

INITIAL STATEMENT OF REASONS  
FOR AMENDMENTS TO REGULATIONS UNDER THE  
CORPORATE SECURITIES LAW OF 1968

As required by Section 11346.2 of the Government Code, the California Corporations Commissioner (“Commissioner”) sets forth below the reasons for the proposed amendments to Section 260.204.9 of Title 10 of the California Code of Regulations (10 C.C.R. Section 260.204.9).

**EXECUTIVE SUMMARY**

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 from the Commissioner unless the adviser is specifically exempt from that requirement. Previously, the Department, by regulation, conferred an exemption from state regulation for investment advisers that satisfied a federal exemption,<sup>1</sup> but that federal exemption expired July 21, 2011.<sup>2</sup> On July 21, 2011, the Department promulgated emergency regulations to preserve the existing exemption from state registration for investment advisers who relied on the expiring federal exemption.<sup>3</sup> In this rulemaking action, the Department proposes a successor exemption for advisers to private funds, provided they (1) have not violated securities laws, (2) file periodic reports with the Department, (3) pay the existing investment adviser registration and renewal fees, and (4) comply with additional safeguards when advising funds organized under Section 3(c)(1) of the Investment Company Act of 1940.<sup>4</sup> The proposed exemption is based on the proposed North American Securities Administrators Association (NASAA) *Model Rule for Exempt Reporting Advisers*, first published December 10, 2010 (available at: <http://www.nasaa.org/1787/proposed-model-rule-for-exempt-reporting-advisers/>).

**DISCUSSION**

By way of background, on July 21, 2010, the President signed *The Dodd-Frank Wall Street Reform and Consumer Protection Act* (“Dodd-Frank”) into law. Public Law No. 111-203. Dodd-Frank substantially revises many federal financial services and securities laws, including eliminating the existing “private adviser” exemption set forth in Section 203(b)(3) (“section 203(b)(3)”) of the Investment Adviser Act of 1940 (“1940 Act”), (15 USCS § 80b-3).<sup>5</sup>

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<sup>1</sup> 15 U.S.C.S. § 80b-3, prior to July 21, 2011.

<sup>2</sup> Public Law No. 111-203.

<sup>3</sup> Cal. Code Regs., tit. 10, § 260.204.9.

<sup>4</sup> 15 U.S.C.S. § 80a-3(c)(1).

<sup>5</sup> As amended section 203(b)(3) is significantly narrowed, and applies solely to “foreign private advisers.”

Prior to Dodd-Frank, Section 203(b)(3) exempted from federal registration any investment adviser who had fewer than fifteen clients and who neither held itself out generally to the public as an investment adviser nor acted 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 relied on the Section 203(b)(3) exemption from registration.

As a successor 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) (“3(c)(1) funds”) or 3(c)(7) (“3(c)(7) funds”) of that act.<sup>6</sup> Generally, persons who exclusively advise private funds are exempt from registration with the Securities and Exchange Commission (“SEC”) if they (1) exclusively advise venture capital funds (17 C.F.R. § 275.203(l)-1), or (2) manage less than \$150 million of assets (17 C.F.R. § 275.203(m)-1). These advisers are referred to as Exempt Reporting Advisers (“ERA”).

In California, investment advisers previously exempt under Section 203(b)(3) of the 1940 Act have a corollary temporary 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, including (1) having assets under management of not less than \$25,000,000, or (2) exclusively advising “venture capital companies,” as that term is defined in the rule.<sup>7</sup> This exemption expires on January 17, 2012. Accordingly, the Commissioner is proposing a permanent successor exemption to replace the “private adviser regime.” This exemption is predicated on the high financial net worth of investors in these vehicles, the traditional indicator supporting the likelihood that investors possess the financial sophistication to protect their own interests, thus minimizing the need for state oversight. The exemption is intended to minimize regulatory burdens to an asset class that provides a critical source of funding for private California companies, while ensuring adequate investor protection through minimum standards and annual reporting.

As explained in the Department’s emergency rulemaking, venture capital funds, provide a crucial source of financing for California start-up companies, which benefits the California start-up labor market (available at: [http://www.corp.ca.gov/OLP/rulemaking\\_laws.asp#0211](http://www.corp.ca.gov/OLP/rulemaking_laws.asp#0211)).

For example, according to the National Venture Capital Association (“NVCA”), from 2000-2010, Venture-capital funds (“VC Funds”), a subset of “private advisers,” invested \$158 billion into California companies; 51% of these funds come from VC firms headquartered in California (NVCA 2010 data). Thus, California VC funds provide a significant, and often times, exclusive financing mechanism for high-tech start-up

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<sup>6</sup> 15 U.S.C.S. § 80a-3(c)(1) and (7).

<sup>7</sup> Existing Rule 260.204.9 uses the term “venture capital company” (10 C.C.R. Section 260.204.9(b)(3)), while Section 203(l) of the Investment Advisers Act of 1940, as amended, and Rule 203(l)-1 (17 CFR 275.203(l)-1), refer to “venture capital funds.” These definitions contain separate parameters and elements, and accordingly should not be deemed interchangeable. For further background see *Letter from Commissioner Preston DuFauchard to Elizabeth M. Murphy, January 21, 2011*.

companies. This financing benefits California labor markets, since one U.S. job is created for every \$74,846 of venture capital invested in California (NVCA 2010 data). Moreover, these jobs are highly concentrated in software, energy, and biotechnology (NVCA 2010 data).

As the California Corporations Commissioner noted in a recent comment letter to the SEC,

The importance of VC Fund investments in California cannot be overstated. One recent source reports that over forty-five percent (45%) of VC Fund deals in the third quarter of 2010 were located in California. (Silicon Valley – 36.1%; LA/Orange counties – 4.83%; San Diego – 4.8%; and Sacramento/Northern California – .11%) See PwC/NVCA Money Tree Report based on data from Thomson Reuters, 2010 Q3, available at [www.pwcmoneytree.com](http://www.pwcmoneytree.com). New ventures whether in fields of computer technology, biotechnology, clean technology, social media, internet search, mobile technology, and others, all trace their formative stages to California VC Fund investments. (*Letter from Commissioner Preston DuFauchard to Elizabeth M. Murphy, January 21, 2011*)

Additionally, there are long term benefits in financing provided by VC Funds. Public companies headquartered in California that were backed by VC Funds account for 2,822,345 jobs and \$84 billion in revenue (2011 Global Insight Study).

Similarly, private equity funds (PE funds) provide a significant source of capital to California companies. According to the Private Equity Growth Capital Council (PEGCC), there are approximately 1,772 PE backed companies headquartered in California, employing approximately 734,000 workers. (*2010 PEGCC California Fact Sheet*, on file with the Department). PEGCC also reports that during the past ten years, PE firms have invested approximately \$168.3 billion in the California economy. In 2010, 195 companies received approximately \$16.2 billion in PE investment. (*Id.*) Notably, California appears to receive significantly more investments by PE funds than any other state. (*Id.*) Thus, it appears that these asset classes provide significant sources of financing to California capital markets, at times when traditional sources of financing have become more difficult to obtain.

Importantly, under the terms of the proposed exemption, these vehicles would be available exclusively to high-net worth investors that are generally more familiar with the investment risks, strategies, and objectives of these vehicles; and while an investor's net worth does not always correlate to financial sophistication, such investors are generally better equipped to shoulder financial losses. However, in light of recent

frauds targeted at high-net worth investors<sup>8</sup>, the Department proposes to include certain investor and regulatory safeguards as a condition to exemptive relief.

More specifically, in order to satisfy the exemption, advisers are required to:

- Not be subject to statutory disqualifications (“bad boy” provisions).
- File periodic informational notices regarding the characteristics of the adviser and associated private funds.
- Pay the standard investment adviser annual registration fee (\$125).

Additionally, advisers to 3(c)(1) funds, that do not fall within the definition of “venture capital company”, must also comply with the additional requirements. While section 3(c)(7) requires fund investors to be “qualified purchasers” (17 C.F.R. § 270.2a51-1), section (3)(c)(1) funds are generally composed of “qualified clients” or “accredited investors.”<sup>9</sup> Importantly, the financial standard for persons to be deemed “qualified purchasers” is significantly higher than for “qualified clients” (17 C.F.R. § 275.205-3) or “accredited investors” (17 C.F.R. § 230.501). Accordingly, in the absence of the “qualified purchaser” safeguard, the Department proposes to include the following safeguards for investors in 3(c)(1) funds:

- Only “accredited investors” may invest in the private fund.
- Advisers may only charge performance fees to persons deemed “qualified clients.”
- Advisers must provide specified financial and organizational disclosures to fund investors.

Lastly, In order to allow such persons to determine how DOC rules will ultimately affect their registration status, it is necessary to provide sufficient time for regulated persons to analyze the final rules and prepare any required application materials. Accordingly, the proposed rule contains an extension of the current exemptive regime, as well as a “grandfathering” provision for certain 3(c)(1) funds formed prior to the promulgation of the rule.

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<sup>8</sup> Desist and Refrain Order (D&R), dated May 13, 2011, issued by the Department to Structured Investments Co., LLC, *et al.*; D&R, dated August 23, 2011, issued by the Department to Glenn R. Wilson, ABW Property Partners #9 L.P. *et al.*; D&R, dated March 26, 2008, issued by the Department to Norman Frank Reed a.k.a. Bob Reed, SmartWear Technologies, Inc.; D&R, dated February 11, 2009, issued by the Department to CanAm Capital Corp., *et al.*; D&R, dated November 4, 2010, issued by the Department to U.S. Biofuels, Inc., *et al.*; D&R, dated, August 11, 2011, issued by the Department to R.E. Loans, LLC *et. al.*; Plea of Guilty, People v. Gina Michelle Mcgee, Plea of Guilty, Superior Court of California, County of Marin (Case No. SC170537B) dated June 2, 2011. See also SEC Release No. IA-2876, p. 7, May 20, 2009.

<sup>9</sup> While section 3(c)(1) does not contain a minimum financial standard for fund investors, minimum financial standards are generally required through the applicability of the Securities Act of 1933, as amended, and/or the Investment Advisers Act of 1940, as amended.

## ECONOMIC IMPACT GOVERNMENT CODE SECTION 11346.2(b)(5)

The Commissioner has made an initial determination that the proposed regulatory action for requirements will not have a significant adverse impact on business, and may on the contrary have a positive impact on capital markets. The Department has not relied upon any other reports or facts to support the initial determination that the regulation will not have a significant adverse economic impact on business.

## TECHNICAL, THEORETICAL AND/OR EMPIRICAL STUDIES, REPORTS OR DOCUMENTS

Other than reports cited in the "Discussion" section, the Department did not rely upon any technical, theoretical, or empirical study, report, or other similar document in proposing this regulatory action. These reports are on file with the Department.

## ALTERNATIVES TO THE REGULATORY ACTION AND REASONS FOR REJECTING THOSE ALTERNATIVES

No reasonable alternatives considered by the Department or that have otherwise been identified and brought to the attention of the Department would be more effective in carrying out the purpose for which the regulation is proposed.

The proposed regulation implements a temporary extension to an existing exemption in order to permit the continued consideration of registration requirements, therefore no alternatives were considered.

## ALTERNATIVES TO THE REGULATORY ACTION THAT WOULD LESSEN ANY ADVERSE IMPACT ON SMALL BUSINESSES

No reasonable alternative considered by the Department or that have otherwise been identified and brought to the attention of the Department would be as effective and less burdensome to affected private persons, or would lessen any adverse impact on small business.

## REPORT REQUIREMENT

This proposed rulemaking action sets forth an exemption upon condition of the filing of a report. In accordance with Government Code Section 11346.3(c), the Department finds that the report is necessary for the health, safety, or welfare of the people of the state.