

SEC INCREASES THE "QUALIFIED CLIENT" NET WORTH AND ASSETS UNDER MANAGEMENT THRESHOLDS

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U.S. Asset Management and Investment Funds Alert

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INTRODUCTION

On 17 June 2021, the U.S. Securities and Exchange Commission (the SEC) issued an order to: (i) increase the net worth threshold for “qualified clients” under Rule 205-3 of the Investment Advisers Act of 1940, as amended (the Advisers Act), from US\$2.1 million to US\$2.2 million; and (ii) increase the dollar amount of the assets under management threshold from US\$1 million to US\$1.1 million (the Order).¹ The Order became effective on 16 August 2021 (the Effective Date).

THE ORDER

A. BACKGROUND

Section 205(a)(1) of the Advisers Act generally prohibits an investment adviser from entering into, extending, renewing, or performing any investment advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds of a client (also known as performance compensation or performance fees).² Section 205(e) of the Advisers Act authorizes the SEC, by rule or regulation, to exempt any person or transaction, or any class or classes of persons or transactions, from the prohibition to the extent the exemption relates to an advisory contract entered into with any person that the SEC determines does not need the protections of the prohibition, on the basis of certain factors described in that section. Prior to the Effective Date, Rule 205-3 under the Advisers Act exempted an investment adviser from the prohibition against charging a client performance fees when the client is a “qualified client” (i.e., the client has at least US\$1 million in assets under management with the adviser immediately after entering into an advisory contract with the adviser (the Assets Under Management Test) or if the adviser reasonably believed, immediately prior to entering into the contract, that the client had a net worth of more than US\$2.1 million (the Net Worth Test); clients satisfying the definition of “qualified purchaser” in Section 2(a)(51)(A) of the Investment Company Act of 1940, as amended (the Investment Company Act), and certain “knowledgeable employees” are also “qualified clients” under Rule 205-3).

The Dodd-Frank Wall Street Reform and Consumer Protection Act³ amended Section 205(e) of the Advisers Act to provide that, by 21 July 2011 and every five years thereafter, the SEC shall, by order, adjust for the effects of inflation the dollar amount thresholds included in rules issued under Section 205(e), rounded to the nearest multiple of \$100,000.

The SEC issued an order to revise the dollar amount thresholds of the Assets Under Management Test and Net Worth Test (to US\$1 million and US\$2 million, respectively, as discussed above) on 12 July 2011.⁴ Rule 205-3 codifies the threshold amounts revised by the 2011 Order and states that the SEC will issue an order on or about 1 May 2016, and approximately every five years thereafter, adjusting for inflation the dollar amount thresholds of the rule's Assets Under Management Test and Net Worth Test based on the Personal Consumption Expenditures Chain-Type Price Index (PCE Index) published by the U.S. Department of Commerce. On 10 May 2021, the SEC published a notice of intent to issue an order that would adjust for inflation the dollar amount thresholds of the Assets Under Management Test and the Net Worth Test. Based on calculations that take into account the effects of inflation by reference to historic and current levels of the PCE Index, the SEC determined that the dollar amount of the Assets Under Management Test would increase from US\$1 million to US\$1.1 million, and the dollar amount of the Net Worth Test would increase from US\$2.1 million to US\$2.2 million.

B. ADJUSTMENT OF DOLLAR AMOUNT THRESHOLDS

Therefore, as of the Effective Date, a qualified client is any client that:

- Has at least \$1.1 million in assets under management with the investment adviser immediately after entering into the an advisory contract with such adviser; or
- Has a net worth⁵ (together, in the case of a client that is a natural person, with assets held jointly with a spouse) that the investment adviser reasonably believes to be in excess of \$2.2 million immediately prior to the client's initial investment.

Clients that have entered into investment advisory contracts prior to the Effective Date in reliance on the lower net worth or assets under management thresholds will be “grandfathered in” under the prior thresholds and not be impacted. However, all investment advisory contracts entered into after the Effective Date will be subject to the new thresholds. Similarly, additional contributions from investors that were already invested in a private fund prior to the Effective Date also will be “grandfathered in.” However, investments by new investors after the Effective Date will be subject to the new thresholds. The changes will primarily affect managers to private funds that rely on the exception from registration as an investment company in Section 3(c)(1) of the Investment Company Act, because investors in private funds that rely on the exception in Section 3(c)(7) of the Investment Company Act will be either qualified purchasers or knowledgeable employees.

TAKEAWAYS

In order to ensure that the new threshold requirements provided under the Order are met, investment advisers, including managers to 3(c)(1) funds, should consider: (i) amending the form subscription documents being used for their 3(c)(1) funds, if applicable; (ii) amending any forms for managed account agreements that provide for incentive compensation; (iii) establishing procedures with their operations and investor relations teams, as well as with each fund administrator, flagging outdated subscription documents and managed account agreements and obtaining updated qualified client representations; and (iv) including a confirmation of the steps provided above into its annual compliance review.

FOOTNOTES

¹ [Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940](#), Release No. 5756 (June 17, 2021).

² See 15 U.S.C. 80b-5(a)(1).

³ Pub. L. No. 111-203, 124 Stat. 1376 (2010).

⁴ See Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Advisers Act Release No. 3236 (July 12, 2011) [76 Fed. Reg. 41,838 (July 15, 2011)] (the 2011 Order). The 2011 Order was effective as of 19 September 2011.

⁵ While a natural person's primary residence must not be included as an asset, indebtedness secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time the investment advisory contract is entered into, may be excluded as a liability (subject to limitations in the case of recently acquired debt). Additionally, indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the residence also must be included as a liability.

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