

July 14, 2011

SEC Issues Order Adjusting for Inflation “Qualified Client” Tests

I. Order Adjusting “Qualified Client” Dollar Amount Tests

On July 12, 2011, the U.S. Securities and Exchange Commission (the “SEC”) issued an order¹ (the “Order”) that adjusts 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 Order revises the assets under management³ and net worth tests of Rule 205-3 to \$1 million and \$2 million, respectively, to account for the effects of inflation.

The Order will be effective on September 19, 2011, which will be approximately 60 days after its publication in the Federal Register.

¹ See SEC Release No. IA-3236 entitled “Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940” (July 12, 2011) at <http://www.sec.gov/rules/other/2011/ia-3236.pdf>.

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

Also, as a reminder, on May 10, 2011, the SEC proposed⁴ related amendments to Rule 205-3 under the Advisers Act, including, among other things, a new paragraph (e) which provides 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. These proposed amendments are still under consideration by the SEC.

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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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⁴ See SEC Release No. IA-3198 entitled "Investment Adviser Performance Compensation" (May 10, 2011) at <http://www.sec.gov/rules/proposed/2011/ia-3198.pdf>.

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