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SEC Update

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Recent Changes to the Net Worth and Assets-Under-Management Tests for Adviser Performance Fees

Effective August 16, 2021, the Securities and Exchange Commission (SEC) adjusted upward the assets-under-management and net worth thresholds in the definition of "qualified client" under Rule 205-3 promulgated under the Investment Advisers Act of 1940 (Advisers Act).[1] Rule 205-3 permits registered investment advisers to charge qualified clients a performance fee.

Section 205(a) of the Advisers Act and Rule 205-3 generally prohibit a SEC registered investment adviser from charging clients compensation based on a share of capital gains on, or capital appreciation of, the funds of a client,[2] generally referred to as "performance fees." Rule 205-3 permits registered investment advisers to charge a performance fee if the client is a qualified client. Prior to August 16, 2021, that term included a client with (a) at least $1 million of assets-under-management with the investment adviser or (b) a net worth of more than $2.1 million (the "net worth test").[3] The Dodd-Frank Act[4] amended Section 205(e) of the Advisers Act to require the SEC to issue an order adjusting for inflation the dollar amount of the tests in Rule 205-3 by July 21, 2011, and every five years thereafter. Pursuant to that provision, in August 2016, the SEC raised the net worth test from $2 million to $2.1 million. The SEC did not change the assets-under-management test in 2016 and left it at $1 million because Section 205(e) requires the inflation adjustments to be rounded to the nearest multiple of $100,000. The adjustment calculation was smaller than this rounding amount, so the assets-under-management test did not need to be changed in 2016.[5] The SEC's recently issued order increased the assets-under-management threshold to $1.1 million and the net worth test to $2.2 million.

History of the Rule and Policy Objectives

In 1983 the SEC proposed a forerunner of Rule 205-3, with the idea that wealthy investors with financial knowledge and experience do not necessarily need the prohibition against performance-based compensation as protection from the potential danger of advisers taking undue risks in pursuit of higher fees as other investors may need.[6] In the 1983 proposal the tests would have been (1) that the adviser make a finding that the client was sufficiently knowledgeable and experienced to understand the merits and risks of a performance-based fee and (2) that the fee contract relate to a minimum of $150,000 in assets.[7] The SEC ultimately withdrew this proposal,[8] but the SEC continued to provide exemptive relief in certain individual cases,[9] and in 1985 the SEC proposed a reformulated general rule that would also allow sophisticated investors to

negotiate performance fees with advisers and thereby increase both flexibility for investors and competition among advisers using objective criteria: the assets-under-management and net worth tests.[10] Rule 205-3 permitted investment advisers to charge performance fees to clients with at least $500,000 under the adviser's management or with a net worth of more than $1,000,000. The rule also required specific disclosures to be made to clients entering into contracts with performance fees and certain terms to be included in such contracts.[11] In 1998 the SEC further streamlined Rule 205-3 to eliminate the provisions of the rule that required specific disclosures and prescribed contractual terms, and the SEC also increased the criteria to at least $750,000 under the adviser's management or a net worth of more than $1,500,000 for clients to enter into performance fee arrangements with their investment advisers.[12]

Private Fund Investors

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 be excluded from the definition of "investment company," and thus not to be subject to registration under the 1940 Act, to look through the vehicle and confirm each of its investors meets the qualified client requirement. Registered advisers to those vehicles must require new investors to meet the new higher threshold for qualified clients. Rule 205-3 does not require a pooled investment vehicle that is relying on the exclusion from the definition of investment company under Section 3(c)(7) of the 1940 Act to look through to its underlying investors for purposes of charging a performance fee.

"Grandfathering"

Rule 205-3 provides that a registered investment adviser and its clients may 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, a new client, 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.[13]

State Registrations of Investment Adviser Representatives

Adjustments to the definition of qualified client in Rule 205-3 also affect other aspects of the Advisers Act and other rules. These adjustments are also important in determining whether someone working for an SEC registered investment adviser would be subject to registration as an investment adviser representative with state securities regulators and be required to take state qualifying examinations. Section 203A of the Advisers Act provides a preemption of state investment adviser registration requirements for SEC registered investment advisers. SEC registered advisers may be subject only to filing a notice with the states and paying a fee, which can be done by checking a box on the investment adviser's form ADV and placing sufficient filing fees for states in a fee account. This preemption also covers "supervised persons" of SEC registered advisers in certain circumstances. A "supervised person" is defined in Section 202(a)(25) of the Advisers Act as "any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser." Under this preemption, the states are only allowed to require registration of supervised persons who have both a place of business in the state and more than a certain number of natural person clients. Specifically, they need to have more than five clients who are natural persons or more than 10 percent of their clients need

to be natural persons, whichever number is greater.[14] Importantly, qualified clients as defined in Rule 205-3 are excluded from the count of natural persons.[15] Therefore, a supervised person of a SEC registered investment adviser must have more than five natural person clients who are not qualified clients or more than 10 percent of his or her clients that are natural persons who are not qualified clients, whichever number is greater, before a state can require the supervised person to register with the state.

High Net Worth Individual on Form ADV

Adjustments to the definition of qualified client may also impact certain answers on Form ADV. Part 1A, Item 5 of Form ADV asks questions about "High Net Worth Individuals," and a High Net Worth Individual is defined to include a qualified client under Rule 205-3.

Suggested Action

Registered investment advisers should review advisory contracts and subscription and other relevant documents for their 3(c)(1) funds and modify them as necessary to reflect the higher assets-under-management threshold and net worth test for qualified clients. Registered investment advisers should also bear these increases in mind when completing Form ADV, revising supervisory procedures and for the registration requirements applicable to their supervised persons.

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NOTES

1 SEC Release No. IA-5756 (June 17, 2021). Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940.

2 *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 (1940 Act) and certain knowledgeable employees as defined in Rule 3c-5 as promulgated under the 1940 Act.

4 Section 418 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (Dodd-Frank Act), amended Section 205(e) of the Advisers Act. Inflation is measured for this purpose of the five-year adjustment requirement by reference to the Personal Consumption Expenditures Chain-Type Price Index.

5 SEC Release No. IA-4421 (June 14, 2016).

6 SEC Release No. IA-865 (June 10, 1983). *See also* discussions in SEC Release No. IA-961 (March 15, 1985); SEC Release No. IA-996 (November 14, 1985); SEC Release No. IA-3372 (February 15, 2012).

7 SEC Release No. IA-865 (June 10, 1983).

8 SEC Release No. IA-911 (May 2, 1984).

9 *See, e.g., Jurika & Voyles,* SEC Release Nos. IA-901 (March 13, 1984) and IA-925 (August 15, 1984); *Presidio Management,* SEC Release Nos. IA-939 (October 25, 1984) and IA-943 (November 27, 1984); *TCW Asset Management Company,* SEC Release Nos. IA-931 (September 13, 1984) and IA-938 (October 10, 1984)).

10 SEC Release No. IA-961 (March 15, 1985); SEC Release No. IA-996 (November 14, 1985). *See also* discussions in SEC Release No. IA-1682 (November 13, 1997); SEC Release No. IA-1731 (July 15, 1998).

11 SEC Release No. IA-961 (March 15, 1985); SEC Release No. IA-996 (November 14, 1985).

12 SEC Release No. IA-1682 (November 13, 1997); SEC Release No. IA-1731 (July 15, 1998). The Rule was also changed to include "qualified purchasers" under section 2(a)(51)(A) of the 1940 Act and "knowledgeable employees" of the investment adviser.

13 Rule 205-3(c)(1).

14 Rule 203A-3(a)(1).

15 Rule 203A-3(a)(3)(i).