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SEC Proposes Higher Net Worth Threshold for Qualified Clients Under Advisers Act

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On Wednesday, May 18, 2016, the ***U.S. Securities and Exchange Commission (SEC)*** proposed to increase the net worth threshold for qualified clients from $2 million to $2.1 million. This proposed adjustment is being made pursuant to a five-year indexing adjustment required by §205(e) of the ***Investment Advisers Act of 1940*** (the Advisers Act), as amended by §418 of the ***Dodd-Frank Wall Street Reform*** and ***Consumer Protection Act of 2010.***

Investment advisers registered with the SEC are prohibited by §205(a)(1) of the Advisers Act from entering into, extending, or renewing any advisory contract which provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client (e.g. a performance-based fee like carried interest). An exemption from this prohibition is provided by Rule 205-3 under the Advisers Act for clients that meet the definition of a qualified client found in the rule.

Currently, Rule 205-3 provides that in order to be deemed a qualified client, a client must have either (i) at least $1 million of assets under the management of the investment adviser, or (ii) a net worth (together, in the case of a client which is a natural person, with assets held jointly with a spouse) which the investment adviser reasonably believes to be in excess of $2 million.[1] These amounts were last adjusted on September 19, 2011, when the assets under management threshold was increased from $750,000, and the net worth threshold was increased from $1.5 million. A qualified client also includes both a qualified purchaser as defined in §2(a)(51)(A) of the Investment Company Act of 1940 (the Investment Company Act) and an investment adviser's knowledgeable employees (which generally include the investment adviser's directors, executive officers and, subject to certain conditions, personnel engaged in investment activities).

Where a private investment fund is exempt from registration as an investment company under §3(c)(1) of the Investment Company Act, the fund sponsor must be mindful of Rule 205-3(b) under the Advisers Act which provides that each equity owner of any such fund will be considered a client for purposes of determining qualified client status. In contrast, this "look through" provision is not

applicable to private investment funds that are exempt from investment company registration under §3(c)(7) of the Investment Company Act.

Because the indexing adjustment required to be made to the $1 million assets under management threshold is smaller than the rounding amount specified under Rule 205-3(e) of the Advisers Act, the SEC is not proposing a change to the $1 million assets under management threshold at this time.

The effective date of the new net worth threshold would be 60 days following the issuance of an order adopting the proposal. The proposal explicitly states that the new net worth threshold would not be retroactively applied to advisory contracts entered into prior to the effective date. Anyone seeking a hearing on the proposal must submit a request in writing to the Office of the Secretary of the SEC on or before 5:30 p.m. ET June 13, 2016.

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[1] While a natural person's primary residence must not be included as an asset, indebtedness secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time the investment advisory contract is entered into, may be excluded as a liability (subject to limitations in the case of recently acquired debt). Additionally, indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the residence must also be included as a liability.

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