STATE OF MINNESOTA

DEPARTMENT OF COMMERCE

In the Matter of the Proposed Securities rule amendments for the purpose of computing sales made under certain exemptions, regulating financial institution securities practices, modifying registration requirements, and providing for modified annual reporting for industrial revenue bonds.

STATEMENT OF AUTHORITY

Minn. Stat. Sec. 80A.25, subd. 1 gives the Commissioner of Commerce ("Commissioner") authority to "from time to time make, amend, and rescind such rules, forms and orders as are necessary to carry out the provisions of Sections 80A.01 to 80A.31...."

Additional rulemaking authority pertaining to the proposed amendments is found at Minn. Stat. Sec. 80A.05 (rules concerning broker-dealer licensing), 80A.12, Subd. 5 (rules pertaining to registration), 80A.14, subd. 4 (rules defining broker-dealers), and 80A.15 (rules modifying certain exemptions).

The Commissioner finds the proposed amendments necessary and appropriate in the public interest for the protection of investors and consistent with the purposes fairly intended by the policy and

provisions of Sections 80A.01 to 80A.31. The Commissioner further finds that the proposed amendments will have the effect of establishing less stringent compliance and reporting requirements for certain small businesses, consolidate and simplify compliance and reporting requirements for small businesses, and will have a favorable regulatory impact on small business in accordance with Minn. Stat. Sec. 14.115.

The Commissioner further finds that the proposed amendments are consistent with the statutory policy of Minn. Stat. Sec. 80A.31, which calls for the coordination of interpretations of Minn. Stat. Ch. 80A. with laws of other states and related federal regulation.

History

On March 19, 1984, the Commissioner published notice of intent to solicit outside information at 8 S.R. 2120 for his consideration in the promulgation of rules and amendments under Minnesota Statutes Chapter 80A. After a review of comments solicitated, the Commissioner published the proposed rules in the State Register on _____

Facts Establishing Reasonableness

Minnesota Rules, Part 2875.0150

Minnesota Rules, Part 2875.0150, Subpart 2, governs the method of computation of sales for purposes of determining the number of sales under the "isolated sales" exemption set forth in Minn. Stat. Sec. 80A.15, subd. 2(a). The purpose of the proposed amendment to Part 2875.0150 is to bring it into comformity with the counting provisions contained in federal rule 501 of Regulation D. The Commissioner believes that the present federal method of computation is consistent with the purposes intended by chapter 80A in the regulation of securities. Also, adoption of the proposed rule will remove inconsistencies between state and federal law.

Federal Rule 501 lowered the requisite beneficial interest a purchaser and related persons must have in a trust, estate, corporation or organization in order for that trust, estate, corporation or organization to be excluded from being counted as a purchaser. A trust, estate, corporation or organization is thus now exempt under federal rule 501 (e) (ii) from being counted as a purchaser if a purchaser and persons related to him collectively have more than a 50 percent beneficial interest in that trust, estate, corporation or organization. The proposed amendment to the Minnesota rule would therefore conform to federal Regulation D.

In addition, for the purpose of determining the requisite beneficial interest, Rule 501 was changed to allow aggregation of the purchaser's beneficial interest with that of persons related to him. Therefore, under federal law the beneficial interest

threshold is based on the collective beneficial interest of the purchaser and related persons. The proposed amendments are also designed to coordinate with this aspect of Regulation D.

Additionally, under the proposed amendments, sales to accredited investors are excluded from the computation of sales. Again, this is in conformity with Federal Rule 501. See rule 501 (e)(iv).

Minnesota Rules, Part 2875.0180

Consistent with the discussion pertaining to Part 2875.0150, the proposed amendment to Part 2875.0180, Subpart 1, is necessary to coordinate with the provisions of the federal law.

Minnesota Rules Part 2875.0185

Minnesota Rules Part 2875.0185 is being proposed to addresses the question of the length of time that a statement of issuer is effective for an offering exempt under Minn. Stat. Sec. 80A.15, Subd. 2(h). Presently, neither the statute nor the rules prescribe when a statement of issuer must be refiled to continue an offering. Accordingly, an offering could conceivably continue indefinitely so long as sales have not been made to twenty-five persons. As a result, investors may be basing their investment decisions on outdated information.

The proposed rule makes the statement of issuer effective for a period of twelve months from its effective date. The issuer would thus be required to file a new statement of issuer if sales of the same issue are to be made after the twelve month effective period.

Minnesota Rules Part 2875.1590

Minnesota Rules, Part 2875.1590, Subparts 1 and 2 are added in response to 1984 amendments to Minn. Stat. Sec. 80A.14, subd. 4 which gave the Commissioner rule-making authority to determine when banks, savings institutions, or savings and loan associations could act for the account of others without being licensed as a broker-dealer. The statute was modified because securities activities and related promotional practices of banks, savings institutions, and savings and loan associations have recently changed significantly from the accommodation functions contemplated by the drafters of the Uniform Securities Act, which contained an exclusion for such financial institutions from the definition of broker-dealer. See J. Long, 1985 Blue Sky Handbook, § 6.03 [3][C] (1984).

Today as a result of recent federal interpretations, "discount brokerage" is often aggressively pursued and promoted by financial institutions. In exchange for promotions in order-handling services, these institutions may receive a portion of the customer's commissions paid to the entity that executes the securities transactions. This changes the nature of brokerage services offered by banks. Rather than merely providing

accommodation services to existing customers, services may now be provided that are functionally indistinguishable from those offered by licensed securities broker-dealers.

In view of the mass-marketing of discount brokerage services through banks which is now occurring and the aforementioned 1984 legislation, the Commissioner is proposing Part 2875.1590. The overriding purpose of 2875.1590 is to indicate the circumstances under which the financial institutions would require securities licensure in the context of marketing discount brokerage services to their customers.

Consistent with the functional regulation concept of Minn. Stat. Chapter 80A, the general approach taken by the rule is to state the conditions for activities which would not require licensure. Accordingly, if the financial institution does not hold itself out to the public as a securities broker through advertising or mass solicitation, and does not contract with licensed broker-dealers to mass market their services without some degree of regulatory accountability; it will not require a broker-dealer license. The proposed rule at Subpart 1(c) makes it clear that investment advice and underwriting are not permitted.

The provisions of proposed Part 2875.1590 are aimed at restricting mass-marketing to the general public without licensure. A concomitant goal, which is set forth at Subpart 1 is to establish a degree of regulatory accountability in those

instances where the financial institutions are marketing the services for licensed broker-dealers by requiring training, supervision, and responsibility by the broker-dealer. There is also a provision for access to records at Subpart 2(C) which would enable the Commissioner to follow-up on complaints about these services without resistance under the bank secrecy laws. It is believed that these requirements will not be burdensome and will address major investor-protection concerns without unnecessary red tape.

Subpart 1(D) is added to clarify that the rules are not intended to confer additional powers on the designated financial institutions.

Minnesota Rules, Part 2875.159Ø at Subpart 2 goes on to state the nature of information and undertakings which must be provided to the Commissioner if the typical program of offering access to the services of a licensed discount broker through financial institutions is undertaken. Among the items of information required would be a description of training programs for bank employees, a written description of the allocation of securities transactions functions between the broker-dealer and the bank, a written commitment from the bank providing the Commissioner access to records of securities transactions in its possession, identification of bank employees who would be involved in marketing securities, and a securities application for persons designated as agents of the licensed broker-dealer. This

information assists in establishing compliance with Minnesota law and would provide useful information for enforcement purposes in the event of future complaints.

In summary, the object of Minnesota Rules Part, 2875.1590 is to establish boundaries for bank activity without broker-dealer licensure, provide fundamental investor protection, and establish where possible a level playing field among those who market financial services.

Minnesota Rule Part 2875.2410

Rule 2875.2410 allows the commissioner, as a condition of registration, to reqiure the escrow of cheap stock shares owned by officers, directors, or persons owning more than ten percent of the outstanding stock of the issuer. The purpose of the rule is to ensure that promoters of the issuer are bound to the company and do not "bail out" to the detriment of public shareholders.

A maximum three year escrow period is proposed as being a reasonable length of time in which to retain the promoters' interest in the issuer. The amendment to Part 2875.2410 therefore removes some of the uncertainty which currently exists as to the time period for escrow.

Minnesota Rules, Parts 2875.2490 and 2875.2500

The proposed rule amendments at 2875.2490 and 2875.2500 are intended to facilitate secondary trading for industrial revenue bonds by providing for financial information in annual report filings about the actual obligor on the bonds rather than the technical issuer, which is often a municipality. Essentially the rule changes provide that information concerning the borrower (which is the source of the investor's return) would be submitted in the annual report filings and that such information would be in accordance with generally accepted accounting principles, however not necessarily audited.

It has been estimated that as many as one-third of small business borrowers are closely-held corporations and therefore do not routinely obtain financial audits. It would impose unnecessarily burdensome expense for such companies to obtain financial audits unless required by the Commissioner in approporiate cases simply for the purpose of filing an annual report. The rules currently require annual reporting by the issuer, which is often a municipality, and therefore the current rules are technically addressed to informing investors and others about the financial condition of the source of return. Both of these problems are dealt with by the proposed rules.

Minnesota Rules, Part 2875.3000

Minnesota Rules Part 2875.3000 requires that a minimal investment have been made in an issuer prior to securities registration. The rule defines what then constitutes the equity investment of the issuer.

Currently, intangible assets, such as patents and trademarks, can be applied to the equity investment of the issuer if they have been evaluated by a qualified independent appraiser. The amendment to Part 2875.3000, Subp. 2, A., allows the evaluation of intangible assets by any reasonable demonstration of value. The allowance for more than a single type of evaluation is being proposed because an evaluation by an independent appraiser can be extremely costly, and many first time issuers cannot afford that expense. The commissioner believes that a reasonable demonstration of value provides issuers with alternatives as to determining the value of intangible assets while maintaining the integrity and purpose of the rule.

For the same reasons just described, 2875.3000, Subp. 2, B., is being amended to reflect the acceptablity of an evaluation of intangible assets through a reasonable demonstration of value.

Minnesota Rules, Parts 2875.3920 and 2875.3920

Finally, the repeal of Minnesota Rules, Parts 2875.3920 and 2875.3930 is being proposed. The primary reason for the proposed repeal is to enhance uniformity between state and federal regulation in accordance with Minn. Stat. Section 80A.31.

Part 2875.3920 places certain limitations and prohibitions on the investments of investment companies. Many of these restrictions duplicate or conflict with provisions of the Investment Company Act of 1940 and the interpretations of the Securities and Exchange Commission. As the federal government imposes restrictions on the investments of investment companies and as conflicting requirements between state and federal regulatory agencies create confusion and inconsistency, the repeal of Part 2875.3920 is necessary.

Part 2875.3930 specifies speculative activities which must be disclosed in boldface type on the cover or following two pages of an investment company's prospectus. Due to the belief that under prior disclosure requirements prospectuses were too lengthy and complex, the Securities and Exchange Commission recently adopted new guidelines to be followed by an investment company when preparing a prospectus. A prospectus prepared according to the new guidelines will be shorter and more likely to be read by investors in its entirety. Thus, the need for highlights in the front of the prospectus is no longer necessary.

In order to allow a standard, uniform prospectus to be filed in Minnesota, the department is proposing that 2875.3930 be repealed. A reduction in unnecessary expenses to investment companies should result, without any reduction in investor protection.

SMALL BUSINESS CONSIDERATIONS

Minnesota Statutes § 14.115 requires that the impact of proposed rules on small businesses be considered in the development of those rules. Specifically, the statute, at subdivision 2, requires that less stringent compliance standards and reporting requirements for small businesses be considered. The statute also requires that methods designed to reduce the impact of the rules on small businesses be incorporated into the rules if they are feasible and consistent with the statutory objectives associated with the rules.

Despite the lack of comments resulting from the department's Notice to Solicit Outside Opinion, the Commissioner considered whether the provisions of the rule might be modified to accomodate the interests of small businesses. Consideration was given to possible ways in which the requirements might be relaxed for small businesses or amended to reduce any burden on small businesses.

The rules were amended and modified in various ways to reduce the burden on small businesses and in many cases on all businesses. The impact of the changes are described in the sections describing each part.

Each of the methods described at Minnesota Statutes § 14.115, subdivision 2 (a) - (3) was considered in proposing the rule. The provisions contained in the proposed rule are believed to be necessary to achieve the legislative purposes.