

## SEC approves more flexible co-investment relief for BDCs and closed-end funds

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The SEC published a notice of intent to grant a simplified and more flexible form of co-investment exemptive relief for BDCs and closed-end funds, although certain critical improvements have not been addressed.

On April 3, 2025, the SEC published a [notice](#) of intent (the Notice) to grant an application for a co-investment exemptive order that significantly departs from existing precedent in ways that offer substantial benefits to business development companies (BDCs), closed-end funds (CEFs) and their investment advisers. In particular, the notice is more welcome news for sponsors of BDCs, adding to the SEC's recent approval of exemptive orders that permit a privately offered BDC to issue multiple share classes and the publication of no-action relief that facilitates the ability of privately offered BDCs to engage in general solicitation and have public-facing websites (read more about those developments [here](#)).

The published notice was issued for an application submitted by FS Credit Opportunities Corp. et. al. (FS), which was substantially similar to an exemptive application originally filed in 2019 but not granted. Since the initial filing by FS on February 21, 2025, multiple other sponsors have filed substantially similar applications, without material modifications. There is a 25-day public comment period for all exemptive orders before they are formally granted. After the 25-day period, assuming the SEC does not receive a request for a hearing on the application, the order will be granted.

### Simplifications and improvements relative to existing co-investment relief

The new relief includes streamlined terms and conditions as compared to past comparable co-investment exemptive orders, including the following improvements relative to existing precedent:

#### Prescriptive requirements to share transactions with a BDC/CEF (i.e., a regulated fund) give way to more typical investment allocation practices

Under existing co-investment relief, all potential co-investment transactions that fall within a regulated fund's investment objectives and strategies and any objective "board-established criteria" must be made available to the regulated fund, often requiring an investment adviser to deviate from its ordinary investment review and allocation processes to comply with the relief. In particular, this has been a significant issue for sponsors considering whether to launch their first regulated fund, as they have been required to evaluate whether any changes to their investment allocation process are required. Additionally, sponsors have been required to track and report to the regulated fund board all investments that were declined by a regulated fund or not made available to a regulated fund, which can be a significant administrative burden for sponsors with significant deal flow.

The new relief effectively will allow an investment adviser to follow its typical allocation process, as long as the investment adviser adopts co-investment policies and procedures that are reasonably designed to ensure that (i) allocations of potential co-investment transactions are made in a manner that is fair and equitable, and (ii) the investment adviser (or sub-adviser) negotiating the transaction considers the interest of the regulated fund. This not only reduces the administrative burden on sponsors with existing regulated funds, but also helps to reduce the barrier to entry for sponsors who are considering launching their first regulated fund.

## **Elimination of the “propping up” condition allows regulated funds to participate in follow-ons to investments made by other affiliates**

Under existing co-investment relief, a regulated fund is prohibited from participating in a co-investment if certain affiliates have a pre-existing investment in the issuer that is the subject of the co-investment and the regulated fund is not also invested in the issuer. In other words, if an affiliate owned a single share of stock in a company, the regulated fund would be blocked from participating in the new transaction. The new relief allows a regulated fund's board to approve the regulated fund's participation in investments where an affiliate is already invested in the issuer and the regulated fund is not.

## **Removal of limitations on participating in follow-on investments if a fund did not participate in the original co-investment**

Related to the “propping up” condition, the current form of relief does not permit a regulated fund or affiliated fund or proprietary account of the sponsor to participate in a follow-on investment in an issuer unless either (i) the fund/proprietary account participated in the initial co-investment and holds investments in the issuer, or (ii) the private fund or proprietary account has no existing investment in the issuer at the time of the follow-on (this excludes regulated funds). The removal of this restriction allows both regulated funds and affiliates to participate in follow-on transactions if they have no investment in the issuer, subject to regulated fund board approval (discussed further below). In practice, this will have at least two significant benefits, as newly launched regulated and private funds will be permitted to participate in follow-on investments in earlier co-investments, and funds that purchase investments in secondary market transactions will be permitted to participate in follow-ons (including so-called “season and sell” transactions).

## **Significant reduction in frequency of board approval of co-investment transactions**

Currently, approval of a regulated fund's board is required for (i) every new co-investment and (ii) any follow-on investments and dispositions, unless the transaction is allocated “pro rata” or limited to “tradeable securities.” Under current relief, a “pro rata” allocation is measured based on the holdings of regulated funds participating in the follow-on or disposition. Accordingly, if a regulated fund does not participate in a follow-on or disposition, the transaction can still qualify as “pro rata” if it is allocated proportionally among the participating affiliates.

Under the new relief, board approval will be required only if an affiliate has an existing investment in the issuer and either (i) the regulated fund does not have an existing investment in the issuer, or (ii) the regulated fund and its affiliates are not participating in the transaction pro rata to their then-current holdings. However, whether the transaction is “pro rata” will be measured based on all affiliate holdings, which means that, if a regulated fund is participating in a transaction and it or one of its affiliates that is currently invested in the issuer does not participate in the follow-on or disposition pro rata based on their existing holdings (or an affiliate that is currently invested is not participating at all), approval by that regulated fund's board will be required.

## **Expanded scope of affiliates eligible to rely on the relief**

The new relief expands the scope of affiliates that are eligible to participate in co-investment transactions. Current relief typically applies to:

- BDCs, CEFs, and private funds relying on Section 3(c)(1), 3(c)(5)(C), 3(c)(7) or Rule 3a-7 under the Investment Company Act of 1940 (1940 Act) that are advised by the same investment adviser or an affiliated investment adviser;
- wholly-owned investment subsidiaries of those BDCs and CEFs;
- certain fund vehicles controlled by those BDCs (but not CEFs); and

- proprietary accounts of the investment adviser and its affiliates.

To the extent a regulated fund has a sub-adviser, the most common form of the current relief typically limits eligibility to funds where the sub-adviser is affiliated with the investment adviser. More bespoke relief has been granted for arrangements where the sub-adviser to a regulated fund is not affiliated with the regulated fund's investment adviser if (i) both advisers apply for the relief together, and (ii) the regulated fund only co-invests with affiliates of the sub-adviser, not the adviser (requirements that are not included in the new relief).

The new relief will also be available to:

- BDCs and CEFs that are sub-advised by a sponsor without requiring the investment adviser and sub-adviser to be affiliated;
- joint venture subsidiaries of BDCs and closed-end funds; and
- entities relying on any provision of Section 3(c) under the 1940 Act (not just Sections 3(c)(1), 3(c)(5)(C) and 3(c)(7)).

While the FS application as originally filed also would have permitted open-end funds (i.e., mutual funds and ETFs) to rely on the relief, that feature was removed in an amended application just prior to the SEC's publication of the Notice.

## Reduced reporting to regulated fund boards and reduced compliance burdens

The current form of relief requires quarterly reports to the board that include (i) a record of all co-investments made by affiliates that were not offered to the regulated fund, (ii) a record of all follow-ons and dispositions made by an affiliate, and (iii) information concerning co-investment transactions, including investments that affiliates made that the regulated fund declined.

In addition, a regulated fund's CCO is required to prepare an annual report evaluating compliance with the terms of the relief, and the regulated fund's board is required to annually consider whether continued participation in the co-investment program is in the fund's best interests.

Under the new relief, a regulated fund's board will be required to review the co-investment policies adopted by the investment adviser to ensure they are reasonably designed to prevent the fund from being disadvantaged by participating in the co-investment program. A regulated fund's board also will be required to approve policies and procedures for the regulated fund that are reasonably designed to ensure compliance with the terms of the relief.

The reporting required under the new relief is less prescriptive. A regulated fund's investment adviser and CCO will be required to provide periodic reporting to the fund's board in the form requested by the board, along with a summary of any significant matters that arose during the relevant period related to compliance with the relief. In addition, the CCO will provide an annual report to the board regarding the regulated fund's participation in the co-investment program and any material changes at the investment adviser level regarding the investment adviser's co-investment policies or participation by affiliated entities in the co-investment program. The CCO will also be obligated to notify the board of any material compliance issue related to the relief.

## Three critical improvements not addressed in the new relief

While there is no question that the new relief addresses a number of issues that the industry has grappled with, some critical pain points have yet to be addressed. Three of the most important unresolved issues are summarized below. There is reason to be cautiously optimistic that the SEC staff will continue to engage with industry representatives to address these points, including recent public statements by senior SEC staff and the fact that the new relief includes specific language stating that the relief will expire in the event that the SEC adopts a rule that provides similar co-investment relief.

## All affiliates must invest on the same terms and in the same class(es) of securities

The new relief will continue to require that affiliates' participation in a co-investment transaction involve the same terms, conditions, price, class(es) of securities and registration rights (if any), with certain specified exceptions regarding settlement timing and sharing of governance rights. That means that, for transactions that involve investments in multiple parts of an issuer's capital structure, each participant will continue to need to invest in each part of the capital structure. Many industry participants would like this requirement to be modified to allow more flexibility for affiliates that may have investment limitations to participate even if they cannot, for example, invest in equity securities or unfunded commitments. One potential solution would be for a regulated fund board to have the ability to approve this type of misalignment, similar to how the new relief permits the board to approve investments where affiliates currently hold an investment that a regulated fund does not.

## **Affiliates continue to be restricted in receiving/retaining compensation related to co-investment transactions**

The new relief will continue to require affiliates to share transaction fees (other than certain brokerage/underwriting/arranger fees) with the regulated funds and other affiliates participating in a transaction pro rata based on the amount invested, and no affiliate can accept any other compensation in connection with a co-investment. The scope of this restriction is currently unclear, and the language in the new relief is substantially similar, leaving existing uncertainty in place.

## **Private equity co-investments remain difficult to fit under the relief**

The current relief and new relief both only provide exemptions from the 1940 Act's "joint transaction" restrictions (i.e., affiliates are on the same side of the transaction) and do not provide exemptions from the restrictions on "principal transactions" (i.e., affiliates are on opposite sides of the transaction). This results in a situation where a regulated fund and its affiliates can make an initial co-investment in an issuer, but if that involves a sizable equity investment, it could result in the issuer becoming an affiliate of the regulated fund following the initial co-investment transaction. Absent principal transaction relief, a regulated fund would be limited in its ability to engage in follow-on activity related to the now-affiliated issuer. In order for a typical private equity strategy to function properly in a regulated fund, co-investment relief needs to include provisions that contemplate this fact pattern and provide the necessary exemption(s).

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

**Leor Landa**

+1 212 450 6160  
leor.landa@davispolk.com

**Andrew M. Ahern**

+1 212 450 3057  
andrew.ahern@davispolk.com

**Sijia Cai**

+1 212 450 3071  
sijia.cai@davispolk.com

**Luke P. Eldridge**

+1 202 962 7144  
+1 212 450 3081  
luke.eldridge@davispolk.com

**Christopher P. Healey**

+1 202 962 7036  
christopher.healey@davispolk.com

**Lee Hochbaum**

+1 212 450 4736  
lee.hochbaum@davispolk.com

**Michael S. Hong**

+1 212 450 4048  
michael.hong@davispolk.com

**Gregory S. Rowland**

+1 212 450 4930  
gregory.rowland@davispolk.com

**Alisa A. Waxman**

+1 212 450 3078  
alisa.waxman@davispolk.com

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