

FINAL
STATEMENT OF REASONS
FOR RULE CHANGES UNDER THE
CORPORATE SECURITIES LAW OF 1968

As required by Section 11346.2 of the Government Code, the Commissioner of Corporations ("Commissioner") sets forth below the reasons for the proposed amendments to Sections 260.210, 260.211, 260.211.1, 260.234 and 260.241 of the California Code of Regulations (10 C.C.R. Sec 2602.10, 260.211, 260.211.1, 260.234 and 260.241.).

The Corporate Securities Law of 1968 ("CSL") requires any broker-dealer who conducts business in this state to obtain a certificate from the Commissioner, unless that broker-dealer is exempt from the licensing requirements.

On June 1, 1998, California was reclassified by the Central Registration Depository ("CRD")/National Association of Securities Dealers Regulation ("NASDR") as an "automatic" state, which means that agents that do not have disciplinary histories can be automatically allowed to be employed by a broker-dealer in this state. Agents with disciplinary histories of the type specified in Corporations Code Section 25212 will continue to have their disciplinary histories reviewed by the Department of Corporations ("Department"). In light of California becoming an automatic state, the Commissioner has reviewed current rules and proposes to amend Section 260.210.

Section 260.210. This section sets forth the procedures for broker-dealers licensed pursuant to Section 25211 of the Corporations Code. The Commissioner proposes to amend Section 260.210(b)(1) to link the review of an agent's disciplinary history by the Department under the CSL with the command instructions of the CRD system.

Under the CSL, the Department does not approve applications for registration or license agents. As an "automatic" state, the Department only reviews the employment histories of individual agents with disciplinary histories for acts prohibited by Section 25212 of the Corporations Code. Upon reviewing the disciplinary history of an individual agent, the Department then notifies the prospective employer of the individual's disciplinary history. Under Section 25213 of the Corporations Code, the Commissioner may issue an order to deny or bar employment of an agent with a prohibited disciplinary history. Also, Section 260.210(b)(1) allows the Department to "abandon" a CRD application if additional information is not received; however, the CRD system only has the command instructions "approve" or "reject". These changes are necessary to link the Department's review of an agent's disciplinary history with the command instructions of the CRD system.

The Commissioner proposes to adopt new subparagraph (b)(2) of Section 260.210 to allow the temporary transfer of the CRD registration of an agent from one broker-dealer to another through the Relicensing program ("Relicensing program") of the North American Securities Administrators Association ("NASAA"). This amendment is consistent with the

policy of the NASDR, will facilitate the transfer of eligible agents within California and alleviate unreasonable delays and burdens on these agents and broker-dealers.

In 1984, the National Association of Securities Dealers, Inc., ("NASD") (now known as the National Association of Securities Dealers Regulation or "NASDR") endorsed the North American Securities Administrators Association's Temporary Agent Transfer ("TAT") program. This program replaced NASD's conditional approval process and permits the immediate but temporary transfer of an agent from one broker-dealer to another broker-dealer upon notification through CRD.

The TAT program was developed in response to the securities industry concerns regarding delays in CRD registration of the transfer of the employment of agents between one broker-dealer to another. Although registrations and terminations through the CRD have reduced overall processing times, other factors (i.e., U.S. Mail) and the failure of timely submission by the terminating broker-dealer firm may slow down the agent transfer process.

The TAT program requires that the request to transfer employment be made no later than seven calendar days after the agent has terminated employment and registration with the terminating broker-dealer where the agent does not have a disciplinary history. The temporary registration period expires 21 days after the date of issuance, unless the CRD registration is made permanent by the filing of a properly completed and executed Form U-4. In addition, both the agent and the broker-dealer must be currently registered with the NASDR in each jurisdiction where the temporary transfer of registration is being requested, and the broker-dealer must have sufficient funds on deposit with the CRD to pay the required CRD registration fees.

Recently, the NASDR, in conjunction with the NASAA, have re-engineered the prior CRD system using, state of the art, Web-based technologies. This modernized Internet-based CRD system ("Web CRD") debuted in August 1999. The goals of Web CRD are to speed-up the CRD registration or notification process while continuing to protect investors from unscrupulous agents and broker-dealers, and provide regulators with the ability to monitor and track agents and broker-dealer firms with disciplinary histories. As part of the Web CRD, the Relicensing program replaces the TAT Program.

The Relicensing program will allow for the automatic CRD registration of agents who have no reportable disclosure items as well certain agents with previously reported disclosure items, but who have no new reportable disclosure items since the last review or approval. An agent may only participate in the Relicensing program if he or she was registered in that jurisdiction within the preceding 30 days, and requests participation in the Relicensing program. A request for participation in the Relicensing program is made by completing and submitting to the agent's employing broker-dealer the Relicensing Section of the Uniform Form U-4

With the exception of California, all other states participate in the TAT Program and upon implementation of the Web CRD all states, including California, will automatically participate in the Relicensing program.

In order for an agent to transfer from one broker-dealer to another, the terminating broker-dealer must file the Form U-5 with the NASDR. Once the Form U-5 is properly filed and approved, the employing broker-dealer must file a Form U-4 with the NASDR. In the interim, an agency may not conduct any business in this state. This unnecessarily penalizes agents that have no disciplinary history.

To facilitate the expeditious transfer of eligible agents within California and alleviate delays, the Commissioner has determined it is necessary to adopt new subparagraph (b)(2) of Section 260.210 to allow the temporary transfer of agents through the Web CRD and to renumber subsequent subparagraphs.

Section 260.211 sets forth the procedures for applying for a certificate as a broker-dealer. Subsection (a) requires the applicant to use the Uniform Application for Broker-Dealer Registration (Form BD), and subsection (b) sets forth the Instructions for California.

The Commissioner proposes to amend subsection (b) to clarify, update or eliminate various requirements contained in subsection (b) of Section 260.211 (Instructions for California).

Part I. Filing Fee and Mailing Address. In late January or early February 2001, the Sacramento Office of the Department of Corporations will move from its current location of 980 Ninth Street, Sacramento, CA to 1515 K Street, Sacramento, CA 95814. Rule 260.211 is being amended to reflect the new address for the Department's Sacramento Office.

Part II. Instructions as to Arrest Records. The California Business and Professions Code Section 461 prohibits public agencies from requesting, on an initial application, that an applicant reveal a record of arrest that did not result in a conviction or plea of nolo contendere. In order to comply with Business and Professions Code Section 461, first-time broker-dealer applicants are instructed to amend specific questions contained in Uniform Application for Broker-Dealer Registration (Form BD) regarding arrest records. Currently, the question number and the manner in which the question is to be modified are set forth in this instruction.

In February 1998, the National Association of Securities Dealers, Regulation ("NASDR") revised Form BD to, among other things, renumber and revise the questions regarding arrest records (Items 7F and 7G). In August 1999, as part of the rollout of Web CRD, Form BD was again amended and Items 7F and 7G were renumbered Items 11H(2) and 11G. The Commissioner is proposing to amend this instruction to direct first-time applicants to a special instruction sheet. The special instruction sheet will provide specific information on the questions in Form BD to be modified in accordance with Business and Professions Code Section 461. The special instruction sheet will also contain other information to assist an applicant in completing the Form BD. The special instruction sheet is available from any of the Department's offices and through the Department's Internet home page. A copy of the special instruction sheet is attached as Exhibit 1.

The Commissioner believes that this amendment presents an efficient and economical solution to rulemaking. The other alternative, to amend this instruction each time the questions in Form BD relating to arrest records are changed, is unnecessarily time-consuming, costly and burdensome to the Department and reviewing agencies.

Part III. Additional Information. Item 2 - Organization Information. This item is being amended to require broker-dealers who file as limited liability companies ("LLC"), to include organizational document specific to LLCs. This addition is necessary because many broker-dealer applicants are filing as LLCs and the organization documents differ from those of a corporation or a partnership.

Part III. Item 3. Other Exhibits. The requirement in Item 3, that the applicant provide the name of its worker's compensation insurance or attach a copy of the certificate of consent to self-insure in Item (B) of Other Exhibits is being deleted. As far as the Department is concerned, this information is unnecessary. Simply asking the question does not verify or validate compliance. Determining compliance with the requirements of Labor Code Section 3700 is under the Department of Industrial Relations' jurisdiction.

Part IV. Investment Adviser Activities. This Part is being amended to clarify that the exemption in Section 25205 of the Corporations Code is not applicable to a broker-dealer registered with the Securities and Exchange Commission as an investment adviser. These broker-dealers should make a notice filing as required by Section 25230.1(b). AB 721 (Chapter 391, Statutes of 1997) amended the Corporate Securities Law of 1968 to conform provisions of the California securities law to the federal National Securities Markets Improvement Act of 1996 ("NSMIA"). One of the provisions of NSMIA provided the Securities and Exchange Commission ("SEC") with exclusive authority for the registration of investment advisers with \$25 million or more in assets under management and advisers to investment companies registered by SEC. As these broker-dealers no longer fall under California jurisdiction, the exemption provided by Corporations Code Section 25205 is no longer appropriate for them.

Currently, broker-dealers who rely on the exemption in Section 25205 are required to submit a copy of Part II of the Uniform Application for Investment Adviser Registration (Form ADV). The Commissioner proposes to require these broker-dealers to submit a complete copy of the Form ADV, a list of investment adviser representatives or associated persons, and the investment adviser representative or associated person's complete name, CRD or social security number, and business address. In addition, the list shall contain a statement affirming that all investment adviser representatives and associated persons included on the list meet the qualification requirements set forth under Section 260.236, Title 10, California Code of Regulations. An officer of the investment adviser must sign this list under penalty of perjury.

The list is necessary to confirm that the investment adviser representatives or associated persons employed by the broker-dealer have satisfied the qualification requirements and also facilitates the reporting requirements under Corporations Code Sections 25608(p) and 25230(b). Corporations Code Section 25230(b) prohibits any person from conducting business as an investment adviser or conducting business on behalf of an investment adviser, unless that person has satisfied the qualification requirements of Section 260.236, Title 10, California Code of Regulations.

These requirements are patterned after the notice requirement of Corporations Code Section 25230.1(b) and are necessary for review purposes, public disclosure and to facilitate the reporting of investment advisers or associated persons required by Corporations Code Sections 25608(p) and 25230(b).

The notice required to be filed with the Department by each SEC-registered investment adviser that conducts business in California consists of: a copy of the Order Granting Registration under the Investment Adviser Act of 1940; a Consent to Service of Process or Form U-2; a complete copy of Form ADV filed with the SEC; a notice filing fee; and Schedule D of Form ADV for each investment adviser representative or associated person with a place of business in California. In lieu of filing the Schedule D, an investment adviser who is dually certificated as a broker-dealer under Corporations

Code Section 25210, that is a member of a self-regulatory organization and whose agents are dually affiliated as investment adviser representatives or associated person may file a list identifying those investment adviser representatives that have a place of business in California. This list must be on company letterhead and include the investment adviser representatives' complete names, CRD numbers, places of business (mailing address, city and zip code) and an affirmative statement that all investment adviser representatives included on that list meet the qualification requirements set forth under 10 CCR Section 260.236. An officer of the Adviser must sign this list under penalty of perjury. (See Commissioner's Release 109-C and SEC Registered Investment Advisor Notice Filing Requirements, Instructions and Fees, attached as Exhibit 2.)

Part IV is further amended to clarify that social security numbers would not become part of public records. This change is necessary to reflect the Department's current practice of not disclosing an individual's social security number when complying with a request pursuant to the Public Records Act.

Section 260.211.1 sets forth the procedures and application for licensing by notification for broker-dealers who are exempt from licensing by Corporations Code Section 25211(b). The Commissioner proposes making similar changes as those proposed for Section 260.211, Part IV., to Section 260.211.1. Subsection (a) and subsection (b), Item 9 of the application by notification, are being amended to require a broker-dealer, who engages in business as an investment adviser in this state, but is not licensed as an investment adviser, to submit with the application by notification, a complete copy of the Form ADV and a list of investment adviser representatives or associated persons and the applicable reporting fee. The necessity for these changes is discussed above, in Section 260.211.

A nonsubstantive change is made to the heading of the form. In late January or early February, 2001, the Sacramento Office of the Department of Corporations will move from its current location of 980 Ninth Street, Sacramento, CA to 1515 K Street, Sacramento, CA 95814. This change is needed to reflect the Department's new office location.

The Commissioner proposes additional amendments to the application for licensing by notification contained in subsection (b). Item 6.b. requires a broker-dealer to attach certain copies of the Form BD. Item 6.b. is being deleted for the following reasons: the pages and schedules listed in Item 6.b. no longer correspond to the recently amended Form BD, and the NASDR is now requiring all broker-dealers, by December 31, 1999, to refile their Form BD's electronically. The complete Form BD will soon be available through Web CRD, eliminating the need for copies to be attached to the application.

New Item 6.b. is former Item 6.b.C. In its current position at the end of the disclosure regarding social securities numbers, the requirement to attach a completed Customer Authorization of Disclosure of Financial Records, is out of place. There is merely a formatting change.

The disclosure regarding social security numbers is being amended to clarify that social security account numbers would not become part of public records. This change is necessary to reflect the Department's current practice of not disclosing an individual's social security number when complying with a request pursuant to the Public Records Act.

Section 260.234 provides an exception from the prohibition on an investment adviser's compensation based on capital appreciation of clients' assets and references subsections (b), (c), (d) and (e) of SEC Rule 205-3. The Commissioner proposes to amend Rule 260.234 to conform it to recent changes and adopt the disclosure requirements which are similar to those disclosure requirements which were eliminated.

On August 20, 1998, the SEC amended Rule 205-3 (17 CFR 275.205-3) to provide investment advisers registered under the Investment Advisers Act of 1940 greater flexibility in structuring performance fee arrangements with clients that are financially sophisticated. New Rule 205-3 permits investment advisers to charge qualified purchasers or qualified clients and certain knowledgeable investment adviser employees performance or incentive fees. The amendments also modified the criteria for client eligibility to enter into a contract under which performance fees can be charged and eliminates provisions that specify required contract terms and disclosures (former subsections (b) through (e)).

In addition to the conforming changes being proposed, the Commissioner proposes to adopt subsection (a)(3) to require full disclosure of all material information regarding the proposed compensation arrangement prior to entering into a contract. The SEC has indicated that the elimination of the contractual and disclosure provisions (former subparagraph (d)) from SEC Rule 205-3 does not alter the obligation of an investment adviser, as a fiduciary, to deal fairly with its clients and to make full and fair disclosure of its compensation arrangements. This obligation includes full client disclosure of all material information regarding a proposed performance based fee arrangement as well as any material conflicts posed by the arrangement. (See SEC Release No. IA-1731, attached.) Subsection (a)(3) does not impose any new standards and merely clarifies existing fiduciary duties of investment advisers.

Section 260.241 sets forth the books and records to be maintained by a broker-dealer. Subsection (a) is being amended to clarify that the Commissioner or the Commissioner's designee has access to and may make copies of any of the books and records maintained by the broker-dealer. This change clarifies the Commissioner's authority contained in Corporations Code Section 25241 to examine books and records of a broker-dealer. References to the Pacific Stock Exchange are being changed to Pacific Exchange, as that is the current name of the exchange.

ALTERNATIVES CONSIDERED

No alternative considered by the Department would be more effective in carrying out the purpose for which the regulation is proposed, would be as effective and less burdensome to affected private persons, or would lessen any adverse impact on small businesses.

FISCAL IMPACT

Cost to Local Agencies and School Districts required to be reimbursed under Part 7 (commencing with Section 17500) of Division 4 of the Government Code: None.

No other nondiscretionary cost or savings are imposed on local agencies.

DETERMINATIONS

The Commissioner has determined that the proposed regulatory action does not impose a

mandate on local agencies or school districts, which require reimbursement pursuant to Part 7 (commencing with Section 17500) of Division 4 of the Government Code.

ADDENDUM REGARDING PUBLIC COMMENTS

No request for hearing was received during the 45-day public comment period, which ended on March 31, 2000. No public hearing was scheduled or heard.

COMMENTS RECEIVED DURING THE 45-DAY COMMENT PERIOD

One comment letter was received during the public comment period. This comment letter is summarized below.

COMMENTOR: Tamara K. Reed, Associate Counsel, Investment Company Institute ("ICI"), letter dated March 30, 2000.

COMMENT 1. Rule 260.211, Part III, requires a broker-dealer to file certain financial statements with the Department. When applied to federally registered broker-dealers, this portion of the rule, exceeds the Department's authority. Section 15(h)(1) of the Securities Exchange Act of 1934, preempts states from requiring any federally registered broker or dealer to file any financial reports that differ from or are in addition to, the requirements in those areas established under that Act. ICI suggests adding the following language:

1. Financial statements: A broker-dealer that is registered under the Securities Exchange Act of 1934 shall file with the Department a copy of its most recent annual financial statement that has been filed pursuant to such Act. All other broker-dealers shall file the financial statements required by (A) and (B), below. All applicants shall file, to the extent applicable, the information required by (C), (D), and (E), below.

RESPONSE: The Department disagrees with ICI's comments. Broker-dealers registered pursuant to Section 15 of the Securities and Exchange Act of 1934 are required to file an audited annual report of financial condition, unless the broker-dealer is otherwise exempt. The information required by Items (A) and (B) are contained in the annual statements of financial condition filed with the SEC by federally-registered broker-dealers and in Commissioner's Rule 260.216.12. Rule 260.216.12 incorporates by reference, the federal rules for minimum net capital and the minimum ratio of net capital to aggregate indebtedness. The Department is not requiring any information that differs from or is in addition to federal requirements; rather, ICI's language would require federally registered broker-dealers to file more information than is required by the current rule. In addition, ICI's suggested language is cumbersome, confusing and may allow a broker-dealer to not file the information required by Items (C), (D), and (E).

As a compromise, the Department proposes adding the following language:

A broker-dealer registered pursuant to Section 15 of the Securities Exchange Act of 1940 may file a copy of its most recent annual report of financial condition and its most recent quarterly financial report required under CFR 240.17a5 in lieu of Items (A) and (B) above.

COMMENT 2. Rule 260.211, Part IV, and Rule 260.211.1(a) and (b) Items 9(b) and (c). ICI recommends that the Department revise the rule to clarify the investment adviser representative or association person that this rule would govern.

Specifically, ICI suggests the following changes:

2. A list of all investment adviser representatives or associated persons. Consistent with Section 25009.5 of the Corporate Securities Law of 1968, an investment adviser that is registered with the U.S. Securities and Exchange Commission under the Investment Advisers Act of 1940 shall provide the Department a list containing each of its “investment adviser representatives” with a “place of business” in California, such as terms are defined in Rule 203A-3 under the Investment Advisers Act of 1940. All other investment advisers shall list each of their investment adviser representatives or their associated persons. Such This list must be submitted on company letterhead and include the complete name of each investment adviser representative or associated person, their CRD number (if any), business address (mailing address, city, state, and zip code), and an affirmative statement that all investment adviser representatives or associated persons on the list meet the qualification requirements set forth under Section 260.236, Title 10, California Code of Regulations. The affirmative statement must be signed, under penalty of perjury, by an officer of the Adviser

3. Reporting fee of \$25 for each investment adviser representative or association person whose name appears on the list provided to the Department pursuant to this rule.

RESPONSE: ICI’s suggested language merely incorporates and restates the language found in Corporations Code Section 25009.5 and is duplicative and redundant, as well as cumbersome and confusing. If a federally registered broker-dealer does not have investment advisers with a place of business in California, they are not subject to these requirements.

However, as a compromise, the Department proposes the following language for Rules 260.211 and 260.211.1 to address ICI’s concern:

2. A list of all investment adviser representatives or associated persons. (An investment adviser registered with the U.S. Securities and Exchange Commission under the Investment Advisers Act of 1940 shall list only investment adviser representatives with a place of business in California, whereas, any other investment adviser shall list any and all of its investment adviser representatives or associated persons regardless of their business location.) This list must be submitted on company letterhead and include the complete name of each investment adviser representative or associated person, their CRD number (if any), business address (mailing address, city, state, and zip code), and an affirmative statement that all investment adviser representatives or associated persons on the list meet the qualification requirements set forth under Section 260.236, Title 10, California Code of Regulations. The affirmative statement must be signed, under penalty of perjury, by an officer of the Adviser

3. Reporting fee of \$25 for each investment adviser representative or association person whose name appears on the list provided to the Department pursuant to this rule.

ICI’s suggestion to Item 3 has been incorporated to Rule 260.211, 260.211.1.

As a point of clarification, ICI “notes that, pursuant to this rule, the Department has proposed to

begin charging a 'reporting fee' of \$25 for each investment adviser representative subject to the Department's qualification requirements." The reporting fee is authorized by Section 25608.1 of the Corporations Code, which was enacted by AB 721 (Chapter 391, Statutes 1997).

COMMENT 3. Rule 260.234. ICI believes that this rule continues to apply to both federally registered investment advisers as well as to those investment advisers that are registered with the Department. ICI suggests adding a new subsection (a) to provide that the provisions of Section 25234(a)(1) of the Code shall not apply to any investment adviser that is registered under the Investment Advisers Act of 1940.

RESPONSE: For clarity, the changes as suggested by ICI are incorporated.

COMMENTS RECEIVED AFTER THE CLOSE OF THE 45-DAY COMMENT PERIOD

One comment letter from Investment Counsel Association of America, Inc., was received after the close of the comment period

COMMENTOR: Karen L. Barr, Investment Counsel Association of America, Inc., ("ICAA") letter dated March 30, 2000 and received on April 4, 2000.

COMMENT: ICAA urges the Department to consider the comments made by ICI and revise Rule 260234 to limit its application to state registered advisers.

RESPONSE: The Department has responded to ICI's comments above.

No other comment letters were received.

COMMENTS RECEIVED DURING THE 15-DAY COMMENT PERIOD ENDING SEPTEMBER 25, 2000.

No comments were received during this comment period.

COMMENTS RECEIVED AFTER THE 15-DAY COMMENT PERIOD ENDING SEPTEMBER 25, 2000.

Two comment letters were received after the comment period from Tami Reed, Associate Counsel, Investment Company Institute. Given the importance of these comments, they are summarized below.

COMMENTOR: Tamara K. Reed, Associate Counsel, Investment company Institute ("ICU"), by letters dated October 3, 2000 and October 16, 2000.

COMMENT: Ms. Cain asserts that the proposed rules should be revised to delete the parenthetical provisions setting forth requirements for listing investment adviser representatives. According to Ms. Cain, broker-dealers registered with the Securities and Exchange Commission as investment advisers cannot rely on the exemption from investment adviser certification afforded by Corporations Code Section 25205, because these persons are not subject to the certification

requirements pursuant to Section 25230.1. (Instead, these federally registered broker-dealers must file a notice with the Commissioner of Corporations under Section 25230.1.) Since the requirements for listing investment adviser representatives applies only to persons seeking to rely on the exemption afforded by Corporations Code Section 25205, it is unnecessary to specify listing requirements for these federally registered broker-dealers that do not rely on the exemption afforded by Section 25205.

RESPONSE: The Department of Corporations concurs with the comments made by Ms. Cain. To avoid the potential conflict with existing law, the Department will delete the unnecessary language from Rules 260.211 and 260.211.1.