

SEC Proposes Expansion of Investment Adviser Performance-Based Compensation Rule

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On September 30, 2026, the Securities and Exchange Commission (the “SEC”) proposed amendments to Rule 205-3 under the Investment Advisers Act of 1940, as amended (the “Advisers Act”), which provides an exemption from the general prohibition under Section 205(a)(1) of the Advisers Act on registered investment advisers receiving performance-based compensation (the “Proposal”) so long as performance-based compensation is limited to “qualified clients”.¹ Most notably for private fund sponsors, the Proposal would expand the definition of “qualified client” to include any investors that satisfy the “accredited investor” definition under Regulation D. The Proposal may also have implications for private fund managers that rely on exemptions from investment adviser registration under state law because certain state-level investment adviser registration exemptions incorporate or otherwise reference the federal qualified client definition.

Expansion of the Qualified Client Definition

Under the current Rule 205-3, an investor generally may qualify as a qualified client if, among other alternatives, the investor has at least \$1.4 million under management with the adviser or has a net worth exceeding \$2.7 million. These thresholds are higher than the financial thresholds applicable to many accredited investors under Regulation D. As a result, an investor may currently qualify as an accredited investor for purposes of investing in a private offering without qualifying as a qualified client for purposes of paying performance-based compensation.

The Proposal would expand the qualified client definition to include any natural person or legal entity investor that satisfies the accredited investor definition under Regulation D. The Proposal would also remove the assets under management and net worth thresholds under the current Rule 205-3 qualified client test. For private funds relying on Section 3(c)(1) of the Investment Company Act of 1940, this change could reduce the need to apply a separate qualified client standard to investors that already qualify as accredited investors.

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Dorsey Observations and Next Steps

If adopted as proposed, the expanded qualified client definition could be particularly significant for private fund managers. Most private fund offerings are already limited to accredited investors under Regulation D. However, the Proposal could expand the pool of prospective investors available to emerging private fund managers while reducing the regulatory burden associated with complying with Rule 205-3.

The Proposal could also benefit advisers operating below the SEC registration threshold that rely on a state private fund adviser exemption. A number of states have adopted exemptions modeled on the North American Securities Administrators Association (“NASAA”) private fund adviser exemption, which may condition relief for advisers to certain funds relying on Section 3(c)(1) on each beneficial owner satisfying the federal qualified client definition. However, state requirements vary, and any effect of the Proposal would depend on the text of the applicable state exemption and how it incorporates Rule 205-3.

Many emerging private fund managers may have a larger network of accredited investor relationships than qualified client relationships during the early stages of their investment advisory business. Currently, under Rule 205-3, private fund managers may receive performance-based compensation from investors who do not satisfy the qualified client definition if those investors were admitted to their private funds prior to registration with the SEC. Following registration with the SEC, however, managers may continue to permit investors that are not qualified clients to invest in future private funds but may not receive performance-based compensation from those investors with respect to such investments. In addition, because the net worth and assets under management thresholds for qualified client status are adjusted for inflation every five years, the pool of qualified client investors may diminish over time as previously eligible investors no longer satisfy the applicable thresholds.

The Proposal could provide the dual benefit of greater flexibility for private fund managers to establish and maintain relationships with accredited investors as their businesses scale and they become registered with the SEC, and greater flexibility for certain accredited investors to participate in investment strategies that historically have been restricted to much larger institutional investors.

Unless and until the Proposal is adopted, investment advisers should continue to comply with the existing qualified client requirements. If the Proposal is adopted, private fund sponsors should consider whether corresponding changes are appropriate for their subscription documents, investor questionnaires, and other offering materials. Advisers that are state-registered or rely on a state-level exemption should also consult the laws and regulations of each relevant jurisdiction before changing investor eligibility standards or performance-based compensation practices, because adoption of the federal amendments may not automatically modify state requirements.

Comments on the Proposal will be due 60 days after publication in the Federal Register.

¹ *Investment Adviser Performance-Based Compensation Modernization*, Investment Advisers Act Release No. IA-7022 (Sept. 30, 2026), available at <https://www.sec.gov/rules-regulations/2026/09/s7-2026-28#33-11443proposed>.