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CLIENT PUBLICATION

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SEC Increases Qualified Client Net Worth Threshold

Every five years, the US Securities and Exchange Commission is required to adjust for inflation the agency's dollar-based qualification tests for when an SEC-registered investment adviser can receive compensation based on investment performance. Those tests establish "qualified client" status. The SEC has concluded its current review and will increase the net worth requirement for qualified client status to $2.1 million (up from $2 million) effective August 15, 2016. An alternative test, which is based on the client's assets under management with the adviser, will stay at $1 million under management.

Background

Section 205 of the US Investment Advisers Act of 1940 generally prohibits a registered investment adviser from receiving compensation based on a share of capital gains on or appreciation of funds of an advisory client (in what is variously termed "performance compensation," "carry" or an "incentive interest"). Recognizing that these arrangements nonetheless can be appropriate, Rule 205-3 under the Act permits such compensation or incentives so long as the advisory agreement is with a "qualified client." Again, the net worth based test for qualified client status is increasing to $2.1 million effective August 15, 2016 (a client's net worth generally being measured together with the client's spouse, if applicable, and excluding the value of a primary residence); the alternative test based on the client having $1 million under the management of the adviser is unchanged. Both amounts will be due for another mandated review against inflation in 2021.

What This Means in Practice

The SEC is clear that the increased net worth requirement generally will not affect contractual arrangements entered into prior to the August 15, 2016 effective date and cites its existing transition provisions under the rule.[1] Under those provisions, an advisory agreement or subscription agreement previously entered into should not be affected by changes to the qualified client tests, but any new advisory agreement or fund subscription agreement must reflect the new requirements.

As a practical matter, many investment advisers already limit their dealings to investors who are "qualified purchasers" for purposes of Section 3(c)(7) of the US Investment Company Act of 1940, the qualification thresholds of which are generally higher than those under Rule 205-3. Rule 205-3, in turn, provides that any investor who is a

[1] See Rule 205-3(c)(1) ("If a registered investment adviser entered into a contract and satisfied the conditions of this section that were in effect when the contract was entered into, the adviser will be considered to satisfy the conditions of this section; provided, however, that if a natural person or company who 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 this section in effect at that time will apply with regard to that person or company.")

"qualified purchaser" for Section 3(c)(7) purposes is automatically a "qualified client" for Rule 205-3 purposes. Relationships and contracts with qualified purchasers, including funds whose equity owners are all qualified purchasers, thus are generally not affected by changes to Rule 205-3's net worth (or AUM) test.

All other investment advisers who wish to enter into new performance compensation or incentive arrangements will update their advisory agreements and fund subscription agreements to reflect the new net worth test. Given the look-through provision in Rule 205-3(b), special attention should be given to subscription agreements for certain types of funds, notably those relying on Section 3(c)(1) of the US Investment Company Act of 1940 (so-called "3(c)(1) funds" or "100-person funds").

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