Client Alert

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CURRENT ISSUES RELEVANT TO OUR CLIENTS FEBRUARY 21, 2012

SEC Adopts Revised Investment Adviser Performance Fee Requirements

The Securities and Exchange Commission (the “SEC”) recently adopted amendments to the dollar amount tests for the “qualified client” definition in Rule 205-3 under the Investment Advisers Act of 1940 (the “Advisers Act”). Rule 205-3 provides exemptions from the general Advisers Act prohibition on performance-based compensation for registered investment advisers. The revised rule changes the current $750,000 assets under management test to $1 million and changes the current $1.5 million net worth test to $2 million. The SEC also amended Rule 205-3 to:

- provide that the SEC will issue orders making future inflation adjustments every five years;
- exclude the value of a person’s primary residence for purposes of the qualified client net worth standard; and
- include transition provisions to take into account performance fee arrangements that were permissible when they were entered into, so that new dollar amount thresholds do not require investment advisers to renegotiate the terms of arrangements that were permissible when the parties entered into them.

The rule changes will be effective in late May 2012, but the SEC is permitting advisers to rely on the amended transition provisions of the new rule before the effective date of the amendments. This is particularly meaningful for advisers to private funds that will be required to register under the Advisers Act by March 30, 2012, under new Dodd-Frank Act rules. The SEC release is available at: http://www.sec.gov/rules/final/2012/ia-3372.pdf.

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 $750,000 under the management of the adviser or
- a net worth of more than $1.5 million (together with assets held jointly with a spouse).

Effective July 21, 2011, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) amended the Advisers Act to 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 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 current $750,000 assets under management test and a $1.5 million net worth test no later than July 21, 2011. On July 12, 2011, the SEC issued an order revising these dollar amount tests for purposes of current Rule 205-3 to account for the effects of inflation. This initial 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. The SEC is order is available at http://www.sec.gov/rules/other/2011/ia-3236.pdf. The new amendments to Rule 205-3 codify these dollar amounts while also addressing future inflation adjustments, treatment of an investor's primary residence, and transition issues raised by the rule changes.

Revised Dollar Amount Tests

The most important change to Rule 205-3 revises the dollar amount tests of the current rule to account for the effects of inflation. In particular, the amended rule codifies the July 2011 SEC order to change the $750,000 assets under management test to $1 million and change the $1.5 million net worth test to $2 million. Registered investment advisers that impose performance fees, including firms that receive incentive allocations or carried interest allocations with respect to private funds, should review advisory agreements and private fund subscription documents to consider whether revisions need to be made to comply with the revised rule, including the new treatment of an investor's primary residence as described below.

Exclusion of Primary Residence from Net Worth Determination

The final rule also amends the qualified client net worth standard to exclude the value of a person's primary residence for purposes of determining net worth under the rule. In making this change, the SEC adopted the same treatment as it recently adopted in connection with the recent changes to the "accredited investor" definition under the Securities Act of 1933 (see our related Client Alert at http://www.chapman.com/media/news/media.1129.pdf). The new net worth standard for natural persons in the "qualified client" definition includes any person whose individual net worth, or joint net worth with that person's spouse, exceeds $2 million, except that the person's primary residence is not included as an asset for purposes of calculating net worth under the amended rule.

The revised rule also excludes from an investor's net worth the amount of debt secured by the property that is no greater than the property's current market value. Therefore, a mortgage on a primary residence is not included in net worth unless the outstanding debt on the mortgage, at the time net worth is calculated, exceeds the market value of the residence. If the outstanding debt exceeds the market value of the residence, the amount of the excess is considered a liability in calculating net worth. As is the case in the recent "accredited investor" rule changes, the SEC did not define "primary residence" in the amended rule.

Transition Rules for Existing Clients/Funds and Advisers

The revised rule includes transition provisions related to the amendments. The transition provisions are designed so that restrictions on performance fee arrangements apply to new contractual arrangements and do not apply retroactively to existing arrangements.

Previously Registered Advisers: The transition provisions provide that if a registered investment adviser entered into a contract and satisfied the conditions of Rule 205-3 that were in effect when the contract was entered into, the adviser will be considered to satisfy the conditions of the revised rule. However, where new parties become party to the contract, the thresholds in effect at the time they become a party will apply with regard to that party. This proviso also applies to an equity owner of a "3(c)(1) fund" (i.e., a private fund excluded from the definition of "investment company" under Section 3(c)(1) of the Investment Company Act of 1940).

Newly Registered Advisers: The transition provisions also provide that if an adviser was previously exempt from Advisers Act registration and subsequently registers, the performance fee restrictions will not apply to an advisory agreement entered into when the adviser was not registered or to an account of an equity owner of a "3(c)(1) fund" if the account was established when the adviser was not registered. However, where new parties become clients of the adviser or new equity owners invest in a "3(c)(1) fund" after the adviser registers with the SEC, the restrictions on performance fee arrangements will apply.

Future Inflation Adjustments

The revised rule also requires that the SEC issue orders beginning in May 2016 and every five years thereafter making future inflation adjustments to the dollar amount tests as required by the Dodd-Frank Act. The rule requires that adjustments be based on the Personal Consumption Expenditures Chain-Type Price Index published by the US Department of Commerce.

What Should I Do Now?

The amendments to the qualified client standard become effective 90 days after publication in the Federal Register, which should occur in the next few days. That means that the new provisions should be effective near the end of May 2012. 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 these changes. Having said that, the SEC is permitting advisers to rely on the revised transition provisions of the new rule before the effective date of the amendments. This is particularly meaningful for advisers to private funds that will be required to register under the Advisers Act by March 30, 2012, under new Dodd-Frank Act requirements. For information on these and other Dodd-Frank developments, please see our summary Dodd-Frank: Impact on Asset Management available at http://www.chapman.com/media/news/media.901.pdf.

If you would like to discuss any of the issues discussed in this Client Alert, please contact any attorney in our Investment Management Group or visit us online at chapman.com.