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SEC Proposes to Update Investment Adviser Performance Fee Rules

Overview

Last week, the Securities and Exchange Commission proposed adjusting the financial thresholds used to define a "qualified client" for purposes of the performance compensation rules under the U.S. Investment Advisers Act of 1940 ("Advisers Act"), generally raising the so-called net worth test from $1.5 million to $2 million and the so-called assets under management test from $750,000 to $1 million. For the most part, only a "qualified client" may be charged performance-based fees by SEC-registered investment advisers, and the Dodd-Frank Act had directed the SEC to revisit these thresholds.

The new thresholds would not apply retroactively, so that performance fee arrangements entered into under the earlier rules would not be affected. The SEC also proposes that newly registered investment advisers need not retroactively apply any qualified client thresholds to performance fee arrangements entered into prior to a firm's registration with the SEC.

The SEC is accepting comments on these proposals until July 11, 2011.[1]

Background

Under Section 205(a)(1) of the Advisers Act, an investment adviser is prohibited from entering into an investment advisory contract that provides for performance fees (or in the words of the Advisers Act, "for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client"). In 1985, the SEC adopted Rule 205-3 to allow an investment adviser to charge a client performance fees in certain circumstances.

When first adopted, Rule 205-3 permitted an adviser to charge performance fees if the client had at least $500,000 under management with the adviser immediately after entering into the advisory contract (the "Assets Under Management Test") or if the adviser reasonably believed the client had a net worth of more than $1 million at the time the contract was entered

[1] The Proposed Rules are described in the SEC's Release "Investment Adviser Performance Compensation" SEC Release IA-3198 (May 10, 2011), currently available at: http://sec.gov/rules/proposed/2011/ia-3198.pdf.

into (the "Net Worth Test"). The SEC stated that these standards would limit the availability of the exemption to clients who are financially experienced and able to bear the risks of performance fee arrangements.

In 1998, the SEC amended Rule 205-3 to increase the dollar amounts of the two tests to adjust for the effects of inflation since the rule was originally adopted. The SEC revised the Assets Under Management Test from $500,000 to $750,000, and the Net Worth Test from $1 million to $1.5 million. These are the requirements that remain in force today and would be changed by the current SEC proposal.

From the beginning, these rules did not limit their application to direct adviser-client relationships. The rules also generally required that the investors in an investment fund be "qualified clients" when the fund is charged a performance fee by the fund's investment adviser (assuming the investment adviser is registered with the SEC and subject to the Advisers Act rules).[2]

The Proposed Thresholds

The SEC now proposes to define a "qualified client" as:

- 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; or
- A natural person who, or a company that, the investment adviser entering into the contract (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, *excluding* the value of the primary residence of such natural person, calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property; *or*
  - Is a "qualified purchaser"[3] as defined in the Investment Company Act of 1940 (the "1940 Act") at the time the contract is entered into.

Inflation-Based Adjustments

In arriving at these new dollar-based thresholds, the SEC considered the effects of inflation by analyzing the historic and current levels of the Personal Consumption Expenditures Chain-Type Price Index ("PCE Index"). The SEC says that it chose the PCE Index because it is an indicator of inflation in the personal sector of the U.S. economy and is used in other provisions of federal securities law.

Going forward, the Dodd-Frank Act sets a five-year cycle for further revision to the thresholds, with the first update now set for May 2016. The SEC proposes to continue to apply the PCE Index, and would use the dollar amount tests adopted in 1998 as a baseline for all future adjustments. Specifically, the proposal provides that the amounts will be calculated by dividing the year-end value of the PCE Index (or a successor index) for the preceding calendar year, by the year-end value of

[2] It is also worth noting that the statutory qualification provision treats non-U.S. persons differently from U.S. persons. See Section 205(b)(5) of the Advisers Act.

[3] A "qualified purchaser" includes, among others, any natural person who owns not less than $5 million in investments.

the PCE Index (or a successor index) for the calendar year 1997 ("PCE Quotient"), then: (i) for the Assets Under Management Test, multiplying $750,000 times the PCE Quotient, or (ii) for the Net Worth Test, multiplying $1,500,000 times the PCE Quotient. In each case the product is rounded to the nearest multiple of $100,000.

Exclusion of the Value of the Primary Residence from the Net Worth Test

The proposed rules would amend the Net Worth Test in the definition of "qualified client," to exclude the value of a person's primary residence *and* debt secured by the property up to the property's current market value. The SEC notes that this change was not required by the Dodd-Frank Act, but is similar to the Dodd-Frank Act's requirement that the SEC exclude the value of a person's primary residence in the definition of "accredited investor" under the Securities Act of 1933.[4]

By way of illustration, a mortgage on the residence would not be included in the net worth calculation unless the outstanding debt on the mortgage exceeds the market value of the residence at the time that net worth is calculated. If the outstanding debt exceeds the market value of the residence, the amount of the excess would be considered a liability in calculating net worth under the proposed rule.

Transition Rules

The proposed rules would allow an investment adviser and its clients to 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. The intent is to minimize the disruption of implementing the new rules.

These grandfathering provisions therefore operate so that restrictions on the charging of performance fees apply to new contractual arrangements and do not apply retroactively to existing contractual arrangements. Grandfathering applies both to a direct adviser-client relationship and to the investment funds context (again, SEC rules generally require that the investors in an investment fund be "qualified clients" if the fund is charged a performance fee by the fund's investment adviser). It is proposed that follow-on investments by grandfathered investors will be permitted. But new investors investing for the first time after the new rules come into effect would be subject to the new rules in full.

Significantly, the proposed transition rules also provide that if an investment adviser was exempt from registration with the SEC and subsequently registers with the SEC, the Advisers Act's prohibition against performance fees would not apply to the contracts the adviser entered into when it was exempt from registration.[5] To be clear, the performance fee rules would apply to new contracts the adviser enters into when it is no longer exempt from registration with the SEC.

[4] The SEC also notes that the definition would be consistent with the SEC's approach when it excluded the value of a person's primary residence and associated liabilities from the determination of whether a person is a "high net worth customer" in Regulation R under the Securities Exchange Act of 1934 and from the determination of whether a natural person has a sufficient level of investments to be considered a "qualified purchaser" under the 1940 Act.

See also "Private Placement Update: SEC Proposes Changes to the Net Worth Standard for Determining Accredited Investor Status" (Feb. 2011) published by Shearman & Sterling LLP, available at: http://www.shearman.com/files/Publication/ce04a825-4b59-4896-aba4-33e5fb5e16b4/Presentation/PublicationAttachment/fa280759-7f7a-4a8c-9f07-a7f3a0425cf8/FIA-021011-Private-Placement-Update.pdf.

[5] The SEC provides the following example: If an investment adviser to an investment fund with 50 investors was exempt from registration with the SEC in 2009, but then subsequently registered because it was no longer exempt from registration (or because it chose voluntarily to register), the prohibition against performance fees in the

We previously commented that the absence of guidance on this last point was a sticking point for firms analyzing their Advisers Act registration obligations in light of the Dodd-Frank Act and considering voluntary registration.[6] While these grandfathering proposals will solve that problem, it may continue to be wise to wait to complete a registration until grandfathering is officially in effect (at least for advisers serving non-qualified U.S. clients or non-qualified U.S. fund investors). Finally, fund managers may wish to build flexibility into their offering documentation to allow the funds to address threshold changes with ease.

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Advisers Act would not apply to the contracts the adviser entered into before it registered, including the accounts of those 50 investors and any additional investments they make in that fund.

6 *See* “Senior SEC Official Discusses Delay in Fund Manager Registration Timeline” (Apr. 8 2011) published by Shearman & Sterling LLP, available at: http://www.shearman.com/senior-sec-official-discusses-delay-in-fund-manager-registration-timeline-04-08-2011/.