

# Client Alert

February 2012

## SEC Adopts Rules Relating to Qualified Client Standard for Performance Fee Rule

### SEC Implementation of the Dodd-Frank Wall Street Reform Act

On February 15, 2012, the Securities and Exchange Commission (“SEC”) adopted new rules under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), as required by Section 418 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). The new rules codify the SEC’s July 12, 2011 order to increase the dollar amount tests applicable to qualified clients that may be charged performance fees under Rule 205-3 under the Advisers Act. A copy of the SEC’s adopting release is available [here](#).

### Background

Section 418 of Dodd-Frank amended Section 205(e) of the Advisers Act to require the SEC to adjust for inflation the dollar amount tests in the rules issued under Section 205(e) before July 21, 2011, and every five years thereafter. Section 205 prohibits investment advisers to be compensated on the basis of a share of capital gains. Rule 205-3, also known as the “performance fee rule,” exempts from this performance fee prohibition any “qualified clients” of the investment adviser. On May 10, 2011, the SEC proposed rules to provide for future inflation adjustments every five years and on July 12, 2011, the SEC issued an order increasing the dollar amount tests for assets under management from \$750,000 to \$1 million and for net worth from \$1.5 million to \$2 million.

In addition, on December 21, 2011, as required by Section 413(a) of Dodd-Frank, the SEC adopted rules to amend the net worth standard for “accredited investors” (as defined under the Securities Act of 1933) to exclude the value of the primary residence in calculating net worth. These accredited investor rules expand upon the Dodd-Frank requirement to exclude the value of the primary residence and any related indebtedness secured by the residence (up to its fair market value) by imposing a new requirement that any incremental debt secured by the primary residence incurred during a 60-day look-back period be counted as a liability. These new rules will be effective as of February 27, 2012.

### Qualified Client Standard

The SEC amended the definition of “qualified client” in Rule 205-3(d)(1) to codify the new dollar amount tests and to exclude the value of the primary residence in calculating net worth similar to the new accredited investor net worth calculation methodology.

The new “qualified client” definition will include:

- a natural person who, or a company that, immediately after entering into the contract has at least \$1 million under the management of the investment adviser;
- a natural person who, or a company that, the investment adviser (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:

- has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than \$2 million; or
- is a qualified purchaser as defined in Section 2(a)(51)(A) of the Investment Company Act at the time the contract is entered into.

For purposes of calculating net worth:

- The person's primary residence shall not be included as an asset;
- Indebtedness that is secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time of the sale of securities, shall not be included as a liability (except that if the amount of such indebtedness outstanding at the time of the sale of securities exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess shall be included as a liability); and
- Indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the primary residence at the time of the sale of securities shall be included as a liability.

Consistent with the approach taken by the SEC in the recent "accredited investor" net worth calculations, debt secured by the primary residence generally will not be included in the calculation except to the extent it exceeds the estimated value of the residence, such as when the mortgage is under water. The SEC also included in the final rule the requirement to include as a liability any incremental debt secured by the primary residence incurred within 60 days of the sale of securities. The SEC explained that this 60-day look-back is intended to reduce the incentive to incur incremental debt secured by the primary residence in order to boost net worth under the rule. As a result, investment advisers may wish to revise their subscription documents for private funds to address this new 60-day look-back provision.

Under the final rule, each of these dollar thresholds would be adjusted by SEC order on or about May 1, 2016, and every five years thereafter based upon the Personal Consumption Expenditures Chain-Type Price Index (or any successor index) published by the U.S. Department of Commerce for 1997.

### **Grandfathering and Compliance Dates**

The SEC also amended the transition rule in Rule 205-3(c) to provide that the prohibition on performance fees will not apply to investment advisers that were previously exempt from registration under Section 203 at the time an advisory contract was entered into or to an account of an equity owner of a private investment company advised by the adviser if the account was established when the adviser was exempt. However, the prohibition will apply if the adviser enters into new contracts or if a new party is added to existing contracts (including with respect to investors in private investment companies advised by the adviser) when the adviser is no longer exempt.

Registered investment advisers that entered into contracts and satisfied the conditions of Rule 205-3 that were in effect when the contract was entered into will satisfy the conditions of the rule. If the adviser enters into new contracts or if a new party is added to existing contracts (including with respect to investors in private investment companies advised by the adviser), then the conditions of the rule in effect at that time will apply to that person or company.

The new rule will be effective 90 days after publication in the Federal Register. The increased dollar thresholds became effective on September 19, 2011 pursuant to the July 2011 order.

### **Additional Information**

The Hunton & Williams Private Investment Funds practice group regularly represents funds, sponsors and a variety of investors in all types of private investment fund matters, including structuring, formation, offerings and compliance. We will continue to monitor the progress of the SEC's rulemaking to implement Dodd-Frank's requirements relating to investment advisers as well as relevant trends in private investment fund regulation.

For additional information on financial industry recovery proposals, see our related memoranda, available on [www.huntonfinancialindustryresourcecenter.com](http://www.huntonfinancialindustryresourcecenter.com). For additional information on recent legislation and regulations relating to regulation of private investment funds and their advisers, see our [prior memoranda](#) available on our website at [www.hunton.com](http://www.hunton.com).

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