The Dodd-Frank Act's Impact on California's Restrictions on Investment Adviser Performance Compensation

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Prior to the enactment of the Dodd-Frank Act, Section 205 of the Investment Advisers Act of 1940 prohibited the receipt of performance compensation by an investment adviser unless the adviser was exempt from registration under Section 203(b) of the Advisers Act. Performance compensation is compensation based on the capital gains or capital appreciation in a client's account. Performance compensation has been a common component of hedge fund manager compensation.

In the halcyon days between the *Goldstein* decision and the enactment of the Dodd-Frank Act, many, but not all, hedge fund managers relied on the exemption from registration in Section 203(b)(3) of the Advisers Act for advisers with fewer than 15 clients. State registered investment advisers, however, were subject to the ban on performance compensation in Section 205 of the Advisers Act.

California has its own prohibition on performance compensation (Cal. Corp. Code § 25234 and Rule 260.234). That prohibition, unlike Section 205 of the Advisers Act, applies only to California registered advisers. Typically, a hedge fund manager that relied on the fewer-than-fifteen client exemption in Section 203(b)(3) of the Adviser Act relied on the exemption in California Rule 260.204.9 (and thus wasn't subject to California's restriction on performance fees).

Effective July 22, 2010, Congress amended Section 205 to make that section applicable only to advisers *registered or required to be registered* with the SEC. This change had the effect of immediately relieving state registered investment advisers from the federal ban on performance compensation.

Although that is complicated enough, matters are likely to be more uncertain at the state level. I expect that the Commissioner will amend Rule 206.204.9 sometime in the next year or two because that rule was intended to dovetail with the soon to be defunct fewer-than-fifteen client exemption and the former, lower threshold for SEC registration. Thus, the applicability of California's ban on performance compensation will depend on whether a fund manager continues to be exempt from registration in California. Until the Commissioner amends Rule 206.204.9, we won't know whether fund managers will continue to be exempt from registration.

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Finally, we may see some changes to Rule 260.234 that exempts certain advisers from the California's prohibition. That rule refers to Rule 205-3 of the Advisers Act. Section 418 of the Dodd-Frank Act requires indexing of the dollar amount tests for purposes of the "qualified client" exemption in Rule 205-3. The Administrative Procedure Act prohibits these changes from being automatically incorporated into Rule 260.234.

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