

# Investment Adviser Registration in California After Dodd-Frank

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## INTRODUCTION

Revisions to the California Code of Regulations are rarely breathlessly anticipated events. Many, however, welcomed with at least a sigh of relief the new regulations on exemption from investment adviser registration (New California Exemption) that the California Corporations Commissioner adopted on August 27, 2012. See 10 Cal Code Regs §260.204.9. These revisions came after a significant period of uncertainty that resulted from a disparity between existing California regulations and new Securities and Exchange Commission (SEC) regulations implemented after the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) (Pub L 111–203, 124 Stat 1376), which President Obama signed on July 21, 2010. As a result of the California revisions, there is now greater certainty about the exemptions from California

registration that are available to certain investment advisers that do business in the state.

This article (1) explains the primary changes to federal and California investment adviser laws as a result of the Dodd-Frank Act and the New California Exemption, (2) discusses when investment adviser registration with the SEC or the California Department of Corporation is required, and (3) outlines some of the unique compliance requirements that California law imposes on investment advisers registered in this state.

## BACKGROUND

### **Federal versus State Regulation: In General and After Dodd-Frank**

The Investment Advisers Act of 1940 (Advisers Act) (15 USC §§80b–1—80b–21) defines an “investment adviser” as any person who, for compensation, is

engaged in the business of advising others or issuing reports or analyses regarding securities. Advisers Act §202(a)(11) (15 USC §80b-2(a)(11)). Persons who fall within the definition of investment adviser are required to register with the SEC or, if applicable, with the states in which they do business, unless they qualify for exemptions from registration. Advisers Act

#### **Former Federal Law (Before Dodd-Frank)**

Before the enactment of the Dodd-Frank Act, unless an exemption from registration was available, an investment adviser with \$25 million or more in assets under management was required to register with the SEC. An investment adviser with less than \$25 million in assets under management was generally *not permitted* to register with the SEC. Former Advisers Act §203A (15 USC §80b-3a), *revised by the Dodd-Frank Act*; Investment Advisers Act Release No. 1633 No. 51 (May 15, 1997) available at <https://www.sec.gov/rules/final/ia-1633.txt>. Before the Dodd-Frank Act, however, many investment advisers took advantage of the former “private adviser” exemption from registration (Former SEC Private Adviser Exemption). Under the Former SEC Private Adviser Exemption, an investment adviser was exempt from SEC registration as long as it (1) had fewer than 15 clients during the preceding 12 months, (2) did not advise any registered investment companies (mutual funds), and (3) did not generally hold itself out to the public as an investment adviser. Former Advisers Act §203(b)(3) (15 USC §80b-3(b)(3)), *repealed as a result of the Dodd-Frank Act*. A pooled investment vehicle that received investment advice based on its investment objectives rather than the individual investment objectives of its investors (*i.e.*, most private funds) counted as a single client under the rule. Former Advisers Act Rule §203(b)(3)-1a (17 CFR §275.203(b)(3)-1), *repealed as a result of the Dodd-Frank Act*. Therefore, under the Former SEC Private Adviser Exemption, an investment adviser with at least \$25 million in assets under management

§§203(a), 203A (15 USC §§80b-3(a), 80b-3a). As a result of the Dodd-Frank Act, responsibility for registering and regulating thousands of investment advisers has shifted from the SEC to the states. SEC Press Release 2012-214. In response, many states, including California, have enacted new state law exemptions from registration.

could manage up to 15 private funds (including hedge funds, private equity funds, and venture funds) or separate accounts for individual investors, without being required to register with the SEC.

#### **Former California Law (Before Dodd-Frank)**

Before the enactment of the Dodd-Frank Act and the resulting New California Exemption, investment advisers that conducted business in California were exempt from investment adviser registration if they (1) met the Former SEC Private Adviser Exemption *and* (2) had assets under management of at least \$25 million *or* provided investment advice solely to venture capital funds (Former California Private Adviser Exemption). Former 10 Cal Code Regs §260.204.9. As a result, smaller investment advisers (*i.e.*, those that had less than \$25 million in assets under management) that advised any types of clients other than venture capital funds were generally required to register as investment advisers with the California Department of Corporations, while larger advisers were often able to escape registration.

After the Former SEC Private Adviser Exemption expired (on July 21, 2011) as a result of the Dodd-Frank Act, the Former California Private Adviser Exemption was effectively eviscerated because it was linked to the Former SEC Private Adviser Exemption. California issued emergency regulations to preserve the Former California Private Adviser Exemption, which emergency regulations it readopted twice before releasing the New California Exemption. As a result, during the interim period when the emergency regulations were in place, there was

significant uncertainty and concern about the scope of the final California successor exemption and when it would be adopted.

**As a result of the Dodd-Frank Act, responsibility for registering and regulating thousands of investment advisers has shifted from the SEC to the states.**

#### **CURRENT LAW:**

#### **WHEN INVESTMENT ADVISER REGISTRATION IS REQUIRED**

##### **Federal Law**

The Dodd-Frank Act created three thresholds for investment adviser registration: (1) the first threshold is for “small” investment advisers, with assets under management of less than \$25 million, (2) the second threshold is for “mid-size” investment advisers, with assets under management of between \$25 million and \$100 million, and (3) the third threshold is for “large” investment advisers with at least \$100 million under management. Advisers Act §203A (15 USC §80b–3a).

##### **Small Advisers**

With a few specific exceptions (*e.g.*, an exception for managers of registered investment funds), a “small” investment adviser is not permitted to register with the SEC and is subject to the registration requirements of the states in which it does business. A small investment adviser in California is subject to the California Department of Corporations rules described below. Advisers Act §203A(a)(1)(A) (15 USC §80b–3a(a)(1)(A)).

##### **Mid-Size Advisers**

A mid-size investment adviser in California must register with the SEC (or be eligible for an exemption) if it is not required to be registered as an investment adviser with the California Department of Corporations (*e.g.*, because it qualifies for an exemption under California law). A mid-size

investment adviser that is required to register with the California Department of Corporations may not register with the SEC. A mid-size investment adviser that maintains its principal office and place of business in California and that would be required to register in 15 or more states would, however, be permitted to register with the SEC. Advisers Act §203A(a)(2)(A) (15 USC §80b–3(a)(2)(A)).

**Although many large investment advisers . . . are able to rely on the New SEC Private Fund Adviser Exemption, many others are not able to do so (*e.g.*, if they manage any separate accounts).**

##### **Large Advisers**

Large investment advisers must register with the SEC unless an exemption from registration is available. Advisers Act §203A(a)(2)(B)(ii)(II) (15 USC §80b–3a(a)(2)(B)(ii)(II)).

##### **Federal Exemptions**

The Dodd-Frank Act also created several new exemptions from registration for investment advisers that would otherwise be required to register with the SEC. Those exemptions include, but are not limited to (1) an exemption for investment advisers solely to private funds with less than \$150 million in assets under management (New SEC Private Fund Adviser Exemption), (2) an exemption for investment advisers solely to venture capital funds, and (3) an exemption for foreign private advisers with no place of business in the United States and a limited number of U.S. clients and U.S. assets under management. 17 CFR §§202(a)(30)–1 (foreign private advisers), 203(l)–1, 203(m)–1. Among other exclusions from the definition of “investment adviser,” there is also a new exclusion for investment advisers solely to single family offices. Advisers Act §202(a)(11)(G) (15 USC §80b–2(a)(11)(G)). Although many large investment advisers that previously relied on the Former SEC Private Adviser Exemption are able to rely on the New SEC Private Fund Adviser Exemption, many

others are not able to do so (*e.g.*, if they manage any separate accounts). In fact, by the SEC's estimation, by April 2012 there had been a 52-percent increase in SEC registration by investment advisers to private funds. See Speech by SEC Staff before the New York City Bar, May 11, 2012: What SEC Registration Means for Hedge Fund Advisers, available at <http://www.sec.gov/news/speech/2012/spch051112nc.htm>.

## California Law

### General Rule

Under California law (as under federal law), an "investment adviser" (subject to certain exclusions) is anyone who, for compensation, engages in the business of advising others regarding securities. Corp C §25009. An investment adviser cannot conduct business as such in California without registration, unless an exemption applies. Corp C §25230. An investment adviser is not subject to registration in California, however, if the adviser does not have a place of business in California and during the preceding 12-month period has had fewer than six clients who are residents of California. Corp C §25202(a). Further, anyone who is registered with the SEC under the Advisers Act is not subject to registration in California (but must file certain notices if the adviser has six or more clients resident in California. Corp C §25230.1. Therefore, anyone who (1) is in the business of advising others regarding securities for compensation, (2) either has a place of business in California or has during the preceding 12 months advised six or more clients who are residents of California, and (3) is not registered as an investment adviser with the SEC, must register in California absent an applicable exemption.

### New California Exemption

Subject to certain exceptions, the New California Exemption provides that "private fund advisers" (as described below) do not need to register in California. 10 Cal Code Regs §260.204.9(b). The New

California Exemption also offers some relief to some smaller investment advisers that may have been required to register in California in the past but may now be exempt from registration. Further, the New California Exemption permanently replaces the eviscerated Former California Private Adviser Exemption. As a result, its adoption removed the significant uncertainty regarding California investment adviser registration regulations that existed previously.

The New California Exemption applies to investment advisers to the following types of funds, as long as the investment advisers meet other qualifications as described below:

*Qualifying Private Funds.* A "qualifying private fund" is an issuer that qualifies for exclusion from the definition of an investment company under one or more of §3(c)(1), §3(c)(5), or §3(c)(7) of the Investment Company Act of 1940 (Investment Company Act) (15 USC §§80a-1—80a-64) (15 USC §80a-3(c)(1), (5), (7)). 10 Cal Code Regs §260.204.9(a)(2). Virtually all private equity, hedge, and venture funds rely on one of these three exemptions. The §3(c)(1) exemption is generally used by funds with not more than 100 investors (who are generally composed of "accredited investors"). The §3(c)(5) exemption is used by certain real estate funds (also generally composed of "accredited investors"). In contrast, the §3(c)(7) exemption is generally used by funds that have "qualified purchasers" as investors. Notably, the financial standard for investors to be deemed "qualified purchasers" is significantly higher than for "accredited investors," which is an important aspect of the rules related to "retail buyer funds" below. See 17 CFR §275.205-3(d).

*Retail Buyer Funds.* A "retail buyer fund" is a subset of a qualifying private fund, and is subject to more restrictions than is a qualifying private fund that is not also a retail buyer fund. Specifically, a retail buyer

fund is a fund that (1) is not a “venture capital company” and (2) qualifies for exclusion from the definition of an investment company under either or both of §3(c)(1) or §3(c)(5) of the Investment Company Act (15 USC §80a–3(c)(1) and (5)). 10 Cal Code Regs §260.204.9(a)(3). Under the New California Exemption, if an investment adviser advises a retail buyer fund, then it is subject to the potentially burdensome requirements described below. The policy behind these additional requirements is to compensate for what the California Department of Corporations sees as the absence of the “qualified purchaser” safeguard. See Revised Final Statement of Reasons for the Adoption of Rules Under the Corporate Securities Law of 1968 (rev’d Aug. 27, 2012), available at [http://www.corp.ca.gov/Regulations/CSL/0211C\\_Final\\_Rev082712.pdf](http://www.corp.ca.gov/Regulations/CSL/0211C_Final_Rev082712.pdf).

*Accredited Investor Requirement.* The investment adviser that advises a retail buyer fund and seeks to rely on the New California Exemption may advise only those retail buyer funds whose outstanding securities are beneficially owned entirely by persons who (A) at the time the securities were sold, were “accredited investors” (as set forth in Rule 501(a) of Regulation D under the Securities Act of 1933, as amended (17 CFR §230.501(a))) or managers, directors, officers, or employees of the investment adviser; or (B) later obtained an interest in the retail buyer fund by a transfer not involving a sale. 10 Cal Code Regs §260.204.9(c)(1)(A)–(B). Therefore, if the fund has any investors that are not accredited (other than those that received an interest as a gift or bequest or employees, managers, directors, or officers of the investment adviser at the time the securities were sold), then the investment adviser cannot rely on the New California Exemption.

**A “retail buyer fund” is a subset of a qualifying private fund, and is subject to more restrictions than is a qualifying private fund that is not also a retail buyer fund.**

*Disclosure Requirement.* The investment adviser that advises a retail buyer fund and seeks to rely on the New California Exemption also must provide to a prospective investor, at or before the time of purchase, a disclosure document that contains all material information regarding (1) all services the investment adviser provides to the fund and its beneficial owners, and (2) all duties the investment adviser owes to the fund and its beneficial owners. 10 Cal Code Regs §260.204.9(c)(2)(A). As a result, the investment adviser should present a carefully drafted disclosure document to the fund’s investors.

*Audited Financial Statements Requirement.* Further, the investment adviser that advises a retail buyer fund and seeks to rely on the New California Exemption must obtain annual audited financial statements from an independent certified public accountant that is registered with and examined by the Public Company Accounting Oversight Board (PCAOB). It must also deliver a copy of the 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). 10 Cal Code Regs §260.204.9(c)(3)(A). Advisers subject to this requirement should make sure that their accountants are registered with and examined by the PCAOB.

*Qualified Client Requirement.* Finally, the investment adviser that advises a retail buyer fund and seeks to rely on the New California Exemption may receive performance fees attributable to an investor that is not a “qualified client” as defined by Rule 205–3(d) of the Advisers Act (17 CFR §275.205–3(d)). 10 Cal Code Regs §260.204.9(c)(4). It is important to note that the “qualified client” eligibility standards are in some cases higher than the “accredited investor” standards, and therefore an investment adviser subject to this rule should determine that the investors in its funds are both accredited investors and qualified clients.

Even if a fund would otherwise be a retail buyer fund subject to the enhanced requirements summarized above (*i.e.*, because not all of its investors are qualified purchasers), it will not be treated as such if it is a “venture capital company.” The California Department of Corporations has stated that venture capital funds provide a crucial source of financing for California start-up companies, which benefits the California labor market and economy. See Title 10. California Department of Corporations, Finding Of Emergency—Readoption, available at [http://www.corp.ca.gov/Laws/CSL/pdf/0211\\_2EA.pdf](http://www.corp.ca.gov/Laws/CSL/pdf/0211_2EA.pdf). Presumably, this is the policy behind providing more favorable regulatory treatment to investment advisers to venture capital funds.

*Venture Capital Company.* A “venture capital company” is an entity that satisfies one or more of the following conditions: (1) On at least one occasion in the year after its original capitalization, and at least once per year thereafter, at least 50 percent of its assets (other than short-term investments) are “venture capital investments” or “derivative investments”; or (2) it satisfies the SEC Rule 203(l)–1 definition of a “venture capital fund” (adopted by the SEC under the Advisers Act at 17 CFR §275.203(l)–(1)); or (3) it satisfies the ERISA definition of “venture capital operating company” (as defined in Rule 2510.3–101(d) (29 CFR §2510.3–101(d)) adopted by the U.S. Department of Labor under the Employee Retirement Income Security Act of 1974 (29 USC §§1001–1461)). 10 Cal Code Regs §260.204.9(a)(4)(A)–(C).

*“Venture Capital Investment.”* A “venture capital investment” is an acquisition of securities in an operating company pursuant to which the investment adviser or an affiliate obtains management rights. 10 Cal Code Regs §260.204.9(a)(5).

*“Derivative Investment.”* A “derivative investment” is 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 (1) on the exercise or conversion of an existing venture capital investment or (2) 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. 10 Cal Code Regs §260.204.9(a)(6).

*“Management Rights.”* “Management rights” are rights to substantially participate in, influence, guide, or counsel an operating company regarding its operations or business objectives. 10 Cal Code Regs §260.204.9(a)(7). Note that the SEC Rule 203(l)–1 (17 CFR §275.203(l)–(1)) definition of “venture capital company” does not require the fund to obtain management rights; therefore, it is beneficial to investment advisers that the New California Exemption has incorporated that more generous SEC definition into its definition of “venture capital company” as an alternative way to qualify for the exemption.

**The New California Exemption also will not apply if the investment adviser or any of its advisory affiliates is disqualified under any of the “bad boy” provisions . . . in Rule 262 of Regulation A.**

*“Operating Company.”* An “operating company” is an entity primarily engaged in the production or sale of a product or service other than capital management that is not an individual or sole proprietorship. 10 Cal Code Regs §260.204.9(a)(8).

*Grandfathering Provision.* An investment adviser to a retail buyer fund of which not all the beneficial owners are accredited investors or for which there is a performance fee but not all the beneficial owners are “qualified clients” may still rely on the New California Exemption if (1) it began advising the fund before August 27, 2012; (2) as of August 27, 2012, the investment adviser stops selling interests to non-accredited investors or charging a performance fee to nonqualified clients; (3) it provides the required

disclosure documentation within 90 days of August 27, 2012; and (4) it provides the required annual audited financial statements for every year that ends after August 27, 2012. 10 Cal Code Regs §260.204.9(h).

*Separate Accounts.* The New California Exemption applies to investment advisers that advise *only* qualifying private funds or retail buyer funds. See 10 Cal Code Regs §260.204.9(a). Therefore, if an investment adviser manages any separate accounts (even if it also advises qualifying private funds or retail buyer funds), the exemption will not apply.

*Exception to Exemption (“Bad Boy” Acts).* The New California Exemption also will not apply if the investment adviser or any of its advisory affiliates is disqualified under any of the “bad boy” provisions set forth in Rule 262 of Regulation A under the Securities Act of 1933, as amended (17 CFR §230.262), or Corp C §25232. These provisions include willful violations of securities laws, suspension from investment advisory activities by either the SEC or a state regulator, findings of liability in certain civil actions, and convictions for violation of certain securities laws.

*Filings.* Investment advisers that rely on the New California Exemption must file each report that an investment adviser is required to file with the SEC under Rule 204–4 under the Advisers Act (17 CFR §275.204). 10 Cal Code Regs §260.204.9(b)(2)(A). This means that investment advisers that qualify for the New California Exemption must file certain sections of Form ADV (the form that investment advisers use to register with the SEC and the states) on the SEC’s IARD system. See <http://www.sec.gov/divisions/investment/iard.shtml>. Although investment advisers exempt from registration in California were formerly able to maintain significant anonymity, the information submitted on Form ADV by an investment adviser relying on the New California Exemption will now be publicly available.

## **REGULATION OF REGISTERED INVESTMENT ADVISERS IN CALIFORNIA**

### **Overview**

Investment advisers that are registered with the California Department of Corporations must develop and maintain compliance procedures to ensure that they comply with numerous legal requirements. The compliance programs of California-registered investment advisers are in many ways similar to those of SEC-registered investment advisers. However, newly registering investment advisers and those transitioning from registration with the SEC to California should be mindful of some unique compliance requirements that the state imposes. Note that a full description of the compliance obligations of investment advisers (whether or not registered with the SEC or California) is beyond the scope of this article.

### **Custody; Independent Representative**

#### **General Rule**

Currently, California law prohibits an investment adviser considered to have “custody” of client assets to manage those assets unless the investment adviser (1) complies with certain segregation, recordkeeping, and client notification procedures; and (2) has the assets over which the investment adviser is deemed to have custody verified by an examination by an independent accountant annually, on a “surprise” basis (California Custody Rule). 10 Cal Code Regs §260.237.

Counsel should note, however, that on October 18, 2012, the California Department of Corporations proposed amendments to the California Custody Rule. See State of California, Department of Corporations, Text of Proposed Changes Under the Corporate Securities Law of 1968 Pursuant to Notice Dated: October 18, 2012, available at

<http://www.corp.ca.gov/Laws/CSL/pdf/0411B.pdf>. Among other things, the proposed amendments to the California Custody Rule would exempt from the surprise audit requirement (1) investment advisers that have custody of client assets due to their authority to deduct advisory fees, and (2) investment advisers to private funds that are subject to annual audit by a PCAOB-registered accounting firm. See Prop 10 Cal Code Regs §260.237(b)(3). These changes would bring the California Custody Rule more in line with the SEC's custody rule.

**[B]ecause a general partner in a fund is presumed to have "custody" simply by virtue of its role as a general partner, it must generally comply with the custody rules.**

#### **What Is "Custody"**

"Custody" generally means holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. Custody also includes (1) possession of client funds or securities; (2) any arrangement under which an investment adviser is permitted to withdraw client funds or securities from a custodian; and (3) acting in any capacity (such as general partner of a limited partnership, managing member of a limited liability company, or trustee of a trust) that technically gives an investment adviser legal ownership of or access to client funds or securities. See Advisers Act Rule §206(4)–2 (17 CFR §275.206(4)–2). Investment advisers to separate accounts generally structure their operations so that they do not have custody over client assets. However, because a general partner in a fund is presumed to have "custody" simply by virtue of its role as a general partner, it must generally comply with the custody rules. Likewise, an investment adviser that is an affiliate of a fund's general partner would also be deemed to have custody of the fund's assets and be required to comply with the custody rules.

#### **Avoiding Custody; Use of Independent Representative**

Many investment advisers in California have traditionally avoided being deemed to have custody of a fund's assets under California law (and therefore avoided the annual surprise audit requirement) by following certain procedures. Under these procedures (1) the assets must be in the actual custody of an independent bank or brokerage firm and (2) the fund must enter into an agreement by which the custodian agrees not to disburse any assets to the general partner or its affiliates unless the custodian has received a letter from an "independent representative" (*i.e.*, an accountant or lawyer) of the fund authorizing the disbursement. See SEC Transition Instructions, published by the California Department of Corporations at [http://www.corp.ca.gov/Laws/CSL/BDIA/Dodd-Frank/pdf/SEC\\_Transition\\_Instructions.pdf](http://www.corp.ca.gov/Laws/CSL/BDIA/Dodd-Frank/pdf/SEC_Transition_Instructions.pdf), and PIMS, Inc. (SEC No-Action Letter, Oct. 21, 1991) 1991 SEC No-Act Lexis 1228. These procedures have often added complexity and cost to the investment adviser's operations due to the need to coordinate payments and withdrawals with both the custodian and the independent representative. Under the proposed amendments to the California Custody Rule, such procedures would not be necessary because the proposed amendments eliminate the surprise audit requirement for investment advisers to private funds that are subject to annual audit by a PCAOB-registered accounting firm.

**The IARs of an investment adviser that qualifies for the New California Exemption do not need to register with the California Department of Corporations.**

#### **Investment Adviser Representatives**

##### **Definition**

Besides registration of investment adviser entities, the California Department of Corporations requires



that representatives of registered investment advisers meet certain qualification requirements. An investment adviser representative (IAR) is any partner, officer, director, or other individual who is employed by or associated with, or subject to the supervision and control of, an investment adviser that is required to register as an investment adviser in California, and who (1) makes any recommendations or otherwise renders advice regarding securities; (2) manages accounts or portfolios of clients; (3) determines which recommendations or advice regarding securities should be given; (4) solicits, offers, or negotiates for the sale or sells investment advisory services; or (5) supervises employees who perform any of the above. Corp C §25009.5(a). The California Department of Corporations has stated that, in addition, each officer, director, or partner exercising executive responsibility (or persons occupying a similar status or performing similar functions) or each person who owns 25 percent or more of the investment adviser is presumed to be acting as an IAR. See [http://www.corp.ca.gov/Laws/CSL/BDIA/State\\_IA.asp](http://www.corp.ca.gov/Laws/CSL/BDIA/State_IA.asp).

The California definition of an IAR is broader than the definition under the Advisers Act, which generally defines IARs as those supervised persons who regularly communicate with more than a certain number of natural person clients. Advisers Act Rule §203A-3(a)(1) (17 CFR §275.203A-3(a)(1)). As a result, California-registered investment advisers will generally have more IARs than similarly situated SEC-registered investment advisers.

### **IAR Qualification Requirements**

The IARs of an investment adviser that registers with the California Department of Corporations must meet the following qualification requirements, which many California investment advisers find to be a significant burden.

*Testing.* Each IAR must pass, within 2 years prior to becoming engaged as an IAR, either (1) the Series 65/Uniform Investment Adviser Law Examination (Series 65) or (2) the Series 7/General Securities Representative Examination (Series 7) and the Series 66/Uniform Combined State Law Examination (Series 66). 10 Cal Code Regs §260.236(a). There are certain waivers and exemptions to the examination requirements. For example, individuals holding certain professional designations such as the Chartered Financial Analyst (CFA) or Chartered Financial Consultant (ChFC) are not required to pass these examinations. 10 Cal Code Regs §260.236(c)(3).

*Confirmation by Investment Adviser.* An investment adviser that employs an IAR must (1) obtain an executed Form U-4 (Uniform Application for Securities Industry Registration or Transfer; see <http://www.finra.org>) from the IAR, (2) obtain evidence that the IAR has passed the examination requirements (or is exempt from passing them), and (3) ascertain by reasonable investigation the good character, business reputation, qualifications, and experience of the IAR. 10 Cal Code Regs §260.236.1.

*Non-California Registered Investment Advisers.* The IARs of an investment adviser that qualifies for the New California Exemption do not need to register with the California Department of Corporations. 10 Cal Code Regs §260.204.9(e). On the other hand, an investment adviser representative (under the SEC definition) of an SEC-registered investment adviser who does business in California may be required to register in California. Corp C §25009.5.

**Net-Worth Requirement**

Investment advisers that are registered with the California Department of Corporations must maintain certain levels of net worth. An investment adviser that has custody of client funds or securities must maintain at all times a minimum net worth of \$35,000. An investment adviser that has discretionary authority over client funds or securities but does not have custody of client funds or securities must maintain at all times a minimum net worth of \$10,000. If an investment adviser accepts prepayment of more than \$500 per client and for 6 months or more in advance, it must maintain at all times a positive net worth. 10 Cal Code Regs §260.237.2.

**CONCLUSION**

After the Dodd-Frank Act was signed, there was a significant period of regulatory uncertainty in California. Many newly formed investment advisers and existing investment advisers that qualified for the Former SEC Private Adviser Exemption waited to learn whether they would be required to register with the California Department of Corporations. Happily for many investment advisers, California has finally implemented the New California Exemption, which should apply to many investment advisers that do business in California. However, this exemption does not apply to investment advisers that manage separate accounts for individual clients. As separate accounts become an increasingly popular alternative to funds, investment advisers in California will have to contend with the trade-off between the burdens of registration and the ability to manage separate accounts. Further, even exempt California investment advisers can no longer keep certain aspects of their business private because they now must publicly file portions of Form ADV. Finally, those investment advisers that are required to register in California must contend with a few uniquely burdensome requirements, including the requirement that their IARs pass examinations and the possible need to submit to surprise audits.

An attorney representing a client that provides investment advice in California must carefully analyze whether the client is required to register with the California Department of Corporations or the SEC. If so, the attorney must work with the client (and possibly a compliance consultant) to develop a robust compliance program to meet the myriad of requirements that federal and California law impose on registered investment advisers. While this area of the law is highly complex and technical, California seems to be moving in the direction of consistency with the SEC, which is helpful for investment advisers and the practitioners who advise them.

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