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New California Exemption for Investment Advisers to Private Funds

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The California Corporations Commissioner has amended section 260.204.9 of Title 10 of the California Code of Regulations (10 C.C.R. section 260.204.9) (the "Amended Rule") to provide for an exemption for certain advisers to "private funds," provided they (1) have not violated securities laws, (2) file periodic reports with the California Department of Corporations, (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)[1] and/or section 3(c)(5)[2] of the Investment Company Act of 1940, as amended (the "Investment Company Act") (these additional safeguards do not apply to funds organized under section 3(c)(7)[3] of the Investment Company Act). The Amended Rule is effective as of August 27, 2012 (the "Effective Date").

The initial report as referenced in clause (2) above and as further described below must be filed no later than 60 days from the Effective Date (i.e., no later than October 26, 2012).

Prior Exemption

Prior to The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), under section 203(b)(3) of the Investment Adviser Act of 1940, as amended (the "Advisers Act"), any investment adviser who (1) had fewer than 15 clients and (2) who neither held itself out generally to the public as an investment adviser nor acted as an investment adviser to any investment company, was exempted from registration with the Securities and Exchange Commission ("SEC") (the so-called "Private Adviser Exemption"). Similarly, in California, prior to the Amended Rule, investment advisers that were exempt under section 203(b)(3) of the Advisers Act were exempt from the California investment adviser licensing requirements if they (1) have assets under management of not less than $25 million or (2) exclusively advise "venture capital companies," as that term is defined in the prior version of section 260.204.9.

New Exemption

Dodd-Frank eliminated the Private Adviser Exemption and replaced it with two more narrowly defined exemptions for advisers to "private funds," which is defined in the Advisers Act to mean an issuer that would be an investment company, as defined in section 3 of the Investment Company Act, but for section 3(c)(1) or section 3(c)(7) of the Investment Company Act. Generally, persons who exclusively advise private funds are exempt from registration with the SEC if they (1) exclusively advise "venture capital funds" (the "Venture Capital Fund Exemption") or (2) manage less than $150 million of assets (the "Private Fund Adviser Exemption"). Advisers

relying on either the Venture Capital Fund Exemption or the Private Fund Adviser Exemption are referred to as Exempt Reporting Advisers.

Pursuant to the Amended Rule, California adopted an exemption from the California investment adviser licensing requirements that is similar to that of the Venture Capital Fund Exemption and the Private Fund Adviser Fund Exemption (collectively, the "California Exemption"). The California Exemption is only available to "private fund advisers," which is defined in the Amended Rule[4] to mean those advisers who provide advice solely to one or more "qualifying private funds."[5]

General Requirements of the California Exemption

In order to rely on the California Exemption, advisers are required to:

- Not be subject to statutory disqualifications[6]
- File periodic informational notices regarding the characteristics of the adviser and associated qualifying private funds[7]
- Pay the standard investment adviser annual registration fee (currently $125)

Additional Safeguards for Retail Buyer Funds

In addition to the general requirements above, private fund advisers to qualifying private funds organized under sections 3(c)(1) and/or 3(c)(5) that do not fall within the definition of "Venture Capital Company," as defined under section 260.204.9(a)(4)[8] ("Retail Buyer Funds"), must also comply with heightened safeguards as described below.

- The private fund adviser shall advise only Retail Buyer Funds whose outstanding securities are beneficially owned entirely by: (A) persons who, at the time the securities were sold, either (i) met the definition of "accredited investor" in Rule 501(a) of Regulation D adopted by the SEC under the Securities Act of 1933, as amended, or (ii) were managers, directors, officers, or employees of the private fund adviser; or (B) any person that obtains the securities through a transfer not involving a sale of that security.[9]
- At or before the time of purchase of any ownership interest in a Retail Buyer Fund, the private fund adviser shall prominently and in plain English disclose (in a private placement memorandum or similar written document) to the purchaser of such ownership interest all material facts regarding the following:
  - (i) All services, if any, to be provided by the investment adviser to a beneficial owner of the fund, and to the fund itself
  - (ii) All duties, if any, the investment adviser owes to a beneficial owner of the fund, and to the fund itself[10]
- The private fund adviser shall obtain, on an annual basis, financial statements of each Retail Buyer Fund advised by the private fund adviser, audited by an independent certified public

accountant that is registered with, and subject to regular examination by, the Public Company Accounting Oversight Board, and shall deliver a copy of such audited financial statements to each beneficial owner of the Retail Buyer Fund within 120 days after the end of each fiscal year (or within 180 days if the Retail Buyer Fund is a fund of funds).[11]

- The private fund adviser may not enter into, perform, renew or extend an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds of an investor that is not a “qualified client” as defined in Rule 205-3 under the Advisers Act.[12]

Federal Covered Investment Advisers

If a private fund adviser is registered with the SEC, the adviser is not eligible for the California Exemption and must comply with the state notice filing requirements applicable to federal covered investment advisers in section 25230.1 of the California Code of Regulations.[13]

Grandfathering for Investment Advisers to Retail Buyer Funds

An investment adviser to a Retail Buyer Fund that existed prior to the Effective Date and that does not satisfy the conditions set forth in subsection (c)(1) [beneficial ownership only by accredited investors] or (c)(4) [performance-based compensation may only be charged to qualified clients] of the Amended Rule, on the Effective Date, may nevertheless be eligible for the California Exemption if the following conditions are satisfied:

- As of the Effective Date, the Retail Buyer Fund ceases to sell interests to investors other than those described in section 260.204.9(c)(1)(A) (i.e., accredited investors and/or managers, directors, officers, or employees of the investment adviser)
- The investment adviser complies with section 260.204.9(c)(4) (i.e., qualified client test) for every beneficial owner who purchases an ownership interest from the Retail Buyer Fund on or after the Effective Date
- The investment adviser discloses in writing the information described in section 260.204.9(c)(2) to every beneficial owner of the fund within 90 days after the Effective Date
- For every fiscal year ending after the Effective Date, the investment adviser delivers audited financial statements to each beneficial owner as required by section 260.204.9(c)(3)

Transition

An investment adviser who becomes ineligible for the California Exemption must comply with all applicable laws and rules requiring registration or notice filing within 90 days after the date the investment adviser’s eligibility for the California Exemption ceases.

1. Section 3(c)(1) excludes from the definition of an "investment company" any issuer whose outstanding securities are beneficially owned by not more than 100 persons, and which is not making and does not currently propose to make a public offering of its securities.

2. Section 3(c)(5) excludes from the definition of an "investment company" any issuer who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type, or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: (A) purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, insurance, and services; (B) making loans to manufacturers, wholesalers, and retailers of, and to prospective purchasers of, specified merchandise, insurance, and services; and (C) purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.

3. Section 3(c)(7) excludes from the definition of an "investment company" any issuer, the outstanding securities of which are owned exclusively by persons who are "qualified purchasers," and which is not making and does not at that time propose to make a public offering of such securities.

4. See section 260.204.9(a)(1).

5. Section 260.204.9(a)(2) defines "qualifying private fund" to mean an issuer that qualifies for the exclusion from the definition of an investment company under one or more of sections 3(c)(1), 3(c)(5), and 3(c)(7) of the Investment Company Act.

6. Specifically, neither the adviser nor any of its advisory affiliates are subject to a disqualification as described in Rule 262 of Regulation A adopted by the SEC under the Securities Act of 1933, as amended (the "Securities Act"); or have done any of the acts, satisfy any of the circumstances, or are subject to any order specified in section 25232(a) through 25232(h) of the California Code of Regulations.

7. The informational notices are those reports and amendments thereto that an Exempt Reporting Adviser that is relying on either the Venture Capital Fund Exemption or the Private Fund Adviser Exemption is required to file with the SEC pursuant to Rule 204-4 under the Advisers Act. A form of such filing may be found at http://www.sec.gov/about/forms/formadv-part1a.pdf. Any foregoing report must be filed electronically through the Investment Advisor Registration Depository ("IARD") and shall be deemed filed when the report and the required fee are filed and accepted by the IARD on California’s behalf.

8. Section 260.204.9(a)(4) defines a "venture capital company" to mean an entity that satisfies one or more of the following conditions:

   (A) 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 percent of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, are "venture capital investments" (see definition below) or "derivative investments" (as defined described in section 206.204.9(a)(6)); or

(B) The entity is a "venture capital fund" as defined in Rule 203(l)-1 adopted by the SEC under the Advisers Act; or

(C) The entity is a "venture capital operating company" as defined in Rule 2510.3-101(d) adopted by the U.S. Department of Labor under the Employee Retirement Income Security Act of 1974.

For purposes of subsection (A) above, "venture capital investment" means an acquisition of securities in an "operating company" (see definition below) as to which the investment adviser, the entity advised by the investment adviser, or an "affiliated person" (see definition below) of either has or obtains "management rights" (see definition below). See section 260.204.9(a)(5).

"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. See section 260.204.9(a)(8).

"Affiliated person" means a person that controls, is controlled by, or is under common control with the other specified person(s). See section 260.204.9(a)(9).

"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. See section 260.204.9(a)(7).

For purposes of subsection (A) above, "derivative investment" means an acquisition of securities 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. See section 260.204.9(a)(6).

9. See section 260.204.9(c)(1).

10. See section 260.204.9(c)(2).

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11. See section 260.204.9(c)(3)(A). Notwithstanding the above, if a Retail Buyer Fund begins operations more than 180 days into a fiscal year, the investment adviser need not comply with the audited financial statements requirement that initial fiscal year, provided that the financial audit for the fiscal year immediately succeeding the stub initial fiscal year is supplemented by, or includes, a financial audit of the stub initial fiscal year. See section 260.204.9(c)(3)(B).

12. See section 260.204.9(c)(4). Under Rule 205-3, a client is a qualified client if (a) such client has at least $1million under management with the adviser immediately after entering into the advisory contract or (b) the adviser reasonably believes that the client has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $2 million (excluding the value of the client's primary residence) at the time the contract is entered into.

13. The initial notice is to be filed with the IARD on Form ADV in accordance with the instructions in Form ADV and is to be filed within 30 days of conducting business in California. The notice will be considered filed when the filing fee and Form ADV are filed with and accepted by IARD. The fee for filing an initial notice is $125.

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