

US Securities and Exchange Commission Clarifies and Expands Its Interpretation of “Knowledgeable Employee” Under the US Investment Company Act

By J. Paul Forrester, Stephanie M. Monaco¹

On February 6, 2014, the Staff of the Division of Investment Management of the Securities and Exchange Commission (“SEC”) issued the Managed Funds Association (the “MFA”) a no-action letter (the “MFA Letter”) clarifying and expanding the SEC’s interpretation of the defined term “Knowledgeable Employee” in Rule 3c-5 under the Investment Company Act of 1940 (as amended, the “Investment Company Act”).

Many hedge funds, private equity funds, and other types of pooled investment vehicles rely on exclusions from the definition of “investment company” provided under Sections 3(c)(1) or 3(c)(7) (each, a “Covered Fund”) of the Investment Company Act. Rule 3c-5 under the Investment Company Act permits a knowledgeable employee of such Covered Funds, and a knowledgeable employee of certain Affiliated Management Persons,² to invest in a Covered Fund that relies on Section 3(c)(1) without being counted toward the 100-person limit imposed upon a Section 3(c)(1) fund. The rule also permits such employees to invest in a Covered Fund that relies on Section 3(c)(7) without having to be a qualified purchaser with respect to a Section 3(c)(7) Fund and without being counted for purposes of determining whether a Section 3(c)(7) fund is owned exclusively by qualified purchasers.

Rule 3c-5 defines the term “knowledgeable employee” to include two categories:

- “Executive officers,” which term includes the “president, any vice president in charge of a principal business unit, division or function (such as sales, administration, or finance), and other officers who performs a policy making function, or any person who performs similar policy making functions” for a Covered Fund or an Affiliated Management Person of the Covered Fund; and
- Non-executive employees (other than those performing solely clerical, secretarial or administrative functions) who regularly participate in the investment activities of a Covered Fund or an Affiliated Management Person of a Covered Fund, provided such employee has been performing such functions and duties on behalf of the Covered Fund or Affiliated Management Person or substantially similar functions or duties for or on behalf of another company for least 12 months.

Principal Business Units

In respect of whether an activity or function rises to the level of principal status, the SEC Staff confirmed its view that:

- The principal status of an adviser’s unit, division, or function depends on the relevant facts and circumstances of a particular investment manager’s business operations;

- Several business units, divisions, or functions within an adviser may each be considered a principal unit, division, or function; and
- The unit, division, or function of an adviser need not be part of the investment activities of a Covered Fund to be considered a principal unit, division, or function.

While the Staff's confirmation of these considerations is helpful, perhaps more notable is the Staff's stated belief that Rule 3c-5 is intended to provide "flexibility in determining whether an individual is in charge of a principal business unit, division, or function." In its request letter, the MFA suggested that activities could be "principal" if they were "high value" and integral to the investment manager's operations. Certain examples were provided by the MFA in respect of certain information technology ("IT") and investor relations functions, including, in the case of IT professionals, professionals (i) charged with building models and systems that translate into certain quantitative trade orders and (ii) who build performance and risk monitoring systems that interact with the investment program.

An investor relations function could be a principal unit if investor relations personnel conduct substantive portfolio reviews with investors and respond to substantive due diligence inquiries. The Staff agreed that such functions could be determined to be "principal," while reiterating the fairly direct and critical ties to the investment manager's investment program and investor due diligence, as opposed to inconsequential assistance.

The Staff's guidance also seems to provide that the heads of certain functions may qualify as knowledgeable employees in addition to the heads of the business units in which they report. For instance, if IT reports to operations, and investor relations to the sales department, the heads of IT and investor relations may potentially qualify as knowledgeable employees in addition to an investment manager's chief operating officer and director of sales and marketing.

Further, the flexibility shown by the Staff, together with a framework for arguing that other functions may be integrally involved with the investment program, may prove particularly beneficial for smaller, flatter organizations where a certain individual may supervise few, if any, others, or may be the only individual (and, by default, the executive officer) leading such function. It is important to emphasize, however, that merely acting in such capacities alone will not make an individual a "knowledgeable employee." The Staff indicated that such individuals "could" be determined to be knowledgeable employees, which is intended to emphasize that status alone will not make an individual a knowledgeable employee. A separate and independent determination is required to be made that such persons generally have such financial knowledge and sophistication and sufficient access to information about the Covered Fund in question in order to understand the strategy and risks inherent in such investments. As noted by the SEC Staff, an investment manager should be able to explain "the basis in [Rule 3c-5] pursuant to which the employee qualifies as a knowledgeable employee."

Policy-Making Functions

With regard to policymaking functions, the MFA Letter essentially provides clarity around a "function over title" approach: regardless of their titles, employees can have a policy-making function and can meet the relevant standard either individually or as part of a committee or group. The MFA Letter clarifies that an employee need not even be an "officer" per se, and that policy-making may be viewed broadly, and can include active members of a group or committee that develops and adopts a manager's policies, such as a valuation committee. Such logic arguably might be extended to active members of other committees, including best execution, risk, operating and other committees that make policies on behalf of the investment manager, which may potentially significantly increasing the pool of potential knowledgeable employees.

Participation in Investment Activities

The MFA Letter significantly expands the SEC Staff's guidance set forth in the 1999 no-action letter addressed to the American Bar Association (the "ABA Letter"). In the ABA Letter, the SEC stated that Rule 3c-5 is intended to cover non-executive employees only if they actively participate in the investment activities of the Covered Fund and certain other investment companies. The SEC further stated that the rule is intended to encompass persons who actively participate in the management of a fund's investments, and not employees who merely obtain information regarding the investment activities of these funds.

The Staff noted that analysts, who research all potential portfolio investments and provide recommendations to the portfolio manager, could be determined to be knowledgeable employees. The Staff also noted that non-executive marketing and investor relations professionals, attorneys (even those who provide advice with respect to, or who participate in, the preparation of offering documents and the negotiation of related agreements), certain brokers and traders affiliated with the Covered Fund or an Affiliated Management Person, and financial, compliance, operational and accounting officers of a fund (including those who have management responsibilities for compliance, accounting and auditing functions of funds) would not qualify as knowledgeable employees under Rule 3c-5.

The MFA Letter makes clear that research analysts may qualify as knowledgeable employees, even if they provide analysis or advice to a portfolio manager with respect to only a portion of a Covered Fund's portfolio (as opposed to the entire portfolio, which was suggested in the ABA Letter) and, importantly, that certain non-investment, non-executive personnel may qualify as knowledgeable employees if they regularly participate in the management of a Covered Fund's portfolio (or a portion thereof).

While the ultimate determination is based on facts and circumstances, and must be made on a case-by-case basis, the SEC Staff noted explicitly that the

following non-investment personnel may be knowledgeable employees:

- A member of the analytical or risk team who regularly develops models and systems to implement a 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 manager³ (in contrast to someone who merely writes the code to a program used by the portfolio manager);
- A trader who is regularly 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, 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
- 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

The MFA Letter also provides that an employee can be regarded as participating in the investment activities of a Covered Fund if his or her functions relate to a portfolio, or portion of a portfolio, of a separate account for clients that are “qualified clients” and are otherwise eligible to invest in the private funds managed by the adviser and whose accounts pursue investment objectives and strategies that are substantially similar to those pursued by one or more of those private funds.

Employees of Relying Advisers in Control Relationships

The MFA Letter provides that knowledgeable employees of a filing adviser, or any of its relying advisers (as set out in the ABA’s 2012 no-action letter regarding which adviser entities have to file a Form ADV), 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.

Other Employees

The SEC Staff emphasized that employees of an adviser other than those described in the MFA Letter may also qualify as knowledgeable employees for purposes of Rule 3c–5 depending on the relevant facts and circumstances relevant to an investment manager’s particular business.

Endnotes

- ¹ Paul Forrester is a respected corporate finance and securities lawyer whose practice is especially focused on structured credit, including collateralized loan obligations, energy (including oil and gas, utilities, shipping, refinery and pipeline) financings and project development, and financing (especially concerning renewable energy, industrial, petrochemical, power and transportation projects and infrastructure). Stephanie Monaco is a member of the Corporate & Securities practice.
- ² The term “Affiliated Management Person” is defined in Rule 3c–5 to mean an affiliated person that manages the investment activities of a fund relying on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act. The SEC Staff has also permitted Section 3(c)(1) and Section 3(c)(7) funds to treat employees who

participate in the investment activities of a company that is excluded from the definition of investment company by Section 3(c)(2), 3(c)(3) or 3(c)(11) as a knowledgeable employee. See PPM America Special Investments CBO II, L.P. SEC No-Action Letter (pub. Avail. April 16, 1998) and the ABA Letter.

- ³ Whether an individual provides analysis or advice that is material to the investment decisions of a portfolio manager is a facts-and-circumstances determination based on whether a reasonable person would consider such analysis or advice to be important to the investment decision. See *TSC Industries, Inc. v. Northway, Inc.*, 426 US 438 (1976). Generally, however, the analysis or advice must be material to the merits of buying, selling, or holding an investment. The SEC Staff does not believe that reviews, analysis or advice as to whether a potential investment is merely eligible for investment by the Covered Fund would be material to the investment decisions of a portfolio manager.

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