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A legal update from Dechert's Financial Services Group

California Commissioner of Corporations Proposes Modifying the State's Investment Advisor Registration Requirements

More investment advisers would be required to follow California's registration requirements under a proposal by the Commissioner (the "Commissioner") of the California Department of Corporations (the "Department"). The proposal would amend Section 260.204.9 (the "Rule") of the Corporate Securities Law of 1968 ("CSL").[1] The proposed amendment to the Rule would narrow the exemption from the state's registration requirements for certain investments pursuant to Section 25230 of the California Corporations Code ("Section 25230").[2] The proposed amendment is targeted primarily at unregistered advisers to hedge funds based in California, but may have a more sweeping impact on advisers to alternative investment vehicles.

Section 25230

Section 25230 requires persons conducting business as an investment adviser in California to be licensed with the Department. However, California Corporations Code Section 25204 provides the Commissioner with authority to exempt any person from the licensing requirement of Section 25230. Accordingly, in 2002, the Commissioner adopted the Rule to exempt from the licensing requirement investment advisers that satisfied certain criteria.

Currently, the Rule exempts from the licensing requirement of Section 25230 any person who meets each of the following criteria:

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 (the "Advisers Act") by virtue of Section 203(b)(3) of that act; and
4. either (i) has "assets under management" of not less than $25 million or (ii) provides investment advice to only venture capital companies.[3]

[1] Cal. Admin. Code Tit. 10, § 260.204.9 Exemption for Certain Investment Advisers with Fewer than 15 Clients. For a copy of the proposal, *see* Pro 41/06 on the California Department of Corporations' web site http://www.corp.ca.gov/pol/rm/4106a.pdf.

[2] A California licensed adviser is required to prepare a Form ADV and other documents to become licensed with the Department of Corporations. Additionally, a California licensed adviser is subject to periodic inspections by the Department and to various reporting requirements, including reporting adviser representatives, compliance with books and records, custody, code of ethics, and minimum net worth requirements.

[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 50% of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, are venture capital investments, or derivative investments. Section 260.204.9 defines a "venture capital investment" as 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.

The proposed amendment would delete items 2 and 4(i) above. As such, the Rule, if amended, would require that an investment adviser meet each of the following criteria to continue to be exempt from registration:

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. 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

3. provides investment advice to only venture capital companies.

The Department's Concerns Regarding Hedge Funds

According to the Department, various factors caused the Commissioner to reexamine the basis for the exemption from registration under the Rule beyond advisers to venture capital companies. Primarily, the impetus for proposing to amend the Rule is the Commissioner's concerns regarding hedge funds advised by California-based advisers. The Department cited concerns with the lack of regulatory oversight of advisers to hedge funds, as set forth in the Securities and Exchange Commission's 2003 report, "Implications of the Growth of Hedge Funds." The Department also cited an increase in fraud related to hedge fund activities and the broader market participation by retail investors in hedge funds as reasons for revisiting the Rule. In addition, the Department cited the U.S. Court of Appeals decision to vacate Rule 206(b)(3)-2 under the Advisers Act; a result of which is that advisers to hedge funds relying on Section 203(b)(3) of the Advisers Act remain not subject to federal registration.[4] The Department bases its authority to regulate advisers on Section 203(b)(3), which arises from the National Securities Markets Improvement Act of 1996 ("NSMIA"). While NSMIA preempts state licensing for certain advisers, it also provides that oversight of Section 203(b)(3) advisers is left to the states. The Department concluded that, based on changing market conditions, the current Rule appears to create an unwarranted disparity in treatment of investment advisers that no longer serves any meaningful public benefit.

However, it is important to note that the SEC has recently adopted a temporary rule and proposed another rule under the Advisers Act in this area. Both the temporary rule and the proposed rule, if adopted, will enlarge the scope of coverage of that Act as it applies to hedge fund managers and other entities and could make the proposed amendment to the California rule unnecessary or superfluous.[5]

Amended Rule Would Apply to Advisers that Do Business in California

The proposed amendment to the Rule would affect only advisers with a place of business in California.[6] The proposed amendment is meant to apply to California-based unregistered advisers of hedge funds, but California-based advisers to other types of pooled investment vehicles that are not venture capital companies may also be affected. For example, advisers to

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Additionally, Section 260.204.9 indicates that 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.

4 *See Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006). *See also* Dechert LLP Financial Services Legal Update, "SEC Staff Issues Guidance In Wake of the Goldstein Opinion" (Issue 12, August 2006), available at http://www.dechert.com/library/FS_Update12_8-06.pdf.

5 *See* Dechert LLP Financial Services Legal Update, "U.S. Temporary Rule Regarding Principal Trades with Certain Advisory Clients and Proposed Interpretive Rule Under the Advisers Act Affecting Broker-Dealers" (Issue 34, November 2007), available at http://www.dechert.com/library/FS_34_11-07_Temporary_Rule_Regarding_Principal.pdf.

6 This limitation arises from California Corporations Code Section 25202(a), which declares: "An investment adviser shall not be subject to Section 25230 if (1) the investment adviser does not have a place of business in this state and (2) during the preceding 12-month period has had fewer than six clients who are residents of [California]."

private equity funds that do not fully satisfy the definition of "venture capital funds" may be required to register with the Department. A California-based adviser that finds itself having to register under the amended Rule would have to be licensed under the CSL, and would be subject to various obligations and restrictions as set forth in the CSL and the rules of the Department.[7] However, California-based advisers to venture capital companies—an important segment in California's entrepreneurial high technology economy—can remain unregistered.

In light of the proposal, investment advisers that do not advise venture capital companies and are not registered with the SEC should consider the requirement of registration with the Department in connection with any office in California or prior to opening any "place of business" in California.

The comment period for the proposed changes ended on November 26, 2007.

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7 *See* supra note 2.

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