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September 13, 2012

VIA E-MAIL

To Our Investment Adviser Clients and Other Friends

Re: California Private Fund Adviser Exemption

Effective August 27, 2012 (the "Effective Date"), the California Commissioner of Corporations (the "Commissioner") amended its rule exempting private advisers from certification as investment advisers under California law. New section 260.204.9 of Title 10 of the California Code of Regulations replaces the existing exemption (for certain adviser's with fewer than fifteen clients) with a new exemption (the "New Exemption") for advisers to certain private funds.

General Requirements for Private Fund Advisers to Rely on the New Exemption

A *private fund adviser* is exempt from California investment adviser certification if it satisfies three criteria. First, it 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 (which requires filing specified sections of Part 1A of Form ADV relating to organization and operations). Second, it must pay application and renewal fees required of a certificated adviser. Third, neither the private fund adviser nor its advisory affiliates may have committed any disqualifying act,[1] 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 certificates.[2]

[1] 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.

[2] *See* Cal. Corp. Code § 25232(a)-(h). The Commissioner's grounds to deny, suspend or revoke an investment adviser certificate are similar, but not identical, to the disqualifying acts under Rule 262. An adviser's New Exemption eligibility under one regime does not guarantee its eligibility under the other.

A *private fund adviser* is an investment adviser that provides advice solely to one or more *qualifying private funds*, which are funds that qualify for exclusion from the definition of "investment company" under one or more of sections 3(c)(1), 3(c)(5) and 3(c)(7) of the Investment Company Act of 1940 (the "ICA"). The New Exemption is not available to an investment adviser that manages any separate accounts or registered investment companies. *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.

An adviser relying on the New Exemption must rely on the corresponding SEC private fund adviser exemption (the "SEC Exemption")[3] or register as an investment adviser with the SEC on reaching $25,000,000 in assets under management. The SEC Exemption becomes unavailable to an adviser and, accordingly, it must register with the SEC on reaching $150,000,000 in assets under management. An adviser that registers with the SEC may not rely on the New Exemption and must comply with California's notice filing requirements.

Additional Requirements for Private Fund Advisers to Certain Retail Buyer Funds

To rely on the New Exemption, a private fund adviser that advises at least one *retail buyer fund* must meet additional requirements. A *retail buyer fund* is a qualifying private fund that is not a venture capital company[4] and that is excluded from the definition of "investment company" under one or both of ICA sections 3(c)(1) and 3(c)(5). A fund that is excluded under ICA section 3(c)(7) is not a retail buyer fund. With respect to each retail buyer fund:

- Each person that is a beneficial owner of the fund must either (a) at the time the securities are purchased (i) be an accredited investor or (ii) be a manager, director, officer or employee of the private fund adviser, or (b) have obtained the securities through a transfer other than a sale of the securities;

- At or before the time of purchase of the securities, the adviser must disclose in writing to each beneficial owner all material facts regarding all services that it will provide and all duties, if any, that it owes to both the fund and such owner;[5]

- The adviser must provide annual audited financial statements for the fund to each beneficial owner within 120 days after the end of each fiscal year (or within 180 days if the retail buyer fund is a fund of funds);[6] and

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[3] *See* 17 C.F.R. 275.203(m)-1.

[4] Please contact us if you have questions regarding what might be deemed a venture capital company.

[5] The Commissioner's guidance on these disclosures states, among other things, that the disclosures' primary function is to ensure that investors are on notice that the investment adviser owes duties to the fund, as an entity, rather than to individual investors.

[6] The adviser does not need to provide audited annual financial statements for the initial year of a fund's

- The adviser must comply with the performance fee rule, which prohibits the adviser from charging a fee based on the capital gains or capital appreciation of the funds of an investor that is not a "qualified client."[7]

A private fund adviser that advises a retail buyer fund beneficially owned by any person who did not meet either of the first two requirements on the Effective Date may nevertheless qualify for the New Exemption if (a) the fund does not accept non-accredited investors after the Effective Date, (b) the private fund adviser complies with the performance fee rule with respect to each beneficial owner acquiring an interest in the fund on or after the Effective Date, (c) the private fund adviser makes the required disclosures (the second requirement) to each of the fund's beneficial owners by November 25, 2012, and (d) the private fund adviser meets the financial statement requirement on each fiscal year end after the Effective Date.

Temporary Filing Extension for Initial Reports

A private fund adviser seeking to rely on the New Exemption, including an adviser switching from the prior exemption, must file its initial reports via the IARD by October 26, 2012. After that date, a private fund adviser must file its initial reports before it may rely on the New Exemption.

Transition Period on Losing the New Exemption

A private fund adviser that relies on the New Exemption and subsequently loses its eligibility to do so must comply with all applicable laws and regulations regarding investment adviser certification and notice filing requirements within ninety days of losing its eligibility. A private fund adviser, for example, may establish a separately managed account if it applies for and receives an investment adviser certificate within ninety days thereafter. Note, however, that the SEC Exemption does not have a similar ninety day grace period. Therefore, an adviser relying on the SEC Exemption must register with the SEC before accepting a client that is not a private fund. If you rely on the New Exemption and the SEC Exemption, you should contact us to discuss registration issues before accepting a client that is not a private fund.

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operations that begin more than 180 days into a fiscal year if the financial statements for the subsequent year are supplemented by, or include, a financial audit for the initial year.

[7] *See* 17 C.F.R. 275.205-3(d)(1).

This letter only generally summarizes the New Exemption, is not intended as specific or complete advice, and is subject to change if and when the Commissioner adopts further rules and 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.

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