IM Guidance Update

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STATUS OF CERTAIN PRIVATE FUND INVESTORS AS QUALIFIED CLIENTS

The Dodd-Frank Act, which resulted in the registration of many investment advisers to hedge, private equity, and other private funds, significantly increased the population of investment advisers to these funds registered with the Commission.[1] The Division has received inquiries concerning the status of certain private fund investors as "qualified clients" under Advisers Act rule 205-3 from investment advisory firms that operate a single advisory business through related investment advisers formed as separate legal entities that are registered jointly with the Commission in reliance on the no-action letter issued by the staff on January 18, 2012 to the American Bar Association (each group, a "Firm"). Rule 205-3 provides an exemption from section 205(a)(1) of the Advisers Act, which prohibits an investment adviser from entering into an investment advisory contract that provides for compensation to the adviser on the basis of a share of capital gains upon or capital appreciation of the client's funds. An investment adviser may charge such a fee under rule 205-3 if the client—including investors in certain private funds—is a "qualified client" as defined in the rule. An investor is a qualified client if, among other ways to qualify, the investor, "immediately after entering into the contract has at least $1,000,000 under the management of the investment adviser."

Firms have asked whether they may aggregate the investments of certain investors when determining whether the investors are qualified clients as defined in rule 205-3. In these cases the related investment advisers that comprise a Firm collectively advise two or more different private funds, each with its own investors. When determining if an investor is a qualified client as defined in rule 205-3 and is therefore eligible to be charged performance-based compensation, Firms have asked whether they may aggregate the investor's investments in all of the private funds advised by the related investment advisers that comprise the Firm. An investor may have invested less than $1,000,000 in any one private fund, but more than $1,000,000 collectively in the private funds advised by the related investment advisers that comprise the Firm. In this situation, consistent with the operation of a single advisory business as described in the no-action letter to the American Bar Association, the staff would not object if the Firm aggregated the investor's investments in all of the private funds advised by

the related investment advisers that comprise the Firm when determining if the investor has at least $1,000,000 "under the management of the investment adviser," and thus is a qualified client as defined in rule 205-3.

Endnotes

1 The Dodd-Frank Act eliminated the private adviser exemption from investment adviser registration, which was available to investment advisers that had fewer than 15 clients with each private fund counting as a single client.

This IM Guidance Update summarizes the views of the Division of Investment Management regarding various requirements of the federal securities laws. Future changes in laws or regulations may supersede some of the discussion or issues raised herein. This IM Guidance Update is not a rule, regulation or statement of the Commission, and the Commission has neither approved nor disapproved of this IM Guidance Update.

The Investment Management Division works to:

- protect investors
- promote informed investment decisions and
- facilitate appropriate innovation in investment products and services

through regulating the asset management industry.

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