SHARTSIS FRIESE LLP
One Maritime Plaza ♦ Eighteenth Floor
San Francisco, California 94111-3598

January 20, 2012

**VIA E-MAIL**

To Our Investment Adviser Clients and Other Friends

**Re: Proposed California Private Fund Adviser Exemption and Temporary Exemption Extension**

**Summary**

*Proposed Exemption*

On December 15, 2011, the California Commissioner of Corporations (the "Commissioner") proposed to amend Section 260.204.9 of Title 10 of the California Code of Regulations to provide an exemption from state registration for private fund advisers (the "Proposed Exemption").[1] Advisers relying on the Proposed Exemption would be required to file reports with the California Commissioner of Financial Institutions, but would not be required to undergo the lengthy process of certification by the Commissioner, which generally takes from ninety to 120 days. We are pleased that the Proposed Exemption generally follows our recommendations in the comment letter we submitted to the Commissioner in December 2010, a copy of which is attached as Exhibit A.

*Extension of Temporary Exemption*

As discussed in our prior letters, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") repealed the federal "private adviser" exemption from registration as an investment adviser (the "Repealed Exemption") under the Investment Advisers Act of 1940 (the "Advisers Act") and created a new exemption available to advisers to private funds (the "Federal Exemption"). California also has a private adviser exemption (the "Temporary Exemption"), which is similar to the Repealed Exemption in that it generally applies to an investment adviser that does not hold itself out to the public as an investment adviser and has fewer than fifteen clients, but is available only to investment advisers that manage at least

[1] The Commissioner's Notice, Text of the Proposal, and Initial Statement of Reasons relating to the Proposal are available at http://www.corp.ca.gov/OLP/rulemaking_laws.asp#0211N.

$25,000,000. This Temporary Exemption expires on April 17, 2012. The Proposed Exemption would further extend the Temporary Exemption through June 28, 2012. Comments on the Proposed Exemption must be submitted to the Commissioner by February 20, 2012.

**The Proposed Exemption**

*General Requirements*

The Proposed Exemption would exempt a *private fund adviser* from California investment adviser registration if the private fund adviser satisfies three criteria. First, the private fund adviser must file with the California Commissioner of Financial Institutions via the IARD all reports required of an exempt reporting adviser under the SEC's regime. Those reports are filed on Part 1 of Form ADV and include only specific sections relating to the private fund adviser's organizational and operational information. Second, the private fund adviser must pay the application and renewal fees required of registered advisers. Third, neither the private fund adviser nor its *advisory affiliates* may have committed any disqualifying act,[2] or have done any of the acts or satisfied any of the circumstances providing grounds for the Commissioner to deny, suspend or revoke its or their investment adviser certificate.[3] A private fund adviser that registers with the SEC would not be eligible for the proposed exemption and must comply with applicable California notice filing requirements.

A *private fund adviser* is an investment adviser that provides advice solely to one or more *qualifying private funds*, defined in the SEC rules as any "private fund that is not registered under section 8 of the Investment Company Act of 1940 . . . and has not elected to be treated as a business development company pursuant to section 54 of that Act," which includes any fund that is exempt from registration as an investment company under section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "ICA"). The Proposed Exemption is not available to an investment adviser that manages any separate accounts. *Advisory affiliates* are (a) all of the private fund adviser's officers, partners and directors (and all persons performing similar functions), (b) all persons directly or indirectly controlling or controlled by the private fund adviser, and (c) all of the private fund adviser's employees.

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[2] Disqualifying acts are set forth in Rule 262 of Regulation A under the Securities Act of 1933, as amended (17 C.F.R. § 230.262). Rule 262 covers acts committed by an issuer, an issuer's predecessors, affiliated issuers, directors, officers or general partners and other related parties, and underwriters within a five- or ten-year period, as applicable. Disqualifying acts generally include, among other things, being (a) convicted of a felony or misdemeanor in connection with the purchase or sale of a security that involved making a false statement or filing with the SEC or arising out of the securities-related conduct, (b) permanently enjoined from engaging in securities purchase or sales-related activities involving making a false filing with the SEC or arising out of the securities-related conduct, and (c) suspended or expelled from a member of a registered national securities exchange or association.

[3] *See* Cal. Corp. Code § 25232.

A private fund adviser that becomes ineligible for the Proposed Exemption must comply with all applicable laws and regulations regarding registration and notice filing requirements within ninety days of losing its eligibility. Thus, for example, a private fund adviser may establish a separately managed account if it registers as an investment adviser within ninety days thereafter.

*Additional Requirements for Private Fund Advisers to 3(c)(1) Funds*

A private fund adviser that advises at least one private fund that is not a venture capital company and relies on the exemption in ICA section 3(c)(1) must meet additional requirements to rely on the Proposed Exemption. With respect to each such 3(c)(1) fund:

- Each person that is a beneficial owner of the fund must, at the time the securities are purchased, meet the applicable accredited investor standard;
- The private fund adviser must disclose in writing to each beneficial owner all services that will be provided, all duties the private fund adviser owes to such owner, and any other material information affecting the rights and responsibilities of such owner;
- The private fund adviser must provide annual audited financial statements for the fund to each beneficial owner; and
- The private fund adviser must comply with California's performance fee rule.

A private fund adviser that advises a 3(c)(1) fund beneficially owned by any person that does not meet the accredited investor standard may nevertheless qualify for the Proposed Exemption if (a) the fund existed before the effective date of the Proposed Exemption, (b) the fund does not accept non-accredited investors after the effective date of the Proposed Exemption, (c) the private fund adviser makes the disclosures described above, and (d) as of the effective date of the Proposed Exemption, the private fund adviser delivers audited financial statements as described above. The foregoing additional requirements are not applicable to an adviser's 3(c)(7) funds.

**Recap of Registration Requirements**

Exhibit B outlines various combinations of SEC and California registration requirements for an investment adviser with an office only in California if the Proposed Exemption is adopted. Exhibit B is divided between advisers that do and do not meet the definition of a private fund adviser, and is further subdivided based on the advisers' assets under management ("AUM"). While Exhibit B provides a general guide for registration requirements, you should not rely on it to address your particular situation and should contact us for the registration requirements applicable to you.

* * * * *

This letter only generally summarizes the Proposed Exemption, is not intended as specific or complete advice, and is subject to change if and when the California Commissioner of Corporations adopts the Proposed Exemption or issues interpretations. If you need assistance in determining the effects of these developments on your business, or preparing to comply with them, please contact Doug Hammer, John Broadhurst, Geoff Haynes, Chris Rupright, Carolyn Reiser, Neil Koren, Jim Frolik, Joan Grant, Ellyn Roberts, Anthony Caldwell, Christina Hamilton or Charles Clinger.

**SHARTSIS FRIESE LLP**

**EXHIBIT A**

SHARTSIS FRIESE LLP'S DECEMBER 2010 LETTER TO THE COMMISSIONER

SHARTSIS FRIESE LLP
One Maritime Plaza ♦ Eighteenth Floor
San Francisco, California 94111-3598

December 3, 2010

***VIA E-MAIL***

Colleen E. Monahan, Esq.
Deputy Commissioner
California Department of Corporations
Office of Legislation and Policy
1515 K Street, Suite 200
Sacramento, CA 95814

Ivan Griswold, Esq.
Department of Corporations
Securities Regulation Division
71 Stevenson Street, Suite 2100
San Francisco, CA 94105-2908

Re: **Regulation of Private Fund Advisers in California**

Dear Colleen and Ivan:

Thank you for arranging the meeting with Commissioner DuFauchard (the "**Commissioner**") on October 18, 2010. We thought it was very constructive. I have summarized below a revised proposal regarding "Private Fund Advisers" (defined below) that attempts to address some of the issues discussed at the meeting. I also listed some of the other issues that were discussed that perhaps could be addressed in the Commissioner's rulemaking.

***Private Fund Advisers.*** We proposed an exemption for Private Fund Advisers from investment adviser registration under California law, or alternatively, a notice requirement instead of registration for Private Fund Advisers. "**Private Fund Advisers**" are investment advisers that advise only "**Private Funds**" (investment funds that rely on the exclusions from the definition of "investment company" provided by sections 3(c)(1) and 3(c)(7) of the federal Investment Company Act of 1940 (the "**ICA**")). Based on our meeting, it appears that the Commissioner is inclined to regulate Private Fund Advisers (other than venture capital advisers) in some manner in California. At our meeting, the Commissioner was particularly concerned that exempting Private Fund Advisers would exclude Private Fund Advisers from the custody and inspection rules that apply to registered investment advisers. We continue to believe that the full investment adviser regulatory framework that applies to other types of investment advisers is not a wise use of state resources for Private Fund Advisers (for the reasons described in my prior letter). We do appreciate the concerns regarding custody and inspection, though. Therefore, we propose a notice requirement for all Private Fund Advisers in California. Each Private Fund Adviser in California would be required to file and periodically update a notice (electronically or otherwise) with the Commissioner that reports:

(1) Its legal name and any name under which it does business;

(2) Its places of business, telephone and facsimile numbers and email address of its contact person;

(3) The name of each Private Fund that it manages (further information regarding each Private Fund already is available electronically on the SEC's EDGAR system, because each Private Fund typically files with the SEC a Form D, which includes information regarding each Private Fund's general partner, key personnel and the exception from the definition of "investment company" under the ICA on which the Private Fund relies, such as section 3(c)(1) or section 3(c)(7));

(4) AUM in each Private Fund;

(5) For each Private Fund, whether the Private Fund Adviser has implemented disbursement procedures or arranged for an annual audit of the Private Fund's financial statements in a manner that complies with the Commissioner's custody rules; and

(6) A certification that each "investment adviser representative" has satisfied the reporting requirements in California Code of Regulations ("**CCR**") section 260.236.1 and the qualification requirements in CCR section 260.236 (such as the Series 65 examination).

The notice could include a certification that the Private Fund Adviser has no clients other than the Private Funds reported and has filed a Form D for each such Private Fund (or offer an explanation why no such filing was made).

We propose that the investment adviser's notice filing become effective once acknowledged by the Department of Corporations, and that the investment adviser be subject to routine inspection by the Department of Corporations, to, among other things, verify compliance with the representations made in the notice filing regarding custody. The acceleration of the date on which an adviser's registration is effective would give Private Fund Advisers more certainty regarding the date they can begin investment operations and also reduce the burden on the Department of Corporations staff from the flood of new investment adviser applications in 2011.

The simplest way to accomplish this would be to amend CCR section 260.204.9(a) as follows:

> §260.204.9. Exemption for Certain Investment Advisers ~~with Fewer than 15 Clients~~.
>
> "(a) An exemption from the provisions of Section 25230 of the Code is hereby granted, as being necessary and appropriate in the public interest and for the protection of investors, to 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 under the federal Investment Advisers~~

~~Act of 1940, as amended, by virtue of Section 203(b)(3) of that act, and (4) either (i) has assets under management, as defined in subsection (b)(2), of not less than $25,000,000~~ provides investment advice solely to Private Funds, as defined in subsection **[insert]** or ~~(ii)~~(2) provides investment advice to only venture capital companies, as defined in subsection (b)(3)."

The definitions in CCR sections 260.204.9(b)(1) and (2) would be deleted, and a new definition for "Private Funds" would need to be added. We recommend that the definition of "Private Funds" cross-reference or otherwise follow the definition of "Private Funds" that the SEC will need to promulgate to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"). We understand that California rulemaking procedures may limit the Commissioner's ability to cross-reference other federal law or regulations. If possible, it also would be helpful to add some mechanism for the Commissioner to respond to subsequent SEC amendments to that definition or new SEC interpretations (for example, through Commissioner opinions or interpretations).

The Commissioner could then propose a new regulation that would apply to Private Fund Advisers to establish the registry described above. We would be happy to assist in drafting any such new regulation.

***Advisers with Over $150 Million in AUM.*** Advisers in the U.S. with AUM of $150,000,000 or more (even Private Fund Advisers) are required to register with the SEC, unless they are exempt or excluded pursuant to another provision of the Advisers Act (such as those for foreign advisers, family offices and venture capital advisers).

***Exemption for Foreign Private Advisers***. Dodd-Frank creates an exemption from SEC investment adviser registration for any adviser that (a) does not have a place of business in the U.S., (b) has fewer than 15 clients and investors in Private Funds in the U.S., (c) has less than $25,000,000 in AUM attributable to such U.S. clients and investors and (d) neither (i) holds itself out to the public in the U.S. as an investment adviser nor (ii) advises mutual funds or business development companies. We believe that given these advisers' limited activities and fund-raising in the U.S., a California registration requirement for these advisers is not warranted.

Thank you again for the opportunity to meet with you. We are happy to provide further comments or to answer any questions you have regarding this letter.

Sincerely yours,

*/s/ Jim Frolik*

James J. Frolik

cc: Christopher J. Rupright, Esq.

## EXHIBIT B

FILING REQUIREMENTS OF CALIFORNIA INVESTMENT ADVISER IF PROPOSED EXEMPTION IS ADOPTED

| AUM | PRIVATE FUND ADVISER ("PFA") REQUIREMENTS | NON-PFA REQUIREMENTS |
|---|---|---|
| Less than $25,000,000 | **SEC** = Adviser is not permitted to be registered with SEC.<br>• If adviser is currently registered, must (a) file amended Form ADV by March 30, 2012, (b) withdraw by June 28, 2012, *and* (c) register with CA by June, 28, 2012 *or* rely on Proposed Exemption.<br>**CA** = Adviser currently must be registered with CA, *but* may withdraw from CA registration by relying on Proposed Exemption. | **SEC** = Adviser is not permitted to be registered with SEC.<br>• If adviser is currently registered, must (a) file amended Form ADV by March 30, 2012, (b) withdraw by June 28, 2012, *and* (c) register with CA by June, 28, 2012.<br>**CA** = Adviser currently must be registered with CA *and* remain registered. |
| $25,000,000 to $100,000,000** | **SEC** = Generally, adviser no longer is permitted to be registered with SEC.***<br>• If adviser currently is registered with SEC → adviser must (a) file amended Form ADV by March 30, 2012, (b) withdraw from SEC registration by June 28, 2012, *and* (c) register with CA by June 28, 2012 *or* rely on Proposed Exemption.<br>• If adviser currently is not registered with SEC due to having relied on Repealed Exemption → see CA requirements.<br>**CA** = If adviser currently is not registered with SEC, adviser must currently be registered with CA *or* relying on Temporary Exemption.<br>• If adviser is currently registered with CA → adviser may remain registered *or* withdraw from CA registration by relying on Proposed Exemption.<br>• If adviser currently is relying on Temporary Exemption → adviser may rely on Temporary Exemption through June 28, 2012, and then must either register with CA *or* rely on Proposed Exemption. | **SEC** = Generally, adviser no longer is permitted to be registered with SEC.***<br>• If adviser currently is currently registered with SEC → adviser must (a) file amended Form ADV by March 30, 2012, (b) withdraw from SEC registration by June 28, 2012, *and* (c) register with CA by June 28, 2012.<br>• If adviser currently is not registered with SEC due to having relied on Repealed Exemption → see CA requirements.<br>**CA** = If adviser currently is not registered with SEC, advisers currently must be registered with CA *or* relying on Temporary Exemption.<br>• If adviser currently is registered with CA → adviser must remain registered.<br>• If adviser currently is relying on Temporary Exemption → adviser must register with SEC by March 30, 2012 (file by February 14), and then switch to registration with CA when Temporary Exemption expires on June 28, 2012. Please contact us if this scenario applies to your advisory firm. |

| AUM | PRIVATE FUND ADVISER ("PFA") REQUIREMENTS | NON-PFA REQUIREMENTS |
|---|---|---|
| $100,000,000** to $150,000,000 | **SEC** = Adviser currently must be registered with SEC *or* have been relying on the Repealed Exemption:<br>• If adviser currently is registered with SEC → adviser must (a) file amended Form ADV by March 30, 2012 *and* (b) either remain registered *or* withdraw from SEC registration by relying on Federal Exemption.<br>• If adviser currently is not registered with SEC due to having relied on Repealed Exemption → adviser must either register with SEC by March 30, 2012 (file by February 14) *or* remain unregistered by relying on Federal Exemption.<br>**CA** = If adviser relies on Federal Exemption, adviser must either register with CA *or* remain unregistered by relying on Proposed Exemption. | Adviser must register with SEC by March 30, 2012 (file by February 14). |
| $150,000,000 or more | Adviser must register with SEC by March 30, 2012 (file by February 14). | Adviser must register with SEC by March 30, 2012 (file by February 14). |

*SEC registered advisers must comply with applicable California notice filing requirements, which are required if the adviser has more than five clients.

**The SEC has adopted a $10,000,000 "buffer" above and below its $100,000,000 registration threshold. Advisers with AUM between $100,000,000 and $110,000,000 may, but are not required to be registered with the SEC. Advisers registered with the SEC need not withdraw their registration until their AUM drops below $90,000,000. These buffers are not considered for purposes of this table.

***An adviser may still register with the SEC if it has AUM of $25,000,000 or more and (a) is required to register in fifteen or more states, (b) is not required to be registered in its home state, or (c) is registered in its home state, but not subject to examination. An adviser must register with the SEC if item (b) or (c) is true, unless the adviser relies on the Federal Exemption.