
PART 744—[AMENDED]

2. The authority citation for 15 CFR part 744 is revised to read as follows:


CONSUMER PRODUCT SAFETY COMMISSION

16 CFR Chapter II

Acceptance of ASTM F963–11 as a Mandatory Consumer Product Safety Standard

AGENCY: Consumer Product Safety Commission.

ACTION: Acceptance of standard.


FOR FURTHER INFORMATION CONTACT: Jonathan Midgett, Ph.D., Office of Hazard Identification and Reduction, U.S. Consumer Product Safety Commission, 4330 East West Highway, Suite 600, Bethesda, MD 20814; telephone (301) 504–7692; email jmidgett@cpsc.gov.

SUPPLEMENTARY INFORMATION:


Section 106(g) of the CPSIA provides that, upon ASTM notifying the Commission of proposed revisions to ASTM F963, the Commission must incorporate the revisions into the consumer product safety rule, unless within 90 days of receiving the notice, the Commission notifies ASTM that it has determined that the proposed revisions do not improve the safety of the consumer product(s) covered by the standard. If the Commission so notifies ASTM regarding a proposed revision of the standard, the existing standard remains in effect, regardless of the proposed revision. If the Commission does not object to the proposed revisions, the revised standard becomes effective 180 days after the date that ASTM notifies the Commission of the revision.

The Commission has determined that the proposed revisions in ASTM F963–11 improve the safety of the consumer products covered by the standard. Therefore, although the CPSCIA does not require us to issue a notice in the Federal Register announcing our decision, we are, through this notice, announcing that the CPSCIA accepts the revisions as mandatory consumer product safety standards. ASTM F963–11 will become effective as a mandatory consumer product safety standard on June 12, 2012. However, because ASTM F963–11 does not incorporate section 4.27 (toy chests) of ASTM F963–07, that provision from ASTM F963–07 regarding toy chests remains in effect.


Todd A. Stevenson,
Secretary, Consumer Product Safety Commission.

[FR Doc. 2012–3990 Filed 2–21–12; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 275


RIN 3235–AK71

Investment Adviser Performance Compensation

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission ("Commission" or "SEC") is adopting amendments to the rule under the Investment Advisers Act of 1940 that permits investment advisers to charge performance based compensation to “qualified clients.” The amendments
revise the dollar amount thresholds of the rule’s tests that are used to determine whether an individual or company is a qualified client. These rule amendments codify revisions that the Commission recently issued by order that adjust the dollar amount thresholds to account for the effects of inflation. In addition, the rule amendments: provide that the Commission will issue an order every five years in the future adjusting the dollar amount thresholds for inflation; exclude the value of a person’s primary residence and certain associated debt from the test of whether a person has sufficient net worth to be considered a qualified client; and add certain transition provisions to the rule.

DATES: Effective Date: The amendments are effective on May 22, 2012.

FOR FURTHER INFORMATION CONTACT:

SUPPLEMENTARY INFORMATION: The Commission is adopting amendments to rule 205–3 [17 CFR 275.205–3] under the Investment Advisers Act of 1940 ("Advisers Act" or "Act").

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I. Introduction

Section 205(a)(1) of the Investment Advisers Act generally restricts 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. Congress restricted these compensation arrangements (also known as performance compensation or performance fees) in 1940 to protect advisory clients from arrangements it believed might encourage advisers to take undue risks with client funds to increase advisory fees. Congress subsequently authorized the Commission to exempt any advisory contract from the performance fee restrictions if the contract is with persons that the Commission determines do not need the protections of those restrictions.

The Commission adopted rule 205–3 in 1985 to exempt an investment adviser from the restrictions against charging a client performance fees in certain circumstances. The rule, when adopted, allowed an adviser to charge performance fees if the client had at least $500,000 under management with the adviser immediately after entering into the advisory contract ("assets-under-management test") or if the adviser reasonably believed the client had a net worth of more than $1 million at the time the contract was entered into ("net worth test"). The Commission stated that these standards would limit the availability of the exemption to clients who are financially experienced and able to bear the risks of performance fee arrangements.

In 1998, the Commission amended rule 205–3 to, among other things, change the dollar amounts of the assets-under-management test and net worth test to adjust for the effects of inflation.

Since 1985, the Commission revised the former from $500,000 to $750,000, and the latter from $1 million to $1.5 million.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") amended section 205(e) of the Advisers Act to require that the Commission adjust for inflation the dollar amount thresholds in rules under the section, rounded to the nearest $100,000. Separately, the Dodd-Frank Act also required that we adjust the net worth standard for an "accredited investor" in rules under the Securities Act of 1933 ("Securities Act").

In May 2011, the Commission published a notice of intent to issue an order revising the dollar amount thresholds of the assets-under-management and the net worth tests of rule 205–3 to account for the effects of inflation. Our release ("Proposing Release") also proposed to amend the rule itself to reflect any inflation adjustments to the dollar amount thresholds that we might issue by order.

In addition, our proposed amendments (i) stated that the Commission would issue an order every five years adjusting for inflation the dollar amount thresholds, (ii) excluded the value of a person’s primary residence from the test of whether a person has sufficient net worth to be considered a "qualified client," and (iii) modified certain transition provisions of the rule.

On July 12, 2011, we issued an order revising the threshold of the assets-under-management test to $1 million.

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1 H.R. Rep. No. 2639, 76th Cong., 3d Sess. 29 (1940). Performance fees were characterized as "heads I win, tails you lose" arrangements in which the adviser had everything to gain if successful and little, if anything, to lose if not. S. Rep. No. 1775, 76th Cong., 3d Sess. 22 (1940).
2 Section 205(3) of the Advisers Act. Section 205(e) of the Advisers Act authorizes the Commission to exempt conditionally or unconditionally from the performance fee prohibition advisory contracts with persons that the Commission determines do not need its protections. Section 205(e) provides that 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 an 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]."
4 See id. at Section II.B.1.
6 See id. at Section 205(a)(1) of the Advisers Act if the dollar amount threshold was a factor in the Commission’s determination that the persons do not need the protections of that section.
9 See section 416 of the Dodd-Frank Act (requiring the Commission to issue an order every five years revising dollar amount thresholds in a rule that exempts a person or transaction from section 205(a)(1) of the Advisers Act if the dollar amount threshold was a factor in the Commission’s determination that the persons do not need the protections of that section).
12 See section 413(a) of the Dodd-Frank Act.
13 See Investment Adviser Performance Compensation, Investment Advisers Act Release No. 3198 (May 10, 2011) [76 FR 27959 (May 13, 2011)] ("Proposing Release"). Rule 205–3 is the only exemptive rule issued under section 205(e) of the Advisers Act that includes dollar amount tests, which are the assets-under-management and net worth tests. See supra text accompanying note 10.
14 Id.
and of the net worth test to $2 million.16 We received approximately 50 comments on our proposed rule amendments.17 Today we are adopting amendments to rule 205–3 largely as we proposed them, with modifications to address issues raised by commenters, as discussed further below.

II. Discussion

A. Inflation Adjustment of Dollar Amount Thresholds

We are amending rule 205–3 in three ways to carry out the required inflation adjustment of the dollar amount thresholds of the rule. First, we are revising the dollar amount thresholds that currently apply to investment advisers, to codify the order we issued on July 12, 2011. As amended, paragraph (d) of rule 205–3 provides that the assets-under-management threshold is $1 million, and that the net worth threshold is $2 million, which are the revised amounts we issued by order.18 Although some commenters objected to raising these dollar amount thresholds,19 section 205(e) of the Advisers Act requires that we adjust the amounts for inflation.20

Second, we are adding to rule 205–3, as proposed, a new paragraph (e) that states that the Commission will issue an order every five years adjusting for inflation the dollar amount thresholds of the assets-under-management and net worth tests of the rule.21 These periodic adjustments are required by the Advisers Act,22 and most commenters supported this amendment to the rule.23 Amended rule 205–3(e) also specifies the price index on which future inflation adjustments will be based.24 The index is the Personal Consumption Expenditures Chain-Type Price Index (“PCE Index”),25 which is published by the Department of Commerce.26 The dollar amount tests we adopted in 1998


19 Some commenters maintained, for example, that raising the dollar amount thresholds would limit the investment options for those investors that rely on investments from smaller funds that rely on investments from private funds managed by the adviser. Only bona fide contractual relationships may be included, i.e., those that the adviser has a reasonable belief that the investor will be able to meet. See Proposing Release, supra note 15, at n.17.

20 See Order Approving Adjustment for Inflation of the Dollar Amount Tests in Rule 205–3 under the Investment Advisers Act adopted April 19, 1940, Investment Advisers Act No. 3236 (July 12, 2011) [76 FR 41838 (July 15, 2011)] (“Order”). The Order is effective as of September 19, 2011. Id. The order applies to contractual relationships entered into on or after the effective date, and does not apply retroactively to contractual relationships previously in existence.

21 The comment letters we received on the Proposing Release are available on our Web site at http://www.secg.org/comments/s7?17-11/s71711.shtml.

22 The calculation used to determine the revised dollar amounts in the tests is described below. See infra note 25. As we noted in the Proposing Release, an investment adviser can include in determining the amount of assets under management the assets that a client is contractually obligated to invest in private funds managed by the adviser. Only bona fide contractual commitments may be included, i.e., those that the adviser has a reasonable belief that the investor will be able to meet. See Proposing Release, supra note 15, at n.17.


24 Rule 205–3(e) provides that the Commission will issue an order on or about May 1, 2016 and approximately every five years thereafter adjusting the assets-under-management and net worth tests for the effects of inflation. These adjusted amounts will apply to contractual relationships entered into on or after the effective date of the order, and will not apply to contractual relationships previously in existence. See supra note 16. The proposed rule would have stated that the Commission’s order would be effective on or about May 1. We have deleted the word “effective” in the final rule to reflect the fact that the effective date will likely be later than May 1. See supra note 16 (setting effective date of the order approximately 60 days after the order’s issuance).

25 See supra note 10.


27 See supra note 10.

the Securities Act, such as Regulation D.33

We proposed to exclude the value of a person's primary residence and the debt secured by the residence, up to the fair market value of the residence, from the calculation of a person's net worth.34 A number of commenters supported the proposed exclusion.35

Many agreed with our statement in the Proposing Release that the value of an individual's residence may have little relevance to the person's financial experience and ability to bear the risks of performance fee arrangements.36 The Certified Financial Planner Board of Standards noted in its comment letter that the value of an individual's equity in a residence is more likely to be a function of the length of time that the investor has owned the home, than to be a function of the investor's experience or sophistication. Commenters also stated that excluding the value of the residence would promote regulatory consistency because it parallels the treatment of a person's primary residence in other regulations of net worth under other securities rules.37

Many commenters objected to the exclusion of the value of a person's primary residence from the calculation of net worth. Commenters expressed concern that the exclusion would limit the investment options of less wealthy investors and restrict their access to advisory arrangements that include performance fees.38 Some argued that excluding the value of a residence would harm advisers to smaller funds that rely on investments from less wealthy investors.39 Others argued that home ownership, compared to home rental, may in fact evidence greater rather than less financial experience on the part of individuals.40

We continue to believe that the value of a person's residence generally has little relevance to the individual's financial experience and ability to bear the risks of performance fee arrangements, and therefore little relevance to the individual's need for the Act's protections from performance fee arrangements.41 Although the process of purchasing and financing a home can contribute to an individual's financial experience, the value of the individual's equity interest in the residence reflects the prevailing market values at the time and can be a function of time in paying down the associated debt rather than a function of deliberate investment decision-making. In addition, because of the generally illiquid nature of residential assets, the value of an individual's home equity may not help the investor to bear the risks of loss that are inherent in performance fee arrangements.

Our exclusion of the value of a person's primary residence from the net worth calculation under the rule is similar to the approach that the Commission has taken in other rules to determine the financial qualifications of investors. For example, the Commission excluded the value of a person's primary residence and associated liabilities from the determination of whether a person is a "high net worth customer" in Regulation R under the Securities Exchange Act of 1934.42 The Commission also excluded the value of a residence from the determination of whether an individual has sufficient financial resources to be treated as a "qualified purchaser" under the Investment Company Act of 1940 ("Investment Company Act") who can invest in certain private funds that are not registered under that Act.43 As discussed above, this approach is also reflected in the Commission's recent amendments to the definition of "accredited investor" in rules under the Securities Act, including Regulation D, as required by the Dodd-Frank Act.44

Some commenters voiced particular concern about the exclusion of the residential value at the same time that we adjust the dollar amount thresholds for inflation, and argued that the two changes together could cause too much change at one time.45 We note that we revised the dollar amount threshold of the net worth test last July and that the

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33 See section 413(a) of the Dodd-Frank Act (requiring the Commission to adjust any net worth standard for an "accredited investor" as set forth in Commission rules under the Securities Act to exclude the value of the investor's primary residence). The Dodd-Frank Act does not require that the net worth standard for an accredited investor be adjusted periodically for the effects of inflation, and the Commission at least every four years to "undertake a review of the definition, in its entirety, of the term 'accredited investor' * * * [as defined in Commission rules] as such term applies to natural persons, to determine whether the requirements of the definition should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy." See section 413(b)(2)(A) of the Dodd-Frank Act. In January 2011, we proposed rule amendments to adjust the net worth standards for accredited investors in our rules under the Securities Act, see Net Worth Standard for Accredited Investors, Securities Act Release No. 9177 (Jan. 25, 2011) [76 FR 5307 (Jan. 31, 2011)] ("Accredited Investor Proposing Release"). We recently adopted those amendments substantially as proposed. See Net Worth Standard for Accredited Investors, Securities Act Release No. 9287 (Dec. 21, 2011) [76 FR 81793 (Dec. 29, 2011)] ("Accredited Investor Adopting Release").

34 See Proposing Release, supra note 15, at n.28 and accompanying text.

35 See, e.g., C. Barnard Comment Letter; CFP Board Comment Letter; MFA Comment Letter, NASAA Comment Letter.

36 See, e.g., C. Barnard Comment Letter; CFP Board Comment Letter; NASAA Comment Letter.

37 See, e.g., Better Markets Comment Letter; CFP Board Comment Letter; NASAA Comment Letter.

38 See, e.g., Better Markets Comment Letter; CFP Board Comment Letter; NASAA Comment Letter.

39 See, e.g., Comment Letter of Matthew Gee (June 14, 2011); Comment Letter of Gunderson Dettmer Stough Villeneuve Franklin Hachigian LLP (July 8, 2011) ("Gunderson Dettmer Comment Letter"); Comment Letter of Alvin Suvil (July 17, 2011) ("A. Suvil Comment Letter").


41 See M. Gee Comment Letter; Comment Letter of Douglas Wood (June 13, 2011) ("D. Wood Comment Letter"). Some commenters appeared to object to excluding residence from net worth on public policy grounds because the exclusion would discourage home ownership. See, e.g., Comment Letter of Ron Cunningham (June 25, 2011) ("R. Cunningham Comment Letter"); D. Wood Comment Letter.

42 See supra note 33 and accompanying text.

43 See, e.g., Definition of Terms and Exemptions Relating to the "Broker" Exceptions for Banks, Securities Exchange Act Release No. 56501 (Sept. 24, 2007) [72 FR 56514 (Oct. 3, 2007)] at Section II.C.1 (excluding primary residence and associated liabilities from the fixed-dollar threshold for "high net worth customers" under Rule 701 of Regulation R, which permits a bank to pay an employee certain fees for the referral of a high net worth customer or institutional customer to a broker-dealer without requiring registration of the bank as a broker-dealer).

44 See Section 3(c)(7) of the Investment Company Act provides an exclusion from the definition of "investment company" for any "issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities." A "qualified purchaser" under section 2(a)(51) of the Investment Company Act [15 U.S.C. 80a–2(a)(51)] includes any natural person who owns not less than $5 million in investments, as defined by the Commission. Rule 2a51–1 under the Investment Company Act excludes within the meaning of "investments" real estate held for investment purposes. 17 CFR 270.2a51–1(b)(2). A personal residence is not considered an investment under rule 2a51–1, although residential property may be treated as an investment if it is not treated as a residence for tax purposes. See Privately Offered Investment Companies, Investment Company Act Release No. 2297 (Apr. 3, 1997) at text accompanying and following n.48.
Our amendment of the net worth standard of rule 205–3 differs from the proposed amendment in one respect. The approach we are adopting today will generally require any increase in the amount of debt secured by the primary residence in the 60 days before the advisory contract is entered into to be included as a liability. As discussed below, this change will prevent debt that is incurred shortly before entry into an advisory contract from being excluded from the calculation of net worth merely because it is secured by the individual’s home.

As proposed, the amended rule would have excluded the value of a person’s primary residence and the amount of all debt secured by the property that is no greater than the property’s current market value.68 The proposed treatment of debt secured by the primary residence was the same as we proposed for the calculation of net worth for accredited investors in our rules under the Securities Act.69

In the Proposing Release, we requested comment on whether the amendments to the rule should contain a timing provision to prevent investors from inflating their net worth by borrowing against their homes, effectively converting their home equity—which is excluded from the net worth calculation under the amendments adopted today—into cash or other assets that would be included in the net worth calculation.51 In particular, we indicated that the amendments could provide that the net worth calculation must be made as of a date 30, 60, or 90 days prior to entry into the investment advisory contract.52 This request for comment was similar to the one we made when we proposed amendments to the net worth standard in rules under the Securities Act, including Regulation D.53

As in the recently adopted accredited investor rule amendments adjusting the net worth standard, the rule amendments to the qualified client net worth standard include a specific provision addressing the treatment of incremental debt secured by the primary residence that is incurred in the 60 days before the advisory contract is entered into.55 Debt secured by the primary residence generally will not be included as a liability in the net worth calculation under the rule, except to the extent it exceeds the estimated value of the primary residence. Under the final rule amendments, however, any increase in the amount of debt secured by the primary residence in the 60 days before the advisory contract is entered into generally will be included as a liability, even if the estimated value of the primary residence exceeds the aggregate amount of debt secured by such primary residence.56 Net worth will be calculated only once, at the time the advisory contract is entered into. The individual’s primary residence will be excluded from assets and any indebtedness secured by the primary residence, up to the estimated value of the primary residence at that time, will be excluded from liabilities, except if there is incremental debt secured by the primary residence incurred in the 60 days before the advisory contract is entered into. If any such incremental debt is incurred, net worth will be reduced by the amount of the incremental debt. In other words, the 60-day look-back provision requires investors to identify any increase in mortgage debt over the 60-day period prior to entering into an advisory contract and count that debt as a liability in calculating net worth.

This approach should significantly reduce the incentive for persons to increase potential client value by taking on incremental debt secured against their homes to facilitate a near-term investment. We believe a 60-day look-back provision addressing the treatment of incremental debt secured by the primary residence that is incurred in the 60 days before the advisory contract is entered into is not required because that debt results from the acquisition of the primary residence. Without this exception, an individual who acquires a new primary residence in the 60-day period before the advisory contract is entered into may have to include the full amount of the mortgage incurred in connection with the purchase of the primary residence as a liability, while excluding the full value of the primary residence, in a net worth calculation. The 60-day look-back provision is intended to address incremental debt secured against a primary residence that is incurred for the purpose of circumventing the standard of the rule. It is not intended to address debt secured by a primary residence that is incurred in connection with the acquisition of a primary residence within the 60-day period.
back period is long enough to decrease the likelihood of circumvention of the standard by taking on new debt and waiting for the look-back period to expire. The 60-day period also is designed to be short enough to accommodate investors who may have increased their mortgage debt in the ordinary course at some point prior to entering into an advisory contract.

Another alternative to address the possibility of parties attempting to circumvent the standard would have been to provide that any debt secured by the primary residence that was incurred after the original purchase date of the primary residence would have been counted as a liability, whether or not the fair market value of the primary residence exceeded the value of the total amount of debt secured by the primary residence. We believe that such a standard would be overly restrictive and not provide for ordinary course changes to debt secured by a primary residence, such as refinancing and drawings on home equity lines. We believe that the approach we are adopting here will protect investors by addressing circumstances in which they may have been induced to incur new debt secured by the primary residence for the purpose of incurring new net worth under the rule, while still permitting ordinary course changes to debt secured by the primary residence. This approach is similar to the approach the Commission recently adopted for accredited investor rule amendments adjusting the net worth standard, and it responds to commenters who urged the Commission to promote regulatory consistency in the treatment of primary residences in other similar contexts in order to promote fairness, facilitate enforcement, and provide clarity for both industry and regulators.57

C. Transition Provisions

We proposed two new transition provisions that would allow an investment adviser and its clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if the performance fees would not be permissible under the contract if it were entered into at a later date. We are adopting the two transition rules substantially as proposed, which commenters supported.58 At the suggestion of one commenter we also are adopting an additional transition provision to address certain transfers of interest, as discussed below.59 The amendments replace the current transition rules section of rule 205–3. Paragraphs (1) and (2) of rule 205–3(c) are designed so that restrictions on performance fees apply only to new contractual arrangements and do not apply to new investments by clients (including equity owners of “private investment companies”) who met the definition of “qualified client” when they entered into the advisory contract.60 If, however, the client did not meet the dollar amount thresholds of the rule.61 This approach minimizes the disruption of existing contractual relationships that met applicable requirements under the rule at the time the parties entered into them.

Rule 205–3(c)(1)(i) provides that, if a registered investment adviser entered into a contract and satisfied the conditions of the rule that were in effect when the contract was entered into, the adviser will be required to satisfy the conditions of the rule.62 If, however, a natural person or company that was not a party to the contract becomes a party, and the conditions of the rule in effect at the time they became a party will apply to that person or company. This provision means, for example, that if an individual met the $1.5 million net worth test in effect before the effective date of our 2011 order and entered into an advisory contract with a registered investment adviser before that date, the client could continue to maintain assets (and invest additional assets) with the adviser under that contract even though the net worth test was subsequently raised to $2 million and he or she no longer met the new test. If, however, another person becomes a party to that contract, the current net worth threshold will apply to the new party when he or she becomes a party to the contract.63

Rule 205–3(c)(2) provides that, if a registered investment adviser previously was not required to register with the Commission pursuant to section 203 of the Act and did not register, section 205(a)(1) of the Act will not apply to the contractual arrangements into which the registered adviser entered when it was not registered with the Commission.64 This means, for example, that if an investment adviser to a private investment company with 50 individual investors was exempt from registration with the Commission in 2009, but then subsequently registered with the Commission because it was no longer exempt from registration or because it chose voluntarily to register, section 205(a)(1) will not apply to the contractual arrangements the adviser entered into before it registered, including the accounts of the 50 individual investors with the private investment company and any additional investments they make in that company. If, however, any other individuals

57 See Accredited Investor Adopting Release, supra note 33, at text following n.46, see, e.g., Better Markets Comment Letter; NASAA Comment Letter.
58 Rule 205–3(c)(1); rule 205–3(c)(2). See, e.g., C. Barnard Comment Letter; Gunderson Dettmer Comment Letter; M. Huntsman Comment Letter; IAA Comment Letter; MFA Comment Letter.
59 See rule 205–3(c)(3).
60 A “private investment company” is a company that is excluded from the definition of an “investment company” under the Investment Company Act by section 3(c)(1) of that Act. Rule 205–3(d)(3). Under rule 205–3(b), the equity owner of a private investment company, or of a registered investment company or business development company, is considered a client of the adviser for purposes of rule 205–3(a). We adopted this provision in 1998, and the provision was not affected by our subsequent rule amendments and related litigation concerning the registration of certain hedge fund advisers. See 1998 Adopting Release, supra note 7; Goldstein v. Securities and Exchange Commission, 451 F.3d 873 (DC Cir. 2006).
61 Rule 205–3(c)(1), as amended, modifies the existing transition rule in rule 205–3(c)(1), which permits advisers and their clients that entered into a contract before August 20, 1998, and satisfied the eligibility criteria in effect on the date the contract was entered into, to maintain their existing performance fee arrangements.
62 One commenter supported the provisions allowing advisers to continue to provide advisory services under performance fee arrangements that were permitted at the time the contract was entered into but stated that the rule should prohibit an adviser from charging performance fees to investors that are not qualified clients with respect to money committed after the effective date for the rule amendments. See G. Merkli Comment Letter. We believe such an approach would be unnecessarily disruptive to advisory relationships.
63 Rule 205–3(c)(1). Similarly, a person who invests in a private investment company advised by a registered investment adviser must satisfy the rule’s conditions when he or she becomes an investor in the company. See rule 205–3(b) (equity owner of a private investment company is considered a client of a registered investment adviser for purposes of rule 205–3(a)).
64 Section 205(a)(1) will apply, however, to contractual arrangements into which the adviser enters after it is required to register with the Commission. See rule 205–3(c). The approach of subsection (c)(2) is similar to the transition provisions we adopted for the registration of investment advisers to private funds. See Registration Under the Advisers Act of Certain Hedge Fund Advisers, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) [69 FR 72054 (Dec. 10, 2004)]. We are adopting the subsection substantially as proposed, but have made minor changes to clarify that the transition provision applies only to contractual arrangements with advisers that were not required to register and did not register with the Commission. Our proposed subsection would have applied to contractual arrangements with any registered investment adviser that previously was “exempt” from the requirement to register with the Commission. The revised language clarifies that the transition provision applies to contractual arrangements with advisers that were not required to register (even if they were not “exempt”), and does not apply to contractual arrangements entered into with advisers who were registered (even if they were not required to register) and registered advisers that previously registered already are subject to section 205(a)(1) and rule 205–3, and therefore would not need the transition relief of rule 205–3(c).
become new investors in the private investment company or if the original investors became investors in a different private investment company managed by the adviser after the adviser registers with the Commission, section 205(a)(1) will apply to the adviser’s relationship with the investors with regard to their new investments.\(^{65}\)

Finally, at the suggestion of one commenter, we have revised the third paragraph of rule 205–3(c), to allow for limited transfers of interests from a qualified client to a person that was not a party to the contract and is not a qualified client at the time of the transfer.\(^{66}\) The approach we are taking is similar to the approach we adopted in rule 3c–6 under the Investment Company Act. Rule 3c–6 provides that, in the case of a transfer of ownership interest in a private investment company by gift or bequest, or pursuant to an agreement relating to a legal separation or divorce, the beneficial owner of the interest will be considered to be the person who transferred the interest.\(^{67}\) We believe that, when those types of transfers occur, the transferee does not make a separate investment decision to enter into an advisory contract with the adviser, but is the recipient, perhaps involuntarily, of the benefits of a pre-existing contractual relationship. Because of the circumstances of these transfers, we believe the transferee is not of the type that needs the protections of the performance fee restrictions. We are therefore amending paragraph (3) of rule 205–3(c) to provide that, if an owner of an interest in a private investment company transfers an interest by gift or bequest, or pursuant to an agreement related to a legal separation or divorce, the transfer will not cause the transferee to “become a party” to the contract and will not cause section 205(a)(1) of the Act to apply to such transferee. Thus, transfers in these circumstances will not cause the transferee to have to meet the definition of a qualified client under rule 205–3.\(^{68}\)

**D. Effective Date**

The rule amendments we are adopting today will be effective on May 22, 2012. In addition, in order to minimize the disruption of contractual relationships that met applicable requirements at the time the parties entered into them, the Commission will not object if advisers rely or relied upon the amended transition provisions of rule 205–3(c) before that date.\(^{69}\)

**III. Cost-Benefit Analysis**

The Commission is sensitive to the costs and benefits imposed by its rules. In the Proposing Release, we analyzed the costs and benefits of the proposed rules and sought comment on all aspects of the cost-benefit analysis, including identification and assessment of any costs and benefits not discussed in the analysis. Only two commenters addressed the cost-benefit analysis.\(^{70}\) These commenters focused on the costs of the rule but did not provide any empirical data.

As stated above, section 205(a)(1) of the Advisers Act generally restricts an investment adviser from entering into an advisory contract that provides for performance-based compensation.\(^{71}\) Congress restricted performance compensation arrangements to protect advisory clients from arrangements it believed might encourage advisers to take undue risks with client funds to increase advisory fees.\(^{72}\) Congress subsequently authorized the Commission in section 205(e) of the Advisers Act to exempt any advisory contract from the performance fee restrictions if the contract is with persons that the Commission determines do not need the protections of those restrictions. Section 205(e) provides that 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].”

The Commission adopted rule 205–3 to exempt an investment adviser from the restrictions against charging a client performance fees where a client has a specified net worth or amount of assets under management. Section 418 of the Dodd-Frank Act amended section 205(e) to require that the Commission adjust for inflation the dollar amount thresholds in rules promulgated under section 205(e) within one year of enactment of the Dodd-Frank Act and every five years thereafter. Generally an inflation adjustment is designed to help make the dollar amount thresholds in a provision continue to serve the same purposes over time. The amendments to rule 205–3 providing that the Commission will issue orders every five years adjusting for inflation the dollar amount thresholds of the rule will codify the Dodd-Frank Act’s amendment of section 205(e) of the Advisers Act that requires the Commission to issue these orders.\(^{73}\) Also, pursuant to section 418’s requirements, the Commission issued an order in July 2011 revising the threshold of the assets-under-management test to $1 million, and of the net worth test to $2 million. The rule amendments will codify in the rule the changes already made to the dollar amount thresholds in the July 2011 Order, and will have no separate economic effect.

As proposed, we are amending rule 205–3 to exclude the value of a natural person’s primary residence and certain debt secured by the property from the determination of whether a person has sufficient net worth to be considered a “qualified client.” We are also modifying the transition provisions of the rule to take into account performance fee arrangements that were permissible when they were entered...
into. We analyze the costs and benefits of these provisions below.

A. Benefits

The exclusion of the value of an individual’s primary residence will benefit certain investors. As discussed above, the Act’s restrictions on performance fee arrangements are designed to protect advisory clients from arrangements that encourage advisers to take undue risks with client funds to increase advisory fees, while rule 205–3 is designed to permit clients who are financially experienced and able to bear the risks of performance fee arrangements to enter into those arrangements. We believe that the value of an individual’s primary residence may bear little or no relationship to that person’s financial experience or ability to bear the risks of performance fee arrangements. The value of the individual’s equity interest in the residence reflects the prevailing market values at the time and can be a function of paying down the associated debt rather than a function of deliberate investment decision-making. In addition, because of the generally illiquid nature of residential assets, the value of an individual’s home equity may not help the investor to bear the risks of loss that are inherent in performance fee arrangements. Therefore, some of the clients who do not meet the net worth test of rule 205–3 without including the value of their primary residence may not possess the financial experience or ability to bear the risks of performance fee arrangements. We estimate that the exclusion of the value of an individual’s primary residence will result in up to 1.3 million households that no longer qualify as “qualified clients” under the revised net worth test and therefore will now be protected by the performance fee restrictions in section 205 of the Advisers Act.

As discussed above, the exclusion of the value of an individual’s primary residence from the calculation of net worth under the rule is similar to changes that Congress required the Commission to make to rules under the Securities Act, including Regulation D. As we noted when we recently adopted those rule amendments, section 413(a) of the Dodd-Frank Act required us to adjust the “accredited investor” net worth standards of certain rules under the Securities Act that apply to individuals, by “excluding the value of the primary residence.” The amendment to rule 205–3 under the Advisers Act we are adopting today, as some commenters argued, will promote regulatory consistency in the treatment of primary residences between this rule and other rules that the Commission has adopted that distinguish high net worth individuals from less wealthy individuals.

The amendments to the rule’s transition provisions will allow advisory clients and investment advisers to avoid certain costs resulting from the statutory mandate to adjust for inflation and the Commission’s resultant July 2011 Order. The amendments allow an investment adviser and clients to retain existing performance fee arrangements that were permissible when the advisory contract was entered into, even if performance fees would not be permissible under the contract if it were entered into at a later date. These transition provisions are designed so that the restrictions on the charging of performance fees apply to new contractual arrangements and do not apply retroactively to existing contractual arrangements, including investments in private investment companies. Otherwise, advisory clients and investment advisers might have to terminate contractual arrangements into which they previously entered and enter into new arrangements, which could be costly to investors and advisers.

B. Costs

The amendments exclude the value of a person’s primary residence and generally exclude debt secured by property (if no greater than the current market value of the residence) from the calculation of a person’s net worth. Based on data from the Federal Reserve Board, approximately 5.5 million households have a net worth of more than $2 million including the equity in the primary residence (i.e., value minus debt secured by the property), and approximately 4.2 million households have a net worth of more than $2 million excluding the equity in the primary residence. Therefore, approximately 1.3 million households will not meet a $2 million net worth test under the revised test, and will therefore not be considered “qualified clients,” when the value of the primary residence is excluded from the test. Excluding the value of the primary residence (and debt secured by the property up to the current market value of the residence) means that 1.3 million households that would have met the net worth threshold if the value of the residence were included, as is currently permitted, will no longer be “qualified clients” under the revised net worth test and therefore will be unable to enter into performance fee contracts unless they meet another test of rule 205–3.

For purposes of this cost-benefit analysis, Commission staff assumes that 25 percent of the 1.3 million households would have entered into new advisory contracts that contained performance fee arrangements after the compliance date of the amendments, and therefore approximately 325,000 clients will not meet the revised net worth test.

80 These figures are derived from the 2007 Federal Reserve Board Survey of Consumer Finances. These figures represent the net worth of households rather than individual persons who might be clients. More information regarding the survey may be obtained at http://www.federalreserve.gov/pubs/os/socfin2007/index.html.

81 Although some of these 1.3 million households may be grandfathered by the transition provisions of the rule, we assume for the purposes of our analysis that none of these households will be grandfathered. This assumption may therefore result in an overestimation of the costs of the rule amendments.

82 This estimate, as described in the Proposing Release, was not premised on the notion that investors would borrow against the equity in their primary residence shortly after the calculation of net worth. See Proposing Release, supra note 15, at nn. 47–48 and accompanying text. The 60-day lookback provision in rule 205–3 that we are adopting today, because it reduces the incentives to incur debt secured by residences in order to boost net worth under the rule, strengthens the accuracy of our estimate. See supra notes 55–57 and accompanying text.

83 The assumption that 25% of these investors would have entered into new performance fee arrangements is based on data compiled in a 2008 report sponsored by the Commission. See Angela A. Hung et al., Investor and Industry Perspectives on Investment Advisers and Broker-Dealers 130 (Table C.1) (2008) (available at http://www.sec.gov/news/press/2008/2008-1_rapididbreport.pdf). That report indicated that 20% of investors charge performance fees. Id. at 105 (Table 6.13).

Commission staff assumes the percentage of investment advisers charging performance fees reflects investor demand for these advisory arrangements. Although the report indicates that 20% of investment advisers charge performance fees, the use of a 25% assumption is intended to

Continued
Commission staff estimates that about 40 percent of those 325,000 potential clients (i.e., 130,000) will separately meet the “qualified client” definition under the assets-under-management test, and therefore will be able to enter into performance fee arrangements.\textsuperscript{84} The remaining 60 percent (195,000 households) will have access only to those investment advisers (directly or through the private investment companies they manage) that charge advisory fees other than performance fees.\textsuperscript{85} Some of these investors may be negatively affected by their inability to enter into performance-based compensation arrangements with investment advisers (which arrangements in some ways align the advisers’ interests with the clients’ interests). These investors also may experience differences in their investment options and returns, changes in advisory service, and the cost of being unable to enter into advisory contracts with their preferred advisers. For purposes of this cost-benefit analysis, Commission staff assumes that approximately 80 percent of the 195,000 households (i.e., 156,000 households) will enter into non-performance fee arrangements, and that the other 20 percent (i.e., 39,000 households) will decide not to invest their assets with an adviser.\textsuperscript{86} Commission staff anticipates that the non-performance fee arrangements into which these clients will enter may contain management fees that yield advisers approximately the same amount of fees that clients would have paid under performance fee arrangements.\textsuperscript{87} Some of these non-performance fee arrangements, if the adviser’s performance is not positive or does not reach the level at which it would have accrued performance fees overestimate rather than underestimate costs, especially given the inherent uncertainty surrounding hypothetical events. It is also notable that an average of only 37\% of investors indicated they would seek investment advisory services in the next five years. The estimate concerning 1.3 million households is derived from the 2007 Federal Reserve Board Survey of Consumer Finances. See supra note 80 and accompanying and following text.\textsuperscript{88}

\textsuperscript{84} This estimate is based on data filed by registered investment advisers on Form ADV.

\textsuperscript{85} Commission staff estimates that less than one percent of registered investment advisers are compensated solely by performance fees, based on data from filings by registered investment advisers on Form ADV.

\textsuperscript{86} This assumption is based on the idea that a substantial majority of investment advisers that typically charge performance fees and that in the future would calculate a potential client’s net worth and determine that it does not meet the $2 million threshold will offer alternative compensation arrangements in order to offer their services. As noted above, Commission staff estimates that less than one percent of registered advisers charge performance fees exclusively. See supra note 85.

\textsuperscript{87} Performance fee arrangements typically include a “hurdle rate,” which is a minimum rate of return that must be exceeded before the performance fee can be charged. See, e.g., Tamar Frankel, The Regulation of Money Managers § 12.03[F] (2d ed. Supp. 2000).

\textsuperscript{88} Although advisers that charge performance fees typically require investment minimums of $10,000 or more, one of the steps that advisers may take to market their services to a larger number of potential clients is to reduce their investment minimums. This may result in slightly higher administrative costs for investment advisers that choose to take such action. See supra notes 38–39 and accompanying text.

\textsuperscript{89} Performance fee arrangements typically include a “hurdle rate,” which is a minimum rate of return that must be exceeded before the performance fee can be charged. See, e.g., Tamar Frankel, The Regulation of Money Managers § 12.03[F] (2d ed. Supp. 2000).

\textsuperscript{90} Although advisers that charge performance fees typically require investment minimums of $10,000 or more, one of the steps that advisers may take to market their services to a larger number of potential clients is to reduce their investment minimums. This may result in slightly higher administrative costs for investment advisers that choose to take such action. See supra notes 38–39 and accompanying text.

\textsuperscript{91} Some commenters argued that excluding the value of an investor’s primary residence from the net worth test of the rule at the same time as adjusting the rule’s dollar amount thresholds for inflation would cause too much change at one time.\textsuperscript{92} Although we attribute the costs of inflation-adjusting the dollar amount thresholds of the rule to the Dodd-Frank Act and the order we issued thereunder, we have considered the relative magnitude of each of these changes to the net worth standard in determining the significance of making these changes at the same time. Based on data from the Federal Reserve Board, approximately 7 million households have a net worth of more than $1.5 million (the previous net worth threshold, including primary residence), and approximately 5.5 million households have a net worth of more than $2 million (the revised net worth threshold established by order in July 2011, including primary residence).\textsuperscript{93} Therefore, inflation-adjusting the dollar amount threshold of the net worth test from $1.5 to $2 million will have caused about 1.5 million households to no longer meet the net worth test of the rule. Therefore the numerical effect of the inflation adjustment of the net worth test’s dollar amount threshold (1.5 million households) is slightly greater than the exclusion of primary residence from the net worth test (1.3 million

\textsuperscript{92} See supra note 90.

\textsuperscript{93} See supra note 90.
The amendments will have no effect on existing contractual relationships that met applicable requirements under the rule at the time the parties entered into them, because those relationships may continue under the transition provisions of the rule. Although an investment adviser could be prohibited from charging performance fees to new clients to whom it could have charged performance fees if the advisory contract had been entered into before the adjustment of the dollar thresholds, we attribute this effect to the Dodd-Frank Act rather than to this rulemaking. One commenter stated that rather than addressing the contention that the adjustment to the dollar amount thresholds is unfair to small investors, the Commission “passed the buck” back to Congress. The Commission, however, is required to adjust the dollar amount thresholds for the effects of inflation. Exempting less wealthy investors from the limits would be contrary to the purpose of the dollar amount thresholds, which is to limit the availability of the exemption to clients who are financially experienced and able to bear the risks of performance fee arrangements.

Section 418 of the Dodd-Frank Act does not specify how the Commission should measure inflation in adjusting the dollar amount thresholds. We proposed, and are adopting, the PCE Index because it is widely used as a broad indicator of inflation in the economy and because the Commission has used the PCE Index in other contexts. It is possible that the use of the PCE Index to measure inflation might result in a larger or smaller dollar amount threshold than the PCE Index to measure inflation might result in a larger or smaller dollar amount threshold than the use of a different Index, but the rounding required by the Dodd-Frank Act (to the nearest $100,000) likely negates any difference between indexes.

IV. Paperwork Reduction Act

The amendments to rule 205–3 under the Investment Advisers Act do not contain any “collection of information” requirements as defined by the Paperwork Reduction Act of 1995, as amended (“PRA”). Accordingly, the PRA is not applicable. We received no comments on any PRA issues.

V. Regulatory Flexibility Act Certification

The Commission certified in the Proposing Release, pursuant to section 605(b) of the Regulatory Flexibility Act of 1980 (“RFA”), that the proposed rule amendments would not, if adopted, have a significant impact on a substantial number of small entities.

As we explained in the Proposing Release, under Commission rules, for the purposes of the Advisers Act and the RFA, an investment adviser generally is a small entity if it: (i) Has assets under management having a total value of less than $25 million; (ii) did not have total assets of $5 million or more on the last day of its most recent fiscal year; and (iii) does not control, is not controlled by, and is not under common control with another investment adviser that has assets under management of $25 million or more, or any person (other than a natural person) that had total assets of $5 million or more on the last day of its most recent fiscal year (“small adviser”).

Based on information in filings submitted to the Commission, 617 of the approximately 11,888 investment advisers registered with the Commission are small entities. Only approximately 20 percent of the 617 registered investment advisers that are small entities (about 122 advisers) charge any of their clients performance fees. In addition, 24 of the 122 advisers required at the time of the Proposing Release an initial investment from their clients that would meet the then current assets-under-management threshold ($750,000), which advisory contracts will be grandfathered into the exemption provided by rule 205–3 under the amendments. Therefore, if these advisers in the future raise those minimum investment levels to the revised level that we issued by order ($1 million), those advisers could charge their clients performance fees because the clients would meet the assets-under-management test, even if they would not meet the revised net worth test that excludes the value of the client’s primary residence. For these reasons, the Commission believes that the amendments to rule 205–3 will not have a significant economic impact on a substantial number of small entities. The Commission requested written comments regarding the certification. One commenter stated that the Proposing Release includes “suspicious” quantified data to support the claim as to how few advisers will be affected by the required review every five years. The commenter provided no further detail about why the quantified data was suspicious, or any

98 See supra text accompanying note 81.
99 See supra note 46 and preceding text.
100 Any further revisions of the dollar amount thresholds of rule 205–3 to adjust for inflation are not scheduled to occur until 2016. See rule 205–3(e).
101 Rule 205–3(c)(3). The rule provides that for purposes of paragraphs 205–3(c)(1) (transition rule for registered investment advisers) and 205–3(c)(2) (transition rule for registered investment advisers that were previously not registered) the transfer of an equity ownership interest in a private investment company by gift or bequest, or pursuant to an agreement relating to a legal separation or divorce, will not cause the transferee to become a party to the contract and will not cause section 205(a)(1) of the Act to apply to such transferee.
102 See P. Goldstein Comment Letter.
104 5 U.S.C. 605(b).
105 See Proposing Release, supra note 15, at Section VI.
106 Rule 0–7(a).
alternative empirical data, and did not address the number of small advisers that would be affected.\textsuperscript{104}

\section*{VI. Statutory Authority}

The Commission is adopting amendments to rule 205–3 pursuant to the authority set forth in section 205(e) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–5(e)).

\section*{List of Subjects in 17 CFR Part 275}

Reporting and recordkeeping requirements, Securities.

\section*{Text of Rules}

- For the reasons set out in the preamble, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

\section*{PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940}

\subsection*{1.} The general authority citation for Part 275 continues to read as follows:

\begin{quote}
\end{quote}

\subsection*{2.} Section 275.205–3 is amended by:

\begin{itemize}
\item a. Revising paragraph (c);
\item b. Revising paragraphs (d)(1)(i) and (ii); and
\item c. Adding paragraph (o).
\end{itemize}

The revisions and addition read as follows:

\section*{§ 275.205–3 Exemption from the compensation prohibition of section 205(a)(1) for investment advisers.}

\begin{quote}
(c) Transition rules—(1) Registered investment advisers. 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 into, the adviser will be considered to satisfy the conditions of this section; \textit{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.

(2) Registered investment advisers that were previously not registered. If an investment adviser was not required to register with the Commission pursuant to section 203 of the Act (15 U.S.C. 80b–3) and was not registered, section 205(a)(1) of the Act will not apply to an advisory contract entered into when the adviser was not required to register and was not registered, or to an account of an equity owner of a private investment company advised by the adviser if the account was established when the adviser was not required to register and was not registered; \textit{Provided}, however, that section 205(a)(1) of the Act will apply with regard to a natural person or company who was not a party to the contract and becomes a party (including an equity owner of a private investment company advised by the adviser) when the adviser is required to register.

(3) Certain transfers of interests. Solely for purposes of paragraphs (c)(1) and (c)(2) of this section, a transfer of an equity ownership interest in a private investment company by gift or bequest, or pursuant to an agreement related to a legal separation or divorce, will not cause the transferee to “become a party” to the contract and will not cause section 205(a)(1) of the Act to apply to such transferee.

(d) \textit{Inflation adjustments.} Pursuant to section 205(e) of the Act, the dollar amounts specified in paragraphs (d)(1)(i) and (d)(1)(ii)(A) of this section shall be adjusted by order of the Commission, on or about May 1, 2016 and issued approximately every five years thereafter. The adjusted dollar amounts established in such orders shall be computed by:

(1) Dividing the year-end value of the Personal Consumption Expenditures Chain-Type Price Index (or any successor index thereto), as published by the United States Department of Commerce, for the calendar year in which the order is being issued, by the year-end value of such index (or successor) for the calendar year 1997;

(2) For the dollar amount in paragraph (d)(1)(i), multiplying $750,000 times the quotient obtained in paragraph (e)(1) of this section and rounding the product to the nearest multiple of $100,000; and

(3) For the dollar amount in paragraph (d)(1)(ii)(A) of this section, multiplying $1,500,000 times the quotient obtained in paragraph (e)(1) of this section and rounding the product to the nearest multiple of $100,000.


By the Commission.

Elizabeth M. Murphy,
Secretary.

[FR Doc. 2012–0406 Filed 2–21–12; 8:45 am]

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\section*{DEPARTMENT OF HOMELAND SECURITY}

\section*{U.S. Customs and Border Protection}

\section*{DEPARTMENT OF THE TREASURY}

\section*{19 CFR Parts 10 and 163}

[CBP Dec. 12–02; USCBP–2011–0030]

RIN 1515–AD75

\section*{Duty-Free Treatment of Certain Visual and Auditory Materials}

AGENCY: U.S. Customs and Border Protection, Department of Homeland Security; Department of the Treasury.

ACTION: Final rule.

SUMMARY: This document adopts as a final rule, without change, the proposed amendments to the U.S. Customs and Border Protection (CBP) regulations to permit an applicant to file the