

1 Department of Commerce

2

3 Adopted Permanent Rules Relating to Securities

4

5 Rules as Adopted

6 2875.1010 INVESTMENT ADVISORY CONTRACTS.

7 Subpart 1. [Unchanged.]

8 Subp. 1a. **Exception.** Subpart 1, item A, does not apply to  
9 an investment advisory contract that provides for compensation  
10 to the investment adviser on the basis of a share of the capital  
11 gains upon, or the capital appreciation of, the funds, or any  
12 portion of the funds, of a client if all the conditions in items  
13 A to D are satisfied.

14 A. ~~Nature of the client:~~

15 ~~(1)~~ The client entering into the contract subject  
16 to this subpart must be:

17 (1) a natural person or a company, as defined in  
18 subpart 2, who immediately after entering into the contract has  
19 at least \$500,000 under the management of the investment  
20 adviser; or

21 (2) a person who the investment adviser and any  
22 person acting on behalf of the adviser entering into the  
23 contract reasonably believes, immediately before entering into  
24 the contract, is a natural person or a company, as defined in  
25 subpart 2, whose net worth at the time the contract is entered  
26 into exceeds \$1,000,000. The net worth of a natural person may  
27 include assets held jointly with the person's spouse.

28 B. The compensation paid to the investment adviser  
29 under this subpart with respect to the performance of any  
30 securities over a given period must be based on a formula which:

31 (1) includes, in the case of securities for which  
32 market quotations are readily available, the realized capital  
33 gains and losses and unrealized capital appreciation and  
34 depreciation of the securities over the period;

35 (2) includes, in the case of securities for which



1 market quotations are not readily available, (i) the realized  
2 capital gains and losses of securities over the period; and (ii)  
3 if the unrealized capital appreciation of the securities over  
4 the period is included, the unrealized capital depreciation of  
5 the securities over the period; and

6 (3) provides that any compensation paid to the  
7 investment adviser under this subpart is based on the gains less  
8 the losses computed in accordance with item B, subitems (1) and  
9 (2), in the client's account for a period of not less than one  
10 year.

11 C. The investment adviser shall disclose to the  
12 client, or the client's independent agent, before entering into  
13 an advisory contract under this subpart, all material  
14 information concerning the proposed advisory arrangement  
15 including the following:

16 (1) that the fee arrangement may create an  
17 incentive for the investment adviser to make investments that  
18 are riskier or more speculative than would be the case in the  
19 absence of a performance fee;

20 (2) where relevant, that the investment adviser  
21 may receive increased compensation with regard to unrealized  
22 appreciation as well as realized gains in the client's account;

23 (3) the periods which will be used to measure  
24 investment performance throughout the contract and their  
25 significance in the computation of the fee;

26 (4) the nature of any index which will be used as  
27 a comparative measure of investment performance, the  
28 significance of the index, and the reason the investment adviser  
29 believes the index is appropriate; and

30 (5) where an investment adviser's compensation is  
31 based in part on the unrealized appreciation of securities for  
32 which market quotations are not readily available, how the  
33 securities will be valued, and the extent to which the valuation  
34 will be independently determined.

35 D. The investment adviser and any person acting on  
36 behalf of the adviser who enters into the contract must

1 reasonably believe, immediately before entering into the  
2 contract, that the contract represents an arm's-length  
3 arrangement between the parties and that the client, or in the  
4 case of a client which is a company as defined in subpart 2, the  
5 person representing the company, alone or together with the  
6 client's independent agent, understands the proposed method of  
7 compensation and its risks. The representative of a company may  
8 be a partner, director, officer, or an employee of the company  
9 or the trustee, where the company is a trust, or any other  
10 person designated by the company or trustee, but must satisfy  
11 the definition of client's independent agent in subpart 2, item  
12 C.

13 Subp. 2. Definitions. As used in this part:

14 A. "Assignment" includes any direct or indirect  
15 transfer or hypothecation of an investment advisory contract by  
16 the assignor or of a controlling block of the assignor's  
17 outstanding voting securities by a security holder of the  
18 assignor; but, if the investment adviser is a partnership, no  
19 assignment of an investment advisory contract is considered to  
20 result from the death or withdrawal of a minority of the members  
21 of the investment adviser having only a minority interest in the  
22 business of the investment adviser, or from the admission to the  
23 investment adviser of one or more members who, after admission,  
24 will be only a minority of the members and will have only a  
25 minority interest in the business.

26 B. "Affiliate" has the same meaning as in section  
27 2(a)(3) of the Investment Company Act.

28 C. "Client's independent agent" means a person  
29 agreeing to act as the client's agent in connection with the  
30 contract other than:

31 (1) The investment adviser acting in reliance  
32 upon this part, an affiliated person of the investment adviser,  
33 an affiliated person of an affiliated person of the investment  
34 adviser, or an interested person of the investment adviser as  
35 defined in item E.

36 (2) A person who receives, directly or

1 indirectly, any compensation in connection with the contract  
2 from the investment adviser, an affiliated person of the  
3 investment adviser, an affiliated person of an affiliated person  
4 of the investment adviser, or an interested person of the  
5 investment adviser as defined in item E.

6 (3) A person with any material relationship  
7 between himself or herself, or an affiliated person of the  
8 person, and the investment adviser, or an affiliated person of  
9 the investment adviser, that exists or has existed at any time  
10 during the previous two years.

11 D. "Company" has the same meaning as in section  
12 202(a)(5) of the Investment Advisers Act of 1940, but does not  
13 include a company that is required to be registered under the  
14 Investment Company Act of 1940, but is not registered. Further,  
15 the term "company" as used in subpart 1a, item A, does not  
16 include (i) a private investment company as defined in item G,  
17 (ii) an investment company registered under the Investment  
18 Company Act of 1940, or (iii) a business development company, as  
19 defined in section 202(a)(22) of the Investment Advisors Act of  
20 1940, unless each of the equity owners other than the investment  
21 adviser entering into a contract under subpart 1a of any such  
22 company is a natural person or company described in this item.

23 E. "Interested person" as used in item C means:

24 (1) Any member of the immediate family of any  
25 natural person who is an affiliated person of the investment  
26 adviser.

27 (2) Any person who knowingly has any direct or  
28 indirect beneficial interest in, or who is designated as  
29 trustee, executor, or guardian of any legal interest in, any  
30 security issued by the investment adviser or by a controlling  
31 person of the investment adviser if the beneficial or legal  
32 interest of the person in any security issued by the investment  
33 adviser or by a controlling person of the investment adviser (a)  
34 exceeds one-tenth percent of any class of outstanding securities  
35 of the investment adviser or a controlling person of the  
36 investment adviser; or (b) exceeds five percent of the total

1 assets of the person seeking to act as the client's independent  
2 agent.

3 (3) Any person, partner, or employee of any  
4 person who at any time since the beginning of the last two years  
5 has acted as legal counsel for the investment adviser.

6 F. "Investment advisory contract" means any contract  
7 or agreement where a person agrees to act as an investment  
8 adviser or to manage any investment or trading account for a  
9 person other than an investment company as defined in the  
10 Investment Company Act of 1940.

11 G. "Private investment company" means a company that  
12 would be defined as an investment company under section 3(a) of  
13 the Investment Company Act of 1940 but for the exception  
14 provided from that definition by section 3(c)(1) of the act.

15 H. "Securities for which market quotations are  
16 readily available" in subpart 1a, item B, have the same meaning  
17 as in Rule 2a-4(a)(1) under the Investment Company Act of 1940.

18 I. "Securities for which market quotations are not  
19 readily available" in subpart 1a, item B, means securities not  
20 described in item H.