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A legal update from Dechert's Financial Services Group

SEC Tightens Performance Fee Rule

The U.S. Securities and Exchange Commission on February 15, 2012 adopted amendments (the "Amendments") to Rule 205-3 under the Investment Advisers Act of 1940 ("Advisers Act"), which tighten the net worth eligibility requirements for "qualified clients" who may pay performance fees to a registered investment adviser.[1]

Rule 205-3 provides an exemption from the general prohibition on charging performance fees under Section 205(a)(1) of the Advisers Act. Under current Rule 205-3, a registered investment adviser is permitted to charge clients a performance fee if the client's net worth or the assets managed for the client by the investment adviser meet certain thresholds. The current rule allows the payment of performance fees if the client has at least $750,000 of assets under management with the adviser prior to entering into the advisory contract, or if the adviser reasonably believes the client has a net worth exceeding $1.5 million at the start of the contractual relationship.

The Amendments make three significant changes to Rule 205-3: (1) an increase to the dollar amount thresholds, requiring a "qualified client" to have at least $1 million of assets under management by the adviser or a net worth exceeding $2 million;[2] (2) a change to the calculation of a client's net worth to exclude from such determination the value of a natural person's primary residence and certain debt secured by the property;[3] and (3) the addition of a requirement that the SEC issue an order every five years adjusting the dollar amount thresholds for inflation.[4] The Amendments are largely the result of a Congressional mandate under Section 418 of the Dodd-Frank Wall Street Reform Act, which required the SEC to adjust certain net worth standards, exclude the value of an individual's primary residence from the net worth calculation and adjust for inflation dollar amount thresholds in the rules under Section 205(e) of the Advisers Act.

Notably, the Amendments include two transition provisions. The first allows performance fee arrangements to remain in effect if they were permissible at the time of entering into the advisory contract. The second provision allows registered investment advisers that were previously not required to register with the SEC as an investment adviser to continue contractual performance fee arrangements entered into prior to registration.[5]

The Amendments institute a method of calculating dollar thresholds consistent with recently adopted changes to the method of calculation for accredited investors. The SEC

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1 Investment Adviser Performance Compensation, Investment Advisers Act Release No. 3372 (February 15, 2012) ("Adopting Release)."

2 Rule 205-3(d). This change codifies an order issued by the SEC on July 12, 2011. *See* Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3236 (July 12, 2011).

3 Rule 205-3(d)(1)(ii)(A). To the extent the amount owed on a property is greater than the property's value, the excess must be deducted from net worth. In certain circumstances, the SEC requires mortgage refinancings to be counted against net worth.

4 Rule 205-3(e).

5 Rule 205-3(c)(2).

recognizes in the Adopting Release that the exclusion of the value of a person's primary residence from the net worth calculation will reduce the pool of "qualified clients" and could affect the amount of fees collected by advisers to the extent clients pursue non-performance fee arrangements with advisers. However, in its cost-benefit analysis, the SEC found that the benefits of protecting financially inexperienced clients from arrangements that "encourage advisers to take undue risks with client funds to increase advisory fees," outweighed the costs.

The Amendments take effect 90 days after their publication in the Federal Register. However, investment advisers may rely on the transition provisions of Rule 205-3(c) immediately.

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