Client Alert.

February 21, 2012

SEC Raises Dollar Thresholds for Advisers to Charge Performance-Based Fees and Grandfathers Performance-Fee Contracts for Previously Unregistered Advisers

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On February 15, 2012, the Securities and Exchange Commission (the "Commission" or "SEC") raised the dollar thresholds for SEC-registered investment advisers to charge performance-based fees to their clients and added a new exemption for advisers who were not required to register prior to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").

Background. Section 205(a)(1) of the Investment Advisers Act generally restricts SEC-registered investment advisers from charging performance-based compensation, unless the client satisfies the definition of a "qualified client." Rule 205-3, adopted in 1985, exempted advisers from this restriction if their clients met either a minimum "assets-under-management test" or, alternatively, a minimum "net worth test." The Commission deemed those clients to be "financially experienced and able to bear the risks of performance fee arrangements."

The Dodd-Frank Act required that the Commission adjust for inflation the dollar amount thresholds in its performance fee rules, rounded to the nearest $100,000.

New dollar thresholds. Under the new rules, investment advisers registered (or required to be registered) with the Commission may receive performance-based compensation from "qualified clients." To be a "qualified client":

- A client must have at least $1 million under management with the adviser (the "assets-under-management test"), *or*
- The adviser must reasonably believe that a client has a net worth of more than $2 million at the time the advisory contract was entered into (the "net worth test").

These new amounts codify the order that the Commission issued on July 12, 2011, which initially set those thresholds.

Exclusion of the value of primary residence from net worth determination. The Commission amended the net worth test to exclude the value of a natural person's primary residence, and certain debt secured by the property.

The new rule is consistent with the net worth calculation rules found elsewhere in the federal securities laws. For example, this change is the same as the new standards contained in "accredited investor" rule in Regulation D, which applies to private offerings of securities, and other provisions of the Securities Act of 1933. (That change to the "accredited investor" rule was required by the Dodd-Frank Act.)

The effect of this new rule is also similar to the existing investments holdings standard that applies for determining whether an individual has sufficient investments to be considered a "qualified purchaser" under the Investment Company Act of 1940 (the "1940 Act"). Only "qualified purchasers" may invest in certain private investment companies that are not registered in under the 1940 Act, such as hedge funds and certain private equity funds.

For purposes of the new "qualified client" rule, debt secured by a primary residence (e.g., a mortgage) generally will not be included as a liability in the net worth calculation under the rule, unless the debt exceeds the estimated value of the primary residence. Any increase in the amount of debt secured by the primary residence in the 60 days before the advisory contract is entered into, however, will be included as a liability in the test. This rule was designed to discourage investors from incurring short-term debt to finance their investments, but to accommodate investors who have refinanced their mortgage in the ordinary course of business.

Adjustment for inflation. In addition to establishing new dollar amount thresholds, the new rules provide for the Commission to issue an order every five years adjusting for inflation the dollar amounts of these thresholds. The rule specifies the price index on which future inflation adjustments will be based.

Transition provisions. The new "qualified client" standard only applies to new contractual arrangements with investment advisers, and does not apply to new investments by clients who met the definition of "qualified client" when they entered into the advisory contract, even if subsequently they do not meet the dollar amount thresholds of the rule.

But, if a natural person or a company who was not a party to an advisory contract becomes a party (including an equity owner of a private investment company advised by the adviser), the conditions in effect at the time will apply to that investor.

The rules do not apply to a transfer of an equity interest in a private investment company by gift or bequest, or pursuant to an agreement related to a legal separation or divorce.

Exemption for advisers that were previously not registered. If an investment adviser was previously exempt from registration under the Advisers Act, and was not registered, the prohibition on payment of performance fees will not apply to an advisory contract entered into when the adviser was not required to register and was not registered, 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 not required to register and was not registered. This provides relief for many private fund advisers who were previously exempt from registration under the now-vacated "fewer than 15 clients" exemption. Under the new rules, funds that were formed before the adviser was registered may continue to pay performance fees (i.e., carried interest), even though the investors may not be "qualified clients." The prohibition, however, will apply with respect 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 required to register.

Similarly, the rules will apply if any of the registered adviser's clients subsequently become new investors in a different private investment company managed by the adviser after it registers.

Effective date. The new rules become effective 90 days after publication in the Federal Register.

> *Investment Adviser Performance Compensation,* Advisers Act Release No. 3372 (February 15, 2012) *available at* http://www.sec.gov/rules/final/2012/ia-3372.pdf.

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