



NASAA

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**July 11, 2011**

*Via Electronic Submission to <http://www.sec.gov/cgi-bin/ruling-comments>.*

**Elizabeth M. Murphy, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090**

**Subject: Investment Adviser Performance Compensation, Release No. IA-3198; File No. S7-17-11**

Dear Ms. Murphy:

The North American Securities Administrators Association, Inc. (“NASAA”)<sup>1</sup> welcomes the opportunity to comment on the above-referenced release (“Release”). NASAA supports the Securities and Exchange Commission’s (the “Commission”) proposal to revise the dollar amounts of the assets-under-management test and the net worth test in the definition of “qualified client” in Rule 205-3 under the Investment Advisers Act of 1940 (“Advisers Act”).<sup>2</sup> NASAA also strongly supports the Commission’s proposal to exclude the value of a person’s primary residence from the “qualified client” net worth test. NASAA is hopeful that the Commission will continue to move forward with these proposals and also will consider the additional ways to further enhance investor protection that NASAA sets forth below in response to this Release.

**1. NASAA supports the Commission’s proposal to revise the dollar amounts of the assets-under-management and the net worth tests of Rule 205-3.**

Rule 205-3 explains the circumstances under which an investment adviser may charge a fee based on the performance of an investor’s account. The limitations contained in this rule embody important investor protection measures given the conflict that arises when an adviser’s fee or some portion thereof is generated from the performance of an investor’s account. As the Commission noted in the Release, these tests have not been revised since 1998. Accordingly, NASAA appreciates Congress’s directive in Section 418 of the Dodd-Frank Act to take the long overdue step of updating these tests. By increasing the assets-under-management test to \$1 million and the net worth test to \$2 million, the Commission, at the general direction of Congress, is ensuring that the tests are at least as effective as they were when last updated in 1998. Furthermore, while we believe that the standard should be reevaluated on a more frequent

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<sup>1</sup> The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc. was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, Canada, Mexico, Puerto Rico and the U.S. Virgin Islands.

<sup>2</sup> 17 C.F.R. §275.205-3.

basis than mandated by the statute, the statutory framework does, at a minimum, require a periodic review of the standard as a safeguard against the eroding effects of inflation.

**2. NASAA strongly supports the Commission's proposal to amend Rule 205-3 to exclude a person's primary residence from the net worth test for a "qualified client."**

NASAA strongly supports the Commission's proposal to amend Rule 205-3 to exclude a person's primary residence from the net worth test for a qualified client. This proposed amendment furthers the investor protections embodied in the Investment Advisers Act and is consistent with the changes to the exclusion of the primary residence in the accredited investor net worth test mandated by Dodd-Frank Act Section 413(a).

The qualified client test allows clients of an investment adviser who are presumably "financially experienced and able to bear the risks associated with performance fees to have the opportunity to negotiate compensation arrangements which they and their advisers consider appropriate."<sup>3</sup> NASAA has previously argued the axiomatic notion that the value of an individual's primary residence does not indicate an individual's level of investment sophistication.<sup>4</sup> Accordingly, NASAA believes the Commission has taken an appropriate and necessary step in proposing that the qualified client definition in Rule 205-3 exclude the value of a client's primary residence from the net worth test.

The Commission's Release also solicits comments on whether the net worth standards in Rule 205-3 should differ from any standards considered in connection with the adjustments to the accredited investor standard. In our November 4, 2010 and March 10, 2011 letters to the Commission, NASAA recommended that the Commission adjust the net worth standard for "qualified clients" in Rule 205-3 to parallel the exclusion of an investor's primary residence contained in the accredited investor definition.

NASAA continues to believe that consistent standards provide an effective and transparent approach for both industry and regulators. Performance based fees often are collected from investors who invest in pooled investment vehicles in private offerings under Rule 506 of Regulation D. Investment advisers to private pooled investment vehicles typically require that the investors satisfy both the accredited investor and qualified client tests in order to collect performance based fees in accordance with Rule 205-3.<sup>5</sup> Thus, NASAA believes that inconsistent standards would be unnecessarily burdensome, costly and produce the curious result that an investor may qualify as a qualified client but not as an accredited investor depending on the value of the investor's primary residence. Therefore, the Commission should aim to make the

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<sup>3</sup> Exemption To Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account, Investment Advisers Act Release No. 996, 50 FR 48556, 1985 SEC LEXIS 2547 (Nov. 26, 1985).

<sup>4</sup> See letter from David S. Massey, NASAA President and Deputy Securities Commissioner, North Carolina Department of the Secretary of State, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Nov. 4, 2010) (regarding the Accredited Investor Standard, Title IV Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, File No. DF Title IV-Accredited Investor), available at <http://www.sec.gov/comments/df-title-iv/accredited-investor/accreditedinvestor-11.pdf>.

<sup>5</sup> See generally, Dale A. Oesterle, Regulating Hedge Funds, 1 ENTREPRENURIAL. BUS. L.J. 1 (2006).

changes to Rule 205-3 consistent with the proposed primary residence exclusion to the accredited investor net worth standard.

- 3. The calculation of net worth should be made on a specified date (such as 60 or 90 days) prior to the day that the advisory contract is entered into to assist in protecting against refinancing transactions intended solely to inflate net worth.**

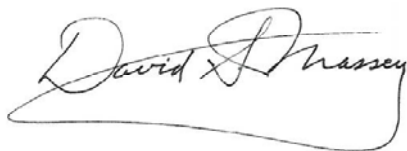
The Commission requests comments regarding whether the proposed rule should provide that the calculation of net worth be made as of a specified date before the advisory contract is signed. Consistent with NASAA's March 10, 2011 comment letter regarding the net worth standard for accredited investors,<sup>6</sup> NASAA strongly supports this approach, and does not believe it would make the calculation of net worth unduly complex. It is conceivable that unscrupulous investment advisers could influence investors to inflate their net worth by borrowing against their homes to attain qualified client status. Placing the net worth calculation date 60 to 90 days before the date that the advisory contract is entered into will make this practice less feasible, thereby further assuring the protections this provision is designed to provide.

- 4. NASAA supports the Commission's proposal to include as a liability against the person's net worth debt secured by the residence in excess of the market value of the residence at the time of the net worth determination.**

The Commission requests comments regarding whether it should include as a liability against the person's net worth debt secured by the residence in excess of the market value of the residence at the time of the net worth determination. Consistent with the 2011 NASAA Accredited Investor Net Worth Standard comment letter, we support the Commission's approach in excluding indebtedness only up to the fair market value of the primary residence.

Thank you for considering our comments on the proposals contained in the Release. Should you have any questions regarding the comments in this letter, please contact Linda Cena, NASAA Investment Adviser Section Chair at [cenal@michigan.gov](mailto:cenal@michigan.gov) or 517-335-1202. In the alternative you may contact Joseph Brady, General Counsel for NASAA, at [jb@nasaa.org](mailto:jb@nasaa.org) or 202-737-0900.

Sincerely,



David S. Massey  
NASAA President and  
Deputy Securities Commissioner, North Carolina Department of the Secretary of State

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<sup>6</sup> See letter from David S. Massey, NASAA President and Deputy Securities Commissioner, North Carolina Department of the Secretary of State, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (March 10, 2011) (regarding the Net Worth Standard for Accredited Investors, Release Nos. 33-9177; IA-3144; IC-29572; File No. S7-04-11), available at: [http://www.nasaa.org/content/Files/Accredited\\_Investor031011.pdf](http://www.nasaa.org/content/Files/Accredited_Investor031011.pdf).