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SEC Approves Adjustments to Dollar Amount Tests for Performance Compensations

By Kay A. Gordon and Matthew R. Silver

On June 14, 2016, the Securities and Exchange Commission (SEC) issued an Order approving adjustments to the dollar amount thresholds of the asset under management test and the net worth tests used to determine whether a fund investor or a managed account client meets the “qualified client” standard under Rule 205-3 of the Investment Advisers Act of 1940 (the “Advisers Act”). That Rule effectively permits investment advisers registered with the SEC to charge their managed account clients and private funds they manage (and, indirectly, fund investors) performance-based compensation (such as a performance fee, a performance allocation or a carried interest) only if such clients and investors meet the “qualified client” standard. Given that private funds that rely on Section 3(c)(7) exemption from registration under the Investment Company Act of 1940, as amended (the “1940 Act”), impose even higher suitability requirements on their investors than the thresholds imposed by the “qualified client” tests, the adjustments to the dollar amount thresholds noted above are mostly relevant for the funds that rely on the Section 3(c)(1) exemption from the registration under 1940 Act.

Effective August 15, 2016, in order for a fund investor or a managed account client to meet the “qualified client” standard, such person or entity generally has to have either: (1) \$1,000,000 in assets under management with the investment adviser, or (2) a net worth of more than \$2,100,000. Presently, a “qualified client” includes a person or entity that has at least \$1,000,000 in assets under management of the investment adviser as well as a person or entity with a net worth of more than \$2,000,000. Accordingly the \$1,000,000 threshold was left unchanged and the \$2,000,000 threshold increased by \$100,000. This increase is a consequence of the Dodd-Frank Wall Street Reform and Consumer Protection Act. That Act amended section 205(e) of the Advisers Act to provide that every five years, the SEC shall adjust for inflation the dollar amount thresholds included

in rules issued under section 205(e), rounded to the nearest \$100,000. The SEC stated that, based on calculations that take into account the effects of inflation by reference to historic and current levels of the PCE Index, the dollar amount of the assets under management test would remain at \$1,000,000, and the dollar amount of the net worth test would increase from \$2,000,000 to \$2,100,000. Furthermore, while the SEC change directly applies to SEC registered investment advisers, many states (for state registered advisers and other classifications of advisers such as, for instance, California Private Fund Advisers under California Code of Regulations §260.204.9) have rules and definitions that cross-reference the SEC definition, and thus will be indirectly impacted by the adjustment.

As a result, private funds relying on the 3(c)(1) exemption from registration under the 1940 Act and charging their investors any type of performance compensation should be accepting new investors on the basis of revised subscription documents incorporating the new standard effective as of August 15, 2016, which will likely be relevant for September 1 subscriptions and closings. The new standard would also apply to managed account agreements entered or modified after the relevant dates. In its adopting release the SEC points out that “to the extent that contractual relationships are entered into prior to the Order’s effective date, the dollar amount test adjustments in the Order would not generally apply retroactively to such contractual relationships, subject to the transition rules incorporated in rule 205-3.”

In light of the adjustment, private fund advisers and advisers with managed account clients should proceed to amend the relevant agreements to incorporate the required standard by August 15, 2016. Should you have any questions about this alert, please feel free to call or email the authors of this alert or your contact within our Investment Management Group.

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