July 20, 2011

SEC Adopts Inflation Adjusted Definition of "Qualified Client" Under The Investment Advisers Act

On July 12, 2011, the Securities and Exchange Commission (the "SEC"), issued Release No. IA-3236 (7/12/11) (the "Order"), raising the dollar amount thresholds in Rule 205-3 under the Investment Advisers Act of 1940 (the "Advisers Act") for purposes of the rule's exemption under the Advisers Act permitting the payment of performance fees to registered investment advisers by "qualified clients."

The Order revises Rule 205-3 to define a qualified client as: 1) a person with at least $1 million under the management of the adviser, or 2) a person whose net worth (including joint assets with a spouse) exceeds $2 million. The superseded thresholds of $750,000 of assets under management with the adviser and $1.5 million in net worth have been in effect since 1998.

The Order will be effective as of September 19, 2011.

The Order was issued in accordance with the amendment to Sec. 205(e) of the Advisers Act by Sec. 418 of the Dodd–Frank Wall Street Reform and Consumer Protection Act, which requires the SEC to make such an adjustment by July 21, 2011 and every five years thereafter. Pursuant to that direction, the SEC had earlier issued a notice of intent to issue the Order together with a rule making proposal to amend Rule 205-3 (see SEC Rel. IA-3198 (5/10/11), http://www.sec.gov/rules/proposed/2011/ia-3198fr.pdf,) ("Proposed Rules") which would 1) determine how the SEC adjusts the qualified client standard for inflation, 2) exclude the value of a primary residence from the qualified client net worth test (the same change that was recently made with respect to the definition of accredited investor) and 3) grandfather existing advisory contracts of A) clients who met the previous qualified client requirements and B) investment advisers who were previously exempt from registration with the SEC. The comment period for this proposed rulemaking expired July 11, 2011, so action by the SEC could be forthcoming at any time.

If the Proposed Rules are adopted by September 19, 2011:

1. registered advisers would be deemed to satisfy the conditions of the proposed amended Rule 205-3 and would not be required to re-qualify clients (or investors in Investment Company Act of 1940 ("Investment Company Act") Section 3(c)(1) funds ("3(c)(1) Funds") they advise) who predate the September 19, 2011 changes to the thresholds; and

2. Advisers who were previously exempt from registration with the SEC and who then register with the SEC would be required to qualify new clients and 3(c)(1) Fund investors in accordance with revised Rule 205-3 for any contracts entered into on and after July 21, 2011.

It should be noted that Rule 205-3 also includes within the definition of "qualified clients" those persons who are "qualified purchasers" under Section Sec. 2(a)(51)(A) of the Investment Company Act which creates an exemption for 3(c)(7) funds. A qualified purchaser is generally a client that has $5 million in investments (although certain other categories also exist). Advisers will not be required to utilize the new qualified client standards for such qualified purchaser clients.

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