

**SEC PROPOSES TO INCREASE THRESHOLDS FOR  
ADVISER PERFORMANCE FEES**

As required by the Dodd-Frank Act,<sup>1</sup> the Securities and Exchange Commission has proposed to increase client net worth and assets-under-management thresholds required to be met before an investment adviser may charge such clients a performance fee.<sup>2</sup> The SEC has also proposed excluding the value of a person's primary residence when determining a person's net worth and adding certain transition provisions. Comments are due on the proposal by July 11, 2011.

Changes to the Assets-Under-Management and Net Worth Tests

Section 205(a) of the Investment Advisers Act of 1940 (the "Advisers Act") and Rule 205-3 under the Advisers Act generally prohibit a registered investment adviser from charging a client a performance fee<sup>3</sup> unless the client is a "qualified client," which is currently defined to include a client with (a) at least \$750,000 under management with the investment adviser (the "assets-under-management test") or (b) a net worth of more than \$1.5 million (the "net worth test").<sup>4</sup> The proposal would raise these amounts to \$1 million and \$2 million, respectively. The SEC also proposes excluding, for purposes of the net worth test, the value of the primary residence of natural persons. The calculation of net worth would also exclude the amount of any debt secured by the primary residence, up to the estimated fair market value of the property. These proposed changes are consistent with the changes made by the Dodd-Frank Act to the net worth threshold for natural persons under the "accredited investor" definition under Regulation D of the Securities Act of 1933, as well as recent proposed SEC interpretations.<sup>5</sup>

Rule 205-3 also requires a registered adviser that charges a performance fee to a pooled investment vehicle relying on Section 3(c)(1) of the Investment Company Act of 1940 (the "1940 Act") to "look through" the vehicle to its investors for purposes of meeting the "qualified

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<sup>1</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). See Section 418.

<sup>2</sup> SEC Release IA-3198 (May 10, 2011), 70 Fed. Reg. 27,959 (May 13, 2011). The SEC Release is available at: <http://www.sec.gov/rules/proposed/2011/ia-3198fr.pdf>. Section 418 of the Dodd-Frank Act requires the SEC to issue an order adjusting the dollar amount tests in Rule 205-3 by July 21, 2011, and every five years thereafter. These dollar amount thresholds will take inflation into account by reference to the Personal Consumption Expenditures Chain-Type Price Index.

<sup>3</sup> Compensation based on a share of capital gains on, or capital appreciation of, the funds of a client. See Section 205(a)(1) of the Advisers Act and Rule 205-3.

<sup>4</sup> The definition of "qualified client" in Rule 205-3 also includes any person that is a "qualified purchaser" under the Investment Company Act of 1940 and certain knowledgeable employees. Those definitions are not proposed to change.

<sup>5</sup> Please see our client memoranda [SEC Proposes Rules to Clarify Accredited Investor Net Worth Standard](#), January 26, 2011 and [Immediate Change in Accredited Investor Requirements in Dodd-Frank Act](#), July 21, 2010.

client” requirement.<sup>6</sup> Registered advisers to those vehicles would need to require new investors to meet the new thresholds for qualified clients.

### Transition Rules

The proposal would add transition provisions to Rule 205-3 that would allow a registered investment adviser and its clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if performance fees would not be permissible under the contract if it were entered into at a later date. Subsequent investments by the client with the adviser or additional investments by an investor in an existing pooled investment vehicle would also be “grandfathered” and permissible. However, 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 thresholds in Rule 205-3 in effect at the time of the investment.<sup>7</sup>

Further, if an investment adviser previously exempt from registration with the SEC subsequently registers, the new thresholds would not apply to any preregistration contractual arrangements. The new thresholds would be applicable to any person that becomes a client or is a new investor in a Section 3(c)(1) vehicle managed by the adviser after the adviser registers.<sup>8</sup>

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<sup>6</sup> Rule 205-3 does not require a pooled investment vehicle that is exempt from the 1940 Act pursuant to Section 3(c)(7) to look through to its underlying investors.

<sup>7</sup> See proposed Rule 205-3(c)(1).

<sup>8</sup> See proposed Rule 205-3(c)(2). The new thresholds would also apply to any new advisory contract with a 3(c)(1) vehicle advised by the adviser after it becomes registered.