

PROPOSED KNOWLEDGEABLE EMPLOYEE EXEMPTION

Introduction

Importance of having "skin in the game"

1. Investors increasingly expect private equity and venture capital fund managers and their investment professionals to have substantial "skin in the game" to better align interests between the investment team and investors.¹ If the investment professionals have an equity interest in the Fund, this further shares the risk and reward and ensures strong alignment of interest. To this end, the Institutional Limited Partners Association (ILPA) Private Equity Principles v2.0 recommend that fund managers "should have a substantial equity interest in the fund, and it should be contributed in cash as opposed to being contributed through the waiver of management fees".² This alignment of interest is of critical importance to investors in a closed-ended fund (such as private equity or venture capital funds) since investors are unable to exit before the end of the fund's term.

Singapore regulatory regime prevents alignment of interests

2. However, the MAS Guidelines on Licensing, Registration and Conduct of Business for Fund Management Companies³ provides that A/I LFCMs and RFMCs (and presumably, VCFMs) may carry on business in fund management with their employees only if these employees meet the definition of an accredited investor (as defined in the SFA). This is not always possible with junior employees (especially since salaries are often low and with participation in carried interest constituting a substantial portion of compensation) and thus prevents fund managers from aligning their investment team's interests with those of investors. To further promote and strengthen Singapore's fund management industry, we believe more should be done to facilitate an investment team's participation in funds it manages.

Recommendations

Knowledgeable employee exemption

3. We urge the MAS consider introducing a knowledgeable employee exemption, which would allow A/I LFCMs, RFMCs and VCFMs to:
 - a. carry on business in fund management with such knowledgeable employees regardless of whether they are accredited investors; and
 - b. market funds managed by them to such knowledgeable employees regardless of whether they are accredited investors (provided, that the fund has been notified to the MAS as a restricted scheme).

¹ <http://www.pionline.com/article/20170320/PRINT/303209979/general-partners-putting-money-where-investments-are>

² <https://ilpa.org/wp-content/uploads/2015/07/ILPA-Private-Equity-Principles-version-2.pdf>

³ At paragraph 2.2.2:

http://www.mas.gov.sg/~media/MAS/Regulations%20and%20Financial%20Stability/Regulations%20Guidance%20and%20Licensing/Securities%20Futures%20and%20Fund%20Management/IID%20Guidelines/SFA04G05GuidelinesOnFMCLicensingAndRegistration_Nov2017.pdf

4. Knowledgeable employees should at least include, with respect to the fund manager, the fund or an affiliated person of the fund manager: (a) a director, trustee, general partner, advisory board member, or person serving in a similar capacity; (b) employees who, in connection with his or her regular functions or duties, participates in the investment activities of the fund; provided, that such employee has been performing such functions and duties for at least 12 months; and (c) employees of certain related advisers of the fund manager. Fund managers should maintain records of how such persons qualify as knowledgeable employees and be able to present such information for the MAS' review upon request.
5. Our proposal above is modelled after the approach adopted in the United States.

Comparative Analysis⁴

Hong Kong: Proposal being considered by the SFC

6. Private funds are commonly marketed solely to "professional investors" (i.e., any individual, either alone or with any of his or her associates on a joint account, having a portfolio of not less than HK\$8 million) in reliance on the relevant exemption. Employees that do not meet the requirements of a "professional investor" are unable to access investment products managed by their employer firms.
7. We understand that the SFC is currently considering a proposal for licensed representatives in Hong Kong to be treated as "professional investors" to allow them to access the investment products managed by their employer firms.

European Union: Employee vehicles and opt-up regime facilitates employee participation

8. Vehicles that are purely for employees are exempt from regulations under the AIFMD. However, local marketing rules in a particular European Union jurisdiction may still apply.
9. Although employees are not "professional investors" under MiFID II, they are able to opt-up as an elective professional client if they are able to meet two out of the following three criteria: (a) made 10 similar investments per quarter for the last four quarters; (b) assets of at least €500,000 (excluding personal residence); and (c) working in the financial services sector for at least a year.

United States: Regulatory regime facilitates knowledgeable employee participation

10. Employee participation is actively facilitated in the United States. In the United States, the knowledgeable employee exemption allows knowledgeable employees to invest in a private fund managed by its employer firm (or its affiliates) regardless of whether the knowledgeable employee is a "qualified purchaser" (i.e., individuals with at least US\$5 million in "investments"). Amongst other things, the exemption enables: (a) the private fund to continue relying on exemptions from registration as an investment company; and

⁴ If helpful, we would be happy to discuss in greater detail the approaches adopted in the abovementioned jurisdictions.

(b) the manager of the private fund to continue relying on exemptions from having to register as a registered investment adviser.

11. Private funds in the United States are typically offered solely to "accredited investors" under Regulation D. The knowledgeable employee exemption does not exempt private funds from the requirement that all investors are "accredited investors". However, we note that the definition of "accredited investors" is more inclusive (e.g., a natural person whose net worth or joint net worth with such person's spouse is in excess of US\$1 million (as opposed to a personal net worth exceeding S\$2 million under the SFA)).
12. The definition of "knowledgeable employee" is broad and has been clarified by the SEC to include: (i) a research analyst who researches all or only a portion of the private fund's portfolio; (ii) a member of the analytical or risk team who regularly develops models and systems to implement the private fund's strategy by translating quantitative signals into trade orders or providing analysis or advice that is material to the investment decisions of a portfolio manager; (iii) a trader who is regularly consulted for advice by the private fund's 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; (iv) a tax professional who is regularly consulted for advice by the private fund's portfolio manager typically before the portfolio manager makes investment decisions and whose analysis or advice is material to the portfolio manager's investment decisions; and (v) an attorney who regularly analyses legal terms and provisions of investments and whose advice is material to the private fund's portfolio manager's decisions.
13. The regulatory regime in the United States is described in greater detail in the appendix attached.

Conclusion

14. Alignment of interest between the investment team and investors, primarily by having "skin in the game", is an important criterion for investors in illiquid closed-ended funds. Whilst fund managers based in the United States and the European Union (and possibly, Hong Kong in the near future) are able to achieve strong alignment of interest with investors, this is currently not the case for Singapore-based fund managers. In order to ensure Singapore remains a hub for private equity and venture capital fund managers, it is important that the regulatory regime allow comprehensive participation by investment teams in funds they manager.

Appendix: Regulatory Regime in the United States

In the United States, the fund registration regime facilitates the participation by "knowledgeable employees" ("**KEs**"), which are described in further detail below, in private funds⁵ that are the employers of such KEs or private funds that are managed by the employers (or certain of their affiliates) of such KEs. For example, KEs are not required to meet certain investor suitability thresholds when they invest in private funds, which are their employers, or are managed by their employers (or certain of their affiliates), in order for such private funds to rely on certain exceptions from fund registration requirements.

Under the United States Investment Company Act of 1940, as amended (the "**Investment Company Act**"), a company that meets the definition of an "investment company", and which uses the means or instrumentality of United States interstate commerce to offer any security of which it is the issuer, must either register with the United States Securities and Exchange Commission (the "**SEC**") as an investment company or be able to rely on an exemption or exception from such registration. One such exception is set forth in Section 3(c)(7) of the Investment Company Act (the "**Section 3(c)(7) Exception**"). The Section 3(c)(7) Exception excludes from the definition of an "investment company" a fund, the outstanding securities of which is owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers" and which is not making (and does not at that time propose to make) a public offering of its securities.⁶

The threshold to be considered a "qualified purchaser" is rather high, with individuals needing to have at least US\$5 million in "investments"⁷ and entities being required to have at least US\$25 million in "investments". However, in 1996, the SEC adopted Rule 3c-5 under the Investment Company Act ("**Rule 3c-5**"), which allows a private fund to continue to rely on the Section 3(c)(7) Exception even if a KE who is not a "qualified purchaser" invests in such private fund.

In addition to ensuring that private funds that offer their securities through the means or instrumentality of United States interstate commerce are excepted or excluded from the definition of an "investment company" under the Investment Company Act (and therefore not required to register as such), such private funds must also ensure that their offerings of securities to investors are not required to be registered under the Securities Act. To this end, interests in non-United States private funds are typically only offered to "US persons" (as that term is defined in Rule 902 of Regulation S promulgated under the Securities Act) that are "accredited investors" (as defined in Rule 501 of Regulation D promulgated under the Securities Act, "**Regulation D**") such that the fund can rely on the exemption from registering the offering of the fund's shares that is provided by Regulation D.⁸ It is noteworthy that the "accredited investor" threshold required under Regulation D is lower than

⁵ Private funds include hedge funds, private equity funds, and other types of pooled investment vehicles that are excepted from the definition of an "investment company" by Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.

⁶ For non-United States funds only "United States persons" (as that term is defined in Rule 902 of Regulation S promulgated under the Securities Act) must be "qualified purchasers".

⁷ The definition of "investments" is set forth in Rule 2a51-1 promulgated under the Investment Company Act.

⁸ Please note that the offering of interests in a non-US fund to non-US persons is generally done in accordance with Regulation S promulgated under the Securities Act.

the "accredited investor" threshold under the Securities and Futures Act of Singapore (the "SFA"). Under Regulation D, the following are considered to be "accredited investors": (a) a natural person who either: (i) has an individual annual income in each of the two most recent years in excess of US\$200,000, and reasonably expects to have an individual annual income in the current year in excess of US\$200,000; or (ii) together with a natural person's spouse, has a joint annual income in excess of US\$300,000 in each of the two most recent years, and reasonably expects their joint annual income in the current year to exceed US\$300,000 (as opposed to an individual income of S\$300,000 in the preceding 12 months under the SFA); or (b) a natural person whose net worth or joint net worth with such person's spouse is in excess of US\$1,000,000 (as opposed to a personal net worth exceeding S\$2 million under the SFA)⁹.

Definition of knowledgeable employee

KEs may include, with respect to the private fund or an affiliated person that manages the investment activities of the private fund (e.g., an investment manager): (a) a director, trustee, general partner, advisory board member, or person serving in a similar capacity; (b) a president, vice-president of a principal business unit; (c) any officer who performs a policy-making function; (d) employees who, in connection with his or her regular functions or duties, participates in the investment activities of the private fund; provided, that such employee has been performing such functions and duties for at least 12 months (this can include: (i) a research analyst who researches all or only a portion of the private fund's portfolio; (ii) a member of the analytical or risk team who regularly develops models and systems to implement the private fund's strategy by translating quantitative signals into trade orders or providing analysis or advice that is material to the investment decisions of a portfolio manager; (iii) a trader who is regularly consulted for advice by the private fund's 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; (iv) a tax professional who is regularly consulted for advice by the private fund's portfolio manager typically before the portfolio manager makes investment decisions and whose analysis or advice is material to the portfolio manager's investment decisions; and (v) an attorney who regularly analyses legal terms and provisions of investments and whose advice is material to the private fund's portfolio manager's decisions); and (e) employees of certain related advisers of the investment manager.¹⁰

With respect to investment managers, such managers are required to make determinations as to which of their employees qualify as KEs based on the facts and circumstances relevant to their business. In this regard, investment managers should maintain records of employees the investment manager has permitted to invest as a KE in a private fund relying on the Section

⁹ "Net worth" means the excess of the estimated fair market value of the person's total assets over total liabilities, individually or jointly with such person's spouse (as applicable). "Total assets" means total assets including automobiles and other personal property but excluding such person's primary residence (and including property owned by a spouse other than the primary residence of the spouse). "Total liabilities" means total liabilities excluding any debt secured by such person's primary residence, except that "total liabilities" includes: (a) any amount of debt secured by such person's primary residence that exceeds the estimated fair market value of such residence; and (b) any amount of debt secured by such person's primary residence that was borrowed within the past 60 days for purposes other than the purchase of such residence.

¹⁰ Section 270.3c-5(a) of the Investment Company Act and <https://www.sec.gov/divisions/investment/noaction/2014/managed-funds-association-020614.htm>

3(c)(7) Exception and the investment manager should be able to explain the basis pursuant to which the employee qualifies as a KE.¹¹

¹¹ <https://www.sec.gov/divisions/investment/noaction/2014/managed-funds-association-020614.htm>