Adviser Performance Fee Rule Amended by the SEC

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Introduction

On February 15, 2012, the U.S. Securities and Exchange Commission (SEC) amended the "qualified client" standard of Rule 205-3 under the Investment Advisers Act of 1940, as amended (Advisers Act). Under the Advisers Act, and the rules promulgated thereunder, investment advisors registered with the SEC, or required to be registered with the SEC, may only charge "qualified clients" performance fees (fees calculated as a share of capital gains on, or appreciation of, the funds of a client).[1] The amendments to Rule 205-3 codify revisions to the qualified client standard that the SEC recently adopted by an order effective September 19, 2011, which order was required to be issued by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).[2] This note briefly describes the key features of the amendments.

The Amendments

Prior to the SEC's recent order adopting revisions to Rule 205-3, a qualified client was defined as any natural person or company with (i) at least $750,000 under management with the investment advisor or (ii) a net worth of at least $1.5MM.[3] The SEC's recent order, now codified by amendments to Rule 205-3, increased those amounts to $1MM and $2MM, respectively.[4]

In addition to changing the definition's dollar thresholds, the SEC also carved out certain exceptions, effective May 22, 2012, to the calculation of a natural person's net worth. First, the calculation of a person's net worth will no longer include the value of such person's primary residence as an asset.[5] Second, indebtedness secured by a primary residence up to the fair market value of the residence will no longer be counted as a liability.[6] However, debt secured by a primary residence will still be included in the net worth calculation: (1) to the extent such debt exceeds the fair market value of the residence[7] and (2) if such debt was incurred during the sixty-day period prior to entry into the investment advisory contract—except if such

indebtedness resulted from the acquisition of the primary residence (i.e., the indebtedness was a mortgage used to purchase the residence).[8] In a release announcing the adoption of the final rule, the SEC explained that the above-described exceptions were adopted to prevent individuals from taking out home-equity loans for the purpose of acquiring other assets and thereby inflating their net worth.[9]

Transitional Measures

To accommodate pre-existing advisory agreements which would become impermissible as a result of the amendments to Rule 205-3, the SEC adopted a number of transition provisions for Rule 205-3. With respect to registered investment advisors, advisory agreements containing performance fees that were permissible under Rule 205-3 when entered into will be exempt from the requirements of the amendments.[10] Likewise, performance fees charged with respect to subsequent investments by a client who is a party to such a pre-existing contract will also be exempt from the strictures of the amendments.[11] With respect to investment advisors previously exempt from registration with the SEC, if such any entity later registers, the new definition of qualified client will only be applicable to advisory agreements which the advisor enters subsequent to registration—pre-registration contracts will not be affected.[12]

The SEC also provided for one other, sundry transitional provision to address the issue of certain transfers of interests in private investment funds. Under the amendments, if such an interest is transferred by gift or bequest, or pursuant to a legal separation or divorce, performance fees payable pursuant to the interest will be permissible under the Advisors Act even if the transferee does not qualify as a qualified client under the revised Rule 205-3.[13]

Pooled Investments Vehicles

Under Rule 205-3, an investment advisor may only charge a performance fee to pooled investment vehicles of the type described in Section 3(c)(1) of the 1940 Act (a “3(c)(1) Vehicle”) if each investor in the pool is itself a qualified client.[14] Given this “look through” feature, the transitional provisions just discussed also apply to performance fees charged to 3(c)(1) Vehicles. Specifically, an investor in a new 3(c)(1) Vehicle or a new investor in an existing

3(c)(1) Vehicle will be subject to the Rule 205-3 thresholds in effect at the time of the investment.

Conclusions

The amendments discussed in this note represent another step in the on-going implementation of the Dodd-Frank Act. As such these amendments attempt to walk the fine line between protecting consumers of financial products and allowing such consumers reasonable freedom with respect to their investment decisions. The skill with which the SEC can walk that line will once again be tested in practice.

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[1] Advisers Act, Section 205(a) and Rule 205-3.

[2] *See* Section 418 of the Dodd-Frank Act, which required the SEC to issue an order adjusting the dollar thresholds in Rule 205-3 by July 21, 2011 and every five years thereafter, adjusting for inflation using the Personal Consumption Expenditures Chain-Type Price Index.

[3] Under Rule 205-3, qualified clients also include natural persons who, or companies that, are "qualified purchasers" under the Investment Company Act of 1940 (the "1940 Act"), as well as certain knowledgeable employees of investment advisors. The recent amendments to Rule 205-3 do not affect these non-monetary definitions.

[4] Revised Rule 205-3(d)(1)(i) & (ii).

[5] Revised Rule 205-3(d)(1)(ii)(A)(*1*).

[6] Revised Rule 205-3(d)(1)(ii)(A)(*2*).

[7] Revised Rule 205-3(d)(1)(ii)(A)(*3*).

[8] Revised Rule 205-3(d)(1)(ii)(A)(*2*)

[9] SEC Release No. IA-3372 at 13. These rules regarding calculation of a client's net worth, and the SEC's rationale therefor, are identical to those recently adopted by the SEC with respect to the definition of an "accredited investor" for purposes of limited securities offerings, discussed in our recent Client Alert, *SEC Adopts Net Worth Standard for Accredited Investors*, January 11, 2012.

[10] Revised Rule 205-3(c)(1).

[11] *Id.*

[12] Revised Rule 205-3(c)(2).

[13] Revised Rule 205-3(c)(3).

[14] Rule 205(b), former and revised.