Simpson Thacher

Regulatory and Enforcement Alert

SEC Increases "Net Worth" and "Assets Under Management" Thresholds for "Qualified Client" Status

June 30, 2021

The U.S. Securities and Exchange Commission recently issued an Order raising the "net worth test" from $2.1 million to $2.2 million and raising the "assets under management test" from $1 million to $1.1 million for purposes of the "qualified client" definition in Rule 205-3 under the Investment Advisers Act of 1940. The new thresholds are effective beginning ***August 16, 2021***, and ***registered investment advisers charging performance-based compensation should timely revise their fund or client documentation accordingly***.

To qualify as a "qualified client" on or after the August 16, 2021 effective date, a natural person or company must:

1. have at least $1.1 million of assets under management with the adviser immediately after entering into the investment advisory contract with the adviser;
2. have a net worth (together, in the case of a client who is a natural person, with assets held jointly with a spouse) of more than $2.2 million (excluding the value of such natural person's primary residence and indebtedness secured by such residence) immediately prior to entering into the contract;
3. be a "qualified purchaser" as defined in Section 2(a)(51)(A) of the Investment Company Act of 1940; or
4. be a "knowledgeable employee" of the adviser.

The Order is important for determining which clients may pay an adviser a performance fee. Section 205(a)(1) of the Advisers Act prohibits an investment adviser registered with the SEC from entering into, extending or renewing any investment advisory contract which provides for compensation to the investment adviser on the basis of a share of capital gains on, or capital appreciation of, the funds of the client (*e.g.*, carried interest or performance fees). Rule 205-3 under the Advisers Act provides an exemption from this prohibition if the client is a "qualified client."

Additionally, an adviser that manages a private fund relying on Section 3(c)(1) of the Investment Company Act must "look through" the fund to determine the qualified client status of each fund investor and each equity owner of any fund investor that is: 1) an "investment company" registered under the Investment Company Act, 2) a private fund relying on Section 3(c)(1) of the Investment Company Act or 3) a "business development company" as

defined in Section 202(a)(22) of the Advisers Act. This "look through" requirement does not apply to private funds relying on Section 3(c)(7) of the Investment Company Act.

New contractual relationships (*e.g.*, subscription agreements or advisory agreements) entered into on or after the August 16, 2021 effective date must reflect the adjusted numbers. Registered investment advisers who manage private funds that rely on Section 3(c)(1) of the Investment Company Act or advise managed accounts and who receive performance-based compensation should ensure that agreements entered August 16, 2021 or later reflect the adjusted thresholds.

Section 418 of the Dodd-Frank Act and Advisers Act Rule 205-3 require the SEC to adjust the dollar amounts in these tests for inflation every five years, rounded to the nearest $100,000; the next adjustment is expected to be in 2026.

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