OLSHAN
OLSHAN GRUNDMAN FROME ROSENZWEIG & WOLOSKY LLP

Client Alert

Corporate Group March 2012

SEC Amends Rule That Permits Registered Investment Advisers to Charge "Qualified Clients" Performance Based Compensation

Recently Increased Thresholds are Codified; Value of Primary Residence Eliminated from Net Worth Calculation; Pre-Amendment Advisory Contracts "Grandfathered"

On February 15, 2012, the Securities and Exchange Commission (the "SEC") amended its rules on investment adviser performance fees to codify the increased net worth and assets-under-management thresholds contained in the definition of "qualified clients." Registered investment advisers are permitted to charge their "qualified clients" performance fees, which is an exception to the general prohibition on charging performance fees set forth in the Investment Advisers Act of 1940 (the "Act"). The amendments were adopted in large part to conform the SEC's rules to certain requirements contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act. The amendments (1) codify the revised dollar amount thresholds used to determine whether an individual or a company is a qualified client, (2) provide that the SEC will issue an order every five years adjusting the dollar amount thresholds for inflation, (3) exclude the value of a person's primary residence and certain associated debt from the test for whether a person has sufficient net worth to be considered a qualified client and (4) add certain transition provisions to the rules. These amendments will become effective on May 22, 2012, although advisers can begin to rely on the transition rules immediately so as not to disrupt existing contractual relationships if an investment adviser is required to register before these amendments take effect.

Section 205(a)(1) of the Act generally restricts an investment adviser from entering into any advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds of a client, unless the SEC has exempted the advisory contract by rule or order. As amended, Rule 205-3 under the Act will allow an investment adviser to charge performance fees if the client has at least $1.0 million in assets under management with the adviser immediately after entering into the advisory contract or if the adviser reasonably believes the client has a net worth of more than $2.0 million at the time the contract was entered into. The amendments codify the same thresholds previously established by a June 2011 order issued by the SEC that became effective in September 2011. The amendments also direct the SEC to issue an order every five years, starting on or about May 1, 2016, adjusting for inflation the dollar amount thresholds of the assets-under-management and net worth tests. The inflation adjusted amounts will apply to contractual relationships entered into on or after the effective date of such an order, and will not apply retroactively to contractual relationships previously in existence.

The amendments also revise the net worth test under Rule 205-3 to exclude the value of a natural person's primary residence and certain debt secured by such property. The change is similar to the recently adopted primary residence exclusion from the net worth calculations for determining whether an individual is an "accredited investor" under Regulation D promulgated under the Securities Act of 1933, as amended. Under amended Rule 205-3, the value of a primary residence can no longer be counted as an asset when calculating net worth for the

purpose of determining an individual's qualified client status, and debt secured by a primary residence is not treated as a liability. However, any indebtedness secured by an individual's primary residence in excess of the property's estimated fair market value, *i.e.*, an "underwater" mortgage, is treated as a liability. Any additional debt secured by the primary residence incurred within 60 days before the investment contract is entered into generally will also be treated as a liability, regardless of whether the estimated value of the primary residence exceeds the aggregate amount of secured debt. The estimate of fair market value of an individual's primary residence does not require a third party opinion or valuation.

The SEC also adopted certain transition provisions applicable to Rule 205-3 in order to allow investment advisers and their current clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if the performance fee arrangements would not be permissible under the amended rules. In addition, if a registered investment adviser previously was not required to register with the SEC as an investment adviser, the prohibition on performance fees set forth in Section 205(a)(1) of the Act will not apply to the contractual arrangements the adviser entered into before it registered. If, however, a private investment company accepts new investors (or if original investors become investors in a different private investment company managed by the adviser) after the adviser registers with the SEC, the rule, as amended, will apply to the new investments.

For more information regarding these amendments, please contact the Olshan attorney with whom you regularly work or one of the attorneys listed below.

Kenneth M. Silverman
ksilverman@olshanlaw.com
212.451.2327

Ryan S. Replogle
rreplogle@olshanlaw.com
212.451.2281