Marlowe Legal LLC Advisors

Investment Advisers Act of 1940

Performance Fees

Concerns for newly registered (and exempt) Private Fund Managers

Managers of private investment funds and partnerships ("Private Fund Managers") are required to register with the SEC as investment advisers under the Investment Advisers Act of 1940 (the "Advisers Act") unless they are otherwise exempt. (See my previous Marlowe Legal Update - Venture Capital and Private Fund Exemptions under the Investment Advisers Act of 1940). Newly registered Private Fund Managers will be subject to many rules and restrictions that will alter the way they have previously done business. One rule that could significantly impact a Private Fund Manager's business is the Performance Fee Rule (Rule 205-3 under the Advisers Act).

While the Advisers Act generally prohibits registered advisers from taking performance fees[1] from clients, the Performance Fee Rule provides a limited exception to such prohibition. Under the Performance Fee Rule, advisers can only take performance fees from "qualified clients," which means clients that (i) have at least $1 million under management with the adviser (the "AUM Test") or (ii) have a net worth of more than $2 million (based on the reasonable belief of the adviser) (the "Net Worth Test"). The SEC recently issued an order that raised these thresholds to their current levels from their previous levels of $750,000 under the AUM Test and $1.5 million under the Net Worth Test. Additionally, the SEC has proposed excluding the value of a client's private residence from the Net Worth Test.

The prohibition on performance fees should not affect a Private Fund Manager's existing funds as the SEC has indicated that Private Fund Managers can continue to take performance fees from clients who were investors in existing funds prior to registering[2]. However, the Performance Fee Rule will apply to new investors in a Private Fund Manager's existing funds as well as all investors in new funds launched by the Private Fund Manager. This may be a significant change for some Private Fund Managers depending on their investor base. Private funds that rely on Section 3(c)(1) of the Investment Company Act of 1940 (the "40 Act") to meet the mutual fund exemption, will have to assess future investors carefully as 3(c)(1) funds rely on the "accredited investor" standard to determine investor eligibility[3]. The "accredited investor" standard is both lower and different than the "qualified client" standard (as currently in place and as proposed). Therefore, Private Fund Managers with funds utilizing the 3(c)(1) exemption who want to continue to take performance fees may have to increase the investment and/or eligibility requirements for future investors (for example, increasing investment minimums). This could result in shutting out a segment of investors that funds may have relied on in the past.

It should be noted that the Performance Fee Rule is not one of the rules that applies to Private Fund Managers that are exempt under the Venture Capital or Private Fund Exemption (see my previous

[1] "Performance fee" is a broad term and includes carries, incentive fees or anything else where the fee is tied to how the assets perform versus a flat fee on the assets under management.
[2] *See* Investment Advisers Act Release No. 3198 (May 10, 2011)
[3] Generally, private funds are mutual funds unless they utilize one of two exemptions from the Investment Company Act of 1940 (the "40 Act"): the exemptions found under Sections 3(c)(1) or 3(c)(7) of the 40 Act. Rule 205-3 will be of little consequence to funds utilizing Section 3(c)(7) as investors in 3(c)(7) funds must meet the "qualified purchaser" standard which would also qualify them as a "qualified client" under Rule 205-3.

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Update found here). Therefore, those Private Fund Managers can continue to take performance fees from new and future investors regardless of their eligibility under the Performance Fee Rule so long as those managers remain exempt from full registration.

The registration deadline for Private Fund Managers is fast approaching so it is important that Private Fund Managers begin to prepare for registration as soon as possible (or analyze whether they are partially exempt). Whether fully registering or filing under an exemption, the registration deadline is March 30, 2012. Because the SEC is permitted to take up to 45 days to approve a filing, the true filing deadline is February 15, 2012. As part of their preparations, Private Fund Managers will need to assess the impact that the Adviser Act rules and regulations, such as the Performance Fee Rule, will have on their business.

Marlowe Legal Advisors has extensive experience working with Private Fund Managers registered under the Advisers Act. Should you have any questions on this Update or would like to discuss how we can assist you with registration or compliance under the Advisers Act, please feel free to contact us at 215-690-1515 or by email at keith@marlowelegal.com.

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About Marlowe Legal Advisors

Keith Marlowe, Esq. is the Founder and Managing Partner of Marlowe Legal Advisors, LLC, a corporate and securities boutique law firm based in suburban Philadelphia, PA. Marlowe Legal Advisors' clients range from start-up businesses to public companies and institutional investment clients. Marlowe Legal Advisors covers a wide range of corporate and securities matters. A portion of Marlowe Legal Advisors' practice is devoted to advising private funds (venture capital, private equity, real estate and hedge funds) on all aspects of their business including formation, offerings, securities issues, operations and compliance as well as assisting investment advisers with registration and compliance. More information on Marlowe Legal Advisors can be found at www.marlowelegal.com. You may also contact Keith Marlowe directly at keith@marlowelegal.com or at 215-690-1414.

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