

SEC Increases Advisers Act Qualified Client Thresholds

June 22, 2021

On June 17th, the Securities and Exchange Commission (the "Commission") issued an order adjusting the dollar amount thresholds for clients of registered advisers to be "qualified clients" under rule 205-3 of the Investment Advisers Act of 1940 (the "Advisers Act"), and thus permitted to pay a "performance fee" under the rule. The Order amends rule 205-3(d)(1) to increase the assets-under-management test from \$1,000,000 to \$1,100,000, and the dollar amount of the net worth test from \$2,100,000 to \$2,200,000. The Order will be effective on August 16, 2021.

Section 205 of the Advisers Act generally prohibits a registered investment adviser from entering into or renewing any investment advisory contracts with a client that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the account of a client (a "performance fee"). Both hedge fund performance fees and private equity fund carried interest allocations are forms of performance fees covered by Section 205. Rule 205-3 provides an exemption from the general performance-based fee prohibition for advisers to private funds whose investors (typically limited partners) are "gualified clients" meeting the financial thresholds.

This adjustment was made pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, which amended section 205(e) of the Advisers Act to require the Commission to adjust for the effects of inflation the dollar amount thresholds included in Rule 205-3, rounded to the nearest multiple of \$100,000. The Commission made the last adjustment in 2016.

The restriction on performance fees applies to registered advisers only, which excludes exempt reporting advisers, foreign private advisers, family offices, etc. The Order does not apply retroactively; thus contractual relationships with clients entered into before August 16, 2021 will not need to change. Although existing investors in section 3(c)(1) funds need not comply with the new thresholds provided they were qualified clients when they made their initial commitment, new investors in existing section 3(c)(1) funds will need to meet the new qualified client thresholds in order to comply with the amended rule. Accordingly, private fund sponsors should consider making revisions to relevant representations in fund subscription and transfer agreements.