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California Department of Corporations Proposes Elimination of Exemption for Certain Advisers

The California Department of Corporations (the "DOC") has proposed amending Rule 260.204.9 under the California Securities Law of 1968 (the "CSL") which, if adopted, would require unregistered investment advisers in California to register with either the DOC or the Securities and Exchange Commission (the "SEC"). The proposed changes could be a significant consideration for investment advisers that plan to have offices or clients in the State of California.

California Rule

California law requires that any person doing business as an investment adviser register with the DOC unless an exemption exists. Advisers who are licensed under the CSL are subject to rules and restrictions promulgated by the Commission of the Division of Corporations.

Advisers who are registered with the SEC are exempt by virtue of Section 203(A) of the Investment Adviser Act of 1940, as amended (the "Advisers Act"), which preempts state registration.

In addition, Rule 260.204.9 exempts from the requirement to register as an investment adviser any person who:

(1) does not hold itself out generally to the public as an investment adviser;

(2) has fewer than 15 clients;

(3) is exempt from registration with the SEC pursuant to Section 203(b)(3) of the Advisers Act (the "Private Adviser Exemption"); and

(4) either (i) has assets under management of $25 million or more or (ii) provides investment advice only to venture capital companies.

Proposed Amendment

The DOC proposes to eliminate clauses (2) and (4)(i) of the existing CSL rule. Investment advisers to venture capital companies would continue to be exempt from registration under the revised rule.

Rule 222-2 promulgated under the Advisers Act allows investment advisers to rely on the definition of "client" contained in the Private Adviser Exemption. The Private Adviser Exemption treats a legal entity as separate and does not include shareholders, partners or beneficial owners as "clients" by virtue of their status with respect to the entity. Under this rule, investment advisers are allowed to treat the fund that they manage as one client.

The DOC has expressed concern about the growth of hedge funds relying on Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940 for exemption from registration thereunder, as well as hedge fund advisers relying on the Private Adviser Exemption from registering under the Advisers Act.

The DOC's concern originates from the SEC's report titled *Implications of the Growth of Hedge Funds*. The DOC has indicated that the need for further oversight stems from the SEC's conclusions with respect to industry growth, increase in fraud and broader market participation. The DOC proposal attempts to address the perceived void created when the U.S. Court of Appeals vacated the SEC's proposed "mandatory registration" rule in the recent case, *Goldstein v. Securities and Exchange Commission*.

Effect of Rulemaking

The proposed rule would impact unregistered investment advisers that have offices in the State of California and certain out-of-state investment adviser (*i.e.*, advisers who do not have a place of business in the state) with six or more clients located in the State of California during the previous 12 months, who would not be subject to federal pre-emption. Such advisers would need to consider registering either at the state level with the DOC or at the federal level with the SEC. As the ongoing compliance obligations related to registration differ between the DOC and the SEC, advisers should consider which type of registration best suits there business plans.

Comments on the proposal are due by November 26, 2007. The proposed amendments, notice and reasoning, respectively, can be found at:

http://www.corp.ca.gov/pol/rm/4106a.pdf
http://www.corp.ca.gov/pol/rm/4106b.pdf
http://www.corp.ca.gov/pol/rm/4106c.pdf

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