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SEC Provides Updated Guidance on ‘Knowledgeable Employee’ Status Under the Investment Company Act of 1940

On February 6, 2014, the Division of Investment Management of the Securities and Exchange Commission (the “SEC”) issued a no-action letter to the Managed Funds Association (the “MFA No-Action Letter”) providing updated guidance on the definition of “knowledgeable employee” in Rule 3c-5 under the Investment Company Act of 1940, as amended (the “Investment Company Act”).¹

Many private funds rely on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act to be excluded from the definition of “investment company.” Section 3(c)(1) excludes funds whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons, and that are not making and do not presently propose to make a public offering of its securities (a “3(c)(1) Fund”). Section 3(c)(7) excludes funds whose outstanding securities are exclusively owned by persons who, at the time of acquisition, are “qualified purchasers,” and that are not making and do not presently propose to make a public offering of its securities (a “3(c)(7) Fund”).² Rule 3c-5 permits a knowledgeable employee of a 3(c)(1) Fund or a 3(c)(7) Fund (a “Covered Fund”), or a knowledgeable employee of an affiliated person that manages the investment activities of a Covered Fund (“Affiliated Management Person”), to invest in a Covered Fund without being counted toward the 100-person limit in Section 3(c)(1) and regardless of whether the knowledgeable employee is a “qualified purchaser” under Section 3(c)(7).

The updated guidance considered the following categories of “knowledgeable employees”:

- **Executive Officer and Policy-Making Employees.** Under Rule 3c-5, the first category of knowledgeable employees are “Executive Officers,” which are in turn defined to include 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.” The SEC confirmed that Rule 3c-5 provides flexibility in determining whether an individual is in charge of a principal business unit, division or function, and that this determination should be made by an investment manager based on the relevant facts and circumstances regarding its business operations. The SEC also confirmed that several business units, divisions or functions could each be a principal business unit, division or function, and that a business unit, division or function does not need to be part of the investment activities of a Covered Fund in order to be considered principal. The SEC also confirmed that the size of the particular department is not determinative as to whether the function is principal. The ultimate determination of whether any business unit, division or function should be deemed principal is a factual determination that must be made on a case-by-case basis. By way of example, the SEC agreed that

¹ The MFA No-Action Letter is 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.

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an investment manager's information technology ("IT") and investor relations departments may be deemed principal business units under certain circumstances (such as the investor relations department being involved with substantive portfolio reviews and due diligence responses or the IT department being involved with building trading models and performance and risk monitoring systems) and the individual in charge of such departments may be deemed a knowledgeable employee. On the other hand, an investor relations department that primarily performs administrative functions such as arranging meetings and disseminating investor communications written by others may not be a principal unit.

The MFA No-Action Letter clarified that Rule 3c-5 does not require policy-making individuals to have a specific title and that employees without senior manager titles may satisfy the definition of "Executive Officer" either individually or by serving as a member of a group or committee that develops and adopts an investment manager's policies, such as a member of a valuation committee.

- **Employees Who Participate in Investment Activities.** The second category of knowledgeable employees includes those employees of a Covered Fund or an Affiliated Management Person who, in connection with their regular functions or duties, participate in the investment activities of such Covered Fund, other Covered Funds or investment companies managed by such Affiliated Management Person, provided that they have been performing such functions and duties for or on behalf of such Covered Fund or Affiliated Management Person, or substantially similar functions or duties, for or on behalf of another company, for at least 12 months ("Participating Employees").
- In an expansion of prior guidance, the SEC confirmed that Participating Employees may include a research analyst who researches only a portion of a Covered Fund's portfolio and provides analysis or advice to the portfolio manager with respect to only that portion of the portfolio.
- The SEC advised that Participating Employees are not limited 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 depending on the facts and circumstances if they regularly participate in the management of a Covered Fund's investments (or a portion thereof), such as:
 - (i) members of an analytical or risk team (who develop trading models or provide material advice about investment decisions as opposed to someone who merely writes code);
 - (ii) traders (who provide analysis and advice material to investment decisions based on market knowledge and expertise as opposed to someone who merely executes investment decisions made by a portfolio manager);
 - (iii) tax professionals (who provide analysis and advice that is material to investment decisions such as determining whether income from an investment may be "effectively connected income" as opposed to someone who merely prepares tax filings); or
 - (iv) attorneys (who provide analysis that is material to investment decisions such as analysis on tranches of a debt investment as opposed to someone who merely negotiates agreements effecting decisions of a portfolio manager or evaluates whether an investment is permitted under the Covered Fund's governing documents).

The SEC's prior guidance was that these types of individuals generally would not be considered knowledgeable employees.³

- **Separate Accounts.** The MFA No-Action Letter also expanded the definition of Participating Employees to include employees of an Affiliated Management Person who participate in the investment activities of separate accounts (or a portion of the separate accounts) for clients that are "qualified clients" and are otherwise eligible to invest in the Covered Funds advised by the Affiliated Management Person and whose accounts pursue investment objectives and strategies that are substantially similar to those pursued by one or more of those Covered Funds.⁴ The SEC noted that such an employee is likely to be just as financially knowledgeable and sophisticated as an employee who participates in the investment activities of a Covered Fund or investment company.
- **Employees of Related Advisers in Control Relationships.** Knowledgeable employees of an adviser or any of its relying advisers may be treated as knowledgeable employees with respect to any Covered Fund managed by the adviser or its relying advisers, provided that the employees meet the other conditions of the rule.⁵ The SEC concluded that employees of affiliated advisers that are deemed to conduct a single advisory business generally would have significant access to information about the Covered Funds managed by the other affiliated advisers within the single advisory business.

Ultimately, the determination of which employee is a knowledgeable employee depends on the facts and circumstances relevant to each investment manager's business. In that regard, the SEC advises that an investment manager should maintain a written record of its knowledgeable employees and should be able to explain the facts and circumstances that support its conclusion that any particular employee qualifies as a knowledgeable employee.

3 See American Bar Association Section of Business Law, SEC No-Action Letter (Apr. 22 1999).

4 "Qualified client" is defined in rule 205-3 under the Advisers Act of 1940.

5 See American Bar Association Section of Business Law, SEC No-Action Letter (Jan. 18, 2012).