INVITATION FOR COMMENTS

CALIFORNIA INVESTMENT ADVISER REGULATIONS

PRO 02/11

BACKGROUND

The Department of Corporations ("Department") licenses and regulates investment advisers under the Corporate Securities Law of 1968 (Corporations Code Section 25000 et seq., the "Corporate Securities Law"). Under the Corporate Securities Law, it is unlawful for an investment adviser to conduct business without first applying for and securing a certificate.

The Department is considering changes to a regulation that impacts California investment advisers, and in accordance with Government Code Section 11346.45, the Department is seeking comments from interested parties and those who would be subject to the proposed regulations, prior to the Department providing notice of a proposed rulemaking action.

More specifically, the Department is seeking comments on amendments to Section 260.204.9 of Title 10 of the California Code of Regulations.


Section 203(b)(3) exempts from federal registration any investment adviser who has fewer than fifteen clients and who neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company. Advisers to alternative investment vehicles such as hedge funds, private-equity funds, and venture capital funds frequently rely on the Section 203(b)(3) exemption from registration.

As a replacement to the "private adviser" exemption, Dodd-Frank creates a new regulatory regime for advisers to "private funds." The term "private funds" refers to investment funds that would be required to register under the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7) of that act. Persons who exclusively advise private funds, are exempt from registration with the Securities and Exchange Commission ("SEC") if they (1) advise venture capital funds, or (2) manage less than $150 million of assets.

March 15, 2011
In California, investment advisers currently exempt under Section 203(b)(3) of the 1940 Act have a corollary exemption under California investment adviser licensing requirements, if they meet the requirements of Section 260.204.9 of Title 10 of the California Code of Regulations, and (1) have assets under management of not less than $25,000,000, or (2) exclusively advise “venture capital companies,” as that term is defined in the rule.

As a result of Dodd-Frank, on July 21, 2011, Section 260.204.9 will no longer provide an exemption from California licensing requirements. In anticipation of these changes, the California Corporations Commissioner will be amending Section 260.204.9 to reflect the changes in the corresponding federal rules. The Commissioner seeks input on the issue of how best to regulate advisers to alternative investment vehicles, while balancing the regulatory burden on such advisers, with any corresponding investor protections issues.

INVITATION

In accordance with Government Code Section 11346(b), the Department seeks to involve parties who would be subject to the regulations and other interested parties in discussions regarding the proposed regulations. The Commissioner invites interested parties to review the accompanying draft text of a proposed regulatory structure for advisers to alternative investment vehicles, and provide comments.

In addition, the Commissioner invites interested parties to consider the following questions:

1. To avoid the “retailization” of private alternative investment funds, should the exemption apply exclusively to advisers to Section 3(c)(7) funds (i.e., not to Section 3(c)(1) funds)?

2. Should all persons investing in a Section 3(c)(1) fund be required to be qualified clients? If so, should the Department issue an order that “grandfathers” Section 3(c)(1) funds organized prior to July 21, 2010?

3. Should the proposed statutory disqualification provisions be expanded to include additional factors?

4. Should the proposed asset under management threshold (AUM) be a different amount than that set forth in the proposed rule (i.e. $100 million)? If so, what is the basis for a different threshold?

5. Are there criteria other than AUM that the Commissioner should consider to determine whether an adviser should be exempt (e.g., the fund is subject to an annual audit)?
6. Should the Department’s definition of venture capital company/fund conform to the proposed SEC definition?

7. Should the Department adopt the North American Securities Administrators Association (NASAA) proposed model rule for an exemption for Private Fund Advisers?

TIME FOR COMMENTS

Accordingly, the Department is providing the attached text of draft regulations to interested parties, and invites interested parties to submit comments on these documents by March 28, 2011. Comments from interested persons will assist the Department in determining whether amendments to regulations under the Corporate Securities Law are necessary and appropriate.

This solicitation for comments from interested parties is not a proposed rulemaking action under Government Code Section 11346, and the public will have an additional opportunity to comment on proposed changes if, after consideration of the comments from interested parties, the Department proceeds with a notice of a proposed rulemaking action.

WHERE TO SUBMIT COMMENTS

You may submit comments by any of the following means:

Electronic

Comments may be submitted electronically to regulations@corp.ca.gov. Please identify the comments as PRO 02/11.

Mail

California Department of Corporations
Office of Legislation and Policy
Attn: Karen Fong (PRO 02/11)
1515 K St., Suite 200
Sacramento, CA 95814

Fax

(916) 322-5875

CONTACT PERSON

Questions regarding this invitation for comments may be directed to Ivan V. Griswold, Corporations Counsel, at (415) 972-8937 or igriswo@corp.ca.gov.
1. Amend Section 260.204.9

§ 260.204.9. Exemption for Certain Investment Advisers with fewer than 15 Clients. Exemption for Certain Investment Advisers to Private Funds.

(a) An exemption from the provisions of Section 25230 of the Code is hereby granted, as being necessary and appropriate in the public interest and for the protection of investors, to any person who (1) does not hold itself out generally to the public as an investment adviser, (2) has fewer than 15 clients, (3) is exempt from registration under the federal Investment Advisers Act of 1940, as amended, by virtue of Section 203(b)(3) of that act, and (4) either (i) has assets under management, as defined in subsection (b)(2), of not less than $25,000,000 or (ii) provides investment advice to only venture capital companies, as defined in subsection (b)(3), satisfies the following conditions:

(1) Disqualification: Neither the person nor any of its affiliated persons (1) are subject to a disqualification as described in Rule 262 of the Securities and Exchange Commission (17 CFR Sec. 230.262), or (2) have done any of the acts, satisfy any of the circumstances, or are subject to any order specified in section 25232, subdivisions (a) through (h) of the Corporate Securities Law of 1968, or any successor thereto.

(2) The person acts an adviser solely to private funds, as defined in subsection (b)(1) of this rule.

(3) Application: The person files with the Commissioner an application consisting of a copy of each report and amendment thereto that an exempt reporting adviser under the Investment Adviser Act of 1940 would be required to file with the Securities and Exchange Commission pursuant to Securities and Exchange

(4) Application fee: The fee for filing an application is $125 as prescribed in Section 25608(q). The payment of this fee shall keep the exemption in effect during the calendar year during which it is granted. The applicant shall remit the fee directly with IARD in accordance with its procedures for transmission to the Commissioner. Fees are not refundable except pursuant to Government Code Sections 13140 through 13144.

(5) The person either (i) has assets under management as defined in subsection (b)(2), of not less than $100,000,000 or (ii) provides investment advice only to venture capital companies, as defined in subsection (b)(3).

(6) The person is exempted from registration with the Securities and Exchange Commission under Section 203(l) or (m) of Investment Adviser Act of 1940 (15 U.S.C. 80b-3(l) or 80b-3(m)).

(b) For purposes of this rule, the following definitions shall apply:

(1) Client shall have the same meaning as defined by the Securities and Exchange Commission under the rule adopted pursuant to Section 222(d) of the federal Investment Advisers Act of 1940, as amended. "Private fund" means an issuer that would be an investment company, as defined in Section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a-3), but for Section 3(c)(1) or 3(c)(7) of that Act.

(2) "Assets under management" means the securities with respect to which an investment adviser and its affiliated persons provide continuous and regular supervisory or management services; provided, that in the case of securities managed for an entity

\(^1\) The application referred to in this subsection will be revised as necessary upon final adoption of Rule 204-4 by the Securities and Exchange Commission.
which is excluded from the definition of investment company by the exclusion provided
in Section 3(c)(1) or Section 3(c)(7) of the federal Investment Company Act of 1940, as
amended, assets under management shall also include any amount payable to such
entity pursuant to a firm agreement or similar binding commitment pursuant to which a
person has agreed to acquire an interest in, or make capital contributions to, the entity
upon demand of such entity.

(3) An entity is a “venture capital company” if, on at least one occasion during the
annual period commencing with the date of its initial capitalization, and on at least one
occasion during each annual period thereafter, at least fifty percent (50%) of its assets
(other than short-term investments pending long-term commitment of distribution to
investors), valued at cost, are venture capital investments, defined in subsection (b)(4)
or derivative investments described in subsection (b)(5).

(4) A “venture capital investment” is an acquisition of securities in an operating
company as to which the investment adviser, the entity advised by the investment
adviser, or an affiliated person of either has or obtains management rights as defined in
subsection (b)(6).

(5) An acquisition of securities is a “derivative investment” if it is acquired by a
venture capital company in the ordinary course of its business in exchange for an
existing venture capital investment either (i) upon the exercise or conversion of the
existing venture capital investment or (ii) in connection with a public offering of
securities or the merger or reorganization of the operating company to which the
existing venture capital investment relates.

(6) “Management rights” means the right, obtained contractually or through
ownership of securities, either through one person alone or in conjunction with one or
more persons acting together or through an affiliated person, to substantially participate
in, to substantially influence the conduct of, or to provide (or to offer to provide) significant guidance and counsel concerning, the management, operations or business objectives of the operating company in which the venture capital investment is made.

(7) An “operating company” means an entity that is primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale (including any research or development) of a product or service other than the management or investment of capital, but shall not include an individual or sole proprietorship.

(8) “Affiliated person” means a person that controls, is controlled by, or is under common control with the other specified persons. Control means possessing directly or indirectly, the power to direct or cause the direction of management and policies.

(c) The application described in subsection (a)(3) of this rule, shall be made electronically through the IARD, with the exception that the Customer Authorization of Disclosure of Financial Records and the Consent to Service of Process shall be submitted directly to the Commissioner. An application shall be deemed approved when (i) the report and the application fee are filed and accepted by the IARD on the Commissioner’s behalf, and (ii) the Customer Authorization of Disclosure of Financial Records and the Consent to Service of Process have been filed with the Commissioner.