**20:08:05:29.  Contents of an investment advisory contract.** The provisions of § 20:08:05:29(1) apply to federal covered investment advisers to the extent that the conduct alleged is fraudulent, deceptive, or as otherwise permitted by the National Securities Markets Improvement Act of 1996.

(1)  It is unlawful for any investment adviser, investment adviser representative, or federal covered investment adviser to enter into, extend, or renew any investment advisory contract unless it provides in writing:

 (a)  The services to be provided, the term of the contract, the investment advisory fee, the formula for computing the fee, the amount of prepaid fee to be returned in the event of termination or non-performance of the contract, and any grant of discretionary power to the investment adviser, investment adviser representative, or federal covered investment adviser;

 (b)  That no direct or indirect assignment or transfer of the contract may be made by the investment adviser, investment adviser representative, or federal covered investment adviser without the consent of the client or other party to the contract;

 (c)  That the investment adviser, investment adviser representative, or federal covered investment adviser may not be compensated on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client;

 (d)  That the investment adviser, investment adviser representative, or federal covered investment adviser, if a partnership, shall notify the client or other party to the investment contract of any change in the membership of the partnership within a reasonable time after the change.

(2)  It is unlawful for any investment adviser, investment adviser representative, or federal covered investment adviser to:

 (a)  Include in an advisory contract, any condition, stipulation, or provisions binding any person to waive compliance with any provision of chapter 47-31B or of the Investment Advisers Act of 1940, or any other practice contrary to the provisions of Section 215 of the Investment Advisers Act of 1940; or

 (b)  Enter into, extend, or renew any advisory contract contrary to the provisions of Section 205 of the Investment Advisers Act of 1940. This provision applies to all advisers and investment adviser representatives registered or required to be registered under chapter 47-31B.

(3)  Not withstanding § 20:08:05:29(1)(c), an investment adviser may enter into, extend, or renew an investment advisory contract which provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds, or any portion of the funds, of the client if the conditions in § 20:08:05:29(3)(a) to (d), inclusive, are met.

 (a)  The client entering into the contract must be:

 (i)     A natural person or a company who, immediately after entering into the contract, has at least $ 1,000,000 under the management of the investment adviser; or

 (ii)   A person who the investment adviser and its investment adviser representatives reasonably believe, immediately before entering into the contract, is a natural person or a company whose net worth, at the time the contract is entered into, exceeds $2,000,000. The net worth of a natural person may include assets held jointly with that person's spouse. For purposes of calculating a natural person's net worth:

 (A)  The person's primary residence may not be included as an asset;

 (B)  Indebtedness secured by the person's primary residence, up to the estimated fair market value of the primary residence at the time the investment advisory contract is entered into may not be included as a liability; and

 (C)  Indebtedness that is secured by the person's primary residence in excess of the estimated fair market value of the residence must be included as a liability.

 (b)  The compensation paid to the investment adviser with respect to the performance of any securities over a given period must be based on a formula with the following characteristics:

 (i)     In the case of securities for which market quotations are readily available within the meaning of Rule 2a-4(a)(1) under the Investment Company Act of 1940 (Definition of "Current Net Asset Value" for Use in Computing Periodically the Current Price of Redeemable Security), the formula must include the realized capital losses and unrealized capital depreciation of the securities over the period;

 (ii)    In the case of securities for which market quotations are not readily available within the meaning of Rule 2a-4(a)(1) under the Investment Company Act of 1940, the formula must include:

 (A)  The realized capital losses of securities over the period; and

 (B)  If the unrealized capital appreciation of the securities over the period is included, the unrealized capital depreciation of the securities over the period; and

 (iii)   The formula must provide that any compensation paid to the investment adviser under § 20:08:05:29 is based on the gains less the losses computed in accordance with § 20:08:05:29(3)(b)(i) and (3)(b)(ii) in the client's account for a period of not less than one year.

 (c)  Before entering into the advisory contract and in addition to the requirements of Form ADV, the investment adviser must disclose in writing to the client or the client's independent agent all material information concerning the proposed advisory arrangement, including the following:

 (i)     That the fee arrangement may cause an incentive for the investment adviser to make investments that are riskier or more speculative than would be the case in the absence of a performance fee;

 (ii)    If relevant, that the investment adviser may receive increased compensation with regard to unrealized appreciation as well as realized gains in the client's account;

 (iii)   The periods which will be used to measure investment performance throughout the contract and their significance in the computation of the fee;

 (iv)   The nature of any index which will be used as a comparative measure of investment performance, the significance of the index, and the reason the investment adviser believes that the index is appropriate; and

 (v)    If the investment adviser's compensation is based in part on the unrealized appreciation of securities for which market quotations are not readily available within the meaning of Rule 2a-4(a)(1) under the Investment Company Act of 1940, how the securities will be valued and the extent to which the valuation will be independently determined.

 (d)  The investment adviser (and any investment adviser representative) who enters into the contract must reasonably believe, immediately before entering into the contract, that the contract represents an arm's length arrangement between the parties and that the client (or in the case of a client which is a company as defined in § 20:08:05:29(6)(d), the person representing the company), alone or together with the client's independent agent, understands the proposed method of compensation and its risks. The representative of a company may be a partner, director, officer, or an employee of the company or the trustee, where the company is a trust, or any other person designated by the company or trustee, but must satisfy the definition of client's independent agent set forth in § 20:08:05:29(6)(c).

(4)  Any person entering into or performing an investment advisory contract under § 20:08:05:29 is not relieved of any obligations under § 20:08:05:28 or any other applicable provision of chapter 47-31B or any rule or order thereunder.

(5)  Nothing in § 20:08:05:29 relieves a client's independent agent from any obligation to the client under applicable law.

(6)  The following definitions apply for purposes of § 20:08:05:29:

 (a)  "Affiliate" is as defined in Section 2(a)(3) of the Investment Company Act of 1940.

 (b)  "Assignment" as used in § 20:08:05:29(1)(b), includes any transaction or event that results in any change to the individuals or entities with the power, directly or indirectly, to direct the management or policies of, or to vote more than 50 percent of any class of voting securities of, the investment adviser or federal covered investment adviser as compared to the individuals or entities who had such power as of the date when the contract was first entered into, extended, or renewed.

 (c)  "Client's independent agent" means any person who agrees to act as an investment advisory client's agent in connection with the contract, but does not include:

 (i)     The investment adviser relying on § 20:08:05:29;

 (ii)    An affiliated person of the investment adviser or an affiliated person of an affiliated person of the investment adviser including an investment adviser representative;

 (iii)   An interested person of the investment adviser;

 (iv)   A person who receives, directly or indirectly, any compensation in connection with the contract from the investment adviser, an affiliated person of the investment adviser, an affiliated person of an affiliated person of the investment adviser or an interested person of the investment adviser; or

 (v)   A person with any material relationship between himself (or an affiliated person of that person) and the investment adviser (or an affiliated person of the investment adviser) that exists, or has existed at any time during the past two years.

 (d)  "Company" means a corporation, partnership, association, joint stock company, trust, or any organized group of persons, whether incorporated or not; or any receiver, trustee in a case under Title 11 of the United States Code, or similar official or any liquidating agent for any of the foregoing, in such persons official capacity. "Company" does not include:

 (i)     A company required to be registered under the Investment Company Act of 1940 but which is not so registered;

 (ii)   A private investment company, for purposes of § 20:08:05:29(6)(d), a private investment company is a company which would be defined as an investment company under Section 3(a) of the Investment Company Act of 1940 but for the exception from that definition provided by Section 3(c)(1) of that act;

 (iii)  An investment company registered under the Investment Company Act of 1940; or

 (iv)  A business development company as defined in Section 202(a)(22) of the Investment Advisers Act of 1940, unless each of the equity owners of any such company, other than the investment adviser entering into the contract, is a natural person or a company within the meaning of § 20:08:05:29(6)(d).

 (e)  "Interested person" means:

 (i)     Any member of the immediate family of any natural person who is an affiliated person of the investment adviser;

 (ii)    Any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued by the investment advisor or by a controlling person of the investment adviser if that beneficial or legal interest exceeds:

 (A)  One tenth of one percent of any class of outstanding securities of the investment adviser or a controlling person of the investment adviser; or

 (B)  Five percent of the total assets of the person seeking to act as the client's independent agent; or

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

 **Source:** 37 SDR 112, effective December 9, 2010; 41 SDR 58, effective October 14, 2014.

 **General Authority:** SDCL 47-31B-502(c), 47-31B-605(a)(2).

 **Law Implemented:** SDCL 47-31B-103, 47-31B-502(c).