

# Chapman Client Alert

May 24, 2016

Current Issues Relevant to Our Clients

## Revised Qualified Client Test for Performance-Based Investment Advisory Fees

The Securities and Exchange Commission (the “SEC”) recently published a notice of its intention to adjust for inflation dollar amount thresholds for the “qualified client” definition under Investment Advisers Act of 1940 (the “Advisers Act”) Rule 205-3. Under Advisers Act Rule 205-3, an investment adviser may charge performance-based fees to a “qualified client” meeting a minimum net worth or minimum assets under the management of the adviser test. The SEC’s proposed order would increase the minimum net worth threshold from \$2,000,000 to \$2,100,000. The order would not increase the minimum dollar amount of assets under management threshold.

### Background

Advisers Act Section 205 generally prohibits a registered investment adviser from receiving compensation that is based on a share of capital gains on or appreciation of funds of an advisory client (among other things). Advisers Act Rule 205-3 provides an exemption from this prohibition for advisory agreements with “qualified clients”. Under the current Rule 205-3, a “qualified client” includes a client that, immediately after entering into the contract, has at least \$1 million under the management of the adviser or a net worth of more than \$2 million.

Effective July 21, 2011, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) amended the Advisers Act to, among other things, require that any rule adopted by the SEC with respect to Advisers Act Section 205 that uses a dollar amount test must adjust for the effects of inflation (based on the Personal Consumption Expenditures Chain-Type Price Index published by the US Department of Commerce) beginning not later than July 21, 2011, and every five years thereafter. As a result, the Dodd-Frank Act required that the SEC revise the then current assets under management test and net worth test (at the time, \$750,000 and \$1.5 million, respectively) no later than July 21, 2011. On July 12, 2011, the SEC issued an order revising these dollar amount tests for purposes of Rule 205-3 to account for the effects of inflation. This order changed the \$750,000 assets under management test to \$1 million and changed the \$1.5 million net worth test to \$2 million effective September 19, 2011. For more information about the SEC’s prior revisions to the dollar amount tests and related rulemaking, please see our February 21, 2012 Client Alert available [here](#).

### Revised Qualified Client Net Worth Test

The anticipated SEC order and related rulemaking would revise the dollar amount net worth test under the current rule from \$2,000,000 to \$2,100,000 and would leave the current dollar amount assets under management test at \$1,000,000. The SEC anticipates that if the order as described is issued, the effective date of the revised dollar amount test will be 60 days following the order date. To the extent contractual relationships are entered into prior to the order’s effective date, the dollar amount test adjustment in the order would not generally apply to such contractual relationships, subject to the transition rules of Rule 205-3. Once the SEC has issued the above described order, advisers relying on the “qualified client” exemption in connection with performance-based fees or incentive/carried interest allocations for individual clients or private investment funds should review their disclosure and subscription documents and revise those documents as necessary to reflect this change.

### For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at [chapman.com](http://chapman.com).



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