

February 23, 2012

*Practice Groups:**Investment
Management**Hedge Funds and
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SEC Amends the “Qualified Client” Standard for Investment Adviser Performance-Based Compensation

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I. Introduction

On February 15, 2012, the U.S. Securities and Exchange Commission (the “SEC”) issued a final rule release (the “[Adopting Release](#)”) amending Rule 205-3 (the “[Rule](#)”) of the U.S. Investment Advisers Act of 1940, as amended (the “[Advisers Act](#)”), pursuant to the requirements of Section 418 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “[Dodd-Frank Act](#)”).¹ The Rule amendments will become effective on May 22, 2012 (the “[Effective Date](#)”)² and will provide for the following new requirements:

- Codification of the increase in the dollar thresholds used to determine whether an investment advisory client is a “qualified client” implemented by an SEC order on July 12, 2011;
- A modified net worth test for “qualified clients,” including a provision that excludes the value of a person’s primary residence and certain debt secured by the residence from the calculation of net worth under the Rule;
- Revised transition provisions of the Rule to allow for the continuation of certain arrangements (including certain new investments under such arrangements) that were permissible at the time the adviser and client entered into the advisory agreement; and
- A requirement for the SEC to issue periodic orders to adjust the dollar thresholds used to determine the qualified client standard to account for inflation.

II. Background

The Advisers Act generally does not permit registered investment advisers to be compensated based on a share of capital gains or capital appreciation of the funds of a client under such adviser’s management (generally known as a performance fee or performance allocation)³ unless the client is a “qualified client,” as defined under the Rule. Before the Dodd-Frank Act, the Rule defined a “qualified client” as (i) a client with at least \$750,000 under the management of the adviser immediately after entering into the advisory contract (the “[AUM Threshold](#)”), or (ii) a client that the adviser reasonably believed (a) had a net worth (in the case of a natural person, together with assets owned jointly by his or her spouse) of more than \$1,500,000 at the time the advisory contract was entered into (the “[Net Worth Threshold](#)”) or (b) was a “qualified purchaser,” as defined in Section 2(a)(51)(A) of the U.S. Investment Company Act of 1940, as amended (the “[Company Act](#)”). The SEC adjusted these thresholds upwards by order on July 12, 2011 in order to implement the

¹ See [Investment Advisers Act Release No. 3198](#) (February 15, 2012).

² The effective date of the Rule is 90 days after publication in the Federal Register.

³ Section 205(a)(1) of the Advisers Act.

requirements of the Dodd-Frank Act, which mandated that the SEC adjust for inflation, by July 21, 2011 and every five years thereafter, the dollar tests used in all rules issued under Section 205(e) of the Advisers Act, including the qualified client test used in the Rule. Separately, the Dodd-Frank Act required the SEC to adopt a new definition of “accredited investor” under the U.S. Securities Act of 1933, as amended, to exclude the value of a person’s primary residence from the “accredited investor” net worth test (although the Dodd-Frank Act did not require a similar amendment to be implemented in respect of the “qualified client” test).

The term “qualified client” is also incorporated in the SEC definition of “investment adviser representative,”⁴ and thus, the newly adopted Rule amendments also affect whether advisory personnel need to be licensed with applicable states as investment adviser representatives.

III. Rule Amendments

A. Changes to the Assets Under Management Test

The amended Rule codifies increases in the dollar thresholds used to determine whether an investor entering into an advisory agreement with an investment adviser will have sufficient assets under management immediately after entering into the advisory contract in order to be deemed a “qualified client”:

- from \$750,000 to \$1,000,000 for the AUM Threshold and
- from \$1,500,000 to \$2,000,000 for the Net Worth Threshold.

To arrive at these dollar thresholds, the SEC utilized the Personal Consumption Expenditures Chain-Type Price Index (“PCE Index”), which is published by the Department of Commerce and which is often used as an indicator of inflation in the personal sector of the U.S. economy.⁵

B. Changes to the Net Worth Test

The Rule makes significant changes to the “qualified client” net worth test. Under the amended Rule, the “qualified client” net worth test:

- Excludes the value of a person’s primary residence from the calculation of a person’s net worth for the purposes of a “qualified client” determination.
- Generally (other than as described below), does not take into account a mortgage on a primary residence in the calculation of a person’s net worth unless the outstanding debt on the mortgage exceeds the fair market value of the property at the time the net worth is calculated, in which case the client’s net worth is reduced by the amount of such excess.
- Requires that any increase in the amount of debt secured by the primary residence in the 60 days before entering into the advisory contract must be included as a liability (a “60-day window”). This provision applies regardless of whether outstanding debt on the mortgage exceeds the fair market value of the property.

The 60-day window provision represents a significant change from the version of the Rule initially proposed by the SEC. The SEC stated, in the Adopting Release, that the purpose of the 60-day

⁴ See Rule 203A-3(a).

⁵ The SEC noted in the Adopting Release that the PCE Index is used in other provisions of the federal securities laws, including for setting net worth requirements in Regulation R under the U.S. Securities Exchange Act of 1934, as amended (*citations omitted*).

window is to prevent investors from inflating their net worth by borrowing against their homes to convert their home equity, which is excluded from the net worth calculation, into cash or other assets that would be included in the net worth calculation.

C. Transition Provisions

The Rule establishes three transition provisions to allow an investment adviser to maintain existing performance fee or allocation arrangements with respect to (1) existing clients of registered investment advisers; (2) clients of previously exempt investment advisers; and (3) transfers of ownership by gift or bequest or pursuant to a legal separation or divorce.

Existing Clients of Registered Investment Advisers. Registered investment advisers would be able to maintain performance fee or allocation arrangements with clients who were “qualified clients” under the Rule at the time the advisory contract with such client was entered into (*i.e.*, before the Effective Date), even if they would not be considered qualified clients after the effective date of the amended Rule. However, if a person or company that was not a party to the contract becomes a party after the Effective Date, that person or company will be required to meet the amended “qualified client” standard.

Clients of Previously Exempt Investment Advisers. Registered investment advisers who were previously exempt from registration with the SEC under Section 203 of the Advisers Act would be able to maintain performance fee or allocation arrangements with clients and accounts of investors in private funds⁶ advised by the adviser if the client advisory contract was entered into or the account was established when the adviser was exempt from registration. The SEC noted that this provision would apply to investment advisers who register either because they were no longer exempt under Section 203 or because they voluntarily chose to register.

Transfers of Ownership by Gift or Bequest or Pursuant to a Legal Separation or Divorce. A person that receives an interest in an advisory client account by gift or bequest, or pursuant to an agreement related to a legal separation or divorce, is not required to be a qualified client at the time of transfer. Therefore, such a person would be able to retain the investment under the terms of the pre-existing advisory agreement.

These transition rules act as grandfathering provisions for both (i) investments made under performance fee or allocation arrangements existing prior to the effectiveness of the Rule amendments (in the case of existing clients of registered investment advisers) or the date of the investment adviser registration (in the case of clients of previously exempt investment advisers) and (ii) additional investments made after the relevant effective date by clients or investors in the private funds (assuming the additional investments are made in the same private funds) under those pre-existing arrangements.

D. Inflation Adjustment of Dollar Thresholds

The SEC has also required, as mandated by the Dodd-Frank Act, that the AUM Threshold and Net Worth Threshold be adjusted for inflation every five years. These adjustments will be calculated using the PCE Index, and the authority for implementing the adjustments will be delegated to the SEC staff.

⁶ This provision is intended to apply to investors in companies that are excluded from the definition of “investment company” under Section 3(c)(1) of the Company Act.

Please contact the authors of this Client Alert or your K&L Gates Investment Management Group attorney contact with any questions or comments you may have regarding the subject matter covered by this alert.

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