

SEC Increases Qualified Client Threshold

Alert

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In an order effective August 16, 2021, the Securities and Exchange Commission (SEC) increased the dollar amount tests in the “qualified client” definition under Advisers Act Rule 205-3.

Background

Section 205(a)(1) of the Investment Advisers Act of 1940 prohibits investment advisers from entering into investment advisory contracts that provide for performance compensation. However, advisory contracts with certain investors are exempted from prohibitions on performance compensation due to factors such as financial sophistication, net worth, experience in financial matters, and assets under management, among others.

Rule 205-3 exempts from the prohibition certain “qualified clients” who meet specific financial thresholds for assets under management, and net worth. Currently (before the new changes take effect on August 16th), as set in May 2016, a “qualified client” is either:

- i. A client with at least \$1 million in assets under management, immediately upon entering into a contract with a registered investment adviser, or
- ii. A client who the registered investment adviser reasonably believes has a net worth (together with assets held jointly with a spouse) of more than \$2.1 million

Under Section 418 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC must adjust the thresholds for the assets under management and net worth tests every five years to reflect inflation.

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Accordingly, on June 17, 2021, the SEC published an order approving an adjustment for inflation for the assets under management test, increasing that from \$1 million to \$1.1 million, and the net worth test, increasing that from \$2.1 million to \$2.2 million. This increase reflects inflation from 2016 through the end of 2020.

Going Forward

Clients who entered into advisory contracts prior to the effective date of the updated tests, with limited exceptions, will be “grandfathered” into the updated rule and will not be affected. However, registered investment advisers, particularly managed accounts and private funds relying on Section 3(c)(1) of the Investment Company Act, should review and update their investment advisory agreements for changes to these thresholds. The updated thresholds should also be included in representations for prospective investors in subscription agreements for funds closing on or after the effective date.

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