

# CLIENT UPDATE

## ARE YOUR EMPLOYEES NOW “KNOWLEDGEABLE”? NEW SEC GUIDANCE FOR PRIVATE FUND MANAGERS

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On February 6, 2014, the staff of the Division of Investment Management of the Securities and Exchange Commission (the “SEC Staff”) issued an interpretative letter to the Managed Funds Association (the “MFA Letter”), which provided updated guidance on the types of employees who can be treated as “Knowledgeable Employees” for purposes of the private fund provisions of the U.S. Investment Company Act of 1940 (the “Investment Company Act”). The new guidance addresses many of the constraints imposed by the SEC Staff’s 1999 letter to the American Bar Association (the “1999 ABA Letter”)<sup>1</sup> and provides private fund managers significantly more flexibility in categorizing employees as Knowledgeable Employees. As a result, private fund managers may be in a position to permit more employees to invest in their firms’ private funds. Private fund managers should review their current policies and procedures relating to identifying Knowledgeable Employees in light of this guidance.

### BACKGROUND

Rule 3c-5 of the Investment Company Act (the “Rule”) provides that a Knowledgeable Employee of a private fund that relies on either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act (together, “Covered Funds”) does not count toward the 100 beneficial

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<sup>1</sup> American Bar Association, SEC No-Action Letter (Apr. 22, 1999).

owner limit in Section 3(c)(1) and is not required to be a “qualified purchaser” for purposes of Section 3(c)(7). The same treatment is afforded to a Knowledgeable Employee of the manager of the Covered Fund (an “Affiliated Management Person”). An employee of a Covered Fund or Affiliated Management Person is considered a Knowledgeable Employee if the individual either (i) is an executive officer or person serving in a similar capacity of the Covered Fund or Affiliated Management Person (an “Executive Officer”); or (ii) participates in the investment activities of the Covered Fund or Affiliated Management Person in connection with his or her regular functions or duties, *provided* that such employee has been performing such functions or duties for the Covered Fund or Affiliated Management Person for at least 12 months (a “Participating Employee”).

### **EXECUTIVE OFFICERS, PRINCIPAL BUSINESS UNITS AND POLICY-MAKING FUNCTIONS**

Rule 3c-5 defines an “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 an Affiliated Management Person. The MFA Letter provides additional clarification as to what functions may constitute a “principal business unit” and the circumstances under which an employee may be viewed as performing a policy-making function, particularly where the employee is acting as a member of a policy-making group or committee.

The MFA Letter confirms that the determination of whether a business unit, division or function qualifies as a principal business unit should be based on an analysis of the relevant facts and circumstances regarding the investment manager’s business operations. The SEC Staff confirmed that (i) a business unit is not required to be part of the investment activities of a Covered Fund in order to be a “principal” business unit; (ii) a firm may have more than one principal business unit; and (iii) the size of the investment manager or business unit is not determinative as to whether a business unit is considered a principal business unit. The MFA Letter provides two examples of business functions that might be viewed as principal business units:

- An information technology department may be a principal business unit if it builds the systems underlying quantitative trading models or performance and risk-monitoring systems that interact with the investment program.
- An investor relations department could be a principal business unit if, for example, the investor relations personnel conduct substantive portfolio reviews with investors and respond to substantive due diligence inquiries. However, an investor relations department might not be viewed as a principal business unit if it merely arranges

investor meetings, disseminates investor communications and performs other administrative tasks.

Perhaps of greater significance, the MFA Letter confirms that a person's status as an Executive Officer does not turn on the person's title or whether the person is in charge of a business unit. Rather, a person who is not in charge of a principal business unit may be considered an Executive Officer if he or she performs a policy-making function through day-to-day involvement in the development and adoption of an investment manager's policies.

In addition, the MFA Letter clarifies that an employee may be involved in a policy-making function either in an individual capacity or as part of a group or committee that performs such functions. For example, each member of a firm's valuation committee may be viewed as being involved in a policy-making function. However, the person's involvement in the committee must be substantive; the SEC Staff does not believe that individuals who merely observe committee proceedings or merely provide information or analysis to the decision makers of a committee would be engaged in making policy and, therefore, such individuals generally would not be Executive Officers under the rule.

## **PARTICIPATION IN INVESTMENT ACTIVITIES**

In the 1999 ABA Letter, the SEC Staff appeared to be skeptical whether certain categories of professionals could be Knowledgeable Employees — focusing, in particular, on marketing and investor relations professionals, brokers and traders, attorneys and financial, compliance, operational and accounting personnel. The SEC Staff suggested that such employees would not have sufficient participation in the investment activities of a Covered Fund to be considered Participating Employees.

The MFA Letter takes a more nuanced approach to this question and emphasizes that any employee who regularly participates in the investment activities of a Covered Fund may be a Participating Employee. In particular, the MFA Letter suggests that, depending on the facts and circumstances, the following persons could be considered Participating Employees if their input is material to the portfolio manager's investment decisions:

- 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 that portion of the Covered Fund's portfolio (the 1999 ABA Letter suggested that an analyst would have to research and provide recommendations to the portfolio manager with respect to all potential portfolio investments in order to be a Knowledgeable Employee);

- A member of the analytical or risk team who regularly develops models and systems that implement the Covered Fund’s trading strategies by translating quantitative signals into trade orders (in contrast to a person who only writes the code of the program);
- A trader who is regularly consulted for analysis or advice relating to his or her market knowledge and expertise by a portfolio manager during the investment process (in contrast to a trader who only executes the investment decisions made by the portfolio manager);
- A tax professional who is regularly consulted for analysis by a portfolio manager before the manager makes investment decisions (in contrast to a tax professional who only prepares the tax filings); and
- An attorney who regularly analyzes legal terms and provisions of potential investments (in contrast to an attorney who only negotiates the agreements that effectuate the investment decisions or an attorney or compliance officer who evaluates whether the investment is permitted under the governing documents of the fund).

In addition, the MFA Letter confirms that an employee of an Affiliated Management Person of a Covered Fund who participates in the investment activities of other investment vehicles that are similar to the Covered Fund (but not the Covered Fund itself) may be a Knowledgeable Employee of the Covered Fund. Previously, the SEC Staff had confirmed that employees involved in the investment activities of investment companies, brokers, market makers, swap dealers, banks, insurance companies and certain pension plans could be Knowledgeable Employees. The MFA Letter extends this approach to employees of Affiliated Management Persons who participate in the investment activities of separate accounts that (i) are established for investors who are “qualified clients” (as defined under the Advisers Act) or who are otherwise eligible to invest in the private funds advised by the sponsor and (ii) pursue investment objectives and strategies that are substantially similar to those pursued by one or more of those private funds.

Finally, the SEC Staff also updated its view that an entity under common control with an Affiliated Management Person could also be deemed to be an Affiliated Management Person (thus allowing its employees to be treated as Knowledgeable Employees of the Covered Fund). Subsequent to setting forth these views, the SEC Staff permitted certain affiliated investment advisers (“relying advisers”) of a registered investment adviser (a “filing adviser”) to be registered with the SEC on the same Form ADV as the filing adviser. The MFA Letter confirms that Knowledgeable Employees of a filing adviser or any of its relying advisers may be treated as Knowledgeable Employees with respect to any Covered Fund managed by the filing adviser or its relying advisers.

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The guidance provided by the MFA Letter is a welcome development. It is also important to note that the guidance is not rigid; the SEC Staff emphasized that “[b]ased on the facts and circumstances relevant to a particular investment manager, other employees may qualify as knowledgeable employees” and that the SEC Staff did not express a view on the status of those employees not covered by the MFA Letter. The SEC Staff also suggested that investment managers should maintain in their books and records a written record of employees that the investment manager has permitted to invest in a Covered Fund as Knowledgeable Employees and should be able to explain the basis pursuant to which the employees qualify as Knowledgeable Employees. Private fund managers should update their compliance policies to reflect this suggestion.

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Please do not hesitate to contact us with any questions.

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