AMENDMENTS TO THE ADVISERS ACT PERFORMANCE FEE RULE

February 27, 2012

To Our Clients and Friends:

On February 15, 2012, the Securities and Exchange Commission (the "SEC") adopted amendments to Rule 205-3 under the Investment Advisers Act of 1940 (the "Advisers Act"). Rule 205-3 permits registered investment advisers to charge performance fees (*e.g.,* carried interest and incentive allocations) to certain "qualified clients." The amendments, among other things, (1) codify a July 12, 2011 SEC order (the "July 2011 Order") that increased the thresholds for being a qualified client, so that qualified clients must have a net worth of more than $2 million or must have at least $1 million of assets under management with the investment adviser (or meet other criteria), and (2) grandfather existing performance fee arrangements. Investment advisers and private fund sponsors that rely on Rule 205-3 (*i.e.*, those that advise registered investment companies or so-called Section 3(c)(1) private funds) should modify their client and investor questionnaires to reflect the new criteria.

BACKGROUND

Section 205(a)(1) of the Advisers Act generally 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. However, 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 of 1940 (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 in the fund that are "qualified clients." Funds that rely on Section 3(c)(7) are not subject to the Advisers Act restrictions on performance fees, and, accordingly, the amendments to the performance fee restrictions discussed in this memorandum are not relevant to those funds.

Previously, to be a "qualified client," a person must have:

- had at least $750,000 under the management of the investment adviser (the "assets under management test");
- had a net worth of more than $1.5 million (the "net worth test");

- been a "qualified purchaser" (as defined under the Investment Company Act); or
- been either a senior employee of the investment adviser (*e.g.*, an executive officer or director) or an employee who regularly participated in the investment activities of the investment adviser for the last year.

Section 418 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") required the SEC, by order, to adjust the financial criteria set forth in Rule 205-3 to reflect inflation and to adjust these amounts for inflation every five years thereafter. The SEC took this action in the July 2011 Order, which raised the assets-under-management and net worth tests to reflect the inflation rate since the criteria were last amended in 1998.

THE AMENDMENTS

New Thresholds, To Be Adjusted for Inflation. The amended Rule 205-3 codifies the July 2011 Order. The threshold in the assets under management test is increased from $750,000 to $1 million, and the threshold in the net worth test is increased from $1.5 million to $2 million. The amendments also provide that the SEC will adjust those thresholds for inflation on or about May 1, 2016, and every five years thereafter, based on the Personal Consumption Expenditures Chain-Type Price Index published by the Department of Commerce.

New Net Worth Calculation. As was the case with the July 2011 Order, the SEC also amended Rule 205-3 to exclude a person's primary residence from the net worth test.[1] This action was not called for by Congress; rather, the SEC took 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, and therefore little relevance to the individual's need for the Investment Advisers Act's protections from performance fee arrangements.

Debt secured by an individual's primary residence generally will not be included as a liability in the net worth test, except to the extent it exceeds the estimated value of the primary residence. Further, any increase in the amount of debt secured by the primary residence in the 60 days before the advisory contract is entered into generally will be included as a liability, even if the

---

[1] *This also reflects the approach that the SEC took in its recent amendment to the definition of "accredited investor." See Net Worth Standard for Accredited Investors, SEC Release No. 33-9287 (Dec. 21, 2011) (adopting 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).*

estimated value of the primary residence exceeds the aggregate amount of debt secured by the primary residence.

Existing Performance Fee Arrangements Grandfathered. Perhaps most importantly for newly-registered investment advisers, amended Rule 205-3 allows 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 a registered investment adviser that previously was exempt from registration and a fund relying on Section 3(c)(1) of the Investment Company Act of 1940 could be maintained after the adviser has registered, even if the existing investors are not "qualified clients." However, new fund investors will be required to be qualified clients. 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.

Certain Transfers Permitted. The SEC also amended Rule 205-3 to allow for certain transfers of interests (*e.g.,* by gift or bequest or pursuant to legal separation or divorce of the qualified client) from a qualified client to a person that not was a party to the contract and is not a qualified client at the time of transfer, stating that, when those types of transfers occur, the transferee does not make a separate investment decision but is the recipient of the benefits of a pre-existing contractual relationship.

* * *

Please call us if you have any questions.

Kenneth J. Berman
+1 202 383 8050
kjberman@debevoise.com

Michael P. Harrell
+1 212 909 6349
mpharrell@debevoise.com

Gregory T. Larkin
+1 202 383 8064
gtlarkin@debevoise.com

Jaime D. Schechter
+1 212 909 6046
jdschechter@debevoise.com