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In Praise of Preferential Treatment in Private Equity: How the Rise of Individualized Investing Has Grown the Private Equity Pie

by

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In Praise of Preferential Treatment in Private Equity: How the Rise of Individualized Investing Has Grown the Private Equity Pie

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Preferential treatment is more common than ever in the $4 trillion private equity industry, thanks to new structures that make it easier to grant different terms to different investors. For decades, 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" that exist outside of pooled funds. Many of the largest and most influential investors have used these individualized approaches to obtain significant advantages that are unavailable to pooled fund investors.

This raises a question that is both economic and philosophical: is preferential treatment a good thing for private equity? The idea of preferential treatment runs counter to many people's inherent sense of fairness, but in this Article I make the case that these trends have been positive, efficiency-enhancing developments for the private equity industry. Most forms of preferential treatment in private equity—including superior customization rights, monitoring and control rights, and fee discounts—increase the overall surplus, or "size of the pie," without appropriating value from non-preferred investors. One form of preferential treatment—the inequitable allocation of investment opportunities to preferred investors—is potentially quite problematic, but a careful analysis shows that it will rarely be in a manager's interest to engage in this kind of activity on a systematic basis in a competitive market.

Regulators should thus be careful not to over-regulate preferential treatment in private equity as individualized investing continues to grow. Yet, the trend toward individualized investing is also likely to produce an interesting side effect: as private equity investors' interests become more individualized the incentive for broad coordination among them will grow weaker, making it more challenging for investors to advocate for industry-wide standards and best practices. Information disclosure is one example of an area where standardization can sometimes be beneficial, raising questions in private equity that resemble the classic debate in the securities literature over mandatory disclosure by public companies.

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> *"What's changed in our industry is 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."*[2]

INTRODUCTION

Private equity is an enormous industry, with nearly $4 trillion in assets under management.[3] Most of the capital in private equity is invested by institutional investors who 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[4] 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.[5] Separate accounts and co-investment vehicles are entities that exist outside and independent 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,[6] including nearly half of all capital committed to new managers,[7] went through these channels in 2015. Statements in recent earnings calls by some of the largest private equity managers corroborate these

[2] Tony James, The Blackstone Group Chief Operating Officer, Q1 2015 Media Call, Apr. 16, 2015.
[3] *See* 2015 Preqin Global Private Equity & Venture Capital Report.
[4] 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.
[5] *See infra* Section I.C. for detail on the definitions of "separate accounts" and "co-investments," respectively.
[6] *See* Antoine Drean, "Private Equity Fundraising is Set to Break Records, But the Plenty Holds Danger," FORBES (Dec. 8, 2015). *See also* Joseph Cotterill, "Shadow Capital Rises Behind Patient Capital," FINANCIAL TIMES (Feb. 9, 2016).
[7] *See* Antoine Drean, "Fundraising for First-Time Private Equity Managers Hits a Post-GFC High," FORBES (June 2015) ("[W]hat is truly interesting is that nearly half of the capital earmarked for new managers in 2015 – 48% – is slated for deal-by-deal, co-investment and managed account structures. Last year 43% of commitments to new managers went to these kinds of vehicles, versus just 17% 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."), *available at* http://www.forbes.com/sites/antoinedrean/2015/06/23/fundraising-for-first-time-private-equity-managers-hits-a-post-gfc-high/.

figures.[8] In fact, the world's largest private equity firm, The Blackstone Group L.P. ("Blackstone"), recently suggested that they are now raising *more* capital through these individualized vehicles than through traditional pooled funds.[9] There are no signs of this trend slowing down.[10]

The largest and most influential investors in private equity have been using these customized vehicles to negotiate for significantly better terms and more robust rights than are available to pooled fund investors.[11] This raises a question that is both economic and philosophical: is preferential treatment a good thing for private equity? Should policymakers be restricting and regulating these trends, or should they be left alone, or even encouraged?

For many people, the idea of preferential treatment runs counter to a deeply ingrained sense of fairness.[12] Indeed, words like favoritism, discrimination, and inequity are saddled with distinctly negative connotations.[13] This Article makes the case that, while instincts favoring egalitarianism may be entirely appropriate—even virtuous—in many contexts, they should not inform private equity policy. When managers have free rein to bestow preferential treatment as they see fit, the outcome is generally a more efficient marketplace for private equity investment, with greater surplus available for investors.

[8] *See, e.g.*, Apollo Q2 2014 Media Call, Aug. 6, 2014 ("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."); Blackstone Media Call, *supra* note 2.

[9] *See* Blackstone Media Call, *supra* note 2 ("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*.").

[10] *See* "Private Equity Fundraising is Set to Break Records, But the Plenty Holds Danger," *supra* note 6 ("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. 2014) (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), *available at* https://www.preqin.com/blog/0/10025/pe-via-separate-accounts.

[11] *See infra* notes 45, 51, and 58 and accompanying text.

[12] *See* STEPHEN T. ASMA, AGAINST FAIRNESS 9-10 (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.").

[13] *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.").

Managers have various strategic incentives to grant preferential treatment to certain investors.[14] 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 want to reward investors who make early commitments that help get a fund off the ground. In addition, managers may also want to use favored treatment to attract certain *types* of investors, independent of the contributions those investors make to any particular fund. 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. Finally, some investors may have the capacity to make direct private equity investments on their own—without the assistance of a manager—and therefore may require a better deal to justify paying for something that they can do themselves.

On the other side of the equation, each private equity investor will, to state the obvious, desire to get the best treatment possible. Investors will deploy their capital to managers and to asset classes that help them achieve the best return on their investment. No one can blame them for bargaining for better 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,[15] signs of aggressive negotiation by institutional investors should be viewed as positive indications of a healthy, functioning industry.

A bedrock principle of the corporate governance literature is that when conflicts of interest exist, they are only problematic insofar as they lead to an *appropriation* of value from investors.[16] That principle will guide this Article's analysis of whether the benefits of preferential treatment in private equity are harming non-preferred investors. In private equity, value is only being appropriated from an investor when two conditions are in place: (i) value is in fact being taken away from the investor, and (ii) value is being taken in a manner that the investor did not reasonably anticipate when she decided to invest with the manager.

The core contention of this Article is that most forms of preferential treatment enabled by individualized investing *create new value* for the preferred investors who receive the favored treatment, rather than *appropriate* that value from non-preferred investors. This logic applies to the following forms of preferential treatment: superior customization of investment strategies and vehicle structuring, superior rights to monitor and control the manager's activities, and

[14] For a detailed discussion of managers' incentives to grant more favorable treatment to certain investors, see Section II.A.
[15] *See, e.g.*, Chris Flood and Chris Newlands, "Calpers' Private Equity Problems Pile Up," FINANCIAL TIMES (July 12, 2015) ("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.").
[16] See REINEIR KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (2004).

superior fees. Individualized investing makes it much easier for managers to grant these kinds of preferential treatment—indeed, these are the very reasons why so many investors have been seeking to form separate accounts and make co-investments in recent years.

Importantly, a darker possibility must also be considered. In addition to the efficiency-enhancing forms of preferential treatment noted above, the rise of individualized investing also makes possible a problematic form of preferential treatment—one that *does* involve an appropriation of value from non-preferred investors to preferred investors. This form of preferential treatment—which I call "inequitable allocation"—occurs when managers allocate superior investment opportunities and other finite resources disproportionately to separate accounts and co-investors and away from pooled funds. Fortunately, a close examination of the incentives of managers and investors in today's individualized marketplace shows that there is little risk of systematic inequitable allocation if we assume a competitive market.

The most important policy lesson from this analysis is one of regulatory restraint. Even though preferential treatment has reached unprecedented levels in private equity, and even though much of this activity is taking place behind closed doors, policymakers should avoid the temptation to over-regulate the practice. However, as the shift toward individualized investing continues apace, an interesting side effect emerges: the incentive for broad coordinated action among private equity investors will grow weaker as their interests become more individualized, making it more challenging for investors to advocate for industry-wide standards and best practices. Information disclosure is one example of an area where standardization can sometimes be beneficial, raising issues in private equity that resemble the classic debate in the securities literature over mandatory disclosure by public companies.[17]

[17] *See, e.g.*, William H. Beaver, *The Nature of Mandated Disclosure*, in ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 317, 320 (Richard A. Posner & Kenneth E. Scott eds., 1980); Frank H. Easterbook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 681 (1984); John C. Coffee Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 725 (1984); Merritt Fox, *Retaining Mandatory Disclosure: Why Issuer Choice is not Investor Empowerment*, 85 VA. L. REV. 1335 (1999); Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World*, 2 Brook. J. Corp. Fin. & Com. L. (2007); Marcel Kahan, *Securities Laws and the Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977 (1992); Admati, Anat and Pfleiderer, *Forcing Firms to Talk: Financial Disclosure Regulation and Externalities*, 13 REV. OF FIN. STUDIES 479 (2000); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L. J. 2359 (1998); Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES 387 (2001); Jonathan Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 60 CARDOZO L. REV. 909 (1994); Stephen J. Choi and Andrew Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. Cal. L. Rev. 903 (1998); HOMER KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE (1979).

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 explains why preferential customization rights, monitoring and control rights, and fee discounts create new value for preferred investors without appropriating value from non-preferred investors, and shows how individualized investing has facilitated a dramatic increase in these kinds of activities. Part III explains how individualized investing opens the door to inequitable allocation and discusses why inequitable allocation is problematic. Part IV describes how the legal and contractual restrictions on managers are often loose enough to permit inequitable allocation. Part V shows why, even in situations where managers have unfettered discretion to engage in inequitable allocation, investor exit rights and the value of pooled fund track record will stop managers from engaging in inequitable allocation on a systematic or sustained basis. Finally, Part VI concludes that policymakers should resist the temptation to over-regulate preferential treatment in private equity. It also describes an interesting side effect arising out of the growth in individualized investing—the fact that the incentive for broad coordinated action among private equity investors weakens as investors' interests become more individualized—and discusses how this raises issues that resemble the classic debate in the securities literature over mandatory disclosure by public companies.

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 generally 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 try to improve portfolio company operations, with the goal of turning around an underperforming or distressed company before eventually reselling it to an acquirer or taking it public through an IPO. None of these activities—purchasing a controlling stake in a private company, improving a company's financial structure or operational performance, and selling a controlling stake—can be done overnight. Accordingly, private equity investments generally require much longer holding periods than other asset classes such as hedge funds and mutual funds.[18]

B. The Basic Structure of Private Equity Funds

[18] *See* BAKER ET AL., PRIVATE EQUITY: OPPORTUNITIES AND RISKS 4-5 (2015).

Private equity managers make money by acting as investment advisers—they manage the capital of others (primarily large institutional investors) for a fee.[19]

Traditionally, private equity managers have raised money predominantly by pooling the capital of their various investors into a single vehicle called a fund.[20] Pooled funds are typically organized as limited partnerships.[21] 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.

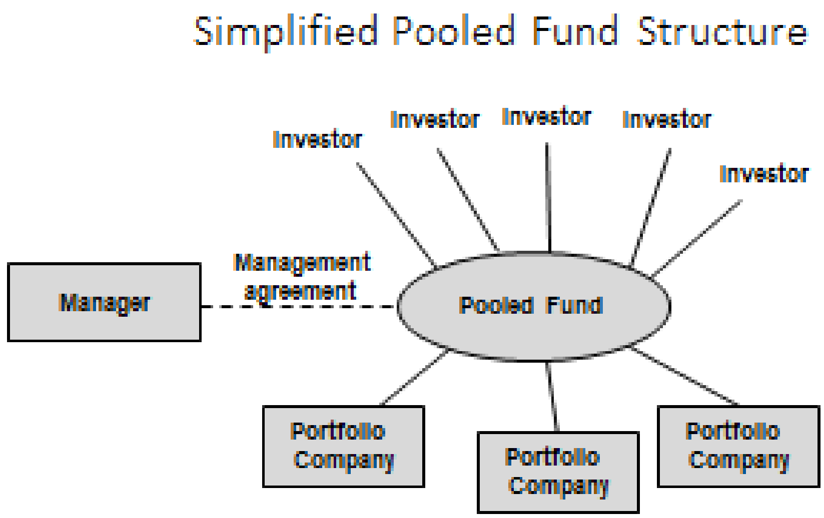

Fig. A

Each fund generally has a stipulated "investment period" during which it is free to acquire portfolio companies (typically 4-6 years in duration), followed by a

[19] Private equity managers typically charge investors a "management fee"—this is usually a flat percentage (typically in the range of 1-2%) of all the investor's assets committed to the manager. 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 7%-9%. The mechanics of carried interest fees can be quite complex, but the details are not important for purposes of this Article.

[20] In this Article I will refer to these vehicles as "pooled funds." Another commonly-used term is "commingled fund."

[21] Because pooled fund 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 complication. 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 together in a single vehicle.

"divestment phase" when it looks to sell its portfolio companies or take portfolio companies 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.[22] As the pooled fund receives proceeds from divestment of portfolio companies, those proceeds are typically distributed immediately to investors net of the manager's carried interest fees. Each fund has a stipulated end date (typically around 10 years after the date of the fund's closing) by which it must liquidate any remaining assets if it has not made full distributions of invested capital by that date.[23]

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 3-6 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 Fig. 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.

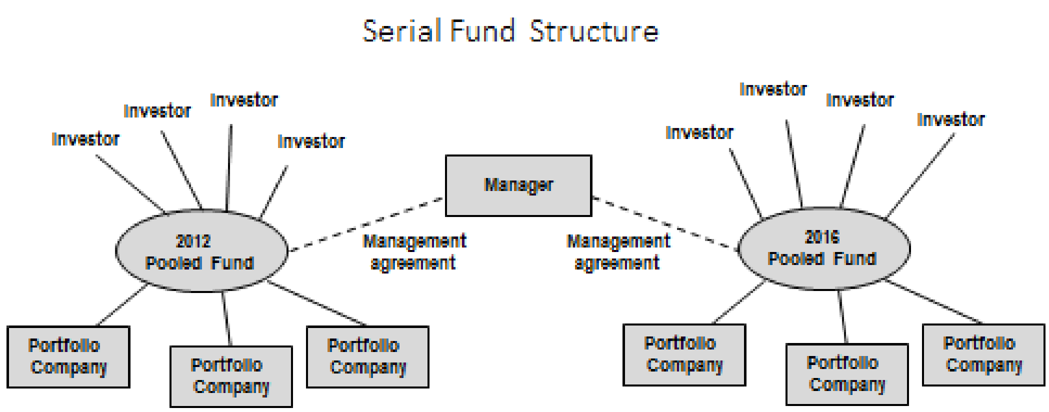

Fig. B

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 the fund manager—a practice I refer to as "individualized investing." Individualized investing can occur in two ways. One approach is called "co-investing." Pooled fund investors commonly negotiate side letters—contracts that override or supplement the

[22] Investors are typically given approximately 10 days to contribute the capital after the manager issues the capital call.

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

pooled fund limited partnership agreement and grant special rights to the recipient of the side letter—with the manager. A wide variety of terms are commonly granted in side letters, such as limitations on the manager's ability to disclose the investor's identity to other investors, and rights to opt out of investments in certain limited industries (such as weapons, pornography, gambling, alcohol, etc.) and regions (such as Iran, North Korea, etc.) pursuant to restrictions that certain investors may be subject to.[24] Notwithstanding the vast array of terms that are often included in side letters, most side letter terms do not modify the investor's pro rata economic interest in the pooled fund (with the narrow exception of limited industry-specific or region-specific opt-out rights) or (ii) give investors preferential rights to exit the fund before others.

The right to "co-invest" with the pooled fund is a particularly important right granted through side letters. When an investor has a co-investment right, the manager may invite that investor to invest directly in one or more of the same portfolio companies that the pooled fund is investing in. A co-investor will thus 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 direct "co-investment" in the portfolio company.[25] For investors, co-investments can be attractive because the fees charged on the co-invested capital are generally significantly reduced (sometimes there is no fee at all).[26] Moreover, co-investment gives investors greater control in two respects: first, they have the right to accept or reject the manager's offer to co-invest, giving them an effective veto right, and second, they sometimes have information rights and voting and consent rights as minority investors in the portfolio companies they co-invest in.[27] 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

[24] For example, public pension funds, the largest investors in private equity, often face statutory restrictions on the industries and geographies they can invest in. Foundations and endowments also are often subject to limitations on investment activities set forth in their charters. Other side letter terms can include clarifications about how certain provisions of the partnership agreement should be interpreted; additional representations from the manager; terms relating to the tax treatment of the investor's holdings; among many others.

[25] This paragraph discusses co-investment by limited partners in pooled funds, but co-investors do not necessarily have to be limited partners in the manager's pooled funds. *See* David Snow, "The New Era of Co-Invest," Privcap article (May 13, 2014) ("Where necessary and strategic, GPs may also look beyond their own LP networks to co-investment specialist vehicles, as well as to investors who are not in the current fund but with whom the GP would like to do business."), *available at* http://www.privcap.com/article/new-age-co-invest/.

[26] *See* "Private Equity Co-Investment: Best Practices Emerging," PricewaterhouseCoopers (Jan. 2015) ("Co-investors often benefit from lower (or no) management fees and carried interest, as well as greater deal selectivity and transparency.").

[27] *See* "Private Equity Co-Investments," Julia D. Corelli and P. Thao Le, Pepper Hamilton LLP (July 2013), *available at* http://www.pepperlaw.com/uploads/files/phwhitepaper_privateequityco_investments_final.pdf.

to acquire by itself (or which will leave the pooled fund under-diversified because the opportunity is so large), but that is possible with the help of co-investments.[28]

Fig. C below shows an arrangement where a pooled fund has three investors – Investor A, Investor B, and Investor C. 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. Investor B has no co-investment interests.

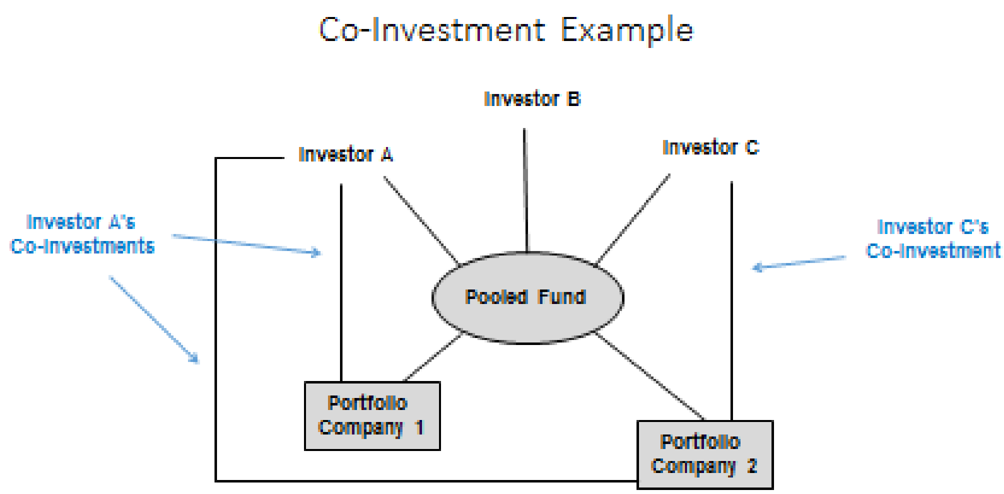

Fig. C

A second form of individualized investing is when a manager manages "separate accounts"—accounts that are managed completely independently of the manager's pooled funds—for individual investors. Separate accounts typically have their own distinct investment mandates, customized governance terms, and customized liquidity structuring, in each case limited only by the imaginations of the investor and the manager at the time that they negotiate the terms of the account.[29] Separate accounts very often have attractive fee terms and provide the investor with superior transparency into and control over the vehicle's investments and investment activities.[30]

[28] *See* Roger Mulvihill, "Co-Investment Heats Up, But Some Are Less Than Thrilled," Law360 (Mar. 19, 2014) ("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.").
[29] 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.
[30] *See infra* Section II.B. for detail on the terms and rights commonly seen in separate accounts and co-investment vehicles.

In Fig. D below, I have provided an example of what a single separate account could look like. In this example, the separate account has invested in some of the same portfolio companies that the pooled fund has 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 will vary considerably depending on the individual investor's preferences.

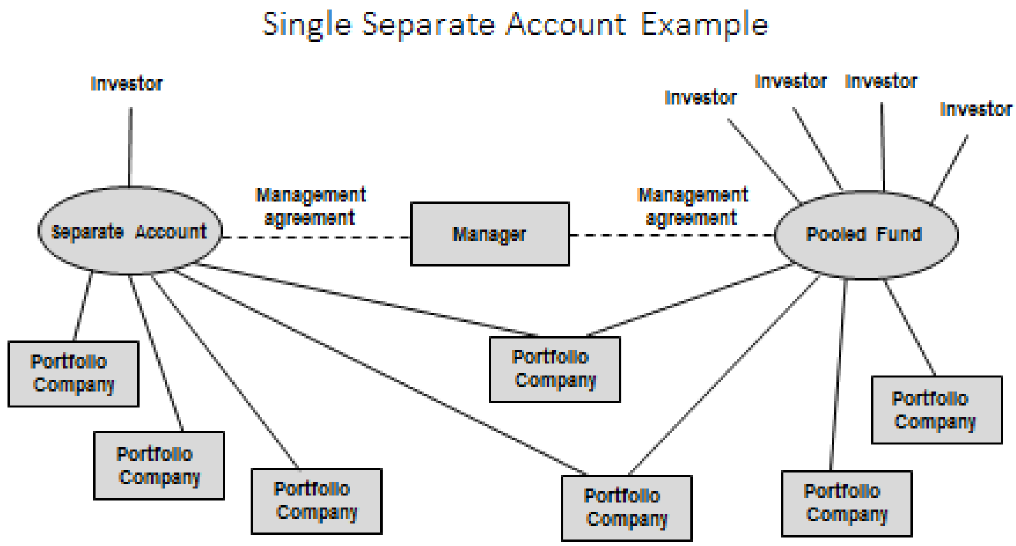

Fig. D

By all measures, separate accounts and co-investments are booming,[31] and there are no signs of this trend slowing down.[32] This perspective is consistent with

[31] *See* Blackstone Media Call, *supra* note 2 ("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."); Tom Stabile, "Where Has All the Private Equity Money Gone?" FINANCIAL TIMES (Apr. 12, 2015) ("A decade ago, there were only a few large institutions that had the stomach or ability to pursue more exotic versions of private 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."), *available at* http://www.ft.com/intl/cms/s/0/c3dd9938-dea9-11e4-8a01-00144feab7de.html?siteedition=uk#axzz3tNgliV00; "Tony James: Blackstone Scales Through New Ideas, Products," PE Hub (Apr. 17, 2015) ("[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."), *available at* https://www.pehub.com/2015/04/tonyjamesblackstonescalesthroughnewideasproducts/; Apollo Q2 2014 Media Call, *supra* note 8 ("As we have highlighted previously, strategic managed accounts,

recent 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,"[33] and with the perspective of practicing attorneys I interviewed who indicated that managers tend to spend far more time negotiating the terms of side letters and separate accounts than the terms of pooled fund limited partnership agreements in the current market. Importantly, larger and more sophisticated investors typically have much better access to separate accounts and co-investments, and greater ability to negotiate attractive terms through them, than investors that are smaller by comparison.[34]

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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."); SEC Release No. IA-4091 "Amendments to Form ADV and Investment Advisers Act Rules," p. 51 ("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."). One source estimates that between January 2007 and March 2014 for every two dollars invested in US commingled private equity funds, one dollar was invested in US co-investments and separate accounts. "Assets Invested in Separate Accounts Starting to Add Up," Arleen Jacobius, PENSIONS & INVESTMENTS (Dec. 22, 2014). 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 Investor Outlook, *Private Equity H1 2015*. 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. Preqin Private Equity Spotlight, "The State of Co-Investments" (Mar. 2014).

[32] *See supra* note 10 and accompanying text.

[33] Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, Securities & Exchange Commission, "Spreading Sunshine in Private Equity" (May 6, 2014).

[34] *See Marco* DaRin & Ludovic Phalippou, *There is Something Special About Large Investors: Evidence from a Survey of Private Equity Limited Partners*, ECGI Working Paper Series in Finance, No. 408 (2014) (finding that 99% or more of large investors (75th percentile) receive both side letters and "most favored nation" clauses in their contracts, whereas smaller investors (25th percentile) receive neither); Preqin Investor Outlook: Private Equity H1 2015 (This report published the results of a survey of over 100 institutional investors, 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."), *available at* https://www.preqin.com/docs/reports/Preqin-Investor-Outlook-Alternative-Assets-H1-2015.pdf; "Private Equity Co-Investment: Best Practices Emerging," *supra* note 26 ("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.").

II. HOW PREFERENTIAL TREATMENT MAKES PRIVATE EQUITY CONTRACTING MORE EFFICIENT

In this Part, I will explain why managers desire to grant preferential treatment to certain investors, and I will discuss how individualized investing has facilitated a dramatic increase in the following forms of preferential treatment: preferential customization rights, monitoring and control rights, and fee discounts. I will then show how these forms of preferential treatment increase the size of the pie by unlocking new value for preferred investors without appropriating value from non-preferred investors.

A. 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.[35] Discriminating between product 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.[36] This type of unequal treatment in product markets has commonly been referred to as "price discrimination."

In addition, producers will often give certain buyers greater ability to customize their product and/or greater control over the delivery and upkeep of their product in cases where the buyer is purchasing particularly large amounts or has 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 they sell to the general public. But if a buyer comes along who is willing to make an unusually large purchase, that buyer may be able to request that the manufacturer make a special batch of carpet with customized color and material combinations. Similarly, while the manufacturer may offer standard delivery, installation 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

[35] I am not the first to compare investment funds to products. *See, e.g.*, John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L. J. 1228 (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."); Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961 (2010).

[36] 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, discounts for people who are in a demographic that is more likely to become repeat buyers, etc.

constantly making new carpet orders, for example, that buyer may be granted greater customization and control even for smaller 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; offering them to potentially large repeat-buyers is calculated to win future business; etc. Moreover, in a competitive market, producers will understand that other producers are likely to offer preferential terms to the most attractive buyers, generating a competition effect.

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 greater fees for the manager). Also, because there are transaction costs associated with meeting with and negotiating 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 on pursuing investment activities.[37] Managers may also 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.[38]

These various motivations relate to specific contributions the investor makes to a manager's fund, but managers can also be incentivized to use favorable treatment to attract certain *types* of investors generally. 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. Moreover, if the manager offers 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, making it a positive signal to the market when the manager is

[37] *See* Adair Morse, *Influence in Delegated Management: Active Investors in Private Equity Funds*, working paper (2013) ("[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 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.").

[38] 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 early investments to determine whether the fund is likely to be successful.

able to attract their investment.[39] Other investors may be unlikely to face liquidity shocks and are therefore more likely to be stable long-term investors.[40] 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.

Moreover, in another recent trend, a growing sub-set of sophisticated investors have developed the capacity to make direct private equity investments, bypassing managers entirely.[41] If managers desire to keep these investors' business, they will almost certainly have 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 different managers will find different characteristics more desirable than others. But for 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 others.

B. Efficient Forms of Preferential Treatment in Private Equity

If you are a preferred private equity investor, there are various forms of preferential treatment that you might seek from a manager. In this Section, I consider the forms of preferential treatment that are generally efficient. I show how these forms are enabled by individualized investing, and explain how they unlock value for preferred investors without appropriating value from non-preferred investors.

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[39] *See* DANIEL HOBOHM, INVESTORS IN PRIVATE EQUITY FUNDS: THEORY, PREFERENCES AND PERFORMANCES 175 (2010) (positing that investor reputation helps explain why some investor types outperform others in private equity).

[40] 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).

[41] 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* "Private Equity Fundraising is Set to Break Records, But the Plenty Holds Danger," *supra* note 6. *See also* Joseph Cotterill, "Direct Investors a Growing Force in Private Markets," FINANCIAL TIMES (June 16, 2015) ("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."), *available at* http://www.ft.com/intl/cms/s/0/5b002968-1404-11e5-9bc5-00144feabdc0.html#axzz3zzUkuLKb; Tommy Wilkes and Anjuli Davies, "Buyout Firms Face Squeeze as Investors Go Direct for Deals," Reuters (Mar. 22, 2013) ("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."), *available at* http://www.reuters.com/article/us-privateequity-investors-idUSBRE92L0IK20130322.

1. *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 desirable capability. An investment mandate spells out the activities and investments that the manager will pursue on behalf of the fund, including investment strategies, industries, portfolio company size limitations, geographical areas of emphasis, etc. Because most private equity investors invest money in a wide range of strategies with a wide range of managers, customization of a vehicle's investment mandate can be quite valuable as the investor seeks to optimize the diversification of her overall portfolio of investments.

In addition, investment vehicles can be structured in different ways to address specific liquidity preferences and other needs of the investor. For example, some investors may require greater flexibility and control over the timing of distributions from the vehicle. Other investors may desire 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.[42] Depending on the unique liquidity preferences of an investor, the ability to customize the structuring of an investment vehicle to accommodate the investor's profile can also carry significant value.

Unfortunately, in a pooled vehicle, because all investors have a pro rata interest in the assets held by the fund, it is impossible to grant this kind of customization to multiple investors. Accordingly, if a single investor has specific investment mandate preferences that would optimize her overall portfolio, it will be very difficult to accommodate them in a pooled vehicle because the vehicle needs to satisfy the preferences of many investors.[43] Similarly, if an investor would benefit from a structure that would accommodate her distinctive liquidity needs, it would be very difficult for the manager to accommodate that need through a pooled fund.[44]

By contrast, in a separate account, it is easy 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

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[42] *See* Jacobius, *supra* note 9 ("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.").

[43] 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.

[44] Interestingly, to the extent that preferred investors desire investment strategies and/or vehicle structuring that deviate from the needs of most pooled fund investors, the net value of customization is actually *negative* in pooled funds, as it would harm the non-preferred investors for the manager to grant customization rights to the preferred investors.

accommodate her liquidity and other needs.[45] Because the assets held by separate accounts are entirely distinct from the assets held by pooled funds, there is nothing stopping separate account holders from customizing as they desire.

This increased capacity for customization made possible by individualized investing increases value for preferred investors but does *no harm* to non-preferred investors. Just because a separate account has been structured a certain way to optimize another investor's liquidity or other preferences, it has no bearing on the performance of the pooled fund. Accordingly, the first requirement for preferential treatment to constitute appropriation of value—the requirement that value *has actually been taken away* from the non-preferred investors—does not apply to preferential customization rights.

In the current marketplace, investors take full advantage of this customizability and the value that it unlocks. Investment strategies in separate accounts vary widely in function and terms, from long-term strategic partnerships across a range of investment strategies to short-term arrangements with extremely narrow mandates, and from vehicles that invest exclusively alongside a manager's pooled funds to vehicles that invest in novel industries and regions. There is no "typical" separate account, as the investment strategy and liquidity structuring are customized to unlock as much value as possible for the individual investor.

2. *Superior Monitoring and Control Rights*

Investors may also desire a superior 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.[46]

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. Less sophisticated investors, on the other hand, may have little use for such rights and be more inclined to defer to the manager.

In pooled funds, even when certain investors might be very interested in monitoring and exerting control over the manager, those investors will find

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[45] *See* "Private Equity Fund Manager Use of Separate Accounts," Preqin (Jan. 9, 2015), *available at* 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.").

[46] *See infra* note 51 and accompanying text.

control 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 activity (for example, she might find that the manager has charged an inappropriate expense or is exerting insufficient effort) 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, if an investor wanted to veto a specific investment opportunity, she would need to convince other pooled fund investors to join her in voting to veto the opportunity.[47] 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.[48]

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." The SEC also noted that "[w]hile investors typically conduct substantial due diligence before investing in a fund, . . . investor oversight is

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[47] The challenges of collective control can be mitigated somewhat by the use of "advisory boards" in pooled funds. An advisory board typically includes a sub-set of the pooled fund's largest and most influential investors as its members. Because advisory board 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 advisory boards, as communication between advisory board members is not costless and advisory board members can have heterogeneous interests. *See infra* note 48.

[48] 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 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).

generally much more lax after closing."[49] This is not surprising—given the collective action and collective control problems in pooled funds, we should expect pooled fund investors to invest only 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 extremely large commitments of capital, their interest in seeing the vehicle perform well will be particularly concentrated. In addition, a separate account investor also avoids collective control problems because she can unilaterally exercise control rights without having to persuade other investors to follow her lead.[50] 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.

These factors help explain why separate accounts tend to offer investors greater transparency into and control over investment decisions.[51] Separate accounts often give investors more tailored and robust reporting. 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

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[49] *See* "Spreading Sunshine in Private Equity," *supra* note 31.

[50] 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.

[51] *See* Antoine Drean, "Private Equity Managers Are Successfully Wooing Individuals, As Institutions Cut Costs," FORBES (Nov. 21, 2014) ("Separate accounts . . . often give investors veto power over specific investment proposals."); and Anand Damodaran, Matthew Judd & James Board, "Combining Managed Accounts with Traditional Fundraising: The Key Issues," PRIVATE EQUITY INTERNATIONAL (Apr. 2013) ("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 and Joseph Magri, "Riding the Wave: Private Investment Funds Moving Towards Managed Accounts Structure," Grant Thornton Asset Management Adviser (Feb. 2013) ("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."), *available at* https://www.grantthornton.com/staticfiles/GTCom/Financial%20services/Asset%20Management Adviser/Asset_Mgmt_Adviser_Riding_the_Wave_Feb2013.pdf. 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 and Christopher Rowley, "A Close Look at Pledge Funds," Law 360 (May 20, 2014), *available at* http://www.velaw.com/uploadedFiles/VEsite/Resources/ACloseLookAtPledgeFunds052114.pdf.

from full veto power to a lesser degree of positive or negative control.[52] Moreover, investors are often given much more powerful governance remedies, including the right to suspend the vehicle's investment period, the right to remove the manager, or the right to dissolve the account, in each case without having to generate support from a super-majority of dozens of other investors.

When preferential monitoring and control rights are granted to certain investors through separate accounts and co-investments, this unlocks a new source of value for those investors and does not appropriate value from non-preferred investors. If the very same monitoring and control rights were granted to pooled fund investors, they would have significantly less value due to collective action and collective control problems. Moreover, even if non-preferred investors were given the same opportunity to invest in separate accounts with robust monitoring and control rights, these rights would offer them limited benefit—or even negative benefit—if they are not sophisticated enough to utilize them for their good.

3. Lower Fees

The appeal of lower fees to investors requires no explanation.[53] When managers reduce the fees charged to certain investors, this is a classic form of price discrimination.[54] One constraint that hinders 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 receive the best terms offered to any other investor in the fund.[55] Also, many investors in a pooled fund will have the right to observe the side letters executed by other investors. As a result, managers cannot keep confidential the preferential terms that they grant to preferred pooled fund investors, and a precedent established for one investor can quickly be demanded by various of the fund's other investors.

Accordingly, rather than charge every individual investor an individualized fee percentage, pooled fund managers generally set a baseline fee that applies to all investors in the pooled fund by default. One way for managers to get around most favored nation obligations and avoid having non-preferred investors feel that they are being treated unfairly is to attach the preferential treatment to objective parameters related to the investor's contribution to the fund, such as the size or timing of their capital contribution.[56] While this approach does enable some price

[52] *See id.*
[53] *See supra* note 19 for a description of the forms that private equity fees usually take.
[54] *See supra* Section II.A. for a discussion of price discrimination in product markets.
[55] *See supra* Section I.C. for a description of side letters in pooled private equity funds.
[56] This helps explain why fee discounts granted to pooled fund investors are generally tied to the size of investors' capital commitments and the timing of the investor's entry into the pooled fund. As an example, a fund might charge a 2% management fee for commitments beneath $100 million, a 1.75% fee for commitments between $100 million and $250 million, and a 1.5% fee for commitments above $250 million. A 1.5% management fee rate might also be reserved for every dollar committed by investors prior to a certain deadline.

discrimination, it does not allow managers to grant preferential fee treatment based solely on the manager's strategic interest in attracting the investor or on the investor's sensitivity to fee rates.

By contrast, when an investor invests in a separate account or makes a co-investment, the terms of that arrangement generally remain private. The most favored nation rights and side letter disclosure rights held by pooled fund investors generally do not extend to the terms of separate accounts or co-investments. In fact, separate account holders typically impose significant restrictions on the manager's ability to disclose information about their accounts—including terms and strategies—to other parties.[57]

Because of this, the manager can customize the terms granted to separate account investors and co-investors without being concerned about spillover effects. This helps to explain why separate accounts and co-investments tend to have significantly lower fee rates than pooled funds.[58]

To understand why price discrimination can be a good thing in private equity, we must appreciate the fact that there is an enormous range of investor types in private equity—from behemoth institutional investors managing hundreds of billions of dollars to investors managing a fraction of that amount and operating on much humbler budgets. As a result, there is a broad range of fees that investors will be willing to pay. Some may have attractive options to invest with other private equity managers, others may have the ability to engage in their own direct investment programs, and others may have attractive options to invest in other asset classes, making them more fee-sensitive.

When price discrimination is not possible, the manager must set a baseline fee that applies to all investors in the pooled fund by default, leaving the more fee-sensitive investors unsatisfied. With individualized fee treatment, by contrast, the manager is in a better position to accommodate more fee-sensitive investors while still offering products that satisfy less demanding investors, thereby generating

[57] *See infra* Section V.C. for further discussion of the confidentiality restrictions applicable to separate accounts.

[58] *See* 2015 Preqin Private Equity Fund Terms Advisor, press release *available at* 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."); "Private Equity Fundraising is Set to Break Records, But the Plenty Holds Danger," *supra* note 6 ("Separate accounts and co-investments provide managers with lower annual fees and a lower share of capital gains than fund investment."); "Private Equity Co-Investment: Best Practices Emerging," *supra* note 26 ("Co-investors often benefit from lower (or no) management fees and carried interest, as well as greater deal selectivity and transparency."); Tom Stabile, "Where Has All the Private Equity Money Gone?", FINANCIAL TIMES (Apr. 12, 2015) ("[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 51 ("Institutional investors are getting more bang for their buck in low-cost separate accounts and other alternatives to classic funds.").

greater surplus for more investors in the aggregate.[59] In the economics literature, there is general consensus that price discrimination is an efficiency-promoting practice when it leads to more of the product in question being produced,[60] and that appears to be precisely the effect when private equity managers are able to engage in price discrimination.

The act of charging preferred investors preferential fees does not constitute an appropriation of value from non-preferred investors to preferred investors. Regardless of what any other investor is being charged, each individual investor can make her own determination at the time of investment whether the fees that *she* is being charged are justified by the expected performance of the manager. The same logic applies to any product market where price discrimination exists, from cars to mortgage loans and toothpaste to tuition.[61]

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

In this Section, I offer a graphic illustration of the impact of preferential treatment through superior customization rights, monitoring and control rights, and fee discounts. When these forms of preferential treatment are constrained, the overall economic outcome will be less efficient. Certain institutional investors who would otherwise be better off investing through a professional manager might decide to launch their own direct investing platform if the manager cannot offer a package this is compelling enough. Alternatively, some investors might simply reduce their overall portfolio exposure to private equity by investing more capital in other asset classes,[62] potentially resulting in sub-optimal portfolio allocations to private equity by those investors.

Fig. E below illustrates the decision-making process a manager will go through when no preferential treatment is possible. The y-axis represents the "value" of the private equity investment with a manager, and it increases with increased customization rights, increased control rights, and fee reductions. The x-axis represents total investment. The demand for investment with a manager will go up as the "value" of the investment increases. Some investors may be willing to

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[59] *See infra* Section II.C. for a graphical depiction of this principle.

[60] *See, e.g.,* Hal R. Varian, *Price Discrimination and Social Welfare*, 75 Amer. Econ. Rev. 870 (1985); and Richard Schmalensee, *Output and Welfare Implications of Monopolistic Third-Degree Price Discrimination*, 71 AMER. ECON. REV. 242 (1981).

[61] We even see price discrimination in mutual funds, a highly regulated corner of the investment fund universe with laws specifically designed to protect unsophisticated investors. Institutional investors are commonly charged significantly lower fees for the same mutual fund products than their less sophisticated "retail" investor counterparts. *See* William Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TULANE L. REV. 1401, 1446 (2006).

[62] The risk of losing these investors is not merely theoretical—one example includes the decision by the California Public Employees' Retirement System, a $300 billion public pension fund known as "Calpers," to reduce the number of its private equity managers from 98 to 30 in 2015 in a move to reduce fees. *See* Alexandria Stevenson, "Calpers to Cut Ties with Many Fund Managers to Save on Fees," N.Y. TIMES (June 8, 2015).

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 customization rights, control rights, and fee levels) 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.

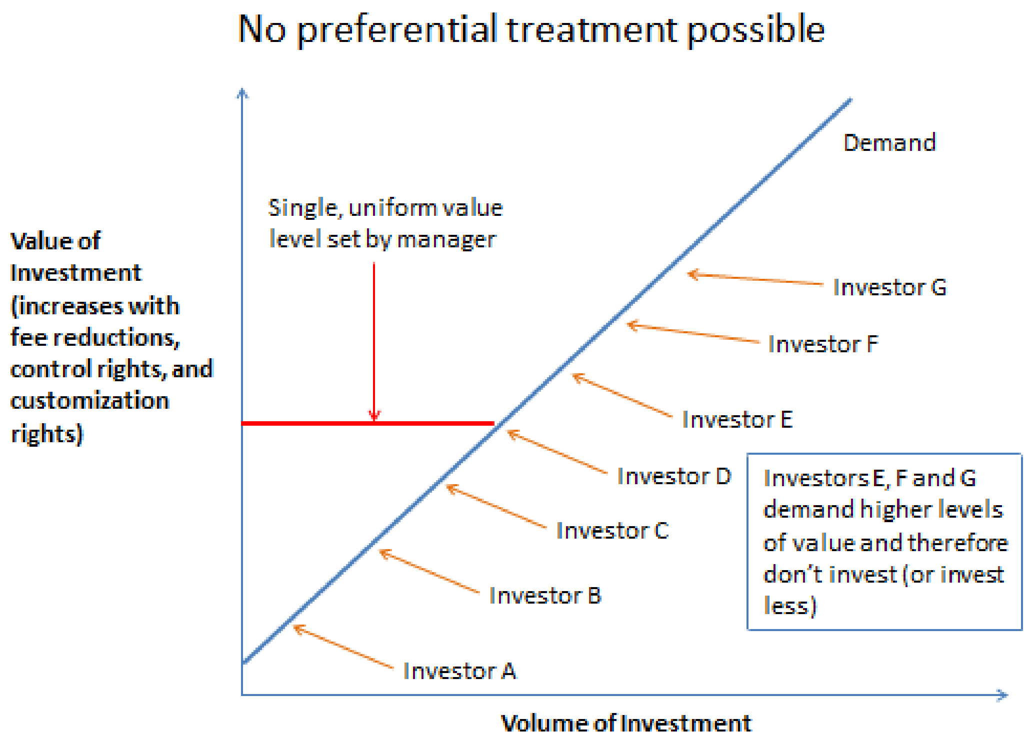

Fig. E

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 certain 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 (such as the ability to engage in direct private equity investment), 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 off-set 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, she will increase the value offered to Investors E, F, and G—through a mix of fee reductions, superior monitoring and control rights, and superior customization rights optimized to meet each investor's respective preferences—up to the point where it is no longer profitable to meet the incremental investor's demand. Importantly, 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 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.

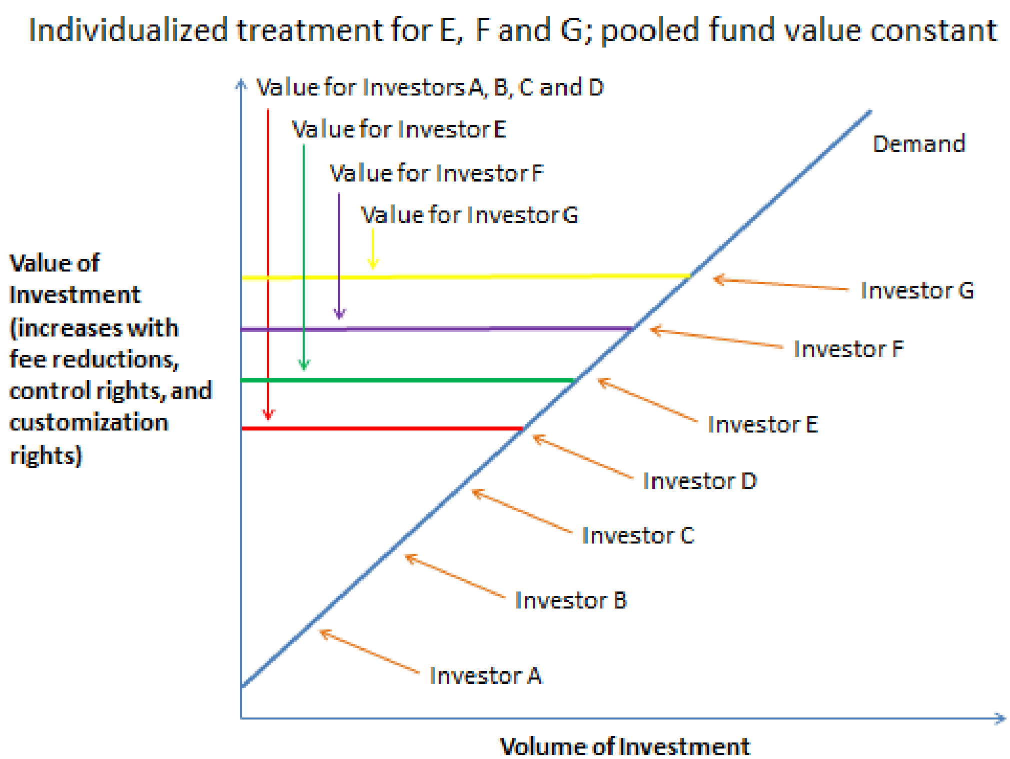

Fig. F

In Fig. F 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. Another possibility is that the pooled fund investors will be worse off when preferential treatment is possible. Fig. G below depicts a situation where the manager has decided to offer customized terms to Investors C and D, rather than keeping 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 Fig. G, receives terms that reflect a lower value than what she would have received in the original pooled fund depicted in Fig. E. Only Investor D, the incremental 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.

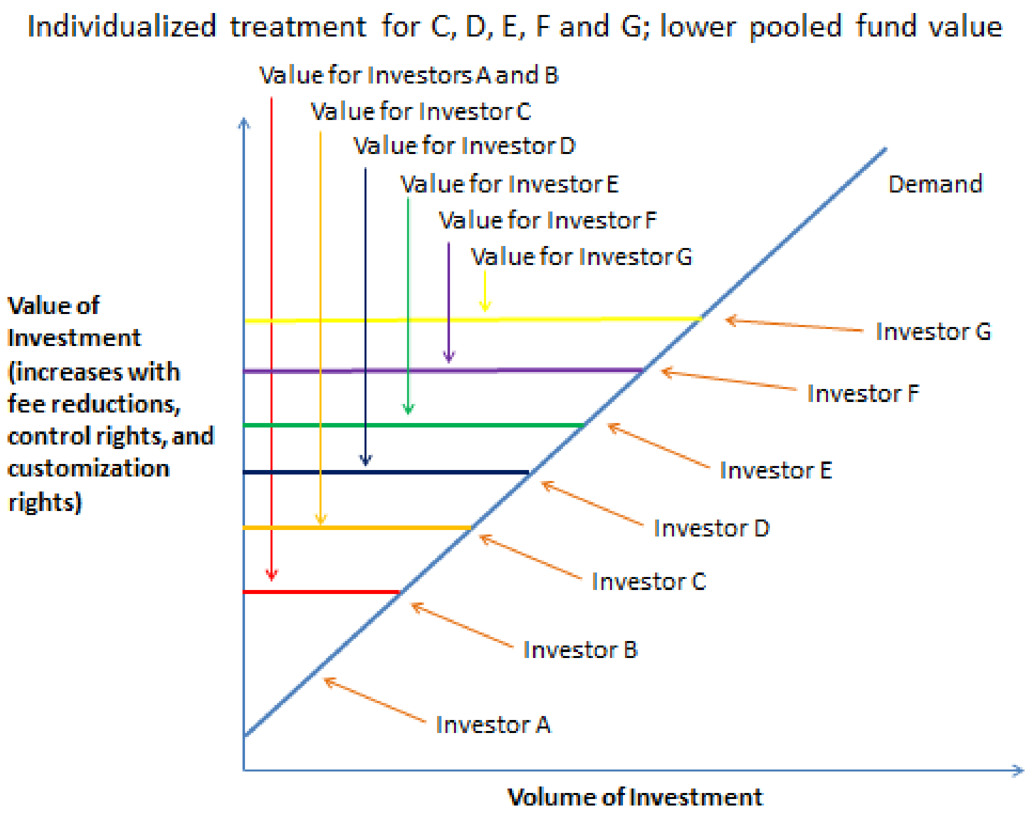

Fig. G

We cannot know exactly how things play out in the real world—i.e., whether the real world is closer to Fig. F than it is to Fig. G, or vice versa—but it is entirely possible that the dynamic illustrated in Fig. G reflects some reality. The increase in value for some investors could in fact be accompanied by a decrease in value for other investors. This raises a *distributional* question—as a policy matter, do we want the terms being granted to pooled fund investors to be of a lower value than they would be if no preferential treatment existed? If not, does this distributional concern outweigh the increase in the size of the pie generated by preferential treatment?

There are a few reasons why the benefits of preferential treatment almost certainly outweigh the possible distributional concern described above. First, as discussed above, two forms of preferential treatment—superior customization and superior monitoring and control rights—serve to unlock positive value for preferred investors but generate *very little* corresponding decrease in value for pooled fund investors (if any decrease at all). Because customization rights are impossible to grant in pooled funds,[63] allowing investors to customize through separate accounts generates a new source of value for preferred investors. On the flipside, because customization rights cannot exist in pooled funds, it is impossible for the investors who remain in pooled funds to receive a *lower* amount of customization rights than they were already receiving.[64]

Similarly, due to collective action and collective control problems in pooled funds, the value of monitoring and control rights in pooled funds are significantly diminished. As a result, allowing investors to invest through separate accounts and co-investment vehicles unlocks a nearly pure increase in positive value. I say "nearly" because, unlike customization which is impossible in pooled funds, control rights are not entirely without value in private equity funds.[65] There is certainly *some* value associated with investors' information rights and control rights in pooled funds, just not as much as value as those rights offer in separate accounts and co-investments.

For these reasons, the net result of the increased customization rights and monitoring and control rights unlocked by individualized investing has been overwhelmingly to increase the size of the pie, without generating much (if any) corresponding harms to pooled fund investors.

Admittedly, the same logic does not apply to preferential fee treatment. When the manager can charge individualized fee levels, it is entirely possible that pooled fund investors will end up paying higher fees than if no preferential treatment were possible.[66] But even if this is the case, it still would *not* constitute an appropriation of value from non-preferred investors to preferred investors.[67] So

[63] *See supra* Section I.B.1.

[64] To the contrary, if anything, pooled fund investors are better off when influential investors who have idiosyncratic customization needs leave the pooled fund—this is because managers will not be tempted to modify the pooled fund's investment strategy or structuring characteristics in ways that benefit the influential investor but harm the rest of the investors.

[65] *See infra* Section IV.B. for a description of common governance rights found in pooled funds.

[66] Importantly, it should be remembered that preferential fee discounts are also a source of efficiency that increases the size of the pie by enabling the manager to satisfy a broader range of investor fee demands. *See supra* Section II.B.3.

[67] *See id.*

long as the manager honestly and completely discloses the pooled fund's fees and accurately represents her background and track record, prospective pooled fund investors are fully empowered to walk away when the fee rates are unattractive enough.[68]

Lastly, even if we assume that non-preferred investors are being charged higher fees than they would in a world with no preferential treatment, it is not clear that this is a bad thing from a policy perspective. As illustrated in Fig. E, when no preferential treatment was possible, Investors A, B, and C benefited because they enjoyed a value level that was higher than the minimum necessary to induce them to invest. On the other hand, Investors E, F, and G were worse off because they were investing less with the manager than they would have if the manager had been able to offer customized value levels. When thinking about this scenario, it is critical to remember that in the real world Investors E, F, and G are generally 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,[69] so Investors E, F, and G 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 much less weight if one is trying to justify a transfer of value from Investors E, F, and G to Investors A, B, and C.

III. A Problematic Form of Preferential Treatment: "Inequitable Allocation"

In this Part, I will consider a problematic form of preferential treatment made possible by individualized investing—the inequitable allocation of investment opportunities and other resources to preferred investors at non-preferred investors' expense. This is unlike the forms of favoritism considered in Part II in that it is not an efficient form of favored treatment. Inequitable allocation does not increase the size of the pie, but rather constitutes a pure appropriation of value from non-preferred investors to preferred investors. This form of favored treatment raises serious normative concerns which will be the focus of Parts III, IV, and V.

[68] This is in contrast with the form of preferential treatment introduced in Part III—inequitable allocation—where the reduction in value is not disclosed in advance to investors.

[69] Public and private pension funds, endowments, and foundations collectively accounted for 57% of investment in private equity in 2013. *See* Private Equity Growth Capital Council, *available at* http://www.pegcc.org/education/fact-and-fiction/. One source estimates that pension funds specifically account for 44% or private equity investment. "Private Equity and Pensions: A Strong Partnership," PE Hub (Jun 30, 2015), *available at* 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* "Private Equity Co-Investment: Best Practices Emerging," *supra* note 26.

A. What is 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 is high-quality investment opportunities. 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.[70]

By allocating a larger portion of good 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 is fully subsidized by the pooled fund investors and that does not touch the manager's pocket.[71] This is in contrast to price discrimination and superior customization and control rights, where the manager internalizes the costs of granting such favorable rights. Unfortunately, whereas superior customization, control rights and price discrimination are generally efficiency-promoting practices, granting preferential allocations to preferred investors is a pure appropriation of value from non-preferred investors—unless the manager discloses the arrangement very clearly before pooled fund investors commit their capital.

B. Inequitable Allocation is an Appropriation of Value from Non-Preferred Investors

Producers in other product markets routinely allocate varying levels of resources to different products. For example, in the automobile product market, the Toyota Motor Corporation sells a premium Lexus product and also a lower-end Toyota product; in the retail clothing market, Banana Republic offers a higher-end Monogram collection in addition to their traditional product line; in the grocery market, grocers will often dedicate a section to organically-grown foods with no genetically-modified organisms. In each of these examples, buyers generally understand that the non-premium brand products are lower-quality than the premium products, and, accordingly, they pay less for those products.

However, this type of activity is problematic in private equity for two reasons. First, unlike the product markets described in the paragraph above, private equity managers rarely advertise products of differing quality levels. Private equity managers may raise funds focused on different investment strategies or different regions or industries, but they almost never launch a fund that is explicitly a second-priority fund that only receives investment opportunities that are passed over by a first-priority fund. Accordingly, when an investor buys an interest in a

[70] By contrast, investment funds that invest primarily in the securities of large, public companies (such as mutual funds and hedge funds) face far fewer limits on the amount of any particular investment opportunity that can be purchased and allocated to clients.
[71] 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 substantial price for this favorable treatment in a competitive market.

private equity fund, her usual expectation is that she will share an equal portion of the manager's best investment opportunities with the manager's other clients invested in the same investment strategy. If a manager were to clearly communicate that a certain fund was a second-priority fund, investors would demand lower fees for interests in that fund, just as consumers refuse to pay the same amount for a Corolla as they do for a Lexus.

Accordingly, the two requirements for a transfer of value to constitute an appropriation are met when a manager engages in inequitable allocation. First, inequitable allocation does in fact cause pooled fund investors to suffer an actual reduction in value. When the pooled fund receives a lower proportion of the manager's best investment opportunities, its performance will suffer. Second, as developed above, this reduction in value is not something that the investor willingly agreed to before investing in the fund. She thought she was investing in, and paid the price for, a Lexus-quality fund, not a Toyota-quality fund.

This appropriation of value is particularly harmful to non-preferred investors because they are locked in to the pooled fund for a long period of time. In certain product markets, it poses little problem to a buyer when the manager makes a decision to allocate resources away from that buyer's product. For example, in the market for potato chip snacks, most buyers do not purchase more than a single-size bag or a bag that they will consume over the course of a few days. If they decide that the quality-level of the chips is not what they expected after making a purchase, they can switch to another brand of chips when they make their next purchase.[72] There is thus very little harm to the consumer. In private equity, by contrast, because investors commit their money to a fund for a decade or more, the harm is much longer-lasting when the quality of that fund is lower than advertised.

C. How Individualized Investing Enables Inequitable Allocation

In pooled funds, inequitable allocation 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 sub-set of investors. With the rise of individualized investing, however, it becomes much easier to for managers to engage in inequitable allocation.

In a separate account, the manager and the separate account holder can negotiate for whatever investment mandate they desire, with as much or as little overlap with the pooled fund investment mandate as desired. Because the assets held in the separate account are entirely separate from the assets held in the pooled fund, every time the manager finds a good investment opportunity that fits in the investment mandate of both the pooled fund and the separate account, the

[72] *See* Morley, *supra* note 35 at 1261-67 for a detailed discussion of how exit rights protect investors when their managers face conflicts of interests.

manager will have to decide how to allocate that opportunity. As will be discussed in greater detail in Section IV.B., managers typically disclose an investment allocation policy when they solicit new investors, but these policies often include qualifiers and exceptions that ultimately leave the manager with significant discretion over investment allocation decisions. Accordingly, when the manager finds a high-quality investment opportunity—one that the manager expects will produce exceptional returns—the manager could simply allocate a larger portion of that investment opportunity to the separate account and a smaller portion to the pooled vehicle.

In Fig. H below, I have provided a very simple example to illustrate how separate accounts can be used to promote inequitable allocation. 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).

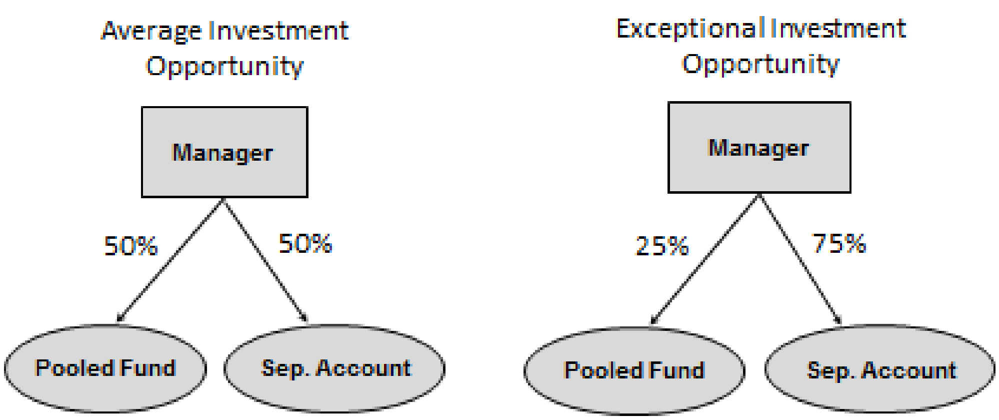

Fig. H

Co-investments enable unequal allocation of investment opportunities in a similar manner. Managers can 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.

Inequitable allocation does not have to be limited to the favorable allocation of investment opportunities. 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 all of its most talented employees to work for a separate account client, leaving less-talented employees to manage the sponsor's pooled fund.[73] 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 this kind of activity is clearly disclosed before non-preferred investors enter into their investment with the manager, it would not be problematic as the non-preferred investors could factor this into the price they are willing to pay from the outset. But without such disclosure, inequitable allocation constitutes an unethical appropriation of value from pooled fund investors to preferred investors.

Unfortunately, it is very difficult to measure or validate how much inequitable allocation is actually happening in the marketplace. As will be discussed in greater detail in Section V.C. below, the terms and track record and investment activity of separate account vehicles are typically subject to substantial confidentiality restrictions. Taking surveys of managers and/or separate account holders or co-investors is unlikely to provide meaningful insight since, if these parties are engaging in inequitable allocation, they would prefer that the practice remain in the dark. Even if their identities were to remain anonymous, they would have no interest in and drawing the attention of regulators and non-preferred investors to the practice.

IV. INEQUITABLE ALLOCATION IN PRIVATE EQUITY: LEGAL AND CONTRACTUAL CONSTRAINTS

In this Part, I review the legal duties that apply to a manager who is thinking about engaging in inequitable allocation. I also consider the contractual limits and controls typically imposed on managers by their investors. Curiously, even though the rise of individualized investing makes it far easier for investors to engage in inequitable allocation, managers have continued to raise successful, large pooled funds in recent years, and contractual limits placed on managers often leave them with significant discretion over the allocation of investment opportunities among their various clients.

[73] Of course, most funds include some kind of "key man" or "key person" provisions that require certain key investment professionals to dedicate substantially all of their business time to working on the fund or on the manager's funds, but these are typically limited only to very high-level personnel.

A. *What the Law Requires*

Under state limited partnership law, managers are generally subject to default fiduciary duties—including the duty of care, duty of loyalty, and duty of good faith—but these duties can be waived in many states.[74] In Delaware, the waiver of all fiduciary duties has become a hallmark of limited partnership agreements governing private equity funds.[75]

This leaves the Investment Advisers Act of 1940 (the "Advisers Act"), federal legislation that imposes a distinct fiduciary duty on investment managers. However, unlike the fiduciary duty arising under state law, this federal fiduciary duty cannot be waived. The Advisers Act is fundamentally a disclosure statute.[76] When it comes to conflicts of interest—including the incentives managers have to treat certain investors more favorably than others—the Advisers Act requires that investors "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,'"[77] but it does not forbid conflicts or demand that any particular outcome is achieved. Thus, to fulfill their fiduciary duties in the face of conflicts of interest, investment managers' legal obligation is to fully disclose their conflicts to investors.[78]

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[74] For example, in 2004, the Delaware General Assembly amended the state's limited partnership, general partnership and limited liability company acts to provide expressly that organizing agreements between the participants may "eliminate" fiduciary obligations entirely.

[75] *See* Leo E. Strine, Jr. & J. Travis Laster, *The Siren Song of Unlimited Contractual Freedom*, ELGAR HANDBOOK ON ALTERNATIVE ENTITIES (eds. Mark Lowenstein and Robert Hillman, Edward Elgar Publishing 2014). When all fiduciary duties are eliminated, limited partners are left to rely on the "implied covenant of good faith and fair dealing." This implied covenant is explicitly protected within the Delaware statutes, but seldom found by Delaware courts as a source of meaningful protection. *See, e.g., Lonergan v. EPE Holdings*, 5 A.3d 1008 (Del. Ch. 2010) (holding that the implied covenant "is not a substitute for fiduciary duty analysis" and that "[w]hen a LPA eliminates fiduciary duties . . . courts should be all the more hesitant to resort to the implied covenant").

[76] As the U.S. Supreme Court has noted, "[a] fundamental purpose [of the Advisers Act was] to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963). *See also Vernazza v. SEC*, 327 F.3d 851, 859 (9th Cir. 2003) ("It is indisputable that potential conflicts of interest are 'material' facts with respect to clients and the Commission."); and *SEC v. K.W. Brown and Co.*, 555 F. Supp. 2d, 1275, 1305 ("The existence of a conflict of interest is a material fact which an investment adviser must disclose to its clients…."). To be sure, some specific substantive rules and standards have been established over the decades in court rulings and enforcement actions by the SEC. *See* Barry P. Barbash & Jai Massari, *The Investment Advisers Act of 1940: Regulation by Accretion*, 39 RUTGERS L. J. 627 (2008). But in most cases, including in conflict of interest situations like those being considered in this Article, the manager can fulfill its obligations under the Advisers Act by fully disclosing the action or conflict in question.

[77] *Capital Gains*, 375 U.S. at 196 (citing *United States v. Mississippi Valley Generating Co.*, 364 U.S. 520 (1961)).

[78] *See* Julie M. Riewe, Co-Chief, Asset Management Unit, Division of Enforcement, Securities & Exchange Commission, "Conflicts, Conflicts Everywhere" (Feb. 26, 2015) ("To fulfill their obligations as fiduciaries, and to avoid enforcement action, advisers must identify, and then address—through elimination *or disclosure*—those conflicts." (emphasis added)); "Regulation of Investment Advisers," SEC Staff of the Investment Adviser Regulation Office (March 2013) ("As

Underlying these legal rules is the assumption that, as long as investors are aware of the relevant conflicts of interest, they can manage them through contract without the assistance of mandatory legal duties. Various commentators have praised the merits of this private ordering approach, but their attention has generally been focused on the ability of investors (collectively) to rein in managerial agency costs, not on the *inter-investor* conflicts that have become more relevant as individualized investing has gained prominence.[79]

This approach to regulating conflicts of interest is in stark contrast with the corporate governance approach to conflicts. In the corporate law context, when any manager or director faces a conflict of interest her discretion is constrained by the "entire fairness" rule—a heavy standard that subjects that director or officer to liability unless the conflicted transaction is deemed to be substantively fair to the corporation.[80] The Advisers Act's disclosure-based regime is far more flexible by comparison.

B. Contractual Constraints

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a general matter, the SEC has stated that the adviser must disclose all material facts regarding the conflict so that the client can make an informed decision whether to enter into or continue an advisory relationship with the adviser, or take some action to protect himself or herself against the conflict.").

[79] *See, e.g.*, Robert P. Bartlett III, *Venture Capital, Agency Costs, and the False Dichotomy of the Corporation*, 54 UCLA L. REV. 37, 51-52 (2006) (noting that commentators generally agree that venture capital contracts have been successful at minimizing agency costs); Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 289-90 (2009) (noting that partnerships have been relatively successful in minimizing agency costs); David Rosenberg, *Venture Capital Limited Partnerships: A Study in Freedom of Contract*, 2002 COLUM. BUS. L. REV. 363, 365 (2006) (arguing that "prevailing practices in the industry bear out the theory that when parties have the ability to contract freely, the marketplace will produce contracts that satisfactorily align the parties' interests through devices other than the threat of legal action"); Morley, *supra* note 35, at 1263 ("[E]xit rights reduce the difficulty of foreseeing future conflicts and the costs of failing to foresee them. In ordinary companies, it is not possible for shareholders to foresee and price conflicts over the life of their investments. . . . In investment funds, by contrast, equity holders only have to foresee and price conflicts up through the next exit date."); LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 193 (2010) (arguing that so-called "uncorporate" governance devices provide "potentially more efficient ways to control the agency costs of centralized management" than corporate governance devices and "provided an important alternative to corporate-style monitoring").

[80] *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing the entire fairness, sufficient to pass the test of careful scrutiny by the courts."). This is generally understood to be the most rigorous of all standards of judicial review in corporate law. *See* Ronald J. Gilson & Jeffrey N. Gordon, *Controlling Controlling Shareholders*, 152 U. PENN. L. REV. 785 (2003). To avoid the burden of showing entire fairness, conflicted parties can follow certain procedural approaches—such as approval of the conflicted transaction by a majority of "disinterested" directors or by a majority of minority investors—to "cleanse" the conflict of interest.

As noted above, once a manager discloses a conflict of interest to investors, it is generally the investor's responsibility to negotiate for contractual protections from those conflicts. In practice, when a manager is managing multiple vehicles that have overlapping investment strategies, she will disclose a description of an "investment allocation policy" to each prospective investor.[81] In some cases, the manager's investment allocation policy will leave full discretion to the manager. Other times, the investment allocation policy will indicate that the manager will make pro rata allocations of investment opportunities to vehicles with overlapping investment strategies.

Even in cases where the investment allocation policy includes a general policy of pro rata allocation, the policy often includes qualifiers and other language that serve to give managers some discretion, notwithstanding the stated general policy of pro rata allocation. Some qualifiers that carve out room for managerial discretion include: consideration of the vehicles' existing exposure to the asset in question; the fact that the investment strategy of a given vehicle may change over time; the fact that specific vehicles may have more than one investment strategy; etc. Very often the investment allocation policy will also make clear that the manager has no legal obligation to offer investment opportunities to a given fund even when the opportunity falls squarely within the fund's mandate.[82]

In extreme cases, pooled fund investors may negotiate for a right of first refusal on all investment opportunities discovered by the manager that fall within the pooled fund's investment mandate. But even in these cases, the right provides only limited protection. One reason for this is that pooled fund investors are more likely to be less sophisticated and to have fewer resources than separate account investors and investors who engage in a great deal of co-investment activity.[83] As a result, they may be less capable of competently assessing whether any given investment opportunity is a good one or not.[84] Moreover, the manager's personnel will generally have much more time to dedicate to researching portfolio companies, including spending more time talking to the company's management

[81] *See generally*, "Private Equity Funds: Key Business, Legal and Tax Issues," Debevoise and Plimpton LLP (2015), Section G, available at http://www.debevoise.com/~/media/files/insights/news/2015/pe_fundskey%20business_legal_tax_issues.pdf.

[82] These observations are based on conversations with practitioners and my own review of the private placement memoranda of various private equity funds.

[83] *See supra* note 34 for survey terms corroborating this assumption.

[84] Exercising a right of first refusal will require the same analysis necessary to exercise co-investment rights. Yet this type of skill is likely to be possessed only by more sophisticated, well-resourced investors. This is because evaluating new investment opportunities requires the investor to have employees who can engage in sophisticated investment analysis—the same analysis that the private equity manager performs when she evaluates investments—to determine if the deal is a good one. This is particularly challenging because the investor typically has a very tight timeline—a week or less in many cases—to make a final determination about whether to invest in or pass on the co-invest opportunity.

and forming a qualitative assessment of the investment opportunity, so she will have an advantage in evaluating the quality of investment opportunities.[85]

Investors in pooled funds generally also possess certain limited mechanisms for controlling and/or influencing the manager of the fund. For example, investors typically have the right to terminate the fund upon certain events.[86] These events generally include a "key person" event (i.e., when specified key personnel leave the manager or cease to devote a specified portion of their time to the pooled fund) or when there is a change of control of the manager. "No-fault" terminations of the fund are also possible, but these typically require an extremely high super-majority vote of the pooled fund investors' interests. Investors may also have the right to remove the manager, but typically only if investors can show that the manager has violated a high standard of care. While these rights are significant, they are generally rarely invoked and require voting thresholds that are quite high.

Another critical limitation of these contractual protections is the fact that, in order for pooled fund investors to benefit from them or use them to hold the manager accountable, investors need to *know* that the manager is engaging in problematic actions. In the case of inequitable allocation, this would require knowing how much of each investment was allocated to each of the various separate accounts and to co-investors, the investment strategy of each separate account, the relative attractiveness of each investment opportunity (which, for the reasons discussed above, is very difficult for investors to determine), and a host of other information that pooled fund investors simply cannot obtain. Even if pooled fund investors could obtain this information, collective action and collective control problems limit their incentive to evaluate it and/or take action when they find problems.[87] Accordingly, private equity managers often operate with a significant amount of leeway when it comes to making investment allocation decisions, leaving the door open to inequitable allocation.

V. THE ROLE OF EXIT RIGHTS AND TRACK RECORD IN LIMITING INEQUITABLE ALLOCATION

Parts III and IV lead us to ask: is the risk of inequitable allocation in the private equity marketplace something that policymakers should be doing something about? The optics of the situation are not great. Managers have an incentive to treat some investors favorably, and separate accounts and co-investments appear to give them a way to do this that does not come out of their pockets, but is

[85] The likelihood that the manager will have a better understanding of the quality of the investment opportunity rises even more when we consider the effect of collective action and collective control problems on pooled fund investors' incentive to dedicate time and resources to doing this kind of research. *See supra* Section II.B.2. for a description of the collective action and collective control problems in pooled funds.

[86] *See* "Private Equity Funds: Key Business, Legal and Tax Issues," *supra* note 81, at Section H.

[87] *See supra* Section II.B.2.

subsidized by less sophisticated investors. The legal regulations and contractual restrictions applicable to these arrangements appear to leave managers with some flexibility to engage in inequitable allocation, and investors have little chance of determining whether this kind of practice is actually happening. Moreover, individualized investing is booming, reaching unprecedented levels with no signs of slowing down.

While this may seem like a recipe calling for an aggressive regulatory response, I show in this Part that the risk of widespread inequitable allocation is actually much less serious than it may appear. Thanks to exit rights and the value of track record in private equity, it will almost never be in a manager's interest to use inequitable allocation to grant favorable treatment to preferred investors. The benefits of inequitable allocation will generally be short-lived and non-scalable, while the harm to the manager's track record—a resource that offers long-lived and scalable benefits to the manager—will be significant. Accordingly, when a manager desires to grant preferential treatment to certain preferred investors, she will almost always prefer to accomplish this exclusively through superior customization rights, control rights, and fee reductions. We should thus not expect inequitable allocation to occur on a systematic or sustained basis in this new era of individualized private equity investing.

A. The Benefits of Inequitable Allocation Are Short-Lived

The first factor limiting inequitable allocation is the fact that the benefits of this activity will be short-lived 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, private equity funds liquidate approximately every decade. 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 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 success level 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 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 who are willing to offer 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. Either way, the investor will decide to exit.

The departure of non-preferred investors from the manager will have a significant negative impact on the manager's future profits. For example,[88] if the pooled fund is charging investors a 2% management fee and investors holding $250 million of capital choose not to reinvest, it will result in the manager losing $50 million of guaranteed management fee revenues (undiscounted) over the life of a 10-year fund. Moreover, if we assume that the manager would have achieved an average of 12% returns on that $250 million of lost capital, the manager is also losing approximately $25 million of carried interest revenues (undiscounted and uncompounded) over the life of a 10-year fund paying 20% carried interest with a 7% hurdle rate.[89]

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 who desires to keep her overall profits constant will be strongly incentivized to attract new investors to replace the departed investors. Unfortunately, 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.[90]

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[88] *See* supra note 19 and accompanying text for a description of the typical fee arrangements observed in pooled funds.

[89] With less capital under management, it is possible that the manager would be able to achieve higher performance per dollar invested and thereby achieve higher carried interest revenues, but the improved performance would have to be massive to make up for the lost management fees and carried interest fees on the lost capital. For example, if we assume that the manager's other vehicles contain $750 million of capital, the manager would have to achieve 17% performance on that $750 million of capital (again, on an undiscounted and uncompounded basis) just to get back to the same level of profitability that she would have achieved with $1 billion of capital at 12% performance.

[90] *See* "Key Due Diligence Considerations for Private Equity Investors," Preqin (July 2014) (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), *available at* https://www.preqin.com/docs/reports/Preqin-Special-Report-Due-Diligence-Private-Equity-Investors-Jul-14.pdf. 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. OF FIN. 1791 (2005) (finding that returns persist strongly across different funds raised by a private equity manager); Ludovic Phalippou and Oliver Gottschalg, *The Performance of Private Equity Funds*, 22 REV. FIN. STUDIES 1747 (2009); Yael Hochberg, Alexander Ljungqvist and Anette Vissing-Jorgensen, *Informational Hold-Up and Performance Persistence in Venture Capital*, 27 REV. FIN. STUDIES 102 (2014), Phalippou (2010);

One way the manager might be able to attract new investors would be to lower her fees. Unfortunately, while this could help the manager convince investors to invest in the fund, it would reduce the profits generated by those investments. If the manager's goal is to revert back to her prior level of profitability, the strategy of lowering fees will thus be of limited usefulness.

Another approach to attracting capital *without* lowering fees might be to promise new investors a pro rata allocation of investment opportunities with the existing, formerly-favored investors.[91] Even better, the manager might be inclined to promise new investors *favorable* allocation over her existing investors. In the first case, where the manager promises pro rata allocation of investment opportunities to new investors, the returns of the investors who were formerly preferred investors will be reduced by the amount of the allocation premium that the manager *is no longer providing them*. In the second case, where the manager promises a favorable allocation to new investors, the investors who were formerly preferred investors will likely suffer from a *negative* allocation premium, as they will now be cross-subsidizing the returns of the new investors.

B. The Benefits of Inequitable Allocation are Non-Scalable

Given the issues outlined above, it is difficult to imagine managers going out of their way to offer preferred investors preferential treatment in the form of inequitable allocation, or for preferred investors to seek inequitable allocation. Preferred investors would be better off asking for a form of preferred treatment that the manager can provide on a more sustained and quantifiable basis.

Are there ways for managers to get around the short-lived benefits problem? One approach might be to offer inequitable allocation 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 new capital. This kind of a strategy could plausibly 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 is implausible because there is no way to scale the benefits of inequitable allocation. 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%

Harris, Jenkinson, Kaplan and Stucke, *Has Persistence Persisted in Private Equity? Evidence from Buyout and Venture Capital Funds*, Working Paper (2014).

[91] As will be discussed in Section V.D., there are practical and legal challenges that make it difficult to promise this kind of treatment.

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%, granting a 5% positive favorability premium to the preferred investor would result in a negative 1% favorability 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 allocation, the negative favorability 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 returns of the pooled fund are completely wiped out, such that pooled fund investors lose all of their money.

As this example shows, if the manager desires to offer inequitable allocation to a larger universe of investors, the size of the underlying pool of disfavored capital would thus have to grow correspondingly large as well. This means that the manager cannot use the promise of inequitable allocation to attract a meaningfully large amount of new capital, *even in cases* where the manager desires only a short-term boost in capital under management.[93]

C. Pooled Fund Track Record Cannot Be Replaced by Individual Investor Track Record

As noted 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 records at all raise less capital and must exert greater time and effort.[94] Track record is thus an

[92] In truth, as more capital is added the expected overall returns of the manager for a strategy will probably go down, since it is generally 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.

[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 cross-subsidized favoritism 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, manager's 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.

[94] *See* Kaplan & Schoar, *supra* note 90 (finding that better performing managers are more likely to raise follow-on funds and larger funds).

extremely valuable asset.[95] This fact is well-understood among managers and investors alike in the marketplace.[96]

However, in the new world of individualized investing, all track records are not equally valuable to the manager. For various reasons, superior pooled fund track record is a greater asset when it comes to raising new capital than the track record of a single investor or of a separate account.[97]

One reason that separate account track records are not as valuable to managers who are trying to raise new capital is that they are generally subject to significant confidentiality restrictions. Most separate account investors carefully guard information about their separate accounts—including the separate account's performance, investment mandate, fees, and other information. This might seem over-the-top to casual observers, but a closer look shows some justification for the practice. First, we can imagine scenarios where a separate account is achieving unusually high investment returns in a distinct strategy or industry that may not be appreciated by the market. To the extent that this is true, it is not in the separate account holder's interests for other investors to see the superior performance or the investment mandate of the account, as this could spur more investment in the strategy or asset class and thereby crowd out attractive opportunities. More generally, investors with high reputations may want to avoid disclosure of information about their separate accounts as some investors may seek to copy the high-reputation investor's strategies, reducing any competitive advantages generated by those strategies.

Another factor that makes pooled fund track record more valuable to the manager is the fact that pooled funds tend to be larger than any individual separate account,[98] making the pooled fund track record a more persuasive data point.

[95] *See infra* Section V.F. for more detail on why pooled fund track record is a valuable asset.

[96] The critical role that track record plays is also observable in the internal employment contracts between private equity managers and their investment professionals. These agreements almost always include a section that addresses whether and how the manager's personnel can use the track record of the manager's funds if the employee is separated from the manager by termination or voluntary departure. I can attest from personal experience as a practicing lawyer that these provisions are very carefully negotiated, as personnel will have little chance of successfully launching start-up management businesses in the future if they cannot advertise the returns of the funds managed by their current employer.

[97] As will be shown 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.

[98] Of course, this does not have to be the case, but it is generally true. To illustrate, even if we assume that 75% of manager's assets under management are invested in separate accounts and only 25% is 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).

Finally, as discussed previously, one of the great benefits of separate accounts and co-investments is the superior customization and control rights that they afford investors. 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. Moreover, to the extent that a separate account investor has significant control rights and uses her control 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, but of the manager's talent *plus* the separate account investor's value-adding abilities.

A similar problem exists for co-investments. Because co-investment arrangements often give investors freedom to turn down co-investment opportunities, the track record of the co-investor will be more a reflection of the co-investor's skill in distinguishing between winning and losing opportunities than of the manager's ability to find consistently good investment opportunities.

D. Challenges with Credibly Committing to Inequitable Allocation

Any time a manager is granting favorable terms to a preferred investor, it is in the manager's interest to communicate those terms to the preferred investor in advance to induce some kind of quid pro quo benefit—such as convincing a preferred investor to make an unusually large investment—in return for the favorable treatment. If the manager never communicates the intent to grant favorable treatment before the preferred investor makes an investment, the manager is essentially giving away something valuable for free when she provides the favorable treatment at a later point in time.

Beyond simply communicating the intent to provide preferential treatment, the manager also needs to *credibly commit* to follow through on the promise of preferential treatment. Without a credible commitment, investors will be wary of giving up value (such as making a larger investment) in return for the favored treatment. For fee discounts and superior customization and control rights, this is relatively simple—the manager can simply describe the reduced fee rate or favorable right in an enforceable contract and sign the contract.

By contrast, credibly committing to provide inequitable allocation to a preferred investor is much more challenging. On one hand, for the reasons already discussed above, the manager does not control how long the favorability premium will last because she does not know how many pooled fund investors will ultimately exit the pooled fund in response to their disfavored treatment. Moreover, while the manager will no doubt have a sense for which investments are likely to be successful and which are less likely, making this determination is more art than science. For these reasons, it will be very hard for the manager to quantify exactly how valuable the preferential treatment will be, let alone commit to providing a specific amount and duration of inequitable allocation. By contrast, a commitment to charge an investor a discounted fee and/or grant significant control rights has a clear value to the investor on the day that they are granted.

In addition, the more explicit the manager's representations with respect to the inequitable allocation, the more clear the manager's fiduciary obligations become under the Advisers Act to disclose the arrangement to the disfavored pooled fund investors before they make their investments. Disclosing this kind of information to prospective pooled fund investors would obviously make it difficult to raise any capital without lowering the pooled fund's fees, negating any benefits the manager might be hoping to gain from inequitable allocation in the first place.

E. Lower Carried Interest Fee Rates Disincentivize Inequitable Allocation

As described above,[99] private equity managers typically charge their investors two 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 above a specified "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.[100] 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 carried interest revenues if she allocates the opportunity to the vehicle paying a 20% rate.

As previously highlighted,[101] investors in separate accounts and co-investments are commonly charged *lower* carried interest fee rates than investors in pooled funds.[102] Accordingly, if the manager's sole interest is to maximize her carried interest profits, she would actually be incentivized to allocate the best investment opportunities *away* from separate accounts and co-investments and toward the pooled fund.

[99] *See supra* note 19 and accompanying text.

[100] 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.

[101] *See supra* note 58 and accompanying text.

[102] *See* 2015 Preqin Private Equity Fund Terms Advisor, *supra* note 58 ("48% of private equity separate accounts use the traditional 20% carry rate figure, compared to 85% of traditional commingled funds that employ this rate. This suggests that GPs largely do not appear to adhere to the industry standard of a 20% carry rate when managing separate accounts."); Hillary Canada, "Getting the Right Recipe for Co-Investments," WALL ST. J. (Mar. 19, 2014) ("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.").

F. The Lasting and Scalable Value of Pooled Fund Track Record

In contrast to the benefits of inequitable allocation, the benefits of a strong pooled fund track record to managers are long-lived and scalable. If a manager achieves high performance for a given pooled fund, the track record established by that performance will make it easier for the manager to raise another pooled fund. Moreover, to the extent that a manager establishes a track record of sustained outperformance over multiple pooled funds, her reputation will be burnished even further. This could be particularly helpful in instances where the manager's most recent pooled fund performance suffers a hiccup. To the extent that there is a history of strong pooled fund performance, prospective investors may be willing to forgive lower performance in the most recent fund. Thus, there is a lasting benefit to achieving consistently attractive pooled fund returns.

Moreover, unlike separate account track record, pooled fund track record is generally understood to be one of the manager's assets, so there are few limitations on the manager's ability to use it for marketing purposes. And because pooled fund investors generally exercise very little control over pooled fund decision-making,[103] the performance of a pooled fund is a clear signal of the manager's talent level, rather than a combination of the manager's talent plus the investors' influence.

Strong pooled fund performance is also scalable in the sense that positive performance today can enable the manager to raise larger and larger future funds if desired. This effect is not even necessarily limited to funds pursuing a private equity strategy—many managers have leveraged a successful track record in private equity to launch successful funds in various strategies, thus enabling them to diversify and increase their overall revenue streams.[104] As outlined in Section V.C. above, these benefits cannot be replicated by marketing the investment performance of separate accounts and/or co-investments.

G. Systematic Inequitable Allocation Highly Unlikely

The entire premise of inequitable allocation is built on the idea that the manager will allow the pooled fund to suffer diminished performance in order to achieve inflated performance at the separate account and co-investment level. Yet, for the reasons discussed above, under most circumstances the benefits of inequitable allocation will be short-lived and non-scalable, while the benefits of a strong pooled fund track record to managers are long-lived and scalable. It thus seems highly implausible that inequitable allocation will occur on a systematic or

[103] *See supra* Section II.B.2. for a description of the collective action and collective control problems in pooled funds and Section IV.B. for a discussion of the limited contractual rights granted to pooled fund investors.
[104] Prominent examples include Blackstone, Apollo Global Management LLC, and TPG Capital, each of which rose to prominence as private equity managers but which now manage a dizzying array of investment funds and strategies ranging from real estate to distressed debt to global macro hedge funds.

ongoing basis in a competitive market. In general, managers will be better off following a consistent policy of making pro rata allocations of investment opportunities to any vehicles whose investment mandate picks up the relevant opportunity. When they desire to grant preferential treatment to certain preferred investors, they will be motivated to accomplish this through superior customization and control rights and fee reductions, not through inequitable allocation.

The value of pooled fund track record thus serves as a strong source of protection for pooled fund investors. Interestingly, in light of the above analysis, it is reasonable to ask whether the manager's true incentives actually tip in the opposite direction—i.e., are managers actually incentivized to engage in inequitable allocation *in favor of pooled funds* and *at the expense of separate account holders*? Fortunately, given the fact that separate account holders and co-investors are generally among the most sophisticated and influential investors in private equity, this is not a question that policymakers need to be overly-concerned about. But the idea that managers' incentives may actually be more aligned with pooled fund incentives does help explain one interesting aspect of separate accounts—the tendency for managers to invest a higher percentage of their own capital in separate accounts than in pooled funds. With pooled funds, managers are typically required to purchase approximately 1% of the pooled fund's interests with their own capital. This is intended to give managers more "skin in the game" above and beyond the incentives created by carried interest. By contrast, it is very common for separate account investors to demand that managers invest a significantly larger amount of their own capital in the separate account—often as much as 5% of the overall assets managed in the account and sometimes much more.[105]

At an initial glance, this difference in "skin in the game" could be viewed as a cause for concern that the manager's interests are more aligned with the interests of separate account holders than pooled fund investors. But this Part's analysis suggests the opposite—that this practice is evidence of just how strong the manager's incentives are to protect the pooled fund track record. Understanding the importance of pooled fund track record to the manager, sophisticated separate account investors demand that the manager invest a higher percentage of her own capital in a separate account to protect against *unfavorable* treatment of her account in favor of the pooled fund.

VI. Policy Discussion

A. The Wisdom of Regulatory Restraint

[105] *See* 2015 Preqin Private Equity Fund Terms Advisor, *supra* note 58 ("29% of private equity fund managers contribute 0-1.99% of the value of their separate accounts, broadly in line with the typical 1% of GP commitment. Almost half (47%) commit 5% or more, while 15% of fund managers contribute over half the total value of their separate accounts.").

In my experience, people often express discomfort when they learn that some investors in private equity have access to significantly better terms than others. The opaqueness and secrecy surrounding individualized investing contribute to this unease. With separate accounts and co-investments, there is a world of deal-making and favoritism that takes place largely behind closed doors. Many, including the SEC, have expressed concern about what this means for the investors who do not have access to this privileged world.[106]

In recent years, the SEC's focus has largely been on educating itself about the workings of the private equity industry, and not on promulgating new regulations for the industry or on unleashing a wave of enforcement actions.[107] Indeed, the express purpose of the Presence Exam Initiative commenced in October 2012 was to "establish a presence with the private equity industry and to better assess the issues and risks presented by its unique business model."[108] Some industry participants and commentators have been holding their breath to see what will come next, now that the SEC has gotten smarter about how things really work in today's marketplace.[109]

In this Article, I have shown why the rise of preferential treatment in private equity has likely had a powerful net positive effect on the industry and has increased the size of the pie available for investors. As policymakers adapt the modern regulatory regime to account for individualized investing, they should

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[106] *See, e.g.*, "Spreading Sunshine in Private Equity," *supra* note 31 ("OCIE's experience is that complexity and rapid growth have created governance and compliance issues that should be addressed as firms mature and evolve. For example, we have seen that much of the growth in private equity is not coming from the traditional co-mingled vehicles but from separate accounts and side-by-side co-investments."); Arleen Jacobius, "Shadow Capital's Growth Could Change Private Equity, Real Estate," PENSIONS & INVESTMENTS (Aug. 4, 2014) ("Co-investing is a hot-button issue with the SEC. The SEC is examining private equity firms over possible inequities between limited partners and other investors."), *available at* http://www.pionline.com/article/20140804/PRINT/308049979/shadow-capitals-growth-could-change-private-equity-real-estate.

[107] I do not mean to say that the SEC has not been bringing enforcement actions against private equity managers. One prominent example includes an action against KKR for failing to allocate expenses appropriately to certain co-investment vehicles. *See* June 29, 2015 SEC Press Release, "SEC Charges KKR with Misallocating Broken Deal Expenses," *available at* http://www.sec.gov/news/pressrelease/2015-131.html. However, given the impressive scope and scale of the presence examination initiative undertaken by the SEC focused on the private equity industry, the overall amount of enforcement activity thus far has been relatively mild.

[108] *See* "Spreading Sunshine in Private Equity," *supra* note 31.

[109] *See, e.g.*, "Recent SEC Settlements Offer Glimpse Into Future of Private Equity Regulation," Nixon Peabody client memorandum (Nov. 17, 2015) ("The regulation of the private equity industry is still in its infancy, but SEC officials make clear that more investigations and charges are on the horizon."), *available at* http://www.nixonpeabody.com/key_takeaways_from_recent_SEC_settlements; Eileen Appelbaum, "Private Equity and the SEC After Dodd-Frank," Center for Economic and Policy Research (Jan. 2015) ("[N]o one is exercising the responsibility to protect the interests of current and future pension fund beneficiaries or insurance company annuitants. . . . The SEC will need to take strong enforcement action and require PE firms to admit wrongdoing and face the consequences so that investors' interests can be protected.").

resist the temptation to undermine these gains by over-regulating and over-restricting preferential treatment.

Of course, some of the distributional concerns discussed in Section II.C. are worthy of further consideration, and policymakers should continue to be vigilant about deterring fraudulent activity and other violations of managers' fiduciary duties under the Advisers Act. But regulating or otherwise limiting preferential treatment *for its own sake* would be a mistake—one that would destroy substantial sources of value that have recently been unlocked by individualized investing.

B. Side Effect of the Rise of Individualized Investing: Coordination Challenges

The most important policy lesson from this Article's analysis is one of regulatory restraint, as discussed above. However, as the shift toward individualized investing continues apace, a side effect raising a different set of policy questions emerges: the incentive for broad coordination among private equity investors will grow weaker as investor interests become more individualized.

As discussed in Section II.E., when all investors are in pooled funds, preferential treatment is much more difficult to mete out to investors. When preferential treatment is diminished, investors have a greater common incentive to coordinate with each other. Coordination can be used for many purposes—for instance, investors could coordinate to share information about trends and best practices in the industry, or, more aggressively, to form unified blocks to strengthen their negotiation positions.[110]

For decades, coordination among private equity investors has been accomplished primarily through a trade association called the Institutional Limited Partners Association, or "ILPA." ILPA was founded in the early 1990s as a small, informal networking club, and it has grown into an organization that includes over 300 members managing well over $1 trillion in private equity assets under management. ILPA's stated priorities include building best practice tools for use by institutional investors and utilizing a research and education platform to address issues that impact private equity.[111]

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[110] The more formal and binding this kind of coordination becomes, the greater the risk of running into antitrust concerns. A detailed review of antitrust considerations is beyond the scope of this Article; suffice it to say that a certain level of coordination has been observed in the industry through ILPA without rising to the level antitrust violations.

[111] *See* ILPA website, *available* at https://ilpa.org/about-ilpa/who-we-are/. The most visible fruit of ILPA has been the publication of a set of "principles" intended to provide a common set of terms that investors could use as the basis for negotiation with fund managers. The ILPA principles also included standardized templates for capital calls and distribution notices, as well as a set of reporting standards designed to enhance and improve investor reporting and transparency. The first version of the ILPA principles was released in 2009, and a revised version was released in 2011.

As individualized investing continues to grow, those investors who are investing more through separate accounts and co-investments will be less inclined to coordinate with other investors. As a result, it would not be surprising to see the influence of ILPA wane in coming years, or, at the very least, for ILPA to represent an increasingly narrow set of institutional investor interests.

Information disclosure is one area that could be affected by a decrease in coordination among investors. Many kinds of disclosure are most useful when they can be compared with the disclosures made by other managers. For example, an investor might think that returns of 20% from a fund might be outstanding, but she will be less impressed if she knows that other funds produced 40% returns at a lower level of risk over the same time period.

The surest way to make disclosures comparable is to require managers to release a standardized set of metrics and to follow a standardized process for calculating those metrics. Unfortunately, mandatory, standardized disclosure carries with it significant costs, including the costs of creating the standardized disclosure regime, the costs to managers of producing the required information, and the costs that arise when the disclosure regime is imperfect (i.e., the required metrics do not actually capture the information that investors will find most beneficial).

Determining whether the value of standardized disclosure will outweigh the costs is not a simple calculation. If all private equity investors were fully aligned and accustomed to operating as a unified whole, we might expect them to jointly determine when that point has arrived and coordinate to formulate a standardized disclosure regime and demand that managers follow that regime.[112] This could be accomplished by a trade association like ILPA. But when the interests of investors in the industry become individualized, this type of broad coordinated action becomes increasingly unlikely.

To be clear, my purpose is not to say that standardized disclosure would be good for private equity. Rather, I am simply acknowledging that the continued growth of individualized investing could make the private equity investor base less capable of coordinating (i) to determine whether the value of standardized

[112] Some scholarship suggests that certain private equity managers may be taking advantage of the lack of industry standardization by manipulating the performance metrics they disclose when raising new funds. *See, e.g.*, PRIVATE EQUITY: OPPORTUNITIES AND RISKS, EDS. BAKER, FILBECK & KIYMAZ (2015) ("[A] top-quartile fund belongs to the 25% best funds in its peer group. Yet, many more funds in the market claim top-quartile performance."); Harris, Jenkinson & Stucke, *Are Too Many Private Equity Funds Top Quartile?*, 24 J. OF APPLIED CORP. FIN. 77 (Fall 2012) ("A common practice is to identify funds whose performance is "top quartile" among the funds started in the same "vintage" year." . . . Unfortunately, however, lack of comprehensive data and industry standardization can lead to widely varying, confusing, and misleading conclusions as to who is really top quartile."); Asset Management: A Systematic Approach to Factor Investing 607 (2014) ("Unfortunately, in the Lake Wobegon world of PE, *everyone* is top quartile."); "Study: 77% of GPs could claim top quartile status," Private Equity Online (July 2009) ("The oft-repeated private equity quip that '75% of funds claim to be in the top quartile' may indeed be true."), *available at* http://peracs.com/report/PEO%20Top%20Quartile.pdf.

disclosure outweighs the costs, and (ii) to take action when that determination has been made.[113] This raises the question of whether there is a role for regulators to play in establishing mandatory disclosure standards for private equity.

This is a deep question—one that demands far more detailed treatment than I can provide in a few short pages here. The question bears similarities to the debate over mandatory disclosure in publicly-held companies, a classic topic in the securities literature.[114] Over eighty years ago, Congress made the determination that, unless compelled, companies were unlikely to provide a level of disclosure that was robust enough to satisfy investors' needs.[115] The result was the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, legislation that imposed a mandatory disclosure regime of remarkable scope and scale that has only grown in prominence and extended its reach over time. Inherent in the judgment to pass the securities laws was a determination that investors could not coordinate to demand the amount and manner of disclosure that they desired.

Unfortunately, if we are hoping to find clear guidance from the securities literature on the wisdom of mandatory disclosure, we will be disappointed. The debate over mandatory disclosure in the public securities context has raged for decades, with some scholars touting the advantages of mandatory disclosure[116] and others questioning the wisdom of such a regime.[117] Further scholarly work extending and applying this literature to the private equity industry would be valuable and timely.

CONCLUSION

The rise of individualized investing has dramatically increased the amount of preferential treatment in today's private equity industry. This Article makes the case that preferential treatment is overwhelmingly good for private equity investors—increasing the size of the overall pie without appropriating value from non-preferred investors. While individualized investing does make possible inequitable allocation, a form of preferential treatment where value is appropriated from non-preferred investors and given to preferred investors, this

[113] In 2015, the comptrollers and treasurers from a dozen pension funds wrote a letter to the SEC asking that the regulator force private equity managers to provide clearer and more consistent disclosure of fees and expenses. *See* Timothy W. Martin, "States, Cities to Ask SEC to Beef Up Disclosures for Private-Equity Firms," WALL ST. J. (July 21, 2015). The fact that these pension funds went to the SEC to ask for stronger disclosure requirements, rather than use ILPA to coordinate and demand better disclosure themselves, may call into question how effectively investors are able to coordinate in today's marketplace.

[114] *See supra* note 17 and accompanying text.

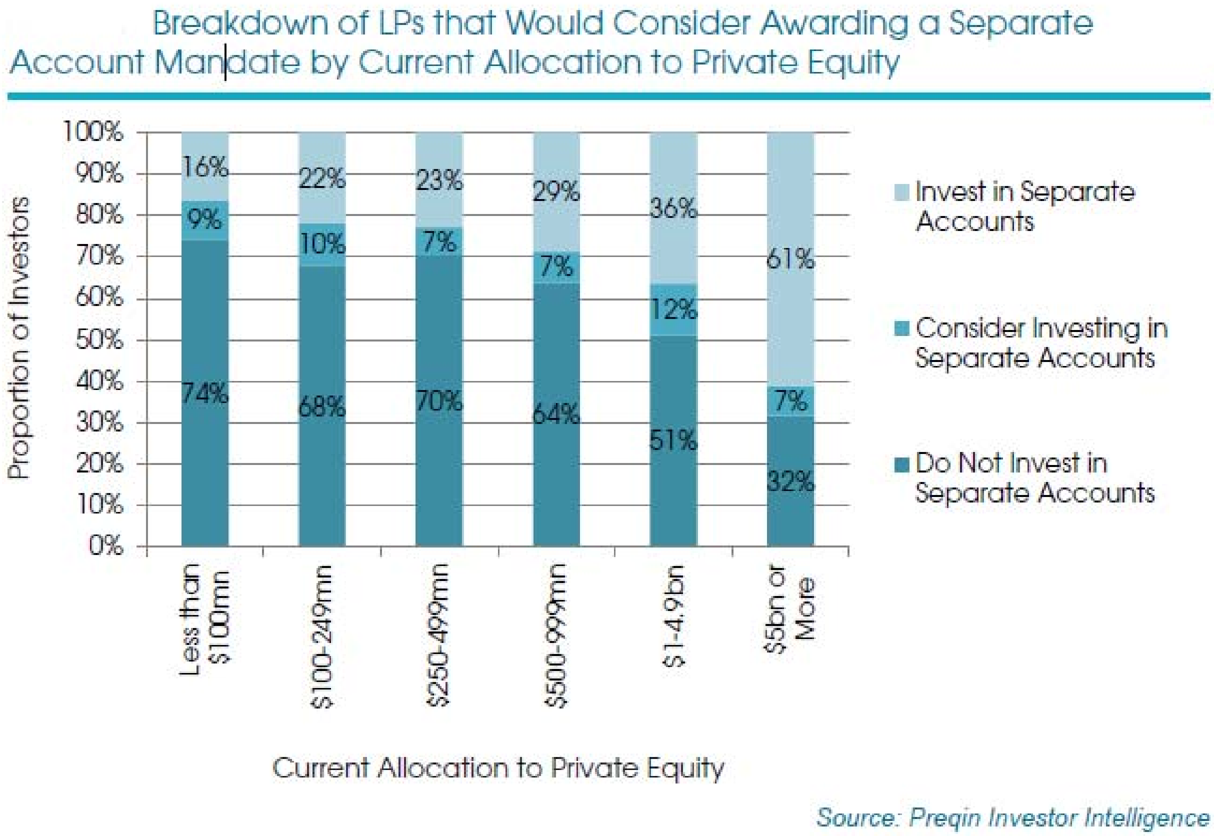
[115] *See* J. S. ELLENBERGER, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (2001).

[116] *See, e.g.*, Coffee, *supra* note 17; Ferrell, *supra* note 17; Fox, *supra* note 17; Kahan, *supra* note 17; Admati et al., *supra* note 17.

[117] *See, e.g.*, Romano, *supra* note 17; Macey, *supra* note 17; Choi & Guzman, *supra* note 17; Kripke, *supra* note 17.

kind of activity is unlikely to occur on a systematic or sustained basis thanks to investor exit rights and the importance of pooled fund track record. The need to regulate preferential treatment in private equity is thus quite limited. However, as the shift toward individualized investing continues apace, the potential for broad coordination among private equity investors will grow weaker as their interests become more individualized, making it more challenging for investors to advocate for industry-wide standards and best practices. Information disclosure is one example of an area where standardization can sometimes be beneficial, raising issues that resemble the classic debate in the securities literature over mandatory disclosure by public companies.

Appendix 1


Breakdown of LPs that Would Consider Awarding a Separate Account Mandate by Current Allocation to Private Equity
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
Invest in Separate Accounts
Consider Investing in Separate Accounts
Do Not Invest in Separate Accounts
Source: Preqin Investor Intelligence