DechertOnPoint

June 2011 / Issue 10

A legal update from Dechert's Financial Services Group

Advisers Take Note: SEC Seeks to Raise the Bar for Charging Performance Fees

The Securities and Exchange Commission (the "SEC") on May 10, 2011 proposed amendments to Rule 205-3 under the Investment Advisers Act of 1940 (the "Advisers Act") that will increase the client net worth and assets under management requirements applicable to U.S.-registered investment advisers that rely on the rule to charge performance fees. If adopted as proposed, the amendments will significantly impact the types of client accounts that may be subject to performance fees assessed by registered investment advisers in the future. The comment period with respect to the proposed amendments ends July 11, 2011.

Background

Section 205(a)(1) of the Advisers Act generally prohibits a U.S.-registered investment adviser from entering into, extending, renewing or performing any investment advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds of a client (*i.e.*, a performance fee). Rule 205-3 provides an exemption from this prohibition and allows a registered investment adviser to charge performance fees to a "qualified client," which currently includes, among others (a) a client with at least $750,000 under management with the adviser immediately after entering into the advisory contract (the "assets under management standard"), or (b) a client that the adviser reasonably believes to have a net worth of more than $1.5 million at the time the contract is entered into (the "net worth standard").[1] With respect to private funds that rely on the exclusion from registration as an investment company provided by Section 3(c)(1) of the 1940 Act, Rule 205-3 generally requires a registered investment adviser to look through to the investors in the fund for purposes of determining "qualified client" status.

The performance fee restrictions of Section 205(a)(1) do not apply with respect to advisory agreements with clients that are not resident in the United States.

Proposed Changes to Rule 205-3

As required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the SEC proposes to increase the assets under management and net worth standards to $1 million and $2 million, respectively. In addition, the proposed amendments would revise the net worth standard to exclude the value of a natural person's primary residence and debt secured

[1] In addition, a client that meets the definition of a "qualified purchaser" for purposes of Section 3(c)(7) of the Investment Company Act of 1940 (the "1940 Act") also satisfies the "qualified client" definition, as do certain knowledgeable employees of an investment adviser.

by the property up to the estimated fair market value of the property.[2] The proposed amendments also will require the SEC to issue an order every five years adjusting these standards for inflation by reference to the historic and current levels of the Personal Consumption Expenditures Chain-Type Price Index, a commonly used indicator of inflation in the U.S. economy.

Impact of Proposed Changes

If adopted as proposed, the amendments will narrow the class of client accounts and Section 3(c)(1) private fund investor accounts on which performance fees may be assessed. However, the proposed amendments include transition rules to allow a registered investment adviser and its clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if the performance fees would not be permissible if the contract were entered into after the effective date of the proposed amendments. Accordingly, if a registered investment adviser entered into a contract and satisfied the conditions of Rule 205-3 that were in effect when the contract was entered into, the adviser will be considered to satisfy the conditions of the amended rule. However, after the effective date of the proposed amendments, any new client advisory agreement, advisory arrangements with respect to a new Section 3(c)(1) private fund, or new investor accounts in an existing Section 3(c)(1) private fund will be subject to the amended terms of Rule 205-3 if a performance fee will be assessed.

If an investment adviser was previously exempt from registration with the SEC pursuant to Section 203 of the Advisers Act and subsequently registers with the SEC, Section 205(a)(1)'s prohibition on performance fees will not apply to contractual arrangements into which the adviser entered when it was exempt from registration with the SEC.

■ ■ ■

This update was authored by Keith T. Robinson (+1 202 261 3438; keith.robinson@dechert.com).

[2] This change is modeled on another provision of the Dodd-Frank Act that requires the SEC to exclude the value of a natural person's primary residence in the net worth component of the definition of "accredited investor" in the rules under the Securities Act of 1933.

Practice group contacts

For more information, please contact the authors, one of the attorneys listed or any Dechert attorney with whom you regularly work. Visit us at www.dechert.com/financial_services.

If you would like to receive any of our other *DechertOnPoints*, please click here.

Karen L. Anderberg
London
+44 20 7184 7313
karen.anderberg@dechert.com

David L. Ansell
Washington, D.C.
+1 202 261 3433
david.ansell@dechert.com

Margaret A. Bancroft
New York
+1 212 698 3590
margaret.bancroft@dechert.com

Sander M. Bieber
Washington, D.C.
+1 202 261 3308
sander.bieber@dechert.com

Stephen H. Bier
New York
+1 212 698 3889
stephen.bier@dechert.com

Thomas C. Bogle
Washington, D.C.
+1 202 261 3360
thomas.bogle@dechert.com

Julien Bourgeois
Washington, D.C.
+1 202 261 3451
julien.bourgeois@dechert.com

Kevin F. Cahill
Orange County
+1 949 442 6051
kevin.cahill@dechert.com

Christopher D. Christian
Boston
+1 617 728 7173
christopher.christian@dechert.com

Elliott R. Curzon
Washington, D.C.
+1 202 261 3341
elliott.curzon@dechert.com

Douglas P. Dick
Washington, D.C.
+1 202 261 3305
douglas.dick@dechert.com

Ruth S. Epstein
Washington, D.C.
+1 202 261 3322
ruth.epstein@dechert.com

Joseph R. Fleming
Boston
+1 617 728 7161
joseph.fleming@dechert.com

Brendan C. Fox
Washington, D.C.
+1 202 261 3381
brendan.fox@dechert.com

Robert M. Friedman
New York
+1 212 649 8735
robert.friedman@dechert.com

David M. Geffen
Boston
+1 617 728 7112
david.geffen@dechert.com

David J. Harris
Washington, D.C.
+1 202 261 3385
david.harris@dechert.com

Christopher P. Harvey
Boston
+1 617 728 7167
christopher.harvey@dechert.com

Robert W. Helm
Washington, D.C.
+1 202 261 3356
robert.helm@dechert.com

Richard M. Hervey
New York
+1 212 698 3568
richard.hervey@dechert.com

Richard Horowitz
New York
+1 212 698 3525
richard.horowitz@dechert.com

Jane A. Kanter
Washington, D.C.
+1 202 261 3302
jane.kanter@dechert.com

Geoffrey R.T. Kenyon
Boston
+1 617 728 7126
geoffrey.kenyon@dechert.com

Matthew Kerfoot
New York
+1 212 641 5694
matthew.kerfoot@dechert.com

Robert H. Ledig
Washington, D.C.
+1 202 261 3454
robert.ledig@dechert.com

Angelyn Lim
Hong Kong
+852 3518 4718
angelyn.lim@dechert.com

George J. Mazin
New York
+1 212 698 3570
george.mazin@dechert.com

Gordon L. Miller
Washington, D.C.
+1 202 261 3467
gordon.miller@dechert.com

Jack W. Murphy
Washington, D.C.
+1 202 261 3303
jack.murphy@dechert.com

John V. O'Hanlon
Boston
+1 617 728 7111
john.ohanlon@dechert.com

Reza Pishva
Washington, D.C.
+1 202 261 3459
reza.pishva@dechert.com

Edward L. Pittman
Washington, D.C.
+1 202 261 3387
edward.pittman@dechert.com

Jeffrey S. Puretz
Washington, D.C.
+1 202 261 3358
jeffrey.puretz@dechert.com

Jon S. Rand
New York
+1 212 698 3634
jon.rand@dechert.com

Robert A. Robertson
Orange County
+1 949 442 6037
robert.robertson@dechert.com

Keith T. Robinson
Washington, D.C.
+1 202 261 3438
keith.robinson@dechert.com

Kevin P. Scanlan
New York
+1 212 649 8716
kevin.scanlan@dechert.com

Jeremy I. Senderowicz
New York
+1 212 641 5669
jeremy.senderowicz@dechert.com

Frederick H. Sherley
Charlotte
+1 704 339 3100
frederick.sherley@dechert.com

Michael L. Sherman
Washington, D.C.
+1 202 261 3449
michael.sherman@dechert.com

Stuart Strauss
New York
+1 212 698 3529
stuart.strauss@dechert.com

Patrick W. D. Turley
Washington, D.C.
+1 202 261 3364
patrick.turley@dechert.com

Brian S. Vargo
Philadelphia
+1 215 994 2880
brian.vargo@dechert.com

M. Holland West
New York
+1 212 698 3527
holland.west@dechert.com

Anthony H. Zacharski
Hartford
+1 860 524 3937
anthony.zacharski@dechert.com

Thomas P. Vartanian
Washington, D.C.
+1 202 261 3439
thomas.vartanian@dechert.com

Jennifer Wood
London
+44 20 7184 7403
jennifer.wood@dechert.com

www.dechert.com

U.S. Austin • Boston • Charlotte • Hartford • Los Angeles • New York • Orange County • Philadelphia Princeton • San Francisco • Silicon Valley • Washington, D.C. • **EUROPE** Brussels • Dublin • London Luxembourg • Moscow • Munich • Paris • **ASIA** Beijing • Hong Kong