Co-Investments Today: Structures, Terms and Fiduciary Duties

Schulte Roth & Zabel

25TH ANNUAL

PRIVATE INVESTMENT FUNDS SEMINAR

JANUARY 19, 2016

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David J. Efron

David practices primarily in the areas of domestic and offshore hedge funds, including fund formations and restructurings. Additionally, he advises hedge fund managers on structure, compensation and various other matters relating to their management companies, and he structures seed-capital and joint venture arrangements. David also represents hedge fund managers in connection with SEC regulatory issues and compliance-related matters.

David is listed in *Chambers Global*, *Chambers USA*, *Expert Guide to the World's Leading Banking*, *Finance and Transactional Law Lawyers*, *The Legal 500 United States* and *Who's Who Legal: The International Who's Who of Private Funds Lawyers*. In particular, *Chambers USA* has noted that David is "an outstanding lawyer, with excellent judgment and the necessary soft touch during the delicate negotiations that occur during a start-up/launch," and clients say "he is attuned to the business considerations and provides measured, reasoned advice that reflects his deep experience and industry knowledge." *The Legal 500 United States* has recognized him as "an extraordinarily capable attorney." A published author on subjects relating to investment management, David recently co-authored *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). He also is a sought-after speaker for hedge fund industry conferences and seminars, and a frequent guest lecturer at New York-area law and business schools. He most recently presented on current trends with emerging managers in a prime brokerage (consulting services) presentation, and on product and marketing strategies for growth for hedge fund COOs and CFOs.

David received his LL.M. in securities regulation, with distinction, from Georgetown University Law Center, his J.D. from Syracuse University College of Law and his B.A. from Vassar College.

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Omoz focuses his practice on the representation of sponsors and investors in the formation and structuring of private equity funds, hedge funds and hybrid funds. He has extensive experience representing sponsors and investors on funds employing real estate, buyout, credit, distressed investment, structured products, activist, multi-strategy and long-short equity strategies. He also represents hedge fund managers and investors in the negotiation of seed-capital transactions, and he advises sponsors of private equity firms in the structuring of complex carry-sharing arrangements among principals and employees. Omoz's recent representations include institutional sponsors and boutique firms in the formation of private equity funds, hedge funds and hybrid funds; lead investors on their investments in private equity funds; hedge fund managers and investors in seed-capital arrangements; investment managers in joint venture arrangements; and investment managers and investors in the formation of special purpose acquisition and co-investment vehicles.

Omoz is recognized as a leading lawyer by *The Legal 500 United States*. He regularly addresses investment managers about current developments relating to private investment funds, and his recent speaking engagements have addressed market terms and regulatory issues surrounding co-investments, market updates for private equity funds and trading compliance. He is a contributor to the *Fund Formation and Incentives Report* (SRZ in association with Private Equity International).

Omoz received his J.D. from University of Michigan Law School and his B.A., with highest honors, from Michigan State University.

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Phyllis is a partner in the New York office, where she focuses her practice on the structuring, formation and operation of private equity funds, including buyout funds, venture capital funds, mezzanine funds, distressed funds and real estate funds. She represents both fund sponsors and investors in her practice. In addition to assisting fund sponsors with their internal management arrangements, succession planning and the creation of internal investment and co-investment vehicles, she has extensive experience with institutional investors and regularly advises clients on market terms of investment funds. Phyllis also advises private equity funds in connection with their investments in, and disposition of, portfolio companies.

Phyllis is recognized as a leading practitioner in her field by numerous independent publications, including *The Legal 500 United States*, *The Best Lawyers in America*, *Who's Who Legal: The International Who's Who of Private Funds Lawyers*, *Expert Guide to the World's Leading Banking, Finance and Transactional Law Lawyers* (Investment Funds, Private Equity) and *Expert Guide to the World's Leading Women in Business Law* (Investment Funds). A member of New York's Private Investment Fund Forum, Phyllis frequently shares her insights on effective fund formation strategies at industry conferences and seminars. She recently discussed compliance concerns for co-investments, and conflicts of interest and other ethics issues for private equity fund managers. Phyllis is also the co-author of *Private Equity Funds: Formation and Operation* (Practising Law Institute), which is considered the leading treatise on the subject, and contributed to *Fund Formation and Incentives Report* (SRZ in association with Private Equity International) as well as a chapter on "Advisers to Private Equity Funds — Practical Compliance Considerations" to *Mutual Funds and Exchange Traded Funds Regulation, Volume 2* (Practising Law Institute).

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Leonora focuses her practice on advising investment funds (including hedge funds, private equity funds, hybrid funds and funds of funds) and investment advisers in connection with their structuring, formation and ongoing operational needs, and general securities laws matters, as well as regulatory and compliance issues.

Leonora attended Nottingham Law School for her Legal Practice Course, and she holds an LLB Law with French Law from Birmingham University in England and an Erasmus French Law Diploma from Limoges Law School in France.

Co-Investments Today: Structures, Terms and Fiduciary Duties

I. What Constitutes a Co-Investment, and When Do Co-Investment Opportunities Arise?

A. A co-investment opportunity is an opportunity to invest alongside a private investment fund, typically on a discretionary basis.

B. Co-investments have historically been utilized by private equity funds, but the relevance and use of co-investments alongside hedge funds has grown.

1. Co-investment opportunities offered by hedge funds can be traced to the reduced use of side pockets. Even where hedge funds include side pockets, investors today often may opt out of side-pocket investments. Therefore, other than small amounts of illiquid investments that can be pursued through the primary fund vehicle, a hedge fund manager targeting illiquid investments often does so through a separate co-investment structure outside its main fund.

2. Co-investment opportunities are generally perceived by managers and investors as enhancements to the participation of investors in a primary fund, although the Securities and Exchange Commission ("SEC") has identified conflicts associated with co-investments.

C. Reasons for which hedge funds offer co-investment opportunities, in addition to pursuing illiquid investments, include:

1. Generating goodwill/building stronger relationships with existing or prospective investors and other strategic parties (such as financing sources, deal sources, or other parties who offer administration, servicing or other expertise):

   (a) Investors seek co-investment opportunities because co-investment fee terms are typically lower than those of the primary fund.

   (b) Access to a manager's "high conviction" ideas (i.e., larger positions related to a manager's conviction in the investment) could improve investor relations.

2. Enabling the manager to close an investment that the primary fund is unable to pursue due to:

   (a) Limited capital available to the primary fund (which is the basis for referring to co-investment entities as "overflow" entities);

   (b) Limitations on investment parameters applicable to the primary fund, such as diversification limits on geography, industry, asset-class or sector (including, as stated above, illiquid investments); and/or

   (c) Constraints presented by pending or potential withdrawals.

3. Enabling the manager to acquire control or influence in a target as part of an activist strategy or in a restructuring or pre-bankruptcy;

4. Spreading risk between the primary fund and co-investors;

5. Allowing a manager to build a track record in strategies that are not core to the primary hedge fund.

D. Co-investment opportunities are offered at various times, generally subsequent to the formation of the primary fund, on an ad hoc basis, when it is determined that the primary fund will not pursue the entire investment.

1. It has become more common for a vehicle to be established for an investor at the time that investor makes its investment in the main fund to facilitate future co-investing, particularly where the investor has approved soft commitments for funding co-investment opportunities that become available.

2. Co-investment funds are also being established to allow investors in the co-investment fund to participate in co-investments with unrelated investment funds.

3. The allocation of co-investment opportunities represents a potential conflict for the manager:

(a) If a co-investment vehicle is established subsequent to the formation of the primary fund, the manager must consider at the time an investment is made whether the primary fund can accommodate a particular investment before an investment can be directed to a co-investment vehicle.

(b) If a co-investment vehicle is established at the same time as the formation of the primary fund, before co-investments are made by such vehicle, the manager should assess what fiduciary and other duties it has to the investors in the co-investment vehicle.

II. Structures for Implementing Co-Investments

A. Basic Options

1. Separate "structure" overseen and controlled by the manager of the primary fund, including by way of:

(a) A managed account;

(b) A fund-of-one for a specific investor;

(c) An investment vehicle set up for multiple investors (i.e., a co-investment fund); or

2. A direct investment in the target by the co-investor.

The manager may consider whether it should have a power of attorney or proxy from investors investing directly into the target to ensure that such investors and the primary fund exercise rights consistently with respect to the investment. This may be achieved through voting or similar agreement that gives the manager control.

B. The structure to be used will depend on a number of factors, including, among others:

1. Whether the structure is for one or more investors; and

2. The tax or regulatory status of the particular investors.

   Investors may present limitations depending on whether they are taxable, tax-exempt, U.S. or non-U.S.; and whether they are subject to certain statutes or rules that may limit their participation (e.g., BHCA, Investment Company Act, ERISA or antitrust rules).

III. Terms of Co-Investments and Co-Investment Vehicles

A. The terms upon which co-investments are made and exited will depend on a number of factors:

   1. Typically, investments by the co-investor will be made and exited on the same terms as the primary fund, subject to tax or regulatory considerations.

      Co-investors and investors in the primary fund should be advised if co-investors are investing or may in the future invest on different terms. With proper disclosure, it should be possible for the primary fund and the co-investment vehicle to exit at different times and on different terms.

   2. Follow-on investments in the same company may not, however, be made pro rata by the primary fund and co-investors.

      (a) Either or both of the primary fund and co-investors may have capital constraints or other objectives that limit their ability to make additional investments in the original issuer.

      (b) If follow-on investments are made on different terms, or if the primary fund and the co-investors make a follow-on investment and the other does not, the primary fund and co-investment vehicle are likely to recognize different returns on their investments in the same investment.

B. The term and conditions of the co-investment vehicles established to make illiquid investments will typically be similar to private equity fund terms, although the term of a co-investment vehicle is typically shorter than the term of a typical private equity fund.

   1. For example, the term of a co-investment vehicle that co-invests with an activist fund is typically three years (subject to extensions), including a one-year investment period followed by a two-year harvest period, and the term of a credit-oriented vehicle is typically four years (subject to extensions), including a one-year commitment period and a three-year harvest period.

   2. Co-investors may seek direct private equity-type rights, including:

      (a) Pre-emptive rights (i.e., right to make follow-on investments in the portfolio company);

      (b) Access to the information provided by the portfolio company, such as financial statements of the portfolio company;

      (c) Access to management of the portfolio company; and

      (d) Co-sale rights/drag rights.

C. Generally, the economic terms of co-investment structures and vehicles differ from those of the primary fund.

1. The carried interest, if paid at all, will be paid upon realization of the entire investment and is likely to be less than 20 percent; management fees may not be charged at all to co-investors. Generally, both are lower than that charged to investors in the primary fund.

2. Whether carry and management fees are charged depends in part on whether the fund manager needs the co-investors' capital to close the deal (i.e., if the primary fund has insufficient capital, taking into account risks, policies and investment restrictions).

   (a) If the fund manager needs the co-investors' capital to close the deal, it will charge little or no fees or carried interest to co-investors; or

   (b) When co-investments are in liquid or quasi-liquid investments and using co-investors' capital is not necessary to close the deal (though it may result in the manager managing a larger position), fees and carry are much more likely to be charged. In such circumstances, the carry charged to co-investors may be the same or less than that charged by the primary fund (e.g., 20 percent or less) while management fees will typically be lower than the level charged by the primary fund.

3. Other factors considered in determining the fee terms applicable to a given co-investor may include:

   (a) Whether the co-investor is a current fund investor (in which case the investor will generally seek to leverage its existing investment and pay lower fees);

   (b) The size of the potential investment by the co-investor (generally, the larger the investor, the lower the fee);

   (c) The importance of the co-investor (e.g., the co-investor may be investing a small amount but may be a large established institutional investor active in investing within the particular strategy or with whom the manager desires to cultivate or develop a more extensive relationship); and

   (d) Time sensitivity of the co-investment opportunity.

4. Expenses

   (a) The co-investment structure will bear its pro rata portion of all investment-related expenses and bear its own expenses.

   (b) Depending on whether the co-investment structure is offered simultaneously with, or subsequent to, the primary fund, co-investors may be responsible for broken-deal expenses (following their approval of the deal). In newer funds, managers may also have negotiated for the primary fund to be responsible for broken-deal expenses of co-investors. Unless clearly disclosed in fund documentation, broken-deal costs cannot be borne by the primary fund (this latter point has been and continues to be an area of focus for the SEC).

   (c) Managers must consider how expenses of co-investment vehicles will be paid if the underlying investment is illiquid.

5. Confidentiality

   Especially with respect to investments in publicly traded securities, the manager must consider issues related to material nonpublic information and ensure that co-investors are restricted from trading and subject to confidentiality undertakings.

6. Depending on the structure used, co-investment structures raise the same legal and regulatory issues as other accounts, including issues under the securities laws, ERISA and filings obligations (including Schedule 13D filings).

IV. How to Select Co-Investors

A. When the fund needs co-investors to close an investment, the best-suited type of investor generally is an institutional investor and has:

   1. Experience in underwriting the particular type of investment; and

   2. The ability to move fast in decision-making and funding.

B. If a general partner is seeking to syndicate an investment, it may not be necessary to seek capital from institutional investors who understand the underlying asset being purchased.

C. Investors may seek co-investment rights through side letters as part of their decision to invest in the primary fund, and the manager must determine the type of commitment that it can offer to such investors.

   1. Often, a side-letter provision contains the manager's simple acknowledgement of the investor's interest in making co-investments, and does not create any duty of the manager.

   2. Other side letters contain affirmative co-investment rights, where the investor may be given the right to take up a pro rata share of co-investment opportunities offered to other investors of the same primary fund.

   3. It is customary for a manager to be able to offer co-investments to strategic investors (e.g., deal sources and financing sources) without sharing such arrangement with investors in the primary fund.

D. Conflicts in Selecting Co-Investors: SEC Focus

   1. The SEC has in recent years identified conflicts of interest as a significant concern in its examinations of private fund advisers, as noted by Julie Riewe (co-chief of the Asset Management Unit of the SEC's Enforcement Division) in her speech "Conflicts, Conflicts Everywhere."

   2. While some conflicts are obvious — like personal trading in the same securities that clients are trading in — others are more nuanced. The SEC's examination staff has recently been focusing more on allocations of investment opportunities and which parties have been offered co-investment opportunities.

   3. In a series of presentations and speeches, the SEC's examination staff and OCIE leadership have highlighted concerns with co-investments — namely concerns over whether investors given co-investment rights were favored over other investors and whether disclosure had been provided to investors.

(a) At the SEC COO Outreach Program in January 2014, the SEC staff raised a concern of "favoring certain clients or funds or favoring certain investors without proper disclosure," cited "co-investment allocation" as an example of favoritism, and went on to state that "Rule 206(4)-8 of the Advisers Act and other antifraud provisions might be violated without adequate disclosure." The speakers recommended that advisers let their investors know on what basis and when co-investment opportunities would be offered, so that investors may have an opportunity to "complain" about the adviser's process.

(b) In May 2014, Andrew Bowden (then director of OCIE) noted that the governing documents of funds that the SEC had reviewed often lacked, among other things, "protocols for mitigating conflicts of interest in connection with co-investment allocations."

(c) In May 2015, current OCIE Director Marc Wyatt said:

"[W]e have detected several instances where investors in a fund were not aware that another investor negotiated priority co-investment rights. Disclosing this information is important because co-investment opportunities have a very real and tangible economic value but also can be a source of various conflicts of interest";

...

"Ironically, many in the industry have responded to our focus by disclosing less about co-investment allocation rather than more under the theory that if an adviser does not promise their investors anything, that adviser cannot be held to account. However, the risk in that approach is that such promises are often made anyway, either orally or through email. I believe that the best way to avoid this risk is to have a robust and detailed co-investment allocation policy which is shared with all investors. To be clear, I am not saying that an adviser must allocate its co-investments pro-rata or in any other particular manner, but I am suggesting that all investors deserve to know where they stand in the co-investment priority stack."

V. Compliance Policies and Procedures

A. Reviewing and updating investor disclosures with respect to co-investments is critical. Generic disclosure as to the possibility of co-investments may be insufficient where there are significant co-investment opportunities offered to some, but not all, fund investors.

1. Disclosures with respect to co-investment opportunities should be consistent with side letters, offering documents, contents of Form ADV and DDQ responses.

2. Compliance policies and procedures should be tailored to the specific circumstances of the business.

   To be "robust and detailed," a co-investment policy should identify who makes the determinations with respect to co-investment allocations, the basis on which such determinations may be made, and the process for contemporaneously documenting the basis for co-investment allocations. The determination as to the fund's optimal investment size is typically an important part of this process.

3. The SEC examination staff seems particularly focused on prior agreements or commitments to provide co-investment opportunities. Any such commitments — whether "hard" or "soft" — should be identified and factored into policies and disclosures.

4. Compliance review of co-investment allocations should be incorporated into the regular testing program.

B. Co-investment vehicles formed by a manager are generally a “client.”

1. Disclosure in Form ADV would include managed co-investment vehicles (depending on the structure of the co-investment vehicle).

2. Custody rules must be satisfied, and therefore, the manager may need to have the financial statements of co-investment vehicles audited.

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