HANDLER THAYER, LLP

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SEC Revises "Qualified Client" Definition

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On February 15, 2012, the Securities and Exchange Commission (the "SEC") released its final rule regarding Investment Adviser Performance Compensation (the "Rule") pursuant to Section 418 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] The Rule increases the assets-under-management ("AUM") and the net worth thresholds for the "qualified client" definition.[2] According to Section 205(a)(1) of the Investment Advisers Act (the "Act"), registered investment advisers ("RIAs") are prohibited from charging performance fees; however, the SEC provided an exemption under Rule 205-3(a) of the Act, allowing RIAs to charge *qualified clients* a performance fee, which is also known as the "Qualified Client Rule."

Prior to the Rule, a *qualified client* was defined as an investor that: (i) had at least $750,000 in AUM with the RIA that held the advisory contract; or (ii) has a net worth of more than $1.5 million.[3] The Rule adopted on February 15, 2012, increases these thresholds to $1 million AUM or a net worth of $2 million.[4] To ensure these thresholds keep pace with inflation, the Rule requires the SEC to review and revise the dollar amount thresholds every five (5) years based upon the Personal Consumption Expenditures Chain-Type Price Index published by the Department of Commerce.[5]

Grandfather Provisions

The SEC has included three (3) grandfather provisions in the Rule. First, contracts entered into by investors who met the *qualified client* definition at the time the contract was executed will be grandfathered and the investor will be deemed a "qualified purchaser" for *that* contract. However, if the investor enters a new contract, or a new party is added to the contract, then the definitions under the Rule will apply. Second, contracts that included performance fees for non-qualified clients and were executed with advisers who were previously unregistered, but have subsequently registered (as is common pursuant to Section 413 of the Dodd-Frank Act) will also be grandfathered by the SEC. Finally, similar to Rule 3c-6 of the Investment Company Act, limited transfers are allowed from a *qualified client* to a "non-qualified client" made as a result of a gift, bequest, or a legal separation or divorce.

Primary Residence

The Rule adopts the same primary residence exclusion used in the recently amended definition for an "accredited investor" under Regulation D.[6] Although the

Dodd-Frank Act did not require the definition of *qualified client* to exclude investors' primary residences, as it did for the "accredited investor" definition, the SEC elected to include the following exclusions in the Rule with respect to the value of a person's residence:

- The person's primary residence shall not be included as an asset;

- Indebtedness that is secured by the primary residence (i.e. a mortgage or home equity loan), *up to* the estimated fair market value of the primary residence shall not be included as a liability, unless indebtedness was incurred less than 60 days prior to the purchase of the securities; and,

- Indebtedness that is secured by the person's primary residence that is in excess of the fair market value of the residence shall be included as a liability.[7]

The SEC added the 60-day look-back rule for any indebtedness incurred on the primary residence to discourage people from borrowing against their homes in order to qualify as a *qualified client*. Without the look-back rule, the SEC was concerned that investors would be encouraged by advisers to take on additional debt secured by their homes in order to make investments with an adviser.[8] Consequently, any investor who converts home equity, which otherwise is excluded, into cash or other assets must exclude this indebtedness as if it was incurred within 60 days of purchasing the securities.[9] As a result, the SEC believes that having a look-back period will make it more difficult for advisers to encourage investors to manipulate their net worth by borrowing against their primary residence.[10]

Impact of the New Rule

The new Rule will essentially reduce the pool of clients who will be eligible to make investments in pooled investment vehicles where the adviser is charging a performance fee. Many advisers, including most hedge fund and private equity fund managers, attempt to align their interests with their client's by structuring pooled investment vehicles where profits are split with investors. For example, a typical fund will allow the adviser to share in some portion of the profits, known as the performance fee. Prior to the passage of the Dodd-Frank Act, most hedge fund managers were not required to comply with the *qualified client* standards because they were not required to be registered investment advisers. The Dodd-Frank Act, however, required many hedge fund managers to register as investment advisers thereby imposing the *qualified client* Rule on these managers. The net effect is that previous managers, who typically solicited investments from *accredited investors* will now only be able to solicit investments from *qualified clients*.

The SEC estimates that only 5.5 million American households have a net worth of more than $2 million *including* the equity of the household's primary residence.[11] According to the SEC, at least 1.3 million of these households are unable to meet the *qualified client* definition if you exclude their primary residence.[12] Consequently, the number of investors that can participate in pool investment vehicles with their advisers just got a lot smaller.

If you have any questions regarding this press release, please contact Steven J. Thayer at (312) 641-2100. For additional information or for a complete copy of the Final Rule, see http://www.sec.gov/rules/final/2012/ia-3372.pdf.

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[1] Investment Adviser Performance Compensation, Investment Advisers Act Release No. IA-3372 (February 2, 2012).

[2] Investment Adviser Performance Compensation, Investment Advisers Act Release No. IA-3372 (February 2, 2012). A “qualified client” should not be confused with an “accredited investor,” which includes investors with a net worth of at least $1 million, or a “qualified purchaser,” which includes investors with AUM of $5 million.

[3] Exemption to Allow Registered 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. 996 50 FR 48556 (Nov. 14, 1985). See 17 CFR § 275.205-3(a) (2007).

[4] Investment Adviser Performance Compensation, Investment Advisers Act Release No. IA-3372 (February 2, 2012).

[5] Investment Adviser Performance Compensation, Investment Advisers Act Release No. IA-3372 (February 2, 2012).

[6] Net Worth Standard for Accredited Investors, Securities Act of 1933 Release No. 33-9287 (December 21, 2011).

[7] Investment Adviser Performance Compensation, Investment Advisers Act Release No. IA-3372 (February 2, 2012).

[8] Investment Adviser Performance Compensation, Investment Advisers Act Release No. IA-3372 (February 2, 2012).

[9] Investment Adviser Performance Compensation, Investment Advisers Act Release No. IA-3372 (February 2, 2012).

[10] Net Worth Standard for Accredited Investors, Securities Act of 1933 Release No. 33-9287 (December 21, 2011).

[11] Investment Adviser Performance Compensation, Investment Advisers Act Release No. IA-3372 (February 2, 2012).

[12] Investment Adviser Performance Compensation, Investment Advisers Act Release No. IA-3372 (February 2, 2012).