

SEC Proposes to Increase Thresholds to Charge Performance Fees

On May 10, 2011, the Securities and Exchange Commission (SEC) indicated that it intends to issue an order increasing the dollar thresholds for the assets under management (AUM) and net worth tests under Rule 205-3 (Rule) of the Investment Advisers Act of 1940 (Advisers Act) that allow certain advisers to charge performance-based fees to qualified clients. While Section 205 of the Advisers Act generally prohibits advisers from charging performance fees for their services, the Rule contains an exception for fees charged to qualified clients. Many managers of funds that are exempt from the Investment Company Act of 1940 by virtue of Section 3(c)(1) (Private Funds) utilize this exception to charge compensation based upon the performance of the funds they manage for these qualified clients. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) required the SEC to adjust the thresholds used to identify qualified clients for inflation by July 21, 2011 and every five years thereafter.

Higher AUM and Net Worth

Currently, the Rule permits advisers to charge performance fees to individual clients and Private Fund investors who hold at least \$750,000 in AUM with the adviser or have a net worth of at least \$1.5 million. The proposed order would increase the AUM threshold to \$1 million and the net worth test to \$2 million.

Consistent with earlier revisions to AUM calculation methods, the SEC also proposed to permit advisers to include any uncalled capital commitments that a Private Fund investor may have as part of the new \$1 million AUM threshold. In December 2010, the SEC proposed changes to exempt Private Fund advisers with less than \$150 million AUM from registering under the Advisers Act. That proposal included a requirement that advisers count any uncalled capital commitments when calculating their AUM for that purpose.

The proposals further contemplated adjustments to the AUM and net worth tests to account for inflation every five years. Future adjustments will be administered by the SEC staff and based upon the Personal Consumption Expenditures Chain-Type Price Index published by the Department of Commerce.

Excluding Home Value From Net Worth

Consistent with, but not required by, Dodd-Frank, the SEC also proposed that clients and Private Fund investors be prohibited from including the value of their primary residence in their net worth calculation under the Rule. Furthermore, clients and Private Fund investors will be required to count the amount of debt which exceeds the value of their home against their assets when determining net worth under the Rule according to the proposal. This requirement comports with the SEC's proposal to amend the definition of accredited investor under Rule 501, as required by Dodd-Frank Section 413.

Transitioning For Current Clients, Private Funds and New Registrants

As proposed, the new AUM and net worth tests will apply to new contractual arrangements only. Therefore, advisers with clients/Private Fund investors who meet the current definition of qualified client will not have to revisit those qualifications after the Rule is amended. The increased thresholds will only apply to new clients or new Private Fund investors.

The SEC left open the possibility that the increased thresholds may apply to dividends and realized capital gains that are reinvested in a Private Fund by a person who invested in the Private Fund before the Rule was amended.

Finally, the SEC proposed that the amended Rule would not apply to individual or Private Fund advisory contracts entered into before an adviser who is currently exempt from registration under Section 203 of the Advisers Act (Exempt Adviser) registers based on Dodd-Frank requirements. For example, if an Exempt Adviser manages a Private Fund from which it receives a performance fee, the Exempt Adviser could continue to charge such fee after registering under the Advisers Act even if the Private Fund investors are not qualified clients under the revised Rule. Furthermore, these investors could make follow-on investments in the Private Fund post-registration without regard to the Rule (though the SEC did request comment on whether it should allow such additional investments without regard to the Rule). However, new investors who are added to the Private Fund after the adviser registers must be qualified clients according to the revised Rule.

What This Means to You

Advisers are encouraged to review the proposed changes to understand how the amendments will affect their ability to charge performance fees to certain clients. Existing clients will be grandfathered

under the current threshold standards, but the new AUM and net worth tests will apply to future clients and potentially to follow-on investments in Private Funds. The SEC will issue an order to adjust the dollar thresholds unless it orders a hearing. Requests for a hearing must be received by June 20, 2011. Comments on the other amendments are due July 11, 2011.

Contact Info

For additional information about these or any other investment management issues, please contact your Husch Blackwell attorney.

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