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Alert

Qualified Client "Assets-Under-Management" and "Net Worth" Test Amounts Increased to $1.1 and $2.2 Million, Respectively

July 1, 2021

Section 205(a)(1) of the Investment Advisers Act of 1940, as amended ("Advisers Act"), generally prohibits registered investment advisers ("RIAs") from entering into any investment advisory contract that provides for compensation to the RIA "on the basis of a share of capital gains upon or capital appreciation of the funds of" a client. Rule 205-3 promulgated under the Advisers Act ("Rule") provides an exemption from this "performance fee" prohibition, allowing RIAs to enter into otherwise prohibited advisory contracts if each client entering into such a contract is a "qualified client," as defined in Rule 205-3(d)(1). As written, Rule 205-3 currently codifies a U.S. Securities and Exchange Commission order from 2011[1] (subject to subsequent adjusting orders, as noted below), under which the definition of qualified client incorporates an "assets-under-management" test and a "net worth" test. Respectively, these include as a qualified client (a) "a natural person who, or a company that, immediately after entering into the contract has at least $1,000,000 under the management of the investment adviser" or (b) "a natural person who, or a company that, the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract … has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2,000,000."[2] Under the Rule, the SEC is required to adjust for inflation the "assets-under-management" and "net worth" tests every five years.[3] Subsequently, in 2016, the SEC promulgated an order[4] that revised the threshold figure of the "net worth" test to $2,100,000 (the "assets-under-management" test was left undisturbed). On June 17, 2021, the SEC once again issued an order ("Order")[5] updating the qualified client definition, this time revising both the "assets-under-management" and "net worth" tests so as to take into account the effects of inflation since the dollar amounts were last reviewed by the SEC in 2016.

Adjustment of the Assets-Under-Management Test

Effective Aug. 16, 2021, the dollar amount of the assets-under-management test is $1.1 million.

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[1] *See* Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, 76 FR 41838 (July 15, 2011), available here.

[2] Investment Advisers Act Rule 205-3(d)(1)(2)(A), available here.

[3] *See* Investment Adviser Performance Compensation, Investment Advisers Act Release No. 3372 (Feb. 15, 2012), available here.

[4] *See* Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Release No. IA-4421 (June 14, 2016), available here.

[5] *See* Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Release No. 5756 (June 17, 2021), available here.

Adjustment of the Net Worth Test

Effective Aug. 16, 2021, the dollar amount of the net worth test is $2.2 million.

Existing Advisory Contracts and Identification of the Client

Like the SEC's 2016 order, the Order notes that the dollar amount adjustment will not apply retroactively, subject to the Rule's transition rules, including Rule 205-3(c)(1), which deems a RIA to have satisfied the conditions of the Rule if such RIA satisfied the conditions in effect at the time the relevant advisory contract was entered into. Accordingly, existing clients of an adviser that were qualified clients at the time they originally entered into an investment advisory contract need not meet the new threshold amount.

Notably, neither the transition rules, nor the Order, grant any relief to fund-of-fund managers with respect to investments in trading funds. Under Rule 205-3(b), an equity owner (i.e., an investor) of a private investment company is considered a client of a RIA for purposes of the Rule. The requirement to "look through" a private investment fund client applies to both the RIA's trading hedge funds and any funds-of-funds that invest in such trading hedge funds.[6] As a result, the RIA of a trading hedge fund must ensure that both the direct investors in the trading hedge fund and the indirect investors in any fund-of-funds that is an investor in the trading hedge fund are qualified clients. In practice, this means that any private fund that relies on Section 3(c)(1) of the Investment Company Act of 1940, as amended ("Company Act"), and that invests in another Section 3(c)(1) fund (that is advised by a RIA) must ensure that its investors satisfy the requirements of the Rule in effect at the time of the initial investment with the target fund.

Timing and Actions to Consider

The Order will become effective as of Aug. 16, 2021. Accordingly, for those RIAs entering into performance-based compensation arrangements with clients on or after Aug. 16, 2021, any such prospective client will need to have assets under management of at least $1.1 million, have a net worth of at least $2.2 million, or otherwise satisfy the definition of qualified client, or another exemption from the performance fee prohibition will need to be satisfied. Managers will need to update the subscription agreements of 3(c)(1) funds to ensure that any new investor that intends to satisfy the definition of qualified client by meeting the assets-under-management or net worth test does so by meeting the new threshold amount. Funds of funds that rely on 3(c)(1) and expect to invest in other 3(c)(1) funds should consider obtaining new certifications from existing investors (especially investors that previously satisfied the qualified client definition based on the old threshold amounts).

No action is necessary for funds that rely on Section 3(c)(7) of the Company Act. The definition of qualified client includes qualified purchasers, as defined in Section 2(a)(51)(A) of the Company Act. Accordingly, private funds that rely on Section 3(c)(7), and their investors, generally satisfy the qualified client requirement by definition.

[6] *See* Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Investment Advisers Act Release No. 1731 (July 15, 1998), note 7, at Section II.C., available here.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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