US Securities and Exchange Commission Amends Dollar Threshold Tests Under Qualified Client Standard, Requires Exclusion of Net Equity in Primary Residence

On February 15, 2012, the Securities and Exchange Commission (the "Commission") adopted amendments to Rule 205-3 under the Investment Advisers of 1940, as amended (the "Advisers Act"), that included increases to the "assets under management" and "net worth" dollar thresholds used to determine whether an individual or company is a "qualified client" for purposes of enabling an investment adviser (including an investment adviser to Section 3(c)(1) funds)[1] to charge performance-based compensation. These increased dollar thresholds codify the increased thresholds that the Commission issued in its July 12, 2011 order as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act[2] (the "Dodd-Frank Act").

The amendments to Rule 205-3 also provide that the Commission will issue an order every five years in the future adjusting the dollar amount thresholds for inflation, exclude the net equity of a person's primary residence from the calculation of "net worth" in a manner mirroring that used to determine if a person is an "accredited investor" under the Securities Act of 1933, as amended (the "Securities Act"),[3] and add certain transitional and grandfathering provisions that provide relief to existing advisory arrangements.

The increased dollar thresholds were effective on September 19, 2011. Other revisions to Rule 205-3 pursuant to the February 15 release will be effective May 22, 2012.

Amendments to Dollar Thresholds; Periodic Adjustments and Calculations

The Dodd-Frank Act amended Section 205(e) of the Advisers Act to provide that, by July 21, 2011, and every five years thereafter, the Commission shall adjust for inflation the dollar amount thresholds included in rules issued under Section 205(e), rounded to the nearest $100,000.[4] There are two dollar amount thresholds provided in rules issued under Section 205(e)—the "assets under management" and "net worth" tests used to determined whether a person or company is a "qualified client" in Rule 205-3. Accordingly, the Commission issued an order on July 12, 2011 increasing the dollar amount thresholds for these two tests.

As provided in the Commission's July 12, 2011 order, and as is now provided in amended Rule 205-3, an individual or company will qualify as a "qualified client" if such individual or company has assets under management with the investment adviser immediately after entering into the contract that equals or exceeds $1 million (up from $750,000 previously) or if such individual or company has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2 million (up from $1.5 million previously).

The Commission also amended Rule 205-3 to provide that the Commission will issue an order every five years that adjusts for inflation the dollar amount thresholds of the assets-under-management and net worth tests of the Rule. While the Dodd-Frank Act amended Section 205(e) of the Advisers Act to require the Commission to adjust the dollar amount thresholds in rules under Section 205, the Rule amendments explicitly state that the next order will be issued on or about May 1, 2016, with subsequent orders issued approximately every five years thereafter. *Importantly*, any adjustments in the dollar thresholds in Rule 205-3 will apply prospectively to contractual relationships entered into on or after the effective date of any order, and not retroactively to contractual relationships in existence prior to such adjustments.

Exclusion of the Value of Primary Residence From Net Worth Calculation; 60-Day Look-Back

Similar to recent amendments to the definition of "accredited investor" under the Securities Act, amended Rule 205-3 requires that for the purpose of calculating net worth under Rule 205-3, a person's primary residence shall not be included as an asset.[5] Accordingly, net worth is to be calculated excluding any positive equity that an individual may have in his or her primary residence. In making this calculation, indebtedness secured by the person's primary residence (e.g., first and second lien mortgages, certain home equity lines of credit) generally is offset against the estimated fair market value of the primary residence. Such debt generally is not included as a liability in calculating a person's net worth under the Rule, except to the extent it exceeds the estimated fair market value of the residence (i.e., an underwater mortgage).

Like the amended definition of accredited investor, amended Rule 205-3 also includes a 60-day look-back provision requiring that any indebtedness secured by the primary residence that has been added within 60 days prior to entering into an advisory agreement be included as a liability of the advisory client (or 3(c)(1) fund investor) in calculating net worth (unless the indebtedness was added as a result of the acquisition of the primary residence). Such recently acquired debt generally must be included as a liability in calculating net equity in a primary residence. The look-back provision is intended to thwart efforts to game the net worth standard by borrowing against the primary residence for the purpose of artificially inflating net worth to meet the "qualified client" definition in the Rule. Absent such provision, an advisory client (or 3(c)(1) fund investor) could effectively convert home equity—which must be excluded from net worth—into cash or other assets permitted to be included in net worth.

Transitional Provisions; Relief for 3(c)(1) Fund Advisers

The Commission adopted certain transitional provisions designed to allow investment advisers and their 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 under the contract if it were entered into as a later date.

- Rule 205-3(c)(1), as amended, provides that a registered investment adviser will be considered to satisfy the conditions of the Rule if the adviser entered into a contract and satisfied the conditions of the Rule that were in effect when the contract was entered into. In other words, an individual or company would generally be subject to the conditions of the Rule that were in effect when they became a party to the advisory contract. This revision is beneficial where an existing client no longer meets the dollar thresholds of the Rule and it permits not only the maintenance of the

existing arrangement but permits additional contributions to be made by such person.

If 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 they become a party will apply to that person or company. We note that while measurement of net worth or assets under management for purposes of Rule 205-3 occurs only once (generally at the time the advisory arrangement is entered into), measurement of a person's net worth for purposes of determining a person's status as accredited investor under the Securities Act is generally required each time an existing investor makes additional contributions to a private fund. Thus, while an adviser to a 3(c)(1) fund may be able to continue charging a performance fee under the Advisers Act based on an investor's initial net worth, subsequent changes in a person's net worth that cause an investor to lose "accredited" status may prevent such investor from making further contributions to a fund or otherwise may impact an issuer's offering of securities and reliance on Regulation D under the Securities Act if they were to take new contributions from an investor after such person loses accredited status.

- Rule 205-3(c)(2), as amended, provides that if a registered investment adviser previously was not required to register with the Commission pursuant to Section 203 of the Advisers Act, and *did not so register*, Section 205(a)(1) of the Act will not apply to an advisory contract that the now-registered adviser entered into and to accounts of 3(c)(1) investors that were established when the adviser was not registered with the Commission. This revision benefits 3(c)(1) fund advisers that recently registered with the Commission due to the elimination of the Section 203(b)(3) private adviser exemption from registration as it allows existing 3(c)(1) fund investors to make additional contributions into funds in which they are currently invested. Section 205(a)(1) *will apply*, however, to new investors in existing 3(c)(1) funds and to investments made by current investors in other funds managed by such advisers after the date of their registration with the Commission.
- Rule 205-3(c)(3) has been revised to provide that if an owner of an interest in a 3(c)(1) fund transfers his or her fund interest to another person by gift or bequest, or pursuant to an agreement related to a legal separation or divorce, the transfer will not cause the transferee to become a party to the contract and will not cause Section 205(a)(1) to apply to such transferee. This revision is consistent with Rule 3c-6 under the Investment Company Act of 1940, as amended (which addresses how funds relying on Section 3(c)(1) and 3(c)(7) may treat such events for purposes of reliance on those exceptions).

If you have any questions about the amendment to the qualified client definition, please contact any of the attorneys listed below or your regular Mayer Brown lawyer.

James B. Carlson
+1 212 506 2515
jcarlson@mayerbrown.com

Rory M. Cohen
+1 212 506 2587
rcohen@mayerbrown.com

Leslie S. Cruz
+1 202 263 3337
lcruz@mayerbrown.com

Frank A. Falbo
+1 312 701 7485
ffalbo@mayerbrown.com

Wendy Dodson Gallegos
+1 312 701 8057
wgallegos@mayerbrown.com

Michael L. Hermsen
+1 312 701 7960
mhermsen@mayerbrown.com

Gary A. Jungels
+1 312 701 8449
gjungels@mayerbrown.com

Adam D. Kanter
+1 202 263 3164
akanter@mayerbrown.com

Elizabeth M. Knoblock
+1 202 263 3263
eknoblock@mayerbrown.com

David Malinger
+1 312 701 8662
dmalinger@mayerbrown.com

Peter M. McCamman
+1 202 263 3299
pmccamman@mayerbrown.com

Stephanie M. Monaco
+1 202 263 3379
smonaco@mayerbrown.com

John W. Noell
+1 312 701 7179
jnoell@mayerbrown.com

Amy Ward Pershkow
+1 202 263 3336
apershkow@mayerbrown.com

Matthew A. Posthuma
+1 312 701 8437
mposthuma@mayerbrown.com

Laura D. Richman
+1 312 701 7304
lrichman@mayerbrown.com

Jerome J. Roche
+1 202 263 3773
jroche@mayerbrown.com

Endnotes

[1] Under Rule 205-3(b), the equity owner of a private investment company, or of a registered investment company or business development company, is considered a client of the adviser for purposes of Rule 205-3(a). Pursuant to Rule 205-3(d)(3), "private investment company" is a company that is excluded from the definition of an "investment company" under the Investment Company Act by reason of Section 3(c)(1) of that Act. Pursuant to Section 205(b)(4), investment advisory contracts with Section 3(c)(7) funds are not subject to the Section 205(a) prohibition on performance fees.

[2] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[3] Release Nos. 33-9287; IA-3341; IC-29891, available at http://www.sec.gov/rules/final/2011/33-9287.pdf

[4] *See* section 418 of the Dodd-Frank Act.

[5] The Dodd-Frank Act does not explicitly require any periodic adjustments to the net worth standard for an accredited investor, but does require the Commission to "undertake a review of the definition, in its entirety, of the term 'accredited investor' at least every four years."

Mayer Brown is a global legal services organization advising many of the world's largest companies, including a significant portion of the Fortune 100, FTSE 100, DAX and Hang Seng Index companies and more than half of the world's largest banks. Our legal services include banking and finance; corporate and securities; litigation and dispute resolution; antitrust and competition; US Supreme Court and appellate matters; employment and benefits; environmental; financial services regulatory & enforcement; government and global trade; intellectual property; real estate; tax; restructuring, bankruptcy and insolvency; and wealth management.

Please visit our web site for comprehensive contact information for all Mayer Brown offices. www.mayerbrown.com

IRS CIRCULAR 230 NOTICE. Any advice expressed herein as to tax matters was neither written nor intended by Mayer Brown LLP to be used and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed under US tax law. If any person uses or refers to any such tax advice in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to any taxpayer, then (i) the advice was written to support the promotion or marketing (by a person other than Mayer Brown LLP) of that transaction or matter, and (ii) such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

Mayer Brown is a global legal services provider comprising legal practices that are separate entities (the "Mayer Brown Practices"). The Mayer Brown Practices are: Mayer Brown LLP and Mayer Brown Europe – Brussels LLP, both limited liability partnerships established in Illinois USA; Mayer Brown International LLP, a limited liability partnership incorporated in England and Wales (authorized and regulated by the Solicitors Regulation Authority and registered in England and Wales number OC 303359); Mayer Brown, a SELAS established in France; Mayer Brown JSM, a Hong Kong partnership and its associated entities in Asia; and Tauil & Chequer Advogados, a Brazilian law partnership with which Mayer Brown is associated. "Mayer Brown" and the Mayer Brown logo are the trademarks of the Mayer Brown Practices in their respective jurisdictions.

This Mayer Brown publication provides information and comments on legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed herein.

© 2012. The Mayer Brown Practices. All rights reserved.