Katten

REGULATED FUNDS ADVISORY

April Welcomes More Flexible Co-Investment Exemptive Relief Under the Investment Company Act of 1940

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On April 3, the US Securities and Exchange Commission (SEC) approved an exemptive application[1] that allows for a more flexible co-investment transaction approval process. This new relief simplifies the process followed by investment managers under prior co-investment exemptive orders to approve the participation of business development companies (BDCs) and/or registered closed-end funds (together with BDCs, Regulated Funds) when making negotiated[2] co-investments together with affiliated funds, where such joint transactions would otherwise be prohibited by the Investment Company Act of 1940, as amended (the 1940 Act), and the rules and regulations thereunder. Although the new exemptive relief is still subject to certain conditions, compared to previous co-investment exemptive orders, the new exemptive relief provides the following benefits.

- Subject to the implementation of certain policies and procedures, the board of directors (the Board) of a Regulated Fund does not need to approve co-investment transactions in advance except for the transactions described in the bullet below.
- A majority vote of the independent directors of the Regulated Fund (a Required Majority) will only be necessary to approve a negotiated co-investment transaction if (i) the Regulated Fund is investing into an issuer where an Affiliated Entity[3] has an existing interest in such issuer, or (ii) the transaction is a non-pro rata follow-on investment or a non-pro rata disposition of an investment.
  - Previously, Regulated Funds were prohibited from participating in a co-investment transaction if certain Affiliated Entities had an existing investment in the subject issuer.
  - Moreover, the previous form of relief did not permit a Regulated Fund to participate in a follow-on investment, unless (i) the Regulated Fund participated in the initial co-investment and continues to hold an investment in the subject issuer or (ii) Affiliated Entities had no existing investment in the subject issuer. With this restriction now removed, Regulated Funds may participate in follow-on investments with their Affiliated Entities even if the Regulated Fund has no existing investment in the subject issuer.

[1] FS Credit Opportunities Corp., et al, SEC Rel. No. IC-35520 (April 3, 2025). Unless there is a request for a hearing, the approval will become effective after a 25-day notice period.

[2] The applications did not seek relief for transactions effected consistent with staff no action positions (See, e.g., Massachusetts Mutual Life Insurance Co. (pub. avail. June 7, 2000), Massachusetts Mutual Life Insurance Co. (pub. avail. July 28, 2000) and SMC Capital, Inc. (pub. avail. Sept. 5, 1995)). In general, these positions allow co-investing with an affiliate if the only term of the investment that is negotiated is price.

[3] "Affiliated Entity" means an entity not controlled by a Regulated Fund that intends to engage in co-investment transactions and that is (a) with respect to a Regulated Fund, another Regulated Fund; (b) an adviser to the Regulated Fund or its affiliates (other than an open-end investment company registered under the 1940 Act), and any direct or indirect, wholly- or majority-owned subsidiary of an adviser to the Regulated Fund or its affiliates (other than of an open-end investment company registered under the 1940 Act), that is participating in a co-investment transaction in a principal capacity; or (c) any entity that would be an investment company but for Section 3(c) of the 1940 Act or Rule 3a-7 thereunder and whose investment adviser is an adviser to the Regulated Fund.

- Joint Ventures,[4] funds that are sub-advised by a sponsor without requiring the adviser and sub-adviser to be affiliated, and entities relying on any provision of Section 3(c) under the 1940 Act, are now able to participate in negotiated co-investment transactions on the same terms as Regulated Funds and Affiliated Entities. Previous co-investment relief generally did not allow these types of entities (other than entities relying on the exemptions in Sections 3(c)(1), 3(c)(5)(C), and 3(c)(7) of the 1940 Act) to participate in negotiated co-investments in reliance on the exemptive relief.
- Investment managers now have more discretion with respect to their investment allocation process under this new relief, so long as investment managers adopt and implement co-investment policies and procedures that are reasonably designed to prevent the Regulated Fund from being disadvantaged in the co-investment program. Prior to participation in co-investment transactions, the Regulated Fund's Board needs to approve the policies and procedures and then must oversee the Regulated Fund's participation in the co-investment program in the exercise of the Boards' reasonable judgment.

Relief Conditions

In addition to the benefits described above, set forth below is a summary of the conditions of the new co-investment exemptive relief.

- Regulated Funds and Affiliated Entities will still be required to acquire or dispose of investments generally on the same terms.[5] If the transaction is a non-pro rata follow-on investment or non-pro rata disposition, then Required Majority approval will be necessary.
- As indicated above, for a Regulated Fund to invest in an issuer in which such Regulated Fund is not an existing investor, but an Affiliated Entity is an existing investor, a Required Majority must approve such Regulated Fund's participation in the transaction.
- Any expenses associated with acquiring, holding or disposing of securities acquired in a co-investment transaction must be shared among the participants in proportion to the relative amounts of securities being acquired, held or disposed.
- Affiliated Entities must continue to share transaction fees (including break-up, structuring, monitoring or commitment fees but excluding broker's fees contemplated by Sections 17(e) or 57(k) of the 1940 Act, as applicable) with Regulated Funds and other Affiliated Entities participating in a co-investment transaction pro rata based on the amount invested or committed. No Affiliated Entity can accept any other compensation in connection with a co-investment transaction.
- As discussed above, investment managers must adopt co-investment policies designed to prevent the Regulated Fund from being disadvantaged in the co-investment program. The Regulated Fund's Board then must approve the policies and oversee the Regulated Fund's participation in the co-investment program.
- Prior to any disposition by an Affiliated Entity of an investment acquired in a co-investment transaction, the adviser to a Regulated Fund that participated in the co-investment transaction will be notified, and the Regulated Fund will be given the opportunity to participate pro rata based on the proportion of its holdings relative to the other Affiliated Entities participating. In a co-investment transaction, prior to any non-pro rata disposition of an investment by a Regulated Fund or if a disposition is not a sale of a Tradable Security,[6] the Required Majority must approve the disposition.

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[4] "Joint Venture" means an unconsolidated joint venture subsidiary of a Regulated Fund, in which all portfolio decisions, and generally all other decisions in respect of such joint venture, must be approved by an investment committee consisting of representatives of the Regulated Fund and the unaffiliated joint venture partner (with approval from a representative of each required).

[5] "Same terms" means the same class of securities, at the same time, for the same price and with the same conversion, financial reporting and registration rights, and with substantially the same other terms.

[6] "Tradable Security" means a security which trades: (i) on a national securities exchange (or designated offshore securities market as defined in Rule 902(b) under the Securities Act of 1933, as amended) and (ii) with sufficient volume and liquidity (findings which are to be made in good faith and documented by the advisers to any Regulated Fund) to allow each Regulated Fund to dispose of its entire remaining position within 30 days at approximately the price at which the Regulated Fund has valued the investment.

- At least quarterly, the Regulated Fund's adviser and chief compliance officer ("CCO") will be required to provide reports to the Regulated Fund's Board regarding the Regulated Fund's participation and activity in co-investment transactions and a summary of deemed significant matters that arose during the period related to the implementation of the adviser's co-investment policies and procedures and the Regulated Fund's policies and procedures.
- Each year, the adviser and CCO must provide information requested by the Regulated Fund's Board related to the Regulated Fund's participation in the co-investment program and any material changes in the Affiliated Entities' participation in the co-investment program, including changes to the Affiliated Entities' co-investment policies.
- The adviser and the CCO must also notify the Regulated Fund's Board of any compliance matters related to the Regulated Fund's participation in the co-investment program that the CCO considers to be material.
- All information presented to the Regulated Fund's Board must be safeguarded for the life of the Regulated Fund and two years after, which will be subject to SEC examination.

Similar to the applications and orders for the new multi-share class exemptive relief, as highlighted in Katten's advisory published last week, investment managers will need to individually apply for and obtain the new co-investment exemptive relief.

CONTACT

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