

Practice Update

The SEC's Qualified Client Proposal: Broader Performance-Fee Access, Narrower State Oversight

October 2, 2026

Investment advisers registered with the Securities and Exchange Commission generally may not enter into advisory contracts that compensate the adviser through a share of a client's capital gains or capital appreciation. These arrangements, commonly called performance fees, have long been treated as creating a potentially asymmetric incentive: the adviser participates in the upside, while the client bears the downside. State securities laws often include parallel restrictions. Rule 205-3 under the Investment Advisers Act of 1940 currently provides a principal exemption as to "qualified clients," qualified purchasers, and certain knowledgeable personnel of the adviser.

The SEC has now proposed to expand the circumstances in which registered advisers could use performance-based compensation. But there is a bigger issue: if adopted as proposed, the number of investment adviser representatives required to register with states will decrease meaningfully.

Principal Concepts of the Proposal

First, the SEC is propounding a broader route for managers of registered management investment companies and business development companies (i.e., regulated funds). Second, it would revise the definition of "qualified client" so that an accredited

Related People

Ronak V. Patel

Related Work

Litigation

Related Offices

Austin

investor under Regulation D would generally qualify. The proposal would remove the separate \$2.7 million net-worth test and \$1.4 million assets-under-management test now embedded in Rule 205-3. Herein we focus on the effect of including accredited investors in the “qualified client” definition, which is further noteworthy because the SEC has also approved a proposal to expand the accredited investor criteria.

Opportunity for Greater Optionality and Alignment

If adopted as proposed, the inclusion of “accredited investors” as “qualified clients” will have numerous implications for SEC registered investment advisers and private fund sponsors. Moreover, as proposed, the change would meaningfully reshape oversight of investment adviser representatives.

To that end, we start by noting that a study published by the SEC’s Office of the Investor Advocate in June 2025 estimated that approximately 12.6% of the U.S. population qualifies as an accredited investor. Notably, that study also included persons without any investments. Far from a precise calculation, the accredited investor figure would jump to approximately 17% of the respondents in the study if limited to those with investments.

Fee Structure Optionality

Broadly, the proposal would *technically* provide SEC-registered investment advisers – and their clients – with greater optionality in establishing fee structures. For example, consider a younger client, with a small investment account but who meets the accredited investor income criteria. That client’s ability to access the services of a top investment adviser may be increased because a performance fee model could align their respective objectives better than an AUM-only fee model.

Practically speaking, however, we counsel advisers to separately managed accounts considering a performance-fee model of the need to address matters such as trading and allocation practices in recognition of the differences between performance fee accounts and other accounts. Moreover, fee structure optionality can introduce the issue of how advisers align any discussions around fee structures with their fiduciary obligations to clients. Yet, on balance, empowering investors with more choices over their investments seems to be a clear positive when proper controls and oversight are maintained.

Greater Alignment for 3(c)(1) Private Fund Managers

For private fund managers, this change would largely align two investor-eligibility screens that currently operate separately. Today, a person may be accredited and eligible to buy an interest in a private fund relying on both Regulation D, Rule 506 and on the 3(c)(1) investment company exemption. However, that person may not be a qualified client, which would result in the fund manager being prohibited from assessing a performance fee at the fund level. As a result, certain private fund managers have to choose between crafting qualified client-only 3(c)(1) funds, navigating difficult administration challenges where only qualified clients are assessed a performance fee, or forgoing the performance fee structure entirely as to their 3(c)(1) funds. The proposal would align the frameworks better such that private fund managers could more easily incorporate a performance fee with respect to a 3(c)(1) fund.

Implications for State Securities Regulation

The proposed change to the federal qualified client criteria would also be very relevant to state-registered investment advisers and – perhaps more notably – to the states’ registration requirements for investment adviser representatives at SEC-registered firms.

Potential for Different State-by-State Approaches

First, many state regimes mirror the federal performance-fee prohibition. If the SEC adopts the proposal, states may keep the existing qualified-client thresholds, adopt the new federal approach, and/or undertake separate rulemaking. We expect that states will not uniformly agree to allow investment advisers to assess performance fees as to accredited investors.

More Persons Advising Retail Investors Will Not Be Registered with State Regulators

While the position on performance fee assessments may vary state-to-state, we expect that state securities regulators will largely (if not uniformly) raise concern about treating accredited investors as qualified clients to the extent state registration requirements are implicated – which they very clearly would be under the current proposal.

State investment adviser representative registration requirements continue to apply to “supervised persons” of SEC-registered firms to the extent they are “investment adviser representatives” with a “place of business” in the state. Of relevance here is the fact that a supervised person of an SEC-registered firm is not an “investment adviser representative” unless she has more than five natural person investment advisory “clients.”

Under the Investment Advisers Act of 1940, clients that meet the definition of “qualified client” are excluded from the client count for purposes of the investment adviser representative definition. Therefore, broadening the “qualified client” definition to include accredited investors will naturally result in fewer investment adviser representatives of SEC-registered firms having to register with state securities regulators. If the definition is changed as proposed, advisers at SEC-

registered firms will more likely not have to register with *any* state regulators because of the broadened exclusion from the client count. Moreover, firms may be incentivized to develop business models that exclude non-accredited investors as clients entirely.

Notably, the SEC recognized the registration impact in its proposing release and reasoned that “Congress reasonably *could* have expected persons with whom the Commission permits advisers to enter into performance fee arrangements pursuant to its authority under section 205(e) to similarly not need the protections of the state qualification requirements for investment adviser representatives under section 203A” (emphasis added). It is highly likely that state securities regulators and other stakeholders will push back in light of the impact on state registrations and the SEC’s relatively broad interpretation of Congressional intent.

Conclusion

The proposal represents a meaningful shift from a framework built primarily around categorical prohibitions and wealth thresholds toward one emphasizing investor eligibility, fund governance, contractual design, and disclosure. The likely outcome, if the rule is adopted substantially as proposed, is not that performance fees will become universal. Rather, advisers will have a larger design space, and boards and clients will carry greater responsibility for deciding when a performance-based model is appropriate. However, the potential for a material reduction in the number of registered investment adviser representatives presents a real issue that policymakers will likely have to navigate.

[1] SEC Release No. 33-11443; IA-7022; IC-36350; File No. S7-2026-28, “Investment Adviser Performance-Based Compensation Modernization” (proposed Sept. 30, 2026)

[2] *Id.* at 95.

This information is intended to inform firm clients and friends about legal developments, including recent decisions of various courts and administrative bodies. Nothing in this Practice Update should be construed as legal advice or a legal opinion, and readers should not act upon the information contained in this Practice Update without seeking the advice of legal counsel. Prior results do not guarantee a similar outcome.