SEC Staff Guidance on "Knowledgeable Employee" Investment Company Act Rule

A "knowledgeable employee" as defined in Investment Company Act Rule 3c-5 is permitted to invest in a private investment company without tainting that company's ability to rely on a statutory exemption from registration with the Securities and Exchange Commission ("SEC"). In a letter dated February 6, 2014, the SEC Staff issued interpretive guidance as to the application of Rule 3c-5.[1]

Background

The Investment Company Act of 1940, as amended ("ICA"), includes two alternative exemptive provisions that permit private investment companies to avoid registration with the SEC under the ICA. Section 3(c)(1) affords an exemption to entities whose securities are beneficially owned by not more than 100 persons; and Section 3(c)(7) affords an exemption to entities whose securities are owned exclusively by "qualified purchasers." [2,3] Private equity funds and hedge funds are examples of the sorts of entities that rely on these exemptive provisions.

ICA Rule 3c-5 permits "knowledgeable employees," as defined in the rule, to invest in such private investment companies ("Covered Funds") without being counted for purposes of the 100 security holder limit (in the case of a Section 3(c)(1) company), or without having to be a "qualified purchaser" (in the case of a Section 3(c)(7) company). The Staff has previously stated that "Rule 3c-5 is premised on the belief that certain persons, because of their financial knowledge and sophistication and their relationship with a Covered Fund, do not need the protection of the [ICA]."[4]

SEC Guidance

While Rule 3c-5 has been in place since 1997 and the SEC has issued interpretations of the rule over the years, the MFA was of the view that there was sufficient uncertainty as to how the rule should be applied as to warrant further guidance from the Staff. In response to the request for such guidance, the Staff issued its letter. The underlying theme of the Staff's guidance is that the application of Rule 3c-5 calls for an analysis of the facts and circumstances in each case noting that in applying the rule "[i]nvestment managers will be required to make determinations as to which of their employees qualify as knowledgeable employees under the rule based on the facts and circumstances relevant to their business." Set forth below are digests of the Staff's responses to specific scenarios about which the MFA sought guidance.

Executive officer and policy-making employees

Rule 3c-5(a)(4)(i) defines the first category of knowledgeable employee of a Covered Fund as any natural person who is an "Executive Officer, director, trustee, general partner, advisory board member, or person serving

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[1] The Staff's letter was in response to a request for such guidance made by the Managed Funds Association ("MFA") and is available along with the MFA request at http://www.sec.gov/divisions/investment/noaction/2014/managed-funds-association-020614.htm.

[2] Qualified purchaser" is defined in Section 2(a)(51) of the ICA.

[3] To qualify for either exemption a company must also not make or propose to make a public offering of its securities. Thus entities relying on Section 3(c)(1) or Section 3(c)(7) only offer and sell their securities in offerings exempt from registration under the Securities Act of 1933.

[4] SEC Staff citing *PPM America Special Investments CBO II, L.P.*, SEC No-Action Letter (pub. avail. April 16, 1998) and *American Bar Association Section of Business Law*, SEC No-Action Letter (Apr. 22, 1999).

in a similar capacity" of a Covered Fund or an Affiliated Management Person[5] of a Covered Fund. Rule 3c-5(a)(3) defines the term "Executive Officer" as the "president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions" for a Covered Fund or for the Affiliated Management Person of a Covered Fund.

Principal business unit. The SEC Staff expressed 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 by the investment manager of the relevant facts and circumstances regarding the investment manager's business operations. While not all business units, divisions, or functions are necessarily principal, it is possible that several business units, divisions, or functions could each be a principal unit, division, or function depending on the facts and circumstances. Moreover, a business unit, division, or function need not be part of the investment activities of a Covered Fund in order to be considered principal, nor is the size of the investment manager or a particular department determinative as to whether a function should be considered principal.

As an example an investment manager that (i) employs one or more technologically driven trading models, whose information technology ("IT") professionals are charged with building the models and systems that translate certain quantitative signals into trade orders, or (ii) employs technology professionals to build performance and risk monitoring systems that interact with the investment program, could deem such an IT department as a principal unit.

As another example, an investor relations department could be a principal business unit at an investment manager that 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. However, an investor relations function would not have principal status where the department merely assisted in arranging meetings between an investment manager's investment staff and prospective investors, disseminated investor communications written by senior executives outside of the investor-relations department, or performed other relatively administrative tasks.

Employees who make policy

The definition of "executive officer" in the rule encompasses any officer who performs a policy-making function or any other person who performs similar policy-making functions on behalf of an investment manager. The 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 on behalf of the investment manager, Covered Fund, or an Affiliated Management Person of the Covered Fund. Accordingly, the Staff was of the view that an employee who does not have a senior manager title, 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. Further, the Staff stated that the rule does not require that the policy-making function 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, such as the valuation committee, could be executive officers under the rule.

However, the Staff does not believe that individuals who merely observe committee proceedings or merely provide information or analysis to the decision-makers of a committee or group would be engaged in making policy and, therefore, such individuals generally would not be executive officers under the rule.

[5] An Affiliated Management Person is defined as an affiliated person that manages the investment activities of a Covered Fund. Rule 3c-5(a)(1)

Employee who participates in the investment activities of a Covered Fund

Rule 3c-5(a)(4)(ii) defines the second category of knowledgeable employee as any employee of a Covered Fund or the Affiliated Management Person of such Covered Fund who, in connection with his or her regular function or duties, participates in the investment activities of such Covered Fund, other Covered Funds, or investment companies the investment activities of which are managed by such Affiliated Management Person of the Covered Fund, provided that such employee has been performing such functions and duties for or on behalf of the Covered Fund or the Affiliated Management Person of the Covered Fund, or substantially similar functions or duties for or on behalf of another company, for at least 12 months ("Participating Employee").

Employees who participate in investment activities. The Staff stated that a research analyst who researches only a portion of the portfolio of a Covered Fund and provides analysis or advice to the portfolio manager with respect to such portion of the Covered Fund's portfolio is participating in the investment activities of the Covered Fund for purposes of the rule. Accordingly, the Staff believes that such a research analyst could be a knowledgeable employee under rule 3c-5(a)(4)(ii).

The Staff confirmed that prior guidance issued[6] was not intended to limit Participating Employees to those individuals charged with overall responsibility for the investment activity of a Covered Fund and that other non-executive employees could be considered Participating Employees if they regularly participate in the management of a Covered Fund's investments (or a portion thereof). While the ultimate determination of whether an individual participates in the investment decisions of a Covered Fund is a factual determination that must be made on a case-by-case basis, the Staff believes that individuals performing the following functions could be considered Participating Employees if they regularly perform such functions or duties and have been doing so for at least 12 months:

- a member of the analytical or risk team who regularly develops models and systems to implement the Covered Fund's trading strategies by translating quantitative signals into trade orders or providing analysis or advice that is material to the investment decisions of a portfolio manager (in contrast to someone 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 that 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, such as when a tax professional's analysis of whether income from an offshore fund's investment may be considered "effectively connected income" is material to a portfolio manager's decision to invest in certain debt instruments (in contrast to a tax professional who merely prepares the tax filings for the Covered Fund); and

[6] SEC Staff citing *American Bar Association Section of Business Law*, SEC No-Action Letter (Apr. 22, 1999) and *Privately Offered Investment Companies*, Investment Company Act Release No. 22597 (April 3, 1997) at text accompanying footnote 124.

- 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, such as where the attorney's legal analysis of tranches of a distressed debt investment is material to a portfolio manager's decision to invest in the loan (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 Covered Fund's governing documents).

Treatment of separate accounts. Rule 3c-5(a)(4)(ii) includes certain employees who participate in the investment activity of not only the Covered Fund, but also other Covered Funds, or investment companies managed by an Affiliated Management Person of the Covered Fund. As Rule 3c-5 is premised on the belief that certain persons, because of their financial knowledge and sophistication and their relationship with a Covered Fund, do not need the protection of the ICA, the Staff recognized that an employee of an Affiliated Management Person who participates in the activities of Covered Separate Accounts,[7] or a portfolio (or portion thereof) of such a Covered Separate Account, is also likely to be as financially knowledgeable and sophisticated as an employee who participates in the investment activities of a Covered Fund or investment company. Accordingly, the Staff took the position that it would not recommend enforcement action to the SEC under Section 7 of the ICA against a Covered Fund if it treated an employee as a knowledgeable employee under Rule 3(c)-5(a)(4)(ii), notwithstanding the fact that the employee participates in the investment activities of Covered Separate Accounts or a portfolio (or portion thereof) of a Covered Separate Account, rather than in the investment activities of a Covered Fund or an investment company.

Employees of related advisers in control relationships. The Staff accepted arguments made by the MFA that if a filing adviser and its relying adviser(s) collectively conduct a single advisory business as described in a letter issued by the Staff in 2012,[8] then each of the filing adviser and relying adviser(s) may be an Affiliated Management Person of a Covered Fund. The Staff stated that an employee of affiliated advisers that are deemed to conduct a single advisory business, under the terms of the prior guidance cited, would generally have significant access to information about the Covered Funds managed by the other affiliated advisers within the single advisory business. As a result, knowledgeable employees of a filing adviser or any of its relying advisers may be treated as a knowledgeable employee with respect to any Covered Fund managed by the filing adviser or its relying advisers, provided that the employees meet the other conditions of the rule.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com.

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[7] The SEC Staff used this term to mean separate accounts, or a portfolio (or portion thereof) of a separate account, for clients that are "qualified clients" and are otherwise eligible to invest in the private funds advised by an Affiliated Management Person and whose accounts pursue investment objectives and strategies that are substantially similar to those pursued by one or more of those private funds. The term "qualified client" is defined in Rule 205-3(d)(1) under the Investment Advisers Act of 1940, as amended.

[8] SEC Staff citing *American Bar Association Section of Business Law*, SEC No-Action Letter (Jan. 18, 2012). In this letter, the Staff established criteria pursuant to which a "filing adviser" could file a single Form ADV on behalf of itself and "relying advisers" that are affiliated with the filing adviser as part of a single advisory business.