May 12, 2011

SEC to Adjust for Inflation "Qualified Client" Tests; Issues Proposed Related Rule Amendments

I. Order Adjusting "Qualified Client" Dollar Amount Tests

On May 10, 2011, the U.S. Securities and Exchange Commission (the "SEC") published a notice[1] that it intends to issue an order that would adjust for inflation two dollar amount tests in Rule 205-3 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"). Rule 205-3 permits SEC-registered investment advisers to charge performance based compensation to "qualified clients."

Section 205(a)(1) of the Advisers Act generally prohibits a registered investment adviser from entering into, extending, renewing or performing any investment advisory contract that provides for compensation to the investment adviser based on a share of capital gains on, or capital appreciation of, the funds of a client (i.e., performance fees).[2] Rule 205-3 under the Advisers Act exempts a registered investment adviser from the prohibition against charging a client performance fees if the client is a "qualified client" which includes, among other things, a client with at least $750,000 under management with the investment adviser immediately after entering into the advisory contact, or a client that the investment adviser reasonably believes to have a net worth of more than $1.5 million at the time the contract is entered into. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") amended Section 205(e) of the Advisers Act to provide that by July 21, 2011 and every five years thereafter, the SEC shall adjust for inflation the dollar amount tests included in rules issued under Section 205(e) of the Advisers Act. Accordingly, the SEC notice provides that it intends to issue an order to revise the assets under management[3] and net worth tests of Rule 205-3 to $1 million and $2 million, respectively, to account for the effects of inflation.

An order adjusting the dollar amount tests specified in the definition of "qualified client" will be issued by the SEC, unless the SEC orders a hearing. Hearing requests should be submitted to the SEC by June 20, 2011.

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1 See SEC Release No. IA-3198 entitled "Investment Adviser Performance Compensation" at http://www.sec.gov/rules/proposed/2011/ia-3198.pdf (the "Proposing Release").

2 Note that Section 205(b)(4) provides that this performance fee prohibition shall not apply to an investment advisory contract, among other contracts, with a company excepted from the definition of an investment company under Section 3(c)(7) of the Investment Company Act of 1940, as amended.

3 In determining the amount of assets under management, an investment adviser may include the assets that a client is contractually obligated to invest in private funds managed by the adviser, i.e., uncalled capital commitments.

II. Proposed Related Amendments to Rule 205-3

The SEC is also proposing related amendments to Rule 205-3 under the Advisers Act. First, the SEC is proposing to add a new paragraph (e) stating that the SEC will issue an order every five years adjusting for inflation the dollar amounts of the assets under management and net worth tests of Rule 205-3, as required by the Dodd-Frank Act. Second, the SEC is proposing to amend the net worth standard set forth in the definition of "qualified client" in Rule 205-3 to exclude the value of a natural person's primary residence, calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property. Note that this change is not required by the Dodd-Frank Act, although it is similar to the requirement in the Dodd-Frank Act that the SEC exclude the value of a natural person's primary residence in the definition of "accredited investor" in rules under the Securities Act of 1933, as amended. Finally, the proposed amendments would replace the current transition rules set forth in Rule 205-3 with two new subsections to allow an investment adviser and its clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if performance fees would not be permissible under the contract if it were entered into at a later date. Proposed Rule 205-3(c)(1) would provide that, if a registered investment adviser entered into a contract and satisfied the conditions of the rule that were in effect when the contract was entered into, the investment adviser will be considered to satisfy the conditions of the rule. If, however, a natural person or company that was not a party to the contract becomes a party, the conditions of the rule in effect at the time they become a party would apply to that person or company. Proposed Rule 205-3(c)(2) would provide that, if an investment adviser was previously exempt pursuant to Section 203 from registration with the SEC and subsequently registers with the SEC, Section 205(a)(1) of the Advisers Act would not apply to the contractual arrangements into which the investment adviser entered when it was exempt from registration with the SEC.

Comments on the proposed amendments are due by July 11, 2011.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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