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SEC To Adjust "Qualified Client" Dollar Thresholds For Investment Adviser Performance Fee Rule, Implementing Requirements Imposed By Dodd-Frank

BY THE INVESTMENT MANAGEMENT PRACTICE

Overview

On May 10, 2011, the Securities and Exchange Commission ("SEC") provided notice of its intent to issue an order which will adjust certain dollar thresholds in Rule 205-3 of the Investment Advisers Act of 1940 (the "Advisers Act"), the rule which permits investment advisers to charge a performance fee to "qualified clients." The SEC also proposed amending Rule 205-3 to (i) require adjustments of these dollar amount thresholds every five years and (ii) exclude a person's primary residence from the test of whether a person has sufficient net worth to be considered a "qualified client."[1]

The SEC has also proposed transition rules that would (i) apply the revised "qualified client" dollar thresholds prospectively, so that arrangements permissible at the time they were entered into are not later required to be renegotiated either as a result of this amendment or future inflation adjustments, and (ii) effectively "grandfather" clients of advisers who were not previously registered with the SEC but are now required to register as an investment adviser under Dodd-Frank. The SEC is accepting comment on the proposed inflation adjustment rule, the proposed treatment of primary residence in the calculation of net worth, and the proposed transition rules until July 11, 2011.

Discussion

1. Revisions to "Qualified Client" Test

The Release provides notice of the SEC's intent to issue an order to revise the "qualified client" dollar thresholds of Rule 205-3 to account for the effects of inflation.[2] Rule 205-3 provides an exception to Section 205(a)(1) of the Advisers Act, which generally prohibits advisers from charging performance fees.[3] Rule 205-3 allows an investment adviser to charge a performance fee to a "qualified client". A "qualified client" is currently defined as a natural person (i) with at least $750,000 in assets under management with the investment adviser immediately after entering into the advisory contract (the "assets under management test"), or (ii) who the adviser reasonably believes has, prior to entering into the advisory relationship, a net worth of more than $1.5 million (the "net worth test").

The order would revise the dollar amounts of the assets under management test from $750,000 to $1 million and the net worth test from $1.5 million to $2 million. Importantly for private fund advisers, in

calculating the assets under management test, an investment adviser may include the total amount of committed capital, including uncalled capital commitments[4]

2. Proposed Rules For Future Inflation Adjustments

The SEC has also proposed amendments to Rule 205-3 to require the SEC to issue an order every five years adjusting the asset under management and net worth test for inflation.[5] The inflation adjustment is proposed to be pegged to changes in the Personal Consumption Expenditures Chain-type Price Index ("PCE Index").[6] The proposal would establish the old $750 million and $1 million Rule 203-3 thresholds as the baseline of future inflation adjustment calculations.

3. Proposed Treatment of Primary Residence Value for Net Worth Calculation

The SEC is also proposing to exclude the value of a natural person's primary residence and debt secured by the property in calculating a person's net worth for Rule 205-3 purposes. While this revision is not mandated by Dodd-Frank, it conforms to the changes in the "accredited investor" standard under the Securities Act of 1933 (the "Securities Act") imposed by Dodd-Frank[7]. In the Release, the SEC notes that the value of a person's residence may have little relevance to an individual's financial experience and sophistication and ability to bear the risks of performance fee arrangements.[8]

The proposed amendment would exclude the value of a natural person's primary residence and the amount of debt secured by the property that is no greater than the property's current market value. As such, a mortgage on a person's residence would not be included in assessing a person's net worth unless the outstanding debt on the mortgage at the time the net worth is calculated exceeds the market value of the residence. If the outstanding debt exceeds the market value of the residence, the amount in excess would be considered a liability in calculating net worth under the proposed amendments to Rule 205-3.

4. Transition Rules

The Release proposes transition rules designed to allow advisers and clients to maintain existing performance fee arrangements that were permissible when the contract was entered into, even if the arrangements would no longer be permissible if entered into anew. As a result, clients who were considered "qualified" because they entered into a contractual arrangement with the adviser under one set of qualified client dollar thresholds, may maintain their performance fee relationships and even make additional "new money" investments with the adviser, even though the client would not be considered "qualified" if it entered into the advisory arrangement at a later date[9]. This has particular relevance given the fact that the qualified client thresholds can now be expected to change every five years.

Second, the rule grandfathers performance fee clients of advisers that are now required to register as a result of Dodd-Frank, so that investment advisers which were previously exempt from registration under the Investment Advisers Act, and therefore were able to enter into performance fee arrangements with clients, may retain these performance fee relationships after registration even though those clients do not meet the "qualified client" tests of Rule 205-3.

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[1] SEC Release No. IA-3198; File No. S7-17-11 (the "Release"). The order adjusting the thresholds for "qualified client" determination and proposed inflation-adjustment mechanism are mandated under section 418 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

[2] Release at 5.

[3] 15 U.S.C. 80b. By prohibiting performance-based fee arrangements, Congress intended to protect advisory clients from arrangements it believed might encourage advisers to take undue risks with client funds to increase advisory fees.

[4] Note that only bona fide contractual commitments are includible in this amount (i.e., those that the adviser has a reasonable belief the investor will be able to meet).

[5] The SEC proposes to delegate this authority to the Staff of the Division of Investment Management by amending its rules of organization to grant the Director of the Division of Investment Management the authority to issue notices and orders implementing these adjustments.

[6] In the Release, the SEC notes that it has used the PCE Index in other contexts, including the determination of whether a person meets a specific net worth minimum in Regulation R of the Securities and Exchange Act of 1934 (the "Exchange Act").

[7] The SEC amended the definition of "accredited investor" in the Securities Act to exclude the value of a natural person's residence pursuant to a Dodd-Frank Act mandate. The Dodd-Frank Act did not require similar amendments to the definition of "qualified client" under rule 205-3 of the Advisers Act. See Securities Act Release No. 9177 (Jan. 25, 2011) [76 FR 5307 (Jan. 31, 2011)]. The SEC notes a number of recent proposals where it determined to exclude the value of a person's primary residence in similar calculations. See Investment Advisers Act Release No.2576 (Dec. 27, 2006) [72 FR 400 (Jan. 4, 2007)] (proposing changes to net worth threshold for establishing when an individual could invest in hedge funds pursuant to the safe harbor of Regulation D); Securities Exchange Act Release No. 56501 (Sept. 24, 2007) [72 FR 56514 (Oct. 2007)] (excluding primary residence and associated liabilities from the fixed-dollar threshold for "high net worth customers" under Regulation R); Investment Company Act Release No. 22597 (Apr. 3, 1997) [62 FR 17512 (Apr. 9, 1997)] (excluding a personal residence within the meaning of investments in real estate held for investment purposes under rule 2a51-1).

[8] Proposing Release at 10-11. Id.

[9] This includes permitting new investments by existing shareholder in a "private fund", exempt from registration under section 3 (c)(1) of the Investment Company Act of 1940. Rule 205-3 requires that shareholders of a private fund must meet satisfy the "qualified client" requirements in order for the adviser to the private fund to charge a performance fee. However, any new investor in the private fund must meet the qualified client test in effect at the time of his/her initial investment.