PUBLICATION

Securities and Exchange Commission Tightens Standards for Performance-Based Compensation

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The Securities and Exchange Commission (SEC) is adopting amendments to the rule under the Investment Advisors Act of 1940 that permits investment advisors to charge performance-based compensation to qualified clients. The amendments increase the dollar amount thresholds of the tests that are used to determine whether an individual or a company is a qualified client. By imposing these heightened standards, the SEC hopes to decrease the risk associated with such fee arrangements.

The Investment Advisors Act generally restricts an investment advisor from providing services for compensation based on a share of capital gains on, or capital appreciation of, a client's funds. The purpose of these restrictions is to protect clients from advisors who may take undue risks to increase advisory fees. Prior to the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the rules allowed an advisor to charge performance fees if the client had at least $750,000 under management with the advisor immediately after entering into the advisory contract or if the advisor reasonably believed the client had a net worth of more than $1.5 million at the time the contract was executed.

The passage of the Dodd-Frank Act required the SEC to adjust for inflation the dollar amount thresholds in these rules. In doing so, the SEC raised the assets-under-management threshold to $1 million and the net worth threshold to $2 million. The revised rule also allows the SEC to issue an order every five years further adjusting for inflation the dollar amount thresholds for these tests.

Though not required by the Dodd-Frank Act, the SEC amended the definition of “qualified client” to exclude the value of a natural person's primary residence and certain debt secured by the primary residence. The SEC indicated that the value of a person's residence generally has little relevance to the individual's financial experience and ability to bear the risks of performance fee arrangements. Moreover, residential assets are generally illiquid in nature, and the value of an individual's home equity may not help the investor bear the risks of loss that are inherent in performance fee arrangements.

In conjunction with these revisions, the SEC adopted three transitional provisions that allow an investment advisor and its client to maintain existing performance fee arrangements that were permissible when the advisory contract was executed. This approach is intended to minimize the disruption of existing contractual relationships that met applicable requirements under the rule at the time the parties entered into them.