"Knowledgeable Employees"

Recent SEC guidance also details broker-dealer registrations

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The US Securities and Exchange Commission recently released guidance on two matters involving "knowledgeable employees" and broker-dealer registration that are relevant to many private fund managers. These communications represent SEC responses to requests for guidance and relief from a number of constituencies, including the private fund manager community.

Knowledgeable employee letter

Many private funds claim an exclusion under Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 that discharges them from an obligation to register as an investment company (companies claiming one of these exclusions are called "Covered Companies" or "Covered Funds").[1] Rule 3c-5 under the Investment Company Act permits a "knowledgeable employee" of a Covered Fund, of a Covered Fund's investment adviser, or certain other affiliated persons, to invest:

- In a Covered Fund excluded under Section 3(c)(1) without being counted for purposes of the 100-person limit; or
- In a Covered Fund excluded under Section 3(c)(7) without having to qualify as a "qualified purchaser."

On 6 February, 2014, the SEC's Division of Investment Management, acting through the Investment Adviser Regulation Office and the Chief Counsel's Office, provided a "Staff Letter" to the Managed Funds Association.[2] This long-anticipated Staff Letter contained guidance regarding various parts of the definition of "knowledgeable employee" in Rule 3c-5 under the Investment Company Act and certain related interpretations under Section 7 of the Investment Company Act.

Executive officers

Rule 3c-5(a)(4)(i) includes an "executive officer… or person serving in a similar capacity" within the definition of "knowledgeable employee." Executive officer is defined in Rule 3c-5(a)(3) 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*" (emphasis added). This language has traditionally served to severely limit the number of individuals within an investment manager who could qualify as knowledgeable employees, notwithstanding the fact that many of these excluded individuals often were quite experienced or accomplished, or that they had quite substantial research or management responsibilities.

Principal status. The Staff Letter provided guidance on when a unit, division or function has "principal" status, confirming that:

- Principal status depends on the relevant facts and circumstances of a particular investment manager's business operations;
- An investment manager may have multiple principal units, divisions or functions; and
- Information technology, investor relations, and other non-investment units, divisions or functions may have principal status.

While the guidance was somewhat non-specific and invokes a classic "facts and circumstances" standard, it is clear that there is a recognition within the SEC that today's investment management responsibilities are varied and multi-disciplinary and that the knowledgeable employee concept should evolve with market practice.

Policy-making function. The Staff Letter also addressed the "policy-making function" prong of the executive officer definition, confirming that an employee can have a policy-making function, regardless of the employee's title, "if he or she makes policy through day-to-day involvement in the development and adoption of an investment manager's policies." The Staff Letter also stated that employees can meet this requirement as part of a committee or group.

Employee who participates in investment activities

Rule 3c-5(a)(4)(ii) includes a second category of knowledgeable employee, which is expressed as an employee of a Covered Fund, of a Covered Fund's investment adviser, or of certain other affiliated persons who regularly participate in the investment activities of the Covered Fund and have been performing these activities for at least 12 months.

Perhaps the most welcome element of the Staff Letter was a determination that analysts and researchers who only have responsibility for a portion of the overall portfolio can be knowledgeable employees. The Staff Letter states that:

> *We believe that a research analyst who researches only a portion of the portfolio of a Covered Fund and provides analysis or advice to the portfolio manager with respect to such portion of the Covered Fund's portfolio is participating in the investment activities of the Covered Fund for purposes of the rule. Accordingly, we believe that such a research analyst could be a knowledgeable employee under rule 3c-5(a)(4)(ii).*

Of course, the Staff guidance is limited to "could be." It is incumbent upon a manager to confirm that such an analyst or researcher, under a facts and circumstances standard and on a case-by-case basis, regularly participates in the management of the Covered Fund's investments (or a portion thereof) and has been doing so for at least 12 months.

Other matters

The Staff Letter also contains similar updating guidance on matters such as the treatment of separate accounts that are not Covered Funds and the inclusion of employees of related advisers.

The Staff Letter concludes with a cautionary reminder on the need to conduct each analysis in good faith and in an auditable manner:

Investment managers will be required to make determinations as to which of their employees qualify as knowledgeable employees under the rule based on the facts and circumstances relevant to their business. In that regard, investment managers should maintain in their books and records a written record of employees the investment manager has permitted to invest in a Covered Fund as knowledgeable employees and should be able to explain the basis in the rule pursuant to which the employee qualifies as a knowledgeable employee.

Based on that language, managers should be prepared to explain the reasons for each determination in the context of an SEC examination.

M&A broker letter

Determining the registration status of third parties providing brokerage or quasi-brokerage services to private funds or to their investment advisers is more important than ever. In recent months, the SEC and the SEC Staff have — through a combination of public statements and enforcement initiatives — made clear that all parties involved in the engagement of an unregistered broker can face liability. The most concrete examples of this effort are the *Ranieri Partners* cases and a related 2013 speech by the chief counsel of the Division of Trading and Markets. (These cases are discussed in SRZ's *Alert* from 9 April 2013).[3]

On 31 January, 2014, the SEC's Division of Trading and Markets issued a no-action letter that provides narrow, but welcome, relief in one often problematic area. In the January letter, the Staff focused on "M&A Brokers," which it defined as:

persons engaged in the business of effecting securities transactions solely in connection with the transfer of ownership and control of a privately-held company … to a buyer that will actively operate the company[.]

Subject to numerous qualifications, this letter could allow some private fund managers (generally private equity fund managers) to pay, or permit a payment to be made, to a person that facilitates a transfer of control but does not hold a broker-dealer registration.

There are a large number of limitations and requirements that must be satisfied for a person to claim M&A Broker (and, therefore, registration-exempt) status. They include the following:

1. That person must not have the ability to bind a party to a covered transaction.
2. That person may not directly or indirectly provide financing for a covered transaction (and to the extent it assists purchasers in obtaining third-party financing, it must comply with all applicable legal requirements and disclose any compensation in writing).
3. That person may not have custody, control or possession of or otherwise handle funds or securities issued or exchanged in connection with a covered transaction or other securities transaction for the account of others.
4. A covered transaction may not involve a public offering, must be conducted in compliance with an applicable exemption from registration under the Securities Act of 1933, and may not include a shell company (with limited exceptions); any securities received by the buyer or that person in a covered transaction must be "restricted securities" within the meaning of Rule 144(a)(3) under the Securities Act of 1933.
5. If that person represents both buyers and sellers, all clients must receive clear written disclosure of the situation and provide written consent to the joint representation.
6. That person can only facilitate a transaction involving a group of buyers if the group was formed without the assistance of that person.
7. The buyer or buyers must control and actively operate the company or the business conducted with the assets of the business at the closing of the covered transaction.
8. That person (and, if an entity, each of its officers, directors or employees): (i) cannot be barred from association with a broker-dealer by the SEC, any state or any self-regulatory organisation; and (ii) cannot be suspended from association with a broker-dealer.

The no-action letter also noted that it was limited to the registration obligation and that other provisions of the federal securities laws, including but not limited to the anti-fraud provisions, would apply. **THFJ**

NOTES

1. In general, Section 3(c)(1) provides an exclusion for funds with 100 or fewer beneficial owners that do not publicly offer their securities and Section 3(c)(7) provides an exclusion for funds that issue securities only to "qualified purchasers" and that do not publicly offer their securities.
2. Available at http://www.sec.gov/divisions/investment/noaction/2014/managed-funds-association-020614.htm.
3. Available at http://www.srz.com/SEC_Focuses_on_Broker-Dealer_Registration_Issues_Facing_Private_Fund_Managers/.