

DEPARTMENT OF CORPORATIONS*Business Services and Consumer and Investor Protection*

Preston DuFauchard
California Corporations Commissioner
Sacramento, California



July 8, 2011

**INVITATION FOR COMMENTS ON PROPOSED RULEMAKING UNDER THE
CORPORATE SECURITIES LAW OF 1968
PRO 04/11**

BACKGROUND

The Department of Corporations ("Department") licenses and regulates investment advisers under the Corporate Securities Law of 1968 (Corporations Code Section 25000 et seq., the "Corporate Securities Law"). Under the Corporate Securities Law, it is unlawful for an investment adviser to conduct business without first applying for and securing a certificate.

The Department is considering changes to a regulation that impacts California investment advisers, and in accordance with Government Code Section 11346.45, the Department is seeking comments from interested parties and those who would be subject to the proposed regulations, prior to the Department providing notice of a proposed rulemaking action.

The Department is seeking comments on amendments to Section 260.237 of Title 10 of the California Code of Regulations.

The existing rule sets forth requirements for investment advisers with custody or possession of clients' funds or securities.

The amendments propose to revise the rule to incorporate changes under federal law and the proposed NASAA Model Rule. By way of background, the U.S. Securities and Exchange Commission ("SEC") recently adopted amendments to the federal custody rule under the Investment Advisers Act of 1940, applicable to federally registered investment advisers. However, pursuant to the National Securities Markets Improvement Act of 1996, such federal changes are not applicable to investment advisers licensed solely in state jurisdictions.

The SEC rules define "custody" in Rule 206(4)-2 (17 C.F.R. §275.206(4)-2). The prior NASAA Model Rule was drafted based on the predecessor federal rule, and therefore the SEC's changes to the federal custody rule required changes in the NASAA Model Rule to provide needed uniformity in this area between the regulation of federal-registered and non-federal registered investment advisers, as well as to provide equivalent levels of investor protection.

A. Executive Summary

Generally, the proposed amendments to this rule strike the existing language and, subject to certain California-specific provisions, enact the proposed NASAA Model Rule. In general, the amendments define “custody,” and, subject to certain limited exceptions, require that advisers with custody maintain the assets with a qualified custodian, as defined in the rule. The amendments also specify that certain audits and independent verifications must be performed by Certified Public Accountants that are registered with, and subject to regular inspection, by the Public Company Accounting Oversight Board (“PCAOB”).

Additionally, subject to exceptions discussed in more detail below, the proposed rule requires investment advisers to comply with the following safeguards:

(1) Notifying the Commissioner that the investment adviser has custody of client funds or securities.

(2) Ensuring that a qualified custodian maintains funds and securities in specified manners.

(3) Notifying clients of the identity and location of the qualified custodian.

(4) Ensuring that clients receive account statements.

(5) Retaining a certified public accountant to conduct a surprise examination of client assets.

B. Background and Discussion

By way of background, in 2003 the general surprise examination requirement was removed from the SEC's custody rule. According to the SEC, the reestablishment of the surprise examination requirement in its most recent revisions to the rule was included in response to "concerns raised by several SEC enforcement actions, including the Madoff fraud." (SEC Release No. IA-2968; March 12, 2010.) The surprise verification requirement increases investor protections by requiring an independent CPA to verify the funds and securities, at a time chosen by the CPA.

A number of exceptions to specified provisions of the general safeguards are included in the proposed rule. These include exceptions for certain privately held securities, investment advisers that have custody due to directly deducting advisory fees from client accounts, and limited partnerships subject to annual audit.

Like the SEC and NASAA rules, advisers that have custody due to fee deduction, and advisers to private funds that comply with the PCAOB audit requirement set forth in subsection (b)(4) of the rule, are excepted from the independent verification requirement.

Commentators have suggested that prior proposed versions of the Department's custody rule (see PRO 27/03) should be revised to fully clarify that compliance with the audit exception would except an adviser from the independent verification requirement. (Comment letter from Eric A. Brill, Esq., dated Feb. 4, 2011.) The NASAA Model Rule fully clarifies that advisers to pooled investment vehicles, satisfying the requirement of the audit requirement, are excepted from the independent verification requirement.

Similarly, when the adviser or its related person serves as qualified custodian for client assets, the adviser must ensure that the CPA is registered with, and subject to regular inspection by, the PCAOB. Additionally, such advisers are required to obtain an internal control report from that CPA.

As explained in more detail in the SEC's adopting release, PCAOB registration likely leads to "greater confidence in the quality of the surprise examination and the internal control report when prepared by an independent certified public accountant that is registered with, and subject to regular inspection by the PCAOB." (SEC Release No. IA-2968, p. 36.) Importantly, under the SEC rule, "an adviser's use of an independent public accountant that is registered with the PCAOB but not subject to regular inspection would not satisfy the rule's requirements." (Id. at footnote 122.) This requirement would also apply to the proposed California rule.

The proposed rule deviates from the NASAA Model Rule in one significant respect; the proposed California rule would allow advisers to pooled investment vehicles that select the independent gatekeeper option, set forth in subsection (a)(5), to be subject to the same account statement requirements as advisers that select the audit exception set forth in subsection (b)(4). Generally, the account statement requirement for advisers that select the audit option are less onerous than the default account statement requirements set forth subsection (a)(4). In particular, such account statements are not required to disclose all transactions that took place during the reporting period.

In contrast, the NASAA Model Rule only allows the relaxed account statement requirement for pooled investment advisers that select the audit option. Since the independent gatekeeper option provides comparable investor protection as the audit option, it appears that the account statement requirements should be consistent for both classes of advisers.

Also noteworthy is the fact that the proposed California rule relaxes certain of the alternative account statement requirements set forth in the NASAA rule. This deviation is intended to ensure that any proprietary trading models developed by an adviser, and indirectly selected by the client, are maintained in a confidential manner.

In summary, the Commissioner seeks input on the issue on how best to increase client protections by providing additional safeguard measures for client funds and securities, including verification by independent third parties. Also, the amendments provide additional guidance to investment advisers by specifically defining the term

“custody” and thus providing added predictability. Lastly, the amendments provide for added flexibility for advisers to pooled investment vehicles, by allowing funds to select the audit exception in lieu of the independent gatekeeper requirement.

INVITATION

In accordance with Government Code Section 11346(b), the Department seeks to involve parties who would be subject to the regulations and other interested parties in discussions regarding the proposed regulations. The Commissioner invites interested parties to review the accompanying draft text of a proposed regulatory structure for advisers to alternative investment vehicles, and provide comments.

TIME FOR COMMENTS

Accordingly, the Department is providing the attached text of draft regulations to interested parties, and invites interested parties to submit comments on these documents by August 5, 2011. Comments from interested persons will assist the Department in determining whether amendments to regulations under the Corporate Securities Law are necessary and appropriate.

This solicitation for comments from interested parties is not a proposed rulemaking action under Government Code Section 11346, and the public will have an additional opportunity to comment on proposed changes if, after consideration of the comments from interested parties, the Department proceeds with a notice of a proposed rulemaking action.

WHERE TO SUBMIT COMMENTS

You may submit comments by any of the following means:

Electronic

Comments may be submitted electronically to regulations@corp.ca.gov. Please identify the comments as PRO 04/11 in the subject line.

Mail

California Department of Corporations
Office of Legislation and Policy
Attn: Karen Fong (PRO 04/11)
1515 K Street, Suite 200
Sacramento, CA 95814-4052

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Fax

(916) 322-5875.

CONTACT PERSONS

Questions regarding this invitation for comments may be directed to Ivan V. Griswold, Corporations Counsel, at (415) 972-8937 or igriswol@corp.ca.gov .