CALIFORNIA PROPOSES TO REVOKE ITS EXEMPTION FOR HEDGE FUND ADVISERS

The Commissioner of the California Department of Corporations (the "Commissioner") recently published a proposal to amend California Rule 260.204.9 to take away the exemption under California law for advisers in California not registered with the Securities and Exchange Commission ("SEC") who have fewer than 15 clients and assets under management of $25 million or more.[1]

As described below, this change will impact advisers not registered with the SEC that have or are contemplating having a "place of business" in California.

The Current Rule

The California Department of Corporations (the "Department") regulates certain activities of investment advisers in California. The Investment Advisers Act of 1940 (the "Advisers Act") Section 203A preempts state licensing provisions for advisers registered with the SEC, although the Department can still require a SEC-registered adviser to file a notice with the Department. For investment advisers not registered with the SEC, Section 25230 of the California Corporate Securities Law ("CSL") requires persons conducting business in California to be licensed with the Department. Investment advisers licensed under the CSL are subject to various obligations and restrictions, as set forth in the CSL and the rules of the Commissioner.[2]

Section 25202 of the CSL provides an exemption for investment advisers having fewer than six clients resident in California, but only if the adviser has no place of business in California. In 2002, the Commissioner adopted Rule 260.204.9, which exempts from licensing certain investment advisers with fewer than 15 clients and more than $25 million in assets under management, or those that provide advice only to venture capital companies as defined in the Rule, regardless of whether the adviser has a place of business in California.

Rule 260.204.9 currently exempts from licensing 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;

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[1] For a copy of the proposal, see PRO 41/06 on the California Department of Corporations website www.corp.ca.gov/pol/rm/rm.htm#PROPOSED%20RULES.

[2] In addition to being required to prepare a form ADV and other documents to become licensed with the Department, a California licensed adviser is subject to various reporting requirements, including reporting adviser representatives, compliance with books and records, custody, ethics, and minimum net worth requirements and to periodic inspections by the Department.

3. Is exempt from registration under the Advisers Act by virtue of Section 203(b)(3) of the Advisers Act; and

4. Either (i) has "assets under management" of not less than $25 million or (ii) provides investment advice only to "venture capital companies," as defined in the Rule.

The Proposed Change

The Department proposes to delete items 2 and 4(i) above, thereby limiting the exemption in California to advisers to venture capital companies as defined in the Rule. The notice concerning the proposal cites the SEC's 2003 report, Implications of the Growth of Hedge Funds, and lists various factors that have caused the Commissioner to reexamine the basis for exempting from registration under Rule 260.204.9 advisers not advising venture capital companies. Those factors include concerns with the growth of the hedge fund industry, increase in fraud related to hedge fund activities, broadening of market participation in hedge funds, and the lack of regulatory oversight of advisers to hedge funds since the Goldstein v. SEC[3] decision, which vacated the SEC's rule changes requiring the registration with the SEC of many advisers to hedge funds.

Effect Limited to Advisers with California Offices

As mentioned above, the proposal will only affect advisers with a place of business in California, since Section 25202 of the CSL exempts from licensing investment advisers with no place of business in California and fewer than six clients resident in California in any 12-month period. The definition of "client" for CSL Section 25202 incorporates the rules adopted under Section 222(d) of the Advisers Act described below and, in addition, excludes certain listed institutions.

Even if there were no California exemption for advisers without a place of business in California, the Advisers Act provides a preemption of the California requirements for "out-of-state" advisers.

In addition to the Advisers Act preemption in Section 203A, which precludes a state from requiring registration of an adviser registered with the SEC, Section 222(d) of the Advisers Act prevents a state from requiring investment advisers not registered with the SEC to register with the state if the adviser does not have a "place of business"[4] in the state and has fewer than six clients that are residents of such state during the preceding 12-month period.

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[3] Goldstein v. Securities and Exchange Commission, 451 F.3d 873 (D.C. Cir. 2006). See also Willkie Farr & Gallagher LLP Client Memorandum, "U.S. Court of Appeals Overturns Hedge Fund Adviser Registration Rule" (June 23, 2006), available at http://www.willkie.com/firm/pubs.aspx.

[4] Rule 222-1 provides that, for purposes of Section 222, "Place of business" of an investment adviser means: (1) an office at which the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and (2) any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients.

Rule 222-2 provides that, for purposes of Section 222(d), advisers may use the definition of "client" as set forth in Rule 203(b)(3)-1, which treats a legal organization (such as a private investment fund) that receives investment advice based on its investment objectives, and not on the individual investment objectives of its owners, as a single client. Thus, because of this preemption, hedge fund advisers generally are not subject to state-level registration in any state other than the state or states in which they are located because they do not have to "look through" the funds they advise for purposes of counting the number of clients in any state.

In light of this proposal, investment advisers not registered with the SEC should consider the requirements of registration with the Department in connection with any office in California or prior to opening a "place of business" in the state.

Comments on the proposed changes will be accepted at the Sacramento Office of the Department until November 26, 2007.

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If you have any questions regarding this memorandum, please contact Martin R. Miller (212-728-8690, mmiller@willkie.com) or the attorney with whom you regularly work.

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