

Private Equity Alert

SEC Issues Guidance Expanding the Scope of Knowledgeable Employee Standard

By Venera Ziegler

On February 6, 2014, the Division of Investment Management of the Securities and Exchange Commission (the SEC) released guidance¹ expanding the categories of individuals who may be deemed “knowledgeable employees” under Rule 3c-5 of the Investment Company Act of 1940 and therefore who may invest in private funds without meeting the qualified purchaser² standard to include individuals such as investor relations employees or policy-making employees who do not actively manage the fund itself.

In a letter to the Managed Funds Association, the SEC stated that depending on the particular facts and circumstances of an investment adviser’s business operations and regardless of the size of the investment adviser, the following types of individuals may be regarded as knowledgeable employees:

- Heads of business units, such as the information technology or investor relations departments. Rule 3c-5(a)(3) requires a business unit, division, or function to be “principal” in order for the head of such unit to qualify as a knowledgeable employee. The SEC stated that (i) the principal status of an adviser’s business unit, division, or function depends on the relevant facts and circumstances of a particular investment adviser’s business operations, (ii) several business units, divisions, or functions within an investment adviser may each be considered a principal unit, division, or function, and (iii) the business unit, division, or function need not be part of the investment activities of a private fund to be considered a principal unit, division, or function. The SEC confirmed that an investor relations function could be a principal function if it was involved with substantive portfolio reviews and due diligence responses, but it would not have a principal status where the department merely assisted in facilitating meetings with investors or disseminated investor communications or performed other administrative tasks.
- Employees involved in the day-to-day development and adoption of an adviser’s policies. The SEC stated that the rule does not require policy-making individuals to have a specific title and includes all employees that have the power to make, and who do make, policies on behalf of the investment adviser, any of the funds managed by the investment adviser or an affiliated adviser. Employees can meet the relevant standard either individually or as part of a committee or group. Individuals, however, who

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merely provide information or analysis to the decision-makers of a committee or a group, would not be engaged in making policies, and therefore would not be considered knowledgeable employees.

- A research analyst who researches only a portion of a fund's portfolio and provides analysis or advice to the portfolio manager with respect to such portion of the fund's portfolio. The SEC further agreed that employees who are members of analytical or risk teams, traders, tax professionals, or attorneys whose analysis or advice is material to the portfolio manager's investment decisions would be participating in the investment activities of the fund (subject to the requirements that such activities be a regular part of the person's duties and that the person has been performing the function for at least 12 months) and could be knowledgeable employees.

- An employee can be regarded as participating in the investment activities of a private fund and therefore could be a knowledgeable employee if such employee participates in activities of separate accounts (or a portion of a separate account) for clients that are "qualified clients"³ 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 the adviser's private funds.
- Knowledgeable employees of "relying advisers"⁴ that are affiliated with the investment adviser as part of a single advisory business who have significant access to information about the private fund of the investment adviser may be treated as knowledgeable employees with respect to any private fund managed by the investment adviser or its relying advisers.

The SEC clarified that investment advisers should maintain in their books and records a written record of employees the investment adviser has permitted to invest in its private funds as knowledgeable employees and should be able to explain the basis pursuant to which the employee qualifies as a knowledgeable employee.

Please do not hesitate to contact us if you have any questions.

1. Available 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 Investment Company Act.
3. "Qualified client" is defined in rule 205-3 under the Advisers Act.
4. See American Bar Association Section of Business Law, SEC No-Action Letter (Jan. 18, 2012).

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