SECURITIES AND EXCHANGE COMMISSION

Investment Advisers Act of 1940
Release No. 3236 /July 12, 2011

Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940

I. Background

Section 205(a)(1) of the Investment Advisers Act of 1940 ("Advisers Act") generally prohibits an investment adviser from entering into, extending, renewing, or performing any investment advisory contract that provides for compensation to the adviser based on a share of capital gains on, or capital appreciation of, the funds of a client (also known as "performance compensation" or "performance fees").[1] Section 205(e) authorizes the Securities and Exchange Commission ("Commission") to exempt any advisory contract from the performance fee prohibition if the contract is with persons that the Commission determines do not need the protections of the prohibition, on the basis of certain factors described in that section.[2]

Rule 205-3 under the Advisers Act exempts an investment adviser from the prohibition against charging a client performance fees in certain circumstances, including when the client is a "qualified client." The rule allows an adviser to charge performance fees if the client has at least $750,000 under the management of an investment adviser immediately after entering into the advisory contract ("assets-under-management test") or

---

1 15 U.S.C. 80b-5(a)(1).

2 Under section 205(e), the Commission may determine that persons do not need the protections of section 205(a)(1) on the basis of such factors as "financial sophistication, net worth, knowledge of and experience in financial matters, amount of assets under management, relationship with a registered investment adviser, and such other factors as the Commission determines are consistent with [section 205]." 15 U.S.C. 80b-5(e).

if the adviser reasonably believes the client has a net worth of more than $1,500,000 at the time the contract is entered into ("net worth test"). The Commission last revised the level of these dollar amount thresholds to account for the effects of inflation in 1998.[3]

II. Adjustment of Dollar Amount Thresholds Under the Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act[4] ("Dodd-Frank Act") amended section 205(e) of the Advisers Act to provide that, by July 21, 2011 and every five years thereafter, the Commission shall adjust for inflation the dollar amount thresholds included in rules issued under section 205(e), rounded to the nearest $100,000.[5] As discussed above, there are two dollar amount thresholds in rules issued under section 205(e), and they are in the assets-under-management and net worth tests in rule 205-3's definition of "qualified client."

On May 10, 2011, the Commission published a notice of intent to issue an order revising the dollar amount thresholds of the assets-under-management test and the net worth test.[6] We stated that, based on calculations of inflation since 1998 when the dollar amount thresholds were last revised, we intended to revise the threshold in the assets-under-management test from $750,000 to $1 million, and in the net worth test from

---

3 *See* Exemption To Allow Investment Advisers To Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Investment Advisers Act Release No. 1731 (July 15, 1998) [63 FR 39022 (July 21, 1998)].

4 Pub. L. No. 111-203, 124 Stat. 1376 (2010).

5 *See* section 418 of the Dodd-Frank Act.

6 *See* Investment Adviser Performance Compensation, Investment Advisers Act Release No. 3198 (May 10, 2011) [76 FR 27959 (May 13, 2011)] ("Proposing Release"). The Commission also proposed for public comment certain amendments to rule 205-3 that would reflect any inflation adjustments to the rule that we issue by order, as well as other rule amendments that would (i) provide that the Commission will issue an order every five years adjusting for inflation the dollar amount tests, (ii) exclude the value of a person's primary residence from the test of whether a person has sufficient net worth to be considered a "qualified client," and (iii) add certain transition provisions to the rule. The deadline for comments on the proposed rule amendments was July 11, 2011. *Id.*

$1.5 million to $2 million.[7] We also stated that these revised dollar amounts would take into account the effects of inflation by reference to the historic and current levels of the Personal Consumption Expenditures Chain-Type Price Index, which is published by the Department of Commerce and often used as an indicator of inflation in the personal sector of the U.S. economy.[8] The revised dollar amounts would reflect inflation from 1998 to the end of 2010, and are rounded to the nearest $100,000 as required by section 205(e) of the Advisers Act, as amended by section 418 of the Dodd-Frank Act.

The Commission's notice established a deadline of June 20, 2011 for submission of requests for a hearing. No requests for a hearing have been received by the Commission.[9]

III. Effective Date of the Order

This Order is effective as of September 19, 2011.

IV. Conclusion

Accordingly, pursuant to section 205(e) of the Investment Advisers Act of 1940 and section 418 of the Dodd-Frank Act,

IT IS HEREBY ORDERED that, for purposes of rule 205-3(d)(1)(i) under the Investment Advisers Act of 1940 [17 CFR 275.205-3(d)(1)(i)], a qualified client means a

---

7 *See id*. at nn.17-18 and accompanying text.

8 *See id*. at nn.19-21 and accompanying text.

9 The Commission has received comments on the rule amendments that it proposed in May 2011, and those comments are available in the public rulemaking file S7-17-11 (available on the Commission's website at http://www.sec.gov/comments/s7-17-11/s71711.shtml). Several commenters expressed concern about the Commission's expressed intent to raise the dollar amount thresholds of rule 205-3. The Dodd-Frank Act clearly mandates that the Commission adjust the dollar amount thresholds that are the subject of this Order. The Commission intends to evaluate the comments it receives on the rulemaking proposal in its consideration of any adoption of the proposed amendments. *See* Proposing Release, *supra* note 6.

natural person who or a company that immediately after entering into the contract has at least $1,000,000 under the management of the investment adviser; and

IT IS FURTHER ORDERED that, for purposes of rule 205-3(d)(1)(ii)(A) under the Investment Advisers Act of 1940 [17 CFR 275.205-3(d)(1)(ii)(A)], a qualified client means a natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2,000,000 at the time the contract is entered into.

By the Commission.

Elizabeth M. Murphy
Secretary