SEC Proposes Changes to Performance Fee Rule

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On May 10, 2011, the Securities and Exchange Commission ("SEC") published a notice of its proposed amendments to Rule 205-3 under the Investment Advisers Act of 1940 ("Advisers Act"). The proposal is in response to a requirement under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") that the SEC take certain actions by July 21, 2011.

Qualified Clients: Increase to Net Worth and Assets Under Management Thresholds

Rule 205-3 (the "Rule") is an exemption from Rule 205(a)(1), which generally prohibits SEC registered investment advisers from charging performance-based fees. Currently, the Rule permits SEC registered investment advisers to charge performance fees to "qualified clients," which is defined as clients that have either (1) a net worth of at least $1.5 million or (2) at least $750,000 in assets under management with the adviser. Pursuant to Section 418 of Dodd-Frank, the new proposed thresholds are increased to (1) $2 million for the net worth threshold and (2) $1 million for the assets under management threshold. Section 418 also requires adjustments to these thresholds every five years.

In connection with the calculation of net worth for purposes of determining "qualified clients," the SEC has also proposed to exclude the value of the client's primary residence, which would have the effect of decreasing the client's net worth by any debt secured by the property in excess of the fair market value of that residence. This change, though not required by Dodd-Frank, parallels the mandated changes earlier this year to the definition of "accredited investor" under Regulation D of the Securities Act of 1933.

Transition Provisions

For existing clients of investment advisers, the SEC has proposed two transition provisions that would allow an SEC-registered investment adviser and its clients to preserve existing performance fee arrangements.

The first of such provisions proposes to grandfather clients who entered into performance fee arrangements that were permissible under the Rule at the time they entered into the advisory contract with their investment adviser. This provision would also extend to additional investments made by such clients after the effectiveness of the proposed amendments.

The second transition provision proposes to grandfather clients of investment advisers that were previously exempt from registration with the SEC, and provides that the prohibition set forth in Section 205(a)(1) would not apply to contractual arrangements entered into at the time the investment adviser was exempt. This provision may affect investment advisers who are required to register with the SEC for the first time as a result of Dodd-Frank. However, if a previously exempt adviser subsequently registers, the new thresholds would not apply to contracts entered into prior to registration.

It should be noted that investors in a pooled investment vehicle relying on the exception under Section 3(c)(1) of the Investment Company Act of 1940 ("1940 Act") are subject to the Rule, as the Rule requires a registered adviser to look at the underlying investors in pooled vehicles for purposes of the "qualified client" requirement. An investor in a new pooled investment vehicle relying on Section 3(c)(1) of the 1940 Act or a new investor in an existing Section 3(c)(1) vehicle would be subject to the Rule

205-3 thresholds in effect at the time of the investment. The Rule does not, however, require a pooled investment vehicle that is excepted as an investment company pursuant to Section 3(c)(7) to look through to its underlying investors.

The comment period for the proposed amendments will be open through July 11, 2011.