ROPES & GRAY

PRIVATE FUNDS REPORT

2020 YEAR IN REVIEW AND A LOOK AHEAD

VOLUME 1

A NEW PRIVATE FUNDS RESOURCE

WELCOME TO THE FIRST EDITION OF *PRIVATE FUNDS REPORT*, a new collection of insights that we plan to publish intermittently throughout the year to supplement the content we produce already. We hope you'll find our articles easily accessible, conversational and to the point—our goal is to provide topical perspective without burdening you with excess detail that could obscure the key issues on which you might want to focus initially. We would welcome your feedback on this new resource.

2020 was a year dominated by the COVID-19 pandemic (please refer to our Coronavirus Resource Center for further information). The public markets roller-coastered up and down, and M&A activity dramatically slowed in the early part of 2020, bouncing back in earnest in the second half of the year. Likewise, fundraising was slow during the second quarter of 2020, but rebounded to a large extent later in the year, with funds ultimately raising similar amounts of capital as they did in 2019, but with a smaller number of large funds stealing the limelight.

Private Funds Report opens with a more detailed look at 2020 fundraising trends. We then explore the regulatory environment in 2020 in the United States and Europe, the effects of the pandemic, and what we might expect in 2021, particularly in light of the new US administration and Brexit.

Two core areas of focus and growth in 2020 were the secondaries market and credit funds. Given their prominence during the year, we examine both of these areas in this edition. We conclude this inaugural edition with a look at environmental, social and governance, or ESG, issues. ESG matters came to the fore in this year of pandemic, with the industry responding positively to investor demand and increased regulatory focus in this area—momentum we expect to continue through 2021.

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To supplement the information in this report, we have provided links to other content we have produced on these topics, including articles, focused reports and podcasts. In addition to providing perspective through future editions of *Private Funds Report*, we are always available to discuss any issue or query in depth virtually or in person, as circumstances allow. We hope you will join us for future webcasts, and encourage you to access the numerous on-demand recordings and content available at ropesgray.com.

In the meantime, we wish you and your loved ones a healthy, safe and successful start to 2021—hopefully with some in-person meetings soon.

—The *Private Funds Report* Editors

FUNDRAISING

The private funds market, like most other markets, was notably impacted by the COVID-19 pandemic last year, with China being one of the only countries to report positive economic growth. However, many of the trends witnessed in 2020 were already on the horizon prior to the pandemic, which has merely hastened these changes. In 2021, we are expecting an acceleration of current fundraising activity levels and a return of less institutionalized market players.

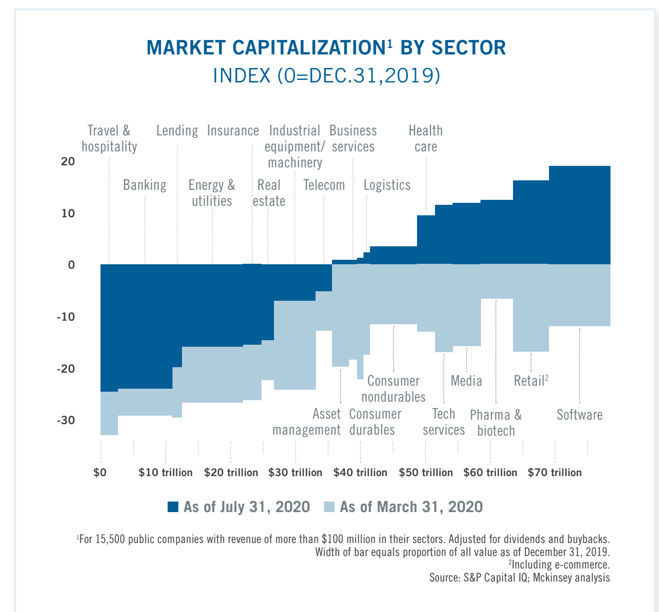
In particular, we anticipate that many fundraises that were paused or delayed in 2020 will re-emerge, and investors that invested heavily at the start of 2020 will return to the market. With the resumption of international travel, investors will once again be able to conduct on-site due diligence—an element of due diligence that proved, by its temporary impracticability, to be a key step in enabling investors to be comfortable investing in new funds, especially with emerging managers. We also expect the growth in the credit market to accelerate, as changes in valuation and performance have made the potential upside of credit products attractive to a larger pool of investors.

FUND SIZE AND FOCUS

As 2020 followed a very active fundraising period across 2018 and 2019, it is no surprise that the COVID-19 crisis caused a slowdown in buyout fundraises, particularly with less established players. Certain sectors, such as the consumer sector, were also disproportionately hit by lockdowns and other measures put in place during the pandemic.

On a total commitments basis, however, the decline was less substantial, with investors favoring larger funds and funds backed by established sponsors with known track records and relationships preceding the pandemic. Significantly fewer funds closed in 2020, compared to 2019, but aggregate commitments did not decline materially.

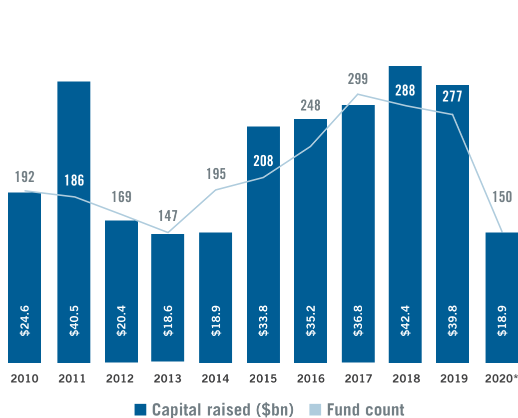
While the general fundraising trend favored the largest and most institutionalized players, fundraises for strategies that focused on themes relevant to this period also saw some success. These include funds focusing on credit, health care, technology, FinTech, cloud computing, e-commerce, logistics/infrastructure and renewable energy, as well as those established to take advantage of specific government programs (e.g., TALF in the United States). Likewise, the market saw a significant rebound in deal volume during the third and fourth quarters, driven particularly by transactions in industries that have been resilient to the pandemic, such as technology and health care. The technology industry, in particular, has benefited from the surge in dedicated technology funds organized in 2019 and early 2020. Similarly, a number of successful fundraises in Asia were backed by small-cap, industry-specialist sponsors, suggesting we may see a gradual shift away from generalist and sector-agnostic strategies.

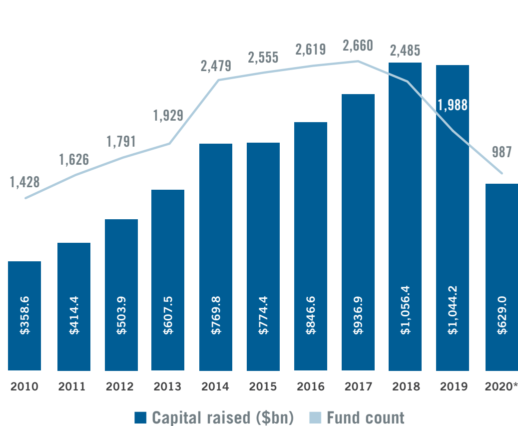


[1]For 15,500 public companies with revenue of more than $100 million in their sectors. Adjusted for dividends and buybacks. Width of bar equals proportion of all value as of December 31, 2019.
[2]Including e-commerce.
Source: S&P Capital IQ; Mckinsey analysis

Fundraises generally took longer in 2020, with extended completion times. Some delays were temporary—for example, in the early days of the COVID-19 crisis, both sponsors and investors needed to adapt to remote working

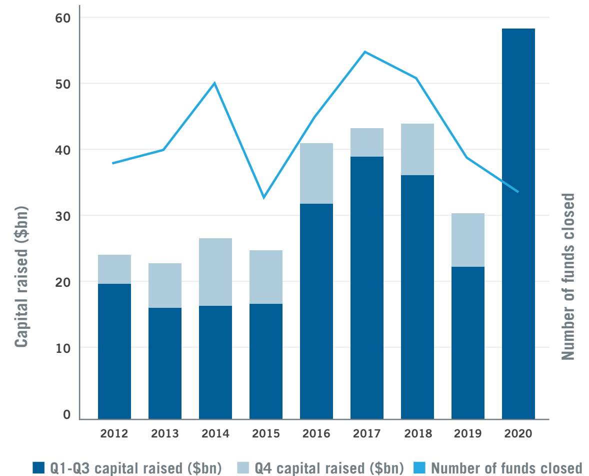
and fully electronic closings. Others, however, have been more persistent. Sponsors, in many cases unable to advance their fundraise plans on their intended timelines, turned to other ways to capitalize on favorable aspects of the market, such as pursuing deals outside of the ordinary fund structures (initially by warehousing deals), fundraising on a deal-by-deal basis, or pivoting to continuation vehicles. Some sponsors looked to capitalize on the boom in special purpose acquisition companies, whether as a means of investment for existing fund vehicles or as standalone business lines.





DEMAND GREW FOR SECONDARIES TRANSACTIONS, SINGLE ASSET FUNDS, CO-INVESTMENTS AND RECAPITALIZATIONS

The slowdown in traditional fundraises did not result in a slowdown in private funds activity overall. In fact, many more secondary processes were completed in 2020, and there were numerous GP recapitalizations. More capital was raised for secondaries in the first nine months of 2020 than during any previous full year, as illustrated by the chart below.



The second quarter of 2020 saw a general freeze on secondaries transactions, as market participants waited for valuations to settle, while the third quarter, in contrast, saw rejuvenated interest in the secondaries market. Another notable trend was the increase of fund recapitalizations and single asset fundraises, with primary fund investors providing top-up funding for selected assets in GP portfolios.

We saw an increase in co-investment activity in general, particularly in nontraditional co-investment deals, such as co-investments in alternative credit funds and activist funds, co-investments in independent sponsor

deals, and co-investments in public-to-private transactions. GPs who were reluctant to exit a deal, or wished to hold onto certain assets, turned increasingly to the secondaries market and offered further co-investment opportunities for investors to participate in these deals. There was also an uptick in co-investments being co-underwritten, rather than being syndicated by sponsors.

Interestingly, the market also saw a reverse in other trends, with some of the traditional buyout funds tapping into minority investment opportunities, especially in the technology sector.

ENVIRONMENTAL, SOCIAL AND CORPORATE GOVERNANCE (ESG) AND IMPACT INVESTING

Sponsors' focus on ESG continued to grow, as sponsors focused on the development of ESG policies and procedures. This was in large part due to managers anticipating increased investor demand, further regulation from the EU (and possibly in post-Brexit UK), the prospect of a shift in the United States' environmental policy during a Joe Biden presidency, and a general sense that a focus on these issues is important and timely among the industry players.

The pandemic also drove quite a few investors to increase their focus on ESG. This trend was evident even in the credit space, where investors sought to ensure that managers were having regard for ESG factors, and were not capitalizing on the pandemic as an opportunity to disregard or overlook ESG principles.

Consistent with the focus on ESG, we continued to see a growing interest in impact funds from a broad range of sponsors, including existing sponsors, new sponsors and nonprofits.

US–CHINA TENSIONS

US–China relations underwent a period of unprecedented turmoil in 2020, with a slew of retaliatory regulations from both the United States and China limiting the sale and operations of key strategic and military technologies and companies, such as TikTok and SMIC. Regulations included China's Unreliable Entities List, the United States' delisting bill, the US Executive Order in respect of Communist Chinese Military Companies and the US Hong Kong Autonomy Act.

Correspondingly, due diligence measures in M&A became increasingly important to investors in assessing and mitigating the risk of supply chain shocks and overall compliance risks with respect to sanctions and other related issues, especially for businesses reliant on key technologies or intellectual property rights held by foreign entities (such as tech and research and development-heavy companies). Additionally, PE investors favored take-privates of Chinese-owned companies on US stock exchanges, likely in view of the United States' China delisting bill (passed in December 2020), and both primary and secondary listings on the Hong Kong and Shanghai stock exchanges increased dramatically.

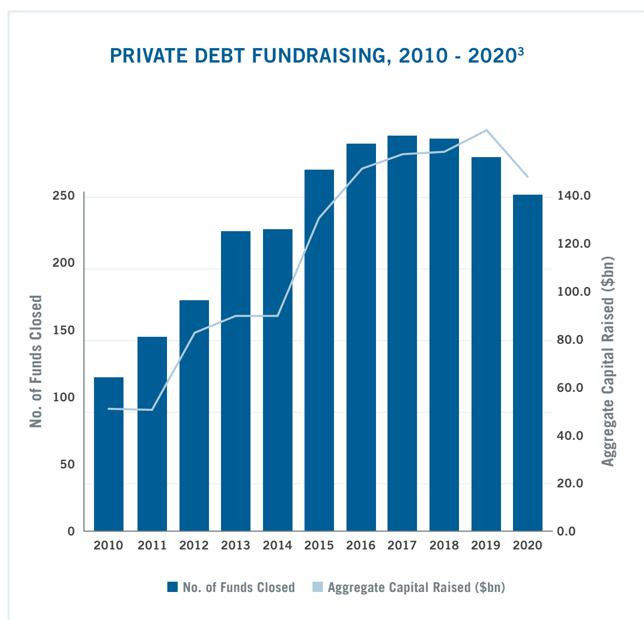
DECLINE IN NAV-BASED OPEN-ENDED PRODUCTS AND DIRECT LENDING; INCREASE IN THE CREDIT MARKET AND SPECIAL SITUATIONS

The arrival of the pandemic saw valuations decrease and a decline in risk appetite from direct lenders, which contrasted with the pre-pandemic boom, when direct lending was borrower-friendly and aggressively levered. The growth of the credit market, on the other hand, has continued, particularly in Europe and North America, and there has been a notable shift toward special situations and global credit strategies. Large managers offering these products have, in particular, been successful in attracting investors.

2020 saw a decrease in investor demand for NAV-based open-ended products more generally, and earlier in the year, many transactions were paused due to market volatility and the difficulty in obtaining up-to-date asset valuations, since valuations lagged market conditions. The difficulty with pricing was likely underway prior to the pandemic, and has since accelerated.

EXPECTATIONS FOR 2021

We expect that many fundraises paused or delayed in 2020 will be coming to the fore in the early to middle part of 2021. Many investors that committed their 2020 investment allocations at the start of 2020, before the outbreak of COVID-19, will be returning to the market.



Assuming that the health crisis improves in 2021 and travel begins to resume, we think it is likely that less institutionalized managers will be out in the market and raising successfully. On the other hand, to the extent that travel restrictions continue well into the year, we anticipate that many investors may have to reassess their requirements for in-person due diligence as a condition to committing to new or emerging managers. We anticipate that many PE deal professionals will continue to think about where and how they work, and the extent to which travel is necessary to perform their jobs well.

In 2021, due to the volatility in asset valuations that we witnessed in 2020, we may see NAV-based open-ended funds replaced by close-ended hybrid vehicles that attempt to do some level of evergreen investments within a traditional runoff period, or funds with different debt vintages included throughout that vehicle to extend the lifetime of the fund.

In Asia, with the continued development of the private funds market and significant capital being allocated to the region, we should expect to see more competition for deals and greater interest in sponsors that can provide value-add. As a result, over time we expect to see fewer growth funds and, instead, more buyout funds and earlier-stage venture capital funds.

Although Joe Biden's inauguration marks a change in administration, US policy on China is expected to change primarily in style, but not in substance. We can expect investors to be doing heightened diligence in fund investments in China and possibly seeking enhanced rights to opt out of particular investments as a way to manage potential regulatory exposure without categorically foregoing all investment opportunities in the region.

FOR FURTHER INFORMATION on our Private Funds practice, click here.

Please see below for additional Ropes & Gray thought leadership pieces related to this topic:

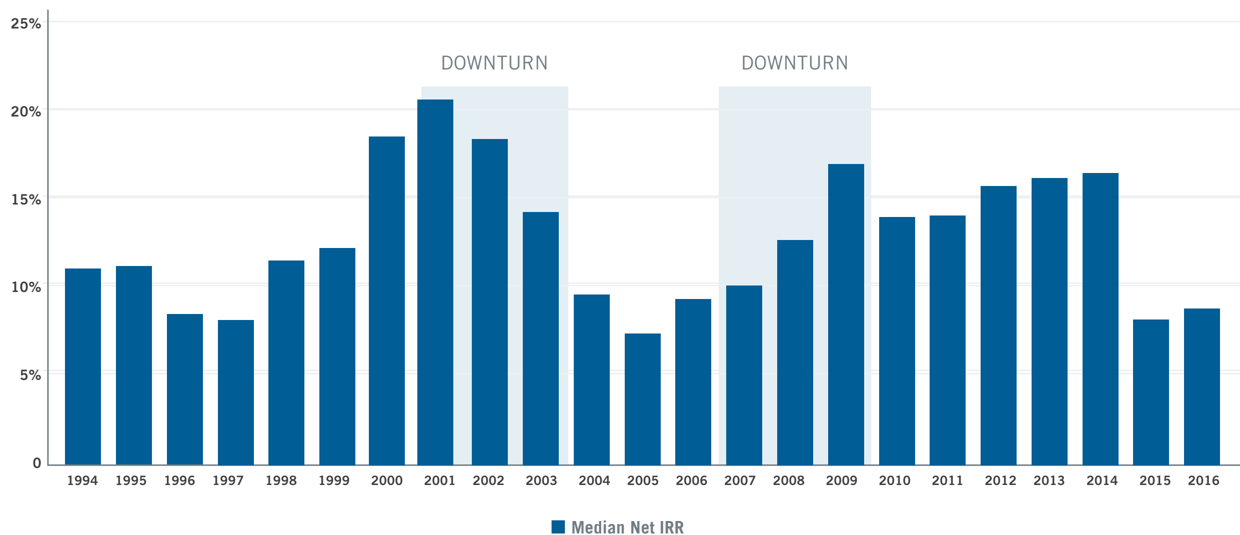
- Analysis of Recent SEC Disclosure Guidance Regarding Special Purpose Acquisition Companies (Article), January 19, 2021 – Christopher Capuzzi, Paul Tropp, Paul Kellogg, Annie Hancock
- COVID-19: Pandemic Fundraising Insights and What Lies Ahead for Private Equity in 2021: Conversation with Tom Burger, Gridiron Capital (Podcast), January 8, 2021 – Deb Lussier, Paul Van Houten

Finally, we anticipate that the growth in the credit market, and PE funds more generally, is likely to continue in an accelerated manner, since vintages raised around the global financial crisis were among the best-performing vintages. From a deal perspective more broadly, the first quarter of 2021 is off to a strong start, and we expect that trend to continue, particularly in the technology and health care sectors.

We are also seeing an increasing number of investors looking at credit products in Europe. Until recently, the risk-return profile was only attractive to a small number of investors within the European market. However, due to changes in valuation and performance, the potential upside from some of these credit products means that they have become more attractive to a growing number of European investors, and so we may see a proliferation of players on the continent in Europe and in the UK.

Additionally in Europe, public market transactions, including P2Ps, continue to be attractive, but PIPEs have continued to struggle compared to the US market because of the regulatory regime. We hope to see more SPAC activity in 2021, following the trends in the United States this year and a potential loosening of the regulatory regime following Brexit. While we expect deal activity to remain subdued in the ongoing uncertainty, investors continue to have record levels of dry powder and will be looking to take advantage of opportunities where they are able to differentiate themselves—for example, distressed or turnaround M&A, carve-outs, and sector track record. With an EU trade deal finally executed, we also expect investors to look at the UK with renewed confidence.

—Tom Alabaster, Arthur Andersen, Vincent Ip, Morri Weinberg



REGULATORY

UNITED STATES

The SEC's Office of Compliance, Inspections, and Examinations remained active in 2020. While certain longstanding aspects of the SEC's playbook endured (e.g., a focus on fees/expenses, conflicts of interest, affiliated service providers and allocations of investment opportunities), the exam process evolved to reflect the realities of the COVID-19 era. Despite initial disruption, exams this year moved at a rapid clip. After kicking off virtually via WebEx, advisers encountered a Staff that was more forthcoming with interview agendas and flexible with deadlines.

Those changes may not last through 2021, but several exam priorities will, including a focus on business continuity planning. Advisers will want to prioritize remote readiness, supervision of remote employees, cybersecurity and monitoring service providers. Valuation also gained traction this year and will likely remain a key priority as the market adjusts to the impact of COVID-19, with the SEC scrutinizing changes to valuation methodology and whether write-downs are appropriately accounted for in fee calculations.

2020 was a busy year on the rulemaking front, as well. The SEC modernized the advertising and solicitation rules, which will, once effective, allow certain testimonials and endorsements and offer tailored requirements for the presentation of performance results that depend on the intended audience.[5]

The SEC proposed raising the Form 13F reporting threshold from $100 million to $3.5 billion;[6] that proposal has received substantial negative comment,[7] and appears unlikely to be adopted as proposed. The SEC also amended proxy solicitation rules to ensure robust disclosure of conflicts of interest,[8] and modernized rules for exempt securities offerings, including allowing investors to qualify as "accredited investors" based on professional knowledge, experience or certifications.[9]

Looking ahead, we expect to see an uptick in exam sweeps testing for LIBOR transition readiness.[10] We expect that SPACs, too, will be front and center, with regulators monitoring for misstatements or omissions in regulatory filings and ensuring disclosure of conflicts relating to compensation and incentives to sponsors.[11] ESG will likely also receive renewed attention by regulators, and advisers will want to ensure that they adhere to any policies they have in place on that front.[12] 2021 brings a new year and with it, new presidential and SEC leadership. Advisers should brace for the potential of an invigorated and more aggressive SEC by, as always, proactively identifying and mitigating regulatory risk.

UK AND EU

From a UK and EU perspective, 2020 was not a key year for regulatory change, but more of a year where continued groundwork has been done by regulators for changes due to happen in 2021 and beyond; for example, in relation to ESG, capital requirements and cross-border marketing. (ESG developments are explained in further detail in the "ESG Investing" article on page 16.) In addition, we have seen the commencement of the review of key pieces of legislation impacting asset managers, including AIFMD and MiFID.

One of the main regulatory issues during 2020 was the continued focus on Brexit. While a deal was reached at the eleventh hour, this did not extend to financial services. Many managers spent 2020 assessing their options and putting contingency plans in place. As we look ahead this year, we will see how the market evolves and whether any further progress can be made in reaching a more consistent way UK managers can operate in the EU.

In relation to COVID-19, from a regulatory perspective, regulators did not provide significant dispensations from the relevant rules for many institutional asset managers, so managers needed to continue to comply as usual. One of the key areas of focus for regulators during the pandemic has been compliance with market abuse rules—throughout the year, there has been a clear expectation

from regulators that compliance should remain a major focus despite the pandemic and remote working.

—*Jason Brown, Eve Ellis, Anna Lawry, Joel Wattenbarger*

FOR MORE INFORMATION on Ropes & Gray's Regulatory practice, click here.

For more information on recent regulatory developments, including SEC exam and enforcement updates, please refer to Ropes & Gray's 2020 Private Funds Regulatory Updates Series.

SEC ENFORCEMENT

After a slow start at the outset of the pandemic, the SEC's Division of Enforcement adapted to remote work and continued to prioritize enforcement against investment advisers. Out of the total 719 actions brought in either federal court or as administrative proceedings during the 2020 fiscal year (which closed on September 30, 2020), 19% (or 137) involved issues relating to investment advisers and investment companies.[13] These efforts reflect a continued focus on several recurring issues relevant to investment advisers:

- **MANAGEMENT OF MATERIAL, NONPUBLIC INFORMATION (MNPI).** In May, the SEC settled an action with Ares Management LLC for its alleged failure to implement adequate MNPI controls in connection with its open market purchase of the publicly traded stock of an existing portfolio company.[14] The case was particularly notable because the underlying trading at issue occurred during the issuer's open trading window. The SEC nonetheless took issue with compliance personnel's alleged failure to conduct a substantive assessment of all potential sources of MNPI, including potential MNPI obtained both by the firm's board designees and in connection with a debt investment. Critically, the order did not charge Ares with insider trading or even allege that Ares possessed actual MNPI. The Staff's determination to nevertheless bring an enforcement action underscores the Staff's focus on ensuring that MNPI policies and procedures are not simply a "check-the-box" exercise, but rather involve active participation by compliance.

- **CROSS TRADES AND "PIGGY-BACKED" PRINCIPAL TRANSACTIONS.** The SEC continued to pursue matters involving cross trades with private funds, including where an adviser executes cross trades through an independent broker-dealer for a small commission and otherwise ensures that the price of the traded security is fair to both the buying and the selling client. In *Palmer Square Capital Management,* the SEC challenged cross trades involving private fund clients in which the adviser's controlling persons owned more than 25% of the fund and other non-registered investment company clients, which the SEC contended also constituted prohibited principal transactions.[15]

- **INVESTMENT STYLE DRIFT AND RISK MANAGEMENT.** The SEC has focused on portfolio risk management and the need for adequate written policies and procedures in place to manage representations regarding a fund's risk profile, a focus that will likely increase in light of recent market volatility. As an example, the SEC recently settled a case against a firm that allegedly failed to implement risk management procedures to limit geographic-based currency positions in a fund, when it represented to investors that its management style was "driven by risk management."

- **FOCUS ON CREDIT.** The past year has also brought a heightened industry focus on valuation and trading issues in credit markets. Of particular interest are situations in which an adviser or sponsor trades in the debt or loans of an affiliated portfolio company. Such a scenario creates a

number of issues that could, depending on the facts, attract the SEC's attention, such as MNPI controls, conflicts of interest and related disclosures, as well as allocation issues.

Advisers should expect more aggressive investigation and enforcement under the new Biden administration. While the new administration may shift some focus, the SEC will likely continue to prioritize issues associated with the areas highlighted above, which represent higher risk, given recent extreme market volatility and dislocation.

—Eva Carman, Dan McCaughey, Matt McGinnis, Dan O'Connor, Dan Ward

FOR MORE INFORMATION on our Securities & Futures Enforcement practice, click here.

For more information on SEC enforcement developments impacting private funds, please refer to the following Ropes & Gray thought leadership piece:

- Private Funds Regulatory Update Series - SEC Enforcement Updates (Webinar), October 21, 2020 – Eva Carman, Dan O'Connor, Dan McCaughey

DEPARTMENT OF LABOR RULEMAKING

After years of relative inactivity on the regulatory and guidance front, the US Department of Labor (DOL) unleashed a deluge of major regulations and other actions of relevance to asset managers starting in mid-2020, impacting the roles and responsibilities of ERISA plan fiduciaries. Instead of breaking entirely new ground, most of this guidance is intended to definitively resolve longstanding questions such as the final fate of the DOL's 2016 fiduciary project; the proper role of environmental, social and governance (ESG) factors in fiduciary investment decision-making; and whether private funds can be offered to 401(k) plan participants. A number of these actions are expected to have a significant impact on the asset management industry in 2021 and beyond, but there is also the possibility of further change in these rules through DOL action, legislation or the courts.

The first major action by the DOL was its June 3 information letter on how defined contribution plans (such as 401(k) plans) can include private equity investments as part of a broader diversified investment menu.[16] While the letter did not change the law, it clarified the DOL's view that under existing law, private funds can be incorporated into target date funds and other multiclass asset allocation funds commonly offered to 401(k) participants. The letter opens the door to hundreds of billions of dollars in potential investment capital, and based on the high levels of interest we have seen from clients, we expect fund of fund, target date and private fund managers to continue to pursue this opportunity in 2021 (and beyond).

The DOL also launched twin regulatory projects over the summer, with expanded regulations that would have broadly prohibited ERISA fiduciaries from considering ESG and other collateral considerations in making investment decisions and voting proxies. The proposed versions of both rules took a prescriptive approach that would have sharply limited investment options for ERISA plans and would have required substantial (and expensive) new compliance and diligence practices for plan fiduciaries. The DOL provided 30-day comment periods for both rulemakings, and received thousands of comments, the large majority of which were sharply negative.[17] In response to these comments, the DOL released substantially revised final regulations on ESG (October 30) and proxy voting (December 11).

The final ESG rule is best understood as an incremental expansion of the DOL's longstanding guidance on

the need for fiduciaries to make investment decisions based solely on the financial interests of plan participants, and not on collateral considerations.[18] Without explicitly referring to ESG, the final rule requires fiduciaries to focus solely on "pecuniary factors," which are defined as factors that a fiduciary prudently determines are expected to have a material effect on the risk and/or return of an investment, based on appropriate investment horizons consistent with the plan's investment objectives and funding policy. In addition, the fiduciary must ensure that when it assigns relative weights to these factors, it bases those weights on a prudent assessment of the impact of each factor on risk and return. In practice, we expect this rule to require managers to reassess how they market their ESG capabilities and philosophies, and may require changes in how the investment decision-making process is documented. Many managers already include risk factors of ESG investing and other descriptions of how ESG is incorporated in the investment process, which may make it easier to comply with the rule. It is important to ensure that all marketing materials and disclosure documents align on this issue, to avoid making it more difficult for an ERISA fiduciary to choose a fund because of inconsistent indications that ESG may play a greater role than is intended for that fund. This rule will pose particular challenges to managers that are also subject to the EU's rules, and navigating the intersection of these rules will require care and special consideration. The DOL's ESG rule is in many ways contrary to the EU's rules; however, the EU's rules generally do not expressly require consideration of nonpecuniary factors, so developing and clearly articulating the economic rationale for considering ESG factors is vital to complying with both regulatory regimes.

FOR FURTHER INFORMATION on our Executive Compensation & Employee Benefits practice, click here.

For further background about each of these developments and other related topics, please refer to the following Ropes & Gray thought leadership pieces:

- The DOL Releases Final Investment Advice Prohibited Transaction Exemption (Article), December 21, 2020, Joshua Lichtenstein, Peter Rosenberg, Sabrina Glaser
- The DOL Finalizes Regulation Imposing New Obligations for Plan Sponsors and Asset Managers in Connection with Proxy Voting and Other Exercises of Shareholder Rights by ERISA Plans (Article), December 16, 2020, Joshua Lichtenstein, Peter Rosenberg, Sabrina Glaser
- ESG: Integrating EU and DOL Requirements (Podcast), December 16, 2020, Eve Ellis, Joshua Lichtenstein
- DOL Finalizes Rule on ESG Considerations for ERISA Plan Investments (Article), November 2, 2020, Melissa Bender, Isabel Dische, Joshua Lichtenstein, Michael Littenberg, Emily Oldshue, Peter Rosenberg, Sabrina Glaser
- The Next Chapter in the DOL's Fiduciary Rule Saga: Relief for Investment Advice Fiduciaries (Article), July 2, 2020, Joshua Lichtenstein, Peter Rosenberg, Sabrina Glaser
- DOL Proposes Rule to Severely Restrict ESG Considerations in Selecting ERISA Plan Investments (Article), June 26, 2020, Melissa Bender, Isabel Dische, Joshua Lichtenstein, Michael Littenberg, Emily Oldshue, Peter Rosenberg, Sabrina Glaser
- The Department of Labor Provides a Road Map for Offering Private Equity and Other Alternative Investments in 401(k) Plans (Article), June 8, 2020, Joshua Lichtenstein, Peter Rosenberg, Sabrina Glaser
- COVID-19: Credit Funds: Considerations for Credit Fund Managers Overseeing ERISA Plan Assets in Light of the Pandemic (Podcast), May 13, 2020, Joshua Lichtenstein, Jessica O'Mary

The DOL's proxy rule is not expected to have as immediate an impact as the ESG rule, but it will require asset managers of ERISA mandates to either follow the proxy voting policies of their plan clients or to adopt new policies, to which ERISA clients will need to agree.[19] Managers of ERISA mandates should begin considering what their ESG proxy voting policies will look like and work on developing new, client-facing policies over the course of 2021. Managers should also begin to evaluate their reliance on proxy advisory firms, to the extent they are currently utilizing their services.

In addition to these regulatory actions, the DOL issued a new fiduciary rule package.[20] Unlike the 2016 rule, which significantly expanded the universe of investment-advice fiduciaries under ERISA, this rule package leaves the range of fiduciaries largely unchanged from the DOL's 1975 interpretation. Notably, the package recharacterizes as fiduciary investment advice recommendations to roll over assets from a plan or IRA to another plan or IRA. The most significant piece of this package is a new prohibited transaction exemption, which will permit broker-dealers and other investment-advice fiduciaries to receive a potentially broader range of transaction-based fees and compensation, which should broadly align with permissible forms of compensation under the US Securities and Exchange Commission's Regulation Best Interest. The exemption also significantly expands the ability of fiduciaries to engage in certain principal transactions with plans. Asset managers should consider whether and how the new flexibility presented under the rule package may assist their businesses, and if the business opportunities are determined to be valuable to a manager, then the manager should begin to develop the required policies and processes to rely on the exemption.

All of these rules remain subject to potential change or clarification by the new administration, the courts and/or legislative action. Asset managers are advised to continue to watch the DOL's activity closely.

—Joshua Lichtenstein

LIBOR TRANSITION FOR THE BUY SIDE

In the wake of the London Interbank Offered Rate (LIBOR) fixing scandal, regulators and industry groups recommended that market participants adopt alternative, overnight risk-free rates (RFRs) to replace key interbank offered rates, such as LIBOR. In the case of LIBOR, the UK Financial Conduct Authority (FCA) announced in 2017 that it would not compel or persuade LIBOR panel banks to submit to LIBOR after the end of 2021. As a result of that announcement and subsequent developments, the existence of LIBOR after that date is fundamentally uncertain. Global efforts to transition away from LIBOR to RFRs before LIBOR ceases or becomes nonrepresentative have accelerated.

As asset managers work toward transitioning away from LIBOR, the importance of planning and preparation cannot be understated. LIBOR cessation will have wide-ranging impacts on an asset manager's business, including on trading and investments, operations, risk, investor relations, marketing, compliance and legal functions.

The US Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE) identified LIBOR transition preparedness as an examination program priority for fiscal year 2020. In June 2020, OCIE published a Risk Alert, including a list of sample examination questions, focused on LIBOR transition preparedness. The Risk Alert highlights five areas of focus related to the LIBOR transition:

- The manager's and investors' exposure to LIBOR-linked contracts that extend past the current expected discontinuation date;
- The manager's operational readiness, including any enhancements or modifications to systems, controls, processes, and risk or valuation models;
- The manager's disclosures, representations, and/or reporting to investors regarding its efforts in respect of the LIBOR transition;

- Identifying and addressing any potential conflicts of interest; and
- Efforts undertaken to replace LIBOR with an appropriate alternative reference rate.

With these areas of focus in mind, managers should consider taking the following steps to prepare for LIBOR's cessation if they have not already done so:

- Form a committee of key stakeholders from the investment, operations, legal, compliance, risk, tax, accounting, investor relations and other relevant teams to assess firmwide LIBOR exposures and prepare a plan and timeline for the transition;
- Conduct a comprehensive review of any documentation and internal and vendor-provided systems and functions that include or refer to LIBOR, including disclosures; fund and investor agreements; trading and investment agreements; vendor contracts; marketing materials; performance composites; information technology systems; and accounting, investor reporting, risk, valuation, and trading systems and functions;
- In the OTC derivatives space, market participants should familiarize themselves with and consider the implications of the contractual fallbacks that automatically have been incorporated into new ISDA-based derivatives transactions via a Supplement to the 2006 ISDA Definitions since January 25, 2021. These fallbacks can also be incorporated into legacy derivatives documentation by adhering to the ISDA 2020 IBOR Fallbacks Protocol;
- Consider incorporating fallbacks in other financial instruments used by the adviser and its clients, including credit agreements, loans, securitized products and floating rate notes;
- Consider implications of any mismatch between LIBOR fallbacks used in hedging arrangements and underlying hedged products, such as loans;[21]
- Review and remediate performance composites and performance advertisements that use LIBOR;
- Review and update fund and investor disclosures and fund documentation;
- Assess and remediate use of LIBOR-based risk or valuation models (internal and vendor-provided systems);
- Update information technology systems (including accounting, investor reporting, risk, valuation and trading) and compliance procedures and controls;
- Communicate with boards, investors, clients, vendors and other service providers; and
- Document steps taken to prepare for LIBOR transition in order to respond to investor and client inquiries and SEC examination requests.

—Egan Cammack, Molly Moore

FOR MORE INFORMATION on our LIBOR practice, click here.

For more information on LIBOR developments impacting private funds, please refer to the following Ropes & Gray thought leadership pieces:

- Minding the Gap in LIBOR Transition Between Commercial Loans and Interest Rate Hedges (Podcast), October 19, 2020 – Egan Cammack, Andy Des Rault
- Transitioning from LIBOR to SOFR (Alert), October 5, 2020
- ICI Memo: LIBOR Update – SEC OCIE Issues Risk Alert on LIBOR Transition Preparedness (Podcast), August 3, 2020 – Jason Brown, Jill Kalish Levy
- CFTC Issues LIBOR Transition Relief for Swaps (Podcast), January 6, 2020 – Isabel Dische, Leigh Fraser

SECONDARIES

2020 was a roller coaster of a year in the secondaries market. COVID-19-related market gyrations scuttled a number of transactions in the second quarter, including both portfolio sales and fund recapitalizations, as buyers reassessed their comfort with transacting on legacy marks. While market participants waited for valuations to settle, we saw heightened interest in preferred equity financings—both by fund sponsors looking for liquidity solutions for their portfolio companies, and by institutional investors looking for a way to monetize their fund holdings. By the third quarter of 2020, interest in fund recapitalization and single asset transactions had returned with a vengeance, a trend that only accelerated as fund sponsors sought to complete these transactions before year-end to avoid tax increases anticipated with a Biden administration.

A second noteworthy development for the secondaries market in 2020 was the Treasury Department's publication of final Partnership ECI Transfer Regulations, which will become effective January 29, 2021. On the positive side, the regulations do eliminate the "Form 8805 glitch" and also make clear that partnerships will not have to withhold on transferees until January 2022. However, in the context of a transferor ECI certificate, among other things, the three-year rule continues to apply (in other words, if a seller does not have three years of good K-1s, it cannot provide the certificate). The continuation of the three-year rule will make it much harder to transfer young partnership interests (including more recently formed AIVs). Additionally, the regulations did not provide a specific exception with respect to deemed partnership transfers pursuant to additional limited partner provisions (or other disguised sales), as requested by some commentators.

While a buyer is required to withhold if a specific exemption does not apply, there is a statement that a withholding agent can try to establish that a reduced rate of withholding was appropriate by establishing the amount actually due by the foreign transferor when trying to establish how much the withholding agent owes to the IRS. Further, the regulations provide that if a buyer can establish "to the satisfaction of the Commissioner" that there was no ECI, interest and penalties will not apply. It is unclear how hard it would be to establish these items. Finally, once partnerships are required to withhold in January 2022, they can withhold even if the relevant certificates are otherwise in good order. The cumulative

FOR FURTHER INFORMATION on our Secondary Transactions practice, click here.

For more information on secondaries developments impacting private funds, please refer to the following Ropes & Gray thought leadership pieces:

- 2020 Secondary Market in Review (Podcast), January 25, 2021 – Isabel Dische, Adam Dobson, Vincent Ip, Dan Kolb, Chune Loong Lum
- COVID-19: End of Life Fund Issues (Podcast), January 6, 2021 – Jason Kolman, Steven Zaorski
- Rep and Warranty Insurance in the Context of Fund Recapitalizations: Considerations for Both Fund Sponsors and Investors (Podcast), December 10, 2020 – Isabel Dische, Adam Dobson, Steven Kaye
- Single Asset Recapitalizations: Considerations for Both Fund Sponsors and Investors (Podcast), November 9, 2020 – Isabel Dische, Adam Dobson, Dan Kolb, Peter Laybourn
- Preferred Equity Financings: Tools for Both Fund Sponsors and Investors (Podcast), May 7, 2020 – Isabel Dische, Adam Dobson, Dan Kolb
- COVID-19: Recent Developments in Credit Funds Secondaries: Has the Pandemic Introduced New Opportunities? (Podcast), April 15, 2020 – Isabel Dische, Katie Waite

impact of the Partnership ECI Transfer Regulations is that secondary buyers and sellers will need to work much more closely with the underlying funds to confirm an approach to ECI withholding, particularly as secondary buyers will not want to risk having an underlying fund withhold on distributions for the credit of the secondary seller.

A third key development in the secondary market over 2020 has been the development of rep and warranty insurance to cover excluded obligations in a fund recapitalization. Historically, secondary buyers haven't been ready adopters of rep and warranty insurance precisely because it is "rep and warranty" insurance, and in fund recapitalization transactions, buyers typically seek an indemnity package not only for breaches of reps and warranties, but also for certain excluded obligations (e.g., partnership audit-related and certain other tax liabilities, liabilities stemming from portfolio companies that are either not a part of the deal or were previously disposed, liabilities relating to claims that the sponsor has breached its contractual or fiduciary duties in connection with the transaction or otherwise, and other uncertain obligations that are not expressly underwritten). Until recently, rep and warranty insurers haven't been willing to underwrite excluded obligations coverage, which has meant that buyers have still wanted to have indemnity protection from the selling funds for such liabilities. And once a selling fund is "stuck" providing an indemnity for excluded obligations, many buyers and fund sponsors have found it easier and less expensive to simply have the seller provide the indemnity for both its reps and excluded obligations, rather than using rep and warranty insurance alongside an indemnity for excluded obligations. In recent months, we've seen rep and warranty insurers get comfortable underwriting excluded obligations, and for the first time ever have seen policies issued to provide such coverage.

Coverage for excluded obligations isn't cheap, but for the secondary buyers in those transactions, it was a way to get protection against a set of potential obligations for which there wasn't another viable recovery source. For a range of reasons, including the cost of coverage, rep and warranty insurance may not make sense for many deals, but in certain circumstances—such as where a seller does not have the ability to claim back distributions from its underlying investors or would like to wind down quickly—it may provide an effective bridge between the interests of secondary sellers and buyers. The right mix of insurance and traditional indemnity sources will be different depending on the facts of each deal and the cost and scope of insuring a particular portfolio, but the introduction of coverage for excluded obligations may make it an attractive option, depending on the facts of a particular transaction.

—Isabel Dische, Adam Dobson, Daniel Kolb

CREDIT FUNDS

In 2020, Ropes & Gray conducted a survey of 100 senior-level executives within US- and UK-based credit funds to find out how credit fund managers were navigating the debt landscape. The survey was conducted in two parts. We had initially completed a survey before the COVID pandemic-related shutdowns in February/March 2020, but due to the magnitude of the impact of the shutdowns, we conducted a follow-up survey six months into the shutdowns, in September 2020.

The differences from Ropes & Gray's prior survey, conducted in 2018, are clear. The 2018 survey showed a pattern of growth and expansion, with most credit managers seeking to diversify into multiproduct platforms or expand their strategy offerings. Early in 2020, 50% of managers were considering new investment strategies—slightly reduced, but largely consistent with the 2018 results. Six months later, that had dropped to 20%, with a third not planning any changes, and almost a quarter of respondents in our mid-COVID-19 survey already closing their less popular strategies. Overall, after experiencing a sustained period of pandemic-related shutdowns, credit managers reported focusing on their core strengths, doubling down on existing strategies that have been tried and proven, rather than

seeking to expand into new strategies that may be more difficult sells to investors already worried about risk.

Of the small pool of managers that reported considering new strategies, their focus was on general credit opportunities, specialty finance and distressed investment strategies. This aligns with what we have seen anecdotally—some managers and investors are certainly reacting to the perceived market opportunity for distressed or stressed products created by the impact of COVID-19 by forming new products, while others who already had distressed or stressed products that could be adjusted to take advantage of COVID-19-related opportunities are taking the more expeditious path of investing out of existing funds.

For the rest, the goal is to concentrate on continuity, and to focus on their most successful strategies, playing it relatively safe in order to weather the storm.

Either way, the latter phase of our latest survey also shows a degree of bifurcation in terms of credit managers' intentions. Strategies that provide downside protection against the impact of COVID-19 are deemed vital, but so are increased return opportunities. If at all possible, managers are trying to cover all their bases, even as fundraising activity has slowed to its lowest levels in the past five years.

As always, taxation remains a key factor in structuring decisions for both managers and investors. For example, treaty fund structures have grown in popularity. In our 2018 survey, 64% of respondents said they were planning to use treaty fund structures for the first time. In the 2020 survey, 57% of participants indicated that they have already used treaty fund arrangements, although the types of treaty products used vary quite a bit among managers.

As credit fund managers have grown comfortable with increasingly diverse, complex and tailored product platforms, they have also been forced to address a wider range of potential conflicts. This has influenced everything from types of additional income (especially in light of increased scrutiny by the SEC) to how they manage investments in different tranches of a company's debt by different investor pools.

In the portion of the survey conducted during the pandemic-related shutdowns, when assessing key drivers of their existing portfolio performance, credit fund managers gave nearly equal weight to access to liquidity, strength of collateral and guaranty packages, and whether investments had robust financial maintenance covenants.

In terms of assessing new investment opportunities, a strong majority (63%) of credit fund managers reported an initial focus on protection against downside risk in assessing investments early in the shutdowns, though just over half of those investors report shifting their focus to securing equity or equity-like returns during the course of the six-month shutdown period—with another 20% of managers reporting a consistent focus on such returns.

In the portion of the survey completed prior to the onset of the pandemic-related shutdowns, credit managers reported being highly focused on key hot button documentation terms, including so-called "black hole" and "trap door" features of investment covenants (84%), with certain respondents singling out specifically movement of material IP away from the "restricted group" (49%); covenant-lite deals (61%); the strength of MFN protections on incremental debt raises (54%); and protection against non pro rata payments and exchanges (52%). Given the multiplicity of liquidity transactions that have been executed following the onset of the shutdowns that rely on weaknesses in one or more of these areas, we would expect that this focus can only have increased.

Through it all, credit managers viewed access to liquidity as the single most significant characteristic of value preservation for deals during the COVID-19 disruption, with the ability to creatively and aggressively structure investments topping the list of factors when it comes to winning new deals.

What does the future hold? Back in 2018, fund managers were most acutely worried about competition, especially about new entrants who might compromise yield in a quest

for volume, thus undercutting potential returns for established players. Our September 2020 survey shines a light on their new predominant concern: investors. From general uncertainty to potential demand for more favorable terms or a shift away from private credit, fund managers are watching investors closely and doing whatever they can to hold on to what they have in the year ahead.

To read Ropes & Gray's report on our 2020 survey of credit fund managers, with our full insights in each of these areas, please click here.

—Laurel FitzPatrick, Alyson Gal, Leonard Klingbaum, Jessica Taylor O'Mary, Robb Tretter

FOR FURTHER INFORMATION on our Credit Funds practice, click here.

For more information on credit funds developments impacting private funds, please refer to the following Ropes & Gray thought leadership pieces:

- 2020 in the Rear View Mirror (almost): Current Topics and Trends in Debt Documentation (Podcast), December 21, 2020 – Joanne De Silva, Alyson Gal, Leonard Klingbaum, Milap Patel, Rob Bennett
- COVID-19: Credit Funds: Fundraising and Restructuring in the Pandemic Environment: U.S. v. Europe (Podcast), August 20, 2020 – Tom Alabaster, Jason Kolman, Matt Czyzyk, Matt Roose
- SEC Issues Risk Alert: Compliance Issues for Investment Advisers Managing Private Funds – What You Need to Know (Podcast), July 22, 2020 – Jason Brown, Dan O'Connor
- Credit Funds – The Market Today, and the Road Ahead (Webinar), June 4, 2020 – Katie Waite, Tom Alabaster, Mike Doherty, Matt Roose, Leonard Klingbaum

ESG INVESTING

While there have been many developments over the course of 2020 in "environmental, social and governance" (ESG) and socially responsible investing, a heightened focus by many investors on the "social" component of ESG marked a notable change from prior years.

The COVID-19 pandemic and its accompanying economic and social disruption heightened market focus on ESG investing. In some cases, investors observed that companies that had integrated ESG principles into their business models pre-pandemic often outperformed those that did not.[22]

In particular, the pandemic caused asset managers to reconsider the importance of social factors, in part because high performance on social metrics appeared to serve as a proxy for corporate resilience. For example, asset managers and owners recognized that companies that protected their workers from health risks—whether by embracing remote work or deploying PPE and workplace modifications—appeared better able to survive the downturn and potentially thrive. Similarly, the existence of robust remote work systems was also tied to the quality of business continuity plans. A recent survey by Greenwich Associates underscores this renewed interest in social factors. In their survey, 70% of respondents expected social considerations to be important or very important going forward, an increase of 20% over pre-COVID-19 crisis results.[23]

Diversity, equity and inclusion (DE&I) efforts, another so-called social factor within ESG, have received heightened attention as an important component of ESG in 2020, spurred by campaigns for racial justice during the summer of 2020. Notably, institutional investors have become increasingly focused on DE&I, not only in connection with the management of risks associated with their portfolio investments, but also with respect to the asset managers charged with overseeing their fund investments.

Over the past year, we have seen asset managers and asset owners focus on a range of "social considerations," including labor standards, human capital management, DE&I, gender equality and community involvement, among others. For example, asset managers began evaluating previously discounted elements of corporate performance, including employee engagement or satisfaction. While not a traditional ESG factor, evidence suggests that companies with more engaged workforces tend to perform better, particularly during times of crisis, which led to increasing interest in the measurement of employee satisfaction. It is worth noting that one key challenge for the industry remains the lack of established or standardized metrics. While this is true in many aspects of ESG integration, social factors pose unique measurement considerations, complicating potentially more widespread adoption of social investing.

In addition to the increased focus on social factors, 2020 also saw continued changes in how asset managers integrated ESG into their own investment decisions. Traditionally, ESG has been viewed as a risk mitigation tool, but in recent years, there has been increased focus on considering ESG as a potential source of alpha. We are increasingly seeing managers evaluating companies individually for ESG-related alpha. While this trend may have been accelerated by pandemic-related market events, we anticipate managers' growing focus on ESG as a source of alpha, along with the heightened focus on social factors, will only continue.

ESG has also continued to be a key focus for regulators during the course of 2020. Europe has led the charge on regulatory change in this area, and 2020 saw further work go into the EU's Sustainable Finance Package, which will start to come into force in 2021. These rules will impact asset managers, including not only those that are regulated in Europe, but also those that market their products there. While the rules are still evolving, now is the time to consider how the rules will impact you, and, importantly, how you will integrate the requirements alongside other ESG considerations, such as those raised by investors and other regulatory regulators.

—Melissa Bender, Isabel Dische, Eve Ellis

FOR FURTHER INFORMATION
on Ropes & Gray's Asset Management ESG practice, click here.

For more information on our ESG, CSR, Business and Human Rights practice, click here.

To visit our CSR and Supply Chain Compliance webpage, click here.

For more information on ESG developments impacting private funds, please refer to the following Ropes & Gray thought leadership pieces:

- ESG: Integrating EU and DOL Requirements (Podcast), December 16, 2020 – Eve Ellis, Joshua Lichtenstein
- Private Funds Regulatory Update Series – ESG Updates (Webinar), November 11, 2020 – Eva Carman, Eve Ellis, Joshua Lichtenstein, George Raine
- Introduction to Gender-Lens Investing (Podcast), July 30, 2020 – Melissa Bender, Isabel Dische
- COVID-19: Rethinking the "S" in ESG in Light of the Pandemic (Podcast), July 23, 2020 – Melissa Bender, Isabel Dische
- ESG Considerations for Asset Managers in Light of the COVID-19 Pandemic (Podcast), May 18, 2020 – Melissa Bender, Isabel Dische

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Private Funds Practice

Ropes & Gray has one of the largest and most sophisticated private investment funds practices. We form and review many hundreds of funds each year, giving us unequaled insight into market terms and developments around the world. With over 140 private fund formation lawyers in the United States, Europe and Asia, we offer clients on-the-ground service globally, providing real-time advice and local knowledge.

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Recognized in 2020 as a leading firm by ***Chambers*** nationwide and globally in Private Equity: Fund Formation and Investment Funds: Hedge Funds.

Recognized in 2019 by ***Law360*** as Practice Group of the Year for Asset Management and Private Equity.

Recognized in 2020 as a top-tier US law firm by ***U.S. News***, with Law Firm of the Year honors in Private Funds/Hedge Funds Law and Leveraged Buyouts and Private Equity Law.

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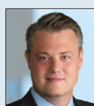
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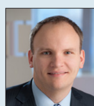
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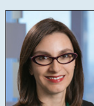
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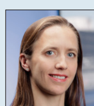
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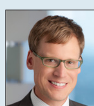
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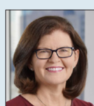
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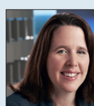
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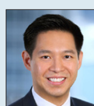
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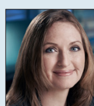
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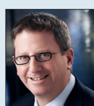
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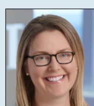
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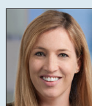
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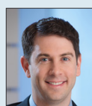
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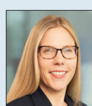
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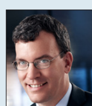
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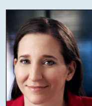
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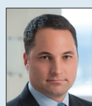
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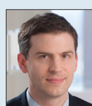
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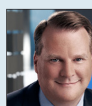
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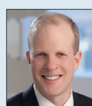
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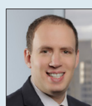
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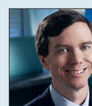
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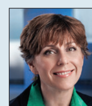
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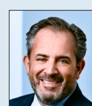
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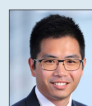
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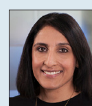
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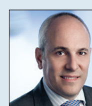
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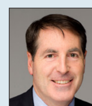
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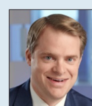
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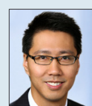
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ENDNOTES

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