

Client Alert.

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SEC Proposes Rules Amending the “Qualified Client” Standard and Issues Final Order Revising Dollar Amount Tests¹

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The Securities Exchange Commission proposed new rules that would increase the threshold for investment advisers to charge incentive compensation to qualified clients. The Commission also proposed new rules that would, among other things, revise the definition of “qualified client” to exclude the value of the principal residence from the calculation of net worth. This Client Alert summarizes the background and the new and proposed rules concerning “qualified client” standards.

BACKGROUND

Section 205(a)(1) of the Investment Advisers Act of 1940 (“Advisers Act”) generally prohibits an investment adviser from entering into, extending, renewing, or performing any investment advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds of a client. Rule 205-3 under the Advisers Act exempts an investment adviser from the prohibition against charging a client performance fees with respect to investors that are “qualified clients.” “Qualified clients” are generally defined to include (i) natural persons or companies that, immediately after entering into the contract, have at least \$750,000 under management with the adviser (“Assets under Management Test”) and (ii) natural persons or companies that the adviser reasonably believes, immediately prior to entering the contract, either have a net worth of more than \$1,500,000 at the time the contract is entered into (together, in the case of a natural person, with assets held jointly with a spouse) (“Net Worth Test”) or are “qualified purchasers,” as defined in the Investment Company Act of 1940 (“Investment Company Act”), at the time the contract is entered into.

Section 205(e) of the Advisers Act permits the SEC to promulgate rules under certain circumstances to exempt any person or transaction, or any class or classes of persons or transactions, from Section 205(a)(1). Rule 205-3 is promulgated pursuant to this authority.

Section 418 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) amends Section 205(e) of the Advisers Act by adding:

“With respect to any factor used in any rule or regulation by the Commission in making a determination under this subsection, if the Commission uses a dollar amount test in connection with such factor, such as a net asset threshold, the Commission shall, by order, not later than 1 year after the date of enactment of the Private Fund Investment Advisers Registration Act of 2010, and every 5 years thereafter, adjust for the effects of inflation on such test. Any such adjustment that is not a multiple of \$100,000 shall be rounded to the nearest multiple of \$100,000.”

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The Dodd-Frank Act therefore required that the “qualified client” standard under Rule 205-3 be adjusted for inflation by July 21, 2011, and every five years thereafter. In Release No. IA-3198 (the “Release”), the SEC proposed amending the “qualified client” standard and Rule 205-3. On July 12, 2011, the SEC ordered, pursuant to the Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Advisers Act (the “Order”), revising the dollar amount tests for “qualified clients.”

ORDER ADJUSTING DOLLAR AMOUNT TESTS

The SEC announced that it intends to revise the Assets under Management Test and Net Worth Test to \$1 million and \$2 million respectively. The SEC said in footnote 17 that an investment adviser could include, in determining the amount of assets under management, the assets that a client is contractually obligated to invest in private funds managed by the adviser. Only bona fide contractual commitments may be included, *i.e.*, those that the adviser has a reasonable belief that the investor will be able to meet.

On July 12, 2011, the SEC ordered, pursuant to the Order, that:

- for purposes of Rule 205-3(d)(1)(i) under the Advisers Act, a qualified client means a natural person who, or a company that immediately after entering into the contract, has at least \$1,000,000 under the management of the investment adviser; and
- for purposes of Rule 205-3(d)(1)(ii)(A) under the Advisers Act, a qualified client means a natural person who, or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than \$2,000,000 at the time the contract is entered.

PROPOSED AMENDMENTS TO RULE 205-3

Inflation Adjustment of Dollar Amount Thresholds

The SEC proposed adding a new paragraph (e) to Rule 205-3 stating that the Commission will issue an order every five years adjusting for inflation the dollar amounts of the assets-under-management and net worth tests of the rule, as required by the Dodd-Frank Act. The SEC stated that the PCE Index will be the inflation index used to calculate future inflation adjustments of the dollar amount tests in the rule. The SEC also stated that it intended to revise subparagraph (d) of Rule 205-3 to reflect the Order adjusting dollar amount tests. Furthermore, the SEC stated that it anticipated that it would delegate to its staff the authority to issue inflation adjustment orders every five years in the future.

Exclusion of the Value of Primary Residence from Net Worth Determination

The SEC proposed to amend the net worth standard in Rule 205-3 in the definition of “qualified client” to exclude the value of a natural person’s primary residence and debt secured by the property. The amendment would only 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. The debt above the market value would be considered a liability in calculating net worth under the proposed amendment to Rule 205-3.

Transition Rules

The proposed amendments would replace the current transition rules section of Rule 205-3 with two new subsections to allow an investment adviser and its clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if performance fees would not be permissible under the contract if it were entered into at a later date.

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First, Proposed Rule 205-3(c)(1) would provide that, if a registered investment adviser entered into a contract and satisfied the conditions of the rule that were in effect when the contract was entered into, the adviser will be considered to satisfy the conditions of the rule. However, if a natural person or company that was not a party to the contract becomes a party (including an equity owner of a private investment company advised by the adviser), the conditions of the rule in effect at the time they become a party would apply to that person or company.

Second, Proposed Rule 205-3(c)(2) would provide that, if an investment adviser was previously exempt pursuant to Section 203 from registration with the Commission and subsequently registers with the Commission, Section 205(a)(1) of the Act would not apply to an advisory contract entered into when the adviser was exempt from registration with the Commission, 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. However, Section 205(a)(1) of the Advisers Act will apply with regard to a natural person or company who was not a party to the contract and becomes a party (including an equity owner of a private investment company advised by the adviser) when the adviser is no longer exempt.

EFFECTIVE AND COMPLIANCE DATES

With respect to the proposals in the Release, the SEC stated that it would follow appropriate time periods before requiring compliance with the new standards. There will most likely be at least 30 days before the proposed rules would become effective.

With respect to the Order, the revised dollar amount tests for “qualified clients” will be effective on September 19, 2011.

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