SIMPSON THACHER

SEC MODIFIES RULE 205-3 REQUIREMENTS FOR PERFORMANCE FEES

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JULY 24, 1998

On July 15, 1998, the Securities and Exchange Commission (the "SEC") adopted amendments to Rule 205-3 under the Investment Advisers Act of 1940 (the "Advisers Act"). This rule creates an exception to the Advisers Act's prohibition in Section 205(a)(1) on registered investment advisers receiving compensation from a client based on a share of the capital gains or capital appreciation of the client's assets, which includes "carried interest" and other special allocations of profits ("performance fees"). The amendments, which will become effective on August 20, 1998, (i) modify the definition of the types of clients that a registered investment adviser can charge performance fees under the rule and (ii) eliminate specific requirements for performance fee formulas and disclosure with respect to such performance fees. The broad effect of the amendments is to significantly expand the flexibility of registered investment advisers to charge performance fees under the rule. As before, unregistered investment advisers continue not to be subject to specific Advisers Act restrictions on performance fees.

QUALIFIED CLIENTS

Under the current rule, registered investment advisers are permitted to charge performance fees to clients which either have at least $500,000 in assets under management with the adviser or have a net worth of more than $1,000,000, except as provided under "Look-Through Requirements for Certain Funds" below ("qualified clients"). The new rule increases the assets under management test to $750,000 and the net worth test to $1,500,000. The new rule also adds two additional categories of qualified clients: (i) "qualified purchasers" for purposes of the recently enacted "qualified purchaser" fund exemption under the Investment Company Act and (ii) certain "knowledgeable employees" of the adviser. Knowledgeable employees are defined in a manner similar to their definition under the Investment Company Act of 1940 (the "Investment Company Act") and include executive officers, directors, trustees, general partners or persons serving in a similar capacity for an adviser and employees of the adviser (other than those performing solely secretarial, clerical or administrative functions) who in their regular duties have participated in the adviser's or another company's investment activities for at least 12 months.

ELIMINATION OF SPECIFIC REQUIREMENTS FOR PERFORMANCE FEE FORMULAS AND DISCLOSURE

The current rule requires the inclusion of certain provisions in performance fee formulas and obligates the adviser to provide certain disclosure to clients regarding performance fees. Most significantly, all performance fees must be based on the performance of a client's account for a period of at least one year. This requirement has frequently forced registered advisers to place their performance fees at risk if investors have the right to redeem their investments within the first year, to require investors to "lock up" their investments with the adviser for at least one year and to wait to take performance fees for one year after commencement of managing a client's assets. The requirement has also resulted in cumbersome fee formulas for situations in which investors subsequently redeem their investments in the middle of a 12 month performance period.

All specific requirements as to performance fee formulas and disclosure have been eliminated in the new rule. An adviser is still obligated to provide clients with full disclosure of the performance fee arrangements. This includes disclosure of all material information regarding a proposed performance fee arrangement and any material conflicts posed by such arrangement.

"LOOK-THROUGH" REQUIREMENTS FOR CERTAIN FUNDS

Where the advisor has a performance fee arrangement with a registered investment company, a business development company or a private investment company relying on a 3(c)(1) exemption under the Investment Company Act, the revised rule continues to require a "look-through" for purposes of the qualified client test; each "equity owner" in any such company other than the adviser and any person who is not charged a performance fee must be a qualified client. However, any equity owner who is the investment adviser or who is not charged a performance fee need not be a qualified client.

"QUALIFIED PURCHASER" FUNDS AND NON-U.S. CLIENTS

The revised rule does not affect the exceptions to the Advisers Act's prohibition on performance fees enacted as part of the National Securities Markets Improvement Act of 1996. These exceptions exempt performance fee arrangements with "qualified purchaser" funds and non-U.S. residents. In informal discussions with the SEC's staff, the firm has been advised that in the staff's view the exception for non-U.S. residents covers funds formed under non-U.S. law for the *bona fide* purpose of sale to non-U.S. residents even if such funds also have U.S. investors that are not eligible clients. As a result, it generally is not necessary for registered advisers to offshore funds to rely on Rule 205-3 in order to charge performance fees to the fund.

TRANSITION PROVISION

The rule has a transition provision allowing investment advisers to maintain their existing performance fee arrangements with clients even if the clients fail to meet the new eligibility criteria; this transition provision appears to permit such clients to increase their investments with the adviser under existing arrangements. However, after August 20, 1998, any new clients to performance fee arrangements would be required to satisfy the new qualified client test.

RECOMMENDED ACTIONS

In light of the revisions to Rule 205-3, registered investment advisers charging performance fees in reliance on Rule 205-3 should take the following actions:

- Subscription forms distributed to new investors should be amended to reflect the new eligibility requirements for qualified clients.
- Advisers should consider amending existing performance fee arrangements to eliminate the one year performance period requirement for new investors.
- All new funds should eliminate the one year performance period requirement and other compensation formula provisions previously required by Rule 205-3.

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