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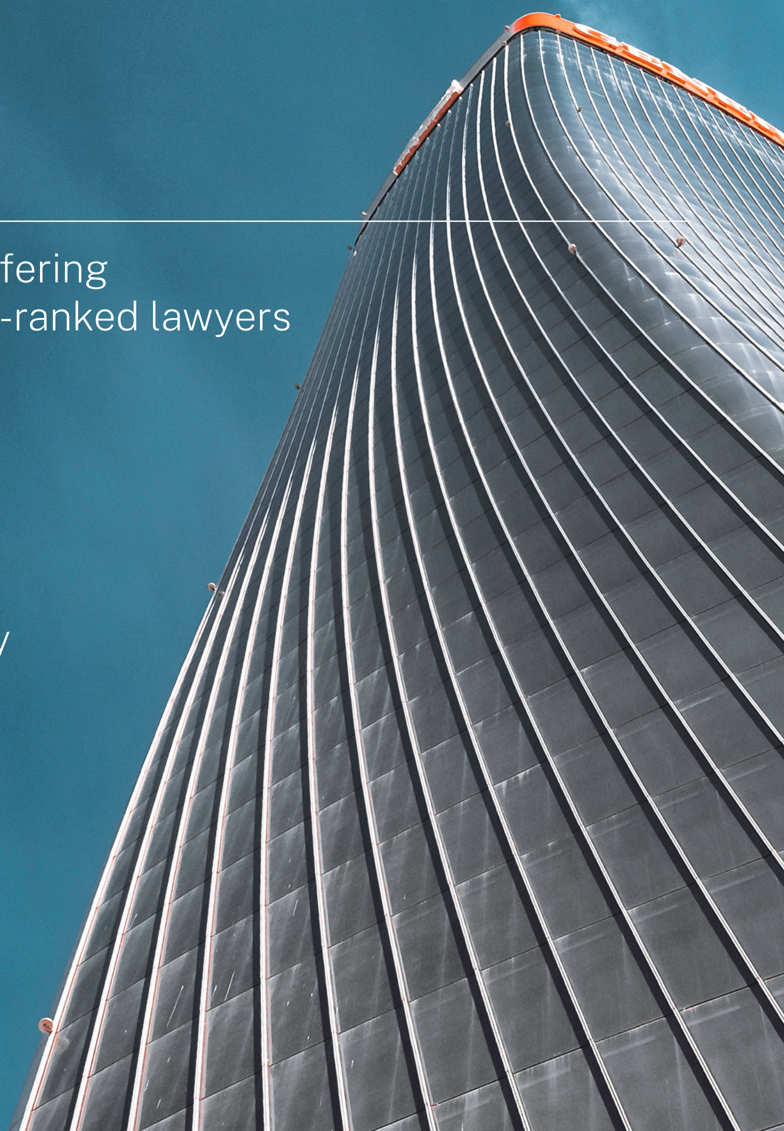

USA: Trends & Developments

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A New Regulatory Landscape for Private Equity

The year 2023 is turning out to be another interesting one for the private equity market. It started slowly, with uncertainty around the direction of the economy apparently staying the hand of many fund managers. According to mid-year data from the venture capital, private equity and M&A database, PitchBook, the deals that closed in the first half of the year, when measured in US dollar value, represented a 58% drop compared to the first half of 2022. Similarly, the global secondary market closed deals worth only USD43 billion in the first half of the year, which is a 25% decrease over the same period in 2022. The market remains a mixed bag, however, as analysts at financial services company, Jefferies, predict that there will be a rebound in the second half of the year, with the secondary transaction volume likely to exceed USD60 billion. European private equity funds in 2023 are also projected to well exceed the EUR68 billion raised in 2022.

As attorneys, we experience the private fund market through the eyes of our clients. While we certainly saw a cautious slowdown in interest in the first half of the year, with both fewer investors eyeing the market and smaller fundraises, we also witnessed new areas of potential growth. For the first time in 2023 we worked with two different clients to raise funds with a focus on carbon credits, with one qualifying as an Article 9 fund under the European Sustainable Finance Disclosure Regulation. While previously quite rare, interest in this type of investment from both the US and Europe is perhaps indicative of a new wave of ESG-focused investors. Only time will tell if this is the case.

By far the most important development in 2023, however, was the passage of several new regulatory regimes and their impact on the private equity market. With new secondary withholding obligations, private fund rules and a complex labyrinth of AML regulations, private fund managers and investors in 2023 have been presented with a new status quo for private funds, and they will need to learn to play by these new rules in order to participate.

Luxembourg AML Laws

We travel to Luxembourg for the first rule change that is having a profound impact on both private equity sponsors and investors in 2023. In late 2022, Luxembourg passed a series of new laws targeted to help fight against money laundering (the “2022 Law”). To comply with the 2022 Law, fund sponsors are now required to apply enhanced due diligence for new transactions by:

- adhering to new requirements for identity verification for clients and their beneficial owners;
- comparing collected data with existing data in the public register of beneficial owners; and
- retaining full copies of the documents, data and information that is collected.

Following the passage of the 2022 Law, private fund managers must now update their AML policies to ensure that they have appropriate risk-based management systems and due diligence procedures in place. In practice, this has resulted in very onerous AML/KYC procedures for private funds domiciled in Luxembourg. Given that Luxembourg has quickly risen to be the largest fund domicile in Europe, this is having a profound impact.

The 2022 Law impacts both private fund sponsors and investors. Fund managers may not register a private fund, and limited partners may not invest in a private fund, unless they can provide extensive documentation proving the identity of the fund's beneficial owners and control persons. In practice, the AML management systems that were put in place to comply with the 2022 Law often require parties to deliver original wet ink copies of all identity and beneficial owner verification documents.

In this post-pandemic world, many professionals continue to work remotely (at least in part) and it is not always easy to obtain wet ink certified or notarised originals. In a world where most jurisdictions are moving towards more streamlined and electronic solutions, requirements to deliver extensive wet ink originals are quite burdensome and, when compared to other jurisdictions, notably off market. In practice, the legal time and money it takes to comply with these requirements is considerable. In the past few months alone, some private fund sponsors and investor clients in the United States have expressed serious dismay at the time and effort required to comply with the AML risk management systems in Luxembourg, noting that they may choose to pursue fewer opportunities in Luxembourg going forward. While there is certainly a need for adequate AML policies and procedures, and strong AML laws are mandated by the European Union's AML Directives, proper regulation needs to be balanced with reasonable implementation to avoid chilling further interest in the Luxembourg fund market.

Secondary Withholding

A second rule change of 2023 that is having a major impact on private equity transactions has been implemented in the world of secondaries. Secondary buyers and sellers are very familiar with the withholding obligations imposed by Section 1446(f) of the US Internal Revenue Code. Generally, unless certain exceptions are met, Section 1446(f) requires buyers to withhold 10% of the amount realised when acquiring a partnership interest from a foreign seller if, prior to the sale, such seller would have recognised income effectively connected with the conduct of a US trade or business (effectively connected income or "ECI") on a hypothetical deemed sale of the partnership's assets. This withholding obligation falls primarily on the transferee of the interest (which could include the buyer in a secondary funds transaction).

Exceptions to a buyer's withholding obligations are generally met if:

- the seller is a US person;
- the seller provides an ECI certificate demonstrating that its annual share of the partnership's ECI was less than USD1 million and less than 10% of its total distributive share of gross income from the partnership;
- the partnership provides an ECI certificate demonstrating that it was not engaged in a trade or business in the US; or
- the partnership provides an ECI certificate demonstrating that, in a deemed sale of the partnership's assets, the ECI attributable to the transferred partnership interest would be less than 10% of such partnership interest's share of the total net gain from the partnership.

This has been the status quo for many years.

Starting on 1 January 2023, however, Section 1446(f) now also imposes secondary withholding obligations on the underlying partnership if the buyer of the partnership interest fails to withhold and cannot demonstrate that an exception from the obligation to withhold was satisfied.

The buyer must now deliver a certificate to the partnership, no later than ten days after the closing, proving that it satisfied its Section 1446(f) withholding obligations. This certification must also include any certifications that the transferee relied on to apply an exception to withholding, or to determine the amount to be withheld.

This is a major departure from market practice for secondary buyers. Historically, secondary buyers often relied on informal diligence to ensure that their withholding obligations were satisfied. This is no longer possible, as a buyer must now provide documentary evidence to the partnership, in the form of one of the certificates noted above, showing that an exception to withholding was met. A buyer has a vested interest in ensuring that such obligation is properly documented, as otherwise the partnership may withhold a portion of the distributions due and payable to the buyer to satisfy the partnership's own residual withholding obligations. Purchase and sale negotiations since 1 January have accordingly focused heavily on ECI matters, with buyers demanding extensive ECI representations and deliverables (that sellers often don't want to give).

This is also a major departure from market practice for the underlying partnerships. In most secondary transactions, private funds take the position that they are doing their limited partners a favour by allowing transfers and will accordingly take on none of the liability in connection therewith. Prior to 1 January 2023, partnerships bore no liability for secondary withholding. Now, if the partnership does not affirmatively verify that a buyer's withholding obligation was satisfied, the partnership itself is on the hook for any withholding shortfall. To avoid such liability, private funds have revamped their transfer agreements to require new ECI representations, deliverables and processes to ensure that any such withholding liability remains with the buyer and seller.

Practically, the revised secondary withholding rules add a new layer of difficulty to any secondary transaction. The additional purchase agreement representations and deliverables relating to secondary withholding obligations mean that secondary transactions now require more time, effort and expense. The additional effort required from private fund partnerships to collect, review and comply with their own Section 1446(f) obligations, in order to avoid any residual liability, will also increase the total cost to be borne by secondary buyers and sellers (who typically reimburse the partnership for all transfer expenses).

These changes are particularly important considering the growing size of the secondary market. Over the past 15 years, secondary transaction volume has skyrocketed from approximately USD20 billion in 2008 to over USD100 billion in 2022. According to Jefferies, 50% of limited partner portfolio transactions in 2022 were first-time sellers. As the secondary market expands, a growing number of buyers and sellers will need to understand how to successfully navigate these new withholding rules.

Private Fund Rules

The most important change to the private fund regulatory landscape in 2023 arrived with the passage by the US Securities and Exchange Commission of highly anticipated new rules and amendments to the Investment Advisers Act of 1940 (the "Advisers Act") that will significantly impact how private funds are managed and administered (the "Private Fund Rules"). Certain material changes to the Advisers Acts that are covered by the Private Fund Rules, and that affect investment advisers in the United States, are summarized below.

Private Fund Audits Rule

A registered investment adviser that provides investment advice directly or indirectly to a private fund must now cause the fund to deliver audited financial statements to the private fund investors. While many private funds already provide audited annual financials to their investors, this will now be mandatory for all funds with registered investment advisers.

Quarterly Statement Rule

The Private Fund Rules also require registered investment advisers to provide quarterly reports to private fund investors. Such quarterly reports must include a table of the fund's fees and expenses, including detailed accounting of all compensation paid to the investment adviser and all other organisational, accounting, legal, administration, audit, tax, due diligence and travel fees and expenses paid by the fund, along with detailed disclosures of the criteria used in calculating such information. Most private funds already provide their investors with quarterly reports, although such reports are usually limited to basic financial information. The level of detail now required to be included in such quarterly reports for funds with registered investment advisers, while not uncommon for side letter agreements with larger investors, is much more in depth than most funds are accustomed to preparing and will require considerable additional effort to implement.

Adviser-Led Secondary Transactions Rule

In connection with any adviser-led secondary transaction, where a registered investment adviser offers a private fund client's investors the choice between (i) selling their interests in the private fund, and (ii) converting or exchanging their interests in the private fund for interests in another investment vehicle, the registered investment adviser is required to obtain and distribute to investors either a fairness opinion or a valuation opinion from an independent third party. The delivery of such opinions is not a universal practice for adviser-led secondaries today, and the implementation of this rule will accordingly increase the cost and administration of such transactions.

Restricted Activities Rules

All investment advisers to private funds are now prohibited from engaging in the following activities, which will likely require significant changes to many private fund procedures:

- charging fees and expenses associated with the investigation of the investment adviser by any government or regulatory authority to a private fund client, unless a majority in interest of the unaffiliated fund investors otherwise consents (and provided that the investment adviser is not sanctioned following such investigation);
- charging the regulatory or compliance fees and expenses imposed on an investment adviser to a private fund client unless the investment adviser distributes a written notice of such fees and expenses to the fund's investors within 45 days after the end of the fiscal quarter in which such fees and expenses were incurred;
- reducing the amount of an investment adviser's claw-back to be the net of actual, potential, or hypothetical taxes, unless the investment adviser provides written notice to the fund's investors within 45 days after the end of the fiscal quarter in which the claw-back occurred;
- charging fees and expenses relating to a portfolio investment held by multiple private fund clients on a non-pro rata basis unless (i) such allocations are fair and equitable, and (ii)

notice thereof is provided to the private fund clients prior to making such allocations; and
- borrowing private fund client assets or receiving a loan or an extension of credit from a private fund client, unless a majority in interest of the unaffiliated fund investors otherwise consents.

Preferential Treatment Rule

One of the most important changes made by the Private Fund Rules relates to preferential treatment for certain fund investors. Very generally, all investment advisers are prohibited from providing private fund investors with certain preferential rights unless such rights are disclosed or offered to all other prospective and current investors. Specifically, an investment adviser may not (i) unless required by applicable law, grant an investor the ability to redeem its interests in a private fund on terms that are reasonably expected to have a material, negative effect on the other investors in the private fund or a similar pool of assets, or (ii) provide a fund investor with private fund information if the investment adviser reasonably expects that providing such information to the investor would have a material, negative effect on the other investors in the private fund or in a similar pool of assets, in each case unless the investment adviser contemporaneously offers such information or redemption rights to all other existing investors in the private fund and any similar pool of assets. Investment advisers are further prohibited from providing any other preferential treatment to a fund investor unless notice of such preferential treatment is provided to the fund's other existing and prospective investors.

The Preferential Treatment Rule is likely to have an extensive impact on how private funds negotiate and agree to side letter provisions with investors. Prior to the adoption of the Private Fund Rules, market practice for many private equity funds was to enter into side letters with larger investors in order to grant them certain preferential rights. Under the Private Fund Rules, however, the investment adviser will now be required to offer any preferential information and redemption rights, and disclose the terms of any other preferential rights, to all investors. The real difficulty arises, however, in that by its terms the rule covers not only the treatment of investors in a single fund, but also investors in a "similar pool of assets". The definition of a similar pool of assets is very broad and includes co-investment vehicles, joint ventures and any other pooled vehicle with at least a partially overlapping strategy with the private fund. It is likely to be very difficult for investment advisers to administer this rule and, going forward, investment advisers will need to consider when preferential rights need to be shared with other clients when negotiating investor side letters.

There has not yet been enough time to unpack the full magnitude of the new Private Fund Rules, although it is abundantly clear that they represent sweeping changes to the regulatory regime for private funds. All investment advisers need to review their current reporting and disclosure policies to ensure compliance with these rules and, given the extensive divergences from current market practice noted above, private fund investors will likely be the beneficiaries of many new reporting policies and heightened fund disclosures in their future dealings with private funds.

A Brave New World

The year is not yet over, but the private fund market in 2023 has already witnessed several sweeping new regulatory and legal changes. From increased European AML obligations, to cumbersome new US secondary withholding requirements, to sweeping new private fund rules for investment advisers, private fund participants in 2023 are witnessing a vastly different regulatory and legal landscape than in prior years. Only time will tell the real impact of these changes, but in any event, private fund attorneys will certainly need to be very familiar with the new status quo to properly advise clients in this brave new world of ever-increasing regulation.

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