

# SEC Amends Definition of "Qualified Client" under the Investment Advisers Act of 1940

On February 15, 2012, the Securities and Exchange Commission (the "Commission") adopted amendments to rule 205-3 under the Investment Advisers Act of 1940 (the "Advisers Act"). The rule amendments alter dollar amount thresholds that determine a "qualified client" under the rule, mandate adjustments for inflation, exclude the value of a natural person's primary residence from the rule's net worth test and add certain transition provisions. The rule amendments take effect 90 days after publication in the Federal Register.

The revised rule raises the monetary threshold for inclusion within the definition of "qualified client" thereby reducing the likelihood that a given client (including equity owners of "private investment companies"<sup>1</sup>) will constitute a "qualified client" and effectively barring certain clients seeking the advantages of performance fee arrangements, as well as investment advisers seeking to charge such fees.

Paragraph (d) of the revised rule codifies a Commission order issued on July 12, 2011 by requiring "qualified clients" to have at least \$1 million in assets-under-management ("AUM") with an adviser or a net worth of at least \$2 million, up from \$750,000 and \$1.5 million, respectively.<sup>2</sup> As amended, rule 205-3(e) now states that the Commission will issue an order

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<sup>1</sup> A "private investment company" in the context of the rule means any company that would be defined as an investment company under Section 3(a) of the Investment Company Act of 1940 but for the exception provided from that definition by Section 3(c)(1) of such Act.

<sup>2</sup> Section 418 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act mandated the increase in thresholds.

every five years adjusting for inflation the dollar amount thresholds of the AUM and net worth tests.<sup>3</sup> The rule amendments also alter the net worth test for determining “qualified client” status by excluding the value of a natural person’s primary residence, as well as debt secured by the residence (up to the estimated value of the residence), when calculating a person’s net worth.<sup>4</sup> The Commission incorporated a look-back provision that requires investors to identify any increase in mortgage debt over the 60-day period prior to entering into an advisory contract and count that debt as a liability in calculating net worth.<sup>5</sup>

Finally, the Commission adopted two new related transition rules, both of which are functionally in force prior to the effective date.<sup>6</sup> Paragraphs (1) and (2) of Rule 205-3(c) limit restrictions on performance fees to new contractual arrangements. Under 205-3(c)(1), clients who met the definition of “qualified client” when they entered into advisory contracts prior to the change in threshold amounts are grandfathered for the purposes of those contracts. Thus, even if they no longer meet the revised AUM and net worth thresholds, restrictions on performance fees do not apply to such existing clients’ new investments following the effective date. Under rule 205-3(c)(2), if a registered adviser previously was not required to register pursuant to section 203 and did not register, section 205(a)(1)’s prohibition on performance fees will not apply to the contractual arrangements into which the adviser entered when it was not registered with the SEC. The revised rules would apply to new contractual arrangements entered into by the investment adviser after it was required to register, however.

For more information: Full SEC Release No. IA-3372 – [Investment Adviser Performance Compensation](#)

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<sup>3</sup> Future inflation adjustments will be based on the Personal Consumption Expenditures Chain-Type Price Index (PCE Index). The first adjustment is slated for on or about May 1, 2016. Investment Adviser Performance Compensation, Advisers Act Release No. IA-3372 (Feb. 15, 2012) (to be codified at 17 CFR Part 275) [the “**Release**”].

<sup>4</sup> The primary residence revision was not required by Dodd-Frank, but was implemented based on the belief that it would be analogous to a Dodd-Frank-mandated change to the definition of “accredited investor” under Regulation D under the Securities Act of 1933, among other reasons. See Release at 8, 10, 11. The Commission further reasoned that, unlike owning certain assets, owning a home does not signal a degree of sophistication sufficient to warrant eliminating individual protection from the restrictions on charging performance compensation. See Release at 10.

<sup>5</sup> See Release at 15.

<sup>6</sup> “The Commission will not object if advisers rely or relied upon the amended transition provisions of rule 205-3(c) before [the effective date].” Release at 20. For a full description of the transition provisions, see pages 16-19 of the Release. Additionally, the revised rules provide that, as in Rule 3c-6 of the Investment Company Act of 1940, limited transfers from a qualified client to a “non-qualified client” made as a result of a gift, bequest, a legal separation, or a divorce will not transform the transferee into a qualified client. Release at 19, 20.

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