

PUBLICATION

SEC Looks to Increase "Qualified Client" Thresholds for Performance-Based Compensation

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The Securities and Exchange Commission (SEC) issued Release No. IA-6955 on March 27, 2026, providing notice of its intent to increase the dollar amount thresholds under Rule 205-3 of the Investment Advisers Act of 1940 (the Advisers Act). The new thresholds, which determine whether a person is a "qualified client" eligible to be charged performance-based compensation, are expected to become effective approximately 60 days after issuance of the formal order (likely in mid-2026). Investment advisers and private fund managers charging carried interest or incentive fees should review their advisory agreements and fund subscription documents before the effective date.

Background

Section 205(a)(1) of the Advisers Act generally prohibits investment advisers from entering into advisory contracts that provide for compensation based on a share of capital gains or capital appreciation of a client's account (i.e., performance fees or carried interest). Rule 205-3 under the Advisers Act provides an exemption from this prohibition where the client is considered a "qualified client."

A "qualified client" is defined by reference to two financial tests:

- **Assets Under Management (AUM) Test:** The client has at least a specified minimum dollar amount under management with the adviser immediately after entering into the advisory contract.
- **Net Worth Test:** The adviser reasonably believes, immediately prior to entering into the advisory contract, that the client has a net worth exceeding a specified minimum threshold (excluding the value of the client's primary residence).

Section 418 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and Rule 205-3(e) require the SEC to issue an order approximately every five years adjusting these thresholds for inflation. Prior adjustment orders were issued in 2011, 2016, and 2021.

The 2026 Order (Release No. IA-6955)

On March 27, 2026, the SEC issued Release No. IA-6955¹, providing notice of its intent to issue an order that would increase the AUM Test and Net Worth Test thresholds to reflect inflation since the 2021 adjustment. The new thresholds, determined by reference to Personal Consumption Expenditures (PCE) Index data, are expected to be set at the following amounts:

Test	Prior Threshold (2021)	New Threshold (2026)
AUM Test	\$1,100,000	\$1,400,000

Net Worth Test	\$2,200,000	\$2,700,000
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Note: The formal order will confirm these amounts upon issuance and publication in the Federal Register. The order is expected to be effective approximately 60 days after its issuance.

Application to Private Funds

3(c)(1) Funds

Each investor in a private fund relying on the Section 3(c)(1) exception to the definition of "investment company" under the Investment Company Act of 1940 is treated as an individual "client" for Rule 205-3 purposes. As a result, each investor in a 3(c)(1) fund that is charged a performance fee or carried interest must individually satisfy the "qualified client" definition at the time of investment.

3(c)(7) Funds

Private funds relying on the Section 3(c)(7) exception are themselves treated as the "client" for Rule 205-3 purposes, rather than each individual investor. Because 3(c)(7) funds are comprised entirely of "qualified purchasers," they typically qualify as "qualified clients" independently of the AUM and net worth tests.

Knowledgeable Employees and Qualified Purchasers

Rule 205-3(d) provides that "qualified purchasers" (as defined under the Investment Company Act) and "knowledgeable employees" of the adviser or its relying advisers also qualify as "qualified clients" without regard to the AUM or net worth tests. These categories are not affected by the inflation adjustment.

Transition Rules

Consistent with prior adjustment orders, the new thresholds will not apply retroactively. Specifically:

- Existing advisory agreements and fund subscription documents entered into before the effective date in reliance on previously applicable thresholds generally will be grandfathered, provided the client or investor satisfied the qualified client standard in effect at the time the agreement was entered into.
- If a person who was not previously a party to an advisory agreement becomes a party on or after the effective date – including a new investor subscribing to a 3(c)(1) fund on or after the effective date – the new, higher thresholds will apply to that person.
- Natural persons and companies that were parties to an advisory contract before the effective date and satisfied the then-applicable standard will continue to be treated as qualified clients under the grandfathered thresholds, even if they would not satisfy the increased thresholds.

Advisers with ongoing fund offerings should be attentive to the effective date. New investors subscribing after the effective date generally will be subject to the new thresholds.

Action Items for Investment Advisers

In light of IA-6955, advisers charging carried interest or other performance-based compensation should take the following steps prior to the effective date:

- **Review advisory agreements and subscription documents:** Confirm that representations and warranties relating to qualified client status accurately reference the applicable threshold and consider whether updates are needed for ongoing or future offerings.

- **Update investor eligibility questionnaires:** Ensure that suitability and eligibility questionnaires and side letter representations are consistent with the new thresholds for investors subscribing on or after the effective date.
- **Confirm fund offering documents:** Private placement memoranda, limited partnership agreements, and related documents for 3(c)(1) funds should be reviewed to confirm accurate references to the qualified client definition.
- **Implement investor tracking procedures:** Advisers should track the effective date carefully and ensure that compliance procedures distinguish between investors who subscribed before the effective date (grandfathered) and those subscribing on or after (subject to new thresholds).
- **Assess state law implications.** State-registered investment advisers should note that Rule 205-3 by its terms applies only to SEC-registered advisers. State-registered advisers should confirm applicable state law requirements regarding performance-based compensation.

For any questions regarding the SEC's intent to increase the "qualified client" threshold, please contact [Paul J. Foley](#), [Cole Beaubouef](#), [Kiki Scarff](#), or [John M. Faust](#).

¹ The Release is available at <https://www.sec.gov/files/rules/other/2026/ia-6955.pdf>.