Co-Investments in Private Equity: The SEC's Focus on Disclosure

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The trend of utilizing co-investments in private equity continues to grow. A Special Report by Preqin found that 69% of the 320 sponsors surveyed offered co-investment rights to their limited partners, with another 18% considering offering co-investment rights in the future.[1] Moreover, 50% of the 222 limited partners surveyed were already co-investing, with another 22% considering co-investment.[2] While co-investment opportunities are valuable to investment advisers and investors alike, they pose certain fiduciary and regulatory challenges for the investment adviser. Importantly, the Securities and Exchange Commission (the "SEC") has provided guidance regarding the use of co-investments in private equity, concluding that registered investment advisers should adopt and implement robust co-investment policies, and that investment advisers should fully disclose co-investment policies to all fund investors.

By way of background, a co-investment is an investment made by an investor alongside, rather than through, a private equity fund in a particular portfolio company. In analyzing a potential investment opportunity, an investment adviser must determine whether the amount of an investment opportunity in which the private equity fund will invest exceeds the amount that would be appropriate for the fund. In the event that the investment adviser determines that the investment opportunity does, in fact, exceed the amount that would be appropriate for the fund, any such excess may be offered to one or more potential co-investors, as determined by the fund's limited partnership agreement, any side letters and the investment adviser's procedures regarding allocation. In these situations, offering co-investment opportunities to existing limited partners or third parties may provide the investment adviser an opportunity to, among other things, close larger deals than the fund alone could support,[3] lower the fund's exposure without diluting the investment adviser's indirect control of the portfolio company,[4] and improve the chance of successfully closing the acquisition.[5]

In determining how to allocate a co-investment opportunity among potential co-investors, an investment adviser may consider many factors, including:

- the perceived ability of the co-investor to quickly decide and fund the agreed investment;
- the co-investor's sophistication, including in regard to relevant industries or co-investment structures generally;
- any previously-expressed interest in co-investment opportunities;
- any tax, regulatory or other legal considerations implicated by the potential co-investor;
- any services provided by the co-investor with respect to the investment opportunity; and
- any perceived opportunity to establish or strengthen a relationship that has the potential to provide long-term benefits to the fund or the investment adviser.

The tactical allocation of co-investment opportunities by investment advisers, along with the growth in the use of co-investments in private equity generally, has attracted the scrutiny of the SEC as part of its broader examination of potential conflicts of interest in private equity.[6] Under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), as investment advisers, private equity managers are fiduciaries to their clients (i.e., the private equity funds themselves) and thus have a "fundamental obligation to act in the best interests" of their clients.[7] Essential to this obligation is the requirement that the investment adviser provides full and fair disclosure of all material facts and must identify, and eliminate or mitigate and disclose, any material conflicts of interest.[8]

The SEC's Office of Compliance, Inspections and Examinations has observed that co-investments may create conflicts of interest between investment advisers and the funds and has expressed concern that fund investors may not be aware that another investor has negotiated priority in co-investment allocations. In a 2015 speech, Mark Wyatt, then-acting director of OCIE, emphasized that investment advisers must fully disclose their co-investment policies and procedures and the existence of any side agreements regarding co-investments, stating that "allocating co-investment opportunities in a manner that is contrary to what [was promised, or disclosed, to] investors can be a material conflict and can result in a violation of federal securities laws."[9] Importantly, however, the SEC does not appear to have demanded that investment advisers first offer any co-investment pro rata to all fund limited partners.[10] Indeed, it is relatively common for investment advisers to retain discretion in regard to the allocation of co-investments. Rather, the SEC demands complete and accurate disclosure to limited partners (e.g., in the fund's offering memorandum) regarding investment advisers' co-investment policies and procedures (i.e., "…where they stand in the co-investment priority stack").[11]

Given the SEC's emphasis on disclosure in this regard, private equity advisers should establish a "robust and detailed co-investment allocation policy which is shared with all investors."[12] Clear disclosure should be given in a fund's offering materials of the investment adviser's co-investment policy. For example, the offering materials and policies and procedures may state that the investment adviser will (subject to its fiduciary duty to the fund and consistent with the fund's limited partnership agreement and any side letters) offer co-investment opportunities to one or more persons, which may or may not include fund limited partners, affiliates of the general partner, and third-parties unaffiliated with the fund or any limited partner, and that in making such allocations the investment adviser will consider the factors described above, among other listed factors specific to the investment adviser.[13]

Co-investments offer unique opportunities to both investment advisers and investors, while also creating unique fiduciary and regulatory challenges. Adopting clear co-investment policies and providing adequate disclosure to investors is essential to an investment adviser's compliance with its fiduciary obligations under the Advisers Act. While it appears that the SEC staff does not demand pro rata allocation of co-investment opportunities among limited partners, the SEC staff has made clear that limited partners must be made fully aware of the investment adviser's intentions and obligations regarding co-investments at the time they initially invest in the private equity fund.[14] As such, investment advisers should establish a written policy regarding allocation of co-investments and disclose this policy to limited partners in the private equity fund's offering materials.

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[1]Preqin, Preqin Special Report: Private Equity Co-Investment Outline (Nov. 2015) ("Preqin 2015").

[2]Id.

[3]Pricewaterhouse Coopers, LLP, A Closer Look: Private Equity Co-Investment: Best Practices Emerging (Jan. 2015) ("PWC Best Practices").

[4]Bob O'Brien, *Behind the Push Toward Co-Investing*, The Deal (Dec. 4, 2015) ("[I]t's a way for GPs to lay off some of their risk.").

[5]Preqin 2015.

[6]*See, e.g.*,PWC Best Practices, *supra* note 3; Julie M. Riewe, Co-Chief, SEC Asset Mgmt. Unit, Div. of Enf't, Speech: Conflicts, Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View (Feb. 26, 2015); Andrew J. Bowden, Director, SEC Off. Of Compliance Inspections and Examinations, Speech: Spreading Sunshine in Private Equity (May 6, 2014).

[7]U.S. Sec. and Exch. Comm'n, Information for Newly-Registered Investment Advisers (2010).

[8]*Id.*

[9]Marc Wyatt, (then-Acting) Director, SEC Off. of Compliance Inspections and Examinations, Speech: Private Equity: A Look Back and a Glimpse Ahead (May 13, 2015).

[10]*Id.*

[11]"[A]ll investors deserve to know where they stand in the co-investment priority stack." *Id.*

[12]Id.

[13]A similar issue arises in connection with the allocation of investment opportunities between or among funds having similar investment strategies but different fee structures. In such a case, investment advisers will have a conflict of interest to the extent they are incentivized to offer more profitable investment opportunities to funds bearing higher fees. There, the investment advisers' allocation policy should address how the adviser will allocate investment opportunities among its funds, and the investors in the various funds should consent to the allocation method.

[14]"To be clear, I am not saying that an adviser must allocate its co-investments pro-rata or in any other particular manner, but . . . all investors deserve to know where they stand in the co-investment priority stack." *Id.*

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