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 adoption of Section 260.204.9 of the California Code of Regulations (10 C.C.R. Sec. 260.204.9).

Under current law, the Department of Corporations regulates certain activities of "investment advisers" in California. Specifically, Corporations Code Section 25230 of the Corporate Securities Law of 1968 (the "CSL") requires persons conducting business as an investment adviser in California to be licensed with the Department of Corporations. Investment advisers licensed under the CSL are subject to various obligations and restrictions, as set forth in the CSL and the rules of the Commissioner.

The definition of "investment adviser" under Section 25009 includes, with certain exceptions, any person who "for compensation, engages in the business of advising others . . . as to the advisability of investing in, purchasing or selling securities . . .." This definition arguably encompasses the general partner or manager (a "GP") of those pooled investment vehicles that are commonly referred to as "venture capital funds" or "venture capital companies" ("VCCs"). These pooled investment vehicles, which historically have been organized as limited partnerships (and, more recently, as limited liability companies), raise funds from multiple investors and use the funds to invest in (or acquire) start-up, operating companies. In the typical VCC, the GP has the sole authority to make investment decisions; the limited partners of the VCC are generally required to fund their capital contributions when and as requested by the GP, and are not permitted to make an investment decision with respect to any particular portfolio investment by the VCC (subject to certain excuse or withdrawal rights in limited circumstances).

Over the last 20-30 years, VCCs have played an increasingly significant role in the establishment and growth of start-up companies in California, particularly technology-based companies. A substantial number of VCCs, including many of the largest, oldest and most recognized VCCs, are based in California.

In 1971, the Department issued Policy Letter No. 151 (the "1971 Letter") indicating that a GP of a single limited partnership would not have to be licensed as an "investment adviser" under the CSL. The basis of the 1971 letter was the Department's view that a GP is, in effect, giving advice to itself rather than to "others" as required under Section 25009 of the CSL. The 1971 Letter had generally been relied on by California-based GPs of VCCs seeking an exemption from licensing in California as an investment adviser.

In April 1998, the Department issued Release No. 110-C (the "1998 Release"), which essentially revoked the 1971 Letter. In the 1998 Release, the Department indicated that the position taken in the 1971 Letter was contrary to the treatment of investment advisers by the Securities and Exchange Commission (the "SEC") under the Investment

Advisers Act of 1940 (the "Federal Advisers Act"). Under the Federal Advisers Act, general partners of limited partnerships are treated as advising others, although GPs that advise fewer than 15 VCCs are typically exempt from registration under Section 203(b)(3) of the Federal Advisers Act and certain rules of the SEC thereunder that are specifically tailored to VCCs (the "SEC Safe Harbor Rules").

As a result of the Department's issuance of the 1998 Release, there is no specific licensing exemption for California-based GPs of VCCs (or any other limited partnerships) similar to the Federal Advisers Act exemption. However, there is an exemption from licensing that can be relied upon by GPs based outside of California. Specifically, Section 25202(a) of the CSL provides that the licensing requirement of Section 25230 shall not apply if:

> "(1) the investment adviser does not have a place of business in this state and (2) during the preceding 12-month period has had fewer than six clients who are resident in this state."

Section 25202(b) of the CSL further provides, essentially, that for purposes of "counting" the number of clients for the fewer-than-six client test of Section 25202(a)(2), an investment adviser may rely on the SEC Safe Harbor Rules. Thus, while the critical elements of the SEC Safe Harbor Rule currently exist under the CSL exemption with respect to GPs based outside of California, these elements do not apply to California-based GPs.

Proposed Rule 260.204.9 reflects the Commissioner's view that, in light of the nature and structure of VCCs, requiring the GPs of VCCs to be licensed in California as "investment advisers" would be unnecessary and unduly burdensome. More importantly, because Section 25202(a) of the CSL generally excludes from licensing in California any GP who does not have a place of business in California and has fewer than six clients who are California residents), requiring a California-based GP to be licensed as an investment adviser under the CSL could encourage such GP to relocate from California to a state that does not require such licensing or that imposes less onerous obligations on registered investment advisers.

Subsection (a) of the proposed rule would exempt from licensing as an investment adviser any person who:

1. Does not hold itself out generally to the public as an investment adviser;

2. Has fewer than 15 "clients";

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

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

Subsection (b) of the proposed rule sets forth definitions of the terms used in the operative provisions of Subsection (a), including a definition of "venture capital company." This definition imposes, as a requirement, the typical investment activity of a VCC. Specifically, under the proposed rule an entity will be considered a "venture capital company" only if it invest a majority of their assets in operating companies and acquires "management rights" in those companies. Historically the management rights acquired by VCCs in connection with their investment in operating companies have included one or more of the following: veto or approval rights as to certain operational or structural matters; inspection or information right; or board membership or observer rights.

The exclusion for VCCs with more than $25 million reflects the current allocation of investment adviser regulation between the SEC and state securities administrators. Under applicable federal law, (i) investment advisers with at least $25 million in assets under management are generally required to register with the SEC and (ii) states may not require licensing of SEC-registered advisers (i.e., California and other states can require licensing of investment advisers not registered with the SEC). The Commissioner believes that GPs of VCCs in excess of $25 million would, if subject to licensing as an investment in California, elect instead to register as an investment adviser with the SEC.

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 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.

Facts evidence, documents, testimony, or other evidence upon which the agency relies to support a finding that the action will not have a significant adverse economic impact on business.

ADDENDUM REGARDING PUBLIC COMMENTS

No request for hearing was received during the 45-day public comment period which ended on April 30, 2001. No public hearing was scheduled or heard.

COMMENTS RECEIVED DURING THE 45-DAY COMMENT PERIOD

COMMENTOR 1: Louis J. Zitnik, CFA, letter dated March 20, 2001.

COMMENTS. The comment contained in this letter supports adoption of the rule while urging the Department to add an exemption for investment advisers who advise clients on a "non-discretionary basis" and, if the rule is not ultimately adopted as proposed with respect to the fewer-than-15 requirement of Subsection 1(a)(2), then to at least exempt investment advisers who have only one client.

RESPONSE: The Department believes that investment advisers who must advise clients on a non-discretionary basis would generally do so under circumstances in which they would otherwise fall within the exemptions set forth in the proposed rule. Those investment advisers falling outside the exemption would most likely be required to register under the federal Investment Advisers Act of 1940, lessening California's interest in requiring state registration.

COMMENTOR 2: Gregory Weiss, Editor of Investment Quality Trends, e-mail dated March 21, 2001.

COMMENTS. The comment contained in this e-mail supports adoption of the rule as proposed.

RESPONSE: The Department recognizes this statement of support for the proposed rule.

COMMENTOR 3: Walter Chang, President, WDC Management, Inc., letter dated March 27, 2001.

COMMENTS. The comment contained in this letter requests an opinion as to whether the proposed rule would require an already-licensed investment adviser with fewer than 15 clients to terminate its license. The comment also requests information on the status of the Investment Adviser Registration Depository under the above circumstances.

RESPONSE: This letter requests advice or an opinion regarding the application of the proposed rule under specific circumstances. The Department cannot provide advice or opinions, except through written requests meeting the requirements of Title 10, California Code of Regulations, Section 250.12.

COMMENTOR 4: Steven J. Insel, Jeffer Mangels Butler & Marmaro LLP, e-mail dated March 28, 2001.

COMMENTS.

1. Assets Under Management of 25 Million Dollars. The comment contained in this e-mail proposes that hedge funds should not be subject to what the author views as an arbitrary $25 million line between exempt and non-exempt investment advisers. The reason stated is that the nature of these funds requires them to wind down and distribute liquidated positions, periodically taking them beneath the $25 million hurdle. In addition, the comment believes that it is not proper that the choice under the proposed rule would be registration vs. non-registration (since the standard for exemption is the same under both state and federal law), while the choice is currently federal registration vs. state registration. The comment suggests that the test be tied to the "nature of the investor" and recommends excluding advisers whose investors meet the requirements of 25102(f)(2) or Rule 260.102.13.

2. Definition of "Operating Company." The comment proposes clarifying the definition of "operating company" in subsection (b)(7) of the proposed rule to expressly include venture capital funds that provide financial services within the definition of "venture capital company." This would prevent a restriction of venture capital to such funds because of the exclusion of companies that invest in them from the definition of "venture capital company" and thus from the exemption.

3. Hedge Funds. The comment seeks guidance in interpreting the definition of "assets under management," specifically as to whether the term "continuous and regular supervisory or management services" would include the services of "fund of funds" managers who select hedge fund managers.

RESPONSE.

1. One purpose for the $25,000,000 hurdle in subsection (a)(4)(i) of the proposed rule was to exempt certain transactions outside of the state's regulatory interest while still requiring that investment advisers register with the Department under circumstances in which registration would comport with the legislative intent behind the Corporate Securities Law of 1968. Corporations Code Section 25230 was enacted, in part, to address unfair trading practices by secondary traders while exempting sales or transactions in which regulation was obviously unnecessary. Federal law uses the $25,000,000 trigger, in the Investment Company Act of 1940, to distinguish between investment advisers who, because of their smaller level of assets under management, might better be left to state rather than federal

regulation. This same trigger level is used by the proposed rule to reflect the state's interest in regulating investment advisers who would otherwise not be subject to regulation at all because of the smaller size of their management portfolios. Therefore, the choice is not "registration vs. non-registration," but rather state registration for investment advisers meeting the other requirements of the rule with less than $25,000,000 in assets under management, unless their clients are all venture capital companies. A different dollar trigger under the proposed rule might create an unintended discrepancy between state and federal law. For instance, a state trigger of less than $20,000,000 might create a situation in which an investment adviser with between $20,000,000 and $25,000,000 in assets under management, whose clients were not all venture capital companies, would be exempt from both state and federal registration because it fell between the state and federal triggers.

2. The definition of "venture capital company" contemplates that venture capital companies are generally possessed of sufficient investment expertise to reduce the state's need for registration, and take an active and participating role in the development of the operating companies in which they invest. That rationale does not, therefore, warrant extension of the proposed exemption to companies that make available managerial assistance to companies that are themselves engaged in management or investment services. In addition, the desired reference to financial services is so broad as to create a potential conflict with the restriction on the management of investment services.

3. To the extent that an investment adviser does not provide "continuous and regular supervisory or management services" with respect to assets, he or she should not have such assets included in the calculation of the trigger in subsection (a)(4)(i). In addition, this is consistent with similar terminology for venture capital companies operating pursuant to Section 203 of the Investment Advisers Act of 1940. Thus, no change is needed.

COMMENTOR 5: Robin E. Jeffs, Robin Jeffs Investment Management, letter dated March 28, 2001.

COMMENTS. The comment contained in this letter requests information regarding the applicability of the proposed rule to this commentor, who has assets under management of less than $25 million, fewer than 15 clients and does not hold himself out generally to the public as an investment adviser.

RESPONSE. This letter requests advice or an opinion regarding the application of the proposed rule under specific circumstances. The Department cannot provide advice or opinions, except through written requests meeting the requirements of Title 10, California Code of Regulations, Section 250.12.

COMMENTOR 6: Amelia N. Carleton, e-mail dated March 30, 2001.

COMMENTS. The comment contained in this e-mail supports adoption of the

rule as proposed.

RESPONSE: The Department recognizes this statement of support for the proposed rule.

COMMENTOR 7: Robert E. Bolman, Bolman & Co. Investment Counsel, letter dated April 4, 2001.

COMMENTS. There is no comment in this letter regarding the proposed rule.

RESPONSE: No response is required.

COMMENTOR 8: Jeffrey T. Kiley, Manager and General Partner, Pacific High Growth Equities, L.P., e-mail dated April 4, 2001.

COMMENTS. The comment contained in this e-mail requests information regarding the applicability of the proposed rule to limited partnerships and specifically to this commentor, who has fewer than 15 clients.

RESPONSE. This e-mail requests advice or an opinion regarding the application of the proposed rule under specific circumstances. The Department cannot provide advice or opinions, except through written requests meeting the requirements of Title 10, California Code of Regulations, Section 250.12.

COMMENTOR 9: Tamara K. Reed, Associate Counsel, Investment Company Institute, letter dated April 20, 2001, received after the 45-day comment period.

COMMENTS. The comment contained in this letter supports adoption of the rule as proposed.

RESPONSE: The Department recognizes this statement of support for the proposed rule.

COMMENTOR 10: Elisa Lowy, Senior Partner, Pillsbury Winthrop LLP, letter dated August 8, 2001, redacting and superceding an earlier letter of April 30, 2001.

COMMENTS.

1. Safe Harbor Provision. The comment contained in this letter takes the position that venture fund managers are not investment advisers and should be excluded from the definition of “investment adviser” with safe-harbor language similar to that found in the Investment Advisers Act.

2. Clarification of the definition of “Management Rights.” To ensure that the proposed rule is consistent with federal law, this comment proposes expressly incorporating the federal definition of "making available significant managerial assistance” with respect to business development companies as the definition for Management

Rights. The comment states that this will clarify that an offer to provide management assistance will be sufficient to characterize the offer as an exercise of management rights even if the offer is not accepted. The comment also states that using the federal definition will ensure that management functions may be performed by one of the investors instead of all investors in the company.

3. Incorporation of the Investment Company Act Definition of "Affiliated Person." The comment proposes defining "affiliated person," as used in the proposed rule's definition of "management rights," as the definition set forth in the Investment Company Act.

4. Addition of "Development" to Subsection (b)(7). The comment proposes clarifying the definition of "operating company" to include entities that are working toward production or sale of their products or services when investment occurs. The comment suggests adding the phrase "research, development," before the word "production" in line two of Subsection (b)(7).

5. Deletion of "In the Ordinary Course of Its Business" from Subsection (b)(5). The comment states that the ordinary course of business for venture capital companies includes converting their investments into the derivative instruments referred to in Subsection (b)(5). However, by including the language "in the ordinary course of its business" in line 2 of that paragraph, it could be inferred that acquiring such derivative instruments may, at times, occur outside the venture capital company's ordinary course of business. Deleting the language will eliminate unnecessary confusion regarding this definition.

6. Typographical Errors. The comment points out that the parenthetical reference to "Section 25009" in Subsection (a) does not express the purpose for its inclusion. There is an extra letter "a" before the word "securities" in the third line of Subsection (b)(2). A comma is required after the word "management" in the fourth line of Subsection (b)(6).

RESPONSE.

1. The Department's rulemaking authority is limited to exempting, rather than excluding, certain persons from the investment adviser registration requirements.

2. The commentor's change is unnecessary because the rule already recognizes the concept of providing management assistance, as suggested. Nevertheless, the Department is amending the definition of management rights to allow for the provision of managerial assistance in the manner suggested by the comment. As revised, the definition clarifies that management rights may be held by one person alone. Additionally, the rule now clarifies that management rights include an offer to provide significant guidance and counsel, as specified. These revisions address the two areas of concern raised in the commentor's letter, without completely re-writing the definition.

3. The Department agrees including a definition of “affiliated person” will avoid ambiguity. The Department has amended the proposed rule accordingly. Although the commentor has suggested adopting a federal definition of affiliated person, the Department's language is based on other well recognized principles of law.

4. This comment makes the valid point that operating companies that are the subject of venture capital investments are often in an inchoate stage of development working towards the production or sale of a product or service. Therefore, the definition of “operating company” should reflect the notion that venture capital companies should not be left out of the exclusion in subsection (a)(4)(ii) simply because the companies in which they invest have products or services that have not yet reached production. While the commentor has suggested language, the Department has addressed this issue in language that more closely achieves the commentor's goal of allowing research and development in connection with the production or sale of a product or service.

5. This comment assumes that all conversions of venture capital investments into derivative instruments occur in the ordinary course of the venture capital company’s business. It is, however, possible for a company to have derivative instruments that do not arise in the ordinary course of its business. Such instruments should not be considered as part of the value of company assets for the purpose of determining whether the company fits within the definition of “venture capital company” in the proposed rule.

6. The revisions to the proposed rule correct the typographical errors pointed out in this comment.

COMMENTS RECEIVED AFTER THE 45-DAY COMMENT PERIOD

COMMENTOR 1: Keith Paul Bishop, Irell & Manella, LLP, Letter dated November 1, 2001.

COMMENTS. The comments were received after the 45-day comment period; however, the Department's responses are set forth below. The comment contained in this letter takes the position that Release 110-C should be withdrawn because the Department failed to provide an opportunity for public comment prior to its promulgation and because of various other reasons outside the subject matter of the proposed rule. With regard specifically to the proposed rule, the comment contained in this letter states that its author supports the proposed rule provided that it includes the “safe harbor” language proposed in the comment received from Pillsbury Winthrop, above, and provided that the Department withdraw Release 110-C.

RESPONSE. The issue raised regarding the “safe harbor” language has been addressed above.

With respect to the Department's withdrawal of Policy Letter No. 151, it may be argued that this policy letter was an underground regulation. Accordingly, the Department's

subsequent issuance of Release No. 110-C has the effect of revoking an otherwise ineffective and unlawful standard of general application. The Department is now (through this rulemaking) seeking to provide the necessary exemption by complying with the Administrative Procedure Act. Thus, the commentor's concerns are being addressed.

No other comments were received.

ADDITIONAL 15-DAY COMMENT PERIOD

Based on the comment letters received during the 45-day public comment period, the Department, issued a Notice of Proposed Final Text for an additional 15-day comment period. This additional comment period began on January 18, 2002 and ended on February 4, 2002. No comments were received as a result of this additional comment period.