STANDARDS BOARD FOR ALTERNATIVE INVESTMENTS

Co-Investments

Executive Summary

Co-investments have become increasingly popular, not just in Private Equity and Real Estate, but also in other liquid and illiquid alternative investment strategies, including alternative credit and activist funds. This memo provides an overview of:

- the co-investment landscape in alternative investments
- key governance and compliance challenges and investor concerns
- an illustrative co-investment process to address these challenges and concerns
- structuring considerations
- fee, expense and other cost considerations
- investment risk disclosure considerations

The Appendix includes:

A: A case study highlighting conflicts of interest in co-investments

B: An indicative structure for a co-investment policy

C: Global regulatory perspective (conflicts of interest)

D: The SEC's perspective on co-investments

E: List of working group members

Introduction

Co-investments allow investors to participate in individual investment opportunities in parallel with the regular fund structure. Co-investments opportunities are made available when opportunities are too large to be (fully) allocated to the relevant fund vehicle(s). In activist funds, co-investment opportunities are a means for the manager to get more voting rights and thereby also can benefit investors in the relevant commingled fund(s). The fees charged on individual co-investments are usually lower than the management and performance fees of the fund(s). The chart below summarizes the landscape for co-investments, including the key drivers, strategies where co-investments are most prevalent and typical approaches regarding structuring and fees.

The SBAI Toolbox is an additional aid to complement the SBAI's standard-setting activities. While alternative investment fund managers sign up to the Alternative Investment Standards on a comply-or-explain basis, the SBAI Toolbox materials serve as a guide only and are not formally part of the Standards or a prescriptive template.

Illustration 1: Overview of co-investment landscape in alternative investments (overflow from commingled fund)[1]

Driver & Example	Structure
Driver: Co-investor capital enhances fund's strategic position **Common examples:** • **Activism** – reaching required ownership threshold • **Stressed/Distressed Credit** want to do whole deal or achieve control/influence	• Usually SPV set up by manager • Increasingly SPC/cell company structures for repeatable co-investment process, and lower set-up costs
Driver: Scalable overflow/best ideas position **Common examples:** • **Event Driven** e.g. stub trades, claims • **Equity Long/Short** e.g. high conviction single stock position • **Thematic/Macro** e.g. country specific macro vehicle	• Tend to be more episodic. Often SPV set up by manager. • Co-investment Fund of One or SMA
Driver: Housing illiquid investments **Common examples:** • **Credit** e.g. illiquid private lending opportunity • **Activist** e.g. LBO opportunities with activist angle • **Long/Short** e.g. pre-IPO equity	• Often SPV/ side-pocket set up by manager. • Fund-of-One/SMA

Managers who grant investors the right to co-invest need to put in place adequate processes to handle the co-investments to address governance and compliance challenges, and investors need to conduct careful operational and investment due diligence of co-investment opportunities. From an operational due diligence perspective, several areas require particular attention:

- Potential conflicts of interest between different co-investors, as well as between the co-investors and the relevant fund(s) (allocation approach, including allocation priority, ability to exit)
- Allocation of expenses (including failed deal expenses)
- Allocation to third parties (e.g., investors who are not invested in the relevant fund(s), thereby helping pay for the manager infrastructure and idea generation in the first place)

Regulatory Perspective

Regulation usually focusses more broadly on addressing conflicts of interest that can arise in investment management. Regulatory approaches vary from jurisdiction to jurisdiction, but the overarching objective is to ensure fair treatment of investors by either managing/mitigating conflicts of interest or disclosing such conflicts, where applicable.[2] Co-investments were explicitly referenced by the SEC in 2016, during

[1] There also can be situations where a deal is not included in the commingled fund (e.g., deal has different objectives from fund), with separate investor capital deployed to absorb the deal, but this would not constitute a "co-investment".

[2] Appendix C provides an overview of the regulatory focus on conflicts of interest for different jurisdictions.

a Compliance Outreach Seminar, where SEC staff noted that it would be fine for a manager to have a co-investment vehicle, but they should not "play favourites with clients." In 2015, Marc Wyatt, the then acting director of the SEC's Office of Compliance and Inspections, raised concerns about insufficient disclosure of certain co-investment allocations to investors in the main fund. He highlighted the importance of disclosure of co-investment allocations to investors in the fund, in addition to adequate policies and procedures, and concluded that "the best way to avoid risk is to have a robust and detailed co-investment policy which is shared with all investors".[3,4]

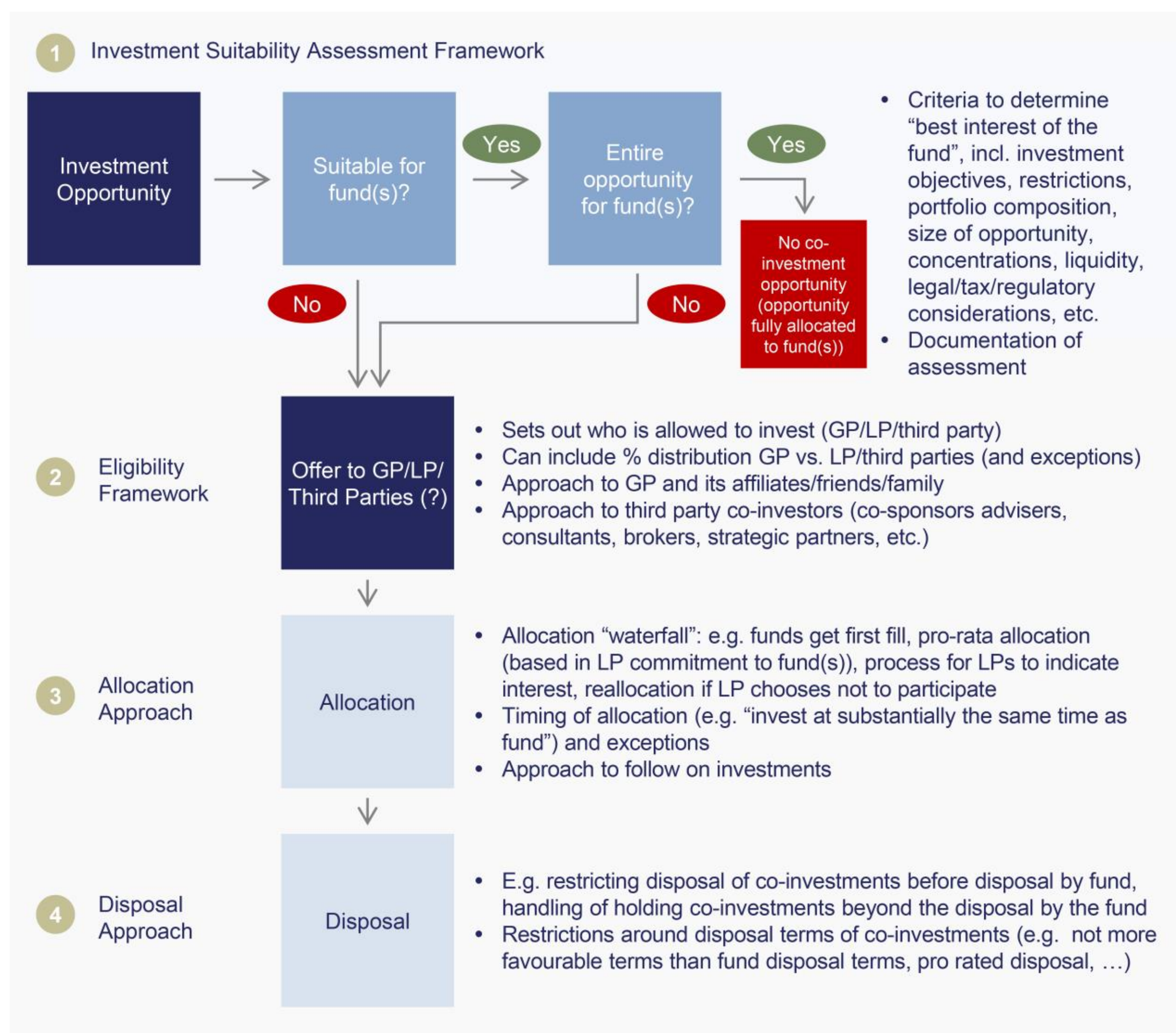
Co-Investment Process and Policy

To address these investor and regulatory concerns, some managers have started to formalise the co-investment process and have put in place co-investment policies, which set out the handling of the process from the allocation decision to disposal of the assets. Usually, the process will include an assessment of the suitability of co-investment opportunities, a determination of who is eligible to invest and a predefined approach to allocation and disposal of investments. The illustration below provides an overview of one approach to a co-investment process.

[3] It should be noted that the SEC's statements were made in speeches/outreach programs and the staffers have disclaimed liability for these statements which may not be reflective of the agency but are their own views on the issues.

[4] See Appendix D for more detail

Illustration 2: Co-Investment Process



The illustration can also serve as a guide for managers to structure their co-investment policy. Appendix B contains an indicative structure for a co-investment policy.

Structuring Considerations

There is a range of possible structuring options for co-investments catering for a variety of strategies (liquid and illiquid). The table below provides some examples, assuming the co-investment trades *pari passu* with the main/flagship fund.

Type	Description	Observations
Advisory	This is where the manager would provide its thesis on the co-investment to the LP/investor, recommend entry and an exit point. However, the LP would retain control over trading of the investment. The LP would go direct to the issuer who could be raising for a follow-on or other type of financing.	• There would be a consulting/advisory agreement in place outlining manager's duties, process to introduce co-investment, reporting and compensation • If the LP does take trading control, disclosure recommended to other fund investors in the event the LP takes a view contrary to manager on the co-investment

Type	Description	Observations
Fund of One	If an LP requests a fund of one (e.g., required by their Investment Committee), a manager could assist with setting up a fund of one used for co-investments. The manager would have full discretionary control over the management of the entity.	• More costly and involved than an advisory or SMA structure • A full audit would be required, as well as appointment of directors or GP (as applicable) and an administrator • Could be set up as onshore or offshore, depending on the tax profile of the LP. • Regarding liquidity, it may be best to set up with a committed capital structure so that the manager could call capital for co-investment opportunities that arise which the LP is interested in as well as call for fund expenses • A waterfall structure could be used to manage cash distributions (e.g., 100% of cost of investment returned to LP, realized gains split 90% to LP and 10% to GP)
Single Managed Account (SMA)	A situation could arise where the LP requests that the manager trade the co-investment within an SMA. The manager via an Investment Management Agreement (IMA), would have full discretionary control over the account.	• LP would have to assist the Prime Broker with setting up of the account and authorizing the manager with discretion. • LP can pull discretion away from manager at any time • More cost-effective for LP as no fund establishment and on-going expenses
Commingled SPV	A manager could establish an SPV through which all interested investors could hold a single co-investment.	• A new SPV would need to be set up for each co-investment, which is less cost-efficient and more time-consuming than the commingled co-investment fund described below, but allows maximum flexibility to vary the structure, terms and investors for each new co-investment opportunity
Commingled Co-Investment Fund	A manager could establish a fund for co-investment/overflow opportunities and invite its investor base to participate. Unlike the above, there could be multiple co-invests within the commingled fund.	• The manager would retain full discretionary control over the vehicle. • Thought should be given to fee/redemption terms
Class/Series within the Flagship Fund	If setting up a new structure is too costly, then one could consider setting up a separate class or series within its flagship fund that could invest in the co-investment. It likely would need to be offered to all of the funds' investors.	• A class/series would allow the co-investments performance to be tracked separately for performance fee purposes • However, legal analysis should be undertaken to determine whether the liability could be isolated to that separate class/series if there were an issue with the co-investment. If not, other non-participating investors could be unfairly disadvantaged by the lack of segregation (e.g., due to leverage considerations or otherwise). If disadvantaging other non-participating investors is probable, such co-investment should not be made within the main fund

Fee, Expense and other Cost Considerations

The allocation of fees, expenses and other costs between the relevant commingled fund(s) and co-investors can be another potential source of conflicts of interest:

- Structuring of co-investment opportunities normally incurs costs, such as legal and structuring fees. To ensure fair treatment of investors, it is important that such fees and expenses are allocated such that investors in the relevant commingled fund(s) are not impacted (i.e., the fees and expenses are either borne by co-investors or by the manager)
- Brokerage commissions and other transaction related costs normally should be allocated in a pro-rata fashion, so no investor is unduly favoured or disadvantaged
- Cost of broken deal expenses should not be imposed solely on the investors in the relevant commingled fund(s) (but be borne by those funds and co-investors pro rata or by the manager)5 This can be challenging, however, depending on when the deal "breaks" before or after investors have fully committed to the co-investment. Prior to receiving binding commitments from investors for the co-investment, it is difficult to determine which prospective investors (if any) should be reasonably expected to bear the deal expenses

The approach to allocating fees, expenses and other costs should be disclosed to all investors.

Investment Risk Disclosure Consideration

The Disclosure section of the Alternative Investment Standards sets out the relevant information that should be provided to investors so that they can make well-informed investment decisions. Any conflicts of interest regarding the manager's co-investment process should be highlighted to investors, including risk factors such as allocation and timing issues, as well as the ability for the manager to receive management or incentive fees on the co-investment which could motivate the manager to act differently. Accordingly, managers should revisit these disclosure requirements with a view to providing adequate disclosure of the opportunities and risks of co-investments, as well as any relevant updates.

[5] SEC: IA Release No. 4131 (June 29, 2015). Case involving improper allocation of broken deal expenses where the co-investment fund received deal allocations but not its share of broken deal expenses.

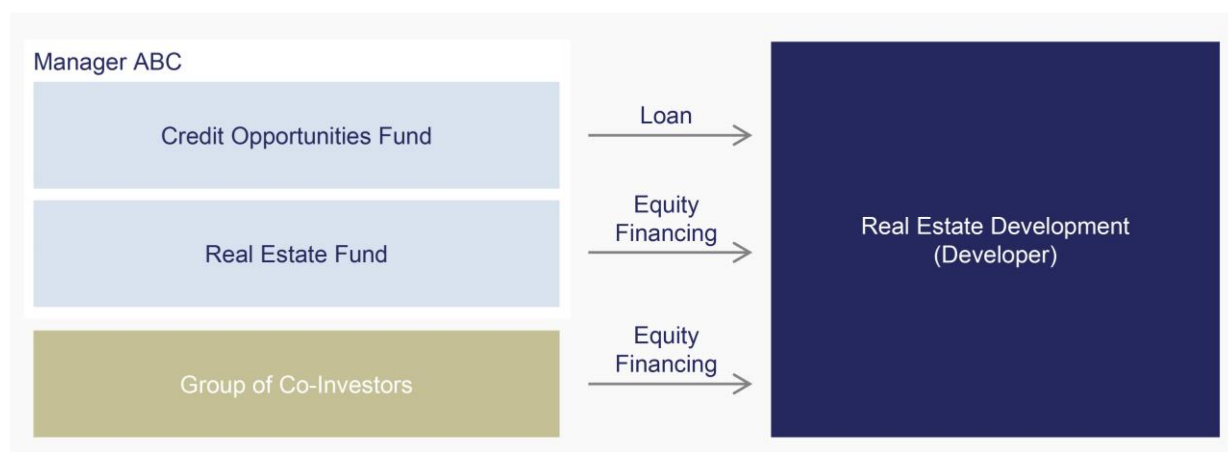
Appendix A

Case Study: Conflicts of interest in co-investments

Thinking in advance about the ways in which alignment of interests plays out in a co-investment scenario is crucial for both investors and fund managers.

Scenario: Fund Manager ABC runs the *"Credit Opportunities Fund",* which makes a loan to a commercial real estate development in Poland (pre-financial crisis). The equity financing is provided by ABC's closed-ended *"Real Estate Fund"* and a group of co-investors. The Real Estate Fund is a much smaller fund than the Credit Opportunities Fund and generates far less revenue for the Fund Manager.

Illustration



Complication

Due to delays in the real estate development and the simultaneous economic slowdown (unfolding of financial crisis in 2008), the letting of the office space is significantly behind schedule giving rise to cash flow problems. This results in the default of the developer when the loan matures. ABC decides to renegotiate the loan, which results in an extension of its maturity and a significant increase in interest rates. From the equity co-investors' perspective, the interest rate is perceived to be excessive, and they threaten legal action. To address the situation, ABC uses the Real Estate Fund to buy out the co-investors at a very small discount to cost.

Assessment

This case highlights the conflicts of interest in situations where a manager acts for both the equity and debt investors and additional complications that arise from the co-investment alongside the Real Estate Fund. The manager was conflicted given the relatively larger importance of the Credit Opportunities Fund vis a vis the Real Estate Fund and appears to have neglected its fiduciary duty to the Real Estate Fund investors. While the co-investors escaped financial harm, ABC ultimately has opened themselves up to litigation by the Real Estate Fund investors.

Appendix B

Indicative Structure for a Co-Investment Policy

A co-investment policy needs to be tailored to a manager's processes and structure. Therefore, co-investment policies will differ between managers. In addition, there can be a need for some degree of flexibility and the ability for managers to make exceptions to account for bespoke LP requests. The list below provides an indicative structure of a co-investment policy (based on the co-investment process overview in Illustration 2):

1. Introduction (including objectives of the co-investment policy, overview conflicts of interest)
2. Suitability assessment (this also can be a separate internal process, which can be referenced in the policy)
3. Eligibility Framework (specifying who can invest)
4. Allocation Approach
5. Disposal Approach
6. Handling of fees, expenses and other cost

Appendix C

Global Regulatory Perspective (Conflicts of Interest)

(Underlined words are hyper-linked to the relevant regulatory documents)

US Securities and Exchange Commission (SEC): Form ADV (Instructions for Part 2)	Disclosure obligation as a fiduciary: (…) As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship. (…) provide the client with sufficiently specific facts so that the client is able to understand the conflicts of interest (…), and can give informed consent to such conflicts or practices or reject them.
US SEC Examination Priorities for 2014	"Registrants [have engaged] in activity that puts their own interests ahead of their clients in contravention of their fiduciary duty and existing laws, rules and regulations." (p.4)
European Securities and Markets Authority (ESMA): Alternative Investment Fund Managers Directive (AIFM-D)	Chapter III (Operating Conditions for AIFMs): • Article 12 (General Principles): "…e) take all reasonable steps to avoid conflicts of interest and, when they cannot be avoided, to identify, manage and monitor and, where applicable, disclose, those conflicts of interest in order to prevent them from adversely affecting the interests of the AIFs and their investors and to ensure that the AIFs they manage are fairly treated; … f) treat all AIF investors fairly. No investor in an AIF shall obtain preferential treatment, unless such preferential treatment is disclosed in the relevant AIF's rules or instruments of incorporation." • Article 14 (Conflicts of interest): "…take all reasonable steps to identify conflicts of interest that arise in the course of managing AIFs… AIFMs shall assess whether their operating conditions may involve any other material conflicts of interest and disclose them to the investors of the AIFs. …
UK Financial Conduct Authority (FCA): Principles 6 & 8	6) A firm must pay due regard to the interests of its customers and treat them fairly. 7) A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
UK FCA: Handbook	• Investment Funds Sourcebook (e.g. FUND 3.2, 3.7, 3.9, 3.10, 3.11) • Other: Conduct of Business Sourcebook (COBS 11.3.1 (3)), Senior Management Arrangements, Systems and Controls (SYSC 10.1)

UK FCA Report (2012)	Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks
Hong Kong Securities and Futures Commission (SFC)	• Code of Conduct: GP6 (Conflicts of Interest) – avoid conflicts, treat clients fairly; paragraph 10.1 (Disclosure and Fair Treatment) • Fund Manager Code of Conduct: 2.1.1-2.1.4 Personal Account Dealing; 2.2. Receipt of Provisions of Benefits
Monetary Authority of Singapore (MAS)	• Securities and Futures Regulation (SFR): Regulation 13B • Securities and Futures Act: Guidelines on Licencing, Registration and Conduct of Business for Fund Management Companies: Measures to mitigate conflicts of interest, disclosure (4.1.3)
Australian Securities and Investment Commission (ASIC):	• Registered Managed Investment Schemes: Guidance on conflicts of interest (guide 76), specific disclosure duties (s601FD, 601FE) of the Corporations Act • Unregistered Schemes: no requirements specific to conflicts of interest, but general Australian Trust law is applicable, separate guidance about corporate governance
Canadian National Instrument (31-103)	Identification of conflicts of interest (13.4), restrictions on managed account transactions (13.5), Disclosure of recommendation of related securities (13.6), relationship disclosure information (14.2), disclosure about fair allocation of investment opportunities (14.3); Companion Policy 31-103 CP 13.4-13.6, 14.2-14.4
Switzerland	Swiss Funds & Asset Management Association: SFAMA Code of Conduct: (5., 10.) Avoidance / disclosure of conflicts of interest [The Swiss Financial Market and Supervisory Authority FINMA has recognised the SFAMA Code of Conduct as a minimum standard]

Appendix D
SEC Perspective on Co-Investments

Excerpt from speech from Marc Wyatt, (Acting Director of the Securities and Exchange Commission's Office of Compliance Inspections and Examinations (OCIE), SEC (2015)[6]

B. Co-Investment Allocation

Another area where we have been dedicating resources is co-investment allocation. We've spoken before about our observation that co-investment allocation was becoming a key part of an investor's thesis in allocating to a particular private equity fund, and over the past year, co-investments have become even more important to the industry.

While most of our co-investment observations have been around policies and procedures, we 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. Therefore, allocating co-investment opportunities in a manner that is contrary to what you have promised your investors can be a material conflict and can result in violations of federal securities laws and regulations.

[6] Source: https://www.sec.gov/news/speech/private-equity-look-back-and-glimpse-ahead.html

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.

Appendix E

Governance Working Group - Co-Investment Workstream

Name	Title	Organisation
Anabelle Perez Grey	General Counsel and CCO	HealthCor Group LLC
John Richardson	COO and General Counsel	Ionic Capital Management
Jessica Ross	Consultant	Albourne Partners
Thomas Deinet	Executive Director	SBAI