

# Client Update

## Proposed Order Regarding the SEC's Performance Fee Rule: Inflation Adjustments to Qualified Client Thresholds

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On May 18, the U.S. Securities and Exchange Commission (the "SEC") published a notice that it intends to issue an order making inflation-related adjustments to the dollar amount thresholds in Rule 205-3 under the U.S. Investment Advisers Act of 1940 (the "Advisers Act"). Rule 205-3 permits registered investment advisers to charge performance-based fees to "qualified clients".<sup>1</sup> The adjustment is required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA").

The proposed change would impact fees charged to private funds that rely on Section 3(c)(1) of the Investment Company Act of 1940 (the "Investment Company Act") as well as separately managed accounts. Private funds that rely on Section 3(c)(7) of the Investment Company Act would not be affected. Existing client fee arrangements entered into prior to the effective date of the order generally would not be impacted by the change.

The final order, when effective, would maintain the dollar amount of the assets-under-management test at \$1,000,000 and would increase the dollar amount of the alternative net worth test from \$2,000,000 to \$2,100,000.

### 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 fund that relies on Section 3(c)(1) of the Investment Company Act, a business development company or a registered investment company, the adviser must

<sup>1</sup> Performance-Based Investment Advisory Fees, Advisers Act Release No. 4388 (May 18, 2016), available at: <https://www.sec.gov/rules/other/2016/ia-4388.pdf>.

“look through” the fund and may only charge such fees with respect to investors that are qualified clients. The “look through” does not apply to a private fund that relies on Section 3(c)(7) of the Investment Company Act.

Rule 205-3 defines a “qualified client” as a person who:

- has at least \$1,000,000 under the management of the investment adviser immediately after entering into the contract (the “assets-under-management test”);
- has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than \$2,000,000 immediately prior to entering into the contract, excluding the value of the primary residence but including indebtedness secured by the primary residence in excess of the fair market value of the residence (the “net worth test”);
- is a “qualified purchaser” (as defined under the Investment Company Act) immediately prior to entering into the contract; or
- is 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 immediately prior to entering into the contract.

### THE PROPOSED ORDER

The DFA requires the SEC to adjust the financial criteria set forth in Rule 205-3 to reflect inflation every five years, rounded to the nearest \$100,000. The last inflation adjustment was in 2011.<sup>2</sup>

The SEC is proposing to issue an order that would maintain the dollar amount of the assets-under-management test at \$1,000,000 and would increase the dollar amount of the alternative net worth test from \$2,000,000 to \$2,100,000. The notice indicates that the dollar amount of the assets-under-management test would not change because the amount of the inflation adjustment calculation is smaller than the rounding amount specified under Rule 205-3.

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<sup>2</sup> Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Advisers Act Release No. 3236 (July 12, 2011), available at <http://www.sec.gov/rules/other/2011/ia-3236.pdf>. The 2011 Order was effective as of September 19, 2011.

### ANTICIPATED EFFECTIVE DATE

The notice provides that requests for hearing must be received by 5:30 pm on June 13, 2016. If no requests for hearing are submitted, we would expect the order to issue shortly after that date. The SEC expects that the effective date of the order will be 60 days following the order date.

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We will provide an update when the SEC publishes its final order. Private equity fund sponsors should begin to plan to revise their subscription documents to reflect the revised financial criteria.

Please contact us with any questions you may have.