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Investment Management, Trading & Markets ADVISORY ■

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SEC Increases Net-Worth Test of the Qualified Client Standard

Effective August 15, 2016, the Securities and Exchange Commission (SEC) is increasing the net-worth test of the "qualified client" standard from $2 million to $2.1 million. Registered investment advisers that charge performance-based fees are only permitted to do so if their clients meet the qualified client suitability standard.

Background

Section 205(a)(1) of the Investment Advisers Act of 1940 generally prohibits investment advisers that are registered, or required to be registered, with the SEC (but not "exempt reporting advisers"[1]) from entering into an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of capital gains upon, or capital appreciation of, the funds of the client, i.e., a "performance-based fee." Rule 205-3(a) of the Advisers Act provides relief from this general prohibition by allowing an investment adviser subject to the rule to charge a performance-based fee to an investor who is considered to be a "qualified client" under Rule 205-3(d) of the Advisers Act. Other than executive officers, directors, trustees, general partners or persons serving in a similar capacity of the investment adviser, or certain employees of the investment adviser, an investor will generally be considered a qualified client only if it is able to meet either the "net-worth test" or the "assets-under-management test" under Rule 205-3(d) of the Advisers Act. Pursuant to Rule 205(e) of the Advisers Act, the dollar amounts specified in these tests will be reviewed and possibly adjusted every five years for inflation. In its current review, the SEC has adjusted the net-worth test of the qualified client standard from $2 million to $2.1 million.

[1] An "exempt reporting adviser" is an investment adviser that qualifies for the exemption from registration under Section 203(l) of the Advisers Act because it is an adviser solely to one or more venture capital funds, or under Section 203(m)-1 of the Advisers Act because it is an adviser solely to private funds and has assets under management in the United States of less than $150 million.

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Frequently Asked Questions

Is the assets-under-management test of the qualified client standard affected by this update?

No. Investors will still be able to meet the qualified client standard under the existing assets-under-management test, i.e., whether the investor will have at least $1 million under the management of the investment adviser after the investor's subscription is accepted by the adviser.

What should investment advisers do next?

Investments advisers, regardless of whether they are subject to the general prohibition from charging performance-based fees, should contact their attorneys for a review and possible update to subscription documents and other types of investment advisory contracts they may have with clients. For example, some advisers that are not subject to the general prohibition may have voluntarily adopted the qualified client standard.

Are state-registered investment advisers affected?

Although this update only applies directly to investment advisers that are registered, or required to be registered, with the SEC, many states apply the SEC's general prohibition from charging performance-based fees to investment advisers registered in that state. State-registered investment advisers should contact their attorneys to see whether they are impacted by these updates at the state level.

Does this update affect already completed subscription agreements?

Rule 205-3(c)(2) of the Advisers Act makes clear that existing investor advisory contracts will not be affected by inflationary updates so long as such contracts were entered into before the effective date for the change (in this case, August 15, 2016) and the relevant investors did in fact meet the qualified client standard in place (in this case, the previous $2 million threshold of the net-worth test) at the time of subscription.

How are 3(c)(7) funds affected?

A "3(c)(7) fund" is exempt from registration as an "investment company" under the Investment Company Act of 1940 if the fund limits investment to those persons who are considered to be "qualified purchasers" as defined in Section 2(a)(51)(A) of the Company Act, among other conditions. Under Rule 205-3(d)(1)(ii)(B) of the Advisers Act, any investor that is considered to be a qualified purchaser is automatically deemed to be a qualified client. A 3(c)(7) fund should therefore be unaffected by this update.

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