

## Investment Funds Alert

### SEC Excludes Value of Primary Residence from Performance Compensation Threshold, but Provides Grandfathering

February 21, 2012

On February 15, 2012, the Securities and Exchange Commission (SEC) adopted amendments to its rule that permits registered investment advisers to charge performance compensation. The amendments will (i) codify the previously adopted increases to the threshold for clients or investors that may be charged performance-based compensation to \$2 million in net worth or \$1 million in assets under management, (ii) conform the \$2 million in net worth standard with the accredited investor standard by excluding the value of an investor's primary residence and related debt (except to the extent that the debt exceeds the value of the primary residence or was increased in the 60 days prior to the investment<sup>1</sup>), (iii) grandfather clients that entered into agreements or investors that invested when either the investment adviser was not registered or a lower monetary threshold applied, (iv) deem persons that receive interests in a 3(c)(1) private fund<sup>2</sup> in certain limited types of transfers to step into the shoes of the transferor and (v) set the SEC's methodology for adjusting the above monetary thresholds for inflation in May of 2016 and every five years thereafter. The amendments will become effective 90 days after publication in the *Federal Register*, but the SEC will not object if registered investment advisers rely on the amendments prior to their effectiveness.

#### Monetary Thresholds and Background of Changes

On May 10, 2011, the SEC proposed to amend the monetary thresholds for charging performance compensation to \$2 million in net worth (from \$1.5 million) or \$1 million in assets under management (from \$750,000). The proposed changes to the rule also would have altered the calculation of the net worth threshold to match the Dodd-Frank Wall Street Reform and Consumer Protection Act's (the "Dodd-Frank Act") changes to the net worth standard for the accredited investors and the SEC's then-proposed codification thereof by excluding the value of the primary residence and debt secured by the primary residence except to the extent that the value of the debt would exceed the value of the residence. The SEC subsequently issued an order on July 12, 2011, however, that only increased the thresholds without excluding the value of the primary residence or related debt.

The SEC has now adopted the proposed amendments to the net worth standard in the performance-based compensation rule by excluding a potential client's or investor's primary residence and any debt secured by the residence except to the extent that the loan is less than or equal to the residence's estimated fair market value. As with the final version of the accredited investor net worth calculation, however, the SEC also includes any increase in debt secured by the person's primary residence occurring within 60 days prior to entering into the advisory contract or investing in the 3(c)(1) private fund on the liability side of the net worth calculation unless the increase was as a result of the acquisition of the primary residence.

<sup>1</sup> Any increases in debt due to the purchase of a new residence will not, however, be included as a liability.

<sup>2</sup> While a "private fund" may be a 3(c)(1) fund or a 3(c)(7) fund, the thresholds in Rule 205-3 under the Investment Advisers Act of 1940 only apply to 3(c)(1) funds. Also, "qualified purchasers" are automatically deemed to be a "qualified client."



## Grandfathering

The SEC adopted two transition rules that will help investment advisers that were registered when the previous monetary thresholds were effective and those that are newly registering with the SEC. The first of the transition rules permits a registered investment adviser to charge performance-based compensation from a client or investor in a 3(c)(1) private fund that satisfied the threshold at the time of its original investment, would not satisfy the increased threshold and wishes to have the registered investment adviser manage additional assets or wishes to make additional investments in the 3(c)(1) private fund in which the investor previously invested. The second of the transition rules permits an investment adviser that was not previously required to register with the SEC and was not so registered (i) to continue to receive performance-related compensation from any clients or investors that entered into a contract or invested in a fund prior to registration and (ii) to receive performance-related compensation with respect to increases in assets under management by existing clients or follow-on investments in a fund in which an investor was previously invested,<sup>3</sup> in each case without complying with the new thresholds. Investments by other clients or investors or investments in other funds will be subject to the new monetary thresholds.

## Involuntary Transfers

The performance compensation rule will now also allow a registered investment adviser to charge performance-based compensation to persons who receive interests in a 3(c)(1) private fund through a bequest or gift or pursuant to an agreement related to a separation or divorce if the person from whom he or she received the interest satisfied the relevant thresholds at the time of its investment.<sup>4</sup>

## Calculation Methodology

The Dodd-Frank Act requires the SEC to adjust the monetary thresholds in its performance compensation rule for inflation every five years. The SEC specified the methodology for computing the adjustment of the monetary thresholds on or about May 1, 2016 and every five years thereafter. The adjusted thresholds will be calculated by multiplying the monetary thresholds in the performance compensation rule prior to the enactment of the Dodd-Frank Act (\$1,500,000 in net worth or \$750,000 in assets under management) by the ratio of (i) the year-end value of the Personal Consumption Expenditures Chain-Type Price Index published by the U.S. Department of Commerce for the previous year to (ii) the year-end value of such index for the calendar year 1997.

## Conclusion

Investment advisers that are registering and previously registered investment advisers should amend their subscription documents to address the new changes to the monetary thresholds for charging performance-based compensation. They may, however, take advantage of the grandfathering provisions in any follow-on investment agreements and rely on their client's and fund investor's status at the time of their original investment.

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<sup>3</sup> The transition relief does not apply if the investor is investing in a different fund.

<sup>4</sup> This rule is similar to Rule 3c-6 under the Investment Company Act of 1940.

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