

SEC Proposes Significant Amendments to Modernize Performance-Based Compensation for Investment Advisers

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On September 30, 2026, the Securities and Exchange Commission (the “SEC” or the “Commission”) proposed amendments to Rule 205-3 under the Investment Advisers Act of 1940 (the “Advisers Act”) that would expand the ability of registered investment advisers (“investment advisers”) to receive performance-based compensation from registered management investment companies and business development companies (“BDCs”) (collectively, “regulated funds”), subject to certain conditions.¹ Additionally, the proposed amendments would broaden the definition of “qualified client” to include those who satisfy the “accredited investor” definition in Regulation D under the Securities Act of 1933 (the “Securities Act”).

Key Takeaways

- **New path to receive performance-based compensation:** If the SEC adopts the proposed rule, investment advisers will be able to charge performance-based fees to all regulated funds, including mutual funds and ETFs, if the fund satisfies three conditions:
 - the performance fee does not exceed 20% of the fund’s net gains;
 - the fund’s board complies with certain fund governance standards listed in Rule 0-1(a)(7) under the Investment Company Act of 1940 (the “Investment Company Act”) (as further described below); and
 - the fund’s board, including a majority of independent directors, determines the performance-based fee is in the best interests of the fund and its shareholders.
- **Amended “qualified client” definition:** Under the proposed rule, the “qualified client” definition would include those who satisfy the “accredited investor” definition under Regulation D. The proposal would eliminate the current \$1.4 million assets-under-management test and \$2.7 million net worth test.
- **Increased disclosure requirements:** If the SEC adopts the proposed rule, all regulated funds that pay performance-based fees will face increased disclosure requirements related to those fees.

Background

Section 205(a)(1) of the Advisers Act generally prohibits an investment adviser from receiving compensation based on a share of capital gains or capital appreciation of a client’s account. Congress included the prohibition in 1940 out of concern that such “profit-sharing” arrangements would incentivize advisers to take inappropriate risks with client funds. Over time, Congress and the Commission carved out exceptions, including Rule 205-3, which permits performance fees for “qualified clients.” Currently, qualified clients include a natural person or company that (1) has at least \$1.4 million under management with the investment adviser, (2) the adviser reasonably believes has a net worth of more than \$2.7 million, or (3) is a “qualified purchaser” under the Investment Company Act, as well as certain executive officers and employees of the adviser who participate in its investment activities. The Commission adjusts the dollar thresholds for inflation every five years.

In practice, these limitations have largely confined performance-fee arrangements to advisers of private funds. Because regulated funds cannot vary advisory fees among shareholders, under existing rules a registered fund wishing to charge a performance fee must restrict its entire investor base to qualified clients (which is a practical

impossibility for funds whose securities trade on public secondary markets, such as ETFs and listed closed-end funds).

According to the Commission, the proposed amendments are designed to (1) modernize performance-based compensation regulations, (2) facilitate capital formation in both public and private markets by promoting innovation in regulated fund structures, and (3) increase investor choice while preserving investor protections.

Expansion of Performance-Based Compensation

The proposed amendments would apply to investment advisers of registered management investment companies and BDCs, including mutual funds, ETFs, interval funds and tender offer funds. The proposed amendments would not cover unit investment trusts or separate accounts offering variable annuity contracts registered on Form N-3. According to the SEC, unit investment trusts do not have a board of directors capable of the ongoing oversight on which the proposal is premised, and Form N-3 separate accounts generally allocate assets to underlying funds where active management occurs, so they do not typically have an adviser whose managerial skill drives the strategy.

Under the proposed amendments, a regulated fund would be a qualified client if either (1) all of its equity owners are qualified clients, or (2) the fund satisfies the following three conditions (the “fund board channel”):

- **20% cap on net gains:** For a regulated fund to be a qualified client, the performance fee may not exceed 20% of the regulated fund’s net capital gains or net capital appreciation over a specified period or as of definite dates.
- **Compliance with fund governance standards:** To be considered a qualified client, the regulated fund’s board must also satisfy the fund governance standards listed in Rule 0-1(a)(7) under the Investment Company Act. These standards require that (i) a majority of the board be independent directors, (ii) the independent directors select and nominate any other independent directors, (iii) any legal counsel to the independent directors be independent, (iv) the board evaluate its own performance and that of its committees at least annually, (v) the independent directors meet at least quarterly without interested directors present, and (vi) the independent directors be authorized to hire employees and retain advisers and experts.
- **Board best-interest determination:** The final condition for a regulated fund to be a qualified client would require the fund’s board, including a majority of independent directors, to determine, as part of its annual Section 15(c) review, that the performance-based fee is in the best interests of the fund and its shareholders. The board must support its best-interest determination with specific written findings, including: (1) the appropriateness of the arrangement considering the fund’s investment strategy and valuation practices; (2) the basis on which the adviser calculates the fee, including the measurement period and whether the fee is based on realized gains, unrealized gains, or both; and (3) the adequacy of any investor protection features (e.g., a preferred return, hurdle, high-water mark, or loss carryforward) or, where none are present, the basis for concluding the arrangement adequately protects shareholders.

Measurement period and frequency. The advisory contract must specify a defined measurement period or reference dates over which the adviser calculates net gains, such as a rolling period like the fiscal year, a cumulative period from a specified inception date, or discrete valuation dates at periodic intervals. The proposal does not set a minimum measurement period or limit how often the adviser may calculate or receive the fee, although the SEC asks whether it should require a quarterly, semi-annual, or annual minimum. Instead, the board must make written findings on whether the measurement period is appropriate in light of the fund’s strategy, investment time horizon, liquidity profile, and portfolio turnover, and in light of any other investor protection features in the arrangement. Because regulated funds bear performance fees through reductions to net asset value, funds must estimate accrued fees each time they calculate net asset value, which for open-end funds means daily.

High-water marks and other investor protections. The proposal permits, but does not expressly require, high-water marks. The proposal does not mandate any particular investor protection feature, but the board’s written findings must address the adequacy of any such features, which the SEC describes as including preferred returns, hurdles (and whether a hurdle is “hard” or “soft”), high-water marks, and loss carryforward mechanisms. If an arrangement includes none of these features, the board must explain why the arrangement nonetheless adequately protects

shareholders. The SEC also encourages boards to consider features common in institutional private fund arrangements, such as holding accrued performance fees in escrow to support loss recovery or clawback obligations.

Amendments to “Qualified Client” Definition

The proposed amendments would expand the definition of “qualified client” in Rule 205-3 by incorporating the “accredited investor” definition under Regulation D of the Securities Act. Under the amended rule, a qualified client would include any natural person or company (other than a private fund relying on Section 3(c)(1) of the Investment Company Act) that the investment adviser reasonably believes is an accredited investor at the time the adviser enters into the advisory contract. The current accredited investor definition includes, among other categories, individuals who (1) have a net worth of over \$1,000,000 (excluding their primary residences), or (2) have income of over \$200,000 (or \$300,000 together with a spouse or spousal equivalent) in each of the two most recent years, with a reasonable expectation of the same in the current year.

In connection with this change, the proposed amendments would remove the \$2.7 million net worth test, the \$1.4 million assets-under-management test, and the five-year inflation adjustment mechanism.

Enhanced Disclosure Related to Performance-Based Compensation

The proposed disclosure amendments would apply to all regulated funds paying any type of performance-based compensation—including fulcrum fees, income-based incentive fees, and BDC fees paid under the statutory exception—not only funds relying on the proposed fund board channel discussed above.

- **Fee table disclosure:** Currently, regulated funds must disclose certain information about their fees and expenses in a standardized table in the prospectus, but they include performance-based compensation within the overall “Management Fees” line. The proposed rule would require regulated funds to separately identify the portion of management fees that is attributable to performance-based compensation compared to asset-based advisory fees, in a new “Performance Fees” caption directly below the “Management Fees” caption. Funds would show the performance fees they actually paid to the adviser or its affiliates during the prior fiscal year and would reflect those fees in the expense example. A new fund without a sufficient operating history could show zero performance fees until after its first fiscal year. An existing fund that newly adopts a performance fee would instead need to restate its fee table to show the performance fee it would have paid had the arrangement been in effect during the prior fiscal year. Looking forward, funds would also need to add a footnote to the fee table that briefly explains the basis on which the adviser charges performance fees, states that the fees may be substantially higher or lower because they depend on fund performance that may fluctuate over time and cross-references the more detailed performance fee disclosure later in the prospectus.
- **Management discussion disclosure:** The proposed rule would require regulated funds to disclose the following information if the investment adviser’s compensation includes a performance fee: (1) the fee rate and the basis on which the adviser calculates it; (2) whether the adviser calculates the fee before or after fees and expenses; (3) the measurement period over which the adviser assesses the fee; (4) any limiting features (e.g., preferred return, hurdle, high-water mark, loss carryforward); and (5) a graphical representation of the fee across a range of hypothetical performance scenarios.
- **Form N-CSR disclosure:** For funds relying on the fund board channel, Item 11 would require reasonably detailed discussion of the factors and conclusions underlying the board’s best-interest determination, mirroring the required written findings.

Next Steps and Comment Period

The proposed amendments could have significant impacts on fund managers, investment advisers, and the industry. In response, sponsors and boards should consider the following:

- **Product development:** Sponsors should evaluate whether they could offer private market or alternative strategies previously confined to private funds through a regulated fund with a performance fee available to all investors. Similarly, sponsors could develop new or modified products in response to the changes to the definition of “qualified client.”
- **Board preparation and disclosure readiness:** Fund boards should begin considering how they would document the required best-interest written findings. Regulated funds that currently pay performance-based compensation should also review the proposed enhanced disclosure requirements.

Comments on the proposed amendments are due 60 days after publication in the Federal Register. Given the breadth and significance of these proposed changes, investment advisers, fund sponsors, and fund boards should carefully evaluate the proposal and consider whether to submit comments during the comment period.

For More Information

We are available at any time to answer questions, discuss scenarios, and provide guidance. If you would like further information concerning the matters discussed in this article, please contact a member of the Investment Management Group or visit us online at chapman.com.

1 Investment Adviser Performance-Based Compensation Modernization, SEC Rel. No. 33-11443; 34-106533; IA-7022; IC-36350 (Sept. 30, 2026).

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