Published on *The National Law Review* https://natlawreview.com

SEC Adopts Higher Net Worth Threshold for Qualified Clients under the Advisers Act

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In an order dated June 14, 2016, the Securities and Exchange Commission (SEC) adopted its prior proposal to increase the net worth threshold for "qualified clients" under Rule 205-3 of the Investment Advisers Act of 1940 (the Advisers Act) from $2 million to $2.1 million. This adjustment is being made pursuant to a five-year indexing adjustment required by §205(e) of the Advisers Act.

Registered investment advisers generally are prohibited by §205(a)(1) of the Advisers Act from charging performance-based compensation. 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."

Currently, Rule 205-3 provides that in order to be a qualified client, a client must have either (i) at least $1 million of assets under the management of the investment adviser[1], 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.[2] 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.

A sponsor of a §3(c)(1) fund must be mindful of Rule 205-3(b) under the Advisers Act, which provides that each equity owner of a §3(c)(1) fund will be considered a client of the fund's advisor for purposes of determining qualified client status. In contrast, this "look through" provision is not applicable to private funds relying on §3(c)(7) of the Investment Company Act.

The effective date of the increase of the net worth threshold is Monday, August 15, 2016.

The new net worth threshold will not be retroactively applied to advisory contracts entered into prior to the effective date. However, sponsors of §3(c)(1) funds should be aware of a couple of important implications. First, prospective investor net worth representations in subscription agreements for any §3(c)(1) funds with closings on or after the effective date should reflect the updated threshold. Second, documents used in effectuating secondary transfers of ownership interests in existing §3(c)(1) funds should also contain representations to reflect the revised net worth requirements.

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[1] Because the indexing adjustment required to be made to the current $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 adopting a change to the $1 million assets under management threshold at this time.

[2] 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.

National Law Review, Volume VI, Number 175