Simpson Thacher

Memorandum

Up Next From the SEC: Increased Co-Investment Flexibility

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Overview

The U.S. Securities and Exchange Commission ("SEC") is beginning to move forward on expressed agenda items to improve retail investor access to alternative investments and private markets. This is one manifestation of a more general trend of the SEC's receptivity to ideas for modernizing and streamlining the regulatory framework of the Investment Company Act of 1940 ("1940 Act") and for permitting greater innovation by, and more efficient operation of, 1940 Act-regulated funds ("1940 Act Funds").

Several projects would further this agenda, including allowing privately-offered business development companies ("BDCs") to issue multiple classes of shares, removing staff guidance that restricts retail funds from investing more than 15% of their assets in private funds, and restoring the ability of 1940 Act Funds to cross trade fixed income securities. At the top of the modernization wish list, however, has been a more principles-based version of exemptive relief that allows 1940 Act Funds to co-invest with affiliated entities. To that end, on April 3, 2025, the SEC published a notice of its intent to grant a co-investment exemptive order on terms that are substantially more flexible than existing co-investment exemptive relief. This new relief, when granted, will permit sponsors to establish more flexible, principles-based, and commercial co-investment programs for 1940 Act Funds that are registered closed-end investment companies ("CEFs") or BDCs (together with CEFs, "Regulated Funds") and should provide many benefits to investors in Regulated Funds and the issuers that raise capital from these fund complexes. The SEC granted this notice in connection with an application submitted by FS Credit Opportunities Corp., and several other sponsors have submitted applications mimicking the same terms and conditions. The SEC has begun publishing notices in respect of these "copycat" applications as well.

Background

At the core of the 1940 Act are broad and stringent rules regulating transactions with affiliates. A 1940 Act Fund's affiliates under the 1940 Act generally include, among others, other 1940 Act Funds managed by the same sponsor, the sponsor's private funds, the sponsor's proprietary accounts, companies controlled by the sponsor or its private funds and/or 1940 Act Funds (which could include, among others, insurance companies, other asset managers, real estate investment trusts, and other retail-oriented investment products), and, with respect to some 1940 Act Funds, companies in which the sponsor or its private funds and/or 1940 Act Funds own as little as 5% of the voting securities. When a sponsor has both a material pecuniary incentive and the ability to cause a 1940 Act fund to participate in a transaction, the 1940 Act generally prohibits the 1940 Act Fund from investing in a

privately placed security alongside its affiliates where terms in addition to the price of the security are negotiated; however, the SEC has developed exemptive relief that generally permits such "co-investments" for Regulated Funds. This co-investment exemptive relief has historically been complex, prescriptive and highly technical in application, resulting in undesirable commercial dynamics.

Key Improvements and Simplifications

- ***Streamlined Investment Allocations:***
  - **Current Practice:** Under existing co-investment relief, all potential co-investment transactions that align with a Regulated Fund's investment objectives and strategies, and that are within a Regulated Fund's "board-established criteria" for co-investment opportunities, must be offered to the Regulated Fund. This often requires investment advisers to deviate from their standard investment allocation processes, creating unnecessary administrative burden and constraining an adviser's ability to allocate investment opportunities in the manner most beneficial to all of its clients.
  - **New Relief:** The new relief will require investment advisers (and any direct or indirect, wholly- or majority-owned subsidiary of an Adviser or its affiliates, such as proprietary accounts) to adopt allocation policies that are reasonably designed to ensure that the Adviser negotiating a co-investment transaction considers the interest in the transaction of any participating Regulated Fund and that opportunities to participate in co-investment transactions are allocated in a manner that is fair and equitable to every Regulated Fund participating in the co-investment program. This revised standard should allow an investment adviser to adopt a more principles-based approach to determine how to allocate potential co-investment opportunities in an equitable manner across all clients without imposing the prescriptive process contained in existing co-investment relief.
- ***Modernizing the "Propping Up" Condition:***
  - **Current Practice:** Under existing co-investment relief, a Regulated Fund cannot participate in an initial co-investment transaction if any affiliates have a pre-existing investment in the issuer and the Regulated Fund does not. This prohibition is based on the concern that a later-in-time investment by a Registered Fund could be used to "prop up" earlier investments by affiliated entities, but in practice it often has prevented Regulated Funds, particularly new products, from investing in attractive opportunities with issuers that are well known by the sponsor. Moreover, the prohibition, without even a *de minimis* exception, fails to recognize that many large asset managers have business units that invest in different types of investments, and thus can unduly preclude a Regulated Fund from investing in many portfolio companies where its affiliate's pre-existing investment does not present the risks of overreaching that the prohibition on joint transactions is intended to address.

    The existing co-investment relief also limits the ability of Regulated Funds, private funds, and other affiliated entities to participate in follow-on transactions. Among other issues, (i) new Regulated Funds cannot be added to an older deal, and (ii) entities that acquired a position in the issuer outside of the co-

investment order (*e.g.,* through a season and sell process or other subsequent secondary transaction) arguably cannot participate in follow-ons. This has meaningfully constrained the ability of complexes that include Regulated Funds from participating fully, or participating at all, in attractive follow-on opportunities where their sponsor's other clients are an incumbent investor.

- **New Relief:** The new relief permits a Regulated Fund's independent board members to approve participation in investments where an affiliate has an existing position in the issuer, even if the Regulated Fund does not. Relatedly, the new relief eliminates entirely the concept of a "follow-on investment" and simply treats all co-investment transactions as individual transactions that need to meet the requirements of the co-investment relief. The new relief applies a simple rule that independent board member approval is required for a Regulated Fund's participation in each co-investment transaction in an issuer in which an affiliate has an interest unless (i) the Regulated Fund already holds the same security as its affiliates, and (ii) all participants participate on a basis that is in approximate proportion to each participant's then-current holdings.

  Specifically, if board approval is required under the new relief, a majority of the Regulated Fund's board members who have no financial interest in the co-investment transaction and a majority of the board members who are not interested persons of the Regulated Fund must find that:

  - the terms of the co-investment transaction are reasonable and fair to the shareholders or partners of the Regulated Fund and do not involve overreaching of the Regulated Fund or its shareholders or partners on the part of any person concerned; and
  - the proposed transaction is consistent with the interests of the shareholders or partners of the Regulated Fund and is consistent with the policy of the Regulated Fund as recited in its public filings and shareholder reports.

  The board members must record in their meeting minutes and preserve in their records a description of the co-investment transaction, their findings, the information or materials upon which their findings were based, and the basis therefor.

  This new provision for board member approval of co-investments where an affiliate has an existing position in the issuer should allow Regulated Funds and their affiliates to access a significantly broader array of investment opportunities, including attractive deals where a sponsor has the benefit of extensive experience with the operations of the issuer. It will also greatly improve the ability of newly launched Regulated Funds to access attractive investment opportunities, provide a smooth ramp period into core alternatives strategies, and allow fund complexes that include Regulated Funds to more readily pursue attractive deal opportunities without artificial constraints.

- ***Reduced Frequency of Board Approval:***
  - **Current Practice:** Independent board member approval is required for (i) every new co-investment involving a Regulated Fund, and (ii) every follow-on investment or disposition involving a Regulated Fund, unless the transaction is allocated pro rata among the participants or involves tradeable securities. For

asset management groups that have an active alternative investment strategy, this requirement can impose a significant burden on boards of participating Regulated Funds, with board members frequently called upon to review and consider the approval of many time sensitive co-investment opportunities between regularly scheduled meetings.

- **New Relief:** As described above, independent board member approval will only be necessary for acquisitions or dispositions made in reliance on the relief if an affiliate has an existing investment in an issuer and the Regulated Fund either does not have an investment in the same securities of the issuer or is not participating pro rata. This change should serve to focus a Regulated Fund board's attention on transactions with more significant potential for conflicts.

- ***More Categories of Affiliates Can Benefit:***
  - **Current Practice:** Existing co-investment orders typically cover BDCs, CEFs, and private funds or other pooled investment vehicles relying on Section 3(c)(1), 3(c)(7), 3(c)(5)(C) or Rule 3a-7 under the 1940 Act advised by the Adviser or an affiliate, along with certain controlled fund vehicles and proprietary accounts.
  - **New Relief:** The new order extends eligibility to several important categories of entities:
    - An Adviser and its affiliates (including, for instance, operating company conglomerates and employees' securities companies, but not including open-end investment companies) and including any direct or indirect, wholly- or majority-owned subsidiary of an Adviser or its affiliates.
    - BDCs and CEFs sub-advised by a sponsor where the primary adviser is unaffiliated with the sponsor.
    - Unconsolidated joint venture subsidiaries of BDCs and CEFs.
    - Any entity that would be an investment company but for Section 3(c) under the Investment Company Act of 1940 or Rule 3a-7 thereunder (*i.e.*, not only entities relying on Sections 3(c)(1), 3(c)(5)(C), and 3(c)(7)).

    Notably, the new relief does not extend to 1940 Act Funds that are open-end investment companies (*i.e.*, mutual funds or ETFs); therefore, these types of 1940 Act Funds still cannot participate in negotiated co-investments with affiliates in reliance on the co-investment order.

- ***Principles-Based Reporting and Compliance Regime***
  - **Current Practice:** Quarterly reports to the board are required, with technical, prescriptive requirements that detail, among other things, all co-investments not offered to a Regulated Fund, follow-ons, dispositions, and declined investments.
  - **New Relief:** The new order instead allows a Regulated Fund's board to determine the format and content of quarterly reports regarding the co-investment program. In addition, each Regulated Fund's investment adviser and chief compliance officer ("CCO") must also provide a summary of significant compliance matters, and the adviser and CCO must also supply an annual report covering the Regulated Fund's participation in the co-investment program and any material changes in the investment adviser's policies or affiliate participation.

Unresolved Issues

While the new relief is a welcome step forward, there are several remaining issues that would benefit from further engagement with the SEC:

- ***Same Terms and Classes of Securities:***
  - **Current Requirement:** Affiliates must invest on the same terms and in the same classes of securities.
  - **Potential Improvement:** Greater flexibility could allow affiliates to participate in different parts of the capital structure. To mitigate potential conflicts, co-investments in different parts of the capital structure could require supplementary board approval and reporting.
- ***Compensation Restrictions:***
  - **Current Requirement:** Affiliates must share transaction fees pro rata (including fees received in connection with the right of one or more Regulated Funds or affiliates to nominate a director or appoint a board observer or otherwise to participate in the governance or management of the portfolio company) and cannot accept other compensation related to participation in a co-investment transaction, except (1) brokerage or underwriting compensation permitted by Section 17(e) or 57(k) of the 1940 Act or (2), in the case of the Advisers, investment advisory compensation paid in accordance with investment advisory agreements between the applicable Regulated Fund or affiliate and its Adviser.
  - **Potential Improvement:** Co-investment transactions can be financially complex, particularly when a transaction is designed to provide financial support in a specific part of an issuer's capital structure or during a particular stage of an issuer's business cycle. Different types of entities can provide value when they source and manage complicated investments, so co-investment relief could be revised to reflect these market realities and allow for compensation for these valuable services while still preventing conflicts of interest and protecting investors.
- ***Limited Relief for Principal Transactions:***
  - **Current Requirement:** The principal transaction prohibitions of the 1940 Act frequently prevent affiliates in a co-investment program from entering into follow-on investments in issuers that become affiliated due to the initial co-investment transaction. For example, if affiliates in a co-investment program make a substantial equity investment in an issuer, the issuer may become an affiliate of the Regulated Funds in the co-investment program by virtue of their equity ownership stake from the initial co-investment transaction. Accordingly, the 1940 Act restrictions on principal transactions prevent Regulated Funds in the co-investment program from making follow-on investments in the now-affiliated issuer when an exemption from the principal transaction prohibitions is not available.
  - **Potential Improvement:** The current principal transaction framework is a major constraint to retail investors' access to certain investment strategies, such as private equity or infrastructure, that seek to make control investments or exert technical control over portfolio companies. Future relief could provide

targeted exemptions from the 1940 Act prohibition on principal transactions to facilitate follow-on investments in issuers that become affiliates of the Regulated Funds.

Conclusion

The SEC's new co-investment exemptive order represents a significant step forward, simplifying processes and reducing barriers for Regulated Funds and affiliated entities. However, ongoing engagement with the SEC will be crucial to ensure that any co-investment rulemaking evolves further to allow individual investors to benefit from access to additional investment opportunities that the new co-investment relief continues to limit to institutional investors.

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