Market Intelligence

# PRIVATE EQUITY 2020

Global interview panel led by Simpson Thacher & Bartlett

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Getting The Deal Through

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Getting The Deal Through

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# Private Equity 2020

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# United States

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## 1 What trends are you seeing in overall activity levels for private equity buyouts and investments in your jurisdiction during the past year or so?

In connection with the unprecedented rise of the covid-19 pandemic, M&A deal volume in the United States in the first half of 2020 decreased 72.4 per cent year-over-year by value to US$274.5 billion, compared to US$996 billion in the first half of 2019, according to Mergermarket. In the first half of the year, 2,139 private equity deals were consummated in the United States, which is over 1,000 fewer compared to the same period in 2019 (Mergermarket). Despite this drop in activity levels, private equity sponsors have emerged as some of the most active dealmakers this year, accounting for 16 per cent of worldwide activity in the first half of 2020, the highest level since 2007 (*Financial Times*). Much of the overall drop in deal value can be attributed to a collapse in 'mega deals' valued at over US$10 billion. For example, accordingly to data supplied by Bloomberg, there were only 10 mega deals in the United States in the first half of 2020, compared to 19 for the same period in 2019, a 47 per cent decrease in volume.

## 2 Looking at types of investments and transactions, are private equity firms primarily pursuing straight buyouts, or are other opportunities, such as minority-stake investments, partnerships or add-on acquisitions, also being explored?

In large part due to the direct and indirect business impacts of, and market uncertainty stemming from, the covid-19 pandemic, private equity sponsors have been cautious while looking for creative ways to deploy their investors' capital. For example, in addition to add-on acquisitions (which have been increasingly more popular over the past few years), we have seen sponsors increasingly turn to private investments in public equity (PIPE) deals and use 'blank check' special purpose acquisition company transactions (SPACs) to deploy capital. PIPE transactions in the first half of 2020 almost doubled in value compared to the same period in 2019. PrivateRaise recorded 83 PIPE deals in the first half of 2020 that amounted to US$10.2 billion in total value, compared with 99 such transactions worth a combined US$5.3 billion in the same period in 2019. According to PitchBook, during the second quarter of 2020, SPACs had the most active quarter on record. In addition, add-on acquisitions and minority investments remain a popular avenue to deploy capital in the United States, with add-on acquisitions making up the highest percentage of leveraged buyouts on record during the second quarter of 2020 (PitchBook).



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## 3 | What were the recent keynote deals? And what made them stand out?

Notable private equity transactions in the United States in the first half of 2020 include:

- the US$22.0 billion merger of Kronos Incorporated and Ultimate Software, backed by Hellman & Friedman;
- the US$14.3 billion take-private of Zayo Group Holdings, Inc by affiliates of EQT Infrastructure IV fund and Digital Colony Partners, which represents the largest syndicated private equity investment and the second largest leveraged buyout since 2008;
- the US$6.0 billion acquisition of iQ Student Accommodation by Blackstone;
- the US$5.9 billion acquisition of Pattern Energy Group Inc by Canada Pension Plan Investment Board; and
- the US$5.6 billion buyout of Tallgrass Energy, LP by a consortium including Blackstone, National Pension Service, Universities Superannuation Scheme, Enagas and GIC.



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## 4 Does private equity M&A tend to be cross-border? What are some of the typical challenges legal advisers in your jurisdiction face in a multi-jurisdictional deal? How are those challenges evolving?

Significant cross-border private equity activity is atypical, although there has been steady interest in cross-border deals, particularly among larger funds with the capacity to manage such transactions. Several large-cap private equity sponsors have stand-alone region-focused funds, such as Asia-focused funds, that have mandates to make investments in particular geographic regions. It is more common for non-US private equity sponsors, such as European funds or Asian funds, to look to the United States for potential investment opportunities.

The primary challenges to cross-border investments revolve around financing, tax considerations, regulatory compliance and securities laws limitations. In addition, US sponsors seeking to sell portfolio companies to non-US buyers, or considering other transactions involving sales to foreign acquirers, should be aware of the possibility of review by the Committee on Foreign Investment in the United States (CFIUS). CFIUS is a multi-agency committee authorised to review transactions that



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could result in foreign control over US businesses for potential impacts on US national security. CFIUS has authority to negotiate and implement agreements to mitigate any national security risks raised by such transactions. If CFIUS determines that such risks cannot be mitigated, CFIUS can recommend that the US President suspend, prohibit or unwind a transaction.

A CFIUS review can add delays and meaningful uncertainty to transactions depending on the nature of the target business and the identity of the foreign acquirer. In transactions involving the sale of portfolio companies that are in sensitive industries or that handle sensitive data and, in each case, that implicate national security concerns, sponsors will be prudent to consider proposing pre-emptive divestitures, discussing possible mitigation measures and building political support. Since 2012, acquisitions involving Chinese acquirers have been the most reviewed transactions pursuant to the CFIUS review process. Given the Trump administration's avowed trade policies and anti-China rhetoric, the heightened tensions around North Korea and Russia, and with the recent enactment of the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), which expanded CFIUS' jurisdiction and created a longer timeframe for CFIUS review, among other reforms, many practitioners anticipate a tougher CFIUS hurdle and expect increased scrutiny of inbound investments from Chinese buyers to continue.

CFIUS has also introduced new regulations imposing mandatory filing requirements for certain transactions involving target companies active in critical technologies, critical infrastructure or that have access to the sensitive personal data of US citizens. A failure to satisfy these new filing obligations could result in significant fines and penalties for the parties, up to the value of the transaction itself, and introduce additional deal uncertainty and regulatory risks.

While the regulatory and other challenges in cross-border sponsor exits and other transactions, including CFIUS review, are often manageable in many contexts, they increase the level of resources required and may otherwise complicate the process for executing such transactions.

## 5 What are some of the current issues and trends in financing for private equity transactions? Have there been any notable developments in the availability or the terms of debt financing for buyers over the past year or so?

Prior to March 2020 and the covid-19 pandemic, the market enjoyed a relaxation of guidelines promulgated by the Federal Reserve and the Office of the Comptroller of the Currency for financial institutions by the new administration, although there was still a high degree of uncertainty in the current regulatory environment.



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Nonetheless, dealmakers had been able to find relatively attractive pricing and availability of credit for transactions. Overall, the debt financing markets in the United States have remained open, with sponsors finding ready access to debt financing, particularly in the first two months of 2020. In the first half of 2020, leveraged loans and high yield bond issuances reached more than US$1 trillion globally, with approximately 44 per cent taking place in the second quarter of 2020 (Mergermarket). Also, as of the end of the second quarter of 2020, median debt-to-earnings before interest, taxes, depreciation and amortisation multiples for private equity buyout transactions was 5.4x, compared to 5.9x for the same period in 2019 (PitchBook). The leveraged loan market was largely shuttered for business in the second half of March 2020 through May 2020, although the high yield debt market was resurgent during this time. The market seemed to open up near the end of May 2020, with certain select credit being able to syndicate non-fungible deals, and with continued market improvement throughout July 2020. Committed financing remained rare through July 2020, although there were limited committed financings signed up in June and July 2020.

## 6 How has the legal, regulatory and policy landscape changed during the past few years in your jurisdiction?

Most private equity firms continue to be required to register with the Securities and Exchange Commission (SEC) as investment advisers and the SEC has continued to focus on examining private equity firms with the goal of, among other things, promoting compliance with certain provisions of the Investment Advisers Act that the SEC deems of particular importance. In recent years, certain private equity industry practices have received significant attention from the SEC, which has led, in certain cases to enforcement actions against private equity fund advisers.

Areas that the SEC continues to highlight as areas of particular concern include, among others, the following.

- The allocation of expenses (including for the compensation of operating partners, senior advisors or consultants and employees of private equity fund advisers or their affiliates (including seconded employees) for providing services (other than advisory services) to funds and portfolio companies, as well as for payments of a private equity fund adviser's regulatory compliance expenses) to funds or portfolio companies, or both.
    - Also, full allocation of broken deal expenses to funds instead of allocating a portion of such expenses to separate accounts, co-investors or co-investment vehicles, in each case without pre-commitment disclosure and consent from investors.



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> "Most private equity firms continue to be required to register with the Securities and Exchange Commission."

- The receipt by private equity firms of transaction-based compensation or other fees or compensation from funds or portfolio companies, or both, outside of the typical management fee or carried interest structure (eg, an acceleration of monitoring fees and compensation for the provision of brokerage services in connection with the acquisition and disposition of portfolio companies without being registered as a broker-dealer) without a corresponding management fee offset.
- The allocation of investment opportunities by private equity sponsors among investment vehicles and funds that they manage.
- The allocation of co-investment opportunities.
- The disclosure of conflicts of interest to investors, including those arising out of:
    - the outside business activities and financial interests of a private equity firm's employees and directors;
    - investments made by affiliated different funds managed by a private equity firm in different levels of a company's capital structure;
    - financial relationships between private equity firms and select investors in their funds (eg, seed investor relationships);



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  - portfolio companies' use of affiliated service providers affiliated with the private equity firm or its principals;
  - fund restructurings; and
  - 'cross transactions' between funds managed by the private equity firm.
- The receipt of service provider discounts by private equity firms that are not given to the funds or portfolio companies.
- Marketing presentations and the presentation of performance information generally.
- Policies and procedures relating to the receipt of material, non-public information (MNPI).

Although we believe the 'broken windows' enforcement approach under the Obama administration has abated, we continue to see private equity remain a priority for SEC enforcement in the Trump administration. We continue to believe that larger, established private equity firms that continue to provide robust pre-commitment disclosure of and obtain consent for conflicts of interest, in addition to maintaining and enforcing sound compliance policies and procedures to mitigate such conflicts of interest, continue to be better positioned to absorb the incremental costs and compliance burdens associated with such scrutiny.

On 22 December 2017, President Trump signed the Tax Cuts and Jobs, which was generally effective as of 1 January 2018. Among the numerous changes included in the Tax Cuts and Jobs Act were:

- a permanent reduction to the corporate income tax rate;
- a partial limitation on the deductibility of interest paid or accrued on indebtedness properly allocable to a trade or business (subject to certain exceptions);
- a new deduction for individuals receiving certain business income from 'pass-through' entities; and
- a partial shift of the US taxation of multinational corporations from a tax on worldwide income to a territorial system (along with a transitional rule that taxes certain historic accumulated earnings and rules that prevent tax planning strategies and shift profits to low-tax jurisdictions).

The impact of the Tax Cuts and Jobs Act on private equity transactions continues to be analysed as the Internal Revenue Service and Treasury have released new regulatory guidance.



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## 7 What are the current attitudes towards private equity among policymakers and the public? Does shareholder activism play a significant role in your jurisdiction?

While negative attitudes concerning private equity buyouts seems to have waned over the past few years, shareholder activism associated with M&A activity has become increasingly prominent – irrespective of whether there is any private equity involvement. As a result, private equity sponsors seeking to effect 'going private' transactions or investing alongside a strategic partner are becoming increasingly mindful of the investor relations aspects of such transactions and are evaluating the risks of potential shareholder activism.

Despite the passage of the Economic Growth, Regulatory Relief and Consumer Protection Act, which rolled back certain regulations and requirements imposed by the Dodd-Frank Act, including stress tests, on small and medium-sized banks, the regulatory landscape largely remains unchanged as of the first half of 2020. However, with a number of prominent private equity names serving in cabinet and other roles in the Trump administration, some people in the industry are expecting



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> "Private equity-backed exit activity slowed down in the first half of 2020, which is consistent with the overall M&A environment following the onset the covid-19 pandemic."

that regulators will continue to take a more relaxed approach to oversight of financial sponsors.

### 8 What levels of exit activity have you been seeing? Which exit route is the most common? Which exits have caught your eye recently, and why?

Private equity-backed exit activity slowed down in the first half of 2020, which is consistent with the overall M&A environment following the onset the covid-19 pandemic. According to data supplied by PitchBook, as of the end of the second quarter of 2020, US private equity sponsors executed 392 exits that aggregated to approximately US$134.8 billion. Notably, secondary buyouts accounted for the largest proportion of private equity-backed exit activity, accounting for approximately 50 per cent of all private equity-backed exits during the first half of 2020 compared to only 26 per cent for the same period in 2019 (PitchBook).

Initial public offering (IPO) exit value during the first half of 2020 accounted for approximately 25 per cent of total private equity-backed exit activity (PitchBook). Despite a slowdown in IPO activity during the first quarter of 2020, overall IPO



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activity rebounded during the second quarter, with 43 IPOs raising nearly US$20.4 billion during the quarter, according to data supplied by FactSet.

The second quarter's four mega-IPOs (IPOs raising over US$1 billion) accounted for approximately 40 per cent of proceeds, together raising approximately US$8.3 billion (FactSet). After a dearth of private equity-backed listings during the first quarter of 2020, five IPOs during the second quarter were backed by private equity sponsors (FactSet). The largest private equity-backed IPO of the first half of 2020 was the offering by ZoomInfo Technologies by Great Hill Partners, which raised approximately US$934.5 million. Not every private equity exit during the first half of the year was a blockbuster hit, however, as the Albertson Cos IPO by Cerberus Capital Management LP raised only US$800 million, underwhelming some analysts (PitchBook).

Affecting exit activity in the first half of 2020 was an increase in deal terminations blamed directly or indirectly on the impacts of covid-19. According to Mergermarket, the largest terminated deals during the first half of 2020 were Xerox's US$35.5 billion takeover bid for HP, Woodward Inc's US$7.4 billion merger with Hexcel Corporation and Simon Property Group's US$6.8 billion acquisition of Taubman Centres.

## 9 Looking at funds and fundraising, does the market currently favour investors or sponsors? What are fundraising levels like now relative to the past few years?

According to Preqin, although global private equity fundraising had a strong first quarter with an approximately 19 per cent increase over the first quarter of 2019 in aggregate capital raised, the economic impact of the covid-19 pandemic took effect in March 2020 and disrupted private equity fundraising. In the second quarter of 2020, aggregate capital raised decreased 23 per cent and the number of funds closed also declined 47 per cent, in each case over the second quarter of 2019 (Preqin).

Moreover, the fundraising process slowed over the first half of 2020, with only 39 per cent of the funds closed doing so within 12 months (as compared to 52 per cent in 2019) (Preqin). Although the number of funds in the market currently fundraising increased over the first half of 2020 by approximately 6 per cent (from 3,524 in January 2020 to 3,754 in July 2020), the amount of aggregate capital targeted has decreased approximately 5 per cent (from US$926 billion in January 2020 to US$884 billion in July 2020) (Preqin).

Global macroeconomic uncertainty and difficult economic and political conditions in certain regions continued to shift fundraising dynamics in favour of North America and Europe in the first half of 2020. In the second quarter of 2020 alone, 116 North



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America-focused vehicles and 45 Europe-focused vehicles closed on US$60.6 billion and US$36.5 billion of aggregate capital, respectively, compared to 42 Asia-focused vehicles, which closed on US$16.5 billion of aggregate capital (Preqin). Further, as of the end of the second quarter of 2020, 49 per cent of institutional investors were seeking to make new commitments in North America-focused and Europe-focused private equity funds in the next 12 months (Preqin).

Institutional limited partners are continuing to place increased emphasis on consistent track records and stability, tending to make larger commitments to fewer private equity funds, and established top quartile sponsors have continued to be able to raise larger funds in shorter periods of time and capture a greater share of the overall private equity fundraising market.

Many institutional investors have increased their overall portfolio allocation to the private equity asset class. The amount of capital distributed by private equity funds to investors in recent years has been significantly more than the amount of capital called from investors. In December 2019, dry powder held by private equity funds reached a record of approximately US$1.5 trillion, more than double the total from 2014 (Preqin). With private equity firms holding a record amount of dry

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powder to deploy and the pandemic lowering valuations, private equity firms are well-positioned to negotiate deals with lower valuations or with more deal structure elements (KelloggInsight).

There has also been a continued focus on strategic relationships and alternative fundraising strategies, including customised separate account arrangements, co-investment arrangements and multi-strategy (umbrella) arrangements and new product development (eg, a number of established sponsors have raised longer life, lower risk and return funds in asset classes like private equity and real estate).

## 10 Talk us through a typical fundraising. What are the timelines, structures and the key contractual points? What are the most significant legal issues specific to your jurisdiction?

While fundraising in today's environment has become less episodic and more resource-intensive, with fund structures, terms and marketing timelines customised to most effectively address the business objectives of the sponsor, the following is a simplified framework and timeline for a typical private equity fundraising.

In most cases, typical fundraising will begin with the preparation and distribution of a private placement memorandum to investors, which includes important information about the sponsor and the fund, including a term sheet setting forth the key terms of the fund and the offering of interests, along with additional disclosure information pertaining to the fund. Many private equity funds are structured as Delaware limited partnerships, but the structure and jurisdiction of the fund will depend largely on the sponsor and the asset class, geographic focus and anticipated investor base of the fund. It is not uncommon for private equity funds to be organised in jurisdictions outside of the United States (eg., the Cayman Islands, Ireland or Luxembourg).

Legal counsel will work closely with the sponsor as part of the fundraising to prepare the draft limited partnership agreement, investment management agreement, subscription agreement and related fund documents, which are the definitive agreements governing the operation of a private equity fund. Key contractual points in the fund documents will vary on a case-by-case basis, but often include economic arrangements (eg, management fees and carried interest), tax structuring provisions and minimisation covenants, investment allocation provisions, limited liability protections, standards of care, governance rights, co-investment arrangements and allocations of expenses. It should be noted that increased regulatory scrutiny has resulted in a change in how marketing and offering documents are prepared. Drafting fund documents is now a resource and time-intensive exercise, as pages and pages of granular disclosure are often added to such documents and more



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frequent updates to such documents are often made throughout fundraising in an effort to increase transparency.

Following delivery of the fund documents to investors, counsel and the sponsor will work closely with investors to resolve any questions or comments and once a critical mass of investors' subscriptions has been secured, the fund will hold an initial closing. Fundraising timelines in private equity can vary significantly depending on the sponsor involved and the type and size of fund being raised, running anywhere from a few months to a few years. Once an initial closing has been held, a private equity fund will typically be permitted to hold subsequent closings over a period of 12 to 18 months (although the fundraising process has been accelerated to six to 12 months in recent years). As the regulation of private equity funds continues to increase, it remains very important for sponsors to work closely with counsel to ensure that all necessary steps are taken to permit marketing in each jurisdiction in which fund interests are to be marketed.

## 11 How closely are private equity sponsors supervised in your jurisdiction? Does this supervision impact the day-to-day business?

Private equity firms are subject to substantial regulation and supervision in the United States and the regulatory environment in which private equity firms operate is becoming increasingly complex. The regulation and supervision of private equity firms affects not only the manner in which interests in private equity funds are marketed and sold to investors, but also the day-to-day business and operations of private equity firms themselves.

The principal laws and regulations applicable to private equity firms affecting their day-to-day business and operations include, among others:

- the Securities Act of 1933 (affecting the manner in which private equity funds market and sell interests to investors);
- the Securities Exchange Act of 1934 (affecting ongoing reporting obligations and placing practical limitations on the number of investors in private equity funds);
- the Advisers Act (imposing substantive regulations and reporting provisions on many private equity fund advisers);
- the Investment Company Act of 1940 (establishing certain eligibility requirements and limitations on investors in private equity funds);
- the Commodity Exchange Act (regulating the ownership of commodities by private equity funds); and
- the Employee Retirement Income Security Act of 1974 (imposing restrictions and onerous fiduciary requirements on private equity funds deemed to hold 'plan assets').



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> "Private equity firms are subject to substantial regulation and supervision in the United States."



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Since the SEC gained oversight of the industry under the Dodd-Frank Act, private equity firms remain the subject of regulatory and public scrutiny. The SEC continues to find more regulatory lapses among private equity firms, particularly related to expenses and expense allocation, conflicts of interest and other disclosure matters and, most recently, MNPI policies and procedures. Private equity firms with dedicated compliance, investor relations and administrative resources necessary to manage the increased regulatory and compliance burdens in addition to investor demands in today's competitive fundraising environment are likely to continue to enjoy an advantage in the future.

## 12 | What effect has the AIFMD had on fundraising in your jurisdiction?

The AIFMD has resulted in two approaches to fundraising in the European Economic Area (EEA) by US fund managers:

- the use of national private placement regimes (NPPRs); and
- the use of hosted solution platforms.

Some US managers avoid active marketing in the EEA but will admit investors to their fund at the initiative of the investor (reverse solicitation). Although reverse solicitation is sometimes referred to as a way of marketing in the EEA, it is an exclusion that allows investors domiciled or established in the EEA (EEA investors) to invest in funds at their own initiative without thereby subjecting the fund manager to compliance with the AIFMD. As it is not a method of active fundraising (or, if used to that effect, it would be a circumvention the AIFMD) it is not considered further in this note.

The two approaches to fundraising reflect the options available under the AIFMD depending on whether the fund manager is:

- a non-EEA alternative investment fund manager (non-EEA AIFM); or
- an authorised EEA alternative investment fund manager (an EEA AIFM).

For marketing by a non-EEA AIFM, the AIFMD allows national authorities to operate (at their option) an NPPR. In countries that permit marketing under NPPRs, a non-EEA AIFM may market an alternative investment fund solely within the territory of the relevant country, provided that the non-EEA AIFM complies, at a minimum, with a limited subset of AIFMD requirements. By contrast, for an authorised AIFM, the AIFMD provides a streamlined passport system that (subject to certain limitations) permits the marketing of EEA funds to professional investors anywhere in the EEA. The AIFMD makes provision for the possibility of extending this passport



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system to non-EEA AIFMs, but there is, as yet, no indication as to when or if it will ever become available to US fund managers.

To understand why the AIFMD has resulted in a bifurcation between NPPRs and hosted solutions, it is useful to consider further aspects of each approach.

**National private placement regimes**

There is no requirement for EEA member states to allow non-EEA fund managers to privately solicit investors in their member state. Where it is permitted, the member state is required to impose at least the following requirements:

- pre-investment disclosure;
- periodic reporting (Annex IV reporting);
- annual report; and
- if applicable:
    - notification and disclosure requirements in relation to the acquisition of significant stakesor control of non-listed companies and issuers; and
    - restrictions on certain distributions, capital reductions and share redemptions in respect of portfolio companies (the anti-asset-stripping rules).

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> “The process for obtaining marketing approval under an national private placement regimes varies, though it usually requires the advice of local counsel and is therefore costly and time-consuming.”



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Member states are free to impose more stringent measures than those listed above. At present, some EEA states do not operate NPPRs at all. Some EEA states apply the minimum requirements described above, others require the minimum plus, for example, the appointment of a depositary, and some require compliance with substantially all of the AIFMD, making it impossible or practically impossible for a non-EEA AIFM to market a fund in that member state.

The process for obtaining marketing approval under an NPPR (where it is allowed) varies, though it usually requires the advice of local counsel and is therefore costly and time-consuming. This has resulted in a number of US private equity funds, particularly smaller firms that do not have the necessary compliance and fundraising infrastructure in place, to be disadvantaged by the complexity and cost, especially where there is no certainty of raising capital. Further, the minimum requirements noted above (and, if applicable, the appointment of a depositary) create an ongoing administrative and compliance burden for the life of the fund (or until registration is terminated).

Notwithstanding these obstacles, for some non-EEA AIFMs, NPPRs have facilitated the repeated raisings of large funds. They has proven to be a reliable and predictable process that is minimally disruptive to the sponsor's existing business model, as costs are known (many are one-off), ongoing compliance for annual reports and regulatory reporting is incremental and it does not involve a long-term or open-ended commitment to an establishment in the EEA or to complying with EU laws as they may evolve or be extended in the future.

**Hosted solutions**

The main disadvantages to NPPRs are:

- it is either not permitted or not practical in certain key countries in western Europe;
- there is (currently) no common meaning of 'pre-marketing' for gauging interest before formally registering under an NPPR;
- NPPRs have a patchwork of notification and application procedures across the member states where they are permitted (and in some cases approval from the regulator can take months); and
- Annex IV reporting must be submitted in different formats through different electronic portals to each member state where the alternative investment fund is registered for marketing.

The main alternatives to NPPR are forming an entity to become authorised as an EEA AIFM and engaging a 'hosted solution'.

Forming a legal entity in an EEA member state and obtaining authorisation as an AIFM is a significant business commitment. Although a small number of US



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managers have established, or acquired, authorised AIFMs, it is not a plausible alternative for most sponsors and is not often considered further.

A hosted-solution involves engaging an authorised EEA AIFM that agrees to manage and market a fund sponsored by a non-EEA AIFM. Typically, a new alternative investment fund is established in the EEA, commonly in Luxembourg or Ireland. The EEA AIFM (the host) agrees to manage the alternative investment fund and market the fund in selected member states under its marketing passport. The EEA AIFM will typically either delegate management to the non-EEA AIFM or engage the non-EEA AIFM to provide investment advice. Increasingly, delegation seems to be more popular than an advisory arrangement, even though it may subject the delegate to certain remuneration rules.

The marketing passport is only available for the marketing of an EEA alternative investment fund and, then, only if the EEA fund is not a feeder fund to a non-EEA master or not a feeder fund to an EEA master that is not managed by an authorised EEA AIFM. For this reason, the hosted solution is commonly used in a parallel investment structure with an non-EEA AIF – which avoids a master–feeder structure.

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The right to market under the passport is that of the EEA AIFM – the AIFM has access to the marketing passport, but that does not allow the non-EEA AIFM to market on its behalf in the EEA. The most straightforward solution to this problem is to engage a placement agent authorised in the EEA to act as an intermediary to the market on behalf of the AIFM.

EEA investors are familiar with the hosted solution model and there is no indication that the involvement of a third-party AIFM adversely affects their investment decision – possibly the opposite is the case for some institutional investors, insofar as they prefer to invest in an EEA alternative investment fund with the full protections of the AIFMD. For a similar reason, regulators may prefer the model to an NPPR, for example, because the alternative investment fund and AIFM are within the regulatory perimeter and EU investors receive the full protection of the AIFMD.

A hosted solution addresses most of the shortcomings of marketing under NPPRs, but most importantly it allows access to all countries in the EEA. However it does entail:

- negotiating a set of service agreements (with the AIFM and possibly with the depositary and fund administrator);
- establishing an EEA alternative investment fund;
- working with, or under, an entity that is itself subject to all of the requirements of the AIFMD;
- establishing a parallel investment structure; and
- engaging a marketing intermediary.

These factors do mean that the costs, which continue for the life of the fund, may only be justified if the marketing effort results in the raising of a significant amount of capital from investors from whom capital could not otherwise be raised under NPPR.

In summary, the AIFMD contemplated marketing by non-EEA AIFMs under NPPRs. While NPPRs are workable and preferable for some non-EEA AIFMs, the advantages of the marketing passport combined with the attractiveness to some institutional investors of investing in an EEA alternative investment fund, managed by an authorised EEA AIFM, has spawned an industry of hosted solution platform providers.

## 13 What are the major tax issues that private equity faces in your jurisdiction? How is carried interest taxed? Do you see the current treatment potentially changing in the near future?

US tax rules are very complex and tax matters play an important role in both fund formation and the structure of underlying fund investments. Tax issues that have been given some focus in recent years:



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- the implementation of the numerous changes related to the Tax Cuts and Jobs Act (see question 6);
- the implementation of due diligence, information reporting and withholding rules pursuant to the Foreign Account Tax Compliance Act;
- the proper tax treatment (including deductibility) of monitoring fees paid by underlying portfolio companies to a private equity fund's investment adviser; and
- the partnership audit rules, which may impose liability for adjustments to a partnership's tax returns on the partnership itself.

Consultation with dedicated tax advisers with respect to specific transactions and issues is highly recommended.

Private equity sponsors and their portfolio companies have also considered the impact of the tax relief provisions of the recently enacted Coronavirus Aid, Relief and the Economic Security Act, including suspending the 80 per cent net operating loss (NOL) limitation. This allows 2018, 2019 or 2020 NOLs to be carried back five years, temporarily increasing the limitation on the utilisation of business interest expense deductions to 50 per cent of adjusted taxable income, excluding cancellation of debt income attributable to certain small business administration loan forgiveness from gross income and delaying employer payroll tax payments, among other changes. Additionally, in light of the covid-19 pandemic, many portfolio companies have repurchased debt at a discount (or had their debt repurchased by a private equity sponsor or related party at a discount), which can result in the cancellation of indebtedness income to the borrower and raise other tax considerations for both issuers and sponsors.

Special consideration is given to structuring the carried interest such that it is treated as a partnership allocation eligible for taxation on a flow-through basis. It is sometimes desirable to separate the general partner (namely, the recipient of the carried interest) and the investment manager (namely, the recipient of the management fee) into separate entities for state tax and other purposes. The Tax Cuts and Jobs Act typically requires the general partner of a private equity fund to hold an investment for three years in order for the carried interest related to such investment be treated as capital gains for tax purposes. Additionally, Congress has previously considered legislation that would subject carried interest, and gain on the sale of investment services partnership interests, to higher rates of US federal income tax than under current law and President Trump has expressed his support for such legislation.

Private equity sponsors must also be aware of tax issues relating to management and employee compensation, which will be relevant to structuring management's



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"Private equity sponsors must also be aware of tax issues relating to management and employee compensation."



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investment and post-closing incentives. An example of one such tax issue is that compensation triggered by a change of control, including certain severance and consideration for equity holdings, may be 'excess parachute payments', which are subject to a 20 per cent excise tax (in addition to ordinary income taxes) and may not be deducted by the target.

Another example involves the tax treatment of different types of stock options. If an option is an 'incentive stock option', under typical circumstances, no income is realised by the recipient upon grant or exercise of the option and no deduction is available to the company at such times. Employees recognise tax at capital gains rates when the shares acquired upon option exercise are ultimately sold (if the applicable holding period requirements are met) and the company takes no deduction. If the award is a non-qualified stock option, no income is recognised by the recipient at the time of the grant and no deduction is available to the company at such time. Rather, income is recognised and the deduction is available to the company at the time of option exercise. There are a number of limitations on incentive stock options and private equity sponsors generally prefer to maintain the tax deduction. Accordingly, non-qualified stock options are more typical.

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A final example involves 'non-qualified deferred compensation'. If a deferred compensation plan is 'non-qualified', all compensation deferred in a particular year and in prior years may be taxable at ordinary income rates in the first year that it is not subject to substantial risk of forfeiture, unless payment is deferred to a date or event that is permitted under tax code Section 409A's rules governing non-qualified deferred compensation.

## 14 | Looking ahead, what can we expect? What might be the main themes in the next 12 months for private equity deal activity and fundraising?

Overall, US private equity deal flow slowed in the first half of 2020 compared to the same period in 2019 as a direct and indirect result of business impacts attributable to the covid-19 pandemic and resulting uncertainty in the financial markets. Despite the slowdown in deal activity, however, debt financing has seen a notable increase, in part due to companies drawing on credit facilities and undertaking capital market activity to increase available capital to help them weather the covid-19 storm.

During the first half of 2020, the covid-19 pandemic disrupted private equity fundraising, disproportionately impacting first time funds and funds that had not yet begun fundraising. Nevertheless, large, blue chip sponsors with strong pre-existing limited partner relationships and fundraisings in process at the beginning of 2020 remained successful. We expect that the trends and developments witnessed in the first half of 2020, with respect to fund formation, will continue as the consolidation in the private equity industry continues too. We believe competition for investor capital among private equity funds will persist, with alternative fundraising strategies and strategic relationships continuing to play a substantial role, Likewise, we believe that allocation decisions by risk-averse limited partners will continue to favour larger, established sponsors with strong track records and the ability to absorb the incremental burdens associated with today's market environment as well as the continued scrutiny and enhanced regulation of the private equity industry. In addition, we believe that private equity funds will encounter valuation issues as uncertainty and volatility within the markets remains (particularly for those firms relying on public company comparisons and discounted cash flow valuations). Finally, a decline in public market values could result in an imbalance in investors' portfolios, causing such investors to sell their private fund stakes to maintain certain asset allocations, and it is possible that funding defaults by such investors will increase.

In conclusion, absent drastic improvements in the outlook of the covid-19 pandemic, we would expect that the second half of 2020 will likely mirror the downward trend the private equity sponsor activity seen in the first half of the year, with the potential for increases in activity levels to the extent that the picture of



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the post-covid-19 world begins to sharpen and the financial markets continue to stabilise. Until the world finds a way to meaningfully manage the risks stemming from the covid-19 pandemic, we will likely see significant softness in M&A activity. High levels of dry powder, combined with easy access to debt financing, is likely to incentivise dealmaking as private equity sponsors navigate the pandemic and pursue opportunities as they arise, but uncertainty regarding valuations and future performance of many companies will remain a fundamental challenge. Political, regulatory and economic uncertainty, exacerbated by the pandemic, is also likely to temper deal flow. Each of these factors creates more headwinds for the direction of private equity deal activity in the second half of 2020 and beyond.

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# The Inside Track

## What factors make private equity practice in your jurisdiction unique?

Overall, the United States continues to rank as the top market for private equity. As the traditional base of private equity, the United States has attracted the lion's share of capital over the years and 2020 has been no different. During the second quarter of 2020 alone, 116 North America-focused vehicles and 45 Europe-focused vehicles closed on US$60.6 billion and US$36.5 billion of aggregate capital, respectively, while 42 Asia-focused vehicles closed on US$16.5 billion of aggregate capital, according to Preqin. Through the years, the private equity industry has matured and the experience of fund managers have broadened such that investors continue to view the United States as an attractive jurisdiction for their investment.

## What should a client consider when choosing counsel for a complex private equity transaction in your jurisdiction?

The main consideration is the depth of experience in the private equity sector and a creative and commercial approach to problem-solving. Practical experience combined with industry acumen are also critical. In addition, counsel should have insight into the needs of every participant in private equity transactions. As such, a client would benefit from counsel that offers cross-practice excellence.

## What interesting or unusual issues have you come across in recent matters?

As the economic effects of the covid-19 pandemic spread and deepened across the globe in the first half of 2020, private equity firms in the United States shifted much of their focus to the continued use of add-on acquisitions to boost the profiles of their existing portfolio companies and PIPE and SPAC investments as a means to deploy capital. We expect the consistent use of SPACs to continue in the second half of 2020. While not historically a traditional investment tool of private equity sponsors, a number of private equity funds have recently invested in these blank-check companies. As private company valuations softened and public equity markets became more volatile during the first half of the year, SPACs have provided an opportunistic avenue for investors to deploy capital and take advantage of target companies that look for liquidity in the near future but, for a variety of potential reasons, may choose not to pursue a traditional initial public offering path. We will continue to see how this area develops going forward.



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