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Co-Investments

Co-Investments in the Hedge Fund Context: Fiduciary Duty Concerns, Conflicts and Regulatory Risks (Part Three of Three)

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This is the third article in our series on co-investments in the hedge fund industry. This article starts by citing evidence of interest among regulators in co-investments, then focuses on the challenging fiduciary duty concerns raised by co-investments, as well as conflicts and regulatory risks that typically arise when structuring or managing co-investments. The first article in this series discussed the rationales for co-investments from the perspectives of hedge fund managers and investors; negotiating dynamics; and investment strategies in which co-investment are relevant. The second article in this series described structuring of co-investments, fees, liquidity and relevant insider trading issues.

Co-Investments on Regulators' Radar

Regulators have explicitly identified co-investments as an examination or enforcement priority on at least two recent occasions. First, at the Regulatory Compliance Association's Compliance, Risk & Enforcement 2013 Symposium, Andrew Bowden, Director of the SEC's Office of Compliance Inspections and Examinations (OCIE), cited co-investments offered to favored clients as a focus area for OCIE examiners. See "RCA Symposium Offers Perspectives from Regulators and Industry Experts on 2014 Examination and Enforcement Priorities, Fund Distribution Challenges, Conducting Risk Assessments, Compliance Best Practices and Administrator Shadowing (Part Two of Three)," Hedge Fund Law Report, Vol. 6, No. 48 (Dec. 19, 2013) ("Bowden then highlighted a few additional focus areas for OCIE examiners, including preferential treatment in the allocation of trades and co-investment opportunities for favored clients; failure to disclose side letters to all investors; failure to provide disclosures concerning changes in the senior management team at a firm; and use of unrealistic performance projections."). Second, at the SEC's 2014 Compliance Outreach Program National Seminar, Igor Rozenblit, a Specialist in the Asset Management Unit of the SEC's Enforcement Division, and Alpa Patel, Senior Counsel in the SEC's Division of Investment Management, discussed fiduciary duty and other concerns raised by co-investments. Also at the SEC seminar, Barbara Burns, Partner and General Counsel at AEA Investors LP, offered a practical perspective on the fiduciary duty concerns raised by co-investments. See "Top SEC Officials Discuss Hedge Fund Compliance, Examination and Enforcement Priorities at 2014 Compliance Outreach Program National Seminar (Part Two of Three)," Hedge Fund Law Report, Vol. 7, No. 8 (Feb. 28, 2014).

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Fiduciary Duty

Fiduciary duty considerations loom large when structuring co-investment vehicles and managing co-investment opportunities. (Structuring of co-investment vehicles was covered in part two of this series.) This is because co-investments typically involve one management company accessing a substantially similar investment opportunity on behalf of different, though potentially overlapping, groups of investors. Satisfying the applicable fiduciary standard does not entail treating differently situated investors in precisely the same way. However, it does require a coherent and plausible rationale for any differences in treatment.

In particular, our conversations with sources yielded three co-investment scenarios in which fiduciary duty considerations are particularly acute: (1) the fund is organized before the co-investment vehicle and the size of the investment opportunity is at or below what the fund can accommodate as a practical matter or based on concentration limits in its governing documents; (2) the fund is organized before the co-investment vehicle and the size of the investment opportunity is above what the fund can accommodate; and (3) the fund and the co-investment vehicle are organized simultaneously. Best practices and issues to consider in each of these scenarios are discussed immediately below.

Fund Is Organized Before the Co-Investment Vehicle and the Size of the Investment Opportunity Is At or Below What the Fund Can Accommodate

The default rule in this scenario is that the fund is first in line for the relevant investment opportunity up to the relevant cap, which may be based on company, industry or geographic concentration limits in the PPM, or other investment considerations. As Stephanie Breslow, a partner at Schulte Roth & Zabel LLP, noted, "You generally should be allocating to the existing hedge fund the opportunities that it can take advantage of before you go out to the broader marketplace and start handing out the excess. The hedge fund investors are expecting that allocation. Normally, of course, managers will have reserved the right to run multiple funds side-by-side and allocate opportunities across investors, and assuming that's clearly disclosed, that's fine. But, typically, a manager will not allocate co-investment opportunities until the hedge fund has gotten its fair share." Kirkland & Ellis LLP partner Robert Sutton echoed that insight, noting that in cases where a fund has a quantitative cap, the burden of explanation – in the course of an examination, for example – would be on a manager that allocated an opportunity to co-investors before allocating the opportunity to the fund up to the cap. Managers in such cases, Sutton said, "would be well advised to have a contemporaneous and coherently articulated written explanation in their files regarding the rationale for allocating the co-investment opportunity."

As a practical matter however, Breslow noted that even if a fund has primary access to an investment opportunity, a co-investment vehicle may start purchasing the relevant investment before the fund finishes. "Take an activist strategy," Breslow offered, by way of example. "If you know how much money you need to effectuate what you are going to do, you may well raise that money at the beginning of the process and then allocate it to the co-investment vehicle alongside the hedge fund pro rata during the buying, because otherwise that second client of yours – the co-investment vehicle – is getting much worse pricing than the hedge fund, which is not what you would want to do." In short, while the fund may be first in time in this scenario, the manager's fiduciary duty is not limited to the fund.

Fund Is Organized Before the Co-Investment Vehicle and the Size of the Investment Opportunity Is Above What the Fund Can Accommodate

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This is the classic justification for offering co-investment opportunities in the hedge fund context. But the mere presence of an opportunity in excess of the relevant fund cap does not conclude the fiduciary duty analysis. Instead, that analysis extends in this scenario to how the manager offers and implements the co-investment. In general, the SEC would like to see an ex ante, objective framework in place and in operation for selecting co-investors. Sutton related, "We have seen the SEC during exams be critical of a policy that is purely discretionary – one that provides that the decision to award the co-investment opportunity may be made in the sole and absolute discretion of the fund manager. Even though the manager may have full discretion as a contractual matter, the SEC is still looking for the manager, as a fiduciary matter, to impose a framework to guide the selection of specific co-investors and to guard against conflicts."

As for the content of that framework, Jeffrey Tabak, a partner at Weil, Gotshal & Manges LLP, noted that the default rule is to offer co-investment opportunities to all fund investors. "That way," Tabak explained "no one can criticize the manager for giving an opportunity to one limited partner or more and not to all limited partners." However, Tabak and others recognized that while this approach may be unimpeachable from a fiduciary duty point of view, it often faces practical obstacles. Breslow identified two of those obstacles: timing (which is related to the average price paid by the fund and the co-investment vehicle for the relevant security) and confidentiality. As she explained, "It's really not in the best interest of investors in the fund for the manager to have to go to all of the investors in the fund and ascertain interest before the manager looks for co-investors. That's not good for the fund for at least two reasons. First, it's going to potentially slow down the acquisition that you need to do on a timely basis because, among other things, it's going to take a lot of time for the manager to explain the position and the rationale. Second, particularly if it's a sensitive position – for example, an activist or distressed position where confidentiality is important – telling a large investor community what you are doing before you have gone public is going to cause leakage and damage the desired result. For these and other reasons, not only do you not have a fiduciary duty to give the co-investment opportunity to all of your investors pro rata, but in fact it would not be in their best interest for you to try to do that. It would hurt the investors in your fund in many cases." Notably, at the 2014 Compliance Outreach Program National Seminar, Rozenblit recognized a similar point on timing, stating, "The co-investment process is very fast moving and you can't always tell your investors about the co-investment before it happens. . . ."

It is also possible that fund investors who were eligible to invest in a commingled fund following a thematic investment strategy subject to company and industry caps may not be able to invest in a co-investment vehicle structured to invest in a single company or opportunity. As O'Melveny & Myers LLP partner Timothy Clark explained, fund investors in such circumstances may face regulatory or competitive issues. For example, by participating in the co-investment vehicle, a corporate fund investor may encounter antitrust problems or may run up against limits on ownership levels within designated markets.

Accordingly, a policy that flatly requires the manager to first offer co-investment opportunities to current fund investors before offering the opportunity to outside investors will often be impracticable and contrary to the best interests of fund investors (for whom such a rule would often result in higher prices and less investment dexterity). Instead, hedge fund managers are typically approaching the co-investment process via wide discretion in governing documents that is limited to some extent by internal policies and procedures. As Schulte Partner Jason Kaplan said, "We are seeing some hedge fund managers add a bit of additional disclosure to fund documents that specifically says that the manager may offer co-investment vehicles whenever and to whomever it wants." But the wide latitude granted by such disclosure is often limited by co-investment allocation policies and procedures that specify a process for selecting co-investors. Sutton has seen, for example, co-investment allocation policies and procedures that

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set out mechanical processes for selecting co-investors, such as rotation-based lists or proration formulas based on submitted indications of interest.

Fund and Co-Investment Vehicle Are Organized Simultaneously

In rare cases, the fund and the co-investment vehicle are organized simultaneously. In such cases, the fund typically has a broader investment mandate into which the co-investment opportunity falls. In such cases, managers often build an allocation formula into the governing documents of the fund and co-investment vehicle in which the allocation of the co-investment opportunities is based on assets under management or other objective factors. However, managers in such circumstances also typically reserve the right to change the formula or the inputs into the formula based on subsequent developments, which are often hard to predict – especially in distressed or activist scenarios (both common fronts for hedge fund co-investment activity).

Conflicts

Co-investments can create at least five conflicts of interest, including conflicts relating to implicit marketing, investments at different levels of the target's capital structure, rescue funds, varying fee structures and principal transactions.

Implicit Marketing

Managers may be tempted to use co-investments as opportunities to initiate relationships with new investors for the manager's current or subsequent funds. Interestingly, Rozenblit, of the SEC's Asset Management Unit, suggested at the 2014 Compliance Outreach Program National Seminar (without explicitly stating) that implicit marketing may be permissible in certain circumstances in the presence of adequate disclosure. "If you're going to allocate co-investments based on who will invest in your next fund," he said, "you ought to communicate that up front to your limited partners." However, Sutton emphasized that the fiduciary litmus test is benefit to fund investors: if a manager could have offered a co-investment opportunity to a fund investor or a non-fund investor and offered the opportunity to the latter, the manager should be able to articulate a reason for the choice that is consistent with the interests of the fund investor. Put another way, while disclosure can impact the reasonableness of a fund investor's expectations, a manager in this context probably cannot contract out of relevant fiduciary duties (or, if it tried to, might encounter incredulousness on the part of SEC examiners). See "Can Hedge Fund Managers Contract Out Of Default Fiduciary Duties When Drafting Delaware Hedge Fund and Management Company Documents?," Hedge Fund Law Report, Vol. 6, No. 14 (Apr. 4, 2013).

Investments at Different Levels of the Target's Capital Structure

If the primary fund and the co-investment vehicle explicitly invest at different levels of the target's capital structure, there is a distinct possibility of conflicts. For example, if the primary fund and the co-investment vehicle invest on different sides of the fulcrum security in a reorganization, the two vehicles may wind up in a zero-sum situation in which it is difficult for the manager to reconcile its fiduciary duty to both. However, based on timing, investment size and other factors, the primary fund and the co-investment vehicle may wind up invested at different levels of the target's capital structure even if they start in the same place. Robust
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disclosure of this possibility, Sutton noted, is the first level of prophylactic. But even if disclosure in this circumstance is sufficient from a legal point of view, it likely would not be sufficient from an investor relations point of view. Managers, accordingly, would be well advised to take this potential conflict into account when making investment decisions. See "PLI Panel Provides Regulator and Industry Perspectives on Ethical and Compliance Challenges Associated with Hedge Fund Investor Relations," Hedge Fund Law Report, Vol. 6, No. 25 (Jun. 20, 2013).

Rescue Funds

Breslow noted that some co-investment vehicles are organized to "rescue" a foundering investment in the primary fund. "The terms of the rescue investment understandably might be quite dilutive of the people in the existing investment," she noted. Accordingly, managers will sometimes offer such rescue co-investment opportunities to investors in the main fund. But fewer than all fund investors may have the money or appetite for investment in the rescue fund. Accordingly, the manager may face a conflict by managing a rescue fund that is investing in the same target on substantially superior terms to the main fund. Such a scenario may also raise the capital structure conflicts discussed immediately above.

Varying Fee Structures

As Breslow noted, "There may be different fees" between the primary fund and the co-investment vehicle. "You should make robust disclosure in the conflicts sections of your hedge fund documents about the fact that you can run other vehicles with partially overlapping investment objectives and that you can charge people different levels of fees. You can have those results, but you should disclose them." As discussed in the second part of this series, fees on co-investment vehicles are usually – though not invariably – lower than fees on primary funds. However, two caveats. First, even if the fees on the co-investment vehicle are lower, that does not eliminate the possibility of conflict but rather changes the character of them. For example, instead of a concern that the manager will allocate superior opportunities to the co-investment vehicle (which in any case would be mitigated by the co-investment vehicle's likely more narrow mandate), fund investors may be more concerned about the aforementioned implicit marketing concern – which would be exacerbated by lower fees on the co-investment vehicle. Second, no rule says that co-investment vehicles always have lower fees, and in scenarios like the "rescue fund" scenario described above, co-investment vehicles may in fact have higher fees than the primary fund, or a different kind of fee structure (e.g., a private equity style waterfall) from which the manager expects to derive more long-term or post-tax value.

Principal Transactions

"The manager itself might be among the people taking advantage of the co-investment opportunity, which should be disclosed as a possibility in the conflicts section of the offering materials," Breslow noted. See "When and How Can Hedge Fund Managers Engage in Transactions with Their Hedge Funds?," Hedge Fund Law Report, Vol. 4, No. 45 (Dec. 15, 2011).

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Breslow noted that "if you are offering a co-investment to benefit plans, you need to be sensitive to what percentage of the class of securities they end up taking out." In general, if benefit plan investors – such as private pension funds – own more than 25 percent of any class of equity
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securities of a fund or co-investment vehicle, the fund or vehicle could be deemed a "plan asset fund" subject to ERISA, including its prohibition against transactions with "parties in interest." See "How Can Hedge Fund Managers Managing Plan Asset Funds Comply with the QPAM and INHAM Exemption Requirements?," Hedge Fund Law Report, Vol. 6, No. 38 (Oct. 3, 2013).

Bad Actor Disqualification

New Rule 506(d) of Regulation D under the Securities Act of 1933 generally provides that an issuer is disqualified from relying on Rule 506(b) (a safe harbor from securities registration) or 506(c) (an exemption from the ban on general solicitation and advertising) if any beneficial owner of 20 percent or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power, has been convicted of, or is subject to any order by the SEC or a state securities regulator involving, certain "scienter-based" securities laws violations. While it is less likely that an institution, as opposed to an individual, would have engaged in "scienter-based" securities laws violations and thus constitute a bad actor under the disqualification rule, nonetheless, managers should evaluate the co-investor base for potential disqualification. See "SEC Provides Guidance on When the Bad Actor Rule Disqualifies Hedge Fund Managers from Generally Soliciting or Advertising," below, in this issue of Hedge Fund Law Report. See also "Implications for Hedge Fund Managers of the SEC's Recent Guidance on the Rule 506 Bad Actor Disqualification Provisions," Hedge Fund Law Report, Vol. 6, No. 47 (Dec. 12, 2013). See generally "Why and How Should Hedge Fund Managers Conduct Background Checks on Prospective Employees? (Part One of Three)," Hedge Fund Law Report, Vol. 6, No. 38 (Oct. 3, 2013).

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Clark noted that "co-investment vehicles are treated like other funds. Accordingly, they have to be exempt pursuant to the Investment Company Act of 1940 and they must be disclosed on the manager's Form ADV. They are also generally included when calculating beneficial ownership for purposes of Schedule 13D." See "How Can Hedge Fund Managers Rebut the Presumption of Materiality of Certain Disciplinary Events in Form ADV, Part 2?," Hedge Fund Law Report, Vol. 5, No. 1 (Jan. 5, 2012). Co-investment vehicles may also have to file or be included on Form PF. See "Challenges Faced By, Risks Encountered By and Lessons Learned From First Filers of Form PF," Hedge Fund Law Report, Vol. 6, No. 4 (Jan. 24, 2013).

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