Co-Investment Funds and Sponsor Fiduciary Duties under the US Advisers Act

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Background

We are often asked whether fiduciary duties apply to sponsors of co-investment vehicles. Co-investment vehicles are funds (i.e., third party managed investment pools), but unlike a "blind pool fund," where the manager is given discretion to select investments, a co-investment vehicle often targets a single identified portfolio company. Nonetheless, as in a blind pool fund, investors in a co-investment vehicle delegate the management of the "pool" of funds to a third-party sponsor. Often the co-investment fund will invest alongside the blind pool fund (the "Main Fund"). Accordingly, it is important to consider whether the sponsors' duties to such investors mirror those duties that managers have to investors in a blind pool fund – in particular, whether the fiduciary duty standard under the U.S. Investment Advisers Act of 1940 (the "Advisers Act") applies to the management of co-investment vehicles.

An investment adviser's fiduciary duty under the Advisers Act includes both a duty of care and a duty of loyalty to its clients.[1] While the application of this fiduciary duty may vary with the scope of the client relationship, it is not permissible for an investment adviser subject to the Advisers Act to contract out of its statutory Advisers Act fiduciary duties.[2] This is in contrast to fiduciary duties established under relevant partnership law (such as the Delaware Revised Uniform Partnership Act), which may permit the waiver of fiduciary duties pursuant to the contract. However, in order for the Advisers Act fiduciary duty standard to apply to the sponsor of a co-investment fund, the sponsor must fit within the definition of an "investment adviser" under the Advisers Act, and the services provided must be investment advisory services. Under Section 202(a)(11) of the Advisers Act, an "investment adviser" is a person who engages in the business of advising others (third parties) with regard to investing in, purchasing or selling securities for compensation. Each of the elements of the definition of "investment adviser" must be met for the definition to apply. This article assesses whether the sponsor of a co-investment fund meets the foregoing criteria such that the Advisers Act fiduciary duty standard would apply.

- **Prong 1: Advice related to Securities**

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[1] See In the Matter of Arleen W. Hughes, Exchange Act Release No. 4048 (Feb 18, 1948) establishing that the fiduciary duty is imposed on an adviser by "operation of law" because of the nature of the relationship between the two parties. See Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Advisers Act Release No. 5248 (June 5, 2019), (available at: https://www.sec.gov/rules/interp/2019/ia-5248.pdf) ("Fiduciary Interpretation"). See Private Fund Risk Alert (Jan. 27, 2022) (available at: https://www.sec.gov/files/private-fund-risk-alert-pt-2.pdf), reaffirming that the fiduciary duty and underlying duties of care and loyalty apply to advisers of private funds. The Securities and Exchange Commission ("SEC") brings enforcement actions related to fiduciary duty under both Sections 206, the anti-fraud provision, and 215(a), validity of contracts.

[2] See Fiduciary Interpretation at fn 29 and accompanying text "In other words, an adviser's fiduciary duty may not be waived, though it will apply in a manner that reflects the agreed-upon relationship."

Does the advice relate to securities? Not all investments made by a co-investment fund will necessarily target securities. For instance, if the co-investment fund invests in a tangible asset, real estate or some type of loan, then it is possible that there are no securities involved in the investment, in which case the Advisers Act may not apply to the sponsor. However, if the co-investment fund makes investments involving equity, quasi-equity or debt securities, the co-investment fund is entering into securities transactions and this prong will be met.[3]

The courts have traditionally used two main tests to determine whether a product is a "security." Under the Howey test, security is (a) an investment of money (b) in a common enterprise (including a fund or pooled vehicle) (c) where a person is led to expect profits (d) solely from the efforts of the promoter or third party.[4]

In addition, the U.S. Supreme Court adopted the Reves "family resemblance" test[5] to determine whether notes were issued in an investment context and therefore resemble securities, as opposed to if they were issued in a commercial context in which case, they resemble loans and not securities. A note is presumed to be a security until the presumption is rebutted by the note's "resemblance" to the enumerated exceptions – (i) a note delivered in consumer financing; (ii) a note secured by a mortgage on a home; (iii) a short-term note secured by a lien on a small business or some of its assets; (iv) a note evidencing a character loan to a bank customer; (v) a short-term note secured by an assignment of accounts receivable; (vi) a note which simply formalized an open-account debt incurred in the ordinary course of business; and (vii) a note evidencing loans by commercial banks for current operations.[6] In determining whether a note bears a resemblance to any of the foregoing enumerated exceptions, or whether a new exception should be added, four factors should be considered – (A) the motivation of buyer and seller; (B) the plan of distribution of the note; (C) the reasonable expectation of the public as to whether the note is a security; and (D) the presence of alternative regulatory regime for the transaction or note.[7]

- **Prong 2: Advice to Third Parties**

Is the sponsor providing advice to "others?" The Advisers Act is implicated only if investment advice is provided to a third party. When the sponsor advises itself or its affiliates, it is not considered to be

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[3] There is currently uncertainty surrounding the treatment of some cryptocurrencies and other assets See SEC v. Ripple Labs, Inc., No. 20-CV-10832 (S.D.N.Y. July 13, 2023). The District Court of the Southern District of New York issued an order that partially granted and partially denied summary judgement claims that the various defendants had engaged in the unregistered distribution of securities in violation of the Securities Act of 1933. The District Court found that institutional investors believed their purchase of a virtual currency XRP, issued by Ripple, would create potential profits based on Ripple's entrepreneurial and managerial efforts, and therefore these institutional investors had purchased an "investment contact" or security. The District Court also found that retail investors purchasing XRP through the marketplace were not purchasing "securities" because they had no expectation that the founders of Ripple were working to increase the value of XRP, and therefore, with respect to these acquisitions through the marketplace, there was no investment contract. It is not clear how orif this standard will be applied to cryptocurrencies and possibly expanded to other types of investments.

[4] SEC v. W.J. Howey Co., 328 U.S. 293 (1946) ("Howey").

[5] Reves v. Ernst & Young, 494 U.S. 56 (1990) ("Reves").

[6] Id. at 65.

[7] Id. at 66-69.

providing advice to third parties.[8] However, if advice is given to unaffiliated investors or third party funds, then this prong of the definition will be met.

- **Prong 3: Provision of Investment Advice**

Is the sponsor providing investment advice? Many co-investment fund sponsors take the position that it is the investor – and not the sponsor – that is making the investment decision to purchase the securities of the target portfolio company in which the co-investment fund invests. This can be supported by factors including providing investors the opportunity to perform diligence on not only the sponsor and the co-investment fund but also the target portfolio company prior to the investors' decision to invest in a co-investment fund. In this respect, sponsors sometimes include in their co-investment fund documentation explicit language requiring each investor to acknowledge that its decision to invest in the co-investment fund and, indirectly, the target portfolio company is being made by the investor itself and not the sponsor.[9] However, even if such disclosure and explicit acknowledgment are included in the co-investment fund documentation, a sponsor may still be considered to be giving investment advice depending on the facts and circumstances, as the question of whether "investment advice" has been provided applies not only to the initial purchase of the underlying target securities but also (i) securities transactions undertaken in the course of the co-investment fund's operations (e.g., reinvestments or refinancings) and (ii) importantly, the decision to exit from the target portfolio company. For example, if the co-investment fund documentation requires the co-investment fund to also operate and divest based on certain principles (i.e. when certain events occur or benchmarks are reached) which are pre-agreed with the investors prior to making their commitment to the co-investment fund, then the sponsor should not be considered to be providing investment advice to the co-investment fund. On the other hand, if there is latitude for the sponsor to exercise discretion regarding the terms or timing of the co-investment fund's operations and exit, then the sponsor will likely be deemed to be providing investment advice in such circumstances, in which case the Advisers Act and consequent fiduciary duties would apply. We note that agreeing that the co-investment fund will divest pari passu alongside the Main Fund could be considered investment advice or discretion depending on the reasons for the exit; in which case the Advisers Act and consequent fiduciary duties would apply.

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[8] A wholly-owned corporate subsidiary exclusively advising the parent or another wholly owned corporate subsidiary would not generally be considered advising "others." See Zenkyoren Asset Management of America Inc., SEC Staff No-Action Letter (June 30, 2011). See also Meag Munich Ergo, SEC Staff No-Action Letter (Feb. 14, 2014); Allianz of America, Inc., SEC Staff No-Action Letter (May 25, 2012); Lockheed Martin Investment Management Co., SEC Staff No-Action Letter (Jun. 5, 2006).

[9] For example, sponsors may include the following types of provisions in their co-investment fund documentation:

Example 1: The Investor (i) has, independently and without reliance upon the Partnership, the General Partner, the Portfolio Company, any of their respective Affiliates or any agent of any of the foregoing, and based on such documents and information as the Investor has deemed appropriate, made its own appraisal of, and investigation into, the business, operations, property, financial and other condition, creditworthiness and consequences of an investment in the Interests and (ii) has made its own investment decision with respect to the investment represented by the Interests.

Example 2: The Investor (i) is not relying upon any information, representation or warranty by any Sponsor-Related Party in evaluating the Portfolio Company, and expressly acknowledges that no Sponsor-Related Party has made any representations or warranties to it in connection therewith, and (ii) has independently and without reliance on any Sponsor-Related Party, based on such documents and information as the Investor has deemed appropriate, made its own appraisal of and investigation into the business, operations, property, financial and other condition, creditworthiness of the Partnership and the Portfolio Company.

Example 3: By accepting an opportunity to purchase or invest in a co-investment opportunity, the Investor acknowledges that none of the Partnership, the General Partner or the Manager is providing or has provided investment advice to the Investor in connection with the offer to make such co-investment opportunity.

- **Prong 4: Compensation**

Is the sponsor being compensated for providing investment advice? If the terms of the co-investment fund provide for the payment of management fees or carried interest, then there is prima facie compensation being paid by the investors of the co-investment fund to the sponsor. However, there are many co-investment funds where the sponsor is only reimbursed for expenses and no management fee or carried interest is paid. In such circumstances, the compensation prong is likely not met, but it is relevant to consider whether there is "indirect" compensation being paid to the sponsor as a result of the sponsor's receipt of (i) management fee or carried interest from the Main Fund and (ii) transaction fees from the target portfolio company. The term "compensation" is broadly construed by the SEC and generally includes any economic benefit,[10] whether in the form of an advisory fee or other fee relating to commissions, total services rendered or some combination thereof.[11] It is not necessary that the compensation be paid directly by the person receiving investment advisory services, but only that the adviser receives the compensation from "some source" for its services.[12] The courts have also construed the term "compensation" broadly – for example, the compensation prong was found to be satisfied by an adviser's "entitlement" to compensation, even in the absence of the actual receipt of such compensation,[13] and also by an adviser's receipt of salary and a percentage of net profits and capital gains[14] or even "ill-gotten gains"[15] (e.g., the use of investors' funds to pay the adviser's personal expenses[16]).[17]

Takeaways and Considerations

As the volume of co-investments continues to increase exponentially, with more investors taking positions in blind pool funds with the principal goal of obtaining co-investment allocations (which frequently far exceed such investors' blind pool commitments), it is critical to assess whether the protections afforded to investors when investing in blind pool funds also apply to their investments in co-investment funds. As discussed above, investors cannot assume the application of such protections. Rather, the terms of many co-investment funds provide the sponsor with latitude to avoid the Advisers Act fiduciary standard entirely, and investors should be alert that where not all of the prongs of the "investment adviser" definition are present (e.g., because the target assets are not securities, there is no provision of investment advice or there is no compensation being paid for such investment advice), the Advisers Act will not apply. In such circumstances, investors may in a worst-case scenario find

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[10] See The Regulation of Investment Advisers (available at https://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf) at fn 4 and accompanying text.

[11] Investment Advisers Act of 1940 Release No. IA-1092 (Oct. 8, 1987).

[12] Id.; See, e.g., Warren H. Livingston, SEC Staff No-Action Letter (pub. avail. Mar. 8, 1980); Kenisa Oil Co., SEC Staff No-Action Letter (May 6, 1982).

[13] See SEC v. Fife, 311 F.3d 1, 11 (1st Cir. 2002).

[14] Abrahamson v. Fleschner, 568 F.2d 862, 870 (2d Cir. 1977) (holding that "compensation" includes salary and a percentage of net profits and capital gains), overruled in part on other grounds by Transamerica Mortg. Advisors, Inc. v. Lewis, 444 U.S. 11 (1979).

[15] See United States v. Ogale, 378 F. App'x 959, 960 (11th Cir. 2010).

[16] See id. at 960-961 (11th Cir. 2010); see also United States v. Miller, 833 F.3d 274, 282 (3d Cir. 2016); United States v. Elliott, 62 F.3d 1304, 1311 (11th Cir. 1996).

[17] While we are not aware of any guidance specifically indicating that indirect compensation related to the sponsor's other investment advisory services provided to the Main Fund would be considered compensation for the sponsor's investment advisory services related to the co-investment fund, we caution parties to be aware of the SEC's broad construal of the term "compensation" when structuring arrangements.

themselves in a co-investment fund managed by a sponsor whose only obligation is to act in accordance with a general contractual standard of good faith, without any duty of loyalty or care.

However, there are other protections that an investor can consider in these situations. For example, an investor can seek to impose a fiduciary duty on the sponsor pursuant to the contract, although this may be difficult to successfully negotiate. An investor can also confirm the scope of the sponsor’s fiduciary duties under the relevant partnership law and limit any efforts by the sponsor to weaken such fiduciary duties in the co-investment fund documentation. Finally, an investor can look to strengthen the requirement that the co-investment fund be managed on a lock-step basis with the Main Fund (e.g., by narrowing the circumstances where the co-investment fund and the Main Fund are permitted to invest, operate or divest on different terms or different timing, such as only where it is required by applicable law or regulation or tax considerations). This creates an important safeguard that allows co-investors to effectively “piggyback” on the sponsor’s fiduciary duties to the Main Fund.

Ultimately, the question of whether a sponsor has fiduciary duties under the Advisers Act to a co-investment fund can be complex and requires a case-by-case assessment. Accordingly, an investor in a co-investment fund should be aware of the regulatory status of the manager and should negotiate the terms of its investment accordingly.

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