A closer look

A publication of PwC's financial services regulatory practice

January 2015

Private equity co-investment: Best practices emerging

Overview

Private equity firms facing Securities and Exchange Commission (SEC) examination in recent years have been preparing for scrutiny of several aspects of their investment adviser compliance programs. Compliance departments tend to devote significant attention to enhancing firm policies and procedures for valuing portfolio companies, allocating expenses among funds and portfolio companies, dealings with affiliates, information barriers, marketing materials, and anti-bribery. They do so with good reason: recent SEC enforcement cases, examination requests, and official speeches strongly suggest they should.

However, one area of enhanced focus in SEC exams that warrants attention from compliance departments is external co-investments, which are investments in portfolio companies by fund limited partners (or other outside parties) alongside one or more private equity funds.

Much of the growth in private equity fundraising since the financial crisis has come from separate accounts and co-investments instead of traditional fund investments.[1] Recent survey data support the notion that external co-investment is no longer the exclusive domain of a few select investors or strategic partners. Limited partners of all sizes are increasingly seeking co-investment opportunities when negotiating new fund agreements with advisers. They are attracted by greater deal selectivity and the prospect of higher net returns through lower fees. For advisers, co-investment may be helpful for fundraising and dealmaking but is challenging from an operational and compliance perspective.

The SEC examination staff has been assessing co-investment practices as part of its broader expressed concern about conflicts of interest in private equity. We believe examiners may focus on preferential allocation of lucrative co-investment opportunities to some limited partners and not to others, and possibly at the expense of primary funds. Examiners may also question whether primary funds are bearing more than their fair share of broken deal expenses when significant co-investor participation is contemplated to pursue larger deals.

This **A closer look** (a) provides an overview of recent trends in private equity co-investment, (b) describes the SEC staff's areas of potential concern and exam focus, and (c) offers leading industry practices for mitigating compliance risks.

pwc

Latest trends in co-investment

Background

External co-investment has long been a common feature of private equity buyout transactions. When a portfolio company investment is too large for a fund, or would cause a breach in diversification requirements, fund advisers may offer limited partners and other outside parties the chance to make minority investments in the deal alongside the fund.[2]

This co-investment can be direct or indirect. Outside institutions with strong operational due diligence capabilities may invest directly in portfolio companies to obtain governance rights and limit management fees. Others may invest indirectly, typically through a co-investment vehicle (comprised of one or more investors) created specifically to invest alongside the primary fund.

Co-investors often benefit from lower (or no) management fees and carried interest, as well as greater deal selectivity and transparency. At the same time, the adviser benefits from the ability to close and control larger transactions than the primary fund can support.

Advisers generally prefer co-investment partners with the capital and flexibility to act quickly under tight deal deadlines, and with the ability to efficiently perform due diligence (building on the adviser's due diligence). Mutual trust plays a large part in the successful execution of external co-investment deals.

Changing dynamics

Although private equity fundraising is returning to pre-2008 financial crisis levels, a significant portion of this growth is attributable to external co-investments.

Investor appetite for co-investment opportunities is at an all-time high, based on a recently published study.[3] Of 140 limited partners surveyed, 73% reported having co-invested in at least one past portfolio company deal, and 77% reported that they are currently seeking co-investment opportunities. In addition, 52% of limited partners reported that they were planning to grow their internal operations to support making and managing co-investments in the coming year.

Of the 80 advisers surveyed, 64% reported that they offer co-investment rights to their limited partners and another 19% were considering doing so in the future. Additionally, the survey found that institutional investors of all sizes participated in co-investments, contrary to the perception that co-investment is the domain of larger investors.

This trend toward greater co-investment reflects the evolving balance of power between private equity advisers and their investors. Because of today's competitive fundraising environment, investors have greater leverage to push for lower fees and more selective opportunities that co-investment can provide. As a result, advisers are increasingly willing to offer co-investment opportunities in side letters to incentivize investors to commit capital early to new funds. Of advisers that offer co-investment opportunities, 76% cited building stronger relationships with limited partners as their reason for doing so, although the primary immediate benefit of such low-fee (or no-fee) capital is to enable advisers to make larger deals.

SEC staff concerns

The SEC staff's focus on conflicts of interest in private equity is nothing new. Beginning in 2011, the Division of Enforcement's Asset Management Unit began a concerted, well-publicized effort to detect improper valuation, expense allocation, and other practices by private equity advisers.

Once private equity advisers began registering in mid-2012 following the passage of Dodd-Frank, the SEC's Office of Compliance Inspections and Examinations (OCIE) made it a priority to detect improperly managed conflicts of interest in "presence exams" and other routine private equity exams. Additionally, in early 2014, OCIE formed a dedicated private fund examination unit, with the mission of achieving more efficient and effective private equity (and hedge fund) exams nationwide by cultivating and deploying specialized resources and expertise.

These efforts have led to increased OCIE questions regarding external co-investment, including the following:

- Whether the allocation of investment opportunities between the primary fund and co-investors is consistent with the adviser's fiduciary duty to the primary fund(s) and the terms of its fund agreements, Form ADV disclosures, and policies and procedures?
- Whether the adviser is offering co-investment opportunities preferentially to select limited partners in a manner not fully disclosed to all limited partners?
- Whether it is fair for the primary fund to bear the full cost of due diligence and other expenses from broken deals in situations where significant, early co-investment was contemplated and arranged?

These questions have surprised many recently-examined advisers, as co-investment practices are largely governed by negotiated contracts and vaguely defined concepts of fairness to limited partners. However, we believe that in most cases, private equity advisers can proactively address these issues through enhanced policies, procedures, and disclosures in fund agreements and Form ADV. Implementing these enhancements will prepare firms both for OCIE examinations and potential inquiries from limited partners.

Why does the SEC care about private equity?

In preparing for or undergoing exams, private equity firms often ask a question similar to the following:

"Why does the SEC care so much about private equity? Fund agreements are heavily negotiated private contracts. Limited partners are sophisticated institutions, family offices, and high-net worth individuals who are able to protect themselves and do so quite effectively. Shouldn't the SEC instead focus on retail investor harm?"

The SEC staff's response is generally twofold. First, private equity practices do impact retail investors. Public and private pensions, endowments, and foundations account for about 60% of private equity investments. In terms of asset allocation, private equity investments comprise over 10% of total public pension fund investment, and are their third most invested asset class behind public equity and fixed income. Second, the SEC staff has observed that limited partners often lack the transparency to monitor their advisers' practices as to fees, expenses, valuation controls, investment allocation, and other areas.

Allocation of investment opportunities

As investment advisers, private equity firms have a fiduciary duty to act in the best interest of each of their clients and funds, to treat each client and fund fairly and equitably, and to make full and fair disclosure of all material facts and conflicts of interest.

Fulfilling this duty is challenging for private equity advisers faced with allocating limited investment opportunities to two or more funds with overlapping investment programs. To address this potential conflict, many firms have taken steps to ensure that fund agreements, policies, procedures, and investor disclosures sufficiently describe the investment allocation process, the various considerations that play into allocation decisions, and, in many cases, the adviser's ultimate discretion to make allocations in good faith.

Co-investment further complicates allocation decisions. If a transaction is large enough that it exceeds the investment thresholds or diversification requirements of the participating fund, offering co-investment to limited partners or other outside parties should not present an allocation issue. However, if the adviser offers co-investment opportunities before the fund's investment appetite is satisfied, an issue may arise about whether the adviser has acted in the fund's best interest. Although there may be valid reasons supporting the allocation decision, the adviser may be challenged later about whether it managed the conflict properly or deprived the fund of its fair share.

In assessing how firms manage this potential conflict, OCIE examiners may review sample transactions to see if the allocations to the fund and co-investment vehicles were fair, equitable, and consistent with the adviser's disclosures. To that end, examiners may seek to confirm that the adviser's investment team determined the optimal investment amount for the fund before considering allocations of excess amounts to co-investors. To the extent the adviser's investment decision for the fund is independent of any later co-investment considerations, and is well documented in accordance with firm policies and procedures, the allocations may not raise concern.

Examiners may also review side letter agreements and communications between investor relations personnel and limited partners (current or prospective) to determine whether co-investment rights were promised to certain investors in connection with fundraising. If there is evidence that the adviser was pressured to offer co-investment – affecting the adviser's allocation decisions vis-à-vis the fund – examiners may question whether the adviser met its fiduciary duty to the fund.

Preferential treatment to certain limited partners

Facing complex transactions and tight deadlines, advisers have a strong incentive to offer co-investment to parties with track records of acting quickly and decisively. However, the terms of the fund's partnership agreement do not always grant the adviser full discretion to offer excess opportunities to outside parties (including limited partners and strategic partners). Instead, some agreements require that opportunities first be offered to existing limited partners before giving the adviser full discretion to offer opportunities to others.

OCIE examiners are likely to focus on whether the adviser's co-investment practices are consistent with its agreements, policies, procedures, and disclosures. Examiners are also likely to assess the quality of the adviser's disclosures to limited partners.

There is a lingering question about what an adviser can reasonably be expected to disclose about its co-investment practices. While OCIE officials have generally acknowledged that an adviser does not owe a fiduciary duty to limited partners but only to the fund, some within the office believe that an adviser's co-investment practices, preferences, and timing are material pieces of information that should be disclosed to all limited partners.[4] In this view, the adviser should disclose that, for example, it may offer co-investment preferentially to certain parties as an incentive to invest in future funds. Additionally in this view, the adviser should disclose its co-investment allocations early enough to give limited partners who did not receive an allocation the chance to voice complaints and perhaps receive an allocation.

In our view, an adviser – in consultation with legal counsel – should consider making appropriate disclosure about co-investment policies so that all limited partners are on notice at the time of investment about the extent of the adviser's discretion to offer co-investment opportunities. However, since fiduciary concepts apply only to the adviser's relationship with its managed funds and other clients, an adviser generally is not obligated to provide limited partners full transparency on a specific deal-by-deal basis, unless required under the fund agreement.

Allocation of broken deal expenses

OCIE's apparent focus on the allocation of broken deal expenses stems from its overall concern in recent years about hidden expenses and expense-shifting practices in the industry. Some believe that both internal and external co-investors frequently receive the upside of lucrative deals without having to bear their fair share of broken deal costs (e.g., due diligence expenses and legal fees) when transactions fall through.

As with most aspects of the co-investment process, the allocation of broken deal expenses is governed by the partnership agreement and other organizing documents. Historically, partnership agreements were often silent on the issue, or else provided that broken deal expenses were to be borne solely by the fund.

OCIE examiners may question whether this practice is unfair to the fund and gives preferential treatment to co-investors. If fund documents are unclear, the analysis generally depends on facts and circumstances. For example, if a deal collapses before outside co-investments are fully identified or arranged, and the overall deal size is within the fund's reasonable mandate, examiners are less likely to take issue with the fund bearing a full share of broken deal expenses. However, if a contemplated deal is so large that it could not have been completed without early, significant co-investor commitments, then examiners may question why the fund should bear the full cost of due diligence and legal negotiations if the deal fails to close.

If an established set of outside co-investors participates routinely in large deals that exceed the fund's mandate, advisers should consider whether it makes sense to allocate broken deal expenses pro rata to the fund based on its investment contribution, with the adviser or co-investors bearing the remaining portion.

To the extent the adviser has discretion to determine allocation of broken deal expenses, OCIE examiners would likely expect the adviser to disclose its expense allocation practice and take steps to mitigate potential conflicts through robust internal policies, procedures, and controls. For smaller or fast-growing private equity advisers, OCIE is unlikely to be sympathetic to arguments that the firm lacks the back office system functionality or compliance procedures to ensure fair allocation of broken deal expenses.

Leading practices for mitigating compliance risks

Based on our understanding of recent SEC staff priorities and industry leading practices, there are several steps private equity advisers should take to proactively address co-investment regulatory issues:

Policies, procedures, and disclosures

- Develop clear written policies and procedures governing the firm's co-investment practices and processes, including when, how, and to whom excess investment opportunities may be offered.
- Track and incorporate all co-investment rights and terms in fund/client agreements and side letters.
- Confirm that the firm's overall practices, policies, and procedures for allocating investments to funds/clients managed side-by-side are fully and fairly disclosed in agreements, applicable offering documents, and in Form ADV Part 2.
- Determine the extent to which broken deal expenses are to be shared with co-investment vehicles or be borne by the adviser, and ensure such practices are reflected in the adviser's policies, procedures, controls, and disclosures to limited partners.

Separation of fiduciary-related activities

- To help ensure that investment appetites of participating funds are met before allocating a portion of a deal to co-investors, consider instituting greater separation in governance and timing between the investment decision process and the allocation decision process. Document both processes as they happen or shortly thereafter, and ensure sufficient involvement by legal and compliance personnel.
- If investment decisions cannot be kept fully independent, sufficient documentation should exist to show that the adviser met its fiduciary duty to the participating fund before considering outside co-investment.

Training

- Train the firm's investor relations personnel on appropriate communications with current and prospective limited partners about the firm's co-investment policies and practices, in order to avoid misunderstandings about whether co-investment opportunities are being promised in exchange for fund investment.

Testing

- As part of the annual compliance review, assess whether the adviser's actual co-investment practices were consistent with its stated policies, procedures, and investor disclosures.
- Test the adviser's expense controls to verify that broken deal expenses are being allocated fairly and in accordance with governing documents, policies, and procedures.

What's next?

As co-investment continues to play a significant role in private equity deal making and fundraising, the SEC staff is increasingly focused on monitoring advisers' activities in this area. We expect the SEC staff to continue scrutinizing seemingly obscure, yet longstanding, practices in private equity in order to promote greater transparency to limited partners. As OCIE's presence exam program winds down, the next round of private equity exams may include deeper dives into co-investment practices.

Endnotes

1. *Spreading Sunshine in Private Equity*, Remarks by Andrew J. Bowden at Private Equity International, Private Fund Compliance Forum 2014, May 6, 2014.
2. Co-investment by the adviser, its employees, and affiliates is also a common industry practice. The focus of this brief is on *external* co-investment – i.e., by parties not affiliated with the adviser.
3. Preqin Private Equity Spotlight, *The State of Co-Investments*, March 2014.
4. SEC, *Compliance Outreach Program for Investment Advisers and Investment Companies*, January 30, 2014.

Additional information

For additional information about this **A closer look** or PwC's Financial Services Regulatory Practice, please contact:

Dan Ryan
Financial Services Advisory Leader
646 471 8488
daniel.ryan@us.pwc.com

Shyam Venkat
Partner, Financial Services Risk Advisory
646 471 8296
shyam.venkat@us.pwc.com

David Sapin
Partner, Financial Services Regulatory Advisory
646 471 8481
david.sapin@us.pwc.com

Armen Meyer
Director of Regulatory Strategy
646 531 4519
armen.meyer@us.pwc.com

Contributors: Anthony Conte, Scott Weisman, Kent Knudson, Stefanie Kirchheimer, Daniel Faigus, and Luciana Parada Villar.

To learn more about financial services regulation from your iPad or iPhone, click here to download PwC's new Regulatory Navigator App from the Apple App Store.

Follow us on Twitter @PwC_US_FinSrvcs