WINSTON & STRAWN LLP

CLIENT ALERT

SEC Increases Thresholds for Qualified Client Status

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Effective as of August 16, 2021, the Securities and Exchange Commission (SEC) has amended the definition of "qualified client" to increase the dollar-amount thresholds under both the assets-under-management and the net-worth tests for qualified-client status. Consequently, the assets-under-management test will increase from $1,000,000 to $1,100,000, and the net-worth test will increase from $2,100,000 to $2,200,000.

Background

Section 205(a)(1) of the Investment Advisers Act of 1940, as amended (Advisers Act), generally prohibits investment advisory contracts that provide for performance compensation or performance fees, including incentive fees and carried interest. Rule 205-3 under the Advisers Act provides an exemption from such prohibition in instances where the client is a "qualified client."

Pursuant to current Rule 205-3 of the Advisers Act, a client (including an investor in a fund relying on the exemption from registration provided under Section 3(c)(1) of the Investment Company Act (a 3(c)(1) fund)) constitutes a "qualified client" if either:

(i) if immediately after entering into a contract with a federally registered investment adviser, such client has at least $1,000,000 under management of the investment adviser; or

(ii) if immediately prior to entering into a contract with a federally registered investment adviser, the investment adviser entering into the contract (and any person acting on its behalf) reasonably believes such client has a net worth (together with assets held jointly with a spouse) of more than $2,100,000.

The Dodd–Frank Wall Street Reform and Consumer Protection Act amended Section 205(e) of the Advisers Act to provide that the assets-under-management and net-worth tests for qualified-client status would be updated every five years by the SEC to adjust for inflation (rounding to the nearest $100,000). The SEC's last adjustment, which was effective as of August 15, 2016, set the net-worth test threshold at $2,100,000, but left the assets-under-management test threshold unchanged at $1,000,000 at such time.

Next Steps

The assets-under-management and net-worth test thresholds have been adjusted as of August 16, 2021, but, with limited exceptions, the change will not affect contracts (including subscription agreements of 3(c)(1) funds) entered into prior to such date. Going forward, federally registered investment advisers should assess the need to update their investment advisory agreements and subscription and offering documents for certain ongoing offerings (including offerings of 3(c)(1) funds) to account for the changes to these thresholds.

Please contact any of the attorneys listed below for further information on the matters discussed herein.

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