Investment Company Act of 1940 – Section 7 and Rule 3c-5
Managed Funds Association

February 6, 2014

RESPONSE OF THE INVESTMENT ADVISER REGULATION OFFICE AND CHIEF COUNSEL'S OFFICE, DIVISION OF INVESTMENT MANAGEMENT

You request guidance regarding various parts of the definition of knowledgeable employee in rule 3c-5 under the Investment Company Act of 1940 ("**Investment Company Act**"). You also request our assurance that we will not recommend enforcement action to the Securities and Exchange Commission ("**Commission**") under Section 7 of the Investment Company Act against Covered Funds (as defined below) that treat certain employees of Covered Separate Accounts (as defined below) as knowledgeable employees.

Background

Private funds include hedge funds, private equity funds, and other types of pooled investment vehicles that are excluded from the definition of investment company by Section 3(c)(1) or 3(c)(7) of the Investment Company Act.[1] Section 3(c)(1) excludes funds whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and who are not making and do not presently propose to make a public offering of its securities.[2] Section 3(c)(7) excludes funds whose outstanding securities are owned exclusively by persons who, at the time of acquisition, are "qualified purchasers" and who are not making and do not at that time propose to make a public offering of such securities.[3] Rule 3c-5 permits a knowledgeable employee of a private fund ("**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 for purposes of the 100-person limit in Section 3(c)(1) or regardless of whether the knowledgeable employee is a "qualified purchaser" for purposes of Section 3(c)(7).

[1] The term "private fund," as used in this letter, refers to a private funds as defined in Section 202(a)(29) of the Investment Advisers Act of 1940 ("**Advisers Act**").

[2] Private funds typically rely on Section 4(a)(2) of the Securities Act of 1933 and Rule 506 under that Act to offer and sell their interests without registration under that Act. The Commission has historically regarded Rule 506 transactions as non-public offerings for purposes of Sections 3(c)(1) and 3(c)(7) of the Investment Company Act. The Commission recently adopted rules implementing Section 201 of the Jumpstart our Business Startups Act ("**JOBS Act**") that removed the prohibition against general solicitation or general advertising for securities offerings made in accordance with new Rule 506(c) and confirmed that the JOBS Act permits private funds to engage in general solicitation in compliance with new Rule 506(c) without losing either of the exclusions under the Investment Company Act. *See Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings*, Securities Act Release No. 3415 (July 10, 2013).

[3] "Qualified purchaser" is defined in Section 2(a)(51) of the Investment Company Act.

Analysis

Executive officer and policy-making employees

Rule 3c-5(a)(4)(i) defines the first category of knowledgeable employee of a Covered Fund as any natural person who is an "Executive Officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity" of a Covered Fund or an Affiliated Management Person of a Covered Fund. Rule 3c-5(a)(3) defines the term "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" for a Covered Fund or for the Affiliated Management Person of a Covered Fund.

<u>Principal business unit</u>. You argue that, depending on the adviser, different business functions can be an integral part of the operations of many investment managers and that the heads of certain business units generally are sophisticated professionals with a broad understanding of the investment manager's operations and investment program. You also argue that whether a business function carries principal status should not depend on the size of the department in question because principal business functions may be implemented by one individual who may not have a staff. Accordingly, you ask for confirmation that: (i) the principal status of a unit, division, or function depends on the relevant facts and circumstances of a particular investment manager's business operations; (ii) several business units, divisions, or functions within an investment manager may each be considered a principal unit, division, or function, and (iii) the unit, division, or function need not be part of the investment activities of a Covered Fund to be considered a principal unit, division, or function.

We believe the rule provides flexibility in determining whether an individual is in charge of a principal business unit, division, or function as described in rule 3c-5(a)(3). We confirm that whether a business unit, division, or function qualifies as a principal business unit, division, or function should be determined through an analysis by the investment manager of the relevant facts and circumstances regarding the investment manager's business operations. While not all business units, divisions, or functions are necessarily principal, it is possible that several business units, divisions, or functions could each be a principal unit, division, or function depending on the facts and circumstances. Moreover, a business unit, division, or function need not be part of the investment activities of a Covered Fund in order to be considered principal, nor is the size of the investment manager or a particular department determinative as to whether a function should be considered principal.

By way of example, you argue that an investment manager's information technology ("**IT**") department may be deemed a principal business unit given certain facts and circumstances. You describe the following circumstances as those under which an investment manager could deem the IT department as a principal unit: (i) an investment manager that employs one or more technologically driven trading models, whose IT professionals are charged with building the models and systems that translate certain quantitative signals into trade orders, and (ii) an investment manager that employs technology professionals to build performance and risk monitoring systems that interact with the investment program.

You further state that the investor relations department could be a principal business unit at an investment manager that relies on investor relations personnel to conduct substantive portfolio reviews with investors and to respond to substantive due-diligence inquiries from institutional investors and consultants. You acknowledge, however, that an investor relations function would not have principal status where the department merely assisted in arranging meetings between an investment manager's investment staff and prospective investors, disseminated investor communications written by senior executives outside of the investor-relations department, or performed other relatively administrative tasks.

While 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, we believe that an investment manager could determine that its IT and investor relations departments are principal business units, divisions, or functions under the circumstances described above and, accordingly, the individual in charge of each such department could be a knowledgeable employee.

Employees who make policy.

You state that rule 3c-5 itself does not require that the policy-making individuals have a specific title or even be "officers" in order to be knowledge employees under the rule, but that rather the rule extends the definition of knowledgeable employee to any person who performs a policy-making function on behalf of the investment manager. You argue that this demonstrates a focus on function over title and that an employee should meet the standard in the rule if he or she has the power to make, and does make, policy on behalf of the investment manager, the Covered Fund, or an Affiliated Management Person. You further argue that an employee may not have a title that is indicative of his or her status as a senior manager but he or she may nonetheless be an executive officer under rule 3c-5(a)(3) because he or she makes policy through day-to-day involvement in the development and adoption of an investment manager's policies.

You argue that employees can meet this standard either individually or as members of a committee or group. You state that an employee who serves as an active member of a group or committee that develops and adopts an investment manager's policies, such as a valuation committee, would meet the standard in rule 3c-5(a)(3). You state that employees who merely observe committee proceedings or provide information to those on the committee or in the group would not be deemed "executive officers" under the rule.

The definition of executive officer in the rule encompasses any officer who performs a policy-making function or any other person who performs similar policy-making functions on behalf of an investment manager. The rule does not require policy-making individuals to have a specific title and includes all employees that have the power to make, and do make, policy on behalf of the investment manager, Covered Fund, or an Affiliated Management Person of the Covered Fund. Accordingly, we believe that an employee who does not have a senior manager title, depending on the facts and circumstances, may still be considered an executive officer under the rule if he or she makes policy through day-to-day involvement in the development and adoption of an investment manager's policies. Further, we agree that the rule does not require

that the policy-making function be concentrated in one individual and that employees serving as active members of a group or committee that develop and adopt an investment manager's policies, such as the valuation committee, could be executive officers under the rule. We do not believe that individuals who merely observe committee proceedings or merely provide information or analysis to the decision-makers of a committee or group would be engaged in making policy and, therefore, such individuals generally would not be executive officers under the rule.

Employee who participates in the investment activities of a Covered Fund

Rule 3c-5(a)(4)(ii) defines the second category of knowledgeable employee as any employee of a Covered Fund or the Affiliated Management Person of such Covered Fund who, in connection with his or her regular function or duties, participates in the investment activities of such Covered Fund, other Covered Funds, or investment companies the investment activities of which are managed by such Affiliated Management Person of the Covered Fund, provided that such employee has been performing such functions and duties for or on behalf of the Covered Fund or the Affiliated Management Person of the Covered Fund, or substantially similar functions or duties for or on behalf of another company for at least 12 months ("**Participating Employee**").

Employees who participate in investment activities. In previous guidance, the staff has stated that whether an employee was participating in investment activities is a factual determination that must be made on a case-by-case basis.[4] While stating that certain types of non-executive employees would not generally be knowledgeable employees because they were not participating in the investment activities, the staff stated that "some research analysts (*e.g.*, a research analyst who researches all potential portfolio investments and provides recommendations to the portfolio manager)" would be knowledgeable employees.[5] You argue 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 only a portion of the Covered Fund's portfolio could be regarded as participating in the investment activities for purposes of the rule.

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).

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[4] *See American Bar Association Section of Business Law*, SEC No-Action Letter (Apr. 22, 1999) ("**ABA Letter**"). *See also Privately Offered Investment Companies*, Investment Company Act Release No. 22597 (April 3, 1997) at text accompanying footnote 124 (explaining that the rule as adopted includes only employees who "participate in" the investment activities of the fund or other investment companies managed by the fund's Affiliated Management Person, as distinguished from employees who merely "obtain information" regarding the investment activities of the fund but may not have investment experience).

[5] Id.

You also ask for confirmation that the guidance in the ABA Letter was not intended to limit Participating Employees 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 if they participate in the management of a Covered Fund's investments (or a portion thereof). You then argue that the individuals in the following factual scenarios should be considered Participating Employees because they are specific examples of employees who participate in investment activities for purposes of rule 3c-5(a)(4)(ii), provided they regularly perform such functions or duties and have been doing so for at least 12 months:

(i) a member of the analytical or risk team who regularly develops models and systems to implement the Covered Fund'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[6] (in contrast to someone who merely writes the code to a program used by the portfolio manager);

(ii) a trader who regularly is 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 (in contrast to a trader that simply executes investment decisions made by the portfolio manager);

(iii) a tax professional who is 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 (in contrast to a tax professional who merely prepares the tax filings for the Covered Fund); and

(iv) an attorney who regularly analyzes 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 (in contrast to an attorney who negotiates agreements that effectuate transactions evidencing the investment decisions of the portfolio manager or an attorney or compliance officer who evaluates whether an investment is permitted under a Covered Fund's governing documents).

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[6] Whether an individual provides analysis or advice that is material to the investment decisions of a portfolio manager is a facts and circumstances determination based on whether a reasonable person would consider such analysis or advice to be important to the investment decision. *See TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). Generally, however, the analysis or advice must be material to the merits of buying, selling, or holding an investment. We do not believe that reviews, analysis, or advice as to whether a potential investment is merely eligible for investment by the Covered Fund would be material to the investment decisions of a portfolio manager.

We confirm that the guidance in the ABA Letter was not intended to limit Participating Employees 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 if they regularly participate in the management of a Covered Fund's investments (or a portion thereof). While the ultimate determination of whether an individual participates in the investment decisions of a Covered Fund is a factual determination that must be made on a case-by-case basis, we believe that individuals described above could be considered Participating Employees if they regularly perform such functions or duties and have been doing so for at least 12 months.

Treatment of separate accounts. Rule 3c-5(a)(4)(ii) includes certain employees who participate in the investment activity of not only the Covered Fund, but also other Covered Funds, or investment companies managed by an Affiliated Management Person of the Covered Fund. The staff previously stated that rule 3c-5 is premised on the belief that certain persons, because of their financial knowledge and sophistication and their relationship with a Covered Fund, do not need the protection of the Investment Company Act.[7] The staff also stated that an employee who participates in the investment activities of a company that is excluded from the definition of investment company by Section 3(c)(2), 3(c)(3), or 3(c)(11) of the Investment Company Act is likely to be as financially knowledgeable and sophisticated as an employee who participates in the investment activities of a Covered Fund or an investment company.[8] As a result, the staff confirmed that it would not recommend enforcement action to the Commission under Section 7 of the Investment Company Act against a Covered Fund if it treated an employee who participated in the investment activities of a company that is excluded from the definition of investment company by Section 3(c)(2), 3(c)(3), or 3(c)(11) as a knowledgeable employee.

You argue that Participating Employees should also include employees of an Affiliated Management Person who participate in the investment activities of separate accounts (or a portfolio (or portion thereof) of a separate account) for clients that are "qualified clients" and are otherwise eligible to invest in the private 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 private funds ("**Covered Separate Accounts**").[9]

We believe that an employee of an Affiliated Management Person who participates in the activities of Covered Separate Accounts (or a portfolio (or portion thereof) of such a Covered Separate Account) is also likely to be as financially knowledgeable and sophisticated as an employee who participates in the investment activities of a Covered Fund or investment

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[7] *See PPM America Special Investments CBO II, L.P.*, SEC No-Action Letter (pub. avail. April 16, 1998) ("**PPM America Letter**") and ABA Letter.

[8] *See* PPM America Letter and ABA Letter. In the ABA Letter, the staff stated that whether a portfolio manager who only manages separately managed accounts could qualify as a knowledgeable employee depends on the particular facts and circumstances.

[9] "Qualified client" is defined in rule 205-3 under the Advisers Act.

company. Accordingly, we would not recommend enforcement action to the Commission under Section 7 of the Investment Company Act against a Covered Fund if it treated an employee as a knowledgeable employee under Rule 3(c)-5(a)(4)(ii), notwithstanding the fact that the employee participates in the investment activities of Covered Separate Accounts (or a portfolio (or portion thereof) of a Covered Separate Account), rather than in the investment activities of a Covered Fund or an investment company).[10]

Employees of related advisers in control relationships. The staff previously stated that determining whether an Affiliated Management Person includes each affiliated entity of a Covered Fund that participates in investment activities of the investment management company depends on the relevant facts and circumstances.[11] The staff has also recently stated that it would not recommend enforcement action to the Commission under Section 203(a) or 208(d) of the Advisers Act if a "filing adviser" filed a single Form ADV on behalf of itself and "relying advisers" that are affiliated with the filing adviser as part of a single advisory business, under certain circumstances.[12] You argue that a knowledgeable employee of a filing adviser or any of its affiliated relying advisers may be deemed a knowledgeable employee with respect to any Covered Fund managed by the filing adviser or its affiliated relying advisers, provided that the relevant adviser entities are permitted to report on a single Form ADV in accordance with the Relying Adviser Letter.

In describing the facts and circumstances under which an affiliated entity of the entity managing a Covered Fund may be considered an Affiliated Management Person of the Covered Fund, the staff highlighted the ability of an employee of an affiliated entity to have significant access to information about the Covered Fund.[13] Given the nature of the factors to be met in order to be considered a single advisory business in the Relying Adviser Letter, we believe that an employee of affiliated advisers that are deemed to conduct a single advisory business, under the terms of the Relying Adviser Letter, would generally have significant access to information about the Covered Funds managed by the other affiliated advisers within the single advisory business. Accordingly, we agree that if a filing adviser and its relying adviser(s) collectively conduct a single advisory business as described in the Relying Adviser Letter, then each of the filing adviser and relying adviser(s) may be an Affiliated Management Person of a Covered Fund. As a result, knowledgeable employees of a filing adviser or any of its relying advisers may be treated as a knowledgeable employee with respect to any Covered Fund managed by the filing adviser or its relying advisers, provided that the employees meet the other conditions of the rule.

Based on the facts and circumstances relevant to a particular investment manager, other employees may qualify as knowledgeable employees for purposes of the rule, and we are not

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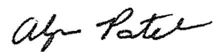
[10] As in the PPM America Letter, whether an employee "participates in the investment activities" of a Covered Separate Account is a separate analysis for purposes of Rule 3c-5(a)(4)(ii).

[11] *See* ABA Letter.

[12] *See American Bar Association Section of Business Law*, SEC No-Action Letter (Jan. 18, 2012) ("**Relying Adviser Letter**").

[13] *See* PPM Letter and ABA Letter.

expressing a view on employees outside the scope of those discussed in this letter. 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.



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