

## SEC Issues No-Action Letter on the Definition of Knowledgeable Employee

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On February 7, 2014 the staff of the Division of Investment Management of the Securities and Exchange Commission (the “SEC”) issued a no-action letter to the Managed Funds Association (the “No-Action Letter”), providing guidance on the definition of knowledgeable employee for purposes of Rule 3c-5 under the Investment Company Act of 1940 (the “Investment Company Act”). Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act set forth the primary exemptions relied on by private funds in order to remain exempt from registration as investment companies.

Section 3(c)(1) excludes funds whose outstanding securities are beneficially owned by no more than 100 persons and that is not making and does not presently propose to make a public offering of its securities. Section 3(c)(7) excludes funds whose outstanding securities are owned exclusively by persons who, at the time of acquisition, are “qualified purchasers,” and which is not making and does not at that time propose to make a public offering of such securities. Rule 3c-5 under the Investment Company Act allows a knowledgeable employee of a private fund relying on Section 3(c)(1) or Section 3(c)(7), or a knowledgeable employee of an affiliated person that manages the investment activities of such a private fund, to own securities of a private fund by providing that (i) a knowledgeable employee will not be counted towards the 100 person limit for a 3(c)(1) fund, and (ii) a knowledgeable employee may invest in a Section 3(c)(7) fund regardless of whether the knowledgeable employee is a “qualified purchaser.” The No-Action Letter provides guidance on various areas covered by the definition of knowledgeable employee under the Investment Company Act rules, a summary of which is set forth below.

### Executive Officer and policy-making employees

The definition of knowledgeable employee includes an “Executive Officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity.” The Investment Company Act defines “Executive Officer” as 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 the following regarding the Investment Company Act’s definition of Executive Officer:

- A. for purposes of what will constitute a principal business unit 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;
- B. several business units, divisions, or functions may each be considered a principal unit, division, or function;
- C. the 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. For example, an information technology or investor relations department may be considered a principal unit, division or function, depending on the circumstances; and
- D. an employee can have a policy-making function regardless of the employee’s title as long as he or she has and uses the power to make policy on behalf of the investment manager; such an employee can meet the relevant standard either individually or as part of a committee or group that develops and adopts policies, such as a valuation committee, but would not include observers to such a committee or employees who merely provide information or analysis to such a committee.

### Employee who participates in the investment activities of a private fund

The definition of knowledgeable employee also includes an employee who participates in the investment activities of the private fund as part of his or her regular function and duties, and has done so for at least 12 months (“Participating Employee”). The SEC confirmed that

Participating Employees would not be limited to individuals with overall responsibility for the investment activities of a covered fund. In particular, the following employees, who otherwise meet the requirements of this provision, may qualify as a knowledgeable employee:

- A. 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;
- B. an employee, such as a research analyst, who researches and provides analysis or advice to the portfolio manager on a portion of the portfolio of a private fund;
- C. an employee whose functions relate to the investment activities of at least a portion of a portfolio of a separate account (i) for a "qualified client," as defined under SEC Rule 205-3 under the Investment Advisers Act of 1940, and (ii) provided the separate account client is otherwise eligible to invest in the private funds managed by the adviser and such accounts pursue investment objectives and strategies that are substantially similar to those of the private fund.

## Knowledgeable employees of a filing adviser

A knowledgeable employee of a filing adviser or any of its relying advisers (as set out in the American Bar Association's January 18, 2012 SEC no-action letter regarding which adviser entities have to file a Form ADV) may qualify as a knowledgeable employee with respect to any private fund managed by the filing adviser or its relying advisers, provided that the employee meets the other conditions of the Investment Company Act rules.

Please note that investment managers are required to make determinations as to which employees qualify as knowledgeable employees based on the relevant facts and circumstances, should be able to explain the basis for such determinations, and should maintain a written record of employees the investment manager has allowed to invest in a private fund. Investment managers should read the entire No-Action Letter before determining whether a particular employee qualifies as a knowledgeable employee under the Investment Company Act rules.

The full text of the No-Action Letter is [available here](#).

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