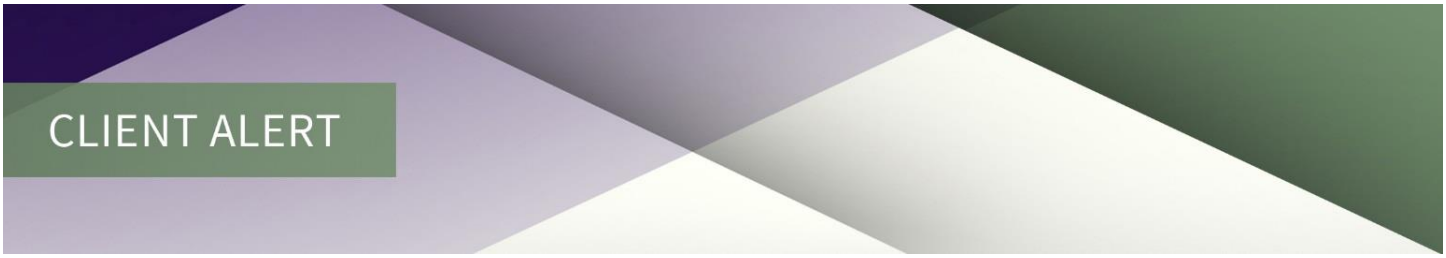

SEC Adjusts the Assets-Under-Management and Net Worth Tests on Adviser Performance Fees

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The Securities and Exchange Commission has adjusted the assets-under-management and net worth tests for a "qualified client" under Advisers Act Rule 205-3.[1] Rule 205-3 permits registered investment advisers to charge qualified clients a performance fee. The new tests are effective as of August 16, 2021.

Section 205(a) of the Advisers Act and Rule 205-3 generally prohibit a registered investment adviser from charging a client a performance fee[2] unless the client is a qualified client. That term is currently defined to include a client with (a) at least $1 million under management with the investment adviser or (b) a net worth of more than $2.1 million (the "net worth test").[3] As required by the Dodd-Frank Act,[4] the SEC issued an order increasing the assets-under-management threshold to $1.1 million and the net worth test to $2.2 million.

1 SEC Release No. IA-5756 (June 17, 2021). The SEC Release is available here. Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940.

2 Compensation based on a share of capital gains on, or capital appreciation of, the funds of a client. *See* Section 205(a)(1) of the Advisers Act and Rule 205-3.

3 The definition of "qualified client" in Rule 205-3 also includes any person that is a "qualified purchaser" under the Investment Company Act of 1940 (the "1940 Act") and certain knowledgeable employees.

4 The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010). Section 418 of the Dodd-Frank Act amended Section 205(e) of the Advisers Act to require the SEC to issue an order adjusting for inflation the dollar amount tests in Rule 205-3 by July 21, 2011, and every five years thereafter. Inflation is measured for this purpose by reference to the Personal Consumption Expenditures Chain-Type Price Index.

Rule 205-3 requires a registered adviser that charges a performance fee to a pooled investment vehicle relying on Section 3(c)(1) of the 1940 Act to look through the vehicle to its investors for purposes of meeting the qualified client requirement.[5] Registered advisers to those vehicles must require new investors to meet the higher threshold for qualified clients.

"Grandfathering"

Rule 205-3 provides that a registered investment adviser and its clients may maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if performance fees would not be permissible under the contract if it were entered into at a later date. Subsequent investments by the client with the adviser or additional investments by an investor in an existing pooled investment vehicle are also "grandfathered" and permissible. However, a new client, an investor in a new pooled investment vehicle relying on Section 3(c)(1) of the 1940 Act or a new investor in an existing Section 3(c)(1) vehicle would be subject to Rule 205-3 thresholds in effect at the time of the investment.[6]

Suggested Action

Registered investment advisers should review advisory contracts and documents for their 3(c)(1) funds and modify them as necessary to reflect the higher qualified client assets-under-management threshold and net worth test.

[5] Rule 205-3 does not require a pooled investment vehicle that is excluded from the 1940 Act pursuant to Section 3(c)(7) to look through to its underlying investors.

[6] See Rule 205-3(c)(1).

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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