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SECURITIES AND EXCHANGE COMMISSION

[Release No. 5756]

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

June 17, 2021.

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 any person that the Commission determines does 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 when the client is a "qualified client."[3] The rule allows an adviser to charge performance fees if the client has at least a certain dollar amount in assets under management (currently, $1,000,000) with the adviser immediately after entering into the

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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).

3 The exemption applies to the entrance into, performance, renewal, and extension of advisory contracts. *See* rule 205-3(a).

advisory contract ("assets-under-management test") or if the adviser reasonably believes, immediately prior to entering into the contract, that the client has a net worth of more than a certain dollar amount (currently, $2,100,000) ("net worth test").[4]

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[5] amended section 205(e) of the Advisers Act to provide that, by July 21, 2011 and every five years thereafter, the Commission shall, by order, adjust for the effects of inflation the dollar amount thresholds included in rules issued under section 205(e), rounded to the nearest multiple of $100,000.[6] The Commission issued an order to revise the dollar amount thresholds of the assets-under-management and net worth tests (to $1,000,000 and $2,000,000, respectively, as discussed above) on July 12, 2011.[7] Rule 205-3 codifies the threshold amounts revised by the 2011 Order and states that the Commission will issue an order on or about May 1, 2016, and approximately every five years thereafter, adjusting for inflation the dollar amount thresholds of the rule's assets-under-management and net worth tests based on the Personal Consumption Expenditures Chain-Type Price Index ("PCE Index," published by the United States Department of Commerce).[8] On June 14, 2016, the Commission issued an order

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4 *See* rule 205-3(d)(1)(i)-(ii); *see also* Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Advisers Act Release No. 4421 (June 14, 2016) [81 FR 39985 (June 20, 2016)] ("2016 Order"). Rule 205-3 includes other definitions of "qualified client" that do not reference specific dollar amount tests. *See, e.g.,* rule 205-3(d)(1)(ii)(B) and rule 205-3(d)(1)(iii).

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

6 *See* section 418 of the Dodd-Frank Act (requiring the Commission to issue an order every five years revising dollar amount tests in a rule that exempts a person or transaction from section 205(a)(1) of the Advisers Act if the dollar amount test was a factor in the Commission's determination that the persons do not need the protections of that section).

7 *See* Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205-3 under the Investment Advisers Act of 1940, Advisers Act Release No. 3236 (July 12, 2011) [76 FR 41838 (July 15, 2011)] ("2011 Order"). The 2011 Order was effective as of September 19, 2011. *Id.*

8 *See* rule 205-3(e).

adjusting for inflation, as appropriate, the dollar amount thresholds of the assets-under-management test and the net worth test (to $1,000,000 and $2,100,000, respectively).[9]

II. Adjustment of Dollar Amount Thresholds

On May 10, 2021, the Commission published a notice of intent to issue an order that would adjust for inflation the dollar amount thresholds of the assets-under-management test and the net worth test.[10] The Commission stated that, based on calculations that take into account the effects of inflation by reference to historic and current levels of the PCE Index, the dollar amount of the assets-under-management test would increase from $1,000,000 to $1,100,000, and the dollar amount of the net worth test would increase from $2,100,000 to $2,200,000.[11] These dollar amounts—which are rounded to the nearest multiple of $100,000 as required by section 205(e) of the Advisers Act—would reflect inflation from 2016 to the end of 2020.

The Commission's notice established a deadline of June 4, 2021 for submission of requests for a hearing. No requests for a hearing have been received by the Commission.

III. Effective Date of the Order

This Order is effective as of August 16, 2021. To the extent that contractual relationships are entered into prior to the Order's effective date, the dollar amount test adjustments in the Order would not generally apply retroactively to such contractual relationships, subject to the transition rules incorporated in rule 205-3.[12]

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9 *See* 2016 Order, *supra* footnote 4. The 2016 Order was effective as of August 15, 2016. *Id.* As a result of the 2016 Order, the dollar amount threshold of the net worth test was increased to $2,100,000, but the dollar amount threshold of the assets-under-management test remained at $1,000,000. *Id.*

10 *See* Performance-Based Investment Advisory Fees, Advisers Act Release No. 5733 (May 10, 2021) [86 FR 26685 (May 17, 2021)]. Because the amount of the Commission's inflation adjustment calculations are larger than the rounding amount specified under rule 205-3, the dollar amount of both tests would be adjusted as a result of the Commission's inflation adjustment calculation effected pursuant to the rule.

11 *See id*. at section II.A.

12 *See* rule 205-3(c)(1) ("If a registered investment adviser entered into a contract and satisfied the conditions of this [section] that were in effect when the contract was entered

IV. Conclusion

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

IT IS HEREBY ORDERED that, for purposes of rule 205-3(d)(1)(i) under the Advisers Act [17 CFR 275.205-3(d)(1)], a qualified client means a natural person who, or a company that, immediately after entering into the contract has at least $1,100,000 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 Advisers Act [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 $2,200,000.

By the Commission.

J. Matthew DeLesDernier
Assistant Secretary

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into, the adviser will be considered to satisfy the conditions of this [section]; Provided, however, that if a natural person or company who was not a party to the contract becomes a party (including an equity owner of a private investment company advised by the adviser), the conditions of this [section] in effect at that time will apply with regard to that person or company."); *see also* Investment Adviser Performance Compensation, Advisers Act Release No. 3198 (May 10, 2011) [76 FR 27959 (May 13, 2011)], at section II.B.3. The 2011 Order and 2016 Order each applied to contractual relationships entered into on or after the effective date and did not apply retroactively to contractual relationships previously in existence. *See* Investment Adviser Performance Compensation, Advisers Act Release No. 3372 (Feb. 15, 2012) [77 FR 10358 (Feb. 22, 2012)], at section I, n.16; 2016 Order, *supra* footnote 4, at section III.