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

As required by Section 11346.9 of the Government Code, the California Corporations Commissioner ("Commissioner") sets forth below the reasons for the proposed amendments to Sections 260.230, 260.230.1, 260.231, 260.231.2, 260.231.3, 260.236, 260.236.1, 260.236.2, 260.237.1, 260.237.2, 260.240, 260.241.2, 260.241.3, 260.241.4 and 260.242 of the California Code of Regulations. (10 C.C.R. Secs. 260.230, 260.230.1, 260.231, 260.231.2, 260.231.3, 260.236, 260.236.1, 260.236.2, 260.237.1, 260.237.2, 260.240, 260.241.2, 260.241.3, 260.241.4 & 260.242).

Under the Corporate Securities Law of 1968 (“CSL”), the Commissioner is responsible for the regulation of certain investment advisers and investment adviser representatives. Pursuant to this authority, investment advisers must obtain a license from the Commissioner, which includes providing an application and various additional documents and fees to the Commissioner. The Commissioner is amending the rules outlining the procedures for applications and other filings by investment advisers and investment adviser representatives to allow all applications, amendments, reports, notices and fees to be filed with the Investment Adviser Registration Depository (“IARD”), to the extent that IARD is capable of receiving such documents.

IARD is an Internet-based national electronic filing system for investment advisers, established through a joint effort between the Securities and Exchange Commission (“SEC”) and the North American Securities Administrators Association (“NASAA”). IARD allows an investment adviser to utilize a modem and the Internet to register as an investment adviser with both the SEC and the states, respectively, and to file many of the required applications, notices, reports, renewals and fees electronically. The SEC and NASAA have contracted for IARD to be built and operated by the National Association of Securities Dealers Regulation, Inc. (“NASDR”).

The SEC has mandated that its investment adviser registrants (i.e., federally-registered investment advisers) use IARD to make all filings with the SEC. NASAA has been working with the various state securities administrators to assist states in transitioning their investment advisers to filing with IARD as soon as practicable. These regulations implement California’s transition to permitting investment advisers to file with IARD, and amend various existing procedures and requirements to provide uniformity with other states and to reduce paperwork.

In order to facilitate online filing through IARD, the Department of Corporations (“Department”) sponsored AB 1048 (Frommer – Chapter 264, Statutes of 2001) in 2001. AB 1048 made the necessary statutory changes to permit electronic filings. This rulemaking action makes changes to rules to implement AB 1048.

The policy objectives in transitioning investment advisers to filing with IARD are as follows: to implement a filing system in California that is uniform with other states and the SEC; to increase consumer awareness and consumer protection by providing for greater public access to information on investment advisers; to enable investment advisers registered in more than one state to utilize a single database for all filing and reporting requirements; to increase consumer protection by enabling securities administrators in other jurisdictions to access California's database on investment advisers; to reduce the additional documents and standards for investment advisers in California that differ from other states; and to improve the efficiency and technology of the Department by eliminating or reducing paper filings and manual record-keeping.

Existing law provides that the Commissioner may, by rule, prescribe the form and detail of an investment adviser's application and other reporting requirements. The Commissioner is adopting rules setting forth procedures to permit both California and federally-registered investment advisers to make most filings electronically with IARD, rather than in paper with the Department.

The rules incorporate by reference several uniform forms in their entirety. The forms are as follows:

- Form ADV, the Uniform Application for Investment Adviser Registration, as amended by Securities and Exchange Commission Release No. IA-1916, 34-43758 (December 21, 2000), effective January 1, 2001;

- Form U-4, the Uniform Application for Securities Industry Registration or Transfer (Rev. Form U-4 (03/2002)), by the National Association of Securities Dealers, Inc. through its wholly owned subsidiary, NASD Regulation, Inc., and approved by the Securities and Exchange Commission in Release No.34-45531 (March 11, 2002);

- Form U-5, the Uniform Termination Notice for Securities Industry Registration (Rev. Form U-5 (03/2002)), by the National Association of Securities Dealers, Inc. through its wholly owned subsidiary, NASD Regulation, Inc., and approved by the Securities and Exchange Commission in Release No.34-45531 (March 11, 2002);

- Form ADV-W, the Notice of Withdrawal from Registration as an Investment Adviser, as amended by Securities and Exchange Commission Release No. IA-1916, 34-43758 (December 21, 2000), effective January 1, 2001;

- Form BD, the Uniform Application for Broker-Dealer Registration, as amended by Securities and Exchange Commission Release No. 41594 (July 2, 1999), effective July 30, 1999; and

- Form BDW, the Uniform Request for Broker-Dealer Withdrawal, as amended by Securities and Exchange Commission Release No. 34-41356 (May 10, 1999), effective June 9, 1999.

All of the forms are available from the Department and are widely available in the securities industry and on the Internet from sources such as the Securities and Exchange Commission, securities administrators of various jurisdictions throughout North America, and self-regulatory organizations (such as the NASDR). The use of these forms is necessary for the Department to participate in IARD and CRD (the Central Registration Depository). Due to the size of the forms, the uniform nature of the forms, and the fact that the forms are incorporated into a national electronic filing system, it is both impractical and cumbersome to publish the forms in the California Code of Regulations. The final text of the rules has been changed from that originally proposed to cite to the versions of the forms being adopted, whenever the uniform forms are referenced.

A substantial portion of the new language in this rulemaking action is taken from NASAA's Model Rules. In particular, the language with respect to filings through IARD was adapted from NASAA's IARD Implementation Model Rules, and the new rule on minimum financial requirements was adapted from NASAA's Rule 202(d)-1, entitled Minimum Financial Requirements for Investment Advisers.

260.230. Electronic Filings

Section 260.230 sets forth the foundation for filings through IARD. The new rule designates IARD to accept filings on behalf of the Commissioner, permits investment advisers to make filings through IARD, provides for the acceptance of electronic signatures, and provides that the electronic signature shall constitute irrefutable evidence of a legal signature. Section 260.230 further provides that documents are considered filed when the necessary fees are filings are received by IARD. Section 260.230 is necessary to transition investment advisers to filing with IARD.

260.230.1. Notice Filing Requirements for Investment Advisers Registered under Section 203 of the Investment Advisers Act of 1940

Section 260.230.1 sets forth the filing requirements for investment advisers registered with the SEC. Section 260.230.1 provides that federally-registered investment advisers must file Form ADV, the Uniform Application for Investment Adviser Registration, with IARD within 30 days of doing business in California. Section 260.230.1 further provides that, until Part 2 of Form ADV is accepted by IARD, federally-registered investment advisers need not provide Part 2 of the form with the notice if they agree to provide it to the Commissioner upon request. Section 260.230.1 further sets forth procedures for the annual renewal of the notice, for amending Form ADV, for reporting investment adviser representatives, and for switching to state registration.

As initially proposed, subsection (f) of the section would have required an investment adviser to file its application with the Department within 60 days of the date the investment adviser's registration with the SEC was subject to termination. This time period was proposed to ensure that an investment adviser whose SEC registration was terminated may obtain licensing and continue in business in California without interruption. However, in response to the concerns of a member of the public about the 60-day time period, the language was amended to eliminate the 60-day period and instead advise investment advisers that they may not engage in business in California after their SEC registration is terminated unless they have secured a certificate from the Commissioner.

Section 260.230.1, in its entirety, is necessary to inform federally-registered investment advisers on the procedures for making notice filings in California. Since the SEC mandates participation in IARD for federally-registered investment advisers, the Department is not proposing rules for federally-registered investment advisers to make notice filings in California through any means other than through IARD.

260.231. Application for Investment Adviser's Certificate

Section 260.231 repeals the existing language of that rule, which set forth an application for state-registered investment advisers, and instead sets forth procedures for state-registered investment advisers to file an application with the Department through IARD. This rule is necessary to inform investment advisers on how to apply for an investment adviser certificate by filing through IARD.

Section 260.231 provides that state-registered investment advisors may file Form ADV with IARD, and instructs state-registered investment advisers to file Part 2 of Form ADV directly with the Commissioner until such time as the form may be filed with IARD. Section 260.231 further instructs investment advisers to complete a Customer Authorization of Financial Records, maintain the document in the investment advisers' books and records, and to provide the document to the Commissioner upon request. The rule requires investment advisers to maintain the document in their books and records in order to facilitate the Department's goal of eliminating paper filings for IARD filers.

As originally proposed, the rule contemplated a separate instruction sheet advising investment advisers regarding which documents to submit with their application, and which documents to keep with their books and records. The separate instruction sheet was intended to allow the Department flexibility in eliminating paper filings. However, to provide greater clarity the Department has eliminated the separate instruction sheet, and instead set forth by rule the documents needed. The rule requires applicants submit a balance sheet with a worksheet that shows compliance with the minimum financial requirements for investment advisers. Applicants must also submit investment advisory contracts and proof of compliance with the qualification requirements of Section 260.236. Subsection (a)(4) further provides that the

Commissioner may request additional documentation pertaining to Form ADV. This provision is necessary to allow the Commissioner to obtain additional information, should initial answers by the applicant on Form ADV need further clarification or documentation prior to the issuance of a certificate.

Section 260.231 also provides that the filing fee is effective for the calendar year during which the certificate is granted, that the fee is nonrefundable, and that the filing is complete when the Commissioner receives the fee and all required submissions. Section 260.231 also sets forth procedures for the annual renewal of the certificate, for amending the filing of Form ADV, for reporting investment adviser representatives, for succeeding to the business of an investment adviser, and for switching to SEC registration. These provisions are necessary to clarify the details of making filings with IARD and obtaining licensure.

As originally proposed, the rule did not have subsections (i) or (j). Subsection (i) was added to set forth the Customer Authorization of Disclosure of Financial Records form and instructions. The form is for use by both investment advisers and broker-dealers, and provides the Department with authority to access a licensee's financial records, as provided.

Subsection (j) sets forth the notices required under the Information Practices Act of 1977, the Privacy Act of 1974, and the Permit Reform Act of 1981. The notices contain disclosures applicable to both investment advisers and broker-dealers, so that the Department may provide the same notice to applicants for either an investment adviser certificate or a broker-dealer certificate. The adoption of the notices assists the Department in complying with the disclosure requirements of the various laws when requiring the use of a uniform form.

260.231.2. Application for Investment Adviser's Certificate for Applicants Not Filing Through the Investment Adviser Registration Depository

Section 260.231.2 sets forth the procedures to apply for an investment adviser's certificate by an applicant that does not participate in IARD. The rule instructs applicants to complete Form ADV and to file it with the Department's Sacramento office. As adopted, new text (from that originally proposed) is added making the notices being adopted in Section 260.231(j) part of Form ADV.

As originally proposed, the rule contemplated a separate instruction sheet advising an investment adviser which documents to submit with an application, and which to keep with the adviser's books and records. The separate instruction sheet was intended to allow the Department flexibility in eliminating paper filings. However, to provide greater clarity the Department has eliminated the separate instruction sheet and instead set forth by rule the documents needed. The rule requires applicants not filing through IARD to submit a Customer Authorization of Disclosure of Financial Records and a balance sheet with a worksheet the shows compliance with the minimum financial

requirements for investment advisers. Applicants must also submit investment advisory contracts and proof of compliance with the qualification requirements of Section 260.236. Subsection (a)(2) further provides that the Commissioner may request additional documentation pertaining to Form ADV. This provision is necessary to allow the Commissioner to obtain additional information, should initial answers by the applicant on Form ADV need further clarification or documentation prior to the issuance of a certificate.

Section 260.231.2 additionally sets forth the fee for filing an application with the Commissioner, provides that the filing fee is effective for the calendar year during which the certificate is granted, and provides that the fee is nonrefundable. Section 260.231.2 further provides that the filing is complete when the Commissioner receives the fee and all required submissions. Section 260.231.2 also sets forth procedures for the annual renewal of the certificate, for submitting amendments to Form ADV, for succeeding to the business of an investment adviser, and for switching to SEC registration. These provisions are necessary to clarify the details of making filings with the Commissioner.

Section 260.231.2 provides that broker-dealers are exempt from the fee requirement for investment adviser certificate applications and renewals. This provision is the result of AB 1048 (Chap. 264, Stats. 2001), which eliminated the exemption from investment adviser licensure for broker-dealers, but instead exempted broker-dealers from any fees associated with obtaining an investment adviser certificate.

As initially proposed, Section 260.231.2 set forth various disclosures on the use of social security numbers, in accordance with Section 7 of the Privacy Act of 1974 (PL. 93-579). However, in the final text these provisions were removed because the Department instead adopted several notices in subsection (j) of Section 260.231, including the disclosures required under the Privacy Act of 1974, and made these notices a part of the application in subsection (a) of this rule.

260.231.3. Representation of Eligibility by Investment Adviser

Section 260.231.3 provides that a filing with IARD or directly with the Commissioner constitutes a representation by the investment adviser that the investment adviser is not ineligible to receive a certificate as an investment adviser based upon the investment adviser's immigration status. Section 260.231.3 further provides that, in lieu of filing the Statement of Citizenship, Alienage, and Immigration Status form, as set forth in Sections 250.60 and 250.61 of the rules, an investment adviser applicant filing with IARD or directly with the Commissioner may instead maintain the executed form in its books and records with the appropriate supporting documentation, provided that the investment adviser agrees to deliver the form and documentation to the Commissioner upon request. The rule is necessary to transition to paperless filings through IARD. By maintaining the form in its books and records with appropriate supporting documentation, the Department may obtain the documentation during its onsite routine regulatory examination of the investment adviser, where

applicable. Applicants filing directly with the Commissioner, rather than through IARD, are also permitted by the rule to maintain the form and supporting documentation as part of their books and records, in order to reduce the paper filings for these persons.

260.236. Qualifications of Investment Advisers and Investment Adviser Representatives

Section 260.236 is amended to remove the waiver from the securities exam qualification requirement for an investment adviser or investment adviser representative that has been employed in the securities business, as specified, in the banking or insurance industries for two or more years since passing specified securities examinations. This amendment is necessary to allow for paperless filings with IARD. California is the only state that permits investment advisers or investment adviser representatives to rely upon such an exemption in establishing their qualification for licensure. As a result, IARD is unable to identify the waiver from the securities exam qualification requirement for such persons. The Department's records indicate that few investment advisers rely upon the exemption. Thus, the exemption is being eliminated, and all investment advisers and investment adviser representatives will be required to meet the same securities exam qualification requirements.

In the final text, the Department has eliminated the continuous reference to both an investment adviser representative and an associated person of an investment adviser, and instead limited the references to just an investment adviser representative. The statute defining the terms (Corporations Code Section 25009.5) defines them to have the same meaning, and therefore the rule was revised to provide that any reference to "investment adviser representative" means both an investment adviser representative and the associated person of an investment adviser. This same change was made to the final text of Section 260.236.1 and Section 260.236.2. The final text also re-inserts the exemption from the qualification requirements for Chartered Financial Analysts. This exemption was inadvertently removed from the rule when the amended text was originally proposed.

260.236.1. Reporting Requirements for Investment Adviser Representatives Filing Through the Investment Adviser Registration Depository

Section 260.236.1 sets forth the procedural requirements for an investment adviser to report the employment of an investment adviser representative or associated person through IARD. As initially proposed, the effective date of the section was delayed because IARD could not accept the reporting of investment adviser representatives. The reporting of investment adviser representatives is now accepted electronically – however, not through IARD, but through CRD. Therefore, the final text no longer delays the reporting of investment adviser representatives and requires the reporting through CRD, rather than IARD.

Section 260.236.1 requires an investment adviser to file Form U-4 with CRD and pay the required fees, and provides that the filing is approved when the Commissioner

approves the filing and the approval is received by CRD. This section is necessary to provide a procedure for investment advisers to report investment adviser representatives and associated persons to the Department. As with Section 260.236, references to "investment adviser representatives or associated persons of investment advisers" has been edited in the final text to simply refer to "investment adviser representatives," with an initial statement clarifying that "investment adviser representative" includes both.

Section 260.236.1 further provides that investment advisers are to maintain for their records evidence that investment adviser representatives meet the securities exam qualification requirements in the rules, and requires investment advisers to ascertain the character, business reputation and experience of an individual prior to employment. These provisions are necessary to ensure that investment adviser representatives are qualified to provide services to investors, and are necessary for the protection of investors. As fiduciaries, investment advisers have a duty to protect the interests of investors.

Also, Section 260.236.1 requires an investment adviser to file changes to Form U-4 within 30 days, and to file Form U-5 within 30 days of the termination of an individual. The section provides that an investment adviser is responsible for the acts, practices, and conduct of an investment adviser representative until Form U-5 is filed. These provisions are necessary to keep the Department's records updated, to alert the Department to changes that may raise investor protection concerns, and to set forth the responsibility of an investment adviser for the acts of any investment adviser representative reported to the Department as employed by the investment adviser.

The Department received comments concerned with the language providing that an investment adviser is responsible for the acts, practices and conduct of an investment adviser representative until Form U-5 is filed. The concern was that a private party may attempt to hold an investment adviser liable for the acts of an investment adviser representative even though the private party knew that investment adviser representative no longer represented the investment adviser, should the investment adviser fail to file Form U-5. To address this comment, the Department amended the text to provide that no civil liability in favor of any private party will arise as a result of the provisions, except as expressly provided in the Corporations Code. This language is similar to the language in Corporations Code Section 25510, and is necessary to clarify that no <u>new</u> liability in favor of a private party was intended by the new text. This clarification is not intended to effect existing liability in favor of a private party.

Subsection (b) of Section 260.236.1 sets forth the filing requirements for an investment adviser representative of a federally-registered investment adviser. The subsection requires the filing of Form U-4 upon the employment of an investment adviser representative, and the filing of Form U-5 within 30 days of the termination of an investment adviser representative. The provisions are necessary for the Department

(and the public) to have a record of the investment adviser representatives engaging in business in this state, to ensure compliance with qualification and employment requirements, and to ensure the individuals have not engaged in past activities that may warrant additional action by the Department, as permitted by law.

260.236.2. Reporting Requirements for Investment Adviser Representatives Not Filing Through the Investment Adviser Registration Depository

Section 260.236.2 sets forth the procedural requirements for an investment adviser to report the employment of an investment adviser representative or associated person when the investment adviser does not participate in IARD. Section 260.236.2 requires an investment adviser to file Form U-4 with the Commissioner and pay the required fees for the reporting of each investment adviser representative, and provides that the filing is approved when the Commissioner notifies the investment adviser. This section is necessary to provide a procedure for investment advisers to report investment adviser representatives and associated persons to the Department.

Section 260.236.2 further provides that investment advisers are to maintain for their records evidence that investment adviser representatives meet the securities exam qualification requirements in the rules, and requires investment advisers to ascertain the character, business reputation and experience of an individual prior to employment. These provisions are necessary to ensure that investment adviser representatives and associated persons are qualified to provide services to investors, and are necessary for the protection of investors. As fiduciaries, investment advisers have a duty to protect the interests of investors.

Also, Section 260.236.2 requires an investment adviser to file changes to Form U-4 within 30 days, and to file Form U-5 within 30 days of the termination of an individual. The section provides that an investment adviser is responsible for the acts, practices, and conduct of an investment adviser representative until Form U-5 is filed. These provisions are necessary to keep the Department's records updated, to alert the Department to changes that may raise investor protection concerns, and to set forth the responsibility of an investment adviser for the acts of any investment adviser representative reported to the Department as employed by the investment adviser.

Finally, Section 260.236.2 provides that an investment adviser is to file with the Commissioner proof of an investment adviser representative's compliance with the qualification requirements set forth in Section 260.236 of these rules. If CRD has the information, then the investment adviser does not need to file it with the Commissioner. These provisions are necessary for the Commissioner to ensure that investment adviser representatives meet the necessary qualification requirements.

The final text differs from the originally proposed text in the same manner, and for the same reasons, that the final text of Section 260.236.1 differs from the originally proposed text.

260.237.1. Alternative Minimum Financial Requirements (Until 1/1/05)

As originally proposed, Section 260.237.1 repealed the existing language regarding capital requirements, and adopted new language setting forth new minimum financial requirements for investment advisers. However, the Department received several comments from members of the public concerned with this action, since the result was that licensed investment advisers had to maintain a greater minimum net worth. To accommodate the concerns received by the Department, the Department is instead allowing investment advisers licensed before March 1, 2003 to comply with the existing minimum financial requirements until January 1, 2005, at which time the section becomes inoperative and investment advisers must comply with the newly proposed minimum financial requirements. As a result, the existing minimum financial requirements remain in Section 260.237.1 and the new minimum financial requirements are set forth in Section 260.237.2. Until January 1, 2005, an investment adviser licensed prior to March 1, 2003 may comply with either rule.

Thus, the only change to Section 260.237.1 in the final text is the language providing that investment advisers licensed prior to March 1, 2003 may comply with the minimum financial requirements of the section, and that the section becomes inoperative on January 1, 2005. The minimum financial requirements of that section remain the same.

260.237.2 Minimum Financial Requirements

Section 260.237.2 adopts the new minimum financial requirements that the Department had originally proposed in Section 260.237.1. The rule makes the new minimum financial requirements required for investment advisers licensed after March 1, 2003 and optional for other investment advisers until January 1, 2005, at which time all investment advisers will be required to comply with the new minimum financial requirements. As noted above, this change is in response to the concerns received by the Department regarding the increase in the net worth requirement.

Section 260.237.2 provides that an investment adviser with custody of client funds or securities must maintain a minimum net worth of $35,000, and provides that an investment adviser with discretionary authority over client funds or securities must maintain a minimum net worth of $10,000. Section 260.237.2 further provides that an investment adviser that accepts a prepayment of more than $500 per client must maintain a positive net worth, and that an investment adviser must notify the Commissioner if its total worth is less than the minimum required and file specified financial statements.

Section 260.237.2 defines “net worth” as an excess of assets over liabilities, as determined by generally accepted accounting principles, but excluding certain specified assets. Section 260.237.2 further specifies what constitutes “custody” of funds and when an investment adviser is “exercising discretion” over funds. Section 260.237.2

provides that the Commissioner may require a current appraisal to establish the worth of an asset, and provides that an investment adviser with a principal place of business in an other state must only maintain the minimum capital required in that other state, provided that the investment adviser is licensed in that other state and in compliance with its minimum capital requirements. The minimum financial requirements are necessary for the protection of investors, and for California's standards to be uniform with the minimum financial requirements imposed in other states. The new rule is necessary for California's financial requirements for investment advisers to be consistent with the requirements of the Uniform Securities Act.

Finally, Section 260.237.2 provides that the minimum financial requirements do not apply to an applicant holding a broker-dealer certificate. This provision is necessary because the CSL already sets forth minimum financial requirements for broker-dealers that differ from those set forth for investment advisers, and it is burdensome and unnecessary to require persons holding both certificates to comply with two different standards.

The Department received concerns with the language requiring specified financial statements when an investment adviser's net worth falls below the required minimum. The concerns were that the language is unclear, and that, in essence, it places an unrealistic burden on an investment adviser to notify the Department the day following its net worth falling below the required minimum. To address these concerns, the Department amended the rule to provide that the reports to the Department were only necessary after an investment adviser's discovery that its minimum net worth was less than required by law. This change relieves an investment adviser of having to track its net worth on a daily basis. However, the Department added a provision providing that an investment adviser will be deemed to have discovered that its net worth is below the minimum required if the failure of discovery is because the investment adviser does not maintain its books and records as required by law. This provision was necessary to ensure that an investment adviser that fails to maintain its books and records and thus fails to detect that its net worth is below the required minimum is not in a better position than an investment adviser that maintains its books and records, discovers its net worth is below the minimum in a timely fashion, and files the required reports with the Department.

260.240. Consent to Service of Process

Section 260.240 provides that an investment adviser's electronic signature on the Execution Page of Form ADV constitutes the consent to service of process required under Section 25240 of the Corporations Code. It also provides that a broker-dealer's electronic signature on the Form BD Execution Page constitutes the consent to service of process required under Section 25240 of the Corporations Code. The most recent versions of both Form BD and Form ADV have a provision for the broker-dealer or investment adviser to consent to service of process upon the administrator of the state where the licensees are filing the forms, and therefore no additional state form is

necessary. Further, for investment advisers filing through IARD and broker-dealers filing through CRD, the rule eliminates the need for the paper filing of a document. The final text differs from that originally proposed in that the Department will no longer require the use of a California-specific form for the consent to service of process. Since the most recent versions of both Form BD and Form ADV include a consent to service of process, no other form is necessary, regardless of whether the applicant or licensee files the form electronically or in paper.

260.241.2. Reports by Broker-Dealers and Investment Advisers

Section 260.241.2 is amended to accommodate the new minimum financial requirements under Section 260.237.2. As originally proposed, the changes eliminated the reporting requirements applicable to the existing net capital rule (Section 260.237.1). However, because the existing minimum net capital rule was not repealed, the final text of Section 260.241.2 accommodates both rules on minimum financial requirements. The changes to Section 260.241.2 provide that the supporting schedules to the annual Statement of Financial Condition for investment advisers must contain computations of the minimum financial requirements under Section 260.237.2, if the investment adviser is subject to that rule. Section 260.241.2 further provides that an investment adviser's financial statements need not be audited if the investment adviser only has discretionary authority over client funds or securities, and provides that every investment adviser subject to the provisions of Section 260.237.2 must file a report within 15 days after its net worth is reduced to less than 120% of its required minimum net worth. These changes are necessary for the reports required of investment advisers to be consistent with the changes made to the minimum financial requirements under Section 260.237.2.

260.241.3. Books and Records to Be Maintained by Investment Advisers

Section 260.241.3 is amended to provide that, in addition the current books and records requirements, every licensed investment adviser's books and records must include worksheets containing computations of minimum financial requirements, a Customer Authorization of Disclosure of Financial Records form, a Statement of Citizenship, Alienage, and Immigration Status form, if applicable, evidence of compliance with Section 260.236, and for investment advisers filing through IARD, Form U-4s with original signatures for all investment adviser representatives. These provisions are necessary to provide the Department with access to these documents during routine regulatory examinations, since other rules may no longer mandate that these documents be submitted in paper to the Department. These provisions will assist the Department in transitioning to paperless filings.

260.241.4. Notice of Changes by Broker-Dealer and Investment Adviser

Section 260.241.4 is amended to set forth procedures for investment advisers to file an amendment to Form ADV, upon change in the information. Section 260.241.4

provides that an investment adviser is to file changed information in its Form ADV with IARD, and that an investment adviser is to file an annual updating amendment with IARD within 90 days of the end if the investment adviser's fiscal year. Section 260.241.4 also provides that an investment adviser is to notify the Commissioner of the employment of an investment adviser representative or associated person. These provisions are necessary to set forth procedures for investment advisers to notify the Department of changes to the information and disclosures provided in Form ADV.

If the investment adviser does not participate in IARD, the rule instructs investment advisers to notify the Commissioner directly of changes to Form ADV by filing the amendments with the Commissioner. The amendments also make clarifications to the procedures for broker-dealers filing amendment to Form BD with the Department.

260.242. Surrender of Certificate as a Broker-Dealer or Investment Adviser

Section 260.242 is amended to repeal the existing language setting forth the procedures and forms for the surrender of a certificate as a broker-dealer or investment adviser, and to adopt new language setting forth new procedures for the surrender of a certificate as a broker-dealer or investment adviser. Section 260.242 provides that a broker-dealer is to file with CRD an application to surrender a certificate as a broker-dealer on Form BDW if the broker-dealer is a member of the NASDR, or to file the form directly with the Commissioner if the broker-dealer is not a member. Further, Section 260.242 provides that an investment adviser is to file Form ADV-W with IARD to surrender a certificate as an investment adviser. If the investment adviser does not participate in IARD, then the investment adviser is instructed to file the form directly with the Commissioner. These provisions are necessary to permit the forms to be filed electronically. Further, the provisions eliminate the Department's form and instead adopt the national, uniform form for investment advisers surrendering their certificate.

ECONOMIC IMPACT (GOVERNMENT CODE SECTION 11346.2(b)(4))

The Department has made a determination that this rulemaking action will not have a significant adverse economic impact on business.

The regulations set forth procedures for investment advisers to make filings with the Department through IARD or directly with the Commissioner. Investment advisers have always made filings directly with the Commissioner, such as applications, amendments, the payment of fees, and the reporting of investment adviser representatives. The new rules redraft all application and filing procedures to set forth the procedures for filing through IARD or directly with the Commissioner. For investment advisers making filings with IARD, the investment advisers will incur fees charged by the operator of IARD, NASDR.

Under the rules being adopted in this rulemaking action, the system is voluntary for state-registered investment advisers. Federally-registered investment advisers are required by federal law to make filings with IARD, and therefore these regulations, standing alone, do not impose the NASDR fees on investment advisers.

For state-registered investment advisers, Corporations Code Section 25608(r) no longer requires a routine regulatory examination fee if they make filings through IARD. Prior to AB 1048 (Chap. 268, Stats. 2001), Section 25608(r) required the Commissioner to charge and collect from an investment adviser the fee for a routine regulatory examination in the amount of the salary paid to the examiners plus expenses and overhead. AB 1048 allowed the Commissioner to waive the fee where the investment adviser makes filings with IARD.

Participation in IARD requires an investment adviser to pay certain fees to the NASDR for the recovery of the cost to create and administer the national database. The costs for making filings with IARD are as follows:

State-registered investment advisers

State-registered investment advisers (i.e., investment advisers that manage less than $25 million in investor funds) will pay $150 to file with IARD, and will pay $100 annually to renew a filing with IARD. The investment advisers pay only the one fee to NASDR, regardless of the number of states that the investment advisers register with.

Federally-registered investment advisers

The cost to file with IARD for federally-registered investment advisers (federally-registered investment advisers are investment advisers that manage $25 million or more in investor funds) varies, depending on the total amount of assets under management. For firms managing between $25 and $100 million in assets, the initial set-up fee is $800, and the annual fee is $400. For firms managing over $100 million in assets, the initial set-up fee is $1,100, and the annual fee is $550.

These firms incur these fees regardless of California's regulations, because the SEC is mandating the use of IARD for these firms. California's transition to IARD will have a positive economic impact on federally-registered investment advisers, because it will eliminate the regulatory burden of manually filing notices in individual states when the firms already have an account with IARD.

Investment adviser representatives

The cost to report an investment adviser representative through IARD is $45, and $45 annually.

AB 1048 (Frommer-Chapter 264, Statutes of 2001)

AB 1048 eliminated the routine regulatory examination fee for investment advisers making filings through IARD. The routine regulatory examination fee averages approximately $600 per investment adviser, and the Department attempts to examine investment advisers on a three-year cycle. The fee will substantially offset any NASDR filing fees for state-registered investment advisers filing with IARD, depending upon the number of representatives that the investment advisers have.

ALTERNATIVES CONSIDERED

No reasonable alternative considered by the Department or that otherwise has been identified and brought to the attention of the Department would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons, or would lessen any adverse impact on small businesses.

In response to concerns about the new minimum net capital rule, the Department has adopted language delaying the change for 2 years in order to allow investment advisers time to increase their minimum net capital. Since one of the purposes for increasing the minimum net capital is to adopt the uniform standard, no other alternative accommodates this purpose. The Department further notes that investment advisers and broker-dealers are not small businesses under Government Code Section 11342.610.

DETERMINATIONS

The Commissioner has determined that the proposed regulatory action does not impose a mandate on local agencies or school districts.

In accordance with Government Code Section 11346.3(c), the Commissioner hereby finds that the filing of Form ADV, Form ADV-W, Form BD, Form BDW, Form U-4, Form U-5, and any amendments thereto, is necessary for the health, safety or welfare for the people of the state. The Commissioner hereby makes the same finding for the filing of any additional form or documentation required to be included with any application for a certificate as an investment adviser and any filings required for the reporting of investment adviser representatives, including any amendments thereto. Specifically, the filings are necessary for the protection of investors in California.

SUMMARY OF OBJECTIONS AND RECOMMENDATIONS

No request for hearing was received during the 45-day public comment period, which ended on March 4, 2002. No public hearing was scheduled or heard.

Comments Received During the 45-Day Comment Period

COMMENTOR 1: Ward Lindenmayer, by e-mail dated January 25, 2002.

COMMENT 1: The commentor states that in the proposed rulemaking action, a Charter Financial Analyst will no longer have the exemption from the qualification requirements for investment advisers. The commentor suggested that the lack of the exemption is an omission.

RESPONSE: The commentor is correct that the elimination of the exemption for a chartered financial analyst was in error. Accordingly, Section 260.236(c)(3) has been amended and the exemption has been reinserted.

COMMENTOR 2: Jessica Crawford, by e-mail dated January 31, 2002.

COMMENT 2: The comment is the same as Comment 1(a).

RESPONSE: See response to Comment 1(a).

COMMENTOR 3: Ellyn Roberts, Shartsis, Friese and Ginsburg, LLP, by letter dated April 2, 2002.

COMMENT 3(a): The commentor refers to the commentor's letter dated December 13, 2000, which was in response to the Department's Initial Request for Comments related to this rulemaking action. The commentor indicates that its comments are the same as those set forth in that letter.

RESPONSE: The Department will respond to each comment individually.

COMMENT 3(b): In the December 13, 2000 letter the commentor indicates that the Department's proposed rules fail to indicate which version of Form ADV an investment adviser is required or permitted to use.

RESPONSE: The final text of the rules cites to Form ADV as amended by Securities and Exchange Commission Release No. IA-1916, 34-43758 (December 21, 2000). The SEC adopted the so-called "new" Form ADV for Part 1 of the form, but retained the "old" Part 2 of Form ADV. The Department is requiring applicants to use the same form as the SEC – i.e., "new" Form ADV for Part 1 and "old" Form ADV for Part 2. Applicants and investment advisers filing through IARD must use "new" Form ADV, because that is the only form available through IARD. For investment advisers submitting amendments to a previously filed "old" Form ADV directly with the Department, rather than through IARD, the Department will accept the amendments on the "old" Form ADV.

COMMENT 3(c): Is registration on IARD permitted, even if not required?

RESPONSE: Yes. This proposed rulemaking action sets forth procedures for filing through IARD and procedures for not filing through IARD, for state-registered investment advisers. The proposed rules only set forth procedures for filing through IARD for federally-registered investment advisers, because federally-registered investment advisers are required by federal law to use IARD.

COMMENT 3(d): The commentor indicates that Section 260.231, the rule regarding applications made through filing with the IARD, provides that the Commissioner may require an applicant to file in addition to Form ADV various other documents. The commentor asked whether such additional documents are required to be filed with Form ADV.

RESPONSE: The final text of the rule has been clarified to set forth the specific documents that must be filed directly with the Department, for filers through IARD and paper filers.

COMMENT 3(e): The commentor asks what constitutes an adequate investigation of the character, business reputation and experience of an individual, as required by Section 260.236.1. The commentor indicates that the proposed rule does not give investment advisers any guidance regarding what they are supposed to do with the results of their investigations. The commentor indicates that, because the only legal impediment to the hiring of an investment adviser representative or associated person by an investment adviser is a bar by a regulatory agency or court, the proposed rule may create disqualification standards without statutory authority.

RESPONSE: Investment advisers are fiduciaries of their clients and have fiduciary duties. As a fiduciary, the investment adviser must exercise a high standard of care in protecting its clients. The proposed rule is not intended to create a new form of liability for investment advisers. Rather, it is intended to assist investment advisers in understanding their obligations as a fiduciary. A reasonable person standard for a fiduciary protecting the interest of its clients is all that is required by the rule, and it is anticipated that each firm will have hiring procedures in place that do not expose the investment adviser's clients to an unreasonable amount of risk.

Further, the Department believes the rule benefits investment advisers. Corporations Code Section 25232 provides that the Commissioner may deny, suspend or revoke the certificate of an investment adviser for, among other things, various acts of its employees. An investigation of a potential employee may alert an investment adviser to potential problems, and thereby provide the investment adviser the ability to circumvent such problems before they occur.

The Department notes that this comment was in response to the Department's Initial Request for Comments. In response to this comment, the Department's

rulemaking action contains additional language providing that, upon completion of the investigation, the investment adviser is to take whatever action it deems appropriate in accordance with sound business practice and the protection of investors. Finally, the Department notes that broker-dealers have complied with the same requirement in the hiring of agents for many years (see Section 260.210(a) of the rules). Over 200,000 agents have been reported to the Department by broker-dealers, and no evidence exists of a problem for broker-dealers to implement the regulatory requirement that they investigate the character, business reputation and experience of the individuals they hire. The Department does not anticipate that investment advisers will have any problems implementing the rule, and believes that most investment advisers that hire representatives already have such procedures in place.

COMMENT 3(f): The commentor asks whether the definition of "net worth" in Section 260.237.1 excludes subordinated debt.

RESPONSE: In the final text, the definition that the commentor is referring to is now in Section 260.237.2. In Section 260.237.2, subordinated debt is no longer excluded from the calculation of net worth. The Department recognizes that the new rule on minimum financial requirements may burden investment advisers who have relied upon the previous rule. Therefore the Department has amended the proposed rule to give an investment adviser a significant amount of time to come into compliance with the new rule. The new rule has been amended to not require investment advisers (licensed before March 2003) to be in compliance with the rule until January of 2005. Until that time, if investment advisers are not in compliance with the new minimum financial requirements they will be required to be in compliance with the existing rule on minimum financial requirements (Section 260.237.1 in the final text).

COMMENTOR 4: Jack Brkich, III, CFP, by e-mail dated February 4, 2002.

COMMENT 4: The commentor has concerns regarding the proposed Section 260.236 qualifications. The commentor is concerned about the lack of an exemption for certified financial planners. The commentor has additional concerns with the exams required under the rule.

RESPONSE: As indicated in the response to Comment 1, the lack of a certified financial planner exemption was an inadvertent deletion from the existing rule and has been corrected. Therefore, the commentor's remaining comments about concerns with the exams under the rule are not relevant to the rulemaking action. The commentor's concerns were based upon the assumption that a certified financial planner would now be subject to the exams. The exams required to comply with the qualification requirements under the law have not been changed by this rulemaking action.

COMMENTOR 5: Douglas B. Martin, Jr., Attorney at Law, by letter dated January 15, 2002.

COMMENT 5: The commentor is concerned with the proposed language of Section 260.236.1, which would make an investment adviser "responsible for the acts, practices, and conduct of an investment adviser representative in connection with acting as an investment adviser representative on its behalf until such time the investment adviser representative has been properly terminated and Form U-5 has been filed with IARD." The commentor suggests that the language is unclear and contradictory. The commentor questions whether the investment adviser is liable for the acts of the investment adviser representative if the investment adviser representative is not terminated "properly," and whether both termination and the filing of Form U-5 is necessary in order for the investment adviser not to be liable for the acts of practices of the investment adviser representative. The commentor indicates that the requirement that the Form U-5 be filed appears to be an in terrorem measure to insure the filing of Form U-5.

The commentor indicates that if that is the purpose then the commentor believes it is unreasonable and would punish the investment adviser and confer a totally adventitious benefit on persons who otherwise would have no claim or cause of action against the adviser. The commentor further indicates that the phrase "properly terminated" seems likely to create disputes. The commentor indicates that the "propriety" of the termination is causally irrelevant to the investment adviser's responsibility towards third parties. Finally, the commentor suggests that the rule would create civil liability where none exists under the statute in contravention of Corporations Code Section 25510.

RESPONSE: In response to the above comments, the Department has removed the word "properly" from the phrase "properly terminated." The language raising concerns with the commentor was borrowed from Section 260.210(b)(4) of the rules, which sets forth the same obligations for broker-dealers terminating agents. Nevertheless, the Department agrees with the commentor that there is no need for the word "properly."

The Department has further addressed the commentor's concerns by adding language that no civil liability in favor of any private party is created by the requirement for the filing of Form U-5, except as otherwise provided by law. While Corporations Code Section 25510 already sets forth this provision, the Department believes the additional language added to the rule resolves any question as to the applicability of the code provision to the responsibility requirement added by this rulemaking action and thus adds clarity to the rule.

Nevertheless, the Department is keeping the regulatory requirement that an investment adviser remains responsible for the acts of its representative until a Form U-5 is filed with the Department. The Department notes that IARD is a public database, and as such it provides notice to the public of the licensure of investment advisers in the various states, as well as the registration of investment adviser representatives. The requirement that Form U-5 be filed, either through IARD or directly with the

Commissioner, in order to relieve an investment adviser of responsibility for oversight of its investment adviser representative is not intended to be an in terrorem measure, but instead a means of providing both the Department and the public with actual notice of the termination of an investment adviser representative. As the regulatory agency responsible for the licensing of investment advisers, the Department holds a licensee responsible for the acts of its investment adviser representatives whom the Department has been given notice are acting as representatives under an investment adviser's license, until the investment adviser provides the Department with notice that such representative has been terminated.

COMMENTOR 6: Keith Bishop, by letter dated December 18, 2001.

COMMENT 6(a): The commentor questions the Commissioner's determination that this proposed regulatory action represents an option for investment advisers since, for federally-registered investment advisers, IARD appears to be the sole means of complying with the notice requirements of the Corporations Code.

RESPONSE: Participating in IARD is voluntary from the state's perspective. Federal law requires federally-registered investment advisers to participate in IARD. Therefore, it is unnecessary for the Department to set forth any other means for a federally-registered investment adviser to provide notice to the Department other than through the IARD.

COMMENT 6(b): The commentor suggests that the fees payable to NASD for the use of IARD should be included in the Commissioner's Notice of proposed rulemaking.

RESPONSE: The fees payable to NASDR for the use of IARD are outlined in the Initial and Final Statement of Reasons for this rulemaking action. However, since participation in IARD is voluntary in California, the Department did not identify the fees payable to NASD as a cost associated with the rulemaking. Federally-registered investment advisers are required by federal law to participate in IARD. Therefore, these fees are not incurred by the Department's regulations, and are not a cost that a business would incur to comply with the regulations. The Department notes that it has sent several notices to investment advisers since 2000 to explain IARD, and has informed its licensees directly about all of the associated NASD fees for investment advisers that choose to make filings through it. These notices were to assist investment advisers in making the business decision of whether to transition to IARD.

COMMENT 6(c): The commentor suggests that the Commissioner failed to consider the additional costs associated with the new requirements regarding the filing of Forms U-4 and U-5.

RESPONSE: The Department agrees that it did not consider the filing of Forms U-4 or U-5, instead of the Schedule D of Form ADV, as imposing additional costs.

Form U-4 is longer and more detailed than Schedule D, and therefore it may take longer to complete the form.

Investment advisers have always had to report investment adviser representatives by filing Schedule D of Form ADV to report investment adviser representatives. The new Form ADV, reformatted to facilitate filing through IARD, no longer has a Schedule D for the purpose of reporting investment adviser representatives. Instead, Forms U-4 and U-5 are to be filed to report the association and termination of investment adviser representatives, respectively.

In examining whether the additional time to complete Form U-4 will have a cost impact on investment advisers, the Department believes that the benefits of filing through CRD may equal or outweigh the cost of the extra time to complete Forms U-4 and U-5. (Investment adviser representatives are reported on Form U-4 through CRD rather than IARD.) An investment adviser is required to report changed information to the Department within 30 days. By having all of an investment adviser representative's information on CRD, should any information on the form require revising for any reason, including disciplinary occurrences or changes in employment, the form may easily be amended online. Further, individuals who are both agents of broker-dealers and investment adviser representatives need only have a single Form U-4 on CRD for all reporting purposes, thereby decreasing the burden of manually filing forms. CRD further maintains information on whether individuals have passed the examinations offered by NASDR that are required under Section 260.236, thereby eliminating paperwork for online filers. Finally, the burden of reporting of investment adviser representatives in multiple jurisdictions by multiple paper filings is eliminated. Nevertheless, the Department agrees with the commentor that the filing of Forms U-4 and U-5 may have differing impacts, depending upon the investment adviser's situation, and the benefits won't outweigh the burden for all investment advisers that report investment adviser representatives.

COMMENT 6(d): The commentor suggests that the Commissioner has failed to determine the cost that would be incurred by persons as a result of the elimination of the waiver from the securities exam qualification requirement for an investment adviser or an investment adviser representative who has been employed in the securities business or banking or banking insurance industries for two or more years. The cost associated with the exam requirement would be necessarily incurred in reasonable compliance with the proposed rule. Accordingly, the commentor suggests that the Commissioner should make a determination as required by the Administrative Procedure Act ("APA").

RESPONSE: The Department has not received an application in reliance upon such waiver in almost a decade. Therefore, the Department has not identified any cost to be incurred by the proposed elimination of the waiver.

COMMENT 6(e): The commentor suggests that the Commissioner is attempting to propose a wide variety of new approval and filing requirements without express legislative direction. The commentor suggests that the rules would constitute a significant increase in filing responsibilities and compliance costs.

RESPONSE: The Department disagrees, and believes that the new regulations will help streamline the application and reporting procedures for investment advisers. Corporations Code Section 25231 provides that the Commissioner may by rule prescribe the information, form and detail necessary for a certificate as an investment adviser. Therefore, the Commissioner has express authority for this rulemaking action.

Further, Corporations Code Section 25612.5, as amended by AB 1048 (Chap. 264, Stats. 2001), sets forth express authority for the Commissioner to participate in IARD. The Department disagrees that the proposed rules will result in a significant increase in filing responsibilities and compliance costs. Prior to proposing this rulemaking action, the Department sought the input of industry group representatives regarding the adoption of these rules. None of these industry group representatives identified these proposed rules as constituting a significant increase in filing responsibilities or compliance costs for the investment advisers that they represent. The Department has not been provided any evidence to support the commentor's suggestion that the rules constitute a significant increase in filing responsibilities and compliance costs, and the feedback it has received from the organizations subject to the new rules does not support this concern.

COMMENT 6(f): The commentor suggests that subsection (a) of Section 260.230.1 should be rewritten as set forth by the commentor. The commentor further suggests that the requirement that the notice under Corporations Code Section 25230.1 be filed within 30 days does not appear to be consistent with the statute.

RESPONSE: The proposed language was taken from the uniform rules adopted by NASAA. However, the Department has rewritten the section to provide greater clarity, as suggested by the commentor. The Department disagrees that the 30-day filing requirement is inconsistent with the statute. Corporations Code Section 25230.1 requires an investment adviser to file with the Commissioner and annual notice. The proposed rule sets forth the timing for the filing of the annual notice, including setting forth requirements for the filing of an initial notice. Section 25610 of the Corporations Code provides, in part, that the Commissioner may from time to time make, amend, and rescind such rules, forms, and orders as are necessary to carryout provisions of the CSL, including rules and forms governing applications and reports. The Department believes that the instruction regarding the filing of Form ADV within 30 days of conducting business in the state is consistent with Corporations Code 25230.1, and within the authority of the Commissioner under Corporations Code 25610. The proposed rule is necessary to define when the initial notice must be filed with the Department.

COMMENT 6(g): The commentor suggests that subsection (b) of section 260.230.1 fails to satisfy the “clarity” requirement of the APA. Because, according to the commentor, proposed section 260.230.1 contemplates the filing of Form ADV with IARD, the commentor questions how the agreement is to be provided to the Commissioner.

RESPONSE: The “agreement” to provide Part 2 to the Commissioner upon request is provided to the Department by the federally-registered investment adviser’s performance of submitting Form ADV to the Department through IARD without Part 2 of the form, paying the required fee, and engaging in business in California as an investment adviser.

COMMENT 6(h): The commentor suggests that subsection (c) of Section 260.230.1 does not satisfy the “consistency” standard of the APA. The commentor states that Corporations Code Section 25230.1 does not provide for the expiration of notices filed under subsection (b) of that section. The commentor further states that the SEC requires investment advisers to file an Annual Updating Amendment within 90 days after the end of the adviser's fiscal year.

RESPONSE: Section 25230.1(b)(1) requires a federally-registered investment adviser to file with the Commissioner an annual notice. According to Webster’s dictionary, "annual" means something that lasts one year. Therefore, Corporations Code Section 25230.1 does provide for the expiration of the notices. With respect to the consistency concern and the filing of the SEC Annual Updating Amendment, the requirement in this rule that the annual state notice be filed by December 31 is consistent with all the other states requiring the same notice filing from a federally-registered investment adviser. If the Department attempts to be consistent with the SEC annual updating amendment, it will then be inconsistent with the notice-filing requirements of the other state jurisdictions that the federally-registered investment advisers must make notice filings with. The Department believes that the national firms will find it easier to have the various states’ notice filings due at the same time.

COMMENT 6(I): The commentor indicates that subsection (f) of Section 260.230.1 does not satisfy the “consistency” standard of the APA because it is in conflict with the Investment Advisers Act of 1940 ("Advisers Act"). The commentor suggests that the Advisers Act prohibits a state from requiring registration of an investment adviser that is registered under the Advisers Act and that the Advisers Act provides a federally-registered investment adviser with 180 days after its assets under management fall below 25 million within which time to file Form ADV-W withdrawing from federal registration. The commentor suggests that the Department’s proposed rule requiring an investment adviser to file an application with the Department within 60 days of its federal registration becoming subject to termination is inconsistent with federal law because it places a requirement on federally-registered investment advisers prior to final termination of their federal registration. The commentor suggests that the requirement be changed to provide that the investment adviser application be filed

within 60 days of the filing of a Form ADV-W withdrawing registration under the Advisers Act.

RESPONSE: The Department notes that the SEC's own rule contemplates the concurrent registration at the state and federal level during the transition from registration with the SEC to state registration (see 17 C.F.R. 275.203A-1(b)(2), which states "During this period while you are registered with both the Commission and one or more State securities authorities, the Investment Advisers Act of 1940 and applicable State law will apply to your advisory activities."). Therefore, the Department does not believe the language of its rule is inconsistent with federal law. The Department set forth the 60-day application lead time in order to assist investment advisers transitioning from federal registration, so that these firms do not find themselves in the situation where they are no longer registered at the federal level but have failed to obtain state licensure timely, and thus may not engage in business for a period of time.

Nevertheless, to address the commentor's concerns, the Department has redrafted the rule to remove the 60-day period, and instead to set forth language making it clear that an investment adviser may not engage in business in California after its federal registration is terminated, unless it has secured a certificate from the Commissioner.

COMMENT 6(j): The commentor suggests that subsection (a)(2) of Section 260.231 does not comply with the rulemaking requirements of the APA in Corporations Code Section 25614. The commentor suggests that, to the extent rule 260.231(a)(2) reserves to the Commissioner the ability to request additional documents pursuant to a separate instruction sheet, the instruction sheet constitutes a "regulation" and cannot be enforced by the Commissioner.

RESPONSE: The Department has eliminated the reference to the separate instruction sheet in the final text.

COMMENT 6(k): The commentor suggests that the Customer Authorization of Disclosure of Financial Records violates the express provisions of the Financial Privacy Act. The commentor suggests that, because Government Code section 7473(c) requires an authorization for the disclosure of financial records to be required by statute in order to be irrevocable, the Department may not provide in its form that it is irrevocable. The commentor suggests that Corporations Code Section 25241 does not require an authorization but merely authorizes the Commissioner to require an authorization and therefore the authorization is not required by statute. Further the commentor suggests that Corporations Code Section 25241 does not expressly authorize the Commissioner to request the authorization of applicants, only persons licensed under Corporations Code Section 25230. Thus, the commentor suggests that Section 25241 does not authorize the Commissioner to request an authorization from an applicant.

RESPONSE: The Department disagrees. If the Commissioner requires an authorization for the disclosure of financial records, then Corporations Code Section 25241 requires it be provided. Specifically, Corporations Code Section 25241 requires every investment adviser to furnish the form upon the request of the Commissioner. It does not provide the investment adviser the option of submitting the form. Therefore Government Code Section 7473(c) allows the authorization to be irrevocable. Further, note that Government Code Section 7490 provides authority for a waiver of the rights under the Financial Privacy Act, when the authorization is pursuant to Corporations Code Section 25241. The Commissioner requests the form from applicants because it is required for investment advisers.

COMMENT 6(l): The commentor suggests that subsection (b) of Section 260.231 violates the APA requirement of non-duplication, to the extent it prescribes the statutory filing fee.

RESPONSE: The APA is not violated where statutory language is repeated in order to provide clarity to a rule. In this instance, the filing fee is included in the rule to provide guidance to applicants on application procedures.

COMMENT 6(m): The commentor states that the last sentence of subsection (b) of Section 260.231 does not satisfy the APA clarity requirement, because Section 250.15 does not establish when refunds are available, but rather specifies that refunds shall be made in accordance with Government Code Sections 13140-44.

RESPONSE: While the Department disagrees that the APA clarity requirement is not satisfied, the rule has been amended to reference the Government Code directly, to address the commentor's concerns.

COMMENT 6(n): The commentor states that the reference in Section 260.231 to the certificate being in effect for the calendar year is not consistent with the provisions of Corporations Code Section 25242(c) which requires notice of any revocation of a certificate for nonpayment of any fee imposed under Corporations Code Section 25608.

RESPONSE: The Department fails to see the inconsistency. The rule sets forth the time that the certificate is in effect upon payment of the initial application fee; the section referenced by the commentor sets forth provisions for the suspension or revocation of a certificate. Corporations Code Section 25608(q)(1) also provides that the payment of the fee keeps the certificate in effect during the calendar year during which it is granted, consistent with the text of the rule.

COMMENT 6(o): The commentor states that subsection (c) of Section 260.231 violates the consistency requirement of the APA because it is inconsistent with the requirements of the Permit Reform Act. The commentor suggests the proposed rule fails to specify certain time periods required by the Permit Reform Act.

RESPONSE: The Department's rules pertaining to the Permit Reform Act are set forth in Section 250.51, which is not being amended in this rulemaking action. The Department fails to see any inconsistency between the rule and the Permit Reform Act.

COMMENT 6(p): The commentor states that subsection (e) of Section 260.231 violates the APA non-duplication requirement by setting forth the annual fee.

RESPONSE: See the Department's response to Comment 6(l). The annual fee is included in the rule to provide guidance to investment advisers on annual filing requirements.

COMMENT 6(q): The commentor indicates that there is a typographical error in the heading to subsection (g) of Section 260.231.

RESPONSE: The Department agrees, and has corrected the error.

COMMENT 6(r): The commentor asks how the Commissioner intends to comply with the Privacy Act of 1974 with respect to filings made through IARD.

RESPONSE: The Department's final text of Section 260.231 includes a notice in subsection (j), incorporated into the uniform forms required under the rules, that sets forth information on the disclosure and use of social security numbers as required by the Federal Privacy Act of 1974.

COMMENT 6(s): The commentor urges the Commissioner to permit filings in the Department's Los Angeles office.

RESPONSE: The investment adviser filings are processed in Sacramento, and thus allowing filings to be mailed to the Los Angeles office would only delay the Department's processing of filings and would not benefit the public.

COMMENT 6(t): The commentor states that Section 260.231.2 violates the rulemaking provisions of the APA and Corporations Code Section 25614 for the reasons the commentor describes with respect to subsection (a)(2) of proposed Section 260.231, and the commentor refers to the commentor's previous comments regarding the use of the Customer Authorization of Disclosure of Financial Records. The commentor further states that, to the extent subsection (b) sets forth the statutory fee it violates the nonduplication requirement of the APA, and the commentor refers to previous comments regarding the period of effectiveness of the certificate and the reference to Section 250.15.

RESPONSE: See the Department's responses to Comments 6(j), 6(k), 6(l), and 6(m).

COMMENT 6(u): With respect to Section 260.231.3, the commentor asks how applicants who file through the IARD are to provide the agreement referred to in subsection (b).

RESPONSE: The rule states that applicants may, in lieu of filing the form with the Department, maintain the form and supporting documentation in the applicant's books and records, if the adviser agrees to provide the form and supporting documentation to the Commissioner upon request. The applicant agrees to provide the form in Section 250.61 of the rules upon request through the applicant's act of applying for a certificate as an investment adviser without submitting the form required by Section 250.61 of the rules, and instead maintaining the form as part of its books and records. Thus, the applicant relies upon Section 260.231.3, which permits the applicant to complete the form and maintain the form in the applicant's books and records rather than submitting it to the Department. The agreement is made through performance.

COMMENT 6(v): The commentor suggests that subsections (a)(2) and (b)(1) of Section 260.236.1 violate the APA's requirements of authority and consistency. According to the commentor, neither Corporations Code Section 25230 nor 25230.1(c) establishes a procedure by which the Commissioner is authorized to "approve" the registration of investment adviser representatives. Rather, according the commentor, Section 25230.1(c) provides that an investment adviser representative must comply with rules adopted for qualification and employment. According the commentor, the proposed rule does not contemplate that the Commissioner has the right to approve or reject the filing of a Form U-4. The commentor further states that to the extent the Commissioner believes he has such authority, the proposed regulation is not consistent with the Permit Reform Act for the reasons the commentor previously discussed.

RESPONSE: The Department disagrees with the commentor. Corporations Code Sections 25230(b) and 25230.1(c) provide the Commissioner with the authority to adopt rules for the qualification and employment of investment adviser representatives. Corporations Code Sections 25608(p) and 25608.1(d) make it clear that a notice or report may be required to implement Corporations Code Sections 25230(b) and 25230.1(c). The filing of Form U-4 is the means established by rule of providing notice to the Commissioner pursuant to Corporations Code Sections 25230(b) and 25230.1(c), and the Commissioner has the authority to determine whether the filing of the form perfects the notice filing requirement under the rules, through the Commissioner's authority to administer the CSL.

Further, through the Commissioner's authority to administer the CSL, the Commissioner has the authority to determine whether the content of the notice or report filed pursuant to Corporations Code Section 25230(b) and 25230.1(c) establishes that the investment adviser representative meets the rules the Commissioner has adopted for the qualification and employment of investment adviser representatives. Thus, the Commissioner has the authority to approve or reject the filing of a Form U-4. The Department is unable to address the commentor's comment regarding the Permit

Reform Act because the Department does not see a previous discussion by the commentor that relates to the subsection referenced.

COMMENT 6(w): The commentor states that the last sentence of subsection (a)(4) of Section 260.236.1 violates the APA's requirements of authority and consistency. The commentor states that nothing in either the statutes cited as authority or reference authorizes the Commissioner to expand or define the vicarious liability of investment advisers.

RESPONSE: See the Department's response to Comment 5(a). Corporations Code Section 25230 provides the Commissioner with authority to adopt rules for the employment of investment adviser representatives. Thus, the Commissioner has authority to adopt this provision.

COMMENT 6(x): The commentor suggests the rule should reference Corporations Code Section 25608(p).

RESPONSE: The Department agrees, and has made the suggested change.

COMMENT 6(y): The commentor states that subsection (b)(2) of Section 260.236.2 violates the authority and consistency requirements of the APA. The commentor states that, to the extent the proposed rule requires a fee in connection with a filing pursuant to Corporations Code Section 25230.1(c), no such fee is authorized by Corporations Code Section 25608(p) which refers only to Corporations Code Section 25230.

RESPONSE: The rule would not be applicable to a filing pursuant to Corporations Code Section 25230.1(c). The first line of the rule provides that it is only applicable to investment advisers licensed pursuant to Corporations Code Section 25230.

COMMENT 6(z): The commentor states that subsection (c) of Section 260.237.1 violates the APA's clarity requirement because the rule requires notification "by the close of business on the next business day," but does not specify after what. The commentor states that requiring advisers to give notice the day after their net worth falls below the required minimum exposes advisers to substantial risk if their worth falls below the minimum without their knowledge.

RESPONSE: This Section is the adoption of the 1999 NASAA Amendments to Uniform Securities Act, Rule 202(d)-1, as amended on 4-18-99. The Department has identified over a dozen other states that have the identical language in their rule. Nevertheless, the Department has clarified the meaning of "next business day" in the final text. The Department has further amended this rule to provide that notice is required the day after discovery that an investment adviser's net worth has fallen below the required minimum, in order to accommodate the commentor's concerns.

COMMENT 6(aa): The commentor states that, as a general matter, the proposed rules do not appear to contemplate compliance with the Information Practices Act of 1977. The commentor asks how an applicant who utilizes IARD will be supplied with the information required by the Information Practice Act.

RESPONSE: The Department has added subsection (j) to Section 260.231 to set forth the notices required under the Information Practices Act of 1977, and has incorporated such notices into the uniform forms required under these rules.

COMMENTORS 7 - 11: Lawrence E. Bartlett, Registered Investment Adviser with the State of California, by letter dated February 4, 2002;

Thaddeus Borek Jr., Principal, Borek Financial Management, by letter dated February 25, 2002;

David Forbes, CFA, CFP, President, Walpole Petra Financial Advisors, LLC, a California-registered Investment Adviser, by letter dated January 28,2002;

Robert H. Neill, Jr., Assistant Director of Government Relations and Counsel, The Financial Planning Association, by letter dated March 1, 2002; and

ewolfers@earthlink.net, by e-mail dated February 7, 2002.

COMMENTS 7 – 11: The commentors object to proposed Section 260.237.1, which increases the minimum net worth requirement from $25,000 to $35,000 for investment advisers with custody of client funds, increases the minimum net worth requirement from $5,000 to $10,000 for investment advisers with discretionary authority over client funds, and eliminates the minimum net worth requirement for investment advisers who have only power of attorney. The commentors generally state that the increase is burdensome on small businesses, that no purpose exists for the minimum net worth requirement, that a minimum net worth requirement does not protect clients yet inconveniences investment advisers, that the public interest is not served by the increase because the rule primarily burdens the advisers with the smaller clients from an under-served population, that no evidence exists of abuse of trading authority by advisers that justifies the increase, that the need to be uniform with other states does not justify the increase, that the increase creates a barrier to entry into the profession, and that the increase amount is arbitrary.

RESPONSE: In light of the concerns regarding the increase in the minimum net worth requirement for certain advisers, the Department has carefully weighed the importance of the increase on investor protections. The Department notes that the existing rules do not require either a bond or professional insurance for investment advisers, and therefore the minimum net capital requirement is the only requirement that ensures solvency of the investment adviser for the protection of investors. The net

worth requirement has not been increased in over a decade, and thus fails to offer the same protection to investors as when first adopted.

Further, as a result of the National Securities Markets Improvement Act, a state may only impose requirements on an out-of-state investment adviser that are the same as those imposed in the adviser's home state. This increases the importance of the need for California's minimum net worth rule to be uniform with other states. California relies upon other states to have a minimum net worth requirement for the advisers located in other states that do business in California for the protection of California investors, and other states rely upon California in the same manner, for advisers located in this state but doing business out of state.

Nevertheless, in light of the concerns, the rule has been amended to provide that compliance will not be necessary until January of 2005 for currently licensed investment advisers. Until such time, advisers may continue to meet the current rule on minimum financial requirements. During the two-year interim, the Department will evaluate whether other provisions would be better suited to protect investors, such as an alternative bonding or insurance option. This resolution provides advisers with close to 3 years from first receiving notice of the proposed increase to obtain the minimum net worth necessary for compliance.

No comments were received during the 15-day comment period under Government Code Section 11346.8(c), which ended on December 24, 2002.