

June 17, 2016

SEC Increases “Qualified Client” Net Worth Threshold

On June 14, 2016, the U.S. Securities and Exchange Commission increased the net worth test threshold for “qualified clients” under Rule 205-3 of the Investment Advisers Act of 1940, as amended, from \$2 million to \$2.1 million.¹ Rule 205-3 permits investment advisers to receive performance-based compensation only when the client is a “qualified client,” which may capture performance fees or distributions of carried interest. After giving effect to the increase, a qualified client² will be a client that either:

- (i) has at least \$1 million in assets under management with the investment adviser immediately after entering into the advisory contract; or
- (ii) the investment adviser reasonably believes, immediately prior to entering into the contract, has a net worth of more than \$2.1 million (“net worth test”).

As a practical matter, both tests are applicable to managed accounts and private funds that rely on the exception to the definition of an investment company provided in §3(c)(1) of the Investment Company Act of 1940, as amended (the “40 Act”), which are required to “look through” to each investor of such fund to determine qualified client status. This “look through” rule does not apply to private funds relying on the exception under §3(c)(7) of the 40 Act.

The effective date of the increase is August 15, 2016. Clients that enter into advisory agreements in reliance on the net worth test prior to the effective date will be “grandfathered” in under the prior net worth threshold.³

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¹ Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, (June 14, 2016), see <http://www.sec.gov/rules/other/2016/ia-4421.pdf>

² Investment Advisers Act Rule 205-3(d) also provides that a “qualified purchaser” or a “knowledgeable employee” is also a “qualified client” for purposes of Rule 205-3.

³ The transition rules set forth in Rule 205-3(c)(1) provide that, if an investment adviser entered into an advisory agreement prior to the effective date with an investor that satisfied the qualified client status rule in effect at the time the advisory agreement was entered into, the qualified client rule will be considered satisfied; however, if an investor that was not a party to the advisory agreement becomes a party to it on or after August 15, 2016 (including an investor coming into a 3(c)(1) fund on or after August 15, 2016), the new standard would apply (i.e., if the new investor is relying on the net worth test, it would need to meet the new \$2.1 million net worth threshold).

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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