

LEGAL UPDATE

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CHANGES IN THE “QUALIFIED CLIENT” TEST: CHALLENGES FOR INVESTMENT ADVISERS CHARGING PERFORMANCE FEES

The Securities and Exchange Commission (the “SEC”) has adopted amendments, effective May 22, 2012, to Rule 205-3 under the Investment Advisers Act of 1940 (the “Advisers Act”) that affect a registered investment adviser’s ability to collect performance-based fees from certain clients. Although registered investment advisers are generally prohibited from collecting compensation from a client if such compensation is based on a share of capital gains on, or capital appreciation of, the client’s funds (“performance fees”), Rule 205-3 permits performance fees to be charged to “qualified clients” who meet either an assets-under-management test or a net worth test. The amendments to Rule 205-3, which change certain important aspects of the definition of qualified client, are relevant to registered investment advisers, particularly those that advise private investment funds relying on Section 3(c)(1) of the Investment Company Act (the “ICA”).¹

BACKGROUND AND TIME LINE

As part of the reforms introduced in the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), Congress directed the SEC to adjust the dollar amount thresholds for qualified client eligibility and thereafter to update these thresholds automatically every five years to account for the effects of inflation. In May 2011, the SEC announced its intent to issue an order that would revise the qualifying client dollar amount thresholds. At the same time, the SEC proposed for public comment certain amendments to Rule 205-3 that would codify the order’s adjustments in the rule itself, as well as (a) address certain details of the computation of net worth for purposes of the rule, (b) establish the quinquennial schedule for, and specify the price index to be used in making, inflation-based adjustments to the dollar amount thresholds, and (c) set out certain transition provisions allowing advisers and their clients to maintain existing performance fee arrangements already memorialized in contracts.²

¹ Rule 205(b) specifies that, for purposes of applying the qualified client thresholds when a registered investment adviser has an advisory contract with an investment company registered under the Investment Company Act of 1940 (the “ICA”), a business development company as defined under the Advisers Act, or a private investment company that is excluded from the definition of “investment company” in reliance on Section 3(c)(1) of the ICA, such investment adviser’s “clients” include investors in the applicable fund. Moreover, the SEC also requires an investment adviser to such a private investment fund to look through each tier of its fund-of-funds investors. Exemption to Allow Investment Advisers To Charge Fees Based Upon a Shares of Capital Gains or Capital Appreciation of a Client’s Account, Investment Advisers Act Release No. 1731 (July 15, 1998) [63 FR 39022 (July 21, 1998)].

² Investment Adviser Performance Compensation, Investment Advisers Act Release No. 3198 (May 10, 2011) [76 FR 27959 (May 13, 2011)], available at <http://www.sec.gov/rules/proposed/2011/ia-3198.pdf> (“Proposing Release”).

As a preliminary step, the SEC issued an order implementing the revisions to the qualifying client dollar amount thresholds on July 12, 2011, with an effective date of September 19, 2011 (“Release No. 3236”). Release No. 3236 provides that to be considered a qualified client under Rule 205-3, a client now must have either at least \$1 million in assets under management with its registered investment adviser or a net worth of more than \$2 million at the time of entering into the applicable advisory contract.³ Registered investment advisers may not charge performance fees to newly-acquired clients who do not meet either the heightened assets-under-management or net worth standard.

Subsequently, after reviewing a range of comment letters, the SEC adopted the final amendments to Rule 205-3 effective May 22, 2012. The SEC’s significant actions relating to the exemption for qualified clients from the prohibition against performance fees fall into the following time line:

- **September 19, 2011:** Effective date for the SEC’s interim order adjusting qualified client dollar amount thresholds (\$1 million assets under management or \$2 million net worth) to bring them into compliance with Dodd-Frank.
- **May 22, 2012:** Effective date for the SEC’s final amendments to Rule 205-3 codifying the adjusted dollar amount thresholds and implementing revisions to the computation of net worth to exclude a client’s primary residence and associated debt.
- **May 1, 2016:** Approximate date of the next SEC order adjusting qualified client dollar amount thresholds for inflation.

COMPUTATION OF NET WORTH

The revised net worth test provides that an individual’s primary residence is not to be considered an asset when determining whether the individual’s net worth meets the \$2 million qualified client threshold. Similarly, indebtedness securing a person’s primary residence, up to the fair value of the residence, generally will not be treated as a liability when calculating net worth. The SEC, however, has added a “look back” provision to prevent persons from borrowing against their homes solely to inflate their net worth for purposes of satisfying the qualified client dollar amount threshold. Any indebtedness secured by an individual’s primary residence that is entered into within 60 days of that individual’s execution of an advisory agreement is treated as a liability when calculating the individual’s net worth for purposes of the revised test.

TRANSITION PROVISIONS

Increases in the qualified client dollar amount thresholds, both as set out in the rule now and as will occur upon each successive five-year adjustment, could cause significant disruption to existing investment advisory relationships if not for the transition provisions in the Rule 205-3 amendments. Under these transition provisions, the revised dollar amount thresholds do not apply to a registered investment adviser’s existing clients, provided the relevant advisory contract was entered into prior to Release No. 3236’s September 19, 2011 effective date or at a time when the adviser was not registered, or required to be registered, with the SEC as an investment adviser. More generally, a client that met the qualified client definition in effect at the time of entering into an investment advisory contract is grandfathered under Rule 205-3’s transition provisions and permitted to preserve the fee arrangements in its contract without regard to any subsequent adjustments to the qualified client thresholds.

When considering clients who put additional funds into their accounts, note that the relevant date for determining which thresholds apply is the date of the advisory contract, not the date a client’s funds are made available to the investment adviser.

³ The revisions replace the previous thresholds of \$750,000 and \$1.5 million, respectively.

Contract renewals or extensions, however, are not grandfathered in, but are treated as new contracts as of the date of the renewal or extension, and thus must meet the qualified client thresholds in effect on that date. If additional clients become parties to a preexisting investment advisory contract, these additional clients will have to meet the qualified client thresholds as of the date they join the contract, but the addition of new clients will not affect the status of clients already party to the contract.

PRACTICE NOTES

Evergreen investor qualification representations. As noted in the attached chart, the SEC will, by order, adjust the qualified client dollar amount thresholds every five years, commencing on or about May 1, 2016, and will adjust the accredited investor dollar amount thresholds test every four years, commencing in 2014. Consequently, practitioners should take into account and anticipate these planned adjustments when drafting subscription documents.⁴ Investor qualification representations that are evergreen will lessen the need for frequent updates to standardized subscription documents to account for inevitable regulatory changes. The ideal investor qualification representations would describe the relevant thresholds with enough detail to enable the subscriber to make informed and accurate representations, without requiring the subscriber to conduct its own review of each relevant statute and rule in detail. An evergreen investor qualification representation in a private investment fund's subscription agreement might read as follows:

The Investor is an "qualified client," as such term is defined in Rule 205-3 under the Investment Advisers Act of 1940, as amended (the "IAA"). Generally, a natural person is such a "qualified client" if, as of the date of this Investment, either (a) such person's net worth, taken together with the net worth of such person's spouse, exceeds US \$2,000,000 (or such other amount as required after periodic adjustments made by rule of the U.S. Securities and Exchange Commission) excluding the value of such person's primary residence and excluding any mortgage or other indebtedness secured by the residence that does not exceed the fair market value of the residence, to the extent such debt was outstanding at least 60 days prior to entering into such contract, or (b) together with this Investment, such person will have at least US \$1,000,000 (or such other amount as required after periodic adjustments made by rule of the U.S. Securities and Exchange Commission) under the management of the Adviser.

Look-through applicable to 3(c)(1) funds-of-funds. When a 3(c)(1) fund (the "upper-tier fund") invests in another 3(c)(1) fund (the "lower-tier fund"), the investment adviser to the lower-tier fund must, for purposes of Rule 205-3, count as its clients all investors in the upper-tier fund. This required look-through poses a problem if the upper-tier fund relies on the grandfathering incorporated into Rule 205-3's transition provisions. While the investment adviser to such upper-tier fund may charge a performance fee to the upper-tier fund notwithstanding that some or all of its investors do not meet the then-current qualified client dollar amount thresholds (but did meet the thresholds in effect at the time of their investment in the upper-tier fund), the investment adviser to the lower-tier fund must treat these investors as indirect investors in the lower-tier fund, using the then-current thresholds, and cannot charge a performance fee to those investors (that is, to the upper-tier fund with respect to its investment in the lower-tier fund) if they do not meet such thresholds. In this scenario, such an upper-tier fund would likely be precluded from investing in other 3(c)(1) funds as long as it has even one investor that is not a qualified client under the dollar amount thresholds applicable at the time of the proposed investment. Although this concern was raised in comments to the proposed amendments to Rule 205-3,⁵ the SEC declined to address this concern in the final rule, noting that allowing an exception for affected funds would permit investment advisers to pool small client accounts to

⁴ The SEC uses the Personal Consumption Expenditures Chain-Type Price Index (referred to as the "PCE Index") to measure inflation for purposes of adjusting the qualified client dollar amount thresholds.

⁵ Letter from the Managed Funds Association to SEC dated July 8, 2011, available at <http://www.managedfunds.org/wp-content/uploads/2011/06/MFA-Comments-on-Qualified-Client-Proposal.pdf>.

circumvent the dollar amount thresholds established in Rule 205-3 and thus undermine its effectiveness.

Therefore, investment advisers that rely on the qualified client exception to collect performance fees from 3(c)(1) funds-of-funds should ensure such funds and their documents are structured to address this scenario. For example, the funds-of-funds' documents could include strong cooperation provisions to enable the fund-of-fund or its investment adviser to collect additional relevant information from investors designed to coincide with the SEC's adjustments to the qualified client dollar amount thresholds and could expressly permit the fund-of-funds to redeem an investor's interest if the investor no longer meets such thresholds. Another approach would be for the fund-of-funds' documents to expressly permit the creation of separate classes of interests, allowing the fund-of-funds to pursue an investment in a lower-tier fund solely for the benefit of its investors that are qualified clients under the then-applicable dollar amount thresholds.

COMPARISON OF INVESTOR SOPHISTICATION TESTS

Although the qualified client tests under revised Rule 205-3 bear similarities to other statutory qualification tests for clients and fund investors, it is important not to confuse the different requirements. In particular, Rule 205-3 under the Advisers Act defines "qualified client," Regulation D under the Securities Act of 1933 (the "Securities Act") defines "accredited investor", and the ICA defines "qualified purchasers" using overlapping but not identical tests, and each definition applies in a different regulatory context. The chart on the following page outlines some key distinctions among these investor tests.

The foregoing is merely a discussion of increases in the "qualified client" thresholds of the Investment Advisers Act of 1940. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Bertrand C. Fry at 212-326-0134 or Jill C. Braibanti at 212-326-0138.

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COMPARISON OF INVESTOR SOPHISTICATION TESTS

Investor Test, Statute and Rule	Threshold for natural persons ⁶	Application	Increase for Inflation
“accredited investor” Securities Act, Regulation D	\$200,000 annual income (or \$300,000 annual income combined with spouse) or \$1 million net worth (including assets held jointly with spouse) at time of investment (excluding primary residence and related debt up to the fair market value of the residence to the extent such debt was outstanding at least 60 days prior to the purchase of the relevant securities) ⁷	Regulation D provides a safe harbor from registration of offered securities for issuers seeking to use the private offering exemption in Section 4(2) of the Securities Act.	Yes: SEC shall review thresholds “in their entirety” every four years, commencing 2014.
“qualified purchaser” Investment Company Act, Sections 2(a)(51) and 3(c)(7), Rule 2a51-1	\$5 million in “investments” (generally excluding art, jewelry, antiques, and real estate used as place of business or for personal use)	Section 3(c)(7)(A) of the ICA excludes an issuer from the definition of an investment company (exempting it from certain registration requirements) if its outstanding securities are owned only by qualified purchasers.	No
“qualified client” Investment Advisers Act, Rule 205-3	\$1 million in assets under management with the applicable registered investment adviser or \$2 million net worth (including assets held jointly with spouse) at time of entering into the applicable advisory contract (excluding primary residence and related debt up to the fair market value of the residence to the extent such debt was outstanding at least 60 days prior to entering into such contract) or is a “qualified purchaser” (see above)	An investment adviser may charge performance-based fees only to a client (including each individually advised client and each direct and indirect investor in a 3(c)(1) fund ⁸) that is a qualified client at the time of entering into its advisory contract.	Yes: SEC will adjust thresholds for inflation every five years, commencing 2016.

⁶ This chart outlines the requirements for clients and/or fund investors that are individuals (i.e., natural persons). Different thresholds apply to investors that are not natural persons.

⁷ The 2010 revisions to the accredited investor test include a grandfather clause; investors who formerly qualified as accredited investors may still exercise a right to purchase securities, provided that as of July 20, 2010, such investors held securities of the issuer and had already acquired the right to purchase additional securities to be exercised.

⁸ Under Section 3(c)(1) of the ICA, an investment fund (a “3(c)(1) fund”) that does not publicly offer its issued securities and has 100 or fewer beneficial owners of its outstanding securities is excluded from being treated as an investment company under the ICA (other than for certain limited purposes). Although 3(c)(1) funds are exempt from registering as investment companies under the Investment Company Act, each ultimate investor in a 3(c)(1) fund must meet the “qualified client” test if the investment adviser to a 3(c)(1) fund seeks to charge performance-based fees in connection with its investment management of the fund.

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Bertrand Fry is a partner in Pryor Cashman's Corporate Group and is co-head of the firm's Investment Management Group. Bert has nearly twenty years of general corporate and transactional experience that includes extensive experience with alternative investment vehicles. In addition to having launched and advised a diverse array of U.S. and non-U.S. investment products, including vehicles engaged in macro, distressed, private equity, venture capital, and real estate investing, debt origination, and quantitative trading of securities and futures, his practice has included, among other things, structuring and advising investment managers and advisers, private company mergers & acquisitions, and joint ventures.

Bert is particularly well attuned to the business needs of his clients, based on more than a decade of in-house experience at the D. E. Shaw group, where Bert was a Senior Vice President and served for a period as Acting General Counsel. During his tenure there, the D. E. Shaw group included several SEC-registered investment advisers and, at its apex, managed approximately \$40 billion across various strategies and multiple funds. Bert also launched and advised a wide range of hedge funds, funds of funds, and their managers as a member of the London office of Dechert LLP.

Bert earned his J.D., with honors, from The University of Texas at Austin School of Law, where he was also an articles editor for the Texas Law Review and received the Outstanding Second-Year Member Award from the Texas Law Review, the Gilbert I. Low Endowed Presidential Scholarship in Law, and Highest Achievement in Contracts.



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