

## 18 NCAC 06A .1805 PERFORMANCE-BASED COMPENSATION EXEMPTION

(a) For purposes of this Rule:

- (1) "Affiliate" shall have the same definition as in Section 2(a)(3) of the federal Investment Company Act of 1940;
- (2) "Client's independent agent" means any person who agrees to act as an investment advisory client's agent in connection with an advisory contract, but does not include:
  - (A) The investment adviser relying on this Rule;
  - (B) An affiliated person of the investment adviser or an affiliated person of an affiliated person of the investment adviser including an investment adviser representative;
  - (C) An interested person of the investment adviser;
  - (D) A person who receives, directly or indirectly, any compensation in connection with the advisory 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
  - (E) 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;
- (3) "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 his capacity as such. "Company" shall not include:
  - (A) A company required to be registered under the federal Investment Company Act of 1940 but which is not so registered;
  - (B) A private investment company (for purposes of this Subparagraph (B), a private investment company is a company which would be defined as an investment company under Section 3(a) of the federal Investment Company Act of 1940 but for the exception from that definition provided by Section 3(c)(1) of that act);
  - (C) An investment company registered under the federal Investment Company Act of 1940; or
  - (D) A business development company as defined in Section 202(a)(22) of the federal Investment Company 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 company within the meaning of Subparagraph (a)(3) of this Rule;
- (4) "Interested person" means:
  - (A) Any parent, spouse, child, or brother or sister of any natural person who is an affiliated person of the investment adviser;
  - (B) 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 adviser or by a controlling person of the investment adviser if that beneficial or legal interest exceeds:
    - (i) one tenth of one percent of any class of outstanding securities of the investment adviser or a controlling person of the investment adviser; or
    - (ii) five percent of the total assets of the person seeking to act as the client's independent agent; or
  - (C) 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.

(b) Notwithstanding Section 78C-8(c)(1) of the Act, 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 Subparagraphs (c) through (h) of this Rule are met.

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

- (1) A natural person or a company who, immediately after entering into the advisory contract has at least five hundred thousand dollars (\$500,000.00) under the management of the investment adviser; or
- (2) 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 one million dollars (\$1,000,000.00).

For purposes of this Rule, the term "net worth" shall have the same meaning as that provided by Rule .1313(b)(2). The net worth of a natural person may include assets held jointly with that person's spouse.

(d) 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:

- (1) 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), 17 C.F.R. 270.2a-4(a)(1), the formula must include the realized capital losses and unrealized capital depreciation of the securities over the period;
- (2) 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, 17 C.F.R. 270.2a-4(a)(1), 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
- (3) The formula must provide that any compensation paid to the investment adviser under this Rule is based on the gains less the losses (computed in accordance with Subparagraphs (1) and (2) of this Paragraph) in the client's account for a period of not less than one year.

(e) 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:

- (1) That the fee arrangement may create 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;
- (2) Where relevant, that the investment adviser may receive increased compensation with regard to unrealized appreciation as well as realized gains in the client's account;
- (3) The periods which will be used to measure investment performance throughout the contract and their significance in the computation of the fee;
- (4) 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
- (5) Where 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, 17 C.F.R. 270.2a-4(a)(1), how the securities will be valued and the extent to which the valuation will be independently determined.

(f) 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 Subparagraph (a)(3) of this Rule, 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 Subparagraph (a)(2) of this Rule.

(g) Any person entering into or performing an investment advisory contract under this Rule is not relieved of any obligations under Section 78C-8(a) or any other applicable provision of the Act or any rule or order thereunder.

(h) Nothing in this Rule shall relieve a client's independent agent from any obligation to the client under applicable law.

*History Note: Authority G.S. 78C-8(b); 78C-8(c)(i); 78C-8(f); 78C-30(a);  
Temporary Rule Eff. January 2, 1989, for a period of 180 days to expire on June 30, 1989;  
Eff. February 1, 1989;  
Temporary Amendment Eff. October 1, 1997;  
Amended Eff. August 1, 1998;  
Pursuant to G.S. 150B-21.3A, rule is necessary without substantive public interest Eff. December 6, 2016.*