

CLIENT MEMORANDUM

SEC Provides Guidance Regarding Knowledgeable Employees Investing in Private Funds

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In a long-anticipated letter, the SEC staff recently published important new guidance on the term “knowledgeable employee” as that term is used in Rule 3c-5 under the Investment Company Act of 1940 (the “1940 Act”). The term is integral to the exemptions on which hedge funds, private equity funds and other private funds typically rely from the 1940 Act’s definition of “investment company.” The letter, which responded to a request from the Managed Funds Association, the principal U.S. trade group representing the private fund industry, represents the first time in almost 15 years that the staff has publicly set out interpretations of the term and generally reflects an expansion of the concept of knowledgeable employee.¹

Background

Most private funds seek to operate outside the scope of the 1940 Act by relying on one of two exemptions from the Act’s definition of investment company, Section 3(c)(1) or 3(c)(7) of the 1940 Act.² Of particular importance to advisers

¹ See [Managed Funds Association, SEC No-Action Letter](#) (Feb. 6, 2014).

² Section 3(c)(1) generally exempts from the definition of investment company a fund that is beneficially owned by not more than 100 persons and that is not making and does not presently propose to make a public offering of those securities. Section 3(c)(7) generally exempts from

SEC Provides Guidance Regarding Knowledgeable Employees Investing in Private Funds

Continued

sponsoring funds relying on either Section 3(c)(1) or 3(c)(7) is the definition of knowledgeable employee, which is set out in Rule 3c-5. Under the rule, a knowledgeable employee is generally permitted: (1) to acquire interests in a fund that is relying on Section 3(c)(1) without being counted for purposes of the section's 100-person limit; and (2) to acquire an interest in a fund that is relying on Section 3(c)(7) without being a qualified purchaser for purposes of the section.

Rule 3c-5 generally defines a knowledgeable employee to include any natural person who is, among others: (1) an "executive officer" or person serving in a similar capacity of the private fund or an "affiliated management person," as defined in the rule, of a private fund relying on Section 3(c)(1) or 3(c)(7); or (2) an employee of such a private fund or affiliated management person (individually a "Covered Entity") who, in connection with his or her regular functions or duties, participates in the investment activities of a Covered Entity for at least 12 months. An "executive officer" is defined for purposes of the rule to include the president; any vice president in charge of a principal business unit, division or function; any other officer who performs a policy-making function; or any other person who performs similar policy-making functions for a Covered Entity.

The only prior guidance of consequence since Rule 3c-5's adoption in 1997 was the SEC staff's letter in 1999 to a subcommittee of the American Bar Association (the "1999 ABA Letter").³ In the 1999 ABA Letter, the staff, among other things, expressed a restrictive view of the rule as it relates to the level of participation in the private fund's investment process required of non-executive employees to be deemed knowledgeable under the rule. The SEC staff indicated that the rule is intended to encompass persons who *actively participate* in the management of the private fund's investments and is not intended to include employees who merely obtain information regarding the investment activities of the fund. The "actively participate" language has proved difficult to apply in assessing the status of individuals as knowledgeable employees.

Discussion

The Managed Funds Association Letter (the "MFA Letter") updates, and significantly broadens, the SEC staff's guidance included in the 1999 ABA Letter.

Employees participating in investment activities

The MFA Letter's most significant interpretation relates to employees deemed to be "actively participating" in the investment activities of a private fund. The staff confirmed that the 1999 ABA Letter was not intended to limit knowledgeable employees to those individuals charged with overall responsibility for the investment activity of the fund.

the definition of investment company a fund whose outstanding securities are owned exclusively by persons who, at the time of acquisition of the securities, are "qualified purchasers," and which fund is not making and does not at that time propose to make a public offering of the securities.

³ See [American Bar Association Section of Business Law, SEC No-Action Letter](#) (Apr. 22, 1999).

SEC Provides Guidance Regarding Knowledgeable Employees Investing in Private Funds

Continued

While re-confirming its position that the ultimate determination of knowledgeable employee status is a factual determination that must be made on a case-by-case basis, the staff expressed the view that each of the following individuals could be deemed to be a knowledgeable employee, so long as the employee has been engaged for at least 12 months in the activity described below:

- a member of the analytical or risk team who regularly develops models and systems to implement fund's trading strategies by translating quantitative signals into trade orders or providing analysis or advice that is material to the investment decisions of one of the fund's portfolio managers (in contrast to a person who merely writes the code to a program used by the portfolio manager);
- a trader who regularly is consulted for analysis or advice by a portfolio manager during the investment process and whose analysis or advice is material to the portfolio manager's investment decisions based on the trader's market knowledge and expertise (in contrast to a trader who simply executes investment decisions made by the portfolio manager);
- a tax professional who is regularly consulted for analysis or advice by a portfolio manager typically before the portfolio manager makes investment decisions and whose analysis or advice is material to the portfolio manager's investment decisions (in contrast to a tax professional who merely prepares tax filings for the fund); and
- an attorney who regularly analyzes legal terms and provisions of investments and whose analysis or advice is material to the portfolio manager's investment decisions (in contrast to an attorney who negotiates agreements that effectuate transactions evidencing the investment decisions of the portfolio manager or an attorney or compliance officer who evaluates whether an investment is permitted under a fund's governing documents).

The staff noted in this regard that the test in assessing whether an employee provides analysis or advice that is material to an investment decision is to ask whether a reasonable person would consider the analysis or advice to be important to the investment decision. According to the staff, the analysis or advice must generally be directed toward the buying, selling or holding of an investment; determining the eligibility of an investment is not enough to meet the test.

Principal business unit

As noted above, a knowledgeable employee includes an executive officer of a Covered Entity. Any vice president in charge of a principal business unit, division or function is an executive officer. In the MFA Letter, the staff articulated the view that whether a business unit, division or function qualifies as a principal business unit, division or function should be determined through an analysis of the relevant facts and circumstances regarding the investment manager's business operations and need not be part of the investment activities of the fund in order to be considered a principal business unit.

SEC Provides Guidance Regarding Knowledgeable Employees Investing in Private Funds

Continued

The staff confirmed specifically that an investment manager's investor relations department could be deemed to be a principal business unit when the manager "relies on investor relations personnel to conduct substantive portfolio reviews with investors and to respond to substantive due-diligence inquiries from institutional investors and consultants." An investor relations department that merely facilitates administrative exchanges between investment staff and investors would not be a principal business unit. The staff also indicated that the question of whether an investment manager's information technology department should be deemed a principal business unit would be analyzed in a manner similar to that used in analyzing an investor relations department.

Employees performing policy-making functions

The staff noted that "[t]he rule does not require policy-making individuals to have a specific title and includes all employees that have the power to make, and do make, policy" and "depending on the facts and circumstances, may still be considered an executive officer under the rule if he or she makes policy through day-to-day involvement in the development and adoption of an investment manager's policies." According to the staff, the policy-making function need not be concentrated in one individual and that employees serving as active members of a group or committee that develop and adopt an investment manager's policies could be executive officers under the rule, but merely observing committee proceedings or merely providing information or analysis to the decision makers of a committee or group, would not be engaging in making policy.

Services in connection with separate accounts

In the MFA letter, the SEC staff effectively expanded the types of clients an individual can serve in coming within the category of a knowledgeable employee. By its terms, Rule 3c-5 limits an affiliated management person to an "affiliated person," as defined in the 1940 Act, who manages the investment activities of the private fund. In the MFA Letter, the staff took the position that an employee of an affiliated management person can be deemed a knowledgeable employee when the employee participates in the investment activities of a separate account (or a portfolio of a portion of a separate account) maintained on behalf of a client of an affiliated management person that is (1) a "qualified client" within the meaning of Rule 205-3 under the Investment Advisers Act of 1940 or is otherwise eligible to invest in private funds advised by the affiliated management person; and (2) whose account (or portfolio or portion of account) pursues investment objectives and strategies that are substantially similar to those pursued by one or more of those private funds.

Employees of related advisers in control relationships

The last of the staff's positions articulated in the MFA Letter also expands the concept of knowledgeable employee. The staff in particular said that, if a "filing adviser" and its "relying adviser(s)," as those terms are used in the staff's January 18, 2012 letter addressed to the American Bar Association's Section of Business Law,⁴ collectively conduct a single advisory

⁴ See [American Bar Association Section of Business Law, SEC No-Action Letter](#) (Jan. 18, 2012).

SEC Provides Guidance Regarding Knowledgeable Employees Investing in Private Funds

Continued

business as described in that letter, then each of the filing adviser and relying adviser(s) may be deemed an affiliated management person of a Covered Entity. Under the staff's position, a knowledgeable employee of a filing adviser or any of its relying advisers may be treated as a knowledgeable employee with respect to the private fund managed by the filing adviser or its relying advisers, as long as the employee meets the other conditions of the rule.

Practical Consequences

The SEC staff's new guidance broadens the scope of persons that may be considered knowledgeable employees and should provide advisers to private funds with a higher level of certainty in making determinations. The staff's broader interpretation was supplemented by the staff's making clear that an adviser also needs to maintain sufficient books and records with written documentation that details the admittance of any employee as a fund investor and the theory under which the employee qualified as a knowledgeable employee, if admitted as one.

If you have any questions concerning the matters described in this memorandum, please contact Barry P. Barbash (202-303-1201, bbarbash@willkie.com), Martin R. Miller (212-728-8690, mmiller@willkie.com), James G. Silk (202-303-1275, jsilk@willkie.com), Timothy A. Kahn (202-303-1133, tkahn@willkie.com) or the Willkie attorney with whom you regularly work.

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