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A legal update from Dechert's Financial Services Group

The SEC Raises Performance Fee Requirements for U.S. Advisers

Effective September 19, 2011, the Securities and Exchange Commission (the "SEC") has increased the client net worth and assets under management requirements applicable to U.S.-registered investment advisers that rely on Rule 205-3 under the Investment Advisers Act of 1940 (the "Advisers Act") to charge performance fees. The changes will impact the types of client accounts and private fund investor accounts that may be subject to performance fees charged by such advisers. In addition, U.S.-registered advisers, as well as those who may soon be required to register with the SEC, should be on the lookout for further changes to the performance fee requirements under the Advisers Act.

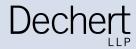
Background

Rule 205-3 provides an exemption from the Advisers Act's general prohibition against a registered investment adviser charging a fee based on a share of capital gains on, or capital appreciation of, the funds of a client (i.e., a performance fee), as long as the client is a "qualified client," as defined in the rule. With respect to private funds that rely on the exclusion from registration as an investment company provided by Section 3(c)(1) of the 1940 Act, Rule 205-3 generally requires a registered investment adviser to look through to the investors in the fund for purposes of determining "qualified client" status.

The performance fee restrictions of the Advisers Act do not apply with respect to advisory agreements with clients that are not resident in the United States.

The New Qualified Client Standards

Following a review mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the SEC has increased the "qualified client" standards effective September 19, 2011, so that such a client is now limited to, among others (a) a client with at least \$1 million under management with the adviser immediately after entering into the advisory contract (the "assets under management standard"), or (b) a client that the adviser reasonably believes to have a net worth of more than \$2 million at the time the contract is entered into (the "net worth standard"). These changes represent a 33.3% increase over the current standards.



In addition, a client that meets the definition of a "qualified purchaser" for purposes of Section 3(c)(7) of the Investment Company Act of 1940 (the "1940 Act") also satisfies the "qualified client" definition, as do certain knowledgeable employees of an investment adviser.



Pending Proposed Amendments to Rule 205-3

As previously reported to you, the SEC has proposed additional changes to Rule 205-3 that would revise the net worth standard to exclude the value of a natural person's primary residence and debt secured by the property up to the estimated fair market value of the property.² Other proposed amendments to the rule also would require the SEC to issue an order every five years adjusting these standards for inflation by reference to the historic and current levels of the Personal Consumption Expenditures Chain-Type Price Index, and to provide guidance to advisers regarding transitioning to the new standards.

Impact on Advisers

U.S.-registered investment advisers should promptly modify compliance policies and procedures to appropriately monitor for the heightened standards by September 19, 2011, and such advisers also should consider whether amendment of disclosure documents, subscription materials and/or advisory agreements may be appropriate. In light of the proposed amendments to Rule 205-3, investment advisers also may wish to exclude the value of a natural person's primary residence (and related secured debt) for purposes of the revised net worth standard, although this is not currently a requirement of the rule.

If adopted as proposed, the amendments to Rule 205-3 will include transition rules to allow a registered investment adviser and its clients to maintain performance fee arrangements that were permissible when the advisory contract was entered into, even if the performance fees would not be permissible if the contract were entered into after the effective date of the proposed amendments. In addition, under the proposed amended terms of Rule 205-3, if an investment adviser was previously exempt from registration with the SEC pursuant to Section 203 of the Advisers Act and subsequently registers with the SEC, Section 205(a)(1)'s prohibition on performance fees will not apply to contractual arrangements into which the adviser had entered when it was exempt from registration.

There is no guarantee that the SEC will implement the proposed amendments to Rule 205-3, and any amendments to the rule may be approved in a different form and/or implemented at a later date. Accordingly, U.S.-registered investment advisers, or those advisers contemplating registration in light of the requirements of the Dodd-Frank Act and rules implemented thereunder, should be on the lookout for further developments relating to the assessment of performance fees.

We will report on important developments as they arise.



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See DechertOnPoint, "Advisers Take Note: SEC Seeks to Raise the Bar for Charging Performance Fees" (June 15, 2011).



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