SEC Issues Order Approving Adjustment to "Qualified Client" Dollar Amount Tests

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An investment adviser registered with the Securities and Exchange Commission may only charge a performance fee with respect to "qualified clients." Under Rule 205-3 of the Investment Advisers Act of 1940, a qualified client currently includes a client who (i) has at least $750,000 under management with the adviser or (ii) has a net worth of more than $1.5 million. On July 12, 2011, the SEC issued an order (the "Order") raising the dollar thresholds set forth above, such that a performance fee may only be charged if the client (i) has at least $1,000,000 under management of the investment adviser or (ii) has a net worth of more than $2,000,000. These tests are measured at the time the client contract is entered into. This change becomes effective as of September 19, 2011. Certain states including Massachusetts also follow the SEC's performance fee eligibility test with respect to advisers located in the state, and it is likely they will adjust their standards to match the new SEC tests. It should be noted that Qualified Purchasers (as defined in section 2(a)(51)(A) of the Investment Company Act of 1940) remain eligible to be charged performance fees in all cases.

Status of Related Proposed Amendments

In certain related amendments to Rule 205-3 proposed on May 10, 2011, the SEC proposed to amend the definition of "qualified client" to exclude from the calculation of an individual's net worth the value of such person's primary residence, as well as the amount of debt secured by the property as long as such debt is no greater than the property's current market value. This proposed change mirrors the recent change to the definition of "accredited investor" under the Securities Act of 1933, which was also implemented as part of the Dodd-Frank Act. In order to minimize the disruption to investment advisers' existing contractual arrangements, the SEC also proposed to let existing performance fee arrangements remain in place as long as the contract was permissible at the time it was entered into under the tests in place at such time. As a result, the Order and proposed rule amendments would not invalidate or penalize existing arrangements with clients.

These proposed rule amendments have not yet been adopted and currently remain under consideration by the SEC.

If you have questions about the Order, please contact Peter Rosenblum or Jeff Collins in Foley Hoag's Investment Management Group at (617) 832-1000 or your Foley Hoag attorney.