

# Client Alert.

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## California Adopts New Private Fund Adviser Exemption

By **Stephanie C. Thomas**

California has adopted a new exemption from the state's investment adviser registration requirements that will require many investment advisers in the state to either submit a copy of their Form ADV to the state by October 26, 2012 or register as an investment adviser in California by November 26, 2012.

### OVERVIEW

Historically, most private fund advisers in California have relied on a self-executing exemption from investment adviser registration in California, which provided an exemption for an adviser that (i) did not hold itself out to the public as an investment adviser, (ii) had fewer than 15 "clients" in the preceding 12 months, (iii) did not advise either a registered investment company or business development company, and (iv) either had assets under management of at least \$25 million or advised only "venture capital companies" (the "Old CA Exemption"). The Old CA Exemption corresponded to a similar exemption from federal investment adviser registration pursuant to Section 203(b)(3) of the Investment Advisers Act of 1940, as amended. The Dodd-Frank Act eliminated this exemption at the federal level, and is credited for eliminating similar exemptions at the state level.

On August 27, 2012, the California Department of Corporations (the "Department") published a new version of the California Code of Regulations, Rule 260.204.9 (the "New CA Exemption"), which provides a more limited exemption from California's state investment adviser registration requirements for advisers to only "qualifying private funds." The New CA Exemption requires that private fund advisers relying on this new exemption file a notice with the Department and pay a filing fee within 60 days of the effectiveness of the New CA Exemption (i.e., October 26, 2012). For investment advisers relying on the New CA Exemption, there are ongoing filing and annual fee requirements with the Department. There are also additional requirements for private fund advisers, depending on the type of private funds advised as well as the qualifications of the investors in those private funds. We've summarized those requirements below.

### NEW CA EXEMPTION SUMMARY<sup>1</sup>

#### Requirements:

Unlike Old CA Exemption, the New CA Exemption is only available to investment advisers who advise *solely* "qualifying private funds" (i.e., advisers that advise separate accounts, individuals, or other advisory clients may not rely on this exemption). A "qualifying private fund" includes any fund relying on the exemptions from registration found in Sections 3(c)(1), 3(c)(5), and/or 3(c)(7) of the Investment Company Act of 1940, as amended, which are the exemptions that most

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<sup>1</sup> The full text of the New CA Exemption is available at [http://www.corp.ca.gov/Regulations/CSL/02110\\_Rev082712.pdf](http://www.corp.ca.gov/Regulations/CSL/02110_Rev082712.pdf).

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private equity funds rely on. A private fund adviser can rely on the New CA Exemption if:

1. Neither the private fund adviser nor its advisory affiliates have any “bad actor” disqualifications.<sup>2</sup>
2. The private fund adviser files a truncated Form ADV for exempt reporting advisers<sup>3</sup> with the Department online through the Investment Adviser Registration Depository (IARD)<sup>4</sup> initially, then files amendments to the Form ADV on an ongoing basis.
3. The private fund adviser pays the Department’s filing fee initially, then on an annual basis thereafter.

## Additional Requirements for a Private Fund Adviser to Retail Buyer Fund(s):

Under the New CA Exemption, if a private fund adviser advises at least one 3(c)(1) and/or 3(c)(5) fund that is not a “venture capital company” (as defined in the New CA Exemption) (a “Retail Buyer Fund”), it must comply with *all* of the following requirements for each Retail Buyer Fund it advises (unless the Retail Buyer Fund qualifies for the grandfathering provision described below):

- A. The private fund adviser shall advise only those Retail Buyer Funds whose outstanding securities are beneficially owned entirely by persons who (i) at the time the securities were sold, were “accredited investors,” or managers, directors, officers, or employees of the private fund adviser; or (ii) later obtained an interest in the Retail Buyer Fund by a transfer not involving a sale.
- B. At or before the time of purchase of any interest in a Retail Buyer Fund, the private fund adviser shall provide to the prospective investor a disclosure document containing all of the material information regarding (i) all services the private fund adviser provides to the fund and the beneficial owners of the fund; and (ii) all duties owed by the private fund adviser to the fund and the beneficial owners of the fund.
- C. The private fund adviser shall obtain annual audited financial statements from an independent certified public accountant that is registered with and examined by the Public Company Accounting Oversight Board, and will deliver a copy of such 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).
- D. A private fund adviser may not enter into, perform, renew or extend an investment advisory contract that provides for performance fees based on the investment profit (e.g., carried interest) attributable to a beneficial owner of a Retail Buyer Fund that is not a “qualified client.”<sup>5</sup>

## Grandfathering Provision:

If the private fund adviser advised an existing Retail Buyer Fund prior to August 27, 2012 with respect to which not all the beneficial owners are “accredited investors,” and/or that charges a performance fee (e.g., carried interest) to any beneficial owners that are not “qualified clients,” the private fund adviser can still rely on the New CA Exemption if:

<sup>2</sup> A private fund adviser may not rely on the New CA Exemption if either the private fund adviser or any of its advisory affiliates are subject to a disqualification as described in Rule 262 of Regulation A adopted by the Securities and Exchange Commission under the Securities Act of 1933, as amended (17 C.F.R. §230.262); or have done any of the acts, satisfy any of the circumstances, or are subject to any order specified in Section 25232, subdivisions (a) through (h) of the California Code of Regulations.

<sup>3</sup> The instructions to Form ADV specify which information on Form ADV is to be completed by exempt reporting advisers. Advisers may obtain a copy of Form ADV with instructions at <http://www.corp.ca.gov/Laws/CSL/BDIA/Forms.asp#IA>.

<sup>4</sup> Information on how to file with the IARD is available on the SEC’s website at <http://www.sec.gov/iard>.

<sup>5</sup> See Rule 205-3 promulgated under the Investment Advisers Act of 1940, as amended, for the definition of “qualified client.”

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1. As of August 27, 2012, the private fund adviser (i) stops selling interests in the Retail Buyer Fund to non-accredited investors, and (ii) does not charge performance fees to any *new* investor that does not meet the definition of “qualified client.”
2. The private fund adviser provides the disclosure document referenced above in paragraph B to the Retail Buyer Fund’s beneficial owners within 90 days of August 27, 2012.
3. The private fund adviser provides the annual audited financial statements referenced above in paragraph C to the beneficial owners of the Retail Buyer Fund for every fiscal year that ends after August 27, 2012.

### Investment Adviser Representatives:

Importantly, unlike investment advisers that are registered with the Department, the associated persons or investment adviser representatives of a private fund adviser relying on the New CA Exemption do not need to register as investment adviser representatives with the Department. Therefore, investment adviser representatives of private fund advisers that are relying on the New CA Exemption are not subject to the qualifying examination requirements (i.e., the Series 65 or the Series 7 and 63 exams), the filing of Form U-4, or the related registration fees.

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