



July 11, 2011

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

Re: Investment Adviser Performance Compensation; File No. S7-17-11

Dear Ms. Murphy:

Better Markets, Inc.<sup>1</sup> appreciates the opportunity to comment on the above-captioned proposed rules (“Proposed Rules”) of the Securities and Exchange Commission (“Commission”). The Proposed Rules would adjust the “Qualified Client” definition to account for inflation, as required by Section 418 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). In addition, the Proposed Rules would exclude the value of an investor’s primary residence from the net worth component of the Qualified Client definition.

### **SUMMARY**

The Proposed Rules are an appropriate implementation of Section 418 of the Dodd-Frank Act. We strongly support the Commission’s decision to exclude the value of an investor’s primary residence from the calculation of net worth for purposes of the Qualified Client definition. This exclusion is fully in keeping with the letter, spirit, and purpose of the Dodd-Frank Act. It will substantially strengthen the value of the Qualified Client definition as a means of identifying investors who are likely better able to understand and assume the risks associated with performance-based fee arrangements. We commend the Commission for taking this pro-investor step in its implementation of the Dodd-Frank Act.

### **COMMENTS**

Section 205(a)(1) of the Investment Advisers Act (“Advisers Act”) generally prohibits an investment adviser from entering into an advisory contract that provides for performance-based compensation. This prohibition is necessary to protect investors from compensation arrangements that encourage advisers to take excessive risks with client funds to increase their fee income,<sup>2</sup> which has been a problem historically.

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<sup>1</sup> Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

<sup>2</sup> Release at 27960.

Commission Rule 205-3<sup>3</sup> implements an exemption from the prohibition against performance-based compensation for advisory contracts with Qualified Clients. Qualified Clients are currently defined to include persons with (a) \$750,000 in assets under management (“AUM”), or (b) \$1.5 million in net worth. The assumption underlying the exemption is that clients meeting this test do not need the protections of Section 205(a)(1) of the Advisers Act since they are “financially experienced and able to bear the risks of performance-based fee arrangements.”<sup>4</sup>

Section 418 of the Dodd-Frank Act requires the SEC to adjust any “dollar amount test” in the Qualified Client definition to account for inflation no later than July 21, 2011, and every 5 years thereafter. To implement this mandate, the Proposed Rules would—

- Immediately increase the AUM and net worth tests to \$1 million and \$2 million respectively, in accordance with Personal Consumption Expenditures Chain-Type Price Index (“PCE”);
- Provide for future inflation adjustments every 5 years, based on the PCE Index; and
- Establish transition rules that would apply the inflation-adjusted dollar amount tests to new contractual arrangements, not to preexisting ones.

The Proposed Rules are an entirely reasonable implementation of the statutory requirements of Section 418 of the Dodd-Frank Act. They represent an important investor protection measure. Tests based on dollar amounts, such as assets under management and net worth, must be adjusted periodically for inflation. Otherwise, they steadily lose whatever value they have as a means for distinguishing more vulnerable investors from those who may be better able to understand and assume certain financial risks. The adjustments to be made under the Proposed Rules will help ensure that the Qualified Client definition retains a greater degree of accuracy over time.

To its credit, the Commission is incorporating another vitally important investor protection measure in the Proposed Rules, which would exclude the value of a natural person’s primary residence from the net worth test.<sup>5</sup> This is an exceedingly important enhancement to the Qualified Client definition for several reasons. The value of an investor’s residence is a poor measure of financial experience and sophistication. As explained in the Release, the value of a person’s residence may have “little relevance to an individual’s financial experience and ability to bear the risks of performance fee arrangements.”<sup>6</sup> In addition, we now know from the financial crisis that home values are

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<sup>3</sup> 17 C.F.R. § 275.205-3.

<sup>4</sup> Release at 27960

<sup>5</sup> The Proposed Rules would exclude both the value of the primary residence and any debt it secures, unless the outstanding debt exceeds the market value of the residence, in which case the amount of the excess debt would be considered a liability in calculating net worth. Release at 27962. This is an appropriate way to implement the primary residence exclusion.

<sup>6</sup> Release at 27962.

subject to extreme variability, making them an especially unreliable gauge in both rising and falling markets.

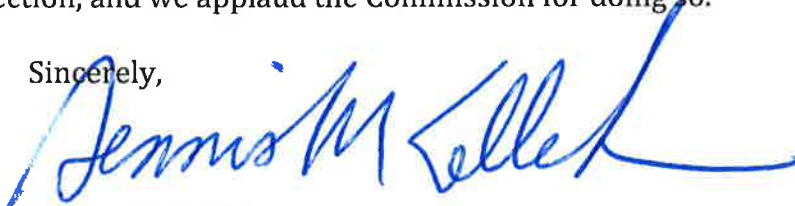
Finally, this step will promote regulatory consistency, as it parallels the treatment of the primary residence in other similar contexts. For example, Section 413(a) of the Dodd-Frank Act requires the value of a primary residence to be excluded from the definition of “accredited investor” in rules promulgated under the Securities Act. The Commission adopted a similar approach when it excluded the value of a person’s primary residence and associated liabilities from the determination of whether a person is a “high net worth customer” in Regulation R under the Securities Exchange Act.<sup>7</sup> The Commission also excluded the value of a person’s primary residence from the determination of whether a natural person has a sufficient level of investments to be considered a “qualified purchaser” under the Investment Company Act.<sup>8</sup>

In addition to protecting an appropriate category of investors, making these various tests consistent promotes fairness, makes regulatory requirements simpler and easier to follow, and facilitates enforcement.

## **CONCLUSION**

In the Proposed Rules, the Commission has taken a strong step in favor of investor protection, and we applaud the Commission for doing so.

Sincerely,



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<sup>7</sup> *Id.*

<sup>8</sup> *Id.*