

# Client Alert

August 2011

## SEC Raises Qualified Client Standard for Performance Fee Rule

### SEC Implementation of the Dodd-Frank Wall Street Reform Act

On July 12, 2011, the Securities and Exchange Commission ("SEC") issued an order under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), as required by Section 418 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") to increase the dollar amount tests applicable to qualified clients that may be charged performance fees by registered investment advisers under Rule 205-3 of the Advisers Act. In addition, on May 10, 2011, the SEC proposed rules to provide for future inflation adjustments every five years. A copy of the SEC's order is available [here](#) and the proposing release is available [here](#).

### Background

Section 418 of Dodd-Frank amended Section 205(e) of the Advisers Act to require the SEC to adjust for inflation the dollar amount tests in the rules issued under Section 205(e) before July 21, 2011, and every five years thereafter. Section 205 prohibits investment advisers to be compensated on the basis of a share of capital gains. Rule 205-3, also known as the "performance fee rule," exempts from this performance fee prohibition any "qualified clients" of the investment adviser.

A different provision in Dodd-Frank requires the SEC to make inflation adjustments in a slightly different context. Section 413 of Dodd-Frank requires the SEC to adjust the dollar amount tests in the "accredited investor" definition as well as to adopt rules to change the net worth standard in that definition to exclude the value of the investor's primary residence in calculating net worth. Although these rules have not yet been adopted, Dodd-Frank and the SEC's guidance currently require the accredited investor definition to exclude the value of the investor's primary residence in calculating net worth.

### Qualified Client Standard

Under Rule 205-3(d)(1) a "qualified client" currently includes:

- a natural person who or a company that has at least \$750,000 under the management of the investment adviser;
- a natural person who or a company that the investment adviser (and any person acting on his behalf) reasonably believes, either:
  - has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than \$1,500,000; or
  - is a "qualified purchaser" as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940.

The SEC's order amends the definition of "qualified client" effective September 19, 2011, to:

- increase the required amount for assets under management with the investment adviser from \$750,000 to \$1,000,000; and
- increase the net worth standard from \$1,500,000 to \$2,000,000.

Under the proposed rules, which have not yet been adopted, each of these standards would be adjusted by SEC order on or about May 1, 2016, and every five years thereafter to adjust for inflation. The SEC expects to delegate to the Director of the Division of Investment Management the authority to issue notices and orders revising these dollar amount thresholds.

Although Dodd-Frank requires the SEC to exclude the value of a natural person's primary residence from his or her net worth calculation in the context of the "accredited investor" definition, it does not require the exclusion of the value of the primary residence in the context of the "qualified client" definition. Despite this distinction in Dodd-Frank, the SEC proposal applies a consistent approach to both the qualified client and accredited investor calculations and excludes from both calculations of net worth the value of the primary residence of a natural person and the amount of debt secured by the property, up to the estimated fair market value of the property.

The SEC solicited comments on several aspects of the proposed rule, including whether to exclude the value of a natural person's primary residence from the net worth calculation.

### **Grandfathering and Compliance Dates**

The SEC also proposes to amend the transition rule in Rule 205-3(c) to provide that the prohibition on performance fees will not apply to investment advisers that were previously exempt from registration under Section 203 at the time an advisory contract was entered into or to an account of an equity owner of a private investment company advised by the adviser if the account was established when the adviser was exempt from registering as an investment adviser with the SEC. However, the prohibition will apply if the adviser enters into new contracts or if a new party is added to existing contracts (including with respect to investors in private investment companies advised by the adviser) when the adviser is no longer exempt.

Registered investment advisers that entered into contracts and satisfied the conditions of Rule 205-3 that were in effect when the contract was entered into will be considered to satisfy the conditions of the rule. If the adviser enters into new contracts or if a new party is added to existing contracts (including with respect to investors in private investment companies advised by the adviser), then the conditions of the rule in effect at that time will apply to that person or company.

The SEC anticipates a compliance date for the proposed rules that is at least 30 days after the final rules are adopted, but has solicited comment on the transition period and compliance date. The increased dollar amount thresholds for purposes of the "qualified client" definition are effective as of September 19, 2011.

### **Additional Information**

The Hunton & Williams Private Investment Funds practice group regularly represents funds, sponsors and a variety of investors in all types of private investment fund matters, including structuring, formation, offerings and compliance. We will continue to monitor the progress of the SEC's rulemaking to implement Dodd-Frank's requirements relating to investment advisers as well as relevant trends in private investment fund regulation.

For additional information on financial industry recovery proposals, see our related memoranda, available on [www.huntonfinancialindustryresourcecenter.com](http://www.huntonfinancialindustryresourcecenter.com). For additional information on recent legislation and regulations relating to regulation of private investment funds and their advisers, see our [prior memoranda](#) available on our website at [www.hunton.com](http://www.hunton.com).

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