

SEC Increases Registered Investment Adviser Performance Compensation Net-Worth and Assets-Under-Management Tests

August 13, 2021

Key Points

- Effective as of August 16, the dollar amount tests specified in the definition of “Qualified Client” in Rule 205-3 under the Investment Advisers Act of 1940 (Advisers Act) will increase for the net-worth threshold from \$2.1 million to \$2.2 million and for the required assets-under-management threshold from \$1 million to \$1.1 million. As a result, federally registered investment advisers (RIAs) should consider taking the following actions to with respect to their documentation:
 - RIAs who charge performance fees should revise applicable net-worth and assets-under-management representations in their 3(c)(1) fund subscription agreements to reflect the updated thresholds for new separately managed account clients and 3(c)(1) fund investors.
 - RIAs who manage separately managed accounts should update their investment advisory agreements for future clients to reflect the increased applicable net-worth and assets-under-management thresholds and/or update their due diligence documentation to remain consistent with the updated definition of “Qualified Client.”

Changes to the “Qualified Client” Definition

Section 205 under the Advisers Act generally prohibits an RIA from receiving compensation based on a share of the capital gains on or appreciation of the assets of an advisory client (i.e., performance fees). Rule 205-3 under the Advisers Act provides an exemption from this prohibition for clients that meet the definition of “Qualified Client” found in the rule.

Currently, the definition of Qualified Client includes, among other persons, a company that, or a natural person who:

- has at least \$1 million of assets under the management of the RIA; or
- has a net worth (together, in the case of a client that is a natural person, with assets held jointly with a spouse) that the RIA reasonably believes to be in excess of \$2.1 million.

On June 17, the Securities and Exchange Commission issued an order increasing the net-worth threshold from \$2.1 million to \$2.2 million and increasing the required assets-under-management threshold from \$1 million to \$1.1 million. Both increases are effective as of August 16. The increases in the net-worth and required assets-under-management thresholds are based on adjustments for inflation.

The change impacts performance fees charged to private funds that rely on Section 3(c)(1) of the Investment Company Act of 1940, as well as to separately managed accounts. RIAs who charge performance fees should revise applicable net-worth and assets-under-management representations in their investment advisory agreements and/or in their due diligence procedures and documentation. Additionally, RIAs should update their 3(c)(1) fund subscription agreements to reflect the updated thresholds for new separately managed account clients and 3(c)(1) fund investors.

However, Rule 205-3 specifically provides that existing investors and clients that no longer meet the new net-worth threshold can continue to be charged performance fees provided they met the net-worth threshold at the time they entered into the advisory contract under which they are charged such performance fees.

The SEC order is available [here](#).

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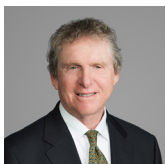
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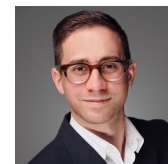
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8/13/21