SEC Proposes Changes to "Qualified Client" Definition and Dollar Amount Tests

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In a release dated May 10, 2011, the Securities and Exchange Commission (the "SEC") announced that, as directed by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), it intends to issue an order that would adjust the dollar amount thresholds for "qualified clients" as defined under rule 205-3 of the Investment Advisers Act of 1940, as amended ("Advisers Act"). In addition, the SEC announced proposed amendments to the "qualified client" definition which would require the SEC to adjust the dollar thresholds for inflation every five years and which would exclude a person's primary residence from the net worth calculation.

Adjustments to Dollar Amount Thresholds

As directed by the Dodd-Frank Act, the SEC has announced its plans to issue an order that would raise the assets under management and net worth tests for "qualified clients". Currently, an investment adviser registered with the SEC may only charge a performance fee in respect of investors who have at least $750,000 under management with the adviser, have a net worth of more than $1.5 million or are a qualified purchaser, as defined in section 2(a)(51)(A) of the Investment Company Act of 1940. The release announces the SEC's plan to increase the assets under management and net worth tests to $1,000,000 and $2,000,000, respectively.

Proposed Amendments to Rule 205-3

The SEC also announced proposed amendments to rule 205-3 which would require the SEC to adjust the assets under management and net worth tests for "qualified clients" for inflation every five years. The adjustment would be based on a formula set forth in the rule which ties to the Personal Consumption Expenditures Chain-Type Price Index published by the United States Department of Commerce. This proposed change, which would be implemented by adding a new paragraph (e) to rule 205-3, is also required under the Dodd-Frank Act.

In addition, the SEC is proposing to amend the definition of "qualified client" to exclude from the calculation of an individual's net worth the value of such person's primary residence, as well as the amount of debt secured by the property as long as such debt is no greater than the property's current market value. This proposed rule mirrors the change to the definition of "accredited investor" under the Securities Act of 1933, which was also implemented as part of the Dodd-Frank Act. The change acknowledges that the value of a person's residence may not necessarily reflect such person's financial experience or ability to bear investment risks, and therefore excludes the value of such residence in determining whether an investor is an "accredited investor" or a "qualified client".

In order to minimize the disruption to investment advisers' existing contractual arrangements, the SEC is proposing to let existing performance fee arrangements remain in place as long as the contract was permissible at the time it was entered into. As a result, the new order and proposed rules would not apply retroactively to invalidate or penalize existing arrangements. However, the transition rule is limited to persons who were a party to the contract when entered into. If a new person becomes a party to the arrangement, then the rules applicable at the time such new person joins will apply with respect to such new person. Consistent with the rationale of minimizing disruption, the proposed transition rule also applies to investment advisers who were exempt from registration when the arrangements were entered into, such that the new thresholds would not apply to these existing arrangements, but would apply to any new contracts established by the investment adviser following its registration.

The SEC is accepting comments on the proposed rule until July 11, 2011.

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