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PREFERENTIAL TREATMENT AND THE RISE OF INDIVIDUALIZED INVESTING IN PRIVATE EQUITY

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ABSTRACT

Preferential treatment is more common than ever in the $4 trillion private equity industry, thanks in part to new structures that make it easier to grant different terms to different investors. Traditionally, private equity managers raised almost all of their capital through "pooled" funds whereby the capital of many investors was aggregated into a single vehicle, but recent years have seen a dramatic increase in what I call "individualized investing"—private equity investing by individual investors through "separate accounts" and "co-investments" outside of pooled funds. Many of the largest and most influential investors have used these individualized approaches to obtain significant advantages that are often unavailable to pooled fund investors.

This raises a question that is both economic and philosophical: Can preferential treatment be a good thing for private equity? The idea of preferential treatment runs counter to many people's intuitive sense of fairness, but in this Article I make the case that these trends are efficiency-enhancing developments for the industry when managers fully abide by their disclosure duties and keep their contractual commitments. Some forms of preferential treatment made possible by individualized investing create new value for preferred investors without harming non-preferred investors. Others generate what I call "zero-sum" benefits

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because they are accompanied by offsetting losses to non-preferred investors, but when disclosure is robust and the market for capital is competitive, there are limits on the amount of zero-sum preferential treatment that we should expect. Even zero-sum preferential treatment can increase the efficiency of private equity contracting to the extent that pre-commitment disclosure gives investors a clear understanding of the quality of the investment product they are buying and the true price at which they are buying it.

Policy should seek to blend three elements. First, to support the efficiency gains made possible by individualized investing, it should support individualized contracting between managers and investors and not presume that preferential treatment is an inherently bad thing. Second, to minimize harms to non-preferred investors, it should promote conflicts disclosure, consistent compliance by managers with their contractual commitments, and clear performance and fee/expense disclosure. Lastly, policymakers should seek to promote these goals at low cost, as non-preferred investors will likely bear much of the cost of policies designed to help them, and high costs could have an anti-competitive effect.

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INTRODUCTION

> *"[W]hat's changed in our industry is there are . . . much more tailor-made products, if you will, than there were several years ago. . . . [W]e're much more in the business of creating special vehicles for LPs that want certain things."*[1]

PRIVATE equity is an enormous industry, with nearly $4 trillion in assets under management.[2] Most of the capital in private equity is invested by institutions that manage money on behalf of others. These investors come in all shapes and sizes, with some managing hundreds of billions of dollars and others managing a tiny fraction of that amount.

Preferential treatment of investors is more common than ever in today's industry, thanks to new structures that make it easier to grant different terms to different investors. For decades, private equity managers[3] raised almost all of their capital through "pooled" funds whereby their investors' capital was aggregated into a single vehicle, but recent years have seen a dramatic increase in what I call "individualized investing"—private equity investing through separate accounts and co-investments.[4] Separate accounts and co-investment vehicles are entities that exist outside of pooled funds, enabling managers to provide highly customized treatment to the investors in them. By one estimate, over 20% of all investment in private equity,[5] including nearly half

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1 Transcript of Blackstone First Quarter 2015 Earnings Call, BLACKSTONE GRP. (Apr. 16, 2015, 9:30 AM) http://s1.q4cdn.com/641657634/files/doc_financials/q12015/BX-Media-Call-1Q-2015.pdf (remarks of Tony James, Chief Operating Officer, The Blackstone Group).

2 *See* PREQIN, GLOBAL PRIVATE EQUITY & VENTURE CAPITAL REPORT (2015) (sample pages available at https://www.preqin.com/docs/reports/2015-Preqin-Global-Private-Equity-and-Venture-Capital-Report-Sample-Pages.pdf).

3 To avoid introducing unnecessary complexity, I will use the term "manager" throughout this Article, even in cases where the term "sponsor" or "adviser" or "general partner" may be more technically correct. For purposes of this analysis, any distinctions between these terms will not be important. For the same reason, I will generally use the term "investor" throughout this Article, even in cases where the term "limited partner" might be more technically correct.

4 *See infra* Section I.C for detail on the definitions of "separate accounts" and "co-investments," respectively.

5 *See* Antoine Drean, *Private Equity Fundraising Is Set to Break Records, but the Plenty Holds Danger*, FORBES (Dec. 8, 2015), http://www.forbes.com/sites/antoinedrean/2015/12/08/private-equity-fundraising-is-set-to-break-records-but-the-plenty-holds-danger/#7459bfa751ac; *see also* Joseph Cotterill, *Shadow Capital Rises Behind Patient Capital*, FIN. TIMES (Feb. 9, 2016), http://www.ft.com/cms/s/2/58c7af5c-4b47-11e5-b558-8a9722977189.html.

of all capital committed to new managers,[6] went through these channels in 2015. Statements in recent earnings calls by some of the largest private equity managers corroborate these figures.[7] There are no signs of this trend slowing down.[8]

The largest and most influential investors in private equity have been using these customized vehicles to negotiate for significant advantages that are often unavailable to pooled fund investors.[9] This raises a question that is both economic and philosophical: Can preferential treatment be a good thing for private equity? The answer to this question helps inform what policymakers should be doing in response to these trends.

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6 *See* Antoine Drean, *Fundraising for First-Time Private Equity Managers Hits a Post-GFC High*, FORBES (June 23, 2015), http://www.forbes.com/sites/antoinedrean/2015/06/23/fundraising-for-first-time-private-equity-managers-hits-a-post-gfc-high/ ("[W]hat is truly interesting is that nearly half of the capital earmarked for new managers in 2015 – 48 percent – is slated for deal-by-deal, co-investment and managed account structures. Last year 43 percent of commitments to new managers went to these kinds of vehicles, versus just 17 percent back in 2008. Before the financial crisis, the vast majority of all first-time manager capital was committed to classic 10-year commingled private equity funds, where the manager called all the shots.").

7 *See, e.g.*, Transcript of Blackstone First Quarter 2015 Earnings Call, *supra* note 1 ("There's a lot more of those SMAs as they're called, separately managed accounts, special purpose vehicles. And sometimes they're for one LP or sometimes they're for two or three. *But much more the money is coming in the form of those separate accounts as a percentage than in the broad commingled funds*.") (emphasis added); Transcript of Q2 2014 Apollo Global Management, LLC Earnings Call, APOLLO GLOBAL MGMT. (Aug. 6, 2014, 11:00 AM), http://phx.corporate-ir.net/External.File?t=1&item=VHlwZT0yfFBhcmVudElEPTUxNjU4NTZ8Q2hpbGRJRD01NTM1MDY= ("As we have highlighted previously, strategic managed accounts, of which we now manage more than $15 billion of AUM in the aggregate, continue to be an area of growth for us. Not only are we seeing interest for new mandates . . . but we're also seeing certain investors with pre-existing accounts increase the size of those mandates as we have successfully deployed their initial capital and met return targets.").

8 *See* Drean, *supra* note 5 ("More than two out of five investors predict that shadow capital will match or exceed classic fund investment within 5 years, according to a survey of private equity investors and managers conducted by Palico, the online private equity marketplace that I founded in 2012. That same survey shows that 17% of investors currently hold 20% or more of their private equity assets outside of classic fund structures, proportions that are likely to rise as shadow capital grows."); Lisa Parker, *Investors Looking to Invest in Private Equity via Separate Accounts*, PREQIN (Oct. 9, 2014), https://www.preqin.com/blog/0/10025/pe-via-separate-accounts (reporting the results of a survey showing that, among investors who had previously awarded a separate account mandate, 68% viewed separate account mandates as a permanent part of their investment strategy and the remaining 32% were considering making separate account mandates an ongoing part of their strategies going forward).

9 *See infra* notes 57, 63, 72, and accompanying text.

For many people, the idea of preferential treatment runs counter to their intuitive sense of fairness.[10] Indeed, words like favoritism, discrimination, and inequity carry distinctly negative connotations.[11] This Article makes the case that, while instincts favoring egalitarianism may be entirely appropriate—even virtuous—in many contexts, they should not necessarily dictate private equity policy. In a competitive market, when managers are free to bestow preferential treatment, and when they adhere to their duty to disclose all material facts under the Investment Advisers Act of 1940 (the "Advisers Act")[12] and keep their contractual commitments, the outcome will generally be a more efficient marketplace for private equity investment.

Managers have various strategic incentives to grant preferential treatment to certain investors.[13] For example, managers tend to make higher profits as they raise more capital, so they may want to incentivize larger capital commitments by favoring investors who make large commitments. Managers may also desire to reward investors that make early commitments that help get a fund off the ground, or who invest in strategies where the manager lacks a pre-existing track record of success. Managers may also be willing to grant better terms to investors who commit capital outside of the manager's pooled fund cycle because this gives them a more diversified stream of fee revenues. In addition, managers may want to use favored treatment to develop relationships with certain *types* of investors generally, independent of the specific contributions those investors make to any particular fund or strategy. For example, investors with large amounts of capital to deploy may be attractive because they have greater potential to make large future commitments to the manager's funds or offer other strategic advantages. Finally, in limited cases certain investors may have the capacity to make direct private equity investments on their own—without the assistance of a manager—and therefore may demand a better deal to justify paying for something that they can do themselves.

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10 *See* STEPHEN T. ASMA, AGAINST FAIRNESS 9–10 (Univ. of Chi. Press 2013) ("Philosophers generally agree that modern Western society is premised on egalitarian ideology. . . . [S]ome Westerners even assume that it is their commitment to equality and fairness that makes them *superior* to other individuals and cultures.").

11 *See id.* at 9 ("When something is fair, it is generally considered free from bias and prejudice. If it's used as an adjective for social interaction or for a distribution of goods, then it generally implies an *equal* measure for concerned parties. . . . [S]omewhere in the background of our usual thinking about fairness is the assumption of the equality of all mankind—egalitarianism.").

12 *See infra* Section V.A.1.

13 For a detailed discussion of managers' incentives to grant favorable treatment to certain investors, see *infra* Part II.

On the other side of the equation, no one can blame private equity investors for bargaining for preferential treatment when they have the leverage to obtain it. In fact, given concerns raised in recent years about less-than-stellar practices by institutional intermediaries in private equity,[14] signs of aggressive negotiation by institutional investors can be viewed as positive indications that these intermediaries are promoting their beneficiaries' interests.

The rise of individualized investing is clearly good for the preferred investors who receive the customized preferential treatment, and it can offer certain benefits for managers as well.[15] But what are the effects on the non-preferred investors who do not participate in such arrangements? Some of the preferential treatment made possible by individualized investing—like when preferred investors customize their investment exposure for the purpose of improving the diversification and asset allocation of their broader portfolios—generates "new value" benefits that do not impact pooled fund investors negatively.[16] However, preferential treatment can also generate "zero-sum" gains, where the benefits to preferred investors are accompanied by corresponding losses to non-preferred investors. Most notably, managers might allocate more of their finite resources—including their best investment opportunities and their most talented personnel—to the separate accounts of preferred investors and to co-investors, a practice that I refer to as "inequitable allocation" in this Article. In addition, managers commonly charge preferential fee rates to preferred investors, a practice that likely results in non-preferred investors paying higher fees than they would if such preferential treatment were not possible.[17] This is another form of zero-sum preferential treatment.

Even though individualized investing makes it easier for managers to engage in zero-sum preferential treatment, there are limits on the amount of such treatment that we should expect to see in the marketplace.[18] First, when managers provide pre-commitment disclosure of their conflicts of interest, prospective non-preferred investors can decide whether the product being offered by the manager is worth the fees and expenses that the manager is

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14 *See, e.g.*, Chris Flood & Chris Newlands, *Calpers' Private Equity Problems Pile Up*, FIN. TIMES (July 12, 2015), http://www.ft.com/cms/s/0/f93b0d6a-23e9-11e5-bd83-71cb60e8f08c.html#axzz4LbKBowUc ("One of California's most senior elected officials has voiced 'great concern' at Calpers' worrying admission that America's largest public pension scheme has no idea how much it pays its private equity managers.").

15 *See infra* Part II.

16 *See infra* Section IV.B.

17 *See id.*

18 *See infra* Section V.A for a complete discussion of each of these limits.

proposing to charge them. Investors can contract for protections against potential harmful treatment, and they can walk away when managers refuse to grant satisfactory protections against conflicts.

Second, even in cases where non-preferred investors lack the influence and/or sophistication to negotiate for robust contractual protections, there are certain non-contractual factors that limit a manager's incentive to allocate its resources inequitably toward preferred investors and away from pooled funds. Gains from engaging in this kind of inequitable allocation will generally be difficult to sustain over the long term (due to investor exit rights) and difficult to scale up.[19] In addition, the track record of a pooled fund has certain marketing advantages over the track record of an individualized vehicle, including the fact that it is often a purer signal of the manager's talent level to prospective investors.[20] This makes it a valuable asset when the manager is looking to raise capital. Finally, in cases where individualized vehicles are being charged lower carried interest rates than pooled funds, the manager will have some incentive to allocate strong-performing deals to the funds charging the higher carried interest rates.

The factors described above do not eliminate zero-sum preferential treatment, and their effectiveness will vary from manager to manager and will depend on how competitive the market for private equity capital is.[21] But they do serve as checks on the overall amount of zero-sum preferential treatment in the private equity marketplace.

Finally, even in a world where zero-sum preferential treatment is abundant, the ultimate outcome can nevertheless lead to greater efficiency to the extent that managers are providing pre-commitment disclosure of the material facts relevant to a decision to invest in their products. Insofar as investors can accurately assess the quality of the product they are buying, and the true price at which they are buying it, efficiency should increase when managers can offer different products at different prices to different investors. In the economics literature, price discrimination is generally considered an efficiency-promoting practice when it leads to more of the product in question being produced and consumed,[22] and that should be the likely effect when private equity managers are able to offer different terms to

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19 *See infra* Sections V.A.2.a and V.A.2.b.

20 *See infra* Sections V.A.2.c.

21 *See infra* Section VI.A.3.

22 *See, e.g.*, Richard Schmalensee, *Output and Welfare Implications of Monopolistic Third-Degree Price Discrimination*, 71 AM. ECON. REV. 242, 243 (1981); Hal R. Varian, *Price Discrimination and Social Welfare*, 75 AM. ECON. REV. 870, 870 (1985).

different investors and when they provide robust disclosure of the material facts surrounding the investment.

In this new world of individualized investing, policy should seek to blend three elements. First, to support the efficiency gains made possible by individualized investing, it should support individualized contracting between managers and investors and not presume that preferential treatment is an inherently bad thing. Second, to minimize harms to non-preferred investors, it should promote conflicts disclosure, consistent compliance by managers with their contractual commitments, and clear performance and fee/expense disclosure. Lastly, it should seek to promote these policy goals at the lowest cost possible, as non-preferred investors will likely bear much of the cost of the policies designed to help them, and high costs could have an anti-competitive effect.

This Article proceeds as follows. Part I provides a basic description of private equity funds and the rise of individualized investing through separate accounts and co-investments. Part II helps explain why managers are motivated to offer preferential treatment to certain investors. Part III describes the following forms of preferential treatment and explains why they are attractive to preferred investors: superior customization, superior monitoring and control rights, superior fees and expenses, and the inequitable allocation of the manager's resources. It also explains why it can be easier for managers to provide these various forms of preferential treatment through individualized arrangements. Part IV presents a graphical depiction of the manager's decision-making process when preferential treatment is and is not possible, respectively, and describes the difference between "new value" and "zero-sum" forms of preferential treatment. Part V describes certain limits on the amount of zero-sum preferential treatment in the marketplace, and discusses how even zero-sum preferential treatment can increase efficiency to the extent that disclosure gives investors a clear understanding of the quality of the product they are buying and the price at which they are buying it. Finally, Part VI addresses possible concerns with the contention that preferential treatment increases the efficiency of the private equity marketplace. It also identifies policy priorities to minimize the harms to non-preferred investors and proposes a blended approach to private equity policy in today's individualized industry.

I. AN OVERVIEW OF PRIVATE EQUITY AND THE RISE OF INDIVIDUALIZED INVESTING

In this Part, I will provide a basic overview of what private equity is and how private equity funds are structured.

A. What is Private Equity?

Private equity firms provide equity and debt capital to privately-held companies. They sometimes take a controlling stake and board seats in the companies they invest in. They often make significant changes to their portfolio companies' balance sheets and seek to improve portfolio company operations, sometimes with the goal of turning around an underperforming or distressed company, before eventually selling it to an acquirer or taking it public through an IPO.[23] None of these activities can be done overnight. Accordingly, private equity investments generally require longer holding periods than other asset classes such as hedge funds and mutual funds.

B. The Basic Structure of Private Equity Funds

Private equity managers make money by investing the capital of others (primarily institutional investors) for a fee.[24]

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23 *See* KENT BAKER ET AL., PRIVATE EQUITY: OPPORTUNITIES AND RISKS 4–5 (H. Kent Baker et al. eds., Oxford Univ. Press 2015).

24 Private equity managers typically charge investors a "management fee," which is usually a flat percentage (typically in the range of 1.5–2%) of all the investor's assets committed to the manager. *See* STEPHANIE BRESLOW & PHYLLIS SCHWARTZ, PRIVATE EQUITY FUNDS: FORMATION AND OPERATION § 2:8.2[B][1] (Carol Benedicto ed., Practising Law Inst. 2015) ("The market rate for management fees of private equity funds is approximately 1.5%–2% of the fund's aggregate capital commitments during the fund's investment period."). Managers also typically charge a "carried interest fee." Unlike the management fee, the carried interest fee typically is not a flat fee, but is equal to a percentage of the fund's positive investment returns over a pre-determined "hurdle rate" or "preferred return." Historically, the conventional carried interest percentage has been 20% of the fund's profits over a "hurdle" rate of 5–12%. *See* JAMES M. SCHELL ET AL., PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS § 2.03[2] (Law Journal Press 2016) ("Fixed rate Preferred Returns commonly range from 5% to 12%."). The mechanics of carried interest fees can be quite complex, but the details are not important for purposes of this Article. In addition, private equity managers often charge their portfolio companies "transaction fees" and "monitoring frees," among others, for services provided by the manager in lieu of investment banking firms, management consulting firms, and etc. Even though such fees are charged to the portfolio companies,

Traditionally, private equity managers raised money predominantly by pooling the capital of their various investors into a single vehicle called a fund.[25] Pooled funds are typically organized as limited partnerships.[26] Every pooled vehicle is governed by a limited partnership agreement, a document that is collectively negotiated between the manager and all pooled fund investors and that sets forth the terms of the fund.

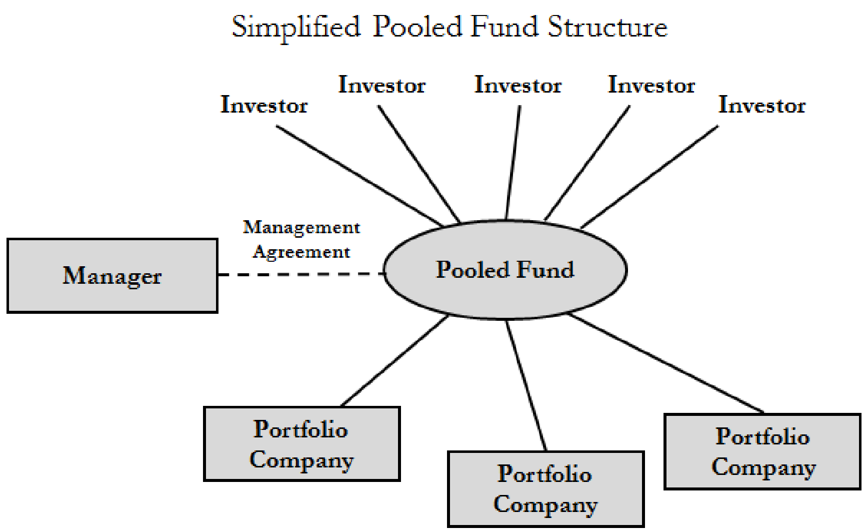

Figure A

Each fund generally has a stipulated "investment period" during which it is free to acquire portfolio companies (typically three to five years in

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they are indirectly borne by the fund's investors unless the fund partnership agreement provides that such fees will "offset" management fees.

25 In this Article, I will refer to these vehicles as "pooled funds." Another commonly used term is "commingled fund."

26 Because pooled funds are usually structured as limited partnerships, the standard architecture of a limited partnership applies to these vehicles. Hence, investors are passive "limited partners," and the manager forms a "general partner" entity that has broad authority to act on behalf of the fund. For purposes of this Article, the details of the limited partnership form will not be important, so I have generally avoided using terms such as "limited partner" and "general partner" in an effort to avoid unnecessary jargon and complexity. For our purposes, what matters is that the manager has broad power to manage the activities of these pooled funds—whether through the fund's general partner (which the manager typically controls) or directly through a management agreement with the fund—and that the investors' capital is pooled in a single vehicle.

duration),[27] after which it looks to manage and develop its portfolio companies and ultimately sell them or take them public through an initial public offering. During the investment period, investors contribute capital to the fund when the manager makes "capital calls" so the fund can make acquisitions and pay the fund's management fees and other expenses.[28] As the pooled fund receives proceeds from the divestment of portfolio companies, those proceeds are generally distributed back to investors net of the manager's carried interest fees. Each fund has a stipulated end date (typically around eight to twelve years after the date of the fund's closing[29]) by which it must liquidate any remaining assets if it has not made full distributions of invested capital by that date.[30]

Because each fund has a limited life, private equity managers must raise funds on a serial basis if they desire to remain in the business of private equity investing. Managers commonly raise new funds every three to five years, launching a new fund as the investment period of a prior fund draws to a close. This means that managers are often managing multiple pooled funds at any given time. In Figure B below, I have illustrated a simple "serial fund" structure for a manager that raised a pooled fund in 2012 and another pooled fund in 2016.

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27 *See* BRESLOW & SCHWARTZ, *supra* note 24, § 2:4.2 ("The appropriate length of the commitment period will vary depending on the investment strategy of the fund, with a time period of three to five years being typical for many strategies.").

28 *See infra* note 67.

29 *See* BRESLOW & SCHWARTZ, *supra* note 24, § 2:4 ("From the first closing until a date typically three to five years following the first (or sometimes following the final) closing, the fund has an "investment" or "commitment" period during which investments in new or existing issuers may be made. Thereafter, the fund typically has a period of perhaps five to seven years to develop, manage, and harvest investments and may make "follow-on investments," that is, investments in existing issuers of securities held in the fund's portfolio.").

30 Often, the life of a pooled fund can be extended for successive one- or two-year periods, but this frequently requires the approval of the fund's investors.

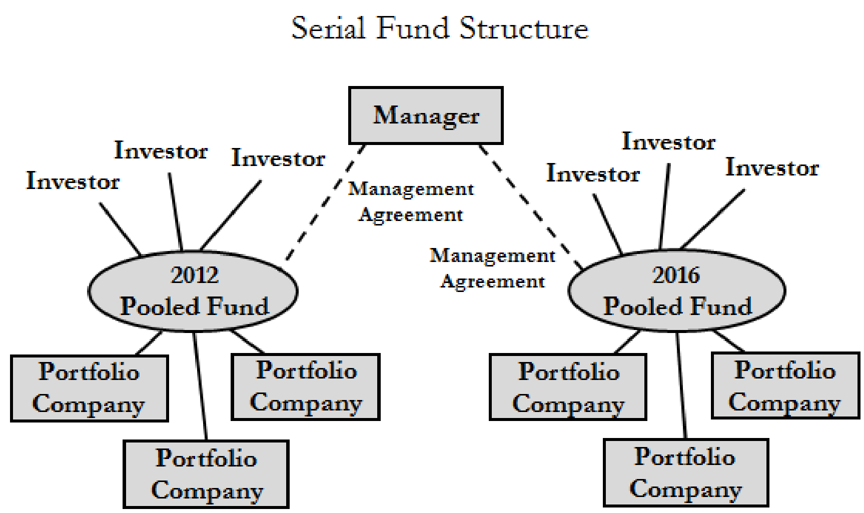

Figure B

C. The Rise of Individualized Investing

In recent years, the private equity industry has witnessed a dramatic upswing in customized contracting between single investors and fund managers—a practice that I refer to as "individualized investing." Individualized investing can occur in two ways. One approach is called "co-investing." Co-investing describes arrangements where the manager invites investors to invest alongside the pooled fund in certain portfolio compan(ies) that the pooled fund is investing in. Co-investors can invest directly in portfolio companies or through co-investment vehicles that aggregate the capital of multiple co-investors for a particular deal.

Often, co-investment opportunities are granted to investors who are already investors in the pooled fund. In these cases, the investor will have exposure to the portfolio company in two ways—first, through her interest in the pooled fund (which invests in the portfolio company), and second, through her "co-investment" in the portfolio company. Co-investment opportunities can also be granted by managers to third-party investors that are not participating in any of the manager's pooled funds.[31]

[31] *See* David Snow, *The New Era of Co-Invest*, PRIVCAP (May 13, 2014), http://www.privcap.com/article/new-age-co-invest/ ("Where necessary and strategic, GPs may also look beyond their own LP networks to co-investment specialist vehicles, as

For investors, co-investments can be attractive because the fees charged on the co-invested capital are generally significantly reduced or eliminated.[32] Also, co-investors typically have the ability to accept or reject the manager's offer to co-invest, giving them an effective veto right on the opportunity.[33] For managers, co-investments can be attractive in cases where they have identified an attractive investment opportunity that is too large for the pooled fund to acquire by itself (or that will leave the pooled fund under-diversified because the investment is so large), but that is possible with the involvement of co-investors.[34]

Figure C below shows an arrangement where there are three investors who are invested in the manager's pooled fund (Investors A, B, and C) and a third-party investor who is not invested in the manager's pooled fund. The pooled fund holds two assets—Portfolio Company 1 and Portfolio Company 2. In addition to their interests in the pooled fund, Investors A and C also have co-investment interests. Investor A has made co-investments in both Portfolio Company 1 and Portfolio Company 2, while Investor C has co-invested only in Portfolio Company 2, and Investor B has no co-investment interests. Investor D has no investment in the pooled fund, but does make a co-investment in Portfolio Company 2.

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well as to investors who are not in the current fund but with whom the GP would like to do business."). For investors that desire to make more targeted investments, or that would like to gain more familiarity with a manager before making a long-term commitment to that manager, co-investing as a third-party can make sense.

32 *See* PRICEWATERHOUSECOOPERS, PRIVATE EQUITY CO-INVESTMENT: BEST PRACTICES EMERGING 2 (2015), http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/private-equity-co-investment.pdf ("Co-investors often benefit from lower (or no) management fees and carried interest, as well as greater deal selectivity and transparency.").

33 *See* JULIA D. CORELLI & P. THAO LE, PRIVATE EQUITY CO-INVESTMENTS 2 (Pepper Hamilton 2013), http://www.pepperlaw.com/uploads/files/phwhitepaper_privateequityco_investments_final.pdf.

34 *See* Roger Mulvihill, *Co-Investment Heats Up, but Some Are Less Than Thrilled*, LAW360 (Mar. 19, 2014, 10:39 PM) ("From the general partners' point of view, co-investing can help fill out investments, particularly where the investments may be too large for their funds.").

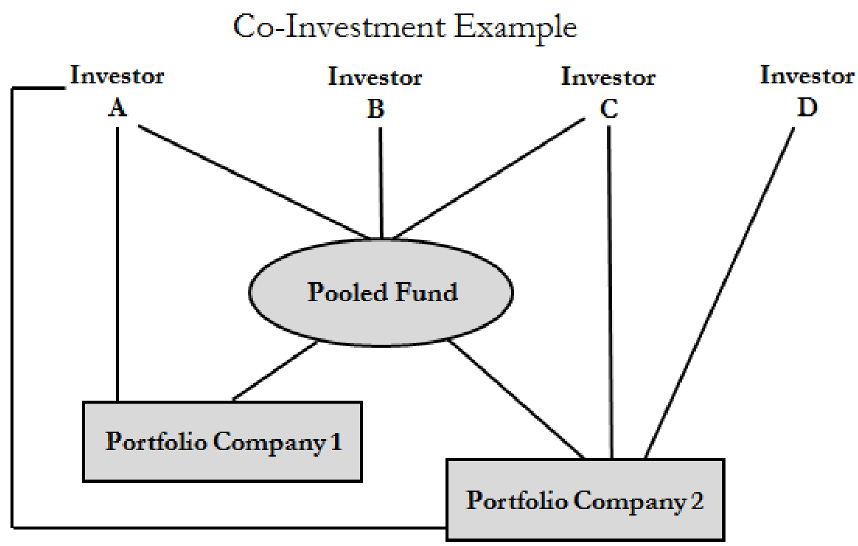

Figure C

Another form of individualized investing is when a manager manages "separate accounts" for individual investors outside of its pooled funds. Separate accounts commonly have their own distinctive investment mandates, customized governance terms, and customized distribution terms, in each case limited only by the imaginations and relative bargaining power of the investor and the manager when they negotiate the terms of the account, and the manager's existing contractual obligations to other investors (including any prohibitions on certain kinds of conflicts of interest).[35] Separate accounts very often have attractive fee terms and provide the investor with more transparent reporting with respect to, and control over, the vehicle's investments and investment activities.[36]

In Figure D below, I have provided a simple example of what a separate account's holdings could look like. In this example, the separate account has invested in some of the same portfolio companies that the pooled fund has

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35 Separate accounts are not limited to private equity investment strategies. They can be used by investors to gain exposure to the various investment strategies offered by a manager—including, for example, hedge fund, real estate, infrastructure, and credit products—without having to invest separately in the various pooled funds managed by the manager.

36 *See infra* Sections III.A, III.B, and III.C for detail on some of the terms and rights commonly seen in separate accounts and co-investment vehicles.

invested in, but it also holds some of its own investments that are not shared with the pooled fund. Given the highly customized nature of separate accounts, there is no way to illustrate a "typical" separate account. The precise investment mandate and structuring details of each separate account can vary considerably depending on the individual investor's preferences.

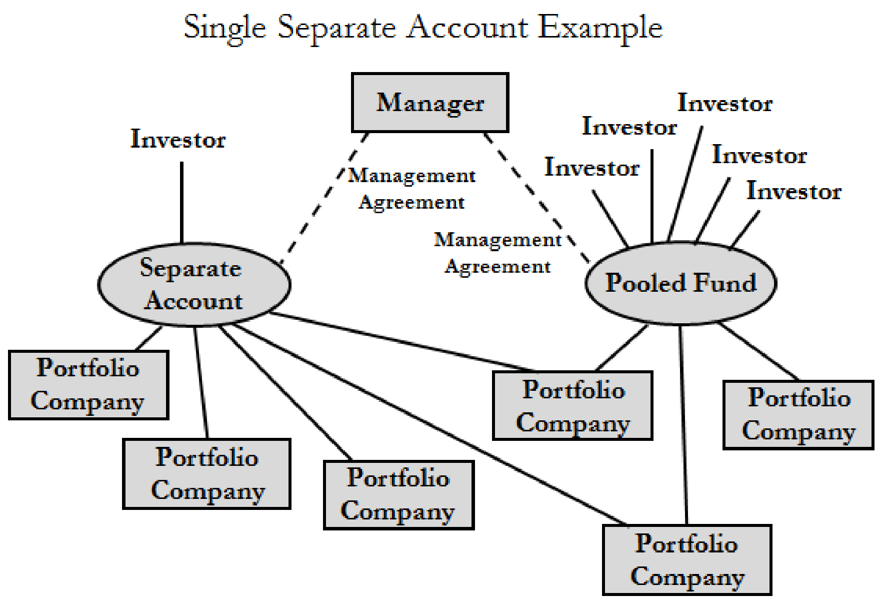

Figure D

By all measures, separate accounts and co-investments are booming,[37] and there are no signs of this trend slowing down.[38] This perspective is consistent

[37] *See* Amendments to Form ADV and Investment Advisers Act Rules, 90 Fed. Reg. 113, at 33,730 (proposed June 12, 2015) (to be codified at 17 C.F.R. pts. 275 & 279) ("Approximately 8,500 investment advisers registered with us (73%) reported assets under management attributable to separately managed account clients. Of those 8,500 advisers, approximately 5,366 advisers reported regulatory assets under management attributable to separately managed account clients of at least $150 million but less than $10 billion and approximately 535 advisers reported regulatory assets under management attributable to separately managed account clients of at least $10 billion."); Tom Stabile, *Where Has All the Private Equity Money Gone?*, FIN. TIMES (Apr. 12, 2015), http://www.ft.com/intl/cms/s/0/c3dd9938-dea9-11e4-8a01-00144feab7de.html?siteedition=uk#axzz3tNgliV00 ("A decade ago, there were only a few large institutions that had the stomach or ability to pursue more exotic versions of private

with Securities and Exchange Commission ("SEC") commentary that "much of the growth in private equity is not coming from the traditional (pooled) vehicles but from separate accounts and side-by-side co-investments."[39] Importantly, larger and more sophisticated investors typically have much

equity: investing alongside the standard commingled fund in custom 'separate accounts' mirroring the main strategy; in deal-by-deal 'co-investments'; or simply through direct investments. Post-crisis, however, institutional investors have gone wild over these special arrangements because they often entail lower fees and more control over asset disposition."); Chris Witkowski, *Tony James: Blackstone Scales Through New Ideas, Products*, PE HUB NETWORK (Apr. 17, 2015), https://www.pehub.com/2015/04/tony-james-blackstone-scales-through-new-ideas-products/ ("[Blackstone is] much more in business creating special vehicles for LPs that want certain things. . . . There's much more money coming into separate accounts than in broad commingled funds."); Transcript of Blackstone First Quarter 2015 Earnings Call, *supra* note 1 ("What's changed in our industry is there are starting to be different LPs who want different things. There are much more tailor-made products, if you will, than there were several years ago. . . . We're . . . much more in the business of creating special vehicles for LPs that want certain things. There's a lot more of those SMAs as they're called, separately managed accounts, special purpose vehicles. And sometimes they're for one LP or sometimes they're for two or three. But much more the money is coming in the form of those separate accounts as a percentage than in the broad commingled funds."); Transcript of Q2 2014 Apollo Global Management, LLC Earnings Call, *supra* note 7 ("As we have highlighted previously, strategic managed accounts, of which we now manage more than $15 billion of AUM in the aggregate, continue to be an area of growth for us. Not only are we seeing interest for new mandates . . . but we're also seeing certain investors with pre-existing accounts increase the size of those mandates as we have successfully deployed their initial capital and met return targets."). One source estimates that between January 2007 and March 2014, for every two dollars invested in U.S. commingled private equity funds, one dollar was invested in U.S. co-investments and separate accounts. Arleen Jacobius, *Assets Invested in Separate Accounts Starting to Add Up*, PENSIONS & INVESTMENTS (Dec. 22, 2014), http://www.pionline.com/article/20141222/PRINT/312229973/assets-invested-in-separate-accounts-starting-to-add-up. One 2015 survey found that for investors with at least $5 billion allocated to private equity, 68% currently invest, or will consider investing, in separate accounts. PREQIN, PREQIN INVESTOR OUTLOOK: ALTERNATIVE ASSETS H1 2015, at 17 (2015), https://www.preqin.com/docs/reports/Preqin-Investor-Outlook-Alternative-Assets-H1-2015.pdf. Another survey found that of 140 investors 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. Jessica Duong, *The State of Co-Investments*, PRIVATE EQUITY SPOTLIGHT, Mar. 2014, at 3, 3, https://www.preqin.com/docs/newsletters/pe/Preqin_Private_Equity_Spotlight_March_2014.pdf.

38 *See supra* note 8 and accompanying text.

39 Andrew J. Bowden, Dir., Office of Compliance Inspections & Examinations, U.S. Sec. & Exch. Comm'n, Address at the Private Equity International Private Fund Compliance Forum: Spreading Sunshine in Private Equity (May 6, 2014) (transcript available at https://www.sec.gov/news/speech/2014--spch05062014ab.html).

better access to separate accounts and co-investments, and greater ability to negotiate attractive terms through them, than smaller investors.[40]

II. WHY GIVE SOME INVESTORS BETTER TREATMENT THAN OTHERS?

To understand the logic of preferential treatment, it is helpful to think about private equity managers as sellers of a product and fund investors as buyers of a product.[41] Discriminating between buyers is a fact of life in most product markets. For example, food producers typically charge less per item when their products are bought in bulk. A bicycle manufacturer may offer better pricing for a bicycle if the purchase is "bundled" with a helmet and training wheels. Grocery stores will give discounts to coupon-clipping buyers. Banks will provide loans with lower interest rates to customers with higher credit scores.[42] This type of unequal treatment in product markets has commonly been referred to as "price discrimination."[43]

In addition, producers will often give certain buyers greater ability to customize their product and/or greater control over the delivery and upkeep

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40 *See* Marco DaRin & Ludovic Phalippou, *There Is Something Special About Large Investors: Evidence from a Survey of Private Equity Limited Partners* 20 (Eur. Corp. Governance Inst. Working Paper Series in Finance, Paper No. 408, 2014), https://pure.uvt.nl/portal/files/1580027/2014-016.pdf ("Once more, we find that LP size is significantly related to all of the variables capturing contracting effort. Larger LPs are more likely to benchmark contracts, to obtain side letters, a Most Favored Nation clause, and to negotiate the contract terms and conditions."); PREQIN, *supra* note 37, at 17 (publishing the results of a survey of over 100 institutional investors, and finding that for investors with $5 billion or more allocated to private equity, 61% invested in separate accounts, compared to only 16% of investors with less than $100 million allocated to private equity and 23% of investors with between $250–499 million allocated to private equity (see Appendix 1 for a chart showing the full results). The report concluded that "[t]he figures highlight a potential barrier preventing smaller investors from accessing these opportunities, as commitment sizes for separate account mandates do tend to be large in size."); PRICEWATERHOUSECOOPERS, *supra* note 32, at 2 ("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.").

41 I am not the first to compare investment funds to products. *See, e.g.*, Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961 (2010); John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228, 1233 (2014) ("[I]n terms of their rights and risks, fund investors look more like buyers of products or services than like investors in ordinary companies.").

42 Other types of price discrimination not captured in the examples above include age-based discounts (such as child discounts and senior discounts), friends and family discounts, and discounts for people who are in a demographic that is more likely to become repeat buyers.

43 *See, e.g.*, *supra* note 22.

of their product in cases where the buyer is purchasing particularly large amounts or has the potential to be a large, repeat buyer. For example, a carpet manufacturer may offer a standard array of colors and materials for the carpets that she sells to the general public. But if a buyer comes along who is willing to make an unusually large purchase, the manufacturer may allow that buyer to order a special batch with customized color and material combinations. Similarly, while the manufacturer may offer standard delivery, installation, warranty, and repair services to the general public, if the order is large enough, she may be willing to offer superior versions of these services to the buyer. Even in cases where the specific order may not be particularly large, the manufacturer may be inclined to offer greater ability to customize and control the product to certain *types* of buyers. In the carpet example, when the buyer is a large home builder who is constantly making new carpet orders, that buyer may be granted greater customization and control even for smaller individual orders.

When sellers offer discounts and superior customization and control rights to certain buyers, they generally are not acting charitably. For example, offering these perks for high-volume purchases encourages larger purchases; offering them for bundled purchases encourages purchases of the producer's other products; and offering them to potentially large repeat-buyers is calculated to win future business. Moreover, there may be competition with other producers who are offering preferential terms to entice the most attractive buyers.

Private equity managers are no different than the producers described above. For example, managers may desire to offer favorable treatment to investors who make larger commitments of capital. This can act as an incentive to encourage investors to make larger capital commitments than they otherwise would make (thereby generating higher aggregate fees for the manager). Also, because there are transaction costs associated with negotiating and dealing with each incremental investor in a private equity fund, having a smaller number of investors who make larger capital commitments can increase the efficiency of the manager's time, freeing her up to focus her time and resources on making investments.[44] Managers may also

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[44] *See* Adair Morse, *Influence in Delegated Management: Active Investors in Private Equity Funds* 5 (Univ. of Cal. at Berkeley, Haas Sch. of Bus. Working Paper, 2013), https://www.bus.miami.edu/_assets/files/faculty-and-research/conferences-and-seminars/finance-seminars/Morse%20Paper.pdf ("[H]aving a large investor may increase the efficiency of private equity fund managers' time. For example, having large limited partners shortens the time needed for fund raising, thereby freeing up private equity manager time for adding value to portfolio companies. Likewise, by ensuring a private

want to reward investors who make early commitments to a fund, as these investors are subject to certain risks that later investors do not face.[45] Managers also sometimes use individualized vehicles when they want to gain experience in new strategies where they have little prior experience,[46] offering preferential terms to help an investor overcome her reservations about the manager's lack of a track record in that strategy.[47] In addition, managers may be willing to grant better terms to investors who commit capital outside of the manager's pooled fund cycle because this gives them a more diversified stream of fee revenues.[48]

These various motivations relate to specific contributions the investor makes to a manager's funds, but managers can also be incentivized to use favorable treatment to attract certain *types* of investors generally.[49] For example, investors that have particularly large amounts of capital under management may be generally attractive because, even if the investor is not making a particularly large commitment in the current vehicle, that investor has greater potential to make large commitments in the future than smaller investors or to offer other strategic advantages. Moreover, if the manager were to offer products in other investment strategies, larger investors would be more likely to have significant capital to deploy in those strategies as well. Another reason might be that some investors have reputations for being prestigious and/or savvy investors, thus making for a positive signal to the

equity fund fills its target fundraising, or fills quickly, the large limited partner may increase the reputational capital of the private equity firm that in turn spills over to benefit the portfolio company.").

45 For example, early investors may face the risk that the fund will be unable to raise a sufficient amount of capital from other investors to achieve the desired scale. Later investors may also have the benefit of observing the fund's earliest investments to determine whether the fund is likely to be successful.

46 PREQIN, THE 2015 PREQIN PRIVATE EQUITY FUND TERMS ADVISOR 9 (2015) (sample pages available at https://www.preqin.com/docs/reports/2015-Preqin-Private-Equity-Fund-Terms-Advisor-Sample-Pages.pdf ("GPs can benefit from separate accounts, for example by allowing them to further develop a track record in a particular region, industry sector or investment strategy.").

47 For example, if an investor is uncertain about the manager's ability in a particular strategy, she may want more control over the manager's investment decisions or the ability to terminate the vehicle's investment period more quickly. Lower fees may also help the investor get comfortable.

48 *See* Becky Pritchard, *Taking Account of Managed Accounts*, WALL ST. J. (Aug. 1, 2016), http://www.wsj.com/articles/pritchards-take-taking-account-of-managed-accounts-1470051004 ("[F]or a firm that has a traditional co-mingled fund, managed accounts can provide a steady flow of fees, which helps when the firm needs to shift its focus from investing to fundraising.").

49 *See* PREQIN, *supra* note 46, at 9 ("Crucially, separate account vehicles provide a platform for the creation of long-term, mutually beneficial LP-GP relationships.").

market when the manager is able to attract their investment. Other investors may be unlikely to face liquidity shocks and are therefore more likely to be stable, long-term investors.[50] Because many of these factors are likely to be attractive to managers generally—not just in private equity but in other asset classes as well—competitive forces will push managers to use preferential treatment to make investing in their funds attractive to their preferred investors.[51]

Moreover, in another recent trend, a limited subset of sophisticated investors are developing the capacity to make direct private equity investments, bypassing managers entirely.[52] To the extent these investors can do so successfully, managers may need to provide them with better deals to justify charging fees for providing a service that they can do themselves.

In this Article, I will refer to investors who possess characteristics that are generally desirable to managers as "preferred investors." Of course, this is not a binary world where investors are either preferred or non-preferred by managers; there is a broad spectrum of investors, and managers will differ in the characteristics they find most desirable. But for the sake of simplicity, it is useful to have a term that describes investors who are generally more likely to have bargaining power with managers than other investors.

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50 *See* Josh Lerner & Antoine Schoar, *The Illiquidity Puzzle: Theory and Evidence from Private Equity*, 72 J. FIN. ECON. 3 (2002) (theorizing that private equity managers use contract terms strategically to screen for investors who are unlikely to have a liquidity shock that would prevent them from investing in the manager's future funds).

51 *See* Antoine Drean, "The Growing Promise and Pitfalls of Private Equity Co-Investment," FORBES (July 13, 2016) ("Competitive pressure is why the number of managers offering co-investment has grown so much. Four out of five investors and managers believe that investors are writing bigger checks to fewer managers since the financial crisis. . . . For managers, co-investment rights are key to being among the lucky few getting large commitments today.").

52 According to a recent estimate, approximately 6.5% of all private equity investment in 2015 was "direct" investment by institutional investors who bypassed professional managers. *See* Drean, *supra* note 5; *see also* Joseph Cotterill, *Direct Investors a Growing Force in Private Markets*, FIN. TIMES (June 16, 2015), http://www.ft.com/intl/cms/s/0/5b002968-1404-11e5-9bc5-00144feabdc0.html#axzz3zzUkuLKb ("Buyout firms are already used to many of their investors asking to co-invest . . . as a way of reducing fees and consolidating capital. Beyond this, 'going direct' may turn investors into competitors."); Tommy Wilkes & Anjuli Davies, *Buyout Firms Face Squeeze as Investors Go Direct for Deals*, REUTERS (Mar. 22, 2013), http://www.reuters.com/article/us-privateequity-investors-idUSBRE92L0IK20130322 ("Tired of hefty fees charged by private equity firms and wanting more say over what they buy, big investors like pension funds and insurers are taking matters into their own hands. Some are buying stakes in companies directly or teaming up to invest alongside private equity firms.").

III. FORMS OF PREFERENTIAL TREATMENT ENABLED BY INDIVIDUALIZED INVESTING

A. Superior Customization

For some investors, the right to customize the investment strategy and/or the structuring of the vehicle that their money is invested in may be a highly desirable capability. An investment mandate spells out the investment activities that the manager will pursue on behalf of the fund, including investment styles, industries, portfolio company size limitations, and geographical areas of emphasis. Because most private equity investors invest money in a wide range of strategies[53] with a wide range of managers,[54] customization of a vehicle's investment mandate can be quite valuable as the investor seeks to optimize the mix of her overall portfolio of investments.

In addition, investment vehicles can be structured in different ways to address specific timing preferences and other needs of the investor. For example, investors might desire investment periods of differing lengths depending on their portfolio needs and other considerations; some might want to achieve aggressive exposure to a particular industry or strategy over a short period of time, while others may prefer to give the manager more time to find promising investment opportunities. Investors may also desire greater flexibility and control over the timing of distributions from the vehicle, while others might want to lock up their capital for longer periods of time to enable the manager to invest in portfolio companies and other assets with especially long time horizons.[55] The ability to customize the structure of an investment vehicle to accommodate an investor's unique profile can carry significant value for certain investors.

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53 *See* Angela Sormani, *An Analysis of US-Based Public Pension Fund Allocations to Private Equity*, PREQIN (June 11, 2015), https://www.preqin.com/blog/0/11528/us-public-pension-funds (stating that public pension funds, which are the single largest institutional investor in private equity funds in terms of the proportion of capital committed, on average allocate only 7% of their assets under management to private equity).

54 *See, e.g.*, Timothy W. Martin, *CalPERS to Cut External Money Managers by Half*, WALL ST. J. (June 8, 2015), http://www.wsj.com/articles/calpers-to-cut-external-money-managers-by-half-1433735976 (reporting the decision of CalPERS to reduce the number of direct relationships it has with private equity, real estate, and other external funds to about 100 from 212).

55 *See* Jacobius, *supra* note 37 ("A big topic among investors is creating separate accounts that are longer than the typical 10-year lifespan of a private equity commingled fund. They are interested in longer lockups—with 20-year spans under discussion—in exchange for consistent returns and distributions.").

This kind of customization cannot be provided in a pooled vehicle to multiple investors because all investors have a pro rata interest in the same assets held by the fund. Accordingly, if a single investor has specific investment mandate preferences that would optimize her overall portfolio, it would be very difficult for the manager to accommodate them in a pooled vehicle, given that the vehicle needs to satisfy the preferences of many investors.[56] Similarly, if an investor would benefit from a structure that accommodates her distinctive investment timing or liquidity needs, it would be very difficult for the manager to accommodate those needs through a pooled fund.

By contrast, because the assets in a separate account are not held pro rata with other investors, it is easier for a manager to customize the vehicle's investment mandate in a manner that complements the investor's overall portfolio mix and/or customize a vehicle's structural characteristics to accommodate her liquidity and other needs.[57]

B. Superior Monitoring and Control Rights

Investors may also value the ability to monitor and control the manager's activities after a vehicle has begun operating and is actively making investments. Monitoring rights can include enhanced and/or tailor-made disclosure that enables the investor to better keep tabs on the manager's activities. Control rights can take various forms, including control over investment decisions and heightened governance remedies.[58]

The value of this kind of control will vary from investor to investor. The most sophisticated investors with the greatest resources may attach a large amount of value to monitoring and control rights, as they will be better equipped to process information disclosed by the manager and to make an independent assessment of the quality of the manager's decision-making.

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56 Moreover, even if an investor has valuable insights about specific investment strategies and/or industries that will be particularly profitable during the vehicle's investment period, that investor will have limited incentive to negotiate for an investment mandate that reflects those insights due to the collective action and collective control problems in pooled funds.

57 *See* Kamarl Simpson, *Private Equity Fund Manager Use of Separate Accounts*, PREQIN (Jan. 9, 2015), https://www.preqin.com/blog/0/10547/pe-separate-accounts ("Account mandates have gained momentum during a time when GPs are finding it more difficult to raise funds, mainly due to investors seeking lower, more justifiable fees and greater control over their respective private equity portfolios.").

58 *See infra* note 63 and accompanying text.

Less sophisticated investors, on the other hand, may have little practical use for such rights.

In pooled funds, even when certain investors might be very interested in monitoring and exerting control over the manager, those investors will find such rights of limited value due to collective action and collective control problems. I will consider the collective action problem first. In a pooled fund, all investors have a pro rata interest in the same set of assets. Accordingly, if an investor monitors the manager's activity closely and uncovers problematic actions (for example, she might find that the manager has charged an inappropriate expense or is dedicating insufficient time to the pooled fund's activities) or wields control rights that result in the fund achieving higher investment performance, that investor only gets to keep a *pro rata portion* of the gains generated by that action. This will limit the investor's incentive to exercise monitoring and control rights to increase the value of the fund, particularly when the investor's capital is spread across many different pooled funds managed by many different managers.

The value of control rights in pooled funds is further diminished by the fact that investors generally must achieve some level of consensus with other pooled fund investors before they can exercise control rights. This is a problem of collective control. If, for example, the pooled fund limited partnership agreement were to grant veto rights over investment decisions to pooled fund investors, no single investor could unilaterally exercise those control rights. Instead, in order to veto a specific investment opportunity, an investor would need to convince other pooled fund investors to join her in voting to veto the opportunity.[59] Depending on how the veto right is structured, the support of a majority or a super-majority of pooled fund investors might be necessary. Given the inherent uncertainty involved in determining the expected performance of any investment opportunity, this support might be difficult to obtain.[60]

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59 The challenges of collective control can be mitigated somewhat by the use of "investor advisory committees" in pooled funds. An investor advisory committee typically includes a subset of the pooled fund's largest and most influential investors as its members. Because advisory committee members are fewer in number and are often more sophisticated than the general pooled fund investor population, the barriers to communication and to collective decision-making in an advisory board are reduced. However, the frictions of collective control are by no means eliminated in investor advisory committees, as communication between advisory board members is not costless, and advisory committee members can have heterogeneous interests. *See also infra* Section V.A.1 for discussion of investor advisory committees.

60 Consensus will be particularly unlikely in cases where investors have heterogeneous and/or conflicting interests with respect to the investment opportunity. For example, if a

Recent examination findings by the SEC support the idea that collective action and collective control problems dampen pooled fund investors' incentive to monitor their managers. After reviewing the contracts and operations of over 150 private equity managers, the SEC noted that "most limited partnership agreements do not provide limited partners with sufficient information rights to be able to adequately monitor not only their investments, but also the operations of their manager."[61] The SEC also noted that "[w]hile investors typically conduct substantial due diligence before investing in a fund, . . . investor oversight is generally much more lax after closing."[62] This should not come as a shock—given the collective action and collective control problems in pooled funds, we should expect pooled fund investors to invest limited resources in monitoring and controlling their managers once a fund has commenced operations.

By contrast, collective action and collective control problems are significantly reduced, if not eliminated, in individualized vehicles. In a separate account, for example, because there is typically only one investor, that investor will enjoy the full benefit of all actions taken to increase the performance of the vehicle. Moreover, because separate account holders typically make very large commitments of capital, their interest in seeing the vehicle perform well will be particularly strong. In addition, a separate account investor avoids collective control problems because she can unilaterally exercise control rights without having to persuade other investors to follow her lead. Co-investors also avoid collective action and collective control problems because they (i) enjoy the full benefit when they do research to determine whether a co-investment opportunity is worthy of investment or not, and (ii) can make unilateral decisions about whether to invest in co-investment opportunities without consulting other investors.

Accordingly, because collective action and collective control problems are dramatically diminished, the incentive for sophisticated investors to engage in more robust monitoring of their managers and to engage in value-adding activities is higher in individualized vehicles than it is in pooled funds.

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specific investment opportunity does not meet the portfolio diversification preferences of certain pooled fund investors but is satisfactory to other pooled fund investors, there will be disagreement about whether to veto that opportunity. *See* Henry Hansmann, *Ownership of the Firm*, 4 J.L. ECON. & ORG. 267, 278 (1988) (arguing that the collective exercise of control is most costly in cases where owners' interests are heterogeneous).

61 *See* Bowden, *supra* note 39.

62 *See id.*

These factors help explain why separate accounts tend to offer investors greater transparency into and control over investment decisions.[63] Separate accounts often give investors more tailored and robust reporting.[64] And, whereas pooled funds offer weak control rights that are rarely invoked in a meaningful way, separate account holders often have control over investment decisions, ranging from full veto power to a lesser degree of positive or negative control.[65] Moreover, investors are often given more powerful governance remedies, including the right to suspend the vehicle's investment period or the right to remove the manager, in each case without having to generate support from a super-majority of dozens of other investors.[66]

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[63] *See* Anand Damodaran, Matthew Judd & James Board, *Combining Managed Accounts with Traditional Fundraising: The Key Issues*, PRIVATE EQUITY INT'L, Apr. 2013, at 26, 26, https://www.ropesgray.com/~/media/Files/articles/2013/03/20130326_PEI.ashx ("Recently, several sophisticated large-ticket investors, ranging from sovereign wealth funds to pension funds, have developed enhanced requirements for the terms under which they are willing to commit their sizable capital . . . . These requirements include increased control over investment decisions related to an investor's commitments (whether merely a level of positive or negative control, or full veto rights."); Joseph London & Joseph Magri, *Riding the Wave: Private Investment Funds Moving Towards Managed Accounts Structure*, ASSET MGMT. ADVISER, Feb. 2013, at 1, 1, https://www.grantthornton.com/~/media/content-page-files/financial-services/pdfs/2013/AM/FS-AM-2013-02-Riding-the-wave-private-investment-funds.ashx ("The financial crisis that began in 2008 and the corresponding regulatory response, coupled with shifting investor demands, has influenced the attractiveness of managed accounts, given their greater transparency, liquidity and risk controls."); Antoine Drean, *Private Equity Managers Are Successfully Wooing Individuals, As Institutions Cut Costs*, FORBES (Nov. 21, 2014), http://www.forbes.com/sites/antoinedrean/2014/11/21/private-equity-managers-are-successfully-wooing-individuals-as-institutions-cut-costs/#32456d901b24 ("Separate accounts . . . often give investors veto power over specific investment proposals."). One example of a separate account vehicle providing an extreme level of investor control is a "pledge fund"—an arrangement in which the investor retains the ability to decide, on a deal-by-deal basis, whether to participate in the investment opportunities brought by the manager. *See* Mark Proctor & Christopher Rowley, *A Close Look at Pledge Funds*, LAW360 (May 20, 2014), http://www.velaw.com/uploadedFiles/VEsite/Resources/ACloseLookAtPledgeFunds052114.pdf.

[64] *See* BRESLOW & SCHWARTZ, *supra* note 24, § 1:5.3 ("A single investor fund is basically a private equity fund tailored to one investor. Investors in these types of funds, like managed accounts, have the ability to control the advisory committee role and can have more rights over the decision-making process in terms of investments. Investors can also obtain greater portfolio transparency and more flexibility on terms.").

[65] *See* Damodaran, Judd & Board, *supra* note 63, at 26.

[66] *See* BRESLOW & SCHWARTZ, *supra* note 24, § 1:5.3 ("In a single investor fund/managed account context, the general partner can generally be removed, or the arrangement terminated, by the single investor.").

When preferential monitoring and control rights are granted to certain investors through separate accounts and co-investments, this provides a source of value that those investors could not have realized through an investment in a pooled fund. Such rights have significantly less value when granted to pooled fund investors due to collective action and collective control problems.

C. Superior Fees and Expenses

The appeal of lower fees and expenses to preferred investors is easy to understand. The lower a vehicle's fees and expenses,[67] the higher its profits will be. Fee and expense levels can make the difference between whether an investment in a private equity fund is a profitable investment or a regrettable one.

When managers charge some investors lower fees and expenses[68] than others, this is a classic form of price discrimination. One constraint on price discrimination in pooled funds is the fact that many investors commonly demand "most favored nation" status in the pooled funds that they invest in. With a most favored nation right, an investor has the right to observe the terms granted to other investors in the fund and to receive the best terms.[69] As a result, managers often cannot keep confidential the preferential terms that they grant to preferred pooled fund investors, and a precedent

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67 Various expenses are commonly passed along to investors in private equity funds. These include operating costs commonly incurred during the course of setting up and operating a private equity vehicle, such as attorney and advisor fees, costs associated with preparing regulatory filings, and costs associated with preparing financial statements and tax returns. "Broken deal expenses" are incurred when resources are expended to examine new investment opportunities that are never realized or dispositions of investments that are never consummated. In addition, private equity managers often charge their portfolio companies "transaction fees" and "monitoring fees." *See id.* § 2:8.2[B][1], [D][1]. By limiting the list of expenses that can be passed along to the investor, or by agreeing to offset the investor's management fees when certain fees are incurred, the manager can increase the profitability of that investor's investment.

68 *See supra* note 24 for a description of the forms that private equity fees usually take.

69 *See supra* Section I.C for a description of side letters in pooled private equity funds. *See also* SCHELL ET AL., *supra* note 24, § 11.14 ("To obtain a contractual right to see other investors' side letters and receive reciprocal rights and privileges, many Limited Partners will negotiate for a 'most favored nations provision' (often called an 'MFN'). An MFN provision usually requires the Sponsor to provide similarly-situated investors (i.e., those with equivalent capital commitments or regulatory circumstances) the opportunity to elect to receive the rights and benefits provided via side letter to other investors in the same Fund.").

established for one investor can quickly be demanded by the fund's other investors.[70]

By contrast, the most favored nation rights and side letter disclosure rights held by pooled fund investors generally do not extend to the terms of a separate account or a co-investment vehicle. And when an investor invests in a separate account, the terms of that arrangement often remain private, depending on the confidentiality terms negotiated between the manager and the investor.[71]

This distinction could help explain why separate accounts and co-investments tend to have significantly lower and more customized fee rates than pooled funds.[72] However, the practical difference in the amount of price discrimination in pooled funds as compared to separate accounts and co-investment vehicles is difficult to measure. Managers of pooled funds commonly narrow the scope of their most favored nation obligations by tying preferential treatment to certain objective conditions, such as the size or timing of an investor's capital commitment.[73] Thus, it is not uncommon to see certain investors enjoy lower fees in pooled funds when their capital

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[70] *See* BRESLOW & SCHWARTZ, *supra* note 24, § 2:4 ("Because this request (for most favored nation provisions) is so common, a sponsor considering whether to give a preferential term to a particular investor must consider the possibility that the same term will be demanded by other investors, or at least those of comparable or greater size.").

[71] *See infra* Section V.A.2.c for discussion of the role of confidentiality in separate accounts. *See also* Pritchard, *supra* note 48 ("This trend has been building over the past five years, with executives reporting a steady proliferation of managed accounts. But such arrangements are typically kept private and little is known of the size or structures of such funds. Only recently have many of these new and sometimes funky arrangements come to light.").

[72] *See* Press Release, Preqin, 48% of Private Equity Separate Accounts Charge a 20% Performance Fee, Compared to 85% of Commingled Funds (Sept. 11, 2015), https://www.preqin.com/docs/press/Fund-Terms-Sep-15.pdf ("Separate accounts and co-investments offer sophisticated investors significantly lower management and performance fees than the widely accepted '2 & 20' rate."); PRICEWATERHOUSECOOPERS, *supra* note 32, at 2 ("Co-investors often benefit from lower (or no) management fees and carried interest, as well as greater deal selectivity and transparency."); Stabile, *supra* note 37 ("[I]nstitutional investors have gone wild over these special arrangements because they often entail lower fees and more control over asset disposition."); Drean, *supra* note 5 ("Separate accounts and co-investments provide managers with lower annual fees and a lower share of capital gains than fund investment."); Drean, *supra* note 63 ("Institutional investors are getting more bang for their buck in low-cost separate accounts and other alternatives to classic funds.").

[73] *See* SCHELL ET AL., *supra* note 24, § 11.14 ("MFN negotiations can become quite elaborate, particularly as the definition of 'similarly situated' evolves and the scope of the MFN is narrowed to exclude rights and benefits granted to investors with larger Capital Commitments.").

commitment exceeds certain thresholds, or when their capital commitment was made prior to a certain date.

As the dollar amounts invested in separate accounts tend to be quite high, we can assume that most separate account investors would have received fee discounts even if they had instead invested their capital in a manager's pooled fund. However, the specific terms attending a pooled fund investment are often more visible to other investors than if the same investment were made through a separate account. This is because the favorable terms granted to a preferred investor are sometimes disclosed broadly to other pooled fund investors as part of the fund's most favored nation process, even when those other investors are restricted from receiving the benefit of such terms due to commitment size and timing conditions as described above. Moreover, separate accounts are sometimes bound by more substantial confidentiality restrictions than pooled funds, depending on the limitations negotiated by the parties.[74] This potential for increased visibility in the pooled fund context (even when most favored nation rights may not apply to the applicable term) could reduce the size of the discounts that the manager will be willing to grant.

D. Inequitable Allocation

Private equity managers have finite resources at their disposal as they seek to achieve high investment performance for their investors. The most important of these finite resources are high-quality investment opportunities and the time and attention of the manager's most talented personnel. In this Article, I use the term "inequitable allocation" to describe any instance where managers allocate their resources disproportionately in favor of preferred investors.

Because private equity funds typically invest in the securities of private, illiquid companies, there are often distinct limits to the amount of any investment opportunity available for the manager to allocate to its clients.[75] By allocating a larger portion of the best investment opportunities to a preferred investor's separate account, and a lesser portion to the pooled fund, the manager can give the separate account holder a form of preferential treatment that does not have an immediate negative impact on the manager

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74 *See supra* note 71.

75 By contrast, investment funds that invest primarily in the securities of large, public companies (such as mutual funds and hedge funds) generally face fewer limits on the amount of any particular investment opportunity that can be purchased and allocated to clients.

(whereas lower fees, for example, will immediately result in lower expected revenues for the manager).[76]

In pooled funds, inequitable allocation of investment opportunities is virtually impossible. Because all investors in a pooled fund have a pro rata interest in the same fund's assets, a manager has no way to allocate superior investment opportunities disproportionately to any subset of investors. With the rise of individualized investing, however, it becomes easier for managers to engage in inequitable allocation so long as there are not contractual restrictions limiting the practice.

In a separate account, the manager and the separate account holder can negotiate for a customized investment mandate, with as much or as little overlap with the pooled fund investment mandate as desired. Every time the manager finds a good investment opportunity that falls within the investment mandate of both the pooled fund and the separate account, the manager will have to decide how to allocate that opportunity.

Managers typically disclose their investment allocation policies when they solicit new investors. Some allocation policies leave the manager with more discretion than others. When a manager has discretion, she could allocate a larger portion of the highest-quality investment opportunities—ones that the manager expects will produce exceptional returns—to the separate account and a smaller portion to the pooled vehicle.

In Figure E below, I have provided a simple example to illustrate how separate accounts can be used to promote inequitable allocation of investment opportunities. In the left-hand scenario below, the manager has found an investment opportunity that she thinks will achieve average performance. The manager's best prediction is that the investment will neither outperform nor underperform future investment opportunities that she expects to find, and she allocates half of the opportunity to the pooled fund and half to the preferred investor's separate account. In the right-hand scenario, the manager has found an investment opportunity that she thinks is going to significantly outperform her other investment opportunities. The manager grants preferential treatment to the preferred investor by allocating a larger percentage of this exceptional opportunity to her separate account (75% in the example below) and a smaller percentage to the pooled fund (25% in the example below).

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76 In the long run, the manager does bear some of the costs. In Section V.A, I discuss how the manager will ultimately pay a price for this favorable treatment in a competitive market.

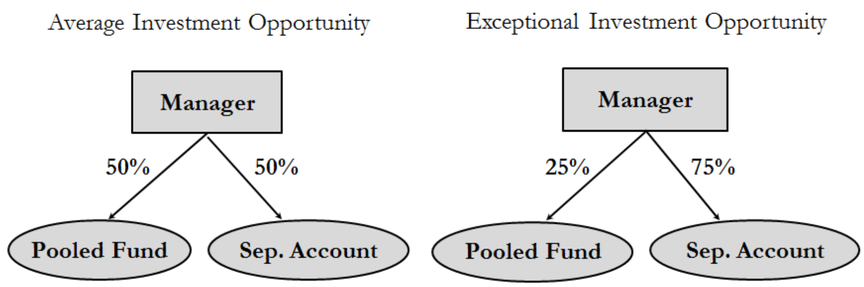

Figure E

Co-investments can enable inequitable allocation of investment opportunities in a similar manner. Unless contractually restricted from doing so, managers could grant larger portions of the best investment opportunities to preferred investors in the form of co-investments, rather than through their pro rata interests in the pooled fund.

As mentioned above, another example of the manager's finite resources includes the talent and time of the manager's employees. In the case of employee talent and time, a manager could decide to allocate more of its most talented employees to manage a separate account, leaving fewer talented employees available to manage the sponsor's pooled fund. Alternatively, holding the employee talent level constant, the manager could pay the employees working on certain favored accounts more than other employees, or pay more in the form of incentive-based compensation, generating an incentive gap between separate accounts and pooled funds. Just as with the favorable allocation of investment opportunities, the favorable allocation of employee talent and time to preferred investors offers a way for the manager to provide a favored benefit to preferred investors at the expense of non-preferred investors.

If the likelihood of this kind of activity is clearly disclosed and understood before non-preferred investors commit to invest with the manager, then investors can factor this into the price they are willing to pay. But without such pre-commitment disclosure, inequitable allocation constitutes an appropriation of value from pooled fund investors to preferred investors. The possibility of hidden inequitable allocation thus raises legitimate policy concerns.

IV. What Happens When Managers Can and Cannot Offer Preferential Terms

A. The Manager's Decision-Making Process

In this Part, I offer a graphical depiction of the decision-making process we would expect managers to go through when preferential treatment is and is not available, respectively. In Figure F below, the y-axis represents the "value" of the private equity investment with a manager, and it increases with increased customization rights, increased control rights, fee reductions, and/or preferential allocation. The x-axis represents total investment. In this representation, I assume that the demand for investing with a manager will go up as the "value" of the investment increases. Some investors may be willing to invest in a manager's fund at a relatively low level of "value"—this group is likely to attach little value to customization and control rights, and they are likely to have fewer attractive alternative investment options. Other investors will be much more sensitive to the "value" level of the manager's fund.

When the manager cannot engage in any preferential treatment, she will have to decide upon a single value level (with a fixed combination of fee levels, customization rights, control rights, and resource allocation) for all investors. The decision about where to set this value will be complex—the manager will want to balance keeping the value level low while still attracting a large number of investors in an attempt to maximize aggregate profits.

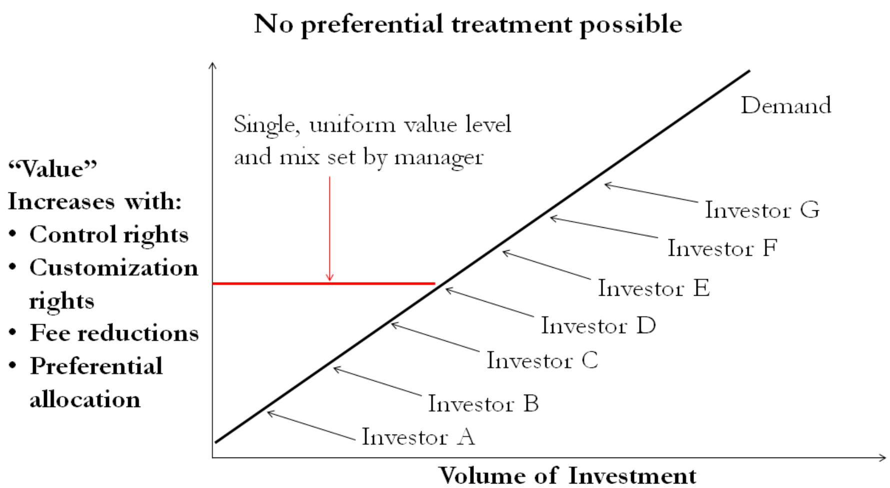

Figure F

When no preferential treatment is possible, the manager will almost certainly set the "value" of the investment (denoted by the red line above) at a level that will be acceptable for many investors, but not good enough for others. In the chart above, Investors E, F, and G demand a higher level of value than the manager is offering, so they either refuse to invest or invest less than they otherwise would if preferential treatment were possible. These investors may have superior alternative options, they may attach unusually high value to monitoring and control rights, and/or they may have unique investment strategy or structuring needs.

When setting the value level, the manager will make a determination as to whether the benefit of the additional capital invested by the next incremental investor will be offset by the increased value that must be offered to all investors in order to attract that investor. Accordingly, unless all of the investors at the top end of the range are clustered tightly together in terms of the value they demand, we would expect to see the manager offer a value level that will be unacceptable to at least some investors.

By contrast, when the manager can engage in preferential treatment, we would expect her to increase the value offered to Investors E, F, and G up to the point where it is no longer profitable to meet the incremental investor's demand. Importantly, in this scenario the manager's decision about offering an increased level of value to Investors E, F, and G is independent of the calculations made about other investors, as the decision to grant preferential treatment to one investor will not have to be matched for other investors. The end result denoted in the chart below, which assumes that the value offered to the pooled fund remains constant, is that: (i) Investors E, F, and G are all better off with preferential treatment; (ii) the manager is better off with preferential treatment because the entry of each of Investors E, F, and G increased her profits; and (iii) Investors A, B, C, and D are no worse off with preferential treatment.

Individualized treatment for E, F and G; pooled fund value constant

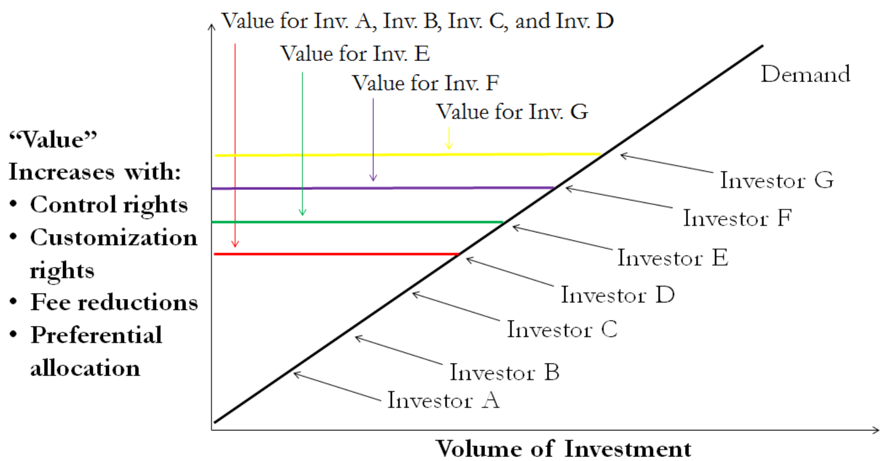

Figure G

In Figure G above, I have assumed that the value level offered to Investors A, B, C, and D remains unchanged regardless of whether preferential treatment is or is not possible. Figure H below, by contrast, depicts a scenario where pooled fund investors *are* worse off when preferential treatment is possible. In Figure H, the manager has offered customized terms to Investors C and D, rather than keep them in a "pooled" fund along with Investors A and B. When she does this, the manager no longer needs to give Investors A and B the same terms that she is giving Investor D. As a result, the value level offered to the "pooled fund," which now includes only Investors A and B, has been reduced to the minimum level necessary to induce Investor B to invest. Moreover, even Investor C, who receives her own individualized terms under the scenario depicted in Figure H, receives terms that reflect a lower value than what she would have received in the original pooled fund depicted in Figure F. Only Investor D, the marginal investor whose preferences set the value level for the original pooled fund, receives the same terms that she would have received under the original pooled fund.

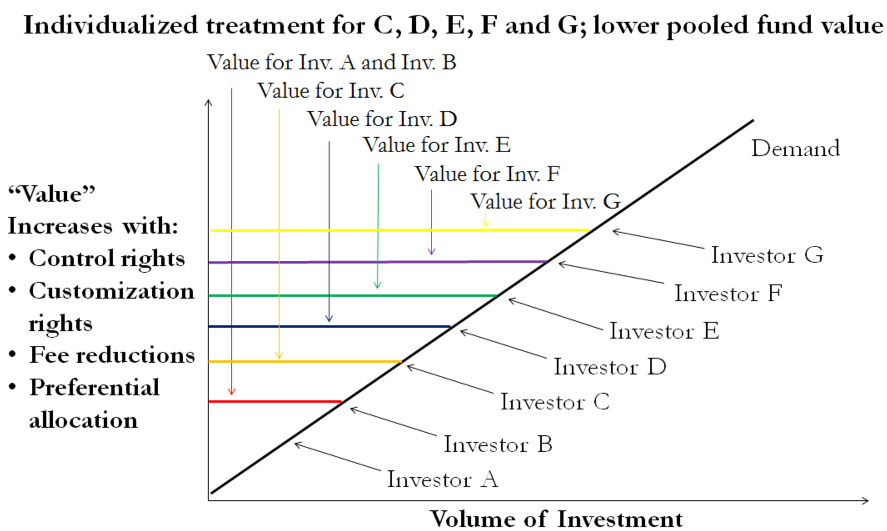

Figure H

B. "New Value" Preferential Treatment Versus "Zero-Sum" Preferential Treatment

This brings us to an important question. Does the real world of private equity contracting look more like Figure G above, where the gains from preferential treatment consist primarily of new value to preferred investors, or more like Figure H above, where the gains to preferred investors are offset by corresponding losses to non-preferred investors?

As discussed in detail in Part III above, individualized investing creates sources of value for preferred investors that cannot be generated in pooled funds. Some of this value is likely to be "new" value. As discussed above, it is impossible for preferred investors to obtain the customized investment exposure in a pooled fund that they can enjoy in a separate account or through co-investments, and there are collective action and collective control problems limiting their incentive to exercise control rights in a pooled fund. When a preferred investor uses these customization and control rights solely to achieve better diversification and asset allocation in her broader portfolio, non-preferred investors are *unlikely to be affected negatively*.[77] For sophisticated investors focused on maximizing their portfolio returns, this ability to customize and control investment exposure can unlock significant value.

However, not all forms of preferential treatment generate "new value" benefits. Some will generate "zero-sum" benefits, where value is simply being transferred from non-preferred investors to preferred investors. The most significant form of zero-sum preferential treatment—one that generates benefits that are, by definition, zero-sum in nature—is the inequitable allocation of the manager's resources.[78] When a manager allocates more of its best investment opportunities and most talented employees to preferred investors' individualized accounts, the result is less value going to non-preferred investors.

Interestingly, some of the other forms of preferential treatment discussed in Part III can indirectly generate higher levels of inequitable allocation in private equity. For instance, when preferred investors are granted superior customization rights,[79] one result will be that the manager is managing more vehicles that are pursuing different strategies. This could lead to the manager being tempted to dedicate its most talented employees to serving the preferred investors' strategies, or otherwise to invest more heavily in supporting those strategies. This temptation could be compounded by the fact that these vehicles often have stronger monitoring rights and governance rights.

Similarly, when an investor has significant influence over the investment decisions of her individualized vehicle,[80] and when the investment mandate of her account overlaps significantly with the pooled fund investment mandate, it could lead to a higher percentage of poor investment opportunities being allocated to the pooled fund. If, for example, a separate account investor has a veto right on investment opportunities, and that investor is good at evaluating the quality of investment opportunities, the pooled fund could end up with a higher share of low-performing investment opportunities. On the other hand, if the separate account investor is not very good at evaluating the

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77 One exception could be if a separate account investor is granted rights to influence the timing of the divestment of assets concurrently held by a pooled fund. Utilizing such rights—even if solely for the purpose of optimizing the investor's overall portfolio diversification—could harm pooled fund investors by forcing the sale of commonly-held portfolio companies at a time that is not optimal for the pooled fund.

78 *See supra* Section III.D.

79 *See supra* Section III.A.

80 *See supra* Section III.B.

quality of investment opportunities, the pooled fund would see the opposite effect.

Unrelated to inequitable allocation, allowing managers to charge preferential fee rates[81] will likely result in non-preferred investors paying higher fees than they would if no preferential fees were possible. As discussed in Section IV.A, in a world where preferential fees are not possible, non-preferred investors can free ride on the manager's desire to set fees at a level that will be attractive to more preferred investors. When the manager can discriminate on price, this ability to free ride falls away. Price discrimination can thus be viewed as another form of zero-sum preferential treatment.

V. PUTTING PREFERENTIAL TREATMENT IN PERSPECTIVE

Section IV.B describes how preferential treatment through individualized contracting can take two general forms: sometimes it can constitute new value that accrues to the benefit of the preferred investor while leaving other investors no worse off, and sometimes it can be a zero-sum benefit where value is merely transferred from non-preferred investors to the preferred investor.

In Section V.A below, I show how, when managers are satisfying their duty to disclose all material facts under the Advisers Act and the market for private equity capital is competitive, there are limits on the amount of zero-sum preferential treatment that we should expect to observe in the private equity marketplace. One limit is the fact that investors are free to contract for protections and/or refuse to invest with managers when protections are not strong enough. There are also non-contractual limits, including the fact that the gains from inequitable allocation are difficult to sustain in the long-term and difficult to scale up, the marketing advantages of a pooled fund track record over the track record of individualized vehicles, and the fact that lower carried interest fee rates disincentivize inequitable allocation. For investors who lack the influence and sophistication to negotiate for contractual protections in today's individualized marketplace, pooled funds thus offer some protection from zero-sum transfers of value.

In Section V.B, I also posit that, even when zero-sum preferential treatment is common, it can nevertheless lead to a more efficient marketplace insofar as pre-commitment disclosure provides investors with a clear

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81 *See supra* Section III.C.

understanding of the quality of the investment product they are buying and the true price at which they are buying it.

A. Limits on Zero-Sum Preferential Treatment

1. Manager's Duty to Disclose Material Facts; Investor Freedom to Contract for Protection and/or Walk Away

Under the Investment Advisers Act of 1940 (the "Advisers Act"), managers are considered fiduciaries to their clients. They are expected to "disclose all material facts to [their] clients in a manner which is clear enough so that a client is fully apprised of the facts."[82] Conflicts of interest are not forbidden under the Advisers Act. Instead, the standard is that prospective investors must "be permitted to evaluate overlapping motivations, through appropriate disclosure, in deciding whether an adviser is serving 'two masters' or only one, 'especially . . . if one of the masters happens to be economic self-interest.'"[83] Managers must "disclose sufficiently specific facts such that the client is able to understand the [manager's] conflicts of interest and business practices, and can give informed consent to such conflicts or practices."[84]

When managers provide such disclosure of the material facts relating to a prospective investor's commitment, it gives the investor an opportunity to negotiate for contractual protections from the disclosed conflicts of interest. For instance, if the non-preferred investor worries that the manager will allocate its most attractive investment opportunities to preferred investors, she could negotiate for a very strict investment allocation policy that dictates how the manager must divide investment opportunities among its various

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[82] Hughes, Exchange Act Release No. 4048 (Feb. 18, 1948), *aff'd sub nom.* Hughes v. SEC, 174 F.2d 969 (May 9, 1949).

[83] SEC v. Capital Gains Research Bureau, 375 U.S. 180, 196 (1963) (citing United States v. Miss. Valley Generating Co., 364 U.S. 520 (1961)); *see also* Julie M. Riewe, Co-Chief, Asset Mgmt. Unit, U.S. Sec. & Exch. Comm'n Div. of Enforcement, Conflicts, Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View (Feb. 26, 2015) (transcript available at https://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html) ("Only through complete and timely disclosure can advisers, as fiduciaries, discharge their obligation to put their clients' and investors' interests ahead of their own.").

[84] Andrew Ceresney, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Securities Enforcement Forum West 2016 Keynote Address: Private Equity Enforcement (Mar. 12, 2016) (transcript available at https://www.sec.gov/news/speech/private-equity-enforcement.html).

clients or for rights of first refusal on investments.[85] Similarly, if a non-preferred investor is concerned that the manager is going to allocate its most talented employees to work on the separate accounts of preferred investors, she could negotiate for strict "key person" provisions that restrict the amount of time specific investment professionals can spend on other projects.[86]

One common contractual protection designed to limit zero-sum preferential treatment is the establishment of an "investor advisory committee" consisting of a subset of the pooled fund's largest and most influential investors. This committee is often given rights to approve certain conflicts of interest faced by the fund manager during the life of the fund.[87] Investors also commonly require the manager to invest some of her own

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85 *See* DAVID WOHL, VENERA ZIEGLER & WALTER TURTURRO, PRIVATE EQUITY ALERT: REGULATORY DEVELOPMENTS AND ANNUAL COMPLIANCE OBLIGATIONS APPLICABLE TO PRIVATE FUND SPONSORS 2 (Weil, Gotshal & Manges LLP 2016), http://www.weil.com/~/media/files/pdfs/160103_pe_alert_feb2016_v41.pdf ("The SEC has stated that co-investment arrangements should be scrutinized to ensure that opportunities have been allocated in a manner consistent with an adviser's stated policies and fiduciary duties. Advisers should maintain co-investment allocation policies that should be disclosed so that all investors are aware of the methodologies used to allocate both investments and related expenses.").

86 *See* BRESLOW & SCHWARTZ, *supra* note 24, § 2:15.1 ("A 'Key Person Event' is triggered by the departure of a designated number of the named 'key persons' in a fund's partnership agreement, and results in the exercise of one or more rights afforded to investors in the partnership agreement. For example, a typical fund agreement provision may name five individuals as key persons; and a key person event may be triggered when there are less than three of such five individuals working for the firm. A key person event may also be triggered when the requisite key persons are not devoting a sufficient amount of time to the fund; however, the time commitment requirement is more difficult to measure. Many partnership agreements contain different key person events. For example, the departure of one of the two founding partners may in and of itself be a key person event, in addition to another test whereby four or more of the junior partners may leave.").

87 *See id.* § 2:12 ("Private equity funds generally form investor committees (also referred to as advisory committees), unless there is an extremely small number of investors. These committees are created primarily to clear conflict-of-interest situations."). Of course, investor advisory committees are not a complete remedy for the problems associated with pooled funds discussed in Section III.B. The collective action and collective control problems described above will still limit the investment advisory committee members' incentives to spend time and effort exercising their control rights as compared with individualized vehicles. *See supra* note 59. Some commentators stress the limited impact of advisory boards. *See* DIANE MULCAHY, BILL WEEKS & HAROLD BRADLEY, WE HAVE MET THE ENEMY . . . AND HE IS US 42 (Ewing Marion Kauffman Found. 2012), http://www.kauffman.org/~/media/kauffman_org/research%20reports%20and%20covers/2012/05/we_have_met_the_enemy_and_he_is_us.pdf ("Unlike a regular Board, the Advisory Board generally does not meet independently, has no ongoing oversight responsibilities (e.g., approving budgets or compensation, or overseeing an audit), and have very limited (if any) approval rights . . . .").

capital in the fund alongside the other pooled fund investors. The more proprietary capital the manager has invested in the pooled fund alongside the investors, the greater the manager's incentive will be to achieve higher performance in that fund.

In the event that the manager refuses to grant satisfactory contractual protections or provide other assurances that the investor will not be treated poorly, the investor can simply refuse to invest, opting instead to invest with a manager who *is* willing to grant terms that protect the investor's interest, or in an asset class where such conflicts are less common.

Accordingly, managers are not allowed to simply transfer value from one investor to another in the dark. They must disclose where conflicts exist and all other material facts relating to the investment, and must negotiate with non-preferred investors to the extent that they desire protections. This duty of disclosure, and the right of prospective investors to refuse to invest, thus serves as a limit on the amount of zero-sum preferential treatment in the marketplace.

2. Non-Contractual Limits on Zero-Sum Preferential Treatment

Even when investors cannot successfully negotiate for robust contractual protections against the various forms of zero-sum preferential treatment, and even when they cannot anticipate precisely how every conflict of interest will be resolved by the manager, they may still rationally decide to invest in the manager's pooled fund due to non-contractual factors that limit the attractiveness of inequitable allocation and align, to a certain extent, managers' interests with pooled fund investors' interests.

a. The Benefits of Inequitable Allocation Are Difficult to Sustain Over the Long Term

One factor limiting inequitable allocation is the fact that the benefits of inequitable allocation will be difficult to sustain over the long term thanks to pooled fund investor exit rights. Unlike a corporation or a closed end fund, where investor capital is locked in to the vehicle perpetually, most private equity funds liquidate approximately every decade.[88] This means that investors have a recurring choice about whether to re-invest in the manager's funds.

To understand why pooled fund investors are likely to exit, it is helpful to break down the component parts of the different parties' returns in an

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[88] *See supra* note 29.

inequitable allocation arrangement. For preferred investors, we can think of their returns as being a function of (i) the return resulting from the manager's baseline level of success in a given investment strategy and (ii) a positive "allocation premium" resulting from the favorable allocation of the manager's investment opportunities in that strategy. The first part is the return that all investors would receive if the manager were making a pro rata allocation of investment opportunities to all investors. The second part reflects the fact that the preferred investor is receiving a higher allocation of the manager's best investment opportunities, either through a separate account or co-investment arrangement. The returns of the non-preferred pooled fund investors, on the other hand, are a function of (i) the return resulting from the manager's baseline success level and (ii) the *negative* allocation premium attached to the *unfavorable* allocation of the manager's investment opportunities.

To the extent that there are managers in the marketplace that are willing to offer pooled fund investment returns that are not reduced by a negative allocation premium, we would expect pooled fund investors to exit after they have been subjected to systematic inequitable allocation. Pooled fund investors may not have any idea that the manager has been appropriating value and transferring it to preferred investors; they may simply come to the conclusion that the manager is less talented than other managers and not performing as well. Either way, in a competitive market the investor will decide to exit.

The departure of non-preferred investors from the manager will have a significant negative long-term impact on the manager's future profits. As a result, if a large number of pooled fund investors choose to exit the manager's future funds in response to inequitable allocation, any manager that desires to keep its overall profits constant will be strongly incentivized to attract new investors to replace the departed investors. But the manager will likely find it difficult to attract new investors in another pooled fund if the performance of her last pooled fund was weak. As will be discussed further in the next section, because it is difficult for managers to signal to investors their talent level, the "track record" of the manager's previous funds is critically important when managers try to raise money from new investors.[89]

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89 *See* PREQIN, KEY DUE DILIGENCE CONSIDERATIONS FOR PRIVATE EQUITY INVESTORS (2014), https://www.preqin.com/docs/reports/Preqin-Special-Report-Due-Diligence-Private-Equity-Investors-Jul-14.pdf (reporting the results of a survey showing that both placement agents and investment consultants believe the track record of the investment team is the most important indicator that a fund will outperform peer funds); Jessica Duong, *The Troubles of First-Time Funds*, PRIVATE EQUITY SPOTLIGHT, Apr. 2014, 7, 7,

One way the manager might be able to attract new investors would be to lower her fees. While this could help the manager convince investors to invest in the fund, lowering fees would also reduce the incremental profits generated by each investor's investment and thus may not improve profitability.

Another approach might be to promise new investors a favorable allocation of investment opportunities and other resources over the manager's existing investors. In this case, the investors who were formerly preferred investors will be forced to suffer a *negative* allocation premium, as they will now be cross-subsidizing the returns of the new investors, which will then prompt *them* to exit when they have the opportunity.[90] Smart investors will thus be leery of any pitch that involves a promise to provide favorable inequitable allocation of resources, because such promises are unlikely to produce lasting benefits.

Of course, this does not mean that the temptation to engage in hidden inequitable allocation is non-existent. If the activity does not have a significantly negative impact on the pooled fund's overall performance, it may not impact pooled fund investors' decisions about whether to exit when the manager raises its next fund. Moreover, some managers may be less concerned than others about the harms of *future* exit if the *immediate* gains

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https://www.preqin.com/docs/newsletters/pe/Preqin_PESL_Apr_14_First_Time_Funds.pdf ("First-time funds have always faced challenges securing third-party capital due to the nature of the private equity industry, which places great emphasis and value on GP track record, history and the team having worked together for a long time. Reluctance from LPs stems from the risks associated with placing their money with a firm that does not have any track record of success in private equity fund management."). The critical role that track record plays among private equity investors is influenced by academic studies showing that private equity managers whose prior funds have performed well are more likely to achieve higher performance in future funds. *See, e.g.*, Steve Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence and Capital Flows*, 60 J. FIN. 1791 (2005) (finding that returns persist strongly across different funds raised by a private equity manager); Yael Hochberg, Alexander Ljungqvist & Anette Vissing-Jorgensen, *Informational Hold-Up and Performance Persistence in Venture Capital*, 27 REV. FIN. STUD. 102 (2014); Ludovic Phalippou & Oliver Gottschalg, *The Performance of Private Equity Funds*, 22 REV. FIN. STUD. 1747 (2009); Robert Harris, Tim Jenkinson, Steven Kaplan & Ruediger Stucke, *Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds* (Darden Bus. Sch., Working Paper No. 2304808, 2014), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2304808.

90 Of course, depending on the strength of the original investor's rights, this type of activity may not even be possible. For instance, if an investor has veto rights on new investments, the manager will not be able to prop up another investor's returns by imposing an unfavorable allocation of investments on that investor. Similarly, if the manager is subject to a robust "key person" standard, she will find it difficult to allocate her most talented personnel toward new investors at the expense of old investors.

from inequitable allocation are significant enough.[91] The exit rights of pooled fund investors thus serve to *limit* the manager's incentive to engage in inequitable allocation, not to eliminate them.

b. The Benefits of Inequitable Allocation Are Difficult to Scale Up

Are there ways for managers to get around the short-lived benefits problem? One approach might be to offer inequitable allocation benefits to an extremely large number of investors, thereby attracting a huge amount of invested capital for a single investment cycle. The deal with the new investors could be that they will all enjoy the benefit of inequitable allocation for a single investment cycle, after which the manager will not raise additional capital. This kind of a strategy, if it could be executed, would make sense near the end of a manager's lifetime as a means of generating a final boost to profitability before closing the business.

Unfortunately for the manager, even this narrow scenario offers limited practical benefit to the manager because the benefits of inequitable allocation are constrained by the size of the underlying disfavored fund. An example helps to illustrate this point. Suppose a manager approaches a prospective preferred investor and promises her that if she invests in a separate account with the manager, her account will be the beneficiary of inequitable allocation. Assume that the manager's baseline talent level in the given strategy will produce 10% expected annual returns for any level of committed capital,[92] and the manager promises that the prospective preferred investor will receive favorable allocations such that her expected annual return will be 15%. If the pooled fund has $100 million under management, the separate account has $20 million under management, and the manager's strategy has expected annual overall returns of 10%, then granting a 5% positive allocation premium to the preferred investor would result in a negative 1% allocation premium for the pooled fund, resulting in 15% expected returns for the preferred investor and 9% expected returns for the pooled fund. If the manager then promises 15% expected returns to a second prospective preferred investor who seeks to invest $20 million through inequitable

[91] *But see* Section V.A.2.b for a discussion of the limits on the size of short-term gains that can be generated by inequitable allocation.

[92] In truth, as more capital is added, the expected overall returns of the manager for a strategy may go down, as it may be more difficult to deploy larger amounts of capital in successful investments than smaller amounts of capital. For the sake of simplicity in this example, I have assumed that the manager can produce a fixed rate of return for any amount of committed capital.

allocation, the negative allocation premium of the pooled fund would rise to 2%, resulting in 15% expected returns for each of the preferred investors and expected returns of 8% for the pooled fund. Taking this example to the extreme, the manager can only promise 15% expected returns to a total of ten preferred investors who are making capital commitments of $20 million before the positive returns to non-preferred investors are completely wiped out.

Accordingly, as the manager attempts to use the promise of inequitable allocation to attract a larger and larger universe of investors, the size of the underlying pool of disfavored capital eventually must grow correspondingly large to support the promised gains. This acts as a limit on the manager's ability to scale up the benefits of inequitable allocation, even in cases where the manager desires only a short-term boost in capital under management.[93]

c. Pooled Fund Track Record Has Marketing Advantages Over the Track Record of Individualized Vehicles

As discussed above, track record plays a critical role in the private equity fundraising marketplace. Managers with superior track records can raise new funds quickly and easily, while managers with poor track records or with no track record at all raise less capital and must exert greater time and effort to raise funds.[94] Track record is thus an extremely valuable asset. This fact is well understood among managers and investors alike in the marketplace.[95]

However, in the new world of individualized investing, all track records are not of equal value to the manager. When it comes to raising new capital, a

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[93] This also means that managers cannot resort to inequitable allocation in cases where they have achieved poor pooled fund performance (and therefore will be unlikely to raise another fund successfully) and are simply looking to juice their short-term returns. In this respect, the problem of inequitable allocation is different than the manager's incentive to take greater risks when she has achieved poor performance. After achieving poor performance in the early life of a fund, managers may be incentivized to make riskier investments with the hope of juicing returns to (i) revive aggregate performance such that she can earn carried interest and (ii) revive overall performance so she can have a better track record to raise a future fund. *See* Victor Fleischer, *The Missing Preferred Return*, 31 J. CORP. L. 77, 95 (2005) ("Anytime the carry is out of the money, the VC will have an incentive to take more risk than is optimal from the investors' point of view.").

[94] *See* Kaplan & Schoar, *supra* note 89 (finding that better performing managers are more likely to raise follow-on funds and larger funds).

[95] *Id.*

successful pooled fund track record has certain advantages over the track record of a single investor or of a separate account.[96]

One advantage of pooled fund track record is that it is often a purer signal of management talent level than the track record of a separate account or co-investment vehicle. As discussed previously, one of the great benefits of separate accounts and co-investments is the superior control and customization rights that they can afford investors.[97] While these rights can be quite valuable for a sophisticated investor, they can also dilute the marketability of the track record achieved by that vehicle. For example, to the extent that a separate account investor has significant control rights and uses those rights to add value to the account—including by vetoing bad investment opportunities and approving good ones—the track record of that separate account is no longer a signal of the manager's talent alone, but of the manager's talent *plus* the separate account investor's value-adding abilities. Thus, on the one hand, if an investor shrewdly utilizes her veto right and rejects the worst investment opportunities presented by the manager, the vehicle's track record will be an inflated signal of the manager's true talent level. On the other hand, if an investor uses her veto right unwisely, the manager will be left with a weak track record that understates her actual performance. A similar problem exists for co-investment arrangements, where investors generally have wide discretion to accept and turn down co-investment opportunities.[98] This additional variable thus makes the track record of the individualized vehicle a less reliable signal of the manager's talent level.

Similarly, to the extent that a separate account achieves high performance but has a highly-tailored, idiosyncratic investment mandate, it will be difficult for the manager to claim that the separate account's performance is representative of the performance the manager can achieve for other investors in more mainstream strategies.

In addition, even if a manager achieves successful track records in its individualized vehicles, those track records may be tainted by the suspicion of preferential treatment if the gap between pooled fund performance and the individualized vehicles (including separate accounts and co-investment arrangements) is too wide. An intelligent investor who is aware of such a gap

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96 As will be discussed below, this is true in cases where the manager is looking to raise a new pooled fund, and it is also true in cases where the manager is looking to raise capital in a new separate account.

97 *See supra* Sections III.A and III.B.

98 *See supra* Section I.C.

will suspect that the individualized vehicles' performance can be explained in part by preferential allocation of the manager's resources to those vehicles.

Critically, this will negatively affect a prospective investor's interest in investing with the manager regardless of whether she is looking to establish a separate account or make a pooled fund investment with a manager. If the investor is considering a pooled fund investment, she will (to state the obvious) be repelled by the poor track record of the manager's pooled fund. On the other hand, if she is looking to establish a separate account, that investor will not want to invest with the manager unless she can receive a credible commitment that *her account* will receive the favorable treatment that generated the successful track records referred to in the paragraph above. She will understand that the manager's track record is a function of both the manager's talent and a favorable allocation premium, and that the benefit of the allocation premium is a zero-sum resource. She will thus want some assurances that she (and not some other investor) will receive the benefit of the allocation premium—perhaps by demanding veto rights on investments or some other commitment from the manager.

Another disadvantage of separate account track records is that they are sometimes subject to more significant confidentiality restrictions than pooled funds,[99] making it harder to market them broadly. With no other investors in the vehicle, separate account investors are more likely to view the agreements governing their capital commitment as their property, and they are accordingly more likely to negotiate for more strict confidentiality limitations. When managers cannot openly market the track record of an individualized vehicle or share the details of that vehicle's terms and conditions, it will be less useful for the manager's fundraising purposes.

Finally, pooled funds also tend to be larger than any individual separate account,[100] arguably making the pooled fund track record a more persuasive data point to prospective investors.

My purpose in this sub-section is not to say that the track records of separate accounts and co-investments are not valuable to a manager.[101] My

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99 *See* Pritchard, *supra* note 48 ("Such arrangements are typically kept private and little is known of the size or structures of such funds. Only recently have many of these new and sometimes funky arrangements come to light.").

100 Of course, this does not have to be the case, but it is often true. To illustrate, even if we assume that 75% of a manager's assets under management are invested in separate accounts and only 25% are invested in a pooled fund, and if we assume that the manager has five separate accounts investments and one pooled fund, then the pooled fund (with $25 million of capital) is still likely to be much larger than any of the individual separate accounts considered alone (which will average $15 million of capital per account).

point is that, all else being equal, the track record of a large pooled fund will ultimately be a more broadly marketable data point for the manager than the track record of an individualized vehicle. And while the benefits of systematic inequitable allocation are difficult to sustain[102] and difficult to scale up[103] as discussed above, a marketable track record can generate gains that are both long-living and scalable.[104]

d. When Carried Interest Fee Rates Are Lower, Inequitable Allocation Is Disincentivized

As described above,[105] private equity managers typically charge their investors two primary types of fees. Management fees are based on a flat percentage of the overall capital that the investor has committed to the manager. Carried interest fees, sometimes referred to as "performance fees," are a percentage of the fund's performance, often above a specified minimum "hurdle" rate. Carried interest fees incentivize the manager to achieve high performance because she will keep a percentage of the returns that she generates.

If a manager has an excellent investment opportunity, she may be incentivized to allocate a higher proportion of that opportunity to the vehicle paying her the highest carried interest fee rate.[106] For example, if one vehicle is paying a 20% carried interest rate, and another vehicle is paying a 10% carried interest rate, the manager will receive twice as much in carried interest revenues if she allocates the opportunity to the vehicle paying the 20% rate (setting aside clawback and other considerations that could make the calculation more complex).

As previously mentioned,[107] existing data suggests that investors in separate accounts and co-investments are often charged lower carried interest

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101 For example, as discussed in Part II, separate accounts can be particularly useful for managers looking to develop a track record in new strategies where they have little prior experience. Prospective investors may justifiably be hesitant to invest with the manager, yet willing to do so if they are granted a separate account with significant protections and control over the vehicle's activities.

102 *See supra* Section V.A.2.a.

103 *See supra* Section V.A.2.b.

104 *See* Kaplan & Schoar, *supra* note 89 (finding that better performing managers are more likely to raise follow-on funds and larger funds).

105 *See supra* note 24 and accompanying text.

106 By contrast, because management fees are calculated based on a fixed rate and a fixed amount of committed capital, they will not impact the manager's decisions about investment allocation.

107 *See supra* note 72 and accompanying text.

fee rates than investors in pooled funds.[108] Accordingly, if the manager's primary interest is to maximize her carried interest profits, she may actually be incentivized to allocate the best investment opportunities *away* from separate accounts and co-investments and toward the pooled fund depending on the circumstances.

B. Why Even Zero-Sum Preferential Treatment Can Be Efficient with Robust Pre-Commitment Disclosure

Even when zero-sum preferential treatment is common (notwithstanding the limits described in Section V.A above), the ultimate effect can still be positive when managers provide robust pre-commitment disclosure. To understand why this is the case, we must appreciate the fact that there is an extremely wide range of investor types in private equity—from behemoth institutional investors managing hundreds of billions of dollars to investors operating on much humbler budgets.[109] As a result, for the reasons discussed above,[110] the value to a private equity manager of partnering with certain investors can be higher than others, and the value of certain terms (such as control rights and tailored customization rights) can be higher to some investors than others.[111] Some investors will have more attractive outside options to invest with high-performing private equity managers, making them more demanding and terms-sensitive consumers.

As discussed in Section IV.A, when preferential treatment is not possible, the manager must offer a baseline package of terms that applies to all investors in the pooled fund by default. With individualized terms and fee treatment, by contrast, the manager is in a better position to accommodate more terms-sensitive investors while still offering products that satisfy other

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108 *See* PREQIN, *supra* note 46, at 9 ("[T]he level of carried interest used by separate accounts is more dispersed than for traditional funds, with only 48% of separate accounts using the traditional 20% figure as their carry rate, compared to 85% of standard commingled funds. . . . 10% of separate account vehicles use a carried interest rate of less than 10%, with over a third of funds employing either 10% or 15% carried interest rates on their separate accounts. . . . In comparison, just 10% of commingled private equity funds employ a carry rate of less than 20%."); Hillary Canada, *Getting the Right Recipe for Co-Investments*, WALL ST. J. (Mar. 19, 2014, 3:30 PM), http://blogs.wsj.com/privateequity/2014/03/19/getting-the-right-recipe-for-co-investments/ ("Fee structures for . . . co-investments vary, but typically include a 1% management fee and 10% carried interest, compared to the industry standard 2% management fee and 20% carried interest charged by many general partners.").

109 *See supra* INTRODUCTION.

110 *See supra* Section II.

111 *See supra* Section III.A and III.B.

investors.[112] In the economics literature, price discrimination is generally considered an efficiency-promoting practice when it leads to more of the product in question being produced and consumed,[113] and that should be the likely effect when private equity managers are able to offer different terms to different investors and when they provide robust pre-commitment disclosure of the material facts relating to the investment.[114]

Insofar as pre-commitment disclosure is strong enough to give investors a clear view of the quality of the product they are purchasing, and the price at which they are purchasing that product, even zero-sum preferential treatment can lead to greater efficiency in the market for private equity capital when the market is competitive.

VI. POLICY DISCUSSION

A. Potential Concerns

1. Is this a Case of the Rich Getting Richer?

Even if the trend toward individualized investing is increasing efficiency and causing the overall pie to get bigger, we could imagine this trend still leading to undesirable outcomes if the growing pie is being apportioned in undesirable ways. As discussed in Part IV above, the gains from individualized investing are not enjoyed by all investors equally. The trend toward individualized investing likely leads to preferred investors receiving greater value from their investments in private equity while non-preferred investors receive less value because they receive fewer free-riding benefits.[115] Is this an anti-progressive result? Are the rich getting richer while the poor get poorer?

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112 *See supra* Section IV.A for a graphical depiction of this principle.

113 *See supra* note 22.

114 One potential objection to this conclusion is the idea that less sophisticated and less influential investors could decide to leave the market for private equity investment entirely if the conflicts of interest become too complex. They may decide that they lack the ability to manage or make sense of these conflicts and search for less complex asset classes. Clearly, this would not be an efficient outcome. Fortunately, this seems like the kind of problem the market can resolve. If a large enough number of investors become uncomfortable due to concerns about preferential treatment, we can imagine entrepreneurial managers responding by offering simpler products with fewer conflicts of interest. The threat of such a market entrant should serve as disciplining force on managers that do engage in preferential treatment.

115 *See supra* Section IV.B.

In thinking about this question, it is important to remember that in the real world the most influential private equity investors often are not billionaires and fat cats. To the contrary, some of the largest and most influential investors in private equity are public and private pension funds, endowments, and foundations,[116] so preferred investors are often managing money on behalf of middle class workers, universities, and nonprofit institutions. Accordingly, while the logic of "income redistribution" or "ability to pay" is often held up as justification for a progressive income tax system, the same logic carries less weight if one is trying to justify a transfer of value from preferred investors to non-preferred investors in private equity, as the demographics of the ultimate beneficiaries of the most preferred investors are quite mixed. This logic becomes even more difficult to justify if the overall value unlocked by the rise of individualized investing for preferred investors (taking into consideration both "new value" preferential treatment and "zero-sum" preferential treatment[117]) is greater than the decrease in value for non-preferred investors.

2. What if Some Investors Are Not Very Sophisticated?

Investors must meet certain sophistication standards to be eligible to invest in private equity.[118] Unfortunately, the prerequisites for investing in private placements do not necessarily guarantee that all private equity investors will be highly sophisticated parties. As discussed throughout this Article, there is enormous variability in the sophistication levels of private equity investors. Moreover, as most private equity investors are institutions

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116 Public and private pension funds, endowments, and foundations collectively accounted for 57% of investment in private equity in 2013. *See Private Equity Minute*, AM. INVESTMENT COUNCIL (last visited Oct. 23, 2016, 2:34 PM), http://www.investmentcouncil.org/private-equity-at-work/education/private-equity-minute/. One source estimates that pension funds specifically account for 44% of private equity investment. Steve Judge, *Private Equity and Pensions: A Strong Partnership*, PE HUB NETWORK (June 30, 2015), https://www.pehub.com/2015/06/private-equity-and-pensions-a-strong-partnership/. 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. *See* PRICEWATERHOUSECOOPERS, *supra* note 32, at 3.

117 *See supra* Section IV.B.

118 To avoid registration under the 1933 Act and the 1940 Act, private equity managers raise capital almost exclusively through private placements. Investors are required to meet sophistication standards designed to ensure that these investors are capable of "fending for themselves" without the benefit of the regulatory protections and oversight of the 1933 Act and the 1940 Act.

managing the capital of underlying beneficiaries, some investors may suffer from agency problems, with employees shirking their duties and/or failing to work hard for their beneficiaries. Thus, even with robust disclosure of all material facts, some investors may be making irrational or uninformed judgments about whether to invest with a particular manager or whether the risk of conflicts of interest is high. These investors might be investing with highly conflicted managers not because they have rationally determined that the expected returns are good enough despite the conflicts, but because they simply do not know any better or their decision-makers suffer from agency problems.

I have two responses to this concern. First, as discussed in detail in Section V.A.2 above, even if an investor lacks the sophistication necessary to evaluate a manager's conflicts of interests and to negotiate for effective protections, that unsophisticated investor can still find some protection by investing in a manager's large pooled funds. There are forces that limit managers' incentive to engage in conflicted activities that harm the performance of their pooled funds. These forces will not *eliminate* zero-sum preferential treatment against pooled funds, and their effectiveness will vary from manager to manager and will depend on the level of competitiveness of the market for private equity capital, but they will serve as checks on the overall amount of such activity in the private equity marketplace.

Second, even if we accept that a significant portion of the private equity investor universe is not very sophisticated or suffers from agency problems, it does not necessarily follow that the best policy response is to impose regulations that restrict preferential treatment or individualized investing for the benefit of non-preferred investors. The Securities Act of 1933 (the "1933 Act") and the Investment Company Act of 1940 (the "1940 Act"), and the rules and regulations accompanying these statutes, have long been established for the purpose of protecting less sophisticated investors. If we are concerned about a certain subset of investors who are investing in private equity, a more sensible response—assuming sufficient support to make the necessary legislative changes—would be to (i) identify who these investors are that require additional protections and (ii) require them to invest in products that are registered under the 1933 Act and the 1940 Act, where they can benefit from the regulations designed to protect less sophisticated investors. This would provide protection to the investors that we might be concerned about without unnecessarily inhibiting individualized investing or imposing restrictions on the investors who are actually capable of fending for themselves in the current marketplace.

Certain limited scholarship has examined ways in which different groups of private equity investors differ from each other.[119] Further research focused on the role of sophistication standards for investing in private equity—and whether these standards are allowing the "right" kinds of investors to invest in today's increasingly complex and individualized private equity marketplace—may be worthwhile in light of current trends.

3. What if the Market for Private Equity Investment Is Not Very Competitive After All?

One of the core assumptions underlying the analysis in Part V.A.2 above is that the market for private equity capital is competitive. When private equity managers must achieve high past performance in order to attract capital from future investors, we would expect them to limit the amount of value transferred from pooled funds to preferred investors through separate accounts and co-investments. So how competitive is the market for private equity fundraising in the real world?

As previously discussed, it is generally understood among industry observers that private equity investors care very much about a manager's track record when they decide where to invest their money.[120] Managers whose funds have performed strongly in the past are more likely to raise follow-on funds and larger funds.[121]

While these are signs of a competitive market, there is also evidence to suggest that the competitiveness of the market for private equity capital is far from perfect. For instance, some research has found that private equity managers sometimes use misleading reporting methods—such as the biased selection of comparison groups and/or the exclusion of unflattering line items—to claim that their performance is strong relative to their peers when it actually is not.[122] In addition, since managers often disclose the performance

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119 *See, e.g.*, Josh Lerner, Antoinette Schoar & Wan Wong, *Smart Institutions, Foolish Choices? The Limited Partner Performance Puzzle*, 62 J. FIN. 731 (2007) (finding that the returns that institutional investors realize from private equity investments differ dramatically across institutions, with endowments significantly outperforming the average private equity investor and funds selected by investment advisors and banks lagging sharply); DaRin & Phalippou, *supra* note 40 (observing that investors with more dollars allocated to private equity conduct more thorough due diligence and have different investment criteria).

120 *See supra* note 89 and accompanying text.

121 *See* Kaplan & Schoar, *supra* note 89.

122 *See* BAKER ET AL., *supra* note 23, at 285 ("[A] top-quartile fund belongs to the 25 percent best funds in its peer group. Yet, many more funds in the market claim top-quartile performance."); Deanna Buckman, *Study: 77% of GPs Could Claim Top Quartile Status*,

of funds that have not yet liquidated their holdings, disclosed performance figures often depend on the subjective valuation of illiquid holdings for which there is not a reliable market price. Some research suggests that managers sometimes manipulate these valuations to generate more attractive performance metrics.[123] To the extent that such problems exist, they make it more difficult for prospective investors to accurately assess the quality of the funds they are considering investing in. This reduces the competitiveness of the market for private equity capital, which has the effect of diminishing the alignment of interest between managers and pooled fund investors described in Section V.A.2.

A fully competitive market requires competition not just along the product quality dimension (i.e., investment performance), but also along the dimension of price. Thus, another important part of keeping the market for private equity capital competitive is making sure that investors understand how much they are paying for the products that they are investing in. SEC examinations in recent years have reported evidence of problems in this area.[124]

These are meaningful concerns. To the extent that it is difficult for investors to determine which managers' funds *actually* achieved strong performance and which managers' funds suffered poor performance, and how much those managers *actually* charge for their products, the overall competitiveness of the industry, and the accountability of managers to non-preferred investors, is diminished.

B. Policy Priorities

Since the financial crisis, the SEC has devoted substantial resources to educating itself about the workings of the private equity industry. Indeed, in

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PRIVATE EQUITY ONLINE (July 28, 2009, 7:24 AM), http://peracs.com/report/PEO%20Top%20Quartile.pdf ("The oft-repeated private equity quip that '75 percent of funds claim to be in the top quartile' may indeed be true."); Harris, Jenkinson, Kaplan & Stucke, *supra* note 89.

123 *See* Brad Barber & Ayako Yasuda, *Interim Fund Performance and Fundraising in Private Equity* (Wharton Fin. Inst. Ctr., Working Paper No. 14-18, 2014), http://fic.wharton.upenn.edu/fic/papers/14/p1418.html; Tim Jenkinson, Miguel Sousa & Rüdiger Stucke, *How Fair Are the Valuations of Private Equity Funds?* (Soc. Sci. Research Network, Working Paper, 2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2229547.

124 *See* Bowden, *supra* note 39 ("By far, the most common observation our examiners have made when examining private equity firms has to do with the adviser's collection of fees and allocation of expenses.").

2012 the SEC launched a "Presence Exam Initiative" for the express purpose of "establish[ing] a presence with the private equity industry and better assess[ing] the issues and risks presented by its unique business model."[125]

This Article is intended to help policymakers and industry observers make sense of one of the most complex and controversial recent trends in private equity. For many people, the idea of preferential treatment runs counter to their intuitive sense of fairness. But in this Article, I have argued that preferential treatment in private equity can actually increase efficiency and the size of the overall pie when managers fully abide by their duties.

As individualized investing continues to grow and as preferential treatment becomes increasingly commonplace in today's private equity marketplace, the goal of policymakers should be to maximize the size-of-the-pie-increasing benefits of individualized investing while minimizing the harmful effects on non-preferred investors. Below I have set forth some policy priorities that can help accomplish these goals, and I have identified some of the challenges and tensions inherent in pursuing these priorities. I ultimately propose a blended approach to policy in this new individualized era of private equity.

1. Promoting Conflicts Disclosure and Compliance with Contractual Commitments

As discussed in Section V.A.1 above, when managers provide clear disclosure of their conflicts of interest, investors' ability to negotiate for protections and/or walk away from investing with a manager serves to limit the amount of zero-sum preferential treatment in private equity. Disclosure does not stop managers from engaging in zero-sum preferential treatment, but it does help non-preferred investors better understand the product that they are buying.

Managers are required to disclose the material facts that are relevant to an investor's investment decision, including conflicts of interest.[126] However, when pooled fund investors are considering whether to invest with a manager, they are generally in a poor position to confirm whether that manager is disclosing all relevant information about its conflicts of interest.

Moreover, even when the investors in a pooled fund have managed to negotiate for meaningful contractual protections, they are generally not in a strong position to confirm whether the manager is abiding by its contractual obligations. As discussed in greater detail in Section III.B above, individual

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125 *See id.*

126 *See supra* Section V.A.1.

investors have limited incentive to monitor managers in a pooled fund due to collective action and collective control problems.

Accordingly, absent private market solutions, regulators can play a role in confirming that managers are providing pre-commitment disclosure of their conflicts of interest and abiding by their contractual commitments, subject to the concerns raised in Section VI.B.3 about the costs imposed by such regulatory action.[127]

2. Promoting a Competitive Marketplace Through Clear Performance and Fee/Expense Disclosure

As noted in Section VI.A.3 above, when performance disclosure by private equity managers is inaccurate or misleading, and when it is difficult for investors to determine the actual fees and expenses associated with investing in a particular fund, the market for raising private equity capital will be less competitive and managers will be less accountable to non-preferred investors. A worthy policy goal, therefore, is to support (i) marketing and valuation practices that provide investors with accurate and comprehensible performance data and (ii) fee and expense disclosure practices that provide investors with a clear sense of the price they are actually paying for private equity products.

In the area of performance data, various regulatory approaches could be considered to support the accuracy of performance disclosures by managers, setting aside for the moment concerns about the costs of such activities as discussed in Section VI.B.3. For example, in the area of valuation, the SEC's approach in recent years has been generally to use its examination powers to confirm that the manager's actual valuation techniques are consistent with the techniques that it has disclosed to current and prospective investors.[128] Such

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127 Following the passage of the Dodd-Frank Act in 2010, the SEC's examination authority over private equity managers was dramatically expanded. In 2012, the SEC started conducting regular examinations of investment advisers, with a target of approximately 10% of all registered advisers per year. *See* Mark Schoeff, Jr., *GOP Senators to SEC Chief Mary Jo White: No More Money Needed to Examine More Advisers*, INVESTMENT NEWS (May 5, 2015, 1:53 PM), http://www.investmentnews.com/article/20150505/FREE/150509966/gop-senators-to-sec-chief-mary-jo-white-no-more-money-needed-to.

128 *See* Bowden, *supra* note 39 ("Some of you may be under the mistaken impression that when our exams focus on valuation, our aim is to second-guess your assessment of the value of your portfolio companies that your funds own . . . to challenge that a portfolio company is not worth X, but X minus 3%. We are not, except in instances where the adviser's valuation is clearly erroneous. Rather, our aim and our exams are much more focused. Because investors and their consultants and attorneys are relying on the

activity has no doubt motivated private equity managers to pay more attention to the way they perform and disclose their valuation practices. Some might argue that even more aggressive approaches, such as treating the examination more like an audit, or imposing standardized valuation and reporting obligations, could lead to further improvements.[129] However, any such improvements, if attainable, would not be costless, as will be considered in Section VI.B.3.

A similar range of possible regulatory approaches—and potential tensions—exists for supporting accurate fee and expense disclosure.[130] This area also highlights the capacity of the private market to achieve improvements when problems are detected, as investors have recently had some success in advocating collectively for more robust fee and expense disclosure by managers. The Institutional Limited Partners Association, or "ILPA," was founded in the early 1990s as a platform for limited partner coordination and has grown to include over 300 members managing over $1 trillion in private equity assets under management. Recently, ILPA established, and has encouraged managers to adopt, a fee disclosure template setting out the fee information that they believe limited partners should have access to. Since the launch of this initiative, many prominent managers have agreed to adopt the ILPA template.[131]

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valuation methodology that an adviser promises to employ, OCIE examiners are scrutinizing whether the actual valuation process aligns with the process that an adviser has promised to investors.").

129 Of course, one should scrutinize the regulator's ability to perform these functions capably. Valuing illiquid private equity assets is a complex exercise, and regulatory staff may lack the expertise to do it effectively. Regulators also may not be able to anticipate the information that investors will find most useful over time when establishing disclosure standards.

130 Regulators have invested significant resources and attention on the combination of examinations and enforcement actions in recent years. *See* Ceresney, *supra* note 84 ("As you'll see in some of the enforcement actions I reference, investors in certain circumstances do not have sufficient transparency into how fees and expenses are charged to portfolio companies or the funds. . . . The Asset Management Unit has now brought eight enforcement actions related to private equity advisors – with more to come.").

131 *See, e.g.*, Press Release, Institutional Ltd. Partners Ass'n, "Leading GPs Endorse the ILPA Reporting Template" (Nov. 3, 2016) ("Since the template was first released in January, the ILPA is delighted to report that the following GPs have given their public backing: Advent International, Apollo, Blackstone, CCMP, Hellman & Friedman, KKR and Silver Lake. They join The Carlyle Group and TPG who endorsed the template upon its initial release on January 29, 2016."); Dawn Lim, "Blackstone, Apollo Among Firms Pledging to Adopt ILPA's Fee-Disclosure Template," WALL ST. J. (Nov. 3, 2016), https://www.wsj.com/articles/blackstone-apollo-among-firms-pledging-to-adopt-ilpas-fee-disclosure-template-1478172605.

3. Tensions in Promoting These Priorities

Unfortunately, while the above policy priorities can help minimize harms caused by preferential treatment to non-preferred investors, the optimal path to achieving these goals is not obvious. This is because compliance with any policies established to achieve these goals are likely to be costly to managers and require an investment in institutional infrastructure and personnel—including lawyers, accountants, compliance consultants and other staff. When taken too far, regulation can lead to two effects that, ironically, could ultimately serve to harm the non-preferred investors that the policies are designed to benefit.

First, as it becomes increasingly costly for first-time managers to establish a new private equity business, the barriers to entering the private equity industry will continue to grow higher. With no prior track record to help them market new funds to prospective investors, new fund managers already face significant challenges when trying to raise capital.[132] Increasing the upfront costs necessary to launch the new business makes a challenging task even more difficult.

Ironically, then, if the push to promote a competitive market through accurate performance and fee/expense disclosure were to significantly increase the costs of setting up a new private equity business, the ultimate effect could be to *decrease* competition as new entrants would be deterred from entering the industry.

In addition, it is important to recognize that managers will no doubt be incentivized to pass on increases in costs associated with such policies to their investors—whether directly (by explicitly passing the expense on to investors) or indirectly (by charging a higher management fee). And for the reasons developed throughout this Article,[133] non-preferred investors are generally more likely to bear a higher portion of such increases than preferred investors, as preferred investors are better-positioned to negotiate for lower

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132 *See* PREQIN, SPECIAL REPORT: MAKING THE CASE FOR FIRST-TIME FUNDS (Nov. 2016) ("First-time funds have traditionally faced challenges securing capital commitments from LPs due to the nature of traditional closed-end fund due diligence. Most investment professionals (or their external advisors) with responsibility to vet these private capital funds typically place significant emphasis on the [manager's] track record, firm and investment history, and the duration of time for which the investment team has been working together. As closed-end funds are long-term and illiquid investments, many [investors] do not feel comfortable committing significant capital to unproven managers, especially as many of these first-time funds focus on diverse and innovative, yet unproven, investment ideas.").

133 *See supra* Part II.

fees and expenses. Accordingly, as policymakers consider what steps ought to be taken to reduce harms to non-preferred investors, they should assume that much of the cost of implementing their policies will be borne by the non-preferred investors they are trying to help.

Policy, then, should seek to blend three elements. First, to support the efficiency gains made possible by individualized investing, it should support individualized contracting between managers and investors and not presume that preferential treatment is an inherently bad thing. Second, to minimize harms to non-preferred investors, it should promote conflicts disclosure, consistent compliance by managers with their contractual commitments, and clear performance and fee/expense disclosure. Lastly, policymakers should seek to promote these policy goals at low cost, as non-preferred investors will likely bear much of the cost of the policies designed to help them, and high costs could have an anti-competitive effect. The true value of the regulator's contribution should be carefully scrutinized and weighed against the cost of any initiative, and the availability of private market alternatives[134] should be considered.

Determining the right policy approach to preferential treatment is a complex optimization problem with no easy answers, and the fight between policymakers over how to resolve it has been ongoing.[135] Recent political developments have introduced greater uncertainty over what exactly the future holds.[136] The first step toward an optimal policy approach is to understand what exactly this trend toward individualization in private equity is all about and why it is happening. This Article has shed light on the complicated and controversial role that preferential treatment through individualized investing is playing in today's individualized private equity

134 See, for example, the discussion of the ILPA fee template in Section VI.B.2.

135 *See*, *e.g.*, Schoeff, Jr., *supra* note 127 ("Republican senators . . . pushed Securities and Exchange Commissioner Mary Jo White to do more with the agency's current budget, which they say has received significant recent increases, instead of asking for more funding to strengthen investment adviser oversight. Ms. White defended the SEC's $1.72 billion budget request for fiscal 2016 . . . . She said that a funding priority is to hire hundreds of more investment adviser examiners to increase the agency's 10% annual examination rate.").

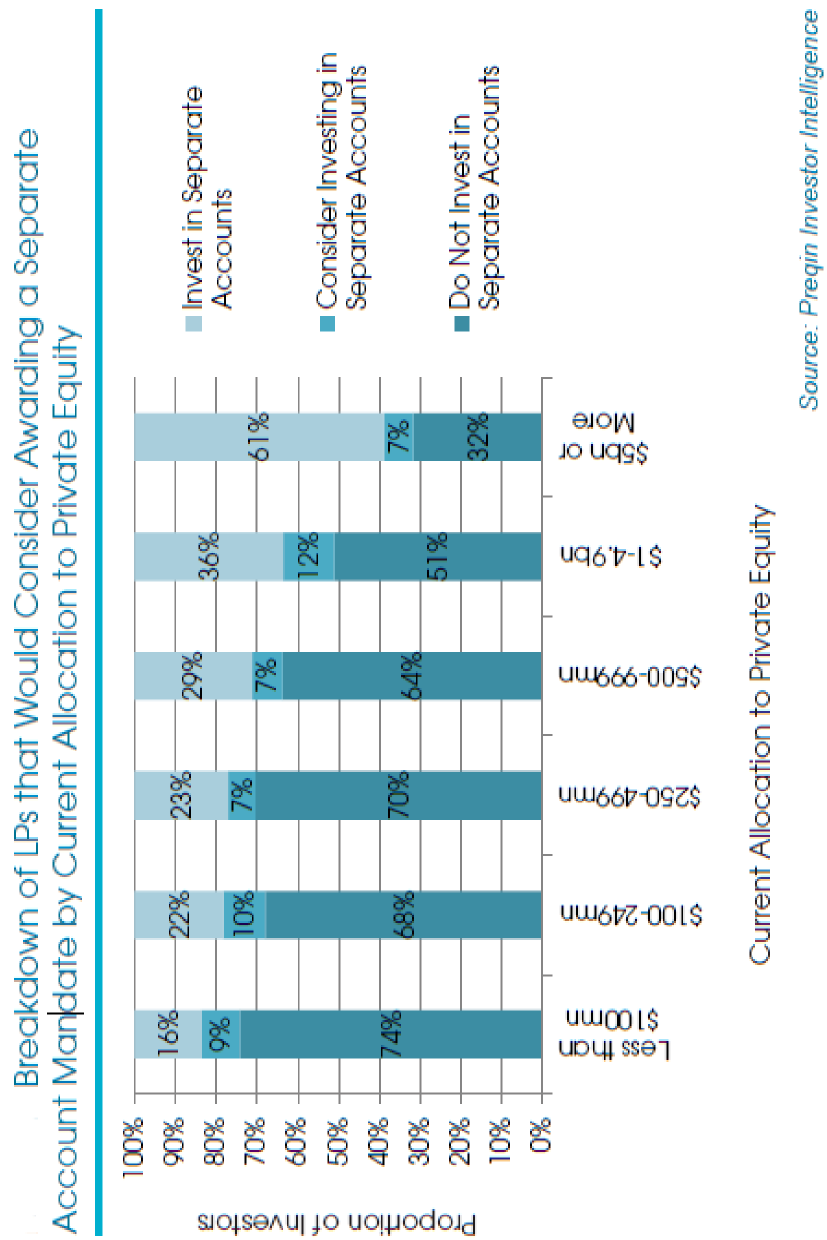
136 *See* Leslie Picker, "Donald Trump Nominates Wall Street Lawyer to Head S.E.C.," N.Y. TIMES (Jan. 4, 2017), https://www.nytimes.com/2017/01/04/business/dealbook/donald-trump-sec-jay-clayton.html ("[Jay Clayton's] nomination to lead the Securities and Exchange Commission is a strong signal that financial regulation in the Trump administration will emphasize helping companies raise capital in the public markets over tightening regulation. In contrast, the agency's two chairwomen under President Obama had regulatory or enforcement backgrounds.").

marketplace, and its potential for increasing the efficiency of the market for private equity capital when managers fully abide by their duties.

CONCLUSION

The rise of individualized investing has facilitated an increase in the amount of preferential treatment in today's private equity industry. The idea of preferential treatment runs counter to many people's intuitive sense of fairness, but this Article makes the case that these trends increase the overall efficiency of the industry when managers fully abide by their disclosure duties and keep their contractual commitments. Some forms of preferential treatment create new value for preferred investors without harming non-preferred investors. Others generate what I call "zero-sum" benefits because they are accompanied by offsetting losses to non-preferred investors, but when disclosure is robust and the market for private equity capital is competitive, there are meaningful limits on the amount of zero-sum preferential treatment that we should expect in the marketplace. Moreover, even zero-sum preferential treatment can lead to an increase in the efficiency of the private equity marketplace to the extent that pre-commitment disclosure is strong enough to give investors a clear view of the quality of the product they are purchasing, and the price at which they are purchasing that product. Policymakers should seek a blended, low-cost policy approach that supports the efficiency gains made possible by individualized investing while seeking to minimize harms to non-preferred investors.

Appendix 1


Breakdown of LPs that Would Consider Awarding a Separate Account Mandate by Current Allocation to Private Equity
Invest in Separate Accounts
Consider Investing in Separate Accounts
Do Not Invest in Separate Accounts
Proportion of Investors
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
16%
9%
74%
22%
10%
68%
23%
7%
70%
29%
7%
64%
36%
12%
51%
61%
7%
32%
Less than $100mn
$100-249mn
$250-499mn
$500-999mn
$1-4.9bn
$5bn or More
Current Allocation to Private Equity
Source: Preqin Investor Intelligence