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VIA E-MAIL

To Our Investment Adviser Clients and Other Friends

Re: New “Qualified Client” Net Worth Standard for Performance Fee Rule

The SEC recently amended the “qualified client” definition in the Performance Fee Rule, Rule 205-3 under the Investment Advisers Act of 1940 (the “Advisers Act”).¹ The amended Performance Fee Rule (the “Amended Rule”) becomes effective on May 22, 2012.

Advisers Act section 205(a)(1) generally prohibits an investment adviser from entering an advisory contract that charges performance-based compensation. The Performance Fee Rule, however, permits an adviser to charge performance-based compensation to “qualified clients.”² One category of qualified client is a natural person whose individual net worth, or joint net worth with his or her spouse, is greater than \$2,000,000 at the time he or she enters into the advisory contract. The Amended Rule will require that, when calculating net worth, a potential investor must:

- Exclude the value of his or her primary residence,
- Exclude debt secured by the residence, up to the fair market value of the residence at the time he or she enters into the contract (except as noted below),
- Include debt secured by the residence that exceeds the fair market value of the residence, and
- Include the amount of any increase in debt secured by the residence (other than debt incurred to buy the residence) within sixty days before he or she enters into the contract.

The Amended Rule includes three transition rules, as described below.

¹ SEC Release No. IA-3372, File No. S7-17-11, *available at* <http://sec.gov/rules/final/2012/ia-3372.pdf>.

² A fund that relies on section 3(c)(7) of the Investment Company Act of 1940 is not required to comply with the Performance Fee Rule.

First, the increased net worth requirement will not apply with respect to an investor who has already entered into an advisory contract and satisfied the Performance Fee Rule requirements then in effect. If an additional party joins that advisory contract, or if a party to that contract enters a new advisory contract, the new conditions will apply with respect to such party. Therefore, an investor that was a qualified client when he or she invested in a private fund or separately managed account will continue to be treated as qualified client with respect to additional capital he or she invests in that fund or account after the Amended Rule becomes effective. The investor must, however, satisfy the definition in the Amended Rule to invest in a different fund or account that will charge performance-based fees.

Second, the Performance Fee Rule does not apply to an advisory contract signed when the investment adviser was not required to be registered, and was not registered, with the SEC. If the adviser registers with the SEC, the Performance Fee Rule will apply with respect to all investments by new investors in its private funds and separately managed accounts that charge performance-based fees. As with the first transition rule, however, an investor that invested in a private fund or separately managed account before the adviser registered may invest additional capital in that fund or account without being a qualified client.

Third, a person who acquires an interest in a private fund by gift or bequest, or pursuant to an agreement related to a legal separation or divorce, is not deemed to “become a party” to an advisory contract for purposes of the first two transition rules. Such a person may therefore be charged performance-based fees even if he or she is not a qualified client under the Performance Fee Rule.

You should promptly revise your offering documents to reflect the new net worth requirements. Please contact us if you need assistance revising your offering documents or if have questions regarding the Amended Rule.

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This letter only generally summarizes the new accredited investor standard in the Amended Rule, is not intended as specific or complete advice, and is subject to change if and when the SEC issues interpretations. If you need assistance in determining the effects of these developments on your business, or preparing to comply with them, please contact Doug Hammer, John Broadhurst, Geoff Haynes, Chris Rupright, Carolyn Reiser, Neil Koren, Jim Frolik, Joan Grant, Ellyn Roberts, Anthony Caldwell, Christina Hamilton or Charles Clinger.

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