SEC AMENDS RULE ON ADVISER PERFORMANCE FEES

The Securities and Exchange Commission has adopted amendments to Rule 205-3 promulgated under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), which permits registered investment advisers to charge "qualified clients" a performance fee.[1] The amendments codify increased qualified client net worth and assets-under-management thresholds effective September 19, 2011, which were adopted by order. The amendments also exclude the value of a person's primary residence and certain associated debt when determining a person's net worth and adopt transition provisions that will, among other things, allow registered advisers to continue to charge performance fees to existing clients and investors even if such persons would not qualify under the revised rule.

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

Section 205(a) of the Advisers Act and Rule 205-3 under the Advisers Act generally prohibit a registered investment adviser from charging a client a performance fee[2] unless the client is a "qualified client," which was previously defined to include a client with (a) at least $750,000 under management with the investment adviser or (b) a net worth of more than $1.5 million (the "net worth test").[3] As required by the Dodd-Frank Act,[4] the SEC issued an order effective September 19, 2011 increasing these amounts to $1 million and $2 million, respectively.

The SEC has now codified that order by amending Rule 205-3. Additionally, effective May 22, 2012, the value of a person's primary residence will not be included as an asset for purposes of the net worth test, and the amount of any debt secured by the primary residence, up to the fair market value of the property, will not be treated as a liability. However, the amended rule will include as a liability for calculating net worth any indebtedness secured by the primary residence entered into in the prior 60 days unless it was used to purchase the residence. The SEC explained that this would reduce the incentive for advisers to encourage potential clients or investors to borrow additional amounts against their homes to increase their net worth

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1 SEC Release IA-3372 (February 15, 2012). The SEC Release is available at: http://www.sec.gov/rules/final/2012/ia-3372.pdf. 77 Fed. Reg. 10,358 (Feb. 22, 2012)

2 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.

3 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 (the "1940 Act") and certain knowledgeable employees. Those definitions have not changed.

4 The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). Section 418 of the Dodd-Frank Act required the SEC to issue an order adjusting the dollar amount tests in Rule 205-3 by July 21, 2011, and every five years thereafter. The SEC issued an order doing so on July 12, 2011, which was effective September 19, 2011. These dollar amount thresholds will take inflation into account by reference to the Personal Consumption Expenditures Chain-Type Price Index.

under the test just prior to becoming a client or an investor. These changes are consistent with the recent changes to the net worth threshold for natural persons under the "accredited investor" definition in Regulation D of the Securities Act of 1933.[5]

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 1940 Act to "look through" the vehicle to its investors for purposes of meeting the "qualified client" requirement.[6] Registered advisers to those vehicles must require new investors to meet the new thresholds for qualified clients.

Transition Rules

The SEC also provides transition provisions for Rule 205-3 that 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 are also "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 Rule 205-3 thresholds in effect at the time of the investment.[7]

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.[8]

Additionally, the amendments provide that 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, will not require the transferee to be a qualified client.[9]

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5 Please see our client memorandum *SEC Adopts Net Worth Standard for Accredited Investors under Regulation D*, December 30, 2011.

6 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.

7 See Rule 205-3(c)(1), as revised. The SEC Release indicates that although the amendments are effective May 22, 2012, the SEC will not object if advisers rely or relied upon the amended transition provisions of Rule 205-3(c) before that date.

8 See Rule 205-3(c)(2), as revised. The new thresholds apply to any new advisory contract with a Section 3(c)(1) vehicle advised by the adviser after it becomes registered.

9 See Rule 205-3(c)(3), as revised.

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If you have any questions concerning the matters described in this memorandum, please contact Martin R. Miller (212-728-8690, mmiller@willkie.com), Joseph P. Cunningham (212-728-8161, jcunningham@willkie.com) or the Willkie attorney with whom you regularly work.

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