Standards Board for Alternative Investments

Bringing managers and investors together to set standards for the alternative investment industry

May 2020

Co-Investments

SBAI Working Groups and Initiatives

SBAI working groups cover a wide range of relevant industry topics to provide guidance to investors and managers on practical issues

NEW: Alternative Credit	• Conflicts of interest • Valuation • Choice of fund structure
Factor Investing	• Back-testing practices • Broker dealer practices
Insurance Linked Funds	• Guidance on valuation of ILS Funds (just published) • Next steps: Side pocketing practices
China Working Group	• Comparing Chinese standards and practice to international practice
NEW: Japan Working Group	• Comparing Japanese standards and practice to international practice
NEW: Governance	• Update Standardised Board Agenda • Governance case studies • Manager committees
NEW: Responsible Investment Working Group	• Develop a framework to help investors and managers calibrate their approach to RI in alternative investment strategies
NEW: Standard Investor Profile (SIP) Template	• Standardising subscription, KYC and AML processes for investors via a standard data structure
Initiative: Culture & Diversity	• Roundtable series • Focus on critical business and strategic issues • C-level working group (to be launched)

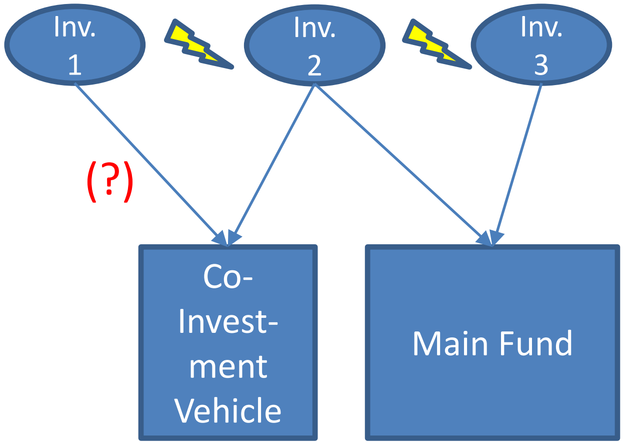
Co-investment landscape

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

Operational Due Diligence Considerations – Why Do We Care?

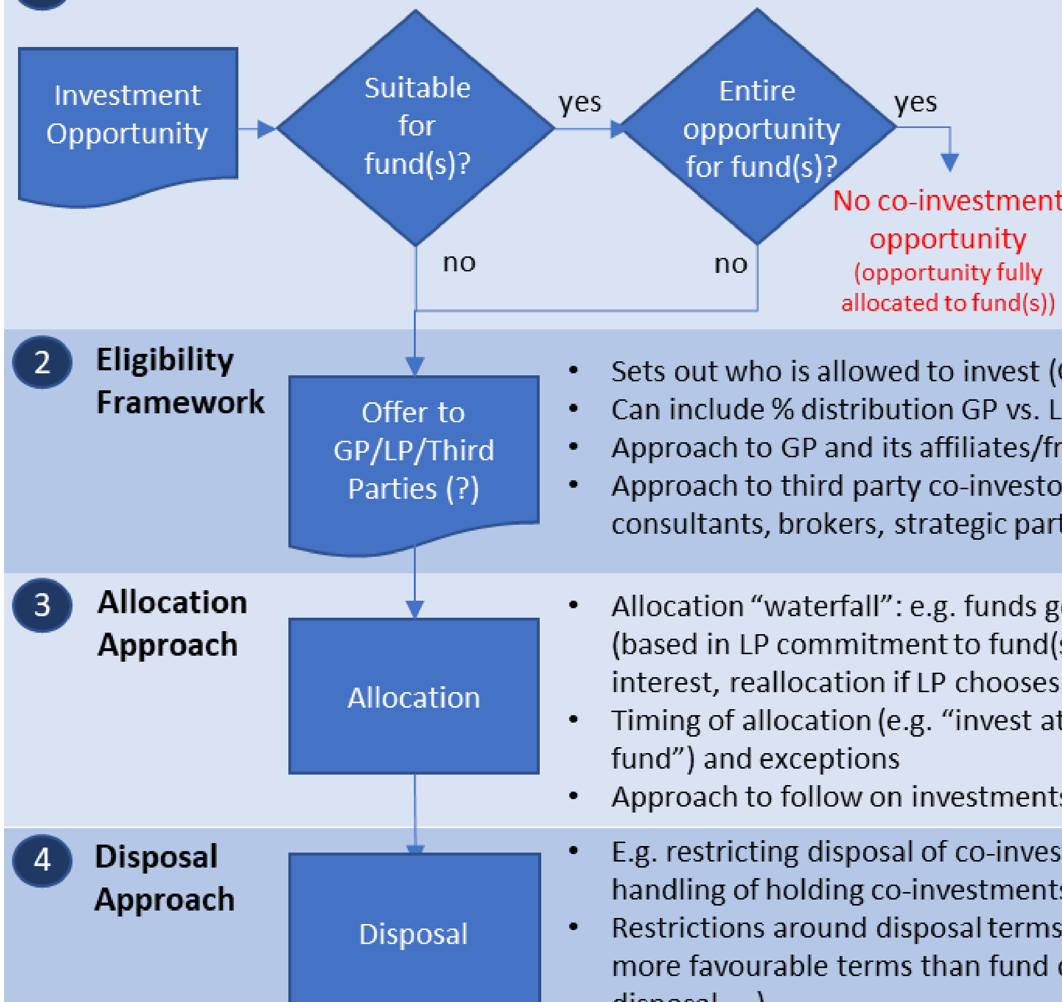
- Potential conflicts of interest between different co-investors, as well as between the co-investors and the relevant fund(s)
  - E.g. allocation approach, including allocation priority, ability to exit
- Allocation of expenses
  - including failed deal expenses
- Allocation to third parties
  - e.g.,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

Conflicts of interest between Investors



Co-Investment Process (Illustration)

1 Investment Suitability Assessment Framework



- Criteria to determine “best interest of the fund”, incl. investment objectives, restrictions, portfolio composition, size of opportunity, concentrations, liquidity, legal/tax/regulatory considerations, etc.
- Documentation of assessment

2 Eligibility Framework

- Sets out who is allowed to invest (GP/LP/third party)
- Can include % distribution GP vs. LP/third parties (and exceptions)
- Approach to GP and its affiliates/friends/family
- Approach to third party co-investors (co-sponsors advisers, consultants, brokers, strategic partners, etc.)

3 Allocation Approach

- Allocation “waterfall”: e.g. funds get first fill, pro-rata allocation (based in LP commitment to fund(s)), process for LPs to indicate interest, reallocation if LP chooses not to participate
- Timing of allocation (e.g. “invest at substantially the same time as fund”) and exceptions
- Approach to follow on investments

4 Disposal Approach

- E.g. restricting disposal of co-investments before disposal by fund, handling of holding co-investments beyond the disposal by the fund
- Restrictions around disposal terms of co-investments (e.g. not more favourable terms than fund disposal terms, pro rated disposal, …)

Allocation of Fees, Expenses and other Cost

- 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:
  - Allocation of legal and structuring fees for the co-investment: 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)

- 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.

Structuring Considerations (Overview)

- Advisory
- Fund of One
- Single Managed Account
- Commingled SPV
- Commingled Co-Investment Fund
- Class/Series within Flagship Fund

Structuring Considerations (cont'd)

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.
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.

Structuring Considerations (cont'd)

Type	Description	Observations
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.

Indicative Structure of a Co-Investment Policy

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

www.sbai.org/toolbox/co-investments