

TITLE 10. CALIFORNIA DEPARTMENT OF CORPORATIONS FINDING OF EMERGENCY

Pursuant to Government Code Section 11346.1, the California Corporations Commissioner ("Commissioner") hereby amends Title 10, Chapter 3, of the California Code of Regulations by amending Section 260.204.9. This emergency amendment extends the period in which certain persons may rely on the existing "private adviser" exemption set forth in Rule 260.204.9.

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

The Department of Corporations ("Department") licenses and regulates investment advisers under the Corporate Securities Law of 1968 (Corporations Code Section 25000 et seq., the "Corporate Securities Law"). Under the Corporate Securities Law, it is unlawful for an investment adviser to conduct business without first applying for and securing a certificate unless the adviser is specifically exempt from that requirement. The Department, by regulation, currently confers an exemption from state regulation for investment advisers that have a federal exemption, but that federal exemption will expire on July 21, 2011. The Department proposes emergency regulations to preserve the existing exemption from state registration for investment advisers who currently rely on the expiring federal exemption.

On July 21, 2010, the President signed *The Dodd-Frank Wall Street Reform and Consumer Protection Act* ("Dodd-Frank") into law. Public Law No. 111-203. Dodd-Frank substantially revises many federal financial services and securities laws. Effective July 21, 2011, Dodd-Frank eliminates the existing "private adviser" exemption set forth in Section 203(b)(3) of the Investment Adviser Act of 1940 ("1940 Act").

Section 203(b)(3) exempts from federal registration any investment adviser who has fewer than fifteen clients and who neither holds itself out generally to the public as an investment adviser nor acts 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 rely on the Section 203(b)(3) exemption from registration.

As a replacement to the "private adviser" exemption, Dodd-Frank creates a new regulatory regime for advisers to "private funds." The term "private funds" refers to investment funds that would be required to register under the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7) of that act. Persons who exclusively advise private funds are exempt from registration with the Securities and Exchange Commission ("SEC") if they (1) advise venture capital funds, or (2) manage less than \$150 million of assets.

In California, investment advisers currently exempt under Section 203(b)(3) of the 1940 Act have a corollary exemption under California investment adviser licensing requirements, if they meet the requirements of Section 260.204.9 of Title 10 of the California Code of Regulations, and (1) have assets under management of not less than \$25,000,000, or (2) exclusively advise "venture capital companies," as that term is defined in the rule.

As a result of Dodd-Frank, on July 21, 2011, Section 260.204.9 will no longer provide an exemption from California licensing requirements. In anticipation of this expiration, the California Corporations Commissioner proposes to provide a temporary six-month extension of Section 260.204.9. This temporary extension is necessary pending final adoption by the SEC of Dodd-Frank-related rules.

The SEC has stated that certain of the Dodd-Frank implementing rules, including those affecting registration of investment advisers may not be adopted until May through July, 2011. (SEC Rulemaking Calendar, available at <http://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtm>). Accordingly, persons that may be required to register under final SEC rules would have a very limited time period in which to prepare their registration documents. In order to allow such persons to determine how SEC rules will ultimately affect their registration status, it is necessary to provide sufficient time for regulated persons to analyze the final rules and prepare any required application materials.

Additionally, the extension is necessary to allow the Department to study how best to regulate advisers to alternative investment vehicles, while balancing the regulatory burden on such advisers, with any corresponding investor protections issues.

Lastly, this extension is necessary to ensure the stability of California capital and labor markets. Alternative investment vehicles, including venture capital funds, have historically provided a crucial source of financing for California businesses.

AUTHORITY

Sections 25204 and 25610, Corporations Code.

REFERENCE

Section 25230, Corporations Code

FINDING OF EMERGENCY

The Commissioner hereby finds that these emergency regulations are necessary to address the elimination of the current exemption from registration for investment advisers who are deemed “private advisers.” Absent emergency regulations, the elimination of the exemption may significantly and immediately impact general welfare by (1) restricting financing to start-up companies (2) increasing unemployment in the “start-up” labor market, and (3) requiring private advisers that are unable to secure registration by July 21, 2011, to cease providing advisory services for compensation.

The nature of these emergency regulations will be to preserve the status quo, exempting private advisers from registration in California during a time of uncertainty as the SEC proceeds with its rulemaking process to implement Dodd-Frank.

These emergency regulations address the marketplace uncertainty that exists as a consequence of the operative date of the change in federal law, by temporarily

continuing the existing California registration exemption for private advisers. The emergency regulations further will provide the Department and industry the opportunity for thoughtful dialogue on the appropriate measure of state oversight after the federal adoption of rules. These emergency regulations are intended to prevent a marketplace reaction of seeking registration in the face of uncertainty; resulting in businesses prematurely incurring costs to comply with a regulatory scheme that ultimately may prove unnecessary for some private advisers. Moreover, it is likely that most private advisers would not be able to secure registration prior to July 21, 2011, thus requiring that they immediately cease providing investment advisory services for compensation in California.

The impact on general welfare, and labor markets more specifically, would be significant and immediate. According to the National Venture Capital Association (“NVCA”), from 2000-2010, Venture-capital funds (“VC Funds”), a subset of “private advisers,” invested \$158 billion into California companies; 51% of these funds come from VC firms headquartered in California (NVCA 2010 data). Thus, California VC funds provide a significant, and often times, exclusive financing mechanism for high-tech start-up companies.

The impact on employment and general welfare of a cessation of advisory business would be immediate, since one U.S. job is created for every \$74,846 of venture capital invested in California (NVCA 2010 data). Moreover, these jobs are highly concentrated in software, energy, and biotechnology (NVCA 2010 data).

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

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

Additionally, there may be long term consequence of a temporary reduction in financing provided by VC Funds. Public companies headquartered in California that were backed by VC Funds account for 2,822,345 jobs and \$84 billion in revenue (2011 Global Insight Study). Thus, a temporary suspension of financing to start-ups would likely result in a corresponding reduction in companies that ultimately go public.

On balance, it is clear that requiring VC Funds to temporarily cease operating would irreparably harm California capital and labor markets.

This situation could not be addressed through nonemergency regulations. While it was known upon the passage of Dodd-Frank that the federal statutory changes would impact Rule 260.204.9, it was unknown at that time, and continues to be unknown until the SEC adopts final rules, what the final federal regulatory landscape for private fund advisers will entail. California continues to consider the policy implications of the changes made by Dodd-Frank and the appropriate overlay of California law. Consequently, these emergency regulations preserving the status quo are necessary, and constitute an emergency.

COSTS TO LOCAL AGENCIES AND SCHOOL DISTRICTS

These regulations do not impose a mandate on local agencies or school districts.

COST OR SAVINGS TO STATE AGENCY

These regulations will not result in any cost or savings to any state agency; any cost to any local agency or school district; any other nondiscretionary cost or savings imposed on local agencies; or any cost or savings in federal funding to the state.

CONTACT PERSON

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Dated: June 13, 2011
Sacramento, California