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SEC Increases Qualified Client Thresholds for Performance Fee Arrangements

Key Takeaways:

- The SEC has increased the qualified client thresholds under Rule 205-3 effective June 29, 2026, raising the assets-under-management test to $1.4 million and the net worth test to $2.7 million. The changes reflect the SEC's required five-year inflation adjustment under the Advisers Act.
- The updated thresholds affect when SEC-registered (and certain state-registered/exempt) investment advisers may charge performance-based compensation, including incentive fees, performance allocations and carried interest. New subscriptions, advisory contracts and transfers after June 29, 2026, must satisfy the revised standards.
- Advisers should update subscription documents, managed account agreements, compliance policies and marketing materials before the effective date. Firms with pending closings or investor admissions should also assess whether transaction timing affects qualified client eligibility.

The SEC has issued a final order raising the dollar thresholds under Rule 205-3 under the Investment Advisers Act of 1940 that determine whether a client qualifies to be charged performance-based compensation. The new thresholds take effect June 29, 2026, and the new thresholds generally do not apply to investments made prior to June 29, 2026.

Under the updated rule, the assets-under-management test increases from $1.1 million to $1.4 million, and the net worth test increases from $2.2 million to $2.7 million. These adjustments reflect a mandatory inflation-based review that the SEC conducts every five years under Section 205(e) of the Advisers Act using the PCE price index, with results rounded to the nearest $100,000.

Background

Section 205(a)(1) of the Advisers Act generally prohibits SEC-registered (and certain state-registered/exempt) investment advisers from charging compensation tied to capital gains or capital appreciation, such as incentive fees, performance allocations or carried interest. Rule 205-3 under the Advisers Act provides an exception to this general rule if

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the client is a “qualified client.”

For private funds relying on the Section 3(c)(1) exemption from registration under the Investment Company Act (*i.e.*, the “100 and under” exception), registered investment companies and business development companies, each equity owner is typically treated as the client for this purpose — meaning the qualified client determination must be made at the investor level.

Once the new thresholds go into effect, individuals and companies with at least $1.4 million of assets under the management with the adviser will be qualified clients. Individuals and companies with a net worth of at least $2.7 million will also be qualified clients. The net worth test continues to include assets held jointly with a spouse. The value of a natural person’s primary residence is excluded, with related mortgage debt also excluded except to the extent it exceeds the property’s fair market value (which mechanic is also unchanged from the existing version of the rule).

Private funds relying on the Section 3(c)(7) exemption from registration under the Investment Company Act (*i.e.* the qualified purchaser exemption) should be unaffected because “qualified purchaser” is itself a category of qualified client. Rules permitting certain employees to be treated as qualified clients also remain unchanged.

Transition Timing and Application of the New Thresholds

The new thresholds do not apply retroactively. Existing advisory contracts and fund investors who qualified under the prior thresholds before June 29 are not affected. However, any new advisory contracts, new fund subscriptions, and other admissions or transfers that result in a person becoming a new party on or after June 29 must be evaluated against the updated figures, where applicable.

Advisers with closings scheduled around the effective date should pay particular attention to timing. An investor who subscribes before June 29 and meets the current thresholds need not re-qualify under the new ones, but the same investor admitted after that date must meet the new thresholds.

Steps Advisers Should Take Before the Effective Date

Investment advisers that charge performance-based fees should act before June 29 to address the following:

- Update subscription agreements and investor questionnaires: Revise to reflect the new AUM and net worth thresholds.
- Review managed account agreements: Confirm whether any agreements reference specific dollar amounts tied to qualified client status and update accordingly.
- Revise compliance policies and procedures: Update internal documentation to reflect the new thresholds.
- Update offering documents and marketing materials: Any materials citing the current thresholds should be corrected before the effective date.
- Evaluate pending closings and transfers: Advisers expecting imminent admissions should consider whether it is appropriate to complete those transactions before June 29, 2026.

This alert is for informational purposes only and does not constitute legal advice. Please contact Bert Stemmler, Daniel McAvoy or your other Polsinelli contacts with questions about how these changes apply to your specific circumstances.