SIDLEY AUSTIN LLP

SIDLEY

FEBRUARY 22, 2012

INVESTMENT FUNDS UPDATE

SEC Adopts Revised Qualified Client Standards for Performance Fees, Including Exclusion of Primary Residence From Net Worth Calculation

On February 15, 2012, the Securities and Exchange Commission (the "SEC") adopted amendments to Rule 205-3 under the Investment Advisers Act of 1940 (the "Advisers Act"),[1] the rule that permits SEC-registered investment advisers to charge performance-based compensation to "qualified clients."[2] The amendments (adopted largely as proposed):

- revise the net worth test in the definition of qualified client to exclude the value of a natural person's primary residence;
- include two "grandfathering" provisions that allow advisers to maintain certain existing performance fee arrangements; and
- codify the higher dollar amount thresholds for qualified client status that were previously set by order and took effect on September 19, 2011.

The amendments will be effective 90 days after publication in the Federal Register, but advisers may rely on the grandfathering provisions in the meantime.

Assets Under Management and Net Worth Thresholds

Under Rule 205-3 as amended, a client (including an investor in a Section 3(c)(1) fund) is a qualified client if:

- the client has at least $1 million under management with the adviser immediately after entering into the advisory contract (the "assets under management test");[3] or

[1] Section 205(a)(1) of the Advisers Act generally prohibits an SEC-registered adviser from charging a client performance-based fees. Rule 205-3 exempts an adviser from the prohibition in certain circumstances, including when the client is a "qualified client." For purposes of Rule 205-3, an investor in a private fund that is excepted from the definition of "investment company" by Section 3(c)(1) of the Investment Company Act of 1940 is considered a client. Rule 205-3(b) treats each equity owner of a Section 3(c)(1) fund, a registered investment company or a business development company as a client of the adviser for purposes of Rule 205-3.

[2] "Investment Adviser Performance Compensation," Investment Advisers Act Release No. 3372 (February 15, 2012) (the "Adopting Release"), available at http://www.sec.gov/rules/final/2012/ia-3372.pdf.

[3] As noted in the Adopting Release, in determining the amount of assets under management an adviser can include the assets that a client is contractually obligated to invest in private funds managed by the adviser. Only *bona fide* contractual commitments may be included; *i.e.*, those that the adviser has a reasonable belief the investor will be able to meet.

- the adviser reasonably believes that the client has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2 million at the time the contract is entered into (the "net worth test").

These rule changes conform the rule's dollar thresholds (previously $750,000 in assets under management with the adviser or $1.5 million in net worth) to the levels set by an SEC order in July 2011 (the "2011 Order").[4] The increase in the thresholds was required by the Dodd-Frank Wall Street Report and Consumer Protection Act (the "Dodd-Frank Act"). The revised rule also provides that the SEC will issue an order every five years adjusting the dollar thresholds for inflation, as required by the Dodd-Frank Act.

Exclusion of Value of Primary Residence From Net Worth Calculation

Amended Rule 205-3 excludes the value of a client's primary residence and certain property-related debt from the net worth calculation, consistent with changes to net worth calculations for determining who is an "accredited investor" that the SEC approved in December 2011.

This provision differs from the proposed amendment in one respect. Debt secured by the primary residence generally will not be included as a liability in the calculation, except to the extent it exceeds the estimated value of the primary residence. However (in a change from the proposal), any increase in the amount of debt secured by the primary residence in the 60 days before the advisory contract is entered into generally will be included as a liability, even if the estimated value of the primary residence exceeds the aggregate amount of debt secured by such primary residence.[5]

"Grandfathering" Provisions

To minimize the disruption of existing contractual relationships, Rule 205-3 as amended contains two transition provisions that allow an SEC-registered adviser to maintain performance fee arrangements that were permissible when the parties entered into them, even if the performance fee otherwise would not be permitted under the rule as amended.

Arrangements with registered advisers that satisfied the conditions of Rule 205-3 in effect when the contract was executed. Under Rule 205-3(c)(1), if a registered adviser entered into a contract and satisfied the conditions of Rule 205-3 that were in effect at the time, the adviser will be considered to satisfy the conditions of the rule. If, however, a natural person or company that was not a party to the contract becomes a party, the conditions of the rule in effect at the time of becoming a party will apply. Similarly, a person who invests in a Section 3(c)(1) fund advised by a registered adviser must satisfy the rule's conditions when he or she becomes an investor in the fund.

For example, if a client met the $1.5 million net worth test in effect before September 19, 2011 (the effective date of the 2011 Order) and entered into an advisory contract with a registered adviser before that date, the client could continue to maintain assets (and invest additional assets) with the adviser under that contract even though the net worth test was subsequently raised and he or she did not qualify under the new test. If, however, another person becomes a party to that contract, the net worth threshold in effect at that time will apply to the new party.

Arrangements with previously unregistered advisers. Under Rule 205-3(c)(2), if a registered adviser previously was not required to register with the SEC and did not register,[6] the Section 205(a)(1) performance fee prohibitions do not apply to the

---

[4] "Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940," Investment Advisers Act Release No. 3236 (July 12, 2011), available at http://www.sec.gov/rules/other/2011/ia-3236.pdf. *See* also Sidley Client Update "SEC Adopts Revised Qualified Client Standards for Performance Fees Under the Advisers Act" (July 15, 2011), available at http://www.sidley.com/sidleyupdates/Detail.aspx?news=4890.

[5] The SEC noted in the Adopting Release that the 60-day look-back provision is designed to address incremental debt secured by a primary residence that is incurred for the purpose of circumventing the rule's net worth standard.

[6] The revised language of this provision, as adopted, clarifies that the transition provision applies to contractual arrangements with advisers when they were not required to register (even if they were not "exempt") and does not apply to contractual arrangements entered into with advisers when they were registered (even if they were not required to register).

contractual arrangements into which the adviser entered when it was not registered. Section 205(a)(1) will apply, however, to contractual arrangements into which the adviser enters after it is required to register with the SEC.

For example, if an adviser to a Section 3(c)(1) fund was exempt from registration with the SEC and subsequently registers with the SEC, the adviser can continue to charge a performance fee to the fund, and the investors can continue to make additional investments in the fund, even if those investors do not meet the Rule 205-3 qualified client standards. The rule would apply, however, to the adviser's relationship with (a) any parties that become new investors in the fund after the adviser registers and (b) any original investors that become investors in a different Section 3(c)(1) fund managed by the adviser after the adviser registers, with regard to these new investments.

If you have any questions regarding this update, please contact the Sidley lawyer with whom you usually work.

The Investment Funds Practice of Sidley Austin LLP

Sidley has a premier, global practice in structuring and advising investment funds and advisers. We advise clients in the formation and operation of all types of alternative investment vehicles, including hedge funds, fund-of-funds, commodity pools, venture capital and private equity funds, private real estate funds and other public and private pooled investment vehicles. We also represent clients with respect to more traditional investment funds, such as closed-end and open-end registered investment companies (*i.e.*, mutual funds) and exchange-traded funds (ETFs). Our advice covers the broad scope of legal and compliance issues that are faced by funds and their boards, as well as investment advisers to funds and other investment products and accounts, under the laws and regulations of the various jurisdictions in which they may operate. In particular, we advise our clients regarding complex federal and state laws and regulations governing securities, commodities, funds and advisers, including the Dodd-Frank Act, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Act of 1933, the Securities Exchange Act of 1934, the Commodity Exchange Act, the USA PATRIOT Act and comparable laws in non-U.S. jurisdictions. Our practice group consists of approximately 120 lawyers in New York, Chicago, Los Angeles, San Francisco, London, Hong Kong, Singapore and Shanghai.

To receive future copies of this and other Sidley updates via email, please sign up at www.sidley.com/subscribe