as every collision creates more debris and a greater risk of new collisions.

Private space activity is a rapidly growing field with enormous investment potential in a strategic sector traditionally dominated by national space agencies.

2. Nathaniel Scharping, "The future of satellites lies in the constellations," *Astronomy*, 30 June 2021, https://astronomy.com/news/2021/06/the-future-of-satellites-lies-in-giant-constellations.
3. European Space Agency, "Space debris by the numbers," 4 April 2022, https://www.esa.int/Safety_Security/Space_Debris/Space_debris_by_the_numbers.

Although some national space laws (like those of France) require actors to register and insure space objects, others do not.

This problem has led some insurers to exit the space market. The vast majority of satellites in congested low Earth orbit are now not insured. Investors will therefore need to mitigate collision risk in other ways, such as through technological solutions like propulsion mechanisms.

Liability Risk

Disputes in the space sector have so far been largely constrained to activities on Earth, such as disputes between manufacturers and operators, the interpretation of contracts, or disputes with States regarding allocation of the radio-frequency spectrum in space.

As space continues to become more crowded, however, disputes arising from events occurring in space seem inevitable. In this new environment, resolving questions of liability and damages is particularly challenging, given the fragmented regulatory framework and the inherent difficulties of establishing the facts surrounding an event taking place in low Earth orbit or beyond. To address this problem, there is an increasing focus on identifying and recording with greater precision the location and velocity of debris and other objects in orbit.

Security Risk

Private actors are also paying increased attention to the security risks that arise from military activity in space. In addition, many space objects and technologies can increasingly be used for both peaceful and military purposes, creating a dilemma for private operators. Satellites and ground components are also vulnerable to cyberattacks and jamming. In February 2022, as Russia commenced its invasion of Ukraine, hackers disabled thousands of satellite modems, disrupting internet access in Ukraine and across Europe. Cyberdefense protocols and technological protections will therefore be increasingly relevant.

What's Next?

Private space activity is a rapidly growing field with enormous investment potential in a strategic sector traditionally dominated by national space agencies. Until the regulatory framework catches up to the pace of commercial activity, investors will be looking to mitigate risks through a combination of technological solutions, industry-driven protocols and careful management of the evolving legal risks.

Debevoise & Plimpton

Understanding NFTs: Key IP Considerations for Issuers, Owners and Investors

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The past year has seen a surge of investor and public interest in non-fungible tokens ("NFTs"), a blockchain-based unique digital record of ownership that may become one of the building blocks of "web3"—the next iteration of the digital revolution, and one that is attracting billions of dollars in investment capital.

Although NFTs have been around for some time, their popularity has recently exploded, garnering significant attention and capital, with monthly transaction volume on the popular NFT marketplace OpenSea exceeding $5 billion in January 2022 alone. This rise of NFTs raises complex intellectual property issues for those who are issuing, buying and selling them.

What Is An NFT? A Primer on Blockchain Technology

A *blockchain* is a digital record of transactions that is cryptographically secured and verified by a decentralized community. Blockchains are used to record transactions in digital assets, including tokens like bitcoin and ether that are individual digital units of value that can be transferred on the blockchain. One important characteristic of tokens like bitcoin and ether is that they are *fungible*—any one bitcoin is the same as any other, just like any dollar is the same as any other.

The premise of a *non-fungible token*, by contrast, is that it is a digital asset that is unique in some way. The NFT derives its value, at least in part, from those unique characteristics, just as a work of art or a piece of real estate does.

Contrary to popular conception, NFTs are not just digital copies of creative works. Rather, most NFTs contain only a link pointing from the token to something that exists elsewhere—whether an image, a video or a text file. Often, that underlying work is cryptographically hashed (*i.e.*, turned into an alphanumeric string that uniquely identifies the data) and included within the NFT.

The provenance of the NFT is a key part of its value: Anyone can theoretically create an NFT linking to an image or file. The permanent record of ownership on the blockchain serves to authenticate the history of each NFT.

Uses of NFTs

NFTs sprang into the public consciousness through the emergence of a market for NFTs for images, with millions of dollars changing hands for NFTs that can be used as profile pictures or digital avatars. But the potential use cases for

NFTs are much broader. At the most basic level, an NFT is a unique digital record. Many forms of unique records underpin modern commerce—from event tickets to property deeds to identity documents. For example, Debevoise is representing StockX against trademark claims brought by Nike that seek to bar StockX's innovative use of NFT technology to create "Vault NFTs" that act as proof of ownership of physical sneakers held in StockX's physical vault. Additionally, the Kings of Leon music group released NFTs entitling holders to tickets to their concerts, merchandise, and benefits like the opportunity to meet the band.

This rise of NFTs raises complex intellectual property issues for those who are issuing, buying, and selling them.

As creators look to build the next generation of technology platforms—"web3," which is intended to represent an evolution from the current, social-media-dominated "web 2.0"—NFTs are expected to play a significant role as digital records of ownership.

Intellectual Property Rights and NFTs

But what, exactly, does the holder of an NFT actually own? Just because an NFT exists in a digital space doesn't mean it can escape the real-world tangle of intellectual property rights that go along with transactions involving trademarks or copyrighted work.

In a standard NFT transaction, the clearest thing the holder owns is the NFT itself, a unique token on a particular blockchain. Other rights—like the copyright to the work to which the NFT is linked, for example—may not necessarily be transferred by the NFT itself. In many NFT transactions, a separate contract or purchase agreement is used to convey rights alongside the NFT.

Creators and buyers of NFTs should therefore keep a few things in mind:

- **Choose Wisely.** NFT creators have a lot of choices to make—from what blockchain to use to mint their NFTs, to what bundle of rights the NFT will convey. Some NFTs may be a digital certificate of ownership; others may be part of a larger ecosystem. Different blockchains' standards for NFTs, as well as their ability to handle smart contracts or other uses for NFTs, pose important choices for creators to consider. And, with stakeholders' increasing focus on ESG issues, choosing a blockchain may also require thinking through the energy use and environmental impacts of NFT transactions.
- **Understand the Entire Transaction.** Most NFTs are not self-contained, and so seeing the whole picture is key. NFTs might be minted on one blockchain but point to a file hosted on a separate blockchain. The provenance of the NFT might be a key part of what makes it valuable. The purchasers' rights might be governed by a contract that is not recorded in the NFT itself. Doing sufficient diligence on all of these aspects of an NFT is of utmost importance.
- **Know Your Rights.** Both buyers and sellers of NFTs should take care to understand what rights are conveyed with the NFT. Some NFTs have no associated display rights; others are intended to transfer title to an underlying work; others do not permit the NFT holder to resell or transfer their NFTs. Some NFT marketplace platforms also have specific terms governing transactions they facilitate.

Defending Your Intellectual Property against Infringing NFTs

The ease with which NFTs can be created and sold has led to a booming marketplace. Because of this, even brands that do not currently have plans to enter the web3 space or mint their own NFTs should be aware of potential threats they might face from NFT creators.

- **Copyright Infringement.** NFTs that link to a digital work may represent an unauthorized reproduction of the underlying work or infringe on copyright holders' control over derivative rights. Especially

for copyright holders in non-digital works, the creation of a digital copy of their art and an accompanying NFT may represent a transformation of the original work in a manner that is part of the creator's copyright. That said, courts may still uphold a fair use defense by an NFT creator.

- **Trademark Infringement.** Many brand owners are already taking steps to register their trademarks for digital works like NFTs. Even without a specific registration for digital goods, however, unauthorized NFTs featuring trademarks may still be infringing. However, just like with copyright, defenses to trademark infringement will likely apply in the digital realm.
- **NFTs and the First Amendment.** Digital works that are sold via NFTs can be expressive works protected by the First Amendment. In a closely watched case in the Southern District of New York that will offer the court a chance to opine on that question, Hermès recently defeated a motion to dismiss its suit against the creator of "MetaBirkin" NFTs, which contain images designed to look like the famous Hermès Birkin bag, but in brightly colored and furry form, despite the artist's First Amendment defense that the MetaBirkins were artistic works.

One other aspect of web3 that intellectual property owners should be aware of is the Ethereum Name Service ("ENS"). ENS functions for the Ethereum blockchain like the Domain Name Service ("DNS") functions for the Internet—it allows you to own a short text address—like "brand.eth"—instead of ordinary wallet addresses, which are long alphanumeric strings.

Because governance of the ENS is currently not as sophisticated as the domain name dispute mechanisms that help police DNS, brand owners should consider defensively registering ENS addresses that contain their brands to minimize risks of fraud and abuse—or the possibility that the "brand.eth" address will be permanently destroyed on the blockchain by a third party.

A final issue to consider is how blockchains limit the remedies that can be sought against infringers. Destroying an NFT is simply not possible due to the permanency of blockchain transactions. At best, an NFT can be "burned," by transferring it to an inaccessible wallet so it can no longer be bought or sold.

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 350 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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