PROPOSED ORDER AND AMENDMENTS REGARDING THE SEC'S PERFORMANCE FEE RULE

May 17, 2011

To Our Clients and Friends:

The Securities and Exchange Commission (the "SEC") has proposed several actions with regard to Rule 205-3 under the Investment Advisers Act of 1940 (the "Advisers Act"). Rule 205-3, as currently in effect, generally prohibits the payment of performance fees (including, for example, carried interest or incentive allocations) to a registered investment adviser, with certain exceptions. Private funds that rely on Section 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act") (the exception from Investment Company Act registration on which most large private equity and hedge funds rely) are excepted from the rule's performance fee prohibition, and the proposed changes do not affect those funds. However, other advisory clients (including private equity and hedge funds that rely on Section 3(c)(1) of the Investment Company Act) who are covered by Rule 205-3—and, therefore, may not pay performance fees unless the advisory clients (or, in the case of a Section 3(c)(1) fund, all of the investors in the fund who pay performance fees) are "qualified clients"—could be impacted by the proposed changes.

The proposed SEC actions would, among other things, (1) raise the threshold for investment advisory clients to be "qualified clients" by adjusting for inflation the financial criteria used to determine whether a client (or investor) is a "qualified client" and backing out the value of a client's primary residence from the rule's net worth test and (2) clarify how the rule will impact performance fee arrangements already in existence. Investment advisers and private fund sponsors that rely on Rule 205-3 should begin to modify their client and investor questionnaires to reflect the new criteria. The good news is that the SEC has proposed a transition period that should avoid the need for investment advisers to change their arrangements with existing clients.

THE CURRENT RULE

Section 205(a)(1) of the Advisers Act prohibits a registered investment adviser from charging fees "on the basis of a share of capital gains upon or capital appreciation of" a client's account. Rule 205-3 permits a registered investment adviser to charge such a fee to "qualified clients." In the case of a private investment pool that relies on Section 3(c)(1) of the Investment Company Act or a registered investment company, the adviser must "look through" the fund and may only charge such fees with respect to investors that are qualified clients.

Under the rule, as now in effect, to be a "qualified client," a person must:

- have at least $750,000 under the management of the investment adviser (the "assets-under-management test");
- have a net worth of more than $1.5 million (the "net worth test");
- be a "qualified purchaser" (as defined under the Investment Company Act); or
- be either a senior employee of the investment adviser (*e.g.*, an executive officer or director) or an employee who has regularly participated in the investment activities of the investment adviser for the last year.

THE PROPOSED ACTIONS WITH RESPECT TO THE RULE

Section 418 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") requires the SEC, by order, to adjust the financial criteria set forth in Rule 205-3 to reflect inflation by July 21, 2011 and to adjust these amounts for inflation every five years thereafter. The SEC is proposing to issue an order that will increase the assets-under-management test from $750,000 to $1 million and the net worth test from $1.5 million to $2 million (reflecting the inflation rate since the criteria were last amended in 1998). Further, the SEC has proposed to amend Rule 205-3 to provide that the SEC will issue inflation adjustment orders every five years based on the Personal Consumption Expenditures Chain-Type Price Index published by the Department of Commerce.

The SEC has also proposed an amendment to Rule 205-3 that would exclude the primary residence from the net worth test in the "qualified client" definition in a similar fashion as has been proposed with regard to the definition of "accredited investor."[1] This action was not called for by Congress; rather, the SEC has taken it on its own initiative. Among other things, the SEC noted that the value of an individual's primary residence has little relevance to his or her financial experience and ability to bear the risks of performance fee arrangements. As with the definition of "accredited investor," debt secured by the primary residence would be excluded up to the value of the primary residence.

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[1] *See Net Worth Standard for Accredited Investors, SEC Release No. 33-9177 (Jan. 25, 2011) (proposing amendments to the definition of "accredited investor" under the rules of the Securities Act of 1933, as required by Section 413(a) of the Dodd-Frank Act).*

Perhaps most importantly for a currently exempt investment adviser, the SEC has proposed an amendment to Rule 205-3 that would allow an investment adviser and its clients to maintain existing performance fee arrangements that were permissible when the advisory contracts were entered into. For example, a performance fee arrangement between an exempt investment adviser that was not subject to the performance fee prohibition and a fund relying on Section 3(c)(1) of the Investment Company Act could be maintained after the adviser has registered, even if the existing investors are not "qualified clients." However, if a new investor enters into the fund, that investor will be required to satisfy the definition of "qualified client" (and the relevant assets-under-management test or net worth test effective at the time of admission). Similarly, a registered investment adviser would not have to terminate a contract with a client that ceases to be a qualified client after giving effect to the inflation adjustment.

Comments on the proposed amendments may be submitted to the SEC until July 11, 2011. Hearing requests on the proposed order may be submitted until 5:30 pm on June 20, 2011.

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Please call us if you have any questions.

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