

SEC Revises "Qualified Client" Dollar Thresholds for Investment Adviser Performance Fee Rule

BY THE INVESTMENT MANAGEMENT PRACTICE

Recently, the Securities and Exchange Commission ("SEC") announced that it is adopting amendments which will adjust certain dollar thresholds set forth 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 amendments also: (i) require adjustments of these dollar amount thresholds every five years for inflation, (ii) exclude the value of a person's primary residence and certain associated debt in determining whether a person has sufficient net worth to be considered a "qualified client," and (iii) add several transition provisions to the Rule.¹

The amendments will be effective 90 days after publication in the Federal Register.

Discussion

1. Revisions to "Qualified Client" Test

The amendments revise the "qualified client" dollar thresholds of Rule 205-3 to account for the effects of inflation, as required by the Dodd-Frank Act.² Rule 205-3 provides an exception to Section 205(a)(1) of the Advisers Act, which generally prohibits SEC-registered investment advisers from charging performance fees. Rule 205-3 allows an investment adviser to charge a performance fee to a "qualified client." Pursuant to the amendments, a "qualified client" is defined as a natural person (i) with at least \$1 million in assets under management with the investment adviser immediately after entering into the advisory contract (the "assets under management test"), or (ii) whom the adviser reasonably believes has, prior to entering into the advisory relationship, a net worth of more than \$2 million (the "net worth test").³

In calculating the assets under management test, private fund investment advisers may include the total amount of committed capital, including uncalled capital commitments.⁴

2. Rules for Future Inflation Adjustments

Pursuant to the Dodd-Frank Act, the amendments to Rule 205-3 require the SEC to issue an order every five years adjusting the assets under management test and the net worth test for inflation. The inflation adjustment will be pegged to changes in the Personal Consumption Expenditures Chain-Type Price Index ("PCE Index"). The amendments establish the former \$750,000 and \$1.5 million Rule 205-3 thresholds as the baseline of future inflation adjustment calculations.⁵

3. Treatment of Primary Residence Value and Certain Associated Debt for Net Worth Test Calculation

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

The amendments exclude debt secured by a natural person's primary residence up to the fair market value of the residence; however, any increase in the amount of debt secured by the primary residence in the 60 days before the advisory contract is entered into must be included as a liability. The SEC's decision to implement this 60-day look-back provision is predicated on its desire to prevent investors from inflating their net worth by borrowing against their homes, effectively converting their home equity — which is excluded from the net worth test calculation under the amendments — into cash or other assets that would be included in the net worth test calculation.⁶ For any outstanding debt secured by the primary residence that exceeds the market value of the residence, the amount in excess is considered a liability in calculating net worth.

4. Transition Rules

The amendments provide 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 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. If, however, another person that was not a party to the contract becomes a party, the conditions of the amended rule will be applicable to that person. This has particular relevance given the fact that the qualified client thresholds will now be adjusted every five years.

Second, the amendments "grandfather" performance fee clients of investment advisers now required to be registered under the Dodd-Frank Act (but previously exempt from registration under Rule 203 of the Advisers Act), so that these performance fee relationships can be retained even if those clients do not meet the amended "qualified client" tests of Rule 205-3.

Finally, the amendments allow for limited transfers of interests from a qualified client to a person who was not a party to the contract and is not a qualified client at the time of transfer. If an owner of an interest in a private investment fund transfers the interest by gift or bequest, or pursuant to an agreement related to a legal separation or divorce, the transfer will not cause the transferee to "become a party" to the contract and will not require the transferee to meet the definition of a qualified client under Rule 205-3.

Fund managers and other advisers should revise their fund subscription documents and other relevant account intake forms to incorporate the new requirements imposed by these amendments.

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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 the proposed inflation-adjusted 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 Prior to the adoption of the amendments to Rule 205-3, these thresholds were \$750,000 and \$1.5 million, respectively.

⁴ 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 Rule 205-3(e) provides that the assets under management and net worth tests will be adjusted for inflation by (i) dividing the year-end value of the PCE Index for the calendar year preceding the calendar year in which the order is being issued, by the year-end value of the PCE Index for the calendar year 1997, (ii) multiplying the threshold amounts adopted in 1998 (\$750,000 and \$1.5 million) by that quotient, and (iii) rounding each product to the nearest multiple of \$100,000. For example, for the order the Commission will issue in 2016, the Commission would (i) divide the year-end 2015 PCE Index by the year-end 1997 PCE Index, (ii) multiply the quotient by \$750,000 and \$1.5 million, and (iii) round each of the two products to the nearest \$100,000.

⁶ There is an exception to the 60-day look-back provision for debt secured by a primary residence in connection with the acquisition of that primary residence. The 60-day look-back period applies to incremental debt secured against a primary residence that is incurred for the purpose of circumventing the net worth standard of the rule.