REVISED FINAL STATEMENT OF REASONS
FOR THE ADOPTION OF RULES UNDER THE
CORPORATE SECURITIES LAW OF 1968

As required by Section 11346.9 of the Government Code, the California Corporations Commissioner ("**Commissioner**") sets forth below the reasons for the adoption of Section 260.204.9 of Title 10 of the California Code of Regulations (10 C.C.R. Section 260.204.9) ("**Final Rule**").

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., "**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.[1] Previously, the Department, by regulation, conferred an exemption from state regulation for investment advisers that satisfied a federal exemption,[2] but that federal exemption expired July 21, 2011.[3] 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.[4] In this rulemaking action, the Department adopts 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) ("**3(c)(1) Funds**") and/or 3(c)(5) ("**3(c)(5) Funds**") of the Investment Company Act of 1940 ("**ICA**").[5] The exemption is based on the North American Securities Administrators Association ("**NASAA**") *Model Rule for Exempt Reporting Advisers*, ("**Model Rule")** adopted December 16, 2011. *Available at:* http://www.nasaa.org/wp-content/uploads/2012/01/NASAA-Registration-Exemption-for-Investment-Adviser-to-Private-Funds-Model-Rule.pdf.

The emergency regulations were re-adopted on January 18, 2012 and April 17, 2012. The notice of proposed rulemaking for the permanent regulations was published in the Notice Register on January 6, 2012. The Department extended the original comment period date from February 20, 2012, to March 25, 2012. The Department received numerous comments and amendments were made to the original proposed text ("**Initial Proposal**"). On June 18, 2012, the Department made the amendments available for a 15-day comment period ("**Amended Proposal**"). The Department received comments during the 15-day comment period, however, no substantive amendments were made to the Amended Proposal.[6]

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[1] Cal. Corp. Code § 25230.
[2] 15 U.S.C.S. § 80b-3, as in effect prior to July 21, 2011.
[3] Pub. L. No. 111-203.
[4] Cal. Code Regs. tit. 10, § 260.204.9.
[5] 15 U.S.C.S. § 80a-3(c)(1) & (5).
[6] Although not a substantive change, the Department has added language to fully clarify that the financial statement delivery requirement in subsection 3(c)(A) is an annual requirement. The Model Rule and

DISCUSSION

By way of background, on July 21, 2010, President Obama signed *The Dodd-Frank Wall Street Reform and Consumer Protection Act* ("**Dodd-Frank**") into law.[7] 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)**" or "**Private Adviser Exemption**") of the Investment Adviser Act of 1940 ("**Advisers Act**").[8]

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 ICA but for Section 3(c)(1) or 3(c)(7) (the latter hereinafter referred to as "**3(c)(7) Funds**") of that act.[9] 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,[10] or (2) manage less than $150 million of assets.[11] These advisers are referred to as Exempt Reporting Advisers ("**ERA**").

In California, investment advisers previously exempt under Section 203(b)(3) of the Advisers Act have a corollary temporary exemption from 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 (the state and federal exemptions are hereinafter collectively referred to as the "**Private Adviser Exemption Regime**").[12] This exemption expires on July 17, 2012. Accordingly, the Commissioner is adopting a

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Department proposals clearly state that the private fund adviser must prepare financial statements on an annual basis and require corresponding delivery of "such" financial statements to investors, thus referencing the annual preparation requirement; the language regarding the fund's first fiscal year (i.e., 120 day delivery requirement) merely represents the commencement of the reporting requirement.

[7] *Supra* note 3.

[8] 15 U.S.C.S. § 80b-3.

[9] 15 U.S.C.S. § 80a-3(c)(1) & (7).

[10] 17 C.F.R. § 275.203(l)-1.

[11] 17 C.F.R. § 275.203(m)-1.

[12] Existing Rule 260.204.9 uses the term "Venture Capital Company" (Cal. Code Regs. tit. 10 § 260.204.9(b)(3)), while Section 203(l) of the Investment Advisers Act of 1940, as amended, and Rule 203(l)-1 (17 C.F.R. 275.203(l)-1), refer to "Venture Capital Funds." For further background *see Letter from Commissioner Preston DuFauchard to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, January 21, 2011;* submitted in response to SEC Release No. IA-3111). Importantly, the Final Rule expands the definition of the term *Venture Capital Company* to include corresponding federal definitions.

permanent successor exemption to replace the expiring regulation. This exemption is generally predicated on the high financial net worth of investors in these vehicles, which is 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 on an asset class that provides an increasingly critical source of funding for private California companies, while providing for robust investor protection through investment disclosures and annual financial 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 labor market.[13]

For example, according to the National Venture Capital Association ("**NVCA**"), from 2002 through 2011, Venture-capital funds ("**VC Funds**"), a subset of private advisers, invested $132 billion into California companies; 50% of these funds came from venture capital firms headquartered in California.[14] Thus, California VC Funds provide a significant, and often times, exclusive financing mechanism for high-tech start-up companies. This financing benefits California labor markets, since one U.S. job is created for every $74,846 of venture capital invested in California.[15] Moreover, these jobs are highly concentrated in software, energy, and biotechnology.[16]

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 $846 billion in revenue.[17]

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 1,777 private equity backed companies headquartered in California, employing approximately 746,800 workers (including employees located outside California).[18] PEGCC also reports that from 2002-2011, PE Funds have invested approximately $180.1 billion in California-based companies. In 2011, 214 companies received approximately $15.7 billion in private equity investment.[19] Notably, California appears to receive 10.9% of all U.S. private equity investments.[20]

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. Accordingly, the exemption would likely benefit California capital and labor markets. In turn, these markets significantly and directly impact the general

[13] Available at: http://www.corp.ca.gov/OLP/rulemaking_laws.asp#0211.
[14] *Venture Capital and Entrepreneurship in California*, NVCA, 2012.
[15] *Id*.
[16] *Id.*
[17] 2011 *Global Insight Study.*
[18] 2011 *PEGCC California Fact Sheet*.
[19] *PEGCC Geographic Dispersion of Private Equity Investment in 2011.*
[20] *Id*.

welfare of California residents.

Importantly, under the terms of the exemption, these vehicles would be available primarily to high-net worth investors[21] 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,[22] the Final Rule includes 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 (frequently referred to as "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, investment advisers to 3(c)(1) and 3(c)(5) Funds that do not fall within the definition of "Venture Capital Company," ("**Retail Buyer Funds**") must also comply with heightened safeguards.[23] Section 3(c)(7) requires fund investors to be deemed qualified purchasers as that term is defined under federal law.[24] In contrast, Retail Buyer Funds are generally composed of qualified clients or accredited investors.[25] Importantly, the financial standard for persons to be deemed qualified purchasers is significantly higher than for qualified clients[26] or accredited investors.[27]

Accordingly, in the absence of the "qualified purchaser" safeguard, the Department

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[21] Certain persons that are professionally associated with the adviser (e.g., employees of the investment adviser) may also invest in these funds, since such persons are likely to have an understanding of the nature and risks of the investment.

[22] 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.

[23] Retail Buyer Funds that also satisfy Section 3(c)(7) are not required to comply with the heightened safeguards.

[24] 17 C.F.R. § 270.2a51-1.

[25] While sections 3(c)(1) and 3(c)(5) of the ICA do not contain minimum financial standards for fund investors, minimum financial standards are generally required through the applicability of the Securities Act of 1933, as amended, and/or indirectly through the Advisers Act, as amended.

[26] 17 C.F.R. § 275.205-3.

[27] 17 C.F.R. § 230.501.

includes the following heightened safeguards for investors in retail buyer funds:

- Only persons that meet the accredited investor standard, or persons that are professionally associated with the adviser as specified in the rule, may invest in the Retail Buyer Fund.
- Advisers may only charge "performance fees" to qualified clients.
- Advisers must provide audited financial statements annually to fund investors.[28]
- Advisers must provide material disclosures regarding the fund and the nature of the advisory relationship between the investment adviser and fund investors.[29]

Lastly, In order to allow such persons to determine how the Final Rule will ultimately affect their registration or exemptive status, it is necessary to provide sufficient time for regulated persons to analyze the final rules and prepare any required application materials. Accordingly, the Final Rule contains a temporary extension of filing requirements, as well as a "grandfathering" provision for certain Retail Buyer Funds formed prior to the promulgation of the Final Rule.

DETERMINATION UNDER GOVERNMENT CODE SECTION 11346.9(a)(2)

The Commissioner has determined that the adoption of the regulation does not impose a mandate on local agencies or school districts, which require reimbursement

[28] The Final Rule requires that financial audits be performed by firms that are registered with, and subject to regular inspection by the Public Company Accounting Oversight Board ("**PCAOB**"). The PCAOB requirement is already applicable to many private funds as part of federal custodial requirement, and has been included in a corresponding California proposal (PRO 04/11, *Custody or Possession of Client Funds or Securities of Clients*, Invitation for Comments, July 8, 2011) ("**Proposed Custody Rule**"). As explained in more detail in the SEC's adopting release regarding custodial requirements, PCAOB registration likely leads to "greater confidence in the quality of the surprise examination and the internal control report when prepared by an independent certified public accountant that is registered with, and subject to regular inspection by the PCAOB." (SEC Release No. IA-2968, December 30, 2009, p. 36.) Importantly, under the SEC rule, "an adviser's use of an independent public accountant that is registered with the PCAOB but not subject to regular inspection would not satisfy the rule's requirements." (*Id*. at note 122.) This requirement would also apply to the Final Rule.

[29] In contrast to the Initial Proposal, the Amended Proposal and the Final Rule set forth a "materiality" threshold regarding any disclosures to be made to Retail Buyer Fund investors. This threshold is designed to promote a distilled disclosure regime, where crucial investment features are fully and prominently disclosed. The Department emphasizes that disclosures provided pursuant to the exemption should be specifically tailored to fund investors; accordingly, the use of plain English, and avoidance of "boilerplate" disclosures is strongly encouraged. Moreover, in addition to affirmative disclosures, the inclusion of negative disclosures (e.g., regarding obligations or duties to fund investors) are required insofar as they ensure that investors have ample notice regarding who the "client" of the investment adviser is, and what legal consequences flow from that advisory relationship (or lack thereof). The Department emphasizes, and concurs with the California Hedge Fund Association Letter, that the primary function of the disclosures will be to ensure that investors are on notice that the investment adviser owes generally owes duties to the fund, as an entity, rather than to individual investors. Lastly, in response to the Gunderson Letter, the Department views the disclosures as intended to provide critical contractual or legal disclosures, rather than merely listing every conceivable duty.

pursuant to Part 7 (commencing with Section 17500) of Division 4 of the Government Code.

ALTERNATIVES CONSIDERED

In accordance with Government Code Section 11346.9(a)(4) other than those alternatives raised by public commenters during the rulemaking comment periods, no alternatives were considered by or brought to the attention of the Department which would be more effective in carrying out the purpose for which this regulation is proposed. For a description of information supporting the Department's adoption or rejections of alternatives raised by the public commenters during the rulemaking comment periods, see Comments Received During the Initial and 15-Day Comment Periods below.

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.

ECONOMIC IMPACT ANALYSIS/ASSESSMENT

The Commissioner has made an initial determination that the regulatory action will not have a significant adverse impact on business, and may on the contrary have a positive impact on capital and labor markets. In light of the importance of California capital and labor markets, the regulation would also likely positively impact the health and welfare of California residents. Although there may be costs associated with the preparation of disclosures or financial statements, the Department understands that such costs are: (1) less than the costs associated with investment adviser registration, and/or (2) are already required to be prepared pursuant to other securities laws, or contractual obligations with fund investors.

Other than the reports cited in the "Discussion" section, 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, or any other impact described in Government Code Section 11346.3.

ADDENDUM, REGARDING PUBLIC COMMENTS

The Notice of Rulemaking Action and the Initial Statement of Reasons were amended on January 3, 2012, to comply with the requirements of Senate Bill 617 (Chapter 496, Statutes of 2011) which amended the Administrative Procedure Act.

The Department published a Notice of Proposed Action in the January 6, 2012 edition of the California Regulatory Notice Register (Register 2012, No. 1-Z, page 3) concerning a Private Fund Adviser Exemption. The original comment period deadline was February 20, 2012.

The Department extended the public comment period deadline to March 25, 2012. No request for hearing was received during the original comment period and the extended comment period.

COMMENTS RECEIVED DURING THE INITIAL COMMENT PERIOD

The Department received 13 public comment letters during the initial public comment period. Those comments are summarized below, together with the Department's response.

1. Commentor: E-mail letter dated January 11, 2012, from Sean Caplice with Gunderson, Dettmer Stough, Villeneuve, Franklin & Hachigian, LLP ("**Gunderson Letter**").

Comment No. 1: Commentor suggests clarifying the definition of a 3(c)(1) Fund.

> Response: The Department has revised the Final Rule to reflect the concerns raised in this letter. Specifically, the rule has been clarified to state that 3(c)(1) funds are those that exclusively qualify for the 3(c)(1) exemption from the ICA.

Comment No. 2: Commentor suggests broadening the definition of the term "Venture Capital Company" to include similar and/or corresponding federal definitions. Specifically, Commentor suggests including similar SEC and U.S. Department of Labor Definitions.

> Response: In light of certain similar definitional parameters, and generally consistent policy aims, the Department has expanded the definition of the term "Venture Capital Company" to include the SEC and Department of Labor definitions.

Comment No. 3: Commentor suggests broadening the pool of eligible persons (even though those persons may not meet the accredited investor standard) that may invest in a 3(c)(1) fund, to include (1) certain staff of the fund (or an affiliate of the adviser), and (2) persons receiving an interest in the fund as a result of the original investor's death, divorce, legal separation or bona fide gifting.

> Response: The Department has revised the proposal to fully clarify that ownership by certain staff persons that do not meet the accredited investor standard, or transfer of an investor's interest as a result of the original investor's death, divorce, legal separation or bona fide gifting would not be a bar to exemptive treatment.

Comment No. 4: Commentor suggests that the exemption's disclosure requirements result in vague, unnecessary and confusing obligations. Commentor recommends clarifying the terms "services", "duties", and "material information" and providing additional guidance regarding the specific requirements of such disclosure items.

> Response: In response to the concerns raised by Commentor, the Department has clarified the scope and extent of the required disclosures most notably by

included a “materiality” threshold, and providing general guidance in this document.[30] The Final Rule has also been revised to clarify instances (such as the examples cited by Commentor) when these disclosures are not required to be met. Lastly, the Department concurs with Commentor that the intent of the rule is not to encourage laundry list boilerplate disclosures. Instead, the rule aims to provide key distilled disclosures.

Comment No. 5: Commentor suggests allowing a waiver of the financial audit requirement if a majority of the fund investors waive this requirement.

Response: The Department deems the financial audit requirement a key condition to exemptive treatment. Furthermore, while the financial audit provides fund financial information to investors, it also serves a strong regulatory oversight purpose, by providing the Department, as necessary, with a financial tool to review fund financial transactions. Consequently, the audit requirement may not be waived by a majority of (or even all) fund investors. The audit requirement provides a meaningful safeguard that will promote financial transparency for investors and the Department. In this respect, similar to the proposed Custody Rule[31] the Department is requiring that financial audits be performed by CPAs that are registered with, and subject to regular inspection by the PCOAB.

Comment No. 6: Commentor suggests clarifying that the limitations set forth in Rule 260.234 are not applicable to venture capital entities.

Response: The Department has revised the proposal to fully clarify that the performance fee limitation does not apply to a venture capital entity.

Comment No. 7: Commentor recommends amending the subdivision (h) grandfathering provision to make it available to all 3(c)(1) Funds that existed prior to the effective date of this regulatory action.

Response: See response to Comment No. 3 of Commentor 7, of the Seward Letter.

2. Commentor: E-mail letter dated February 8, 2012, from Matthew Schwartz with Financial Services Institute, Inc. (“**FSI”**).

Comment No. 1: Commentor recommends amending the proposed regulatory action to adopt the entire NASAA Model Rule including adoption of the “qualified client” minimum for 3(c)(1) funds, and the adoption of the SEC’s definition of “Venture Capital Fund.” Commentor further states that by adopting the entire NASAA Model Rule aids in creating a uniform regulatory framework in the states and removes compliance hurdles for firms subject to this regulatory action.

Response: While the Department agrees with FSI that increased uniformity among blue-sky laws provides for a more efficient legal framework, California has

[30] *Supra* note No. 29.
[31] *Supra* note No. 28.

deviated from the NASAA Model Rule in that the proposal would allow accredited investors (and under some circumstances persons that do not meet the accredited investor standard)[32] to invest in 3(c)(1) Funds managed by exempt advisers. This standard provides flexibility for fund managers that wish to allow staff that do not meet the qualified client or accredited investor standards (either because they do not meet the financial criteria, or because they do not meet the parameters of eligible employees) to invest in a fund. Importantly, these individuals may not be charged performance based fees; accordingly, there is a strong financial disincentive for advisers to allow persons that do not meet the qualified client standard to invest in a Retail Buyer Fund. While the Final Rule deviates from the Model Rule, it does so by providing more flexibility, and thus any adviser who meets the exemption in the Model Rule would be eligible for the California exemption. Moreover, the deviation does not unnecessarily complicate the structure of the rule; and thus, we do not anticipate that the deviation will cause confusion in this respect.

In response to FSI's, and others', concerns regarding the need for uniformity when defining venture capital-type entities, the Department has amended the proposal to also include the definition of "Venture Capital Fund" as defined by the SEC.[33]

3. Commentor: Letter dated February 10, 2012, from Charles Flynn with Marin Mortgage Bankers.

Comment No. 1: Commentor is licensed by the Department of Real Estate and currently issues securities that are exempt from qualification requirement under Section 25102.5 and the exemptions provided in Sections 25102(f) and 25102.1(d) of the Corporate Securities Law. Commentor is concerned that the proposed regulatory action will require licensed real estate brokers to register as investment advisers because the mortgage loans that they fractionalize or manage through funds fall within the definition of “securities” under Section 25019 of the Corporations Code. Commentor recommends amending the proposed regulations to provide an exemption from registration as an investment adviser applicable to licensed California real estate brokers and their agents.

Response: See Response to Comment No. 1 of Commentor 11, the CMA Letter.

4. Commentor: E-mail letter dated March 12, 2012, from Gerald Lopatin.

Comment No. 1: Commentor states that the proposed temporary exemption timeframe is insufficient and recommends that the exemption be extended to June 28, 2013 to provide an adequate amount of time for the transition period.

Response: To ensure that affected persons had sufficient time to familiarize themselves with the final rule, and to allow the Department to fully study how best to regulate this class of advisers, the Department extended the private

[32] *See* response to the Gunderson Letter.
[33] *Id.*

adviser exemption[34] until July 16, 2012. Furthermore, the Final Rule provides for further filing extensions and grandfathering provisions.

5. Commentor: E-mail letter dated March 15, 2012, from Matthew Giles with Goodwin Procter ("**Goodwin Letter**").

Comment No. 1: Commentor recommends amending the definition of qualifying private fund to mean an issuer that qualifies for the exclusion from the definition of an investment company under one or both of section 3(c)(1) and section 3(c)(7) of the ICA rather than limiting the proposed regulatory action to advisers that rely on SEC Rule 203(m)-1. Commentor provided language that would clarify the scope of the existing proposal.

Response: In order to fully clarify the scope of eligible funds, the Department adopts Commentor's suggested language (subject to certain changes as a result of the expansion of the exemption to 3(c)(5) Funds).

6. Commentor: Letter e-mailed and facsimile dated March 25, 2012, from Andrew Springer with Resolve, Inc.

Comment No. 1: Commentor states the proposed regulatory action does not adequately protect investors in 3(c)(1) Funds and that it fails to meet the legislative intent of Dodd-Frank, in that it provides less transparency and oversight than the Private Adviser Exemption Regime. Accordingly, Commentor recommends the department amend the proposed regulatory action to apply exclusively to investment advisers of 3(c)(7) Funds, which will require all advisers to 3(c)(1) Funds not registered with the SEC to apply for a license from the Department.

Response: In contrast to the Private Adviser Exemption Regime, the Final Rule would result in increased financial transparency, oversight and investor safeguards, and consequently the Commissioner has determined that the Final Rule adequately balances a moderate level of regulatory oversight over 3(c)(1) Funds (and Retail Buyer Funds generally) with the competing need of facilitating a critical source of funding for private California companies. The Private Adviser Exemption Regime failed to include any reporting requirements, statutory disqualifications, mandatory disclosures or direct limitations on investor characteristics (e.g. even a limited number of non-accredited investors could participate in these offerings), while the current proposal would increase contractual and financial transparency and include significant investor safeguards. Nevertheless, Commentor rightfully emphasizes the need for increased transparency in this asset class; and in response to this and other comments[35]; the Amended Proposal and Final Rule include a requirement that financial audits be performed by PCAOB firms.

With regard to advisers to 3(c)(1) and 3(c)(5) Funds exemption eligibility, we emphasize that such eligibility is conditioned on the strict compliance with the heightened standards set forth in the exemption.

[34] Cal. Code Regs. Tit. 10, CCR § 260.204.9.

[35] *See* California Hedge Fund Association Letter.

Commentor also notes that the accredited investor or qualified client standards do not indicate financial sophistication on the part of investors. The Department concurs with this statement, insofar as the inclusion of any net worth standard is not a perfect proxy for financial sophistication. This is true regardless of the standard that is employed (e.g., qualified purchaser). However, the standards' wide use across state and federal securities laws; convenience, predictability and clarity for investors, issuers and investment advisers; and recent enhancements as a result of Dodd-Frank, result in the metric being a more realistic proxy for sophistication than any other known standard. In general, the proposal seeks to ensure that only investors that are generally capable of shouldering the financial risk of the offerings are permitted to participate in the offerings, while allowing this segment of the capital markets to develop. In this respect, and in the context of the exemption more generally, the Department seeks to achieve an optimum balance between investor protection and overly intrusive regulations.

Lastly, the Department will continue to closely study this sector to ensure that the current safeguards provide sufficient protection to investors in these funds. In particular, the Department will consider whether the application of certain rules applicable to registered investment advisers should be amended to be applicable to exempt advisers.

7. Commentor: E-mail letter dated March 26, 2012, from Robert Van Grover with Seward & Kissel LLP ("**Seward Letter**").

Comment No. 1: Commentor recommends amending the proposed regulation to permit a limited number of investors who may not meet the financial requirements of the accredited investor standard but who are knowledgeable and experienced in financial and business matters to invest with an exempt adviser without causing the exempt adviser to be required to obtain a certificate under Corporations Code Section 25230(a). Commentor father suggest limiting the exempt advisers to no more than 35 investors in each 3(c)(1) fund that are not accredited investors.

Response: As discussed in the Initial Statement of Reasons and in the response to the ABA Letter, the Department views the exemption for registration as conditioned on increased investor safeguards; one of the critical safeguards is the financial suitability standards set forth directly (i.e., accredited investor, qualified purchaser) and indirectly (i.e., qualified client) in the Final Rule. The ability to financially shoulder the risk inherent in these investment classes amply justifies a minimum financial standard. Additionally, we note that the Final Rule deviates from the NASAA Model Rule in that, in the interest of flexibility for fund managers, it permits accredited investors to participate in these private funds (so long as they are not charged a performance fee). The Final Rule also provides flexibility to advisers in regard to incentivizing staff, by allowing certain staff persons that do not meet the accredited investor standard to invest in the fund (see response to the Gunderson Letter).

Comment No. 2: Commentor recommends the proposed regulation should permit exempt advisers to receive performance-based compensation regardless of whether investors are qualified clients.

Response: The prohibition on performance fees will significantly increase clarity and consistency in this investment class, by ensuring that exempt advisers are subject to the same compensation structure limitations as registered investment advisers.

Comment No. 3: Commentor recommends the proposed regulation should permit exempt advisers to receive performance-based compensation from existing investors on a grandfathered basis.

Response: With regard to Section III of the Comment Letter, the Department understands the Commentor's concerns regarding existing contractual arrangements and accordingly has significantly revised the "grandfathering" provisions to ensure that existing funds are allowed to continue operating under existing compensation structure.

8. Commentor: E-mail letter dated March 25, 2012, from Christopher Ainsworth with Maerisland Capital, LLC on behalf of the Public Policy Committee of the California Hedge Fund Association ("**California Hedge Fund Association Letter**").

Comment No. 1: Commentor recommends amending the definition of 3(c)(1) Fund to be consistent with the approach the SEC took in describing 3(c)(1) Funds in Rule 205-3 under the Advisers Act.

Response: See response to Comment No. 1 of Commentor 1, the Gunderson Letter.

Comment No. 2: Commentor states that recent amendments to the definition of accredited investor in Rule 501(a) of Regulation D under the Securities Act of 1933 could create confusion regarding which definition must be applied to which investors. Commentor recommends amending the accredited investor definition in subdivision (c)(1) of Section 260.204.9.

Response: In order to promote clarity regarding which version of the accredited investor standard to apply. Commentor's suggested language has been included in the Final Rule.

Comment No. 3: Commentor suggests that the disclosure requirements in subdivision (c)(2) of Section 260.204.9 of the proposed regulation are unclear and would not provide any investor protections that are not already provided by other securities laws and regulations.

Response: The Department has amended the disclosure requirements in light of this and other comments. The Final Rule clarifies disclosure requirements, as stated in response to the Gunderson Letter.[36]

Comment No. 4: Commentor suggests adding additional requirements to the proposed financial audit requirement in subdivision (c)(3) of Section 260.204.9.

Response: In light of the added clarity and quality of the financial audits that would result from adopting the Commentor's suggestions, the comments regarding financial audit requirements and procedures are adopted in their entirety. In order to balance the cost of requiring the PCOAB audit requirement, the Final Rule provides that financial audits should be provided after the fund's first full fiscal year. However, as noted in the comment letter, the audit of the first fiscal year will be required to cover the short year.

Comment No. 5: Commentor suggests amending the grandfathering provisions to apply to the requirement in subdivision (c)(4) of Section 260.204.9 that exempt 3(c)(1) Fund advisers from complying with the performance-based compensation.

Response: See response to Comment No. 3 of Commentor 7, the Seward Letter.

9. Commentor: E-mail letter dated March 25, 2012, from Kerry Parker with California Hedge Fund Association. Kerry Parker's letter is the same letter the Department received from Christopher Ainsworth.

Response: See comments and responses to Commentor 8, the California Hedge Fund Association Letter.

10. Commentor: E-mail letter dated March 26, 2012, from Keith Bishop on behalf of the American Bar Association Committee ("**Committee**") on State Regulation of Securities ("**ABA Letter**").

Comment No. 1: Commentor states that the definition of advisory affiliates is unclear and should be amended to meet the clarity standard set forth in Government Code Section 11349(c). With respect to sections II, IV, VII and VIII of the Committee's comment letter, the Committee identified a number of instances where the Initial Proposal lacked clarity. The Committee provided language to remedy the areas of possibly confusion addressed in sections II, IV, VII and VIII of the Committee's comment letter.

Response: The text of the exemption has generally been amended in the manner suggested by the Committee. The Final Rule adopts much of the Committee's language verbatim.

Comment No. 2: Commentor recommends amending the disqualification requirement in the proposed regulation because it is far broader than SEC Rule 262 and would make it difficult, if not impossible, for investment advisers to determine with certainty whether they and their advisory affiliates can rely on the exemption.

[36] *See* response to Comment No. 4 of the Gunderson Letter.

Response: The statutory disqualification provisions included in the Final Rule mirror those included in a recent broker-dealer safe harbor,[37] and thus promote consistency among California "bad boy" provisions. Moreover, it is reasonable for the Department to condition a registration exemption on the investment adviser not engaging in activity that gives rise to potential disciplinary action. In order to increase investor safeguards, the reduced regulatory oversight requires that eligible investment advisers have conducted their business in a legal manner. However, the Department will monitor this element of the exemption to study whether any regulatory changes are required in this respect. The Department notes that for purposes of determining eligibility under the Final Rule, but not for purposes of interpreting Section 25232 more generally, the terms "violation" or "violated" would require a finding by a court or regulatory agency.

Comment No. 3: Commentor suggests that the renewal fee is unclear as to what "it" is referring to. Commentor recommends amending the renewal fee for clarity.

Response: See Response to Comment No. 1 of Commentor 10, the ABA Letter.

Comment No. 4: Commentor suggests that the disclosure requirements are vague, overbroad, and will create uncertainty. Commentor recommends amending the disclosure requirements so not to condition the availability of the exemption on satisfaction of specific disclosure requirements.

Response: The Department has revised the language to provide greater clarity surrounding the content and scope of the required disclosures. These supplemental disclosure requirements will provide a meaningful informational tool for fund investors, and thus, remain a condition of the revised exemption. *See also* note No. 29.

Comment No. 5: Commentor states that it is unclear whether the proposed ban on performance compensation, except as permitted under Corporations Code Section 25234(a)(1) and Rule 260.234, only applies to 3(c)(1) Funds or all funds advised by the private fund adviser. Commentor recommends that the exemption for advisers to these funds not be conditioned upon the non-receipt of performance compensation.

Response: The Final Rule fully clarifies that the prohibition on performance compensation applies to individual funds that have at least one investor that does not meet the qualified client standard. The prohibition does not carry-over to other funds advised by the exempt adviser. However, the performance fee limitation is included in the Final Rule as it serves to financially incentivize managers to exclusively allow investors that meet the qualified client standard into the fund. We emphasize that the Final Rule deviates from the NASAA Model Rule in that it allows persons that only meet the accredited investor standard to invest in these funds. This deviation was created to allow flexibility for advisers with regard to providing employment compensation incentives. However, the Department anticipates that the qualified client standard will serve indirectly as

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[37] Cal. Code Regs. tit. 10, § 260.004.1.

the default standard for participation in a Retail Buyer Fund.

Comment No. 6: Commentor recommends amending the definition of qualified private fund to be identical to the definition provided for in Rule 203(m)-1 under the Advisers Act.

Response: See Response to Comment No. 1 of Commentor 10, the ABA Letter.

Comment No. 7: Commentor states that the grandfathering provision would prohibit a number of advisers from relying on the exemption because their funds include beneficial owners that are not qualified clients as suggested by the title. Commentor points out that the SEC recently adopted a broad grandfathering provision in Rule 205-3(c) under the Advisers Act. Commentor recommends amending the grandfathering provision to provide that investment advisers to 3(c)(1) Funds (other than venture capital companies) are eligible for the private adviser exemption so long as the subject fund existed prior to the effective date of the regulation.

Response: See Response to Comment No. 1 of Commentor 10, the ABA Letter.

11. Commentor: E-mail letter dated March 26, 2012, from K. Bradley Rogerson with Stein & Lubin LLP on behalf of the California Mortgage Association ("**CMA Letter**").

Comment No. 1: Commentor suggests that the Initial Proposal fails to exempt most private real estate lenders in California that fund their mortgage loans through affiliated mortgage funds because many private mortgage funds will be unable to meet the requirements of Section 3(c)(1) or 3(c)(7) of the ICA. Commentor further states that historically private real estate lenders have been exempt from the certification requirements applicable to investment advisers under existing Section 260.204.9. Commentor recommends amending the proposed regulation to exclude private real estate lenders from the certification requirements.

Response: The Initial Proposal would have applied exclusively to investment advisers that advise 3(c)(1) Funds and/or 3(c)(7) Funds. Both of these exclusions from the ICA include limitations on public offerings of the fund's securities; thus, the use of the term "private" when describing, or in some cases defining, these vehicles. In contrast, Section 3(c)(5) of the ICA, which many real estate-oriented fund advisers rely on, does not contain a similar public offering limitation. The Initial Proposal, like the corresponding NASAA and SEC rules, was intended to provide registration relief to funds that are not publicly marketed. Historically, exemptive treatment (whether in the context of investment adviser/company registration, or securities offerings) has frequently been conditioned on the lack of public marketing of securities or advisory services[38] (or

[38] In the SEC's 2004 ultimately unsuccessful attempt at private fund registration, staff noted that: "in the context drafting the 3(c)(7) exclusion, for companies whose investors have an extremely high net worth, Congress, in the context of the 1996 National Securities Markets Improvement Act of 1996 (NSMIA) (143 Pub L. No. 104-290, 110 Stat. 3416 (1996), codified in scattered sections of the United States Code) left intact the public marketing prohibition." (Registration Under the Advisers Act of Certain Hedge Fund Advisers, SEC Release IA-2333 (2004), at note 143.)

numerical limitations on the number of purchasers/clients).[39] Consequently, 3(c)(5) Funds were not included in the pool of eligible funds, based on the lack of a "private" definitional element.

However, pursuant to post-Dodd-Frank federal legislation,[40] offerings conducted under Rule 506 of Regulation D may be made through general solicitation without being considered public offerings for purposes of federal law.[41] This is a significant deviation from longstanding historical requirements. It is the Department's understanding that private funds frequently rely on Rule 506 to issue securities. Thus, one of the important limitations of the Sections 3(c)(1) and 3(c)(7) ICA exclusions has been significantly narrowed. Accordingly, it would appear that one of the primary policy reasons for excluding 3(c)(5) Funds from the scope of the exemption has been significantly diluted.

In response to the CMA's Letter, and the passage of the JOBS Act, the Final Rule exempts 3(c)(5) Funds. However, advisers and their respective funds will be required to comply with the heightened safeguards applied to Retail Buyer Funds. For example, a 3(c)(5) Fund that primarily invests in real estate or in instruments secured by real estate will be required to obtain financial audits on an annual basis.

12. Commentor: E-mail letter dated March 26, 2012, from Lexi Howard with California Mortgage Association. Lexi Howard's letter is the same letter the Department received from K. Bradley Rogerson.

Response: See comments and responses to the CMA Letter, Commentor 11.

13. Commentor: E-mail letter dated March 26, 2012, from Eric Brill, Esq.

Comment No. 1: Commentor is supportive of efforts to broaden the exemption, by moving away from the "asset under management" ("**AUM**") distinction contained in an earlier proposal.[42] The Department's shift from an AUM-based requirement to a standard that instead looks to the fund investor characteristics is based on Commentor's[43] and other earlier comments.

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[39] SEC Staff also noted that, "the legislative history of section 3(c)(1) of the Investment Company Act of 1940 [15 U.S.C. 80a-3(c)(1)], a parallel section to section 203(b)(3) that was enacted at the same time, reflects Congress' view that privately placed investment companies, owned by a limited number of investors likely to be drawn from persons with personal, familial, or similar ties, do not rise to the level of federal interest. See 1940 Senate Hearings, supra note 73 [referencing: Investment Trusts and Investment Companies: Hearings on S.3580 Before the Senate Comm. on Banking and Currency, 76th Cong., 3d. Sess. (Apr. 22-23, 1940)." (*Id*. at note 139.)

[40] On April 5, 2012, President Barack Obama signed the *Jumpstart Our Business Startups* (JOBS) *Act* (H.R. 3606) into law ("**JOBS Act**") (Pub. L. No. 112-106.)Subject to rulemaking by the SEC, Title II of the JOBS Act repeals the prohibition on general solicitation in the context of offerings conducted pursuant to Rule 506 of Regulation D (17 C.F.R. § 230.506).

[41] Title II of the JOBS Act.

[42] Invitation for Comments, PRO 02/11, March 15, 2011, text of the proposal available at: http://www.corp.ca.gov/Laws/CSL/pdf/0211_InvitationText.pdf.

[43] Commentor submitted a comment letter in response to the Department's Invitation for Comments (*see* comment letter from Eric Brill, dated April 11, 2011).

Comment No. 2: Commentor asks: "Why is registration not deemed necessary for an investment adviser to advise a "qualified client" and "accredited investor" who invests in a "private fund," but is deemed necessary if the very same client invests instead through a separate managed account arrangement?

Response: Commentor rightfully emphasizes that the fund investors and managed account clients may have similar financial characteristics, yet only advisers to private funds are eligible for exemptive relief.[44] However, the Department is providing registration relief for certain private funds based on public interest, and more specifically, (1) these funds' direct and significant contributions to California capital market,[45] and (2) to maintain consistency with the regulatory landscape of federal and other states' laws. However, while the funds' contributions appear significant, the Department has included robust investor safeguards to promote transparency and minimize fraud in this asset class.

Additionally, we note that while the contributions (from a capital perspective, investor education, and otherwise) of all investment advisers are significant, and provide an important asset to the California economy, the impact of managed accounts on direct financing for California businesses would likely be more dispersed, and not as readily quantifiable.

In light of the important policy considerations raised by the comment letter, the Department will continue to monitor this issue in the context of investment adviser supervision.

Comment No. 3: Commentor recommends clarifying disclosure requirements.

Response: *See* note No. 29.

COMMENTS RECEIVED DURING THE 15-DAY COMMENT PERIOD

The Department received four public comment letters on the Amended Proposal during the 15-day public comment period, which ended on July 3, 2012. Those comments are summarized below, together with the Department's response.

1. Commentor: E-mail dated July 3, 2012, from Sean Caplice with Gunderson Dettmer Stough Villeneuve Franklin & Hachigian, LLP.

Comment No. 1: Commentor recommends that the Department provide guidance on the disclosure requirements.

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[44] We note that investment advisers to managed accounts frequently provide advisory services with regard to the totality of a client's investable assets; in contrast, in the private fund context, standard investment diversification practices would dictate that investors only commit a portion of their overall financial assets into a specific private fund. Thus, based on the broad impact to an investor's entire portfolio, investment advisers to managed accounts would appear to merit heightened regulatory requirements in this regard.

[45] *See* Discussion, pp. 2-3.

Response: The Department does not view any additional changes to the rule as being required. However, *see* note No. 29 for further clarification on the scope of required disclosures.

Comment No. 2: Commentor suggests that clarification is needed regarding the meaning of the terms "beneficial owner" and "purchaser."

Response: The Final Rule has been clarified in this regard.

2. Commentor: E-mail letter dated July 3, 2012, from K. Bradley Rogerson with Stein & Lubin LLP on behalf of the California Mortgage Association ("**2nd CMA Letter**").

Comment No. 1: CMA expresses support for the revisions to the Initial Proposal.

Comment No. 2: CMA requests the addition of an alternative to the accredited investor standard applicable to Retail Buyer Funds that qualify the offer and sale of their securities with the Department under Corporations Code Sections 25111, 25112, or 25113.

Response: Although Commentor rightfully points out Department's suitability standards contain certain limitations not present in the accredited investor standard (e.g., 10% of the investor's total net worth, exclusion of furnishings and automobiles), the Department views the accredited investor standard as the minimum financial floor for investment in a Retail Buyer Fund. The Department's core financial suitability standards, set forth in detail in Commentor's letter, are generally lower than the accredited investor standard. High-financial net worth is a central condition to the granting of exemptive registration relief. Moreover, as discussed in the response to Comment No. 1 of the Seward Letter, the Department has significantly relaxed financial net worth standards vis-a-vis the Model Rule by allowing accredited investors, and staff of the investment adviser, to invest in Retail Buyer Funds. We also note that even after the Dodd-Frank increases to the accredited investor financial standards, the definition remains sufficiently broad so as to encompass, in 2007, approximately 8.3 million households (7.2% of U.S. households).[46] Accordingly, the Final Rule does not contain an alternative suitability standard.

3. Commentor: E-mail dated July 3, 2012, from John Graziano with BaySierra Financial, Inc. Commentor's e-mail is acknowledging receipt of Bradley Rogerson's letter on behalf of the California Mortgage Association.

4. Commentor: E-mail letter dated July 3, 2012, from Lexi Howard with California Mortgage Association. Lexi Howard's letter is the same letter the Department received from Bradley Rogerson.

Response: See comments and response to the 2nd CMA Letter.

[46] SEC Release Nos. 33-9287; IA-3341; IC-29891, note 72 (December 21, 2011).