CLIENT ALERT

SEC Expands Scope of 'Knowledgeable Employees' Who Can Invest in Funds

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The SEC has issued new and helpful guidance for investment fund managers who wish to expand the scope of their "knowledgeable employees" who can invest their personal capital into hedge funds, private equity and other private investment funds. The "knowledgeable employees" exemption is important for private investment funds utilizing the Section 3(c)(1) or 3(c)(7) exemptions from registration under the Investment Company Act of 1940 because "knowledgeable employees" are not included in calculating a Section 3(c)(1) fund's investors and are not required to be "qualified purchasers" in a Section 3(c)(7) fund. The new SEC guidance significantly expands the ability of research analysts, analytics / risk team members, traders, tax professionals and attorneys to qualify as "knowledgeable employees." In addition, depending upon the investment strategy of the fund, the new SEC guidance may also permit IT and investor relations professionals to qualify as "knowledgeable employees." Many managers (especially managers of newly formed entities) struggle with the important rules, regulations and lore in this area, and the SEC's evolving view is welcome news.

Background

For many years, investment fund managers have debated internally both whether to permit employees of more modest net worth to invest in their funds and, if so, which employees to permit to invest. Part of this is sincere altruism: fund managers sincerely believe that their funds will be top decile performers and that participating employees will financially benefit from that performance (not only a financial bonus, if you will, but also for recruiting and retention purposes). Part of this is a desire by the employees themselves, who work closely with the fund manager and feel strongly about the underlying investment decisions being made, to invest their own capital in the same opportunities. Particularly as the complexity of fund trading, operational and execution strategies have grown and funds have needed to bring in expertise in additional areas, both investment funds and many of their employees have chafed against SEC rules and guidance that have limited employees' ability to participate in their employers' funds.

The issue is complex within the sanctity of the fund manager's office. One counter-balance has always been investment manager paternalism: it is possible that the funds will not be a roaring success, and investors (including employees) must be prepared to lose their entire investment. Those employees who are not über-wealthy will not be in a good position to lose their capital, and fund managers then will face unhappy – and financially strapped – employees.

The SEC's Regimen

Investment funds commonly utilize the Section 3(c)(1) or 3(c)(7) exemptions from registration under the Investment Company Act of 1940. Under the Section 3(c)(1) exemption, an investment fund is limited to having not more than 100 investors; a Section 3(c)(7) fund can have up to 499 investors but they must all be "qualified purchasers." The "knowledgeable employee" exception is significant because "knowledgeable employees" are not included in calculating a Section 3(c)(1) fund's investors and are not required to be "qualified purchasers" in a Section 3(c)(7) fund.

SEC Rule 3c-5 defines "knowledgeable employees" as:

- "executive officers," directors, trustees, general partners, advisory board members and persons serving in a similar capacity with a Section 3(c)(1) or 3(c)(7) fund or its investment manager affiliate. "Executive officers" are the president, vice president in charge of a particular business unit, division or function, or any other officer or other person who performs a similar policy-making role for the fund or its investment manager affiliate, or
- employees of a Section 3(c)(1) or 3(c)(7) fund or its investment manager affiliate who participate in the investment activities of the fund or certain other related funds as part of their regular functions, subject to their having performed those functions or substantially similar functions for at least 12 months.

Although Rule 3c-5 appears broad on its face, the SEC had previously limited the actual employees who would qualify as "knowledgeable employees." For example, the SEC had previously stated that it would not generally regard the following types of employees as "knowledgeable employees": Series 7-registered brokers and traders of a fund; research analysts who cover only a particular focus area within a fund; marketing and investor relations professionals; finance, compliance, operational and accounting officers; and certain attorneys providing guidance on a fund's investment activities. The SEC had noted, however, that the test for being a "knowledgeable employee" requires an evaluation of the relevant facts and circumstances. Based on this, fund managers with their professional advisors have reached conclusions specific to a particular investment fund business.

The Latest Guidance

Against this backdrop, on February 6, 2014, the SEC issued a new no action letter expanding the scope of who may qualify as a "knowledgeable employee." Here are the new key highlights:

- While maintaining that the analysis of which employees are knowledgeable is always a "factual determination made on a case-by-case basis," the SEC concurred that the following persons would likely constitute knowledgeable employees if they regularly, and had for 12 months, performed the listed functions and duties:
  - an analyst providing research or advice with respect to a portion of, as opposed to all of, a fund portfolio;
  - a member of the analytics or risk team who regularly develops models and systems to implement the fund's trading strategies or who otherwise provides analysis or advice material to the investment decisions of the fund;
  - a trader or tax professional regularly consulted for investment analysis or advice prior to the investment decisions of the fund's manager, and whose analysis is material to the investment decisions of the fund; and
  - an attorney whose legal analysis, such as when the analysis relates to a debt instrument in which the fund is considering an investment, is material to fund investment decisions.
- The SEC indicated flexibility in the scope of who can be an "executive officer" by acknowledging that a fund can have more than one principal business unit, division or function. The SEC agreed that the following functions could constitute principal business units in certain circumstances: (1) IT departments in funds employing quantitative or algorithmic trading driven strategies, (2) IT departments that build interactive performance and risk monitoring systems, and (3) investor relations departments that are involved in substantive portfolio reviews with clients and/or that respond to substantive due diligence inquiries from investors.
- The SEC noted that an employee's title is not dispositive in determining whether the employee is a "knowledgeable employee." Employees may be performing "policy making functions" through participation as an active member of a group that develops the manager's policies (such as a valuation committee) and thus qualify as "knowledgeable

employees." By contrast, the SEC specifically stated that observers or providers of information to these groups would not be "knowledgeable employees."

- The SEC also agreed that the "knowledgeable employee" exception could apply with respect to certain separately managed accounts and certain other controlled funds and management companies.

This new SEC no-action letter is indicative of other guidance issued recently by the SEC that aligns regulations more closely with industry practice and allows for greater ease in capital raising and other transactions (for example, see our prior alert on M&A brokers). Despite the loosening of certain restrictions, however, the SEC will evaluate the facts and circumstances of each individual case. Your Crowell & Moring attorneys are prepared to help you in evaluating the facts and circumstances of your specific fund, and in shaping your appropriate path forward.

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