MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

February 5, 2014

Via Electronic Mail:

Mr. Douglas J. Scheidt
Associate Director and Chief Counsel
Division of Investment Management
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Managed Funds Association Comments on the "Knowledgeable Eemployee" Definition

Dear Mr. Scheidt:

Managed Funds Association ("MFA")[1] respectfully requests from the Staff of the Division of Investment Management (the "Division") guidance regarding the definition of "knowledgeable employees" in Rule 3c-5 (the "Rule") under the Investment Company Act of 1940 (the "Investment Company Act") and assurances that it will not recommend enforcement action to the Securities and Exchange Commission (the "SEC") under Section 7 of the Investment Company Act against excluded investment companies that treat certain employees, as described below, as knowledgeable employees.

Regulatory Background

Private funds[2] 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 Section 3(c)(7) of the Investment Company Act. Section

[1] The Managed Funds Association (MFA) represents the global alternative investment industry and its investors by advocating for sound industry practices and public policies that foster efficient, transparent, and fair capital markets. MFA, based in Washington, DC, is an advocacy, education, and communications organization established to enable hedge fund and managed futures firms in the alternative investment industry to participate in public policy discourse, share best practices and learn from peers, and communicate the industry's contributions to the global economy. MFA members help pension plans, university endowments, charitable organizations, qualified individuals and other institutional investors to diversify their investments, manage risk, and generate attractive returns. MFA has cultivated a global membership and actively engages with regulators and policy makers in Asia, Europe, North and South America, and other regions where MFA members are market participants.

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

3(c)(1) excludes funds whose outstanding securities (other than short-term paper) are beneficially owned by not more than 100 persons and that are not making and do not presently propose to make a public offering of its securities (a "3(c)(1) fund"). Section 3(c)(7) of the Investment Company Act excludes funds whose outstanding securities are owned exclusively by persons who, at the time of acquisition, are "qualified purchasers,"[3] and that are not making and do not at that time propose to make a public offering of such securities (a "3(c)(7) fund").[4] The Rule permits a knowledgeable employee of a 3(c)(1) fund or 3(c)(7) fund, or a knowledgeable employee of certain of the fund's affiliates, to invest in a 3(c)(1) fund without being counted for purposes of the 100-person limit in Section 3(c)(1) or in a 3(c)(7) fund regardless of whether the knowledgeable employee is a qualified purchaser.

The SEC adopted the Rule in 1997 in response to very specific directions contained in Section 209(d)(3) of the National Securities Markets Improvement Act of 1996 ("NSMIA"), which, among other things, required the SEC to adopt rules "to permit the ownership of securities by *knowledgeable employees* of [a 3(c)(1) fund or 3(c)(7) fund or its affiliate] without loss of the exception [under Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act]."[5] The text of Section 209(d)(3) of NSMIA does not limit the scope of persons the SEC may by rule deem to be a knowledgeable employee. Nor are there such limitations, to our knowledge, in the legislative history of NSMIA.

The SEC adopted the Rule to define knowledgeable employee specifically to include two categories of employees of a 3(c)(1) fund or 3(c)(7) fund (such funds together, "Covered Funds") or an affiliated person that manages the investment activities of a Covered Fund (an "Affiliated Management Person").

1. Senior personnel of a Covered Fund or the Covered Fund's Affiliated Management Person; and

2. An employee who regularly participates in the investment activities of a Covered Fund or an Affiliated Management Person of a Covered Fund.

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

[4] Private funds, including 3(c)(1) funds and 3(c)(7) funds, typically comply with the requirement that they not make a public offering by conducting private placements in compliance with Rule 506 in Regulation D or Regulation S, each under the Securities Act of 1933. The SEC recently adopted rules implementing Section 201 of the Jumpstart our Business Startups Act (the "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).

[5] The National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416 § 209(d)(3) (emphasis added) .

In written guidance to the American Bar Association Subcommittee on Private Investment Entities,[6] the SEC Staff articulated the view that non-executive employees who "actively participate in the investment activities of the Fund" are within the scope of the Rule but not employees who merely obtain information regarding the investment activities of a Covered Fund in the ordinary course.

Policy Background

When managers and their employees invest their own capital alongside a fund's investors, it tends to ensure that the interests of managers and staff are aligned with investors' interests, providing an added element of investor protection. Indeed, it is often investors themselves who seek out this assurance.[7] In the course of their due diligence, investors typically ask for the extent or amount that employees are invested in the fund, and the Form ADV actually compels disclosure in this area. In addition, permitting more employees to invest in funds managed by their employer can facilitate a manager's adoption of a more restrictive personal trading policy, which also may be in outside investors' best interests.

In the years since the SEC adopted the Rule and the Staff has issued related guidance, significant uncertainty has arisen among market participants about how to apply the Rule, which has led to a divergence of opinions and practices. In light of this uncertainty, we are asking the Division Staff to provide additional guidance. In the absence of this guidance, investment managers may place unnecessary limitations on investment by employees who should be deemed knowledgeable employees.

Proposed Guidance Regarding the Scope of Knowledgeable Employees in Light of Market Changes

Executive Officer and Policy-Making Employees

As noted above, the first category of knowledgeable employees includes senior personnel, which Rule 3c-5(a)(4)(i) defines 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 for the Affiliated Management Person of a Covered Fund. Rule 3c-5(a)(3) goes on to define the term "Executive Officer" as the

[6] *American Bar Association Section of Business Law*, SEC No-Action Letter (Apr. 22, 1999) (the "ABA Letter"). *See also*, *Privately Offered Investment Companies*, Investment Company Act Release No. 22597 (April 3, 1997) ("Adopting Release").

[7] *See*, CalPERS internal memorandum on improving the relationship between CalPERS and its hedge fund partners, available at http://www.calpers.ca.gov/eip-docs/investments/assets/equities/hedge-fund-memo.pdf (discussing the importance of aligning interests between investors and the manager, including requesting the manager reinvest a portion of its performance fees in the investment fund). *See also*, Agarwal, Vikas, Daniel, Naveen and Naik, Narayan, Role of Managerial Incentives and Discretion in Hedge Fund Performance, Journal of Finance, Vol. 64, no. 5 (October, 2009) (finding that managerial ownership of hedge funds is positively related to superior performance of the fund).

"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.

The spirit and intent of this aspect of the Rule is clear: to include the adviser's senior personnel -- those with responsibility and oversight over significant functions -- within the scope of knowledgeable employees because it is precisely these kinds of employees who investors would benefit from having invested (and at-risk) alongside them. It can sometimes be difficult to arrive at precise titles or labels that fit this definition. Accordingly, we believe that a principles-based approach would most fit within the language and spirit of the Rule, particularly given that the Rule expressly provides such flexibility by including not just titled executive officers but a "person serving in a similar capacity."

Principal Business Unit. As the private fund industry has grown over the past decade, the scope of operations conducted in-house by the investment managers to Covered Funds also has grown. At many private fund advisers, in-house employees perform a variety of high-value business functions beyond portfolio management, including, among others: investor relations; compliance; legal; risk management; operations; marketing; information technology; and accounting. Depending on the adviser, these business functions can be an integral part of the operations of many investment managers. The heads of these business units generally are sophisticated professionals with a broad understanding of the investment manager's operations and investment program.

We request confirmation that, given the potential differences in operations and structures among investment managers, what constitutes 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," we also believe that several business units, divisions, or functions could be "principal" 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."

By way of example, we believe that a private fund manager's information technology department may be deemed a "principal" business unit in a number of circumstances. These, we respectfully submit, should include an investment manager that employs one or more technologically driven trading models, whose IT professionals are charged with building the systems that translate certain quantitative signals into trade orders. We also believe that the information technology department would be a principal business unit at a manager that employs technology professionals to build performance and risk monitoring systems or other systems that interact with the investment program. In such circumstances, we believe the firm's head of information technology should be permitted to invest in the funds managed by his or her employer.

Likewise, we respectfully submit that the investor-relations department would be a "principal" business unit at an adviser that relied on investor-relations personnel to conduct substantive portfolio reviews with investors and to respond to substantive due-diligence inquiries from institutional investors and consultants. We acknowledge, however, that an investor-relations function would not have "principal" status where the department merely assisted in arranging meetings between a manager's investment staff and prospective investors, disseminating investor communications written by senior executives outside of the investor-relations department, or performing other relatively administrative tasks.

We also submit that whether a function carries "principal" status need not depend on the size of the department in question. In a smaller, flatter organization, an employee charged with the investor relations function or the compliance function might qualify as the head of a principal business unit, even if he or she were the only employee dedicated to that function. We seek the Staff's confirmation on this point as well.

Employees Who Make Policy. Unlike many larger financial institutions, investment managers to Covered Funds often have flatter organizational structures in which a number of employees are involved in the policy-making of the investment manager. The Rule itself does not require that the policy-making individuals have a specific title or even be "officers" in any general sense; rather the Rule extends to any person who performs a policy-making function on behalf of the investment manager. We believe this focus on function over title acknowledges the potentially differing organizational structures of investment managers. We believe an employee meets 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. We believe employees can meet this standard either individually or as members of a committee or group. For example, an employee may not have a title that is indicative *per se* of his or her status as a senior manager (*e.g.*, assistant controller or assistant general counsel) but he or she may nonetheless be an Executive Officer because he or she makes policy through day-to-day involvement in the development and adoption of an investment manager's policies. We believe 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). We also believe that employees merely observing committee proceedings or merely providing information to those on the committee or the group would not be deemed to be "Executive Officers" under the Rule.

Employees Who Participate in the Investment Activities of a Covered Fund

As discussed above, the definition of knowledgeable employee also includes 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 the funds managed by the Affiliated Management Person. Specifically, Rule 3c-5(a)(4)(ii) states that an employee "(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 a Covered Fund, other Covered Funds, or investment companies the investment activities of which are managed by such Affiliated Management Person of the Covered Fund is a knowledgeable employee, "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" (a "Participating Employee").

Employees Who Participate in Investment Activities. In the ABA Letter, the Staff stated that whether an employee was participating in investment activities is a factual determination that must be made on a case-by-case basis. The Staff also noted in the ABA Letter 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, even though other employees would not be viewed as knowledgeable employees under 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 only a portion of the Covered Fund's portfolio should be regarded as participating in the investment activities for purposes of the Rule. Accordingly, we request confirmation that this guidance in the ABA Letter permits analysts who research at least a portion of the portfolio of a Covered Fund to be Participating Employees, rather than just those analysts who research all potential investments for the entire portfolio of a Covered Fund.

We also request confirmation that the guidance in the ABA Letter was not intended to limit Participating Employees merely 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). Accordingly, we request confirmation that the individuals in the following factual scenarios are specific examples of employees who participate in investment activities for purposes of Rule 3c-5(a)(4)(ii) and, if they regularly perform such functions or duties and have been doing so for at least 12 months, should be considered Participating Employees:

(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 (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 who simply executes investment decisions made by the portfolio manager); and

(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).[8]

Treatment of separate accounts. Many hedge fund managers also manage separate accounts for clients that could invest in commingled funds, such as a Covered Fund or an investment company, but for various reasons prefer to have the investment manager manage their assets through a separate account. We believe that Participating Employees should 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" (as defined in Rule 205-3 under the Advisers Act) 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").

As the Staff has previously stated, the Rule 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.[9] To

[8] *See* Adopting Release 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 "obtain information" regarding the investment activities of the fund but may not have investment experience (such as compliance personnel)).

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

ensure that a knowledgeable employee has the appropriate level of financial knowledge and sophistication, Rule 3c-5(a)(4)(ii) generally requires that knowledgeable employees participate in the investment activities of a Covered Fund or an investment company. In previous no-action letters, the Staff has 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.[10] We believe a similar analysis should apply to knowledgeable employees who participate in the investment activities of Covered Separate Accounts. In particular, we believe an employee of an Affiliated Management Person that participates in the activities of Covered Separate Accounts (or a portfolio ((or portion thereof)) of such a Covered Separate Account) also is likely to be as financially knowledgeable and sophisticated as an employee who participates in the investment activities of a Covered Fund or investment company.[11] Accordingly, we ask the Division Staff to confirm that it would not recommend enforcement action to the SEC under Section 7 of the Investment Company Act against a Covered Fund if employees participating in the investment activities of Covered Separate Accounts (or a portfolio (or portion thereof) of a Covered Separate Account) were deemed to be knowledgeable employees under Rule 3c-5(a)(4)(ii), provided such employees satisfy all the other elements for being a Participating Employee.[12]

Employees of related advisers in control relationships. In the ABA Letter, the Division Staff was asked whether an Affiliated Management Person could include each affiliated entity of a Covered Fund (regardless of corporate structure) that participates in investment activities of the investment management company. While the Staff noted that they had provided similar relief in the PPM America Letter, the Staff noted that such relief generally would depend on the relevant facts and circumstances. In January 2012, the SEC Staff issued no-action relief permitting a "filing adviser" to file 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 the circumstances described in the letter.[13] We believe that treating Participating Employees of an adviser that is part of a single advisory business as described in the Relying Adviser Letter as knowledgeable employees of any Covered Fund managed by the filing adviser or its relying adviser affiliates is consistent with the general approach taken in Rule 3c-5(a)(4)(ii) and consistent with the Staff's

[10] *See*, the PPM America Letter and the ABA Letter.

[11] 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.

[12] We agree, as in the PPM America Letter, that whether an employee "participates in the investment activities" of the separate account is a separate analysis for purposes of Rule 3c-5(a)(4)(ii).

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

recognition that multiple adviser entities can be engaged in a single business. Accordingly, we ask the Division Staff to provide guidance 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.

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 it is important to clarify that the Staff is not 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 its 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 of the investment manager and should be able to explain the basis in the Rule pursuant to which the employee qualifies as a knowledgeable employee.

Conclusion

While the ABA Letter and the PPM America Letter were useful starting points in clarifying the intended scope of the Rule, we request that the Division Staff provide further guidance in light of market changes and widely varying market practices to assist investment managers in evaluating which employees qualify as knowledgeable employees. We believe such guidance will help address uncertainty that has arisen from changes in market practice since the ABA Letter and the PPM America Letter, consistent with the SEC's stated recognition that regulations need to be reviewed over time to account for changes in markets.[14]

If you have any questions regarding any of these comments, or if we can provide further information with respect to these issues, please do not hesitate to contact Benjamin Allensworth or me at (202) 730-2600.

Respectfully submitted,

/s/ Stuart J. Kaswell

Stuart J. Kaswell

Executive Vice President and Managing Director, General Counsel

[14] *See*, *Retrospective Review of Existing Regulations*, Investment Advisers Act Release No. 3271 (September 6, 2011) and Executive Order 13579.