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SEC to Increase Qualified Client Net Worth Threshold

Every five years, the US Securities and Exchange Commission is required to adjust for inflation the agency's dollar-based qualification tests for when an SEC-registered investment adviser can receive compensation based on investment performance. Those tests establish "qualified client" status, which requires that the client generally should have $1 million under management with the adviser or a net worth of $2 million. The $2 million net worth test is set to increase to $2.1 million.

Background

Section 205 of the US Investment Advisers Act of 1940 generally prohibits a registered investment adviser from receiving compensation based on a share of capital gains on or appreciation of funds of an advisory client (in what is variously termed "performance compensation," "carry" or an "incentive interest"). Recognizing that these arrangements nonetheless can be appropriate, Rule 205-¬3 under the Act permits such compensation or incentives so long as the advisory agreement is with a "qualified client."

A "qualified client" is generally one that, immediately after entering into the contract, has at least $1 million under the management of the adviser or a net worth (together with the person's spouse, if applicable, and excluding the value of a primary residence) of more than $2 million. Those amounts were set by the SEC in July 2011 and, given the five-year passage of time, are due for a mandated review against inflation over the period.

Having conducted its review, the SEC announced on May 18, 2016 that it intends to issue an order in the near future that would leave the $1 million assets under management test unchanged and would reset the $2 million net worth test at $2.1 million. The order will be issued automatically absent a request for a public hearing.[1] The proposed change then becomes effective 60 days after the issuance of the order. This is the same sequence that the SEC followed when it last adjusted the qualified client tests in 2011.

What this Means in Practice

The SEC is clear that the increased net worth requirement generally will not affect contractual arrangements entered into prior to the effective date of the planned order and cites its existing transition provisions under the rule.[2] Under those provisions, an advisory agreement or subscription agreement previously entered into should not

[1] Anyone seeking a hearing on the proposal should submit a request in writing to the Office of the Secretary of the SEC on or before 5:30 p.m. ET June 13, 2016.

[2] See Rule 205-3(c)(1) ("If a registered investment adviser entered into a contract and satisfied the conditions of this section that were in effect when the contract was entered into, the adviser will be considered to satisfy the conditions of this section; provided, however, that if a natural

be affected by changes to the qualified client tests, but any new advisory agreement or fund subscription agreement must reflect the new requirements.

As a practical matter, many investment advisers already limit their dealings to investors who are "qualified purchasers" for purposes of Section 3(c)(7) of the US Investment Company Act of 1940, the qualification thresholds of which are generally higher than those under Rule 205-3. Rule 205-3, in turn, provides that any investor who is a "qualified purchaser" for Section 3(c)(7) purposes is automatically a "qualified client" for Rule 205-3 purposes. Relationships and contracts with qualified purchasers (including funds whose equity owners are all qualified purchasers) thus are generally not affected by the proposed change to the net worth test.

Assuming the change goes forward, all other investment advisers who wish to enter into new performance compensation or incentive arrangements will be updating their advisory agreements and fund subscription agreements to reflect the new net worth test. Given the look-through provision in Rule 205-3(b), special attention should be given to subscription agreements for certain types of funds, notably those relying on Section 3(c)(1) of the US Investment Company Act of 1940 (so-called "3(c)(1) funds" or "100-person funds").

person or company who was not a party to the contract becomes a party (including an equity owner of a private investment company advised by the adviser), the conditions of this section in effect at that time will apply with regard to that person or company.")

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