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United States Government Accountability Office
Washington, DC 20548

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March 2, 2012

The Honorable Tim Johnson
Chairman
The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Spencer Bachus
Chairman
The Honorable Barney Frank
Ranking Member
Committee on Financial Services
House of Representatives

Subject: *Securities and Exchange Commission: Investment Adviser Performance Compensation*

Pursuant to section 801(a)(2)(A) of title 5, United States Code, this is our report on a major rule promulgated by the Securities and Exchange Commission (Commission), entitled "Investment Adviser Performance Compensation" (RIN: 3235-AK71). We received the rule on February 17, 2012. It was published in the *Federal Register* as a final rule on February 22, 2012, with an effective date of May 22, 2012. 77 Fed. Reg. 10,358.

The final rule amends the rule under the Investment Advisers Act of 1940 that permits investment advisers to charge performance based compensation to "qualified clients" also known as rule 205-3. 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 5 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.

Enclosed is our assessment of the Commission's compliance with the procedural steps required by section 801(a)(1)(B)(i) through (iv) of title 5 with respect to the rule. Our review of the procedural steps taken indicates that the Commission complied with the applicable requirements.

If you have any questions about this report or wish to contact GAO officials responsible for the evaluation work relating to the subject matter of the rule, please contact Shirley A. Jones, Assistant General Counsel, at (202) 512-8156.

signed

Robert J. Cramer
Managing Associate General Counsel

Enclosure

cc: Elizabeth M. Murphy
Secretary of the Securities and
Exchange Commission

ENCLOSURE

REPORT UNDER 5 U.S.C. § 801(a)(2)(A) ON A MAJOR RULE
ISSUED BY THE
SECURITIES AND EXCHANGE COMMISSION
ENTITLED
"INVESTMENT ADVISER PERFORMANCE COMPENSATION"
(RIN: 3235-AK71)

(i) Cost-benefit analysis

The Commission states that it is sensitive to the costs and benefits imposed by its rules. In its Proposing Release, the Commission 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.

The Commission notes that the final rule's exclusion of the value of an individual's primary residence will benefit certain investors. The Commission believes 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 Commission states that 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, according to the Commission, 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. The Commission estimates 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. Additionally, the Commission believes the amendments 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. According to the Commission, 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. Finally, the Commission believes that the amendments 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 performance fees would not be permissible under the contract if it were entered into at a later date.

The Commission believes that the amendments are unlikely to impose a significant net cost on most advisers and clients. The Commission notes the costs such as 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, the Commission estimates the percentage of households that will separately meet the "qualified clients" definition under the assets-under-management test, and, therefore, will be able to enter into performance fee arrangements, while the percentage who 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. Of that latter percentage, the Commission estimates that the majority will enter into non-performance fee arrangements, while the minority will decide not to invest their assets with an adviser. For those households in non-performance fee arrangements, a client might end up paying higher overall fees than if he had paid performance fees, depending on the adviser's performance. The Commission recognizes that the exclusion of the value of a person's primary residence from the calculation of a person's net worth will reduce the pool of potential qualified clients for advisers which, in turn, might result in a reduction in the total fees collected by investment advisers. In order to replace those clients and lost revenue, the Commission believes some advisers may choose to market their services to more potential clients, which may result in increased marketing and administrative costs.

(ii) Agency actions relevant to the Regulatory Flexibility Act, 5 U.S.C. §§ 603-605, 607, and 609

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

(iii) Agency actions relevant to sections 202-205 of the Unfunded Mandates Reform Act of 1995, 2 U.S.C. §§ 1532-1535

As an independent regulatory agency, the Commission is not subject to title II of the Unfunded Mandates Reform Act of 1995.

(iv) Other relevant information or requirements under acts and executive orders

Administrative Procedure Act, 5 U.S.C. §§ 551 et seq.

On May 13, 2011, the Commission published a notice of proposed rulemaking entitled "Investment Adviser Performance Compensation." 76 Fed. Reg. 27,959.

The Commission received approximately 50 comments on the proposed rule amendments and is adopting amendments to rule 205–3 largely as proposed, with modifications to address issues raised by commenters, which the Commission discusses in the final rule.

Paperwork Reduction Act, 44 U.S.C. §§ 3501-3520

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 Commission states that the PRA is not applicable and it received no comments on any PRA issues.

Statutory authorization for the rule

The Commission states that it 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).

Executive Order No. 12,866 (Regulatory Planning and Review)

As an independent regulatory agency, the Commission is not subject to the review requirements of the Order.

Executive Order No. 13,132 (Federalism)

As an independent regulatory agency, the Commission is not subject to the review requirements of the Order.