

CLIENT UPDATE

SEC Raises “Qualified Client” Standards

July 22, 2011. In order to continue to be allocated incentive fees on capital gains earned by their investors, many hedge and private equity fund managers will soon have to attract a somewhat higher level of investor due to a new order issued by the Securities and Exchange Commission.

The Commission, spurred by the Dodd-Frank Act, has increased to \$1,000,000 the so-called “assets under management” test and doubled to \$2,000,000 the so-called “net assets” test for determining whether an investor is a “qualified client,” the economically lowest level of investor from whom a registered investment adviser may earn a performance or incentive fee. These new thresholds become effective on September 19, 2011. Under the Dodd-Frank Act, the SEC was required to increase these thresholds (which had last been revised in 1998) no later than July 21, 2011 to adjust for inflation.

Both the current and new rule primarily affect advisers to private funds that have fewer than 100 investors, the so-called “3(c)(1) funds,” (named for the section of the Investment Company Act that exempts such funds from mutual fund registration). The prohibition on taking performance fees is inapplicable to managers of so-called “3(c)(7) funds,” since all of the investors of those funds must already meet wealth standards higher than those applicable to “qualified clients.”

The SEC’s order, issued July 12, 2011, follows the SEC’s issuance of a release on May 10, 2011 in which it had proposed this and certain other amendments to Rule 205-3 under the Investment Advisers Act. These proposed rules, which the SEC has said it continues to consider, include the following:

- an adjustment to the “net worth” test to specify that a natural person’s net worth excludes the value of the person’s primary residence, together with the amount of debt secured thereby (up to the property’s current market value);
- a provision specifying that, in complying with the Dodd-Frank Act’s requirement that the SEC update the “qualified client” standards every five years, the SEC issue an order every five years adjusting the “net worth” and “assets under management” tests based upon the Personal Consumption Expenditures Chain-Type Price Index;
- a “grandfathering” provision whereby an investment adviser is deemed to satisfy the exception permitting the payment of a performance fee if the contract satisfied the

relevant “qualified client” conditions in effect when the contract was entered into (but requiring any client who subsequently becomes party to such contract to satisfy the conditions as then in effect); and

- a separate “grandfathering” provision stating that the prohibition on the payment of performance fees will not apply to an advisory contract entered into by an investment adviser who was exempt from registration at the time the contract was entered into, where such investment adviser subsequently becomes required to register (but requiring any client who subsequently becomes party to such contract to satisfy the “qualified client” conditions).

If you have any questions about the foregoing or would like to discuss this development, please do not hesitate to contact any of the Morrison Cohen lawyers listed below, or any other Morrison Cohen lawyer with whom you regularly work.

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