Proskauer

SEC Amends the Advisers Act Performance Fee Rule to Tighten Standards for "Qualified Clients" and Adopt "Grandfathering" Provisions

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On February 15, 2012, the Securities and Exchange Commission ("SEC") adopted amendments to Rule 205-3 under the Investment Advisers Act of 1940 ("Advisers Act"), which permits SEC-registered investment advisers to charge performance-based fees to "qualified clients" under certain conditions. The amendments codify the higher dollar thresholds that investors must meet in order to be considered "qualified clients" under Rule 205-3 (as originally increased by SEC order, effective September 2011). In addition, effective May 22, 2012, Rule 205-3 has been amended to (i) exclude the value of a client's primary residence from the determination of his or her net worth for purposes of meeting the qualified client threshold, (ii) adopt two new "grandfathering" provisions to allow investment advisers to maintain pre-existing performance fee arrangements, and (iii) provide for periodic five-year adjustments to the qualified client dollar thresholds to reflect the impact of inflation.

Background

Subject to certain exceptions, SEC-registered investment advisers are generally prohibited under Section 205(1)(a) of the Advisers Act from entering into investment advisory contracts that provide for performance-based fee compensation. "Carried interest" arrangements for venture capital and private equity funds and "incentive allocation" arrangements for hedge funds are considered performance-based fee arrangements for this purpose.

Rule 205-3 provides an exception from the prohibition on performance fees for "qualified clients" that meet certain financial standards. These standards include an "assets under management" test (which exempts clients whose assets under management with an adviser exceed a certain minimum threshold) and a "net worth" test (which exempts clients whose net worth exceeds a certain minimum threshold).[1]

Increases to Qualified Client Thresholds

Pursuant to a mandate in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), the SEC issued an order in July 2011 increasing the minimum dollar thresholds applicable to qualified clients under the "assets under management" and "net worth" tests to reflect the effects of inflation since 1998, the last time the dollar thresholds were adjusted under Rule 205-3. In particular:

1. To meet the "assets under management" test, the minimum amount of assets that a client must have under management with an adviser was increased to $1 million (the previous threshold was $750,000); and
2. To meet the "net worth" test, the minimum net worth that a client must have was increased to $2 million (the previous threshold was $1.5 million).

The increased thresholds became effective as of September 2011. The amendments to Rule 205-3 adopted by the SEC on February 15th codify these changes.

In addition, when the amendments to Rule 205-3 become effective in May 2012, the value of a natural person's primary residence and certain debt secured by the property will be excluded in determining whether a person has sufficient net worth to be considered a "qualified client" under the "net worth" test.[2]

Transition Provisions

The SEC also adopted two transition provisions that will allow SEC-registered investment advisers to maintain their pre-existing performance fee arrangements with clients that do not meet the revised qualified client standards. In particular:

1. If a registered adviser entered into a performance fee arrangement with a client (including investors in private funds) that was a qualified client at the time the contract was entered into, amended Rule 205-3 will permit such performance fee arrangement to continue even if the client no longer meets the revised qualified client standards under the Rule.

2. In addition, if a registered adviser entered into a performance fee arrangement with a client (including investors in private funds) at a time when the adviser was not registered or required to be registered under the Advisers Act, amended Rule 205-3 will permit the performance fee arrangement to continue even if the client does not meet the qualified client standards.

In either case, such grandfathered clients may continue to make additional investments with the adviser (or into the private fund in which such client has invested) in reliance on the transition provisions. However, any new parties to the arrangement (including new investors in a private fund) will be required to meet the revised standards under Rule 205-3. In addition, the revised standards will also apply to any grandfathered clients entering into new contracts (or investing into new private funds) with the registered investment adviser. Advisers may rely on these transition provisions in advance of their formal effective date of May 22, 2012.

The SEC has also allowed for limited transfers of interests from a qualified client to a non-qualified client who was not a party to the performance fee contract if that interest is transferred by gift or bequest or pursuant to an agreement relating to a legal separation or divorce.

Periodic Adjustments for Inflation

In accordance with the mandate contained in Dodd-Frank, the SEC also amended Rule 205-3 to require the SEC to adjust the dollar thresholds for the "assets under management" and "net worth" tests for inflation every five years. These adjustments will be based on the Personal Consumption Expenditures Chain-Type Price Index, using the 1998 dollar thresholds as the base line.

Please contact any member of the Proskauer Private Investment Funds Group with any questions pertaining to the SEC rules on investment adviser performance-based compensation.

[1] "Qualified purchasers" (as such term is defined under the Investment Company Act of 1940) and certain knowledgeable employees are also considered qualified clients under Rule 205-3. With regard to funds that rely on the Section 3(c)(1) exemption to registration under the Investment Company Act (no more than 100 beneficial owners), it is generally necessary to look through the fund to determine if all beneficial owners (i.e., investors in the fund) meet the requirements for a qualified client. Look through is not necessary for funds that rely on the Section 3(c)(7) exemption from registration under the Investment Company Act (all "qualified purchasers").

[2] Debt secured by the primary residence generally will not be included as a liability in the calculation, except to the extent it exceeds the estimated value of the primary residence. However, any increase in the amount of debt secured by the primary residence within the 60 days prior to the day the advisory contract is entered into (other than debt incurred in connection with the acquisition of a primary residence) generally will be included as a liability.

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