Kenneth Berland California Bar #250255

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<u>Education</u>

University of Southern California School of Law
J.D., *Order of the Coif*, 2005
Southern California Law Review, Articles Editor

High Honors Grades
Business Organizations, Civil Procedure, Contracts, Criminal Law, Evidence, Federal Courts, Gender Discrimination, Intellectual Property, and International Law

Honors Grades
Constitutional Law I, Criminal Procedure, Internet Law, Legal Profession (Ethics), Poverty Law, Property, and Taxation

University of Wisconsin, Madison
B.S., Political Science and Creative Writing, 1991

<u>Experience</u>

Howard Rice Nemerovski Canady Falk & Rabkin, San Francisco
Business Associate, March 2007–March 2008
Drafted, reviewed and negotiated documents for business transactions. Extensive work negotiating software and digital content licensing for both licensors and licensees. Drafted DMCA and CDA compliant policies for clients with Internet operations. Negotiated legal terms for services agreements and strategic business alliances for clients with SaaS business models. Drafted and reviewed agreements collateral to human resources, including independent contractor agreements and proprietary information and inventions agreements. Negotiated and drafted agreements for venture financings, particularly preferred stock financings. Maintained agreements for hedge fund formation and limited partner subscriptions. Assisted in mergers and acquisitions including drafting merger agreements and asset purchase agreements.

United States Court of Appeals for the Sixth Circuit, Louisville
Clerk to Danny J. Boggs, Chief Judge, 2005–2006
Researched and analyzed federal and state law issues requiring decision by the court including: patent, copyright and trademark; labor and employment; contracts; sovereign immunity and state's rights; immigration; and death penalty and criminal law. Drafted memoranda analyzing cases and motions before the Court. Engaged in oral argument with and recommended specific outcomes to Judge Boggs. Drafted opinions and orders consistent with the Court's rulings.

Susman Godfrey, Los Angeles
Summer Associate, 2004 (offer extended)
Assisted in preparation of trial briefs for a large private antitrust action.

Orrick, Herrington & Sutcliffe, Los Angeles
Summer Associate, 2004 (offer extended)
Conducted due diligence and drafted documents for a private company acquisition. Analyzed issues relating to public finance.

The Advancement Project, Los Angeles
Summer Intern, 2003
Assisted noted civil rights attorney Connie Rice, appointed by the Los Angeles Police Commission to write a final analysis of the Rampart corruption scandal.

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Hero Consulting

Partner, 1998–2005

Consultant for e-commerce, digital feature film and television commercial production. Film projects included The Core, Pearl Harbor and Driven. Television commercial projects included Energizer Titanium and AT&T Ants. Production company clients included Rhythm & Hues, Asylum, Method Studios, Ring of Fire and Zen Kitty. Internet clients included Filmson.com and Funbets.com.

Idea Technologies Corporation, Santa Monica

Founder, 1998–2000

Held exclusive contract with West Publishing Group to design and deploy Pocket Paralegal, a wireless information retrieval system for attorneys.

Twentieth Century Fox/VIFX, Los Angeles

Technical Director, 1996–1998

Created digital effects for feature films including Volcano, Jingle All the Way and Face/Off. Supervised teams in creating systems for the visualization of special effects. Provided in-house consulting for complex aspects of digital film-making.

Freelance Digital Artist, New York

Digital Artist, 1993–1996

Clients included Charlex, Sony Music Studios, Balsmeyer and Everett and RVI .

Admissions

California, 2007

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Attorneys for Defendants and Cross-complainant

SUPERIOR COURT OF THE STATE OF CALIFORNIA
IN AND FOR THE COUNTY OF MARIN
UNLIMITED JURISDICTION

EDWARD VOLK, an individual, Plaintiff, v. HANK MALASKY, an individual, DIVEX, INC., a California Corporation, and DOES 1 -20, inclusive, Defendants. AND RELATED CROSS-ACTION	No. CV 065564 **DEFENDANT'S MOTION IN LIMINE NO. 1 (Right to Jury Trial))** Trial Date: July 8, 2008 Time: 9:30 am Dept: B.

I.

INTRODUCTION.

Defendants respectfully move the Court for an order in limine ordering that the trier of fact in this action shall be the Court and not a jury. It is anticipated that Plaintiff will demand a jury trial. This demand should be denied and the matter should be heard by the trial court alone.

The Complaint in this action alleges five causes of action: 1) breach of contract, 2) breach of fiduciary duty, 3) constructive fraud, 4) dissolution and accounting and 5) repayment of a personal loan.[1] Each of these, it will be shown, sound exclusively in equity.

II.

ARGUMENT

A. Plaintiff's First Four Causes Of Action Are Equitable

1. The Cause of Action for Dissolution And An Accounting Is Equitable

In a two-person copartnership, the disassociation of either partner, rightfully or wrongfully, causes a winding-up of the partnership. Corp, Code § 16701; Pearson v. Higgins, 49 F.2d 47, 48 (9th Cir. 1931). Under the Uniform Partnership Act of 1994 (the "UPA"), therefore, any dissociation of a copartner triggers a winding-up, entitling each partner "to a settlement of all partnership accounts." Corp Code § 16807(b).

> In settling accounts among the partners, the profits and losses that result from the liquidation of the partnership assets shall be credited and charged to the partners' accounts. The partnership shall make a distribution to a partner in an amount equal to any excess of the credits over the charges in the partner's account.
>
> After the settlement of accounts, each partner shall contribute, in the proportion in which the partner shares partnership losses, the amount necessary to satisfy partnership obligations that were not known at the time of the settlement and for which the partner is personally liable under Section 16306.

Corp. Code § 16807(b),(d).

It is well settled that a "suit for partnership accounting is one addressed to the equitable jurisdiction of the court." Peterson v. Lightfoot, 47 Cal. App. 646, 649 (1st Dist. 1920). The

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[1] The Complaint mistakenly labels the fifth cause of action "Sixth Cause of Action." For the sake of consistency, this Motion will refer to that cause of action as the final cause of action.

judicial application of this rule spans three centuries. See Russell v. Ford, 2 Cal. 86, 87 (1852) (accounting must be rendered by a court of equity); Ab Grp. v. Wertin, 59 Cal. App. 4th 1022, 1028 (4th Dist. 1997) (accounting is an equitable action).

In Dills v. Delira Corp., 145 Cal. App. 2d 124 (2d Dist. 1956), the plaintiff sued for damages and for a declaration form the court that a partnership existed. Id. at 126–28. The court construed plaintiff's partnership claims as claims for equitable relief and tried them without a jury. Id. On appeal, the reviewing court held that where a plaintiff "allege[s] the existence of a partnership, [and seeks] a declaration of his interest therein," "the action is one in equity." Id. at 129-30. See also Cutter Labs. v. R. W. Ogle & Co., 151 Cal. App. 2d 410, 418 (2d Dist. 1957) (declaration of the existence of a partnership is a matter sounding in equity).

There is no dispute in this case that the UPA is the governing statute and that there were only two partners to any alleged partnership. Therefore, simply by operation of law, there must be an accounting performed in equity before the trial court. An accounting under UPA § 16807, with respect to both partners, is required before any damages may be awarded.

2. The Cause Of Action For Breach Of Fiduciary Duty Is Equitable

Actions for breach of fiduciary duty are also actions squarely within the realm of courts of equity. Interactive Multimedia Artists v. Superior Court, 62 Cal. App. 4th 1546, 1555 (2d Dist. 1998). The appropriate remedy for a breach of fiduciary duty is restitution or a constructive trust and each is "premised on equitable principles." Id.

In Interactive Multimedia Artists the plaintiffs alleged a breach of fiduciary duty by the minority shareholders of a California corporation coupled with claims for breach of contract. Id. at 1550. The trial court denied the plaintiffs a jury and the reviewing court upheld the decision under both California and Delaware law. The reviewing court concluded that a breach of fiduciary duty is a cause of action based on "powers in trust" and "equitable principles." Id. at 1555. "Where there is a violation of these principles, equity will undo the wrong or intervene to prevent its consummation." Id. (emphasis in original). Accordingly, "[u]nder California law, a party is not entitled to a jury trial in an equitable action." Id.

Here, the Complaint second cause of action prays for damages for a breach of the fiduciary duty imposed by section 16404 of the UPA. There is no distinction between the equitable nature of the fiduciary duty owed by a corporate director or minority shareholder to the corporation on one hand and the fiduciary duty of one partner to the other: each stems from basic concepts of agency. See Koyer v. Willmon, 150 Cal. 785, 787 (1907) (in a copartnership, each partner occupies the position of trustee to the other with regard to all the partnership transactions); Restatement (Third) of Agency § 8.01, General Fiduciary Principle (relationship between principal and agent is a fiduciary relationship; a duty to act loyally for the principal's benefit).

3. The Cause Of Action For Constructive Fraud Is Equitable

Constructive fraud is "any breach of duty which, without an actually fraudulent intent, gains an advantage to the person in fault, or anyone claiming under him, by misleading another to his prejudice, or to the prejudice of anyone claiming under him." Engalla v. Permanente Med. Grp., 15 Cal. 4th 951, 981 (1997). "It is generally asserted against a fiduciary by one to whom a fiduciary duty is owed." Id.

It should be noted that a breach of fiduciary duty usually constitutes constructive fraud. Alliance Mortgage Co. v. Rothwell, 10 Cal. 4th 1226, 1239 (1995) (citing Salahutdin v. Valley of Cal., Inc., 24 Cal. App. 4th 555, 563 (1st Dist. 1994)). In this particular case, the cause of action for constructive fraud is duplicative of Plaintiff's fiduciary duty claim.

However, a claim by Plaintiff that his constructive fraud allegation allows him the right to a jury would be specious. This argument would, in effect, require a jury to hear all fiduciary claims that are cleverly coupled with an allegation of constructive fraud. This would eviscerate the clear holding in Interactive Multimedia Artists. 62 Cal. App. 4th 1546.

4. Plaintiff's First Cause Of Action Is Merely A Breach Of Fiduciary Duty Claim Clothed In Legal Garb

The first infirmity evident in Plaintiff's first cause of action is that it is an attempt to transform an equitable claim into a legal claim for the benefit of securing a jury. An examination of the Complaint shows this to be true: Plaintiff's breach of contract claim contains the identical allegations as his breach of fiduciary duty claim. First, Plaintiff's primary allegation to support the breach of contract is the existence of a partnership. Second, to support his claim of breach, Plaintiff alleges a dissolution of the partnership and an improper accounting. Finally, Plaintiff's claim for damages is identical to his prayer under the second cause of action for breach of fiduciary duty. The identity of elements and prayers between the two cause of action is no accident, claims one and two are the same.

Following on this principle, the second infirmity in the first cause of action is that it fails to allege a breach of contract simply because it fails to allege any contractual breach. In ¶ 17 of the Complaint, Plaintiff alleges that Defendant breached the contract "by repudiating the existence of the partnership." However, Plaintiff fails to allege that the partnership agreement was for any definite period of time or for the completion of a particular undertaking. Under operative law, therefore, the alleged partnership was one at will, incapable of breach through repudiation.

Where the partners have not agreed to remain partners until the expiration of a definite period of time or the completion of a particular undertaking, the partnership is a partnership at will. Id. at § 16101(9); Clarke v. Fiedler, 44 Cal. App. 2d 838, 849 (2d Dist. 1941) ("As to the duration of the partnership the agreement is silent, and no evidence on that subject was introduced at the trial. The partnership was therefore one at will."). When one of the partners in an at will copartnership expresses the will to dissolve the partnership, the partnership is dissolved and statute requires that it subsequently be wound up. Id. at § 16801(1).

Under the UPA, a repudiation of the partnership cannot be distinguished from a partner's express will to dissolve and wind up the partnership. Id. at § 16801(1). See Middleton v. Newport, 6 Cal 2d 57 (1936) ("The abandonment or dissolution of a partnership or joint adventure may take place by conduct inconsistent with its continuance"). Therefore, in a partnership at will, a partner's repudiation is not wrongful and does not constitute a breach of the partnership agreement. Id.

When fairly evaluated, in light of Plaintiff's other claims, the first cause of action for breach of contract is at once subsumed and invalidated by the equitable claims alleged elsewhere in the complaint. What remains, save for the final cause of action, are prayers for relief that sound solely in equity.

B. The Entire Action Is One in Equity Because the Gist Of The Action Is Equitable

In determining whether a right to a jury trial exists, "the court is not bound by the form of the action but rather by the nature of the rights involved and the facts of the particular case—the gist of the action." C&K Eng'g Contractors v. Amber Steel, 23 Cal. 3d 1, 9 (1978). A plaintiff cannot guarantee his right to a jury merely by including legal claims. Id. "The fact that damages is one of a full range of possible remedies does not guarantee the right to a jury." S. Pac. Transp., 58 Cal. App. at 436; Interactive Multimedia Artists v. Superior Court, 62 Cal.App.4th 1546, 1551 (2d Dist. 1998) (action addressed to equity powers of the court is one for the trial court alone).

In C&K Engineering, the complaint included claims for both promissory estoppel and breach of contract. 23 Cal. 3d at 9. The trial court denied the plaintiffs a jury. Id. On appeal, the court held that the "gist" of promissory estoppel is equitable and that the trial court was correct to treat the entire action as "equitable in nature, to be tried by the court." Id. at 11. See also Walton v. Walton, 31 Cal. App. 4th 277, 284 (3d Dist. 1995) (affirming denial of jury on equitable specific performance claim coupled with claim for damages).

Obviously, the mere allegation of a contract claim cannot transform all equitable partnership actions into actions at law. See Schaefer v. Gunzburg, 246 F.2d 11, 16 (9th Cir. 1957) (argument that interpretation of an alleged partnership agreement was a legal question for a jury rejected, because, "in effect, if the claim of plaintiff is correct, there could never have been a suit in equity for the relief asked for in this complaint without a jury trial upon the question of whether there was a partnership or not").

Here, the plaintiffs have made legal claims for breach of contract and for repayment of a personal loan. As we have seen, the breach of contract claim is, when fairly construed, really an equitable claim for breach of fiduciary duty. Regardless, as we have also seen, if construed as a legal claim, it fails on the face of the Complaint. The second legal claim, for repayment of a $5,000 loan does not approach the magnitude of Plaintiff's equitable claims. It must be assumed that this claim was inserted as a legal claim to secure a jury. A de minimus claim such as the last cause of action does nothing to alter the gist of the action from one in equity to one at law.

C. The Right To A Jury Trial Must Have Either Constitutional Or Statutory Authorization

The California Constitution guarantees the right to a jury trial in actions at law, not those in equity. Cal. Const. art. I, § 16; People v. Englebrecht, 88 Cal. App. 4th 1236, 1245 (4th Dist. 2001). The right is coextensive with the right "existing at common law at the time the Constitution was adopted." S. Pac. Transp. v. Superior Court, 58 Cal. App. 3d 433, 436 (1st Dist. 1976). Thus:

> The Legislature cannot, by providing new remedies in form equitable, convert a legal right into an equitable one so as to infringe upon the right of trial by jury. On the other hand, if the action is essentially one in equity and the relief sought depends upon the application of equitable doctrines, the parties are not entitled to a jury trial.

Hodge v. Superior Court, 145 Cal. App. 4th 278, 283 (2d Dist. 2006).

The precedents are clear, see e.g., Ford, 2 Cal. at 87, that partnership matters are not embraced by a right to a jury trial.

D. Judicial Economy Demands That The Court First Proceed In Equity And Then Try Plaintiff's Legal Claim

Where plaintiff's claims are both legal and equitable, the equitable claims are properly tried first by the court. Nwosu v. Uba, 122 Cal. App. 4th 1229, 1238 (6th Dist. 2004). This procedure promotes judicial economy and obviates the necessity for a subsequent trial of the legal issues. Id.

In Dills v. Delira Corp., 145 Cal.App.2d 124, 129 (2d Dist. 1956), the plaintiff sued for a declaration of his interest in and the existence of a partnership. The complaint also included common counts for money had and received based upon his alleged share of the profits. 145 Cal. App. 2d at 129. The court tried the equitable issues first, determined that no partnership existed, and then concluded that no trial was needed to occur on the legal claims. Id. The reviewing court rejected a challenge based upon the denial of a right to a jury trial and held that there was no right to litigate the claims before a jury after the issue had been decided by the judge. Id. at 130–31. See also Cutter Labs. v. R. W. Ogle & Co., 151 Cal. App. 2d 410, 418 (2d Dist. 1957) (declaration of the existence of a partnership is a matter sounding in equity).

Here, the Plaintiff has joined his nonexistent breach of contract claim with a de minimis common count for repayment of a $5,000 loan. Clearly, judicial economy requires that the court first rule upon the existence of the partnership and conduct an accounting before submitting any legal claims to a jury.

III.

CONCLUSION

For all the foregoing reasons, Plaintiff's jury demand should be denied and the matter should be heard by the trial court alone.

Dated: June 30, 2008

LIPPENBERGER, THOMPSON, WELCH SOROKO & GILBERT LLP

by Carl Lippenberger
Carl Lippenberger
Attorneys for Defendants and Cross-complainant

PROOF OF SERVICE BY MAIL

I, Nessa West, declare:

I am employed in the County of Marin; my business address is 201 Tamal Vista Boulevard, Corte Madera, California 94925. I am over the age of 18 years and not a party to the foregoing action. On the date set forth below, I served the attached documents:

DEFENDANT'S MOTION IN LIMINE NO. 1

__________ **(by United States Mail)** on all parties in said action, in accordance with Code of Civil Procedure Section 1013, by placing a true copy thereof enclosed in a sealed envelope in a designated area for outgoing mail, addressed as set forth below. At Lippenberger, Thompson, Welch, Soroko & Gilbert LLP, mail placed in that designated area is given the correct amount of postage and is deposited that same day, in the ordinary course of business, in a United States mailbox in the City of Corte Madera, County of Marin, California.

__________ **(by facsimile delivery)** by faxing a true copy thereof to the person at the fax number set forth below.

____X____ **(by Overnight Delivery)** by depositing a true copy thereof in a sealed packet for overnight mail delivery, with charges thereon fully prepaid, in an Overnight Delivery Express collection box, at Corte Madera, California, and addressed as set forth below.

Ronald D. Foreman, Esq.
Foreman & Brasso
930 Montgomery Street, #600
San Francisco, CA 94133

I declare under penalty of perjury and the laws of the United States that the foregoing is true and correct. Executed June 30, 2008, at Corte Madera, California.

[signature]
Nessa West

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November 26, 2007

Kenneth Berland
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VIA EMAIL: regulations@corp.ca.gov

Ms. Karen Fong
Office of Legislation and Policy
Department of Corporations
1515 K Street, Suite 200
Sacramento, California 95814-4052

Re: California Department of Corporations File No: PRO 41/06—Exemption for Certain Investment Advisers Pursuant to Corporations Code Section 25230

Dear Ms. Fong:

I am writing to comment on the above-referenced proposal (the "Proposed Rule") issued by the California Commissioner of Corporations (the "Commissioner") on September 14, 2007, to amend section 260.204.9 of Title 10 of the California Code of Regulations to eliminate the current exemption for investment advisers with fewer than 15 clients.

I provide these comments on my own behalf, on behalf of Howard Rice Nemerovski Canady Falk & Rabkin, A Professional Corporation (the "Firm"), and on behalf of the Firm's many clients who do business in California as exempted investment advisers.

We have two short comments to make regarding the Proposed Rule. Briefly, we believe that (*i*) the Commissioner should pay closer attention to the structure of federal law before enacting the Proposed Rule and (*ii*) if enacted, the Proposed Rule will discourage large out-of-state advisers from conducting business in California and eliminate any economic benefits for the state that would otherwise spring from Congress's carefully-crafted national plan.

Additionally, I recommend that the period for comment regarding the Proposed Rule be extended at least ninety days to February 26, 2008 to allow a better understanding of the proposed changes and solicitation of comments from a wider variety of commenters.

1. The Proposed Rule Imposes Regulatory Burdens in an Area Reserved for the Federal Government.

On October 11, 1996, President Clinton signed into law the National Securities Improvement Act of 1996 ("NSMIA").[1] Title III of NSMIA, the Investment Advisers Supervision Coordination Act (the "Coordination Act"), created a new regime of state and federal cooperation with respect to the regulation of investment advisers.[2] The Coordination Act states that no adviser with assets under management of less than $25 million (the "Interstate Amount") may register with the Securities and Exchange Commission (the "SEC").[3] Next, the Coordination Act expressly preempts state law with respect to SEC registered advisers and states that no law of any state may require the registration of any SEC registered adviser.[4] Preemption within the Coordination Act stops there—the power of the states to enforce laws with respect to fraud or deceit is preserved.[5]

(a) The Structure of NSMIA.

The structure of the Coordination Act reveals Congress's plan with respect to the division of regulatory authority between federal and state regulators. The Proposed Rule fails to respect this structure and thus does violence to the intent of Congress. In its first breath, the Coordination Act divides the world of advisers into two groups by imposing a $25 million threshold. Regulation of advisers managing assets under the Interstate Amount, was thought by Congress to be a state concern. Importantly, Congress gave the SEC the authority to alter the point of division, an acknowledgment by Congress that the $25 million mark is a lynchpin of the legislation and the regulatory regime it created, the Interstate Amount, therefore, must be kept relevant.

Second, consider what the Coordination Act did *not* do. It did not alter Section 203(b)(3) of the Advisers Act, the portion of that act that creates an exemption from registration for those advisers with fewer than 15 clients ("Private Advisers")—the advisers affected by the Proposed Rule. For whatever reason, not at all discussed in the statutory history of NSMIA, the effect of NSMIA is that Private Advisers do not require registration, either before NSMIA or after.

At some level, it seems that Congress is split on the issue, some of her legislation points to an adviser's number of clients, while other legislation highlights assets under management as the gateway to federal concerns. However, it is clear, at least intuitively, that the Interstate Amount has a relation to national importance that is undeniable. In invalidating a rule similar to the

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1 Pub. L. No. 10-290, 110 Stat. 3416 (1996).

2 Section 203A of the Investment Advisers Act of 1940 (the "Advisers Act"), as amended (codified at 15 U.S.C. § 80b).

3 Section 203A(a)(1)(A) of the Advisers Act (codified at 15 U.S.C. § 80b–3a(a)(1)(A)).

4 *See* § 203A(b)(1)(A) of the Advisers Act.

5 *See* § 203A(b)(2) of the Advisers Act.

Proposed Rule, the District of Columbia Circuit concluded that assets under management are the appropriate test:

> If Congress did intend [203(b)(3)] to prevent regulation only of small-scale operations—a policy goal that is clear from neither the statute's text nor its legislative history—the Commission's rule bears no rational relationship to achieving that goal. The number of investors in a hedge fund—the "clients" according to the Commission's rule—reveals nothing about the scale or scope of the fund's activities. It is the volume of assets under management or the extent of indebtedness of a hedge fund or other such financial metrics that determines a fund's importance to national markets.

Goldstein v. SEC, No. 04-1434, slip op. at 19 (D.C. Cir. June 23, 2006).

Given these two assumptions—(*i*) Private Advisers do not require federal regulation and (*ii*) states should not regulate advisers managing assets not in excess of the Interstate Amount—it is an almost inescapable conclusion that the Coordination Act reveals a Congressional intent not to ensnare Private Advisers managing assets in excess of the Interstate Amount in the net of state regulation.

(b) The Clear and Manifest Purpose of Congress.

Fortunately, in determining the purpose of Congress we are aided by a legislative history that speaks directly to the Commissioner's Proposed Rule. Congress's purpose in enacting NSMIA was:

> to modernize and rationalize certain important aspects of the regulatory scheme governing our capital markets, including the respective responsibilities of Federal and State governmental authorities over the securities markets. . . . to further advance the development of national securities markets and eliminate the costs and burdens of duplicative and unnecessary regulation by, as a general rule, designating the Federal government as the exclusive regulator of national offerings of securities.[6]

The Senate Report delivered with the Senate's version of NSMIA (in which the Coordination act is identical to the version that emerged from the Conference Committee) contained these remarks:

> [E]liminating overlapping regulatory responsibilities will allow the regulators to make the best use of their scarce resources to protect clients of investment advisers. The states should play an important and logical role in regulating small investment advisers whose activities are likely to be concentrated in their home state. Larger advisers, with national businesses, should be registered with the Commission and be subject to national rules.
>
> * * *
>
> The legislation allows states to assume the primary role with respect to regulating advisers that are small, local businesses, managing less than $25 million in client assets,

[6] H.R. Rep. No. 104-622 at 18, *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=104_cong_reports&docid=f:hr622.104.pdf [hereinafter House Report].

> while the Commission's role is focused on larger advisers with $25 million or more in client assets under management.
>
> * * *
>
> Investment advisers registered with the states will no longer have to register with the SEC. Investment advisers registered with the SEC will no longer have to register with the states but will continue to pay fees to the states. State regulators will enforce books and records and financial responsibility laws for investment advisers registered in their state. Both the Commission and the states will be able to continue bringing anti-fraud actions against investment advisers regardless of whether the investment adviser is registered with the state or the SEC.[7]

There is, therefore, a very strong case to be made that the intent of Congress was to "divide between the SEC and States regulation of the 22,500 registered investment advisers who are entrusted with over $10 trillion in customer funds," giving them "distinctly separate regulatory roles,"[8] and that the factor to be used in this division should be the amount of assets under management.

None of this is consistent with the position of the Commissioner embodied in the Proposed Rule. It makes little sense for Congress to exempt Private Advisers from federal regulation while simultaneously allowing them to be regulated by the states. And it makes less sense for Congress to allocate regulation of advisers managing assets less than the Interstate Amount to the states while simultaneously allowing the states to regulate Private Advisers without regard to the amount under management.

Clearly, the attention of the Commissioner, according to Congress's plan, should be focused upon fraud and advisers managing less than the Interstate Amount. The Commissioner then, should not have a need to expand regulation to combat "the increase in fraud related to hedge fund activities" in an area where Congress has explicitly preserved the states' common law and police power to prosecute fraud and deceit in connection with *any* investment adviser.[9] Similarly, the Commissioner's appeal to an "unwarranted disparity in treatment of investment advisers that no longer serves any meaningful public benefit"[10] is in direct conflict with the clear plan of Congress to create a dual system of regulation based upon disparities in treatment that are fundamental to the Coordination Act.

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[7] S. Rep. No. 293, 104th Cong., 2d Sess., 3–4 (1996), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=104_cong_reports&docid=f:sr293.104.pdf

[8] Senate Floor Remarks of Senator D'Amato (June 27, 1996) (the Senate version of NSMIA was introduced by Senators Gramm, D'Amato, Dodd, Bryan and Moseley-Braun).

[9] *See* Section 203A(b)(2) of the Advisers Act.

[10] California Commissioner of Corporations, Notice of Proposed Rulemaking 41/06 at 2 (Sept. 14, 2007), *available at* http://www.corp.ca.gov/pol/rm/4106a.pdf

(c) Consistent SEC Interpretations.

The Securities and Exchange Commission's interpretation of the Coordination Act is consistent with the statutory history and the plan elucidated above: "Congress concluded that if the overlapping regulatory responsibilities of the [SEC] and the states were divided by making the states primarily responsible for smaller advisory firms and the Commission primarily responsible for larger firms, the regulatory resources of the Commission and the states could be put to better, more efficient use."[11] More explicitly, the SEC has stated, multiple times, that state authority under NSMIA is limited to three areas:

> First, states may investigate and bring enforcement actions against Commission-registered advisers with respect to fraud and deceit. States may not, however, indirectly regulate activities of Commission-registered advisers by enforcing state requirements that define ''dishonest'' or ''unethical'' business practices unless the prohibited practices would be fraudulent absent the requirements. Second, states may require Commission-registered advisers to file, for notice purposes only, documents filed with the Commission. Thus, for example, a state could require a Commission-registered adviser to file its Form ADV with the state, but could not require the adviser to provide any information on the state filing other than the information that is required by the Commission. Third, states may require Commission-registered advisers to continue to pay state filing, registration, and licensing fees.[12]

These clear statements serve to highlight our belief that the Commissioner's interpretation of the Coordination Act is at odds with the basic assumptions of NSMIA. The Interstate Amount is the bifurcation point, not an adviser's number of clients. The structure of NSMIA, its legislative history and the interpretations of the SEC all support this conclusion.

2. The Proposed Rule Damages California's Economy.

(a) National Advisers Will Be Deterred From Entering California

At least three states with large financial sectors, Connecticut[13], Florida[14] and New York[15], have laws that are consistent with the position that state regulation of advisers managing assets in excess of the Interstate Amount is inconsistent with NSMIA. In each of those states Private

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[11] Proposed Rules Implementing Amendments to the Investment Advisers Act of 1940, 61 Fed. Reg. 68,481 (Dec. 27, 1996) (to be codified at 17 C.F.R. Parts 275 and 279).

[12] *Id.* at 68,482; *See also* Final Rules Implementing Amendments to the Investment Advisers Act of 1940, 62 Fed. Reg. 28,125 (May 22, 1997).

[13] Order Governing Certain Federally Exempt Investment Advisers, John P. Burke, Connecticut Banking Commissioner (Oct. 14, 1997) (*available at* http://www.ct.gov/dob/cwp/view.asp?a=2252&dobNAV_GID=1662&q=299210).

[14] *See* FLA. STAT. ch. 517.021(b)(7).

[15] 11.13(a)(6) of the Investment Adviser Regulation (*available at* http://www.oag.state.ny.us/investors/investment_advisor_regulations_2003.pdf).

Advisers managing well above the Interstate Amount have created businesses that are clearly national in scale. Of course, many more are approaching this point, because, as the Commissioner has noted, the industry has been experiencing remarkable growth. Each of these large, Private Advisers will, in the future, be faced with a decisions as to whether operations inside of California will be profitable.

This choice places into sharp focus the damage done to NSMIA by the Proposed Rule. Far from creating a level playing field of state regulation, allowing the truly national firm to expand its operations to include every state without regulatory costs, the Proposed Rule creates a set of "California-only" regulations that serve to frustrate the creation of a national market. Expansion into California is stymied.

(b) California Based Advisers May Relocate to Other States

A second, and related point, no doubt made by many other commenters, is that the Proposed Rules may cause newly-regulated advisers to flee California.

A fact of global markets is that capital is highly mobile. It is also true that the means of managing capital are equally mobile. Private Advisers can conduct their operations from anywhere on the globe, and correspondingly seek favorable business environments. They are uniquely attuned to costs—it is their business to analyze and understand return on capital. I have noticed that a sophisticated understanding of regulatory arbitrage appears to be a constituent characteristic of all of the Firm's Private Adviser clients.

Finally, with respect to the Commissioner's reasoning in the Proposed Rules regarding the growth of hedge fund activity within the state, we note an obvious collision between the Commissioner and Congress. The Commissioner should not depend upon the growth in hedge fund activity (as disclosed in the SEC's 2003 *Hedge Fund Report*) as a basis for the Proposed Rule when Congress has cited the growth of hedge funds as one of the reasons *animating* the preemption of state law contained in NSMIA. Among the many goals of Congress within the new legislation, one was to spur investment by sophisticated investors by creating a new exemption for the investment in hedge funds by qualified purchasers. In discussing that goal, the House stated that:

> The Committee recognizes the important role that these pools can play in facilitating capital formation for U.S. companies. The Committee expects that the legislation will significantly reduce regulatory restrictions that have affected these pools, and will remove incentives that have caused some Americans to invest in unregulated offshore markets.[16]

Here, through the Proposed Rule, the Commissioner attempts to duplicate the regulatory mistakes made by Congress that were finally ameliorated by NSMIA. Instead of driving this activity offshore, the Commissioner proposes to send it to other states by creating costs for Private Advisers in California through state regulation.

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[16] House Report at 18.

3. Conclusion.

For the reasons stated above, we recommend to the Commissioner that the Proposed Rule not be adopted.

Sincerely,

Howard Rice Nemerovski Canady
Falk & Rabkin
A Professional Corporation

Kenneth Berland