



# Compliance Corner

## Getting Knowledgeable About “Knowledgeable Employees”

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### Introduction

When an investment adviser sponsors the formation of a hedge fund, private equity fund, or other “private fund,”<sup>1</sup> the investment adviser often seeks to have its principals and employees invest in the fund alongside third-party investors. In fact, an investment adviser will typically find that the investors in its private funds (particularly institutional investors, whose interest can be critical to the funds’ growth) demand assurances of such investment, as evidence that the investment adviser has “skin in the game.” At the same time, the investment adviser’s most valued employees may regard an opportunity to invest in the adviser’s private funds as an important perk of their employment and a meaningful element of their compensation.

Because the private funds, however, rely on exclusions from the definition of “investment company” under the Investment Company Act of 1940, as amended (the “Investment Company Act”) that require the funds’ investors to be “qualified purchasers” or to limit the number of their investors, the investment adviser frequently faces a tension between complying with these regulations and conforming to these business expectations. Rule 3c-5 under the Investment Company Act eases this tension by creating a category of “Knowledgeable Employee” that is permitted to invest in the adviser’s private funds without implicating these exclusions. In

a recent no-action letter issued to the Managed Funds Association (the “MFA NAL”),<sup>2</sup> the SEC has clarified certain aspects of the Knowledgeable Employee definition. The MFA NAL builds on the more expansive no-action letter issued to the ABA’s Section of Business Law relatively shortly after the introduction of Section 3(c)(7) and the promulgation of Rule 3c-5,<sup>3</sup> and the issuance of the MFA NAL provides a welcome opportunity for investment advisers to refresh their policies and procedures relating to investments by their personnel into the funds they manage.

### Knowledgeable Employees

A significant portion of private investment funds rely on either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act to be excluded from the definition of “investment company” (and consequently, among other things, the requirement to register under the Investment Company Act and to comply with most of the specific requirements applicable to registered investment companies). A private fund that is not making, and does not currently propose to make, a public offering of its securities can rely on Section 3(c)(1) if its outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons. On the other hand, such a private fund can rely on the exclusion under Section 3(c)(7) if its outstanding securities are exclusively owned by persons who, at

the time of acquiring such securities, are “qualified purchasers”.

Absent Rule 3c-5, if a significant number of an investment adviser’s principals and employees were to invest in a Section 3(c)(1) fund that the adviser advises, they would use up some—potentially quite a few—of the 100 “slots” that otherwise would enable the fund to admit additional third-party investors. A Section 3(c)(7) fund also faces a concerning difficulty: in order to be a “qualified purchaser,” each natural person investor (including any person who holds a joint, community property, or other similar shared ownership interest with that person’s spouse) must own not less than \$5,000,000 in “investments” (where “investments” is defined Rule 2a51-1); an investment adviser’s personnel—including, for many newly established investment advisers, even its most senior personnel—may not meet this high threshold. Rule 3c-5 addresses these two issues by providing that persons who are Knowledgeable Employees are (a) not counted toward the 100 slots for purposes of Section 3(c)(1) and (b) permitted to invest in a Section 3(c)(7) fund even if they are not qualified purchasers.

A person’s status as a Knowledgeable Employee is determined in relation to a particular Section 3(c)(1) or Section 3(c)(7) fund (each, a “Covered Company”) and any investment adviser of a Covered Company that manages its investment activities (an “Affiliated

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Management Person"). Under Rule 3c-5, a person may qualify as a Knowledgeable Employee with respect to a particular Covered Company by falling into one of two broad categories:

- executive officers, directors, trustees, general partners, advisory board members, and persons serving in similar capacities of the Covered Company or of an Affiliated Management Person of the Covered Company; or
- an employee of the Covered Company or an Affiliated Management Person of the Covered Company (other than an employee performing solely clerical, secretarial, or administrative functions with regard to such company or its investments) who, in connection with his or her regular functions or duties, participates in the investment activities of such Covered Company, other Covered Companies, or investment companies the investment activities of which are managed by such Affiliated Management Person of the Covered Company, provided that such employee has been performing such functions and duties for or on behalf of the Covered Company or the Affiliated Management Person of the Covered Company, or substantially similar functions or duties for or on behalf of another company, for at least 12 months.

For purposes of this article, the requirements imposed by the first category are referred to as the "Policy-Making Test" and the requirements imposed by the second category are referred to as the "Investment Activities Test".

### **Policy-Making Test**

The term "executive officer" in the Policy-Making Test is defined for purposes of Rule 3c-5 to mean, for the Covered Company or any Affiliated

Management Person of the Covered Company, such entity's:

- president;
- vice-president in charge of a principal business unit, division, or function;
- any other officer who performs a policy-making function; and
- any other person (*i.e.*, not an officer) who performs similar policy-making functions

In the MFA NAL, the SEC staff acknowledges that, in looking to whether a person is in charge of a principal business unit, division, or function, Rule 3c-5 allows an investment adviser the flexibility to make the determination based on the specific facts and circumstances regarding the investment adviser's business operations. Although to qualify under the Policy-Making Test the relevant business unit, division, or function must be a principal one—and thus, it would be expected that, certainly in larger investment advisory complexes, it may be that not all units, divisions, or functions are principal—an investment adviser is permitted (based on its facts-and-circumstances analysis) to determine that it has several principal business units, divisions, and/or functions. In addition, business units, divisions, and functions that are not integral to the investment activities of the relevant Covered Company or Affiliated Management Person may nonetheless be considered principal. Rule 3c-5 itself calls out sales, administration, and finance departments as business units that are potentially "principal" within an Affiliated Management Person. Adding to these, the MFA NAL details certain other business units that are candidates for treatment as "principal" for these purposes:

- the information technology ("IT") unit of an Affiliated Management Person that employs one or more technologically driven trading mod-

els and tasks its IT professionals with building models and systems that translate certain quantitative signals into trade orders;

- the IT unit of an Affiliated Management Person that employs IT professionals to build performance and risk-monitoring systems that interact with the Affiliated Management Person's investment program; and
- the investor relations ("IR") unit of an Affiliated Management Person that relies on IR personnel to conduct substantive portfolio reviews with investors and to respond to substantive due-diligence inquiries from institutional investors and consultants.

The MFA NAL confirms that the SEC staff would regard the person in charge of the foregoing business units as a Knowledgeable Employee. In contrast, it is worth noting that in the same no-action letter, the SEC staff confirmed that the head of IR would *not* be in charge of a principal business unit, division, or function if the IR department's function was merely to assist in arranging meetings between the Affiliated Management Person's investment staff and prospective investors, to disseminate investor communications written by senior executives outside of the IR department, or to perform only other relatively administrative tasks.

If a person is an officer but not the head of a business unit, division, or function for, or does not have an officer title with, a Covered Company or its Affiliated Management Person, she can still qualify as a Knowledgeable Employee under the Policy-Making Test if she makes policy through day-to-day involvement in the development and adoption of the Affiliated Management Person's policies. However, investment advisory firms have, as a practical matter of governance and internal procedure, often found themselves making

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critical policy decisions through groups or committees, rather than by the fiat of individuals (particularly among the increasingly numerous large investment advisory firms). Thus a practical business reality met with a regulatory ambiguity: was a member of a policy-making committee individually eligible as a Knowledgeable Employee? The MFA NAL resolved this ambiguity; the SEC staff will regard a person as satisfying this element of the Policy-Making Test even if she exercises this policy-making function not individually, but only through serving as an active member of a group or committee that develops and adopts the Affiliated Management Person's policies. By way of example, a non-officer employee who serves as an active member of an Affiliated Management Person's valuation committee could be an "executive officer," and consequently a Knowledgeable Employee, for purposes of Rule 3c-5. In contrast, however, an employee, even if holding a specific officer title, whose only interaction with the Affiliated Management Person's policy-making was to observe committee proceedings or provide information or analysis to the decision-makers of a policy-making group or committee would not be regarded by the SEC staff as being such an "executive officer" and thus, unless she qualified under a different test, would not be a Knowledgeable Employee.

### **Investment Activities Test**

While it's clear that under the Investment Activities Test, an employee that performs only clerical, secretarial, or administrative functions with regard to an Affiliated Management Person would not be a Knowledgeable Employee, the ABA NAL established early on that the SEC staff requires investment advisers to apply a facts-and-circumstances analysis to their determination of which of their employees have sufficient participation in the investment

activities of the relevant Covered Company or other Covered Companies to qualify as Knowledgeable Employees. In response to the requesting letter's inquiries, however, the MFA NAL builds on this guidance to state that a person may be a Knowledgeable Employee under this prong even if he participates in managing the investments of a portion, but not all, of a Covered Company's investments. Thus, in order to qualify as a Knowledgeable Employee under the Investment Activities Test, a person's role must require it to actively participate in the management of a Covered Company's investments (or a portion thereof), and cannot comprise merely obtaining information regarding the Covered Companies' investment activities (although a person does not have to be charged with overall responsibility for the investment activity of a Covered Company to be a Knowledgeable Employee). The MFA NAL helps round out the illustrative list of the types of persons whose involvement would (under most circumstances) likely qualify them as Knowledgeable Employees:

- Portfolio managers of all or a portion of the Covered Company's investment strategies;
- Research analysts who research potential portfolio investments for all or a portion of a Covered Company's portfolio and provide analysis, advice, and/or recommendations to the portfolio manager(s) with respect to the relevant portion of the portfolio;
- Members of the Affiliated Management Person's analytical or risk team who regularly develop models and systems to implement the Covered Company'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;
- Traders who are regularly 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;

- Tax professionals who are 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; and
- Attorneys who regularly analyze 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.

At the same time, the MFA NAL brings into relief the SEC staff's view that the following persons, even though potentially having an equally sophisticated understanding of the Covered Company's investments and/or strategies, have functions with too attenuated a connection to the Covered Company's investment activities and thus would *not* be expected to be Knowledgeable Employees:

- Traders who simply execute investment decisions made by the portfolio manager;
- Computer programmers who merely write the code to a program used by the portfolio manager to evaluate or identify investment opportunities;
- Tax professionals who merely pre-

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pare the tax filings for the Covered Company;

- Attorneys who negotiate agreements that effectuate transactions evidencing the investment decisions of the portfolio manager; and
- Attorneys or compliance officers who evaluate whether an investment is permitted under a Covered Company's governing documents.

### **Covered Companies, Separate Accounts, and Relying Advisers**

To be a Knowledgeable Employee with respect to a particular Covered Company under the Investment Activities Test—and thus to be permitted to invest in such Covered Company without counting as taking one of such Covered Company's 100 permitted "slots" or being required to be a "qualified purchaser," as the case may be—a person must be an employee either of the Covered Company (which would be an unusual employment arrangement for most private funds) or of an Affiliated Management Person (that is, the investment adviser) of the relevant Covered Company. Recognizing the establishment of the "relying adviser" regime in connection with the SEC staff's guidance concerning the Form ADV, the MFA NAL states that if a filing adviser and its relying adviser(s) collectively conduct a single advisory business such that the relying adviser can be listed as such on the filing adviser's Form ADV, then each of the filing adviser and relying adviser(s) may be treated as an Affiliated Management Person of the applicable Covered Company. Thus, Knowledgeable Employees of a filing adviser or any of its relying advisers may be treated as Knowledgeable Employees with respect to any Covered Company managed by the filing adviser or any of its relying advisers. Moreover, the employee can qualify as a Knowledgeable Employee with respect to a particular Covered Company even if the employee's requisite participation

in investment activities is not for the Covered Company in which he seeks to invest, but rather for certain other Covered Companies or, as noted in the MFA NAL, in certain separate accounts advised by the Affiliated Management Person. Taken together, Rule 3c-5 and the SEC staff's guidance with respect to it qualify a person as a Knowledgeable Employee where he, in connection with his regular functions or duties, participates in the investment activities of any of the following:

- the Covered Company in which he seeks to invest;
- other Covered Companies or investment companies the investment activities of which are managed by the Affiliated Management Person of the Covered Company in which he seeks to invest or by a relying adviser of such Affiliated Management Person;
- investment vehicles that are excluded from the definition of "investment company" by Section 3(c)(2), 3(c)(3), or 3(c)(11) of the Investment Company Act that are managed by the Affiliated Management Person or a relying adviser of such Affiliated Management Person; and
- separate accounts (or a portfolio, or a portion thereof, of a separate account) for clients that are "qualified clients" and are otherwise eligible to invest in private funds advised by the Affiliated Management Person and whose accounts pursue investment objectives that are substantially similar to those pursued by one or more of such private funds.

### **Determination and Verification of Status**

It is, of course, essential to recognize that the term "Knowledgeable Employee" is very specifically defined, and many of an investment adviser's personnel who might regard themselves, in a colloquial sense, as

"knowledgeable" about the funds the adviser manages or about investments generally nonetheless may not satisfy the definition. Investment advisers should be prepared to explain this definition to their relevant personnel, as the term "knowledgeable employee"—in contrast to terms like "accredited investor" and "qualified purchaser"—doesn't necessarily present itself on first glance as a legal term of art.

The Knowledgeable Employee definition also differs from the "accredited investor" and "qualified purchaser" tests because it cannot be established by self-certification.<sup>4</sup> The authority and responsibility to determine whether an officer or employee is a Knowledgeable Employee reside with the applicable investment adviser and private fund. Consequently, it is essential that investment advisers adopt policies providing for a compliance review of each officer's and employee's subscription into a private fund that the adviser manages. Particularly for investment funds relying on the exclusion under Section 3(c)(7), if the officer or employee is not able to certify that he is a "qualified purchaser" at the time of making his investment, then the adviser's procedures should provide for a facts-and-circumstances review of the officer's or employee's title, role, and functions in light of the guidance from the SEC staff.

The Knowledgeable Employee test is applied at the time of investment. For hedge funds and any other private fund that has ongoing offerings, the investment adviser's procedures should be applied with each incremental investment by the officer or employee. Because an officer's or employee's qualification as a Knowledgeable Employee can change depending on the person's title, role in the adviser's business, and changes in the way the adviser conducts its business or organizes the units in its firm, it is critical that this

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policy be followed for each investment and a careful evaluation be made and documented with each investment. Investment advisers should be particularly mindful of the 12-month look-back in the Investment Activities Test. A period of hiatus or change in an officer's or employee's role can require that such person be reclassified for these purposes. Finally, where a determination is made that an officer or employee is a Knowledgeable Employee, the investment adviser should be sure that the documentation that it keeps to support this analysis is consistent with other internal and external characterizations of the relevant person's role.

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*1 Although this article addresses the concept of a "knowledgeable employee" under the Investment Company Act of 1940, as amended, the term "private fund" is used as defined in Section 202(a)(29) of the Investment Advisers Act of 1940, as amended.*

*2 Managed Funds Association, SEC No-Action Letter (Feb. 6, 2014).*

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

*4 Private funds that rely on the newly adopted Regulation Rule 506(c) under the Securities Act of 1933, as amended, may be required to follow certain procedures to verify investors' accredited investor status.*