

Client Alert

SEC Expands Class of Knowledgeable Employees Eligible to Invest in Private Funds

February 21, 2014. Managers of hedge funds and private equity funds may accept investments from an expanded array of key employees without risking their regulatory exemption from registration under the Investment Company Act of 1940, following guidance issued earlier this month by the U.S. Securities and Exchange Commission.

The guidance responded to an inquiry from The Managed Funds Association seeking clarification on who may be considered a “knowledgeable employee”, since such a person is not counted towards the 100-investor limit imposed on funds that rely on the registration exemption under Section 3(c)(1) of the Investment Company Act, and may invest in a fund whose investors are limited to “qualified purchasers” under Section 3(c)(7) of the Act, even if the employee doesn’t otherwise meet that definition.

The guidance addressed two prongs of the definition of “knowledgeable employee.” The first prong, embodied in Rule 3c-5(a)(4)(i), includes a natural person who is 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 the fund.

Without changing the basic principle that identifying a principal business unit requires a fact-specific analysis, the new guidance expressly stated that a fund manager may have more than one “principal business unit,” including a division not directly involved in rendering investment advice. Under appropriate circumstances, the Commission said, a fund manager’s information technology or investor relations department could meet the definition, giving as an example the IT department of a fund focusing on algorithmic trading. Consequently, the heads of those departments would qualify to invest in the fund.

Furthermore, the Commission articulated that policy-making employees need not have a specific title or be formally identified as officers in order to be considered "knowledgeable employees." Instead, the SEC explained, the employee may still be covered by the rule if he or she "makes policy through day-to-day involvement in the development and adoption of an investment manager's policies", even if such activities are shared with others, such as members of the fund manager's valuation committee.

The second prong of the "knowledgeable employee" definition, embodied in Rule 3c-5(a)(4)(ii), focuses on employees who have been involved in investment activities for the fund and its affiliates for at least 12 months.

In the new guidance, the SEC, while again confirming the fact-specific analysis needed to be performed for any particular individual, concluded that research analysts who cover a portion, but not all, of a fund's portfolio could qualify as knowledgeable employees, even if they did not have investment discretion. The Commission also agreed that persons whose job description did not directly involve investments, such as tax, legal, risk management and trading professionals, may qualify as knowledgeable employees. Examples given by the Commission included:

- a member of the analytical or risk team who regularly develops models and systems to implement the 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 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, 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 fund's governing documents).

The Commission also extended its guidance to employees of affiliates who manage separate accounts with substantially similar strategies to the funds, as well as to employees of affiliated investment advisers who are part of a single advisory business.

For more information concerning this development, and to discuss any other fund formation-related matters, please do not hesitate to contact either of the Morrison Cohen attorneys named below, or your usual Morrison Cohen attorney contact.

David Lerner
212-735-8609
dlerner@morrisoncohen.com

Jessica Levin
212-735-8753
jlevin@morrisoncohen.com