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STATE OF MINNESOTA
DEPARTMENT OF COMMERCE

IN THE MATTER OF THE PROPOSED AMENDMENTS OF SECURITIES RULES REGULATING INVESTMENT ADVISERS COMPENSATION)	STATEMENT OF NEED AND REASONABLENESS

STATEMENT OF AUTHORITY

Minnesota Statutes section 80A.06, subdivision 5 contains provisions relating to investment advisers' compensation. This section was amended by Laws of Minnesota 1987, chapter 336 and provides, in part:

> All charges made by an investment adviser for services and all charges by a licensed broker-dealer for services rendered as a broker-dealer or for advice with respect to securities shall be reasonable, and except in compliance with rules adopted by the commissioner, no charges shall be based upon or measured by profits accrued or to accrue from transactions recommended or carried out by an investment adviser, or licensed broker-dealer.

Additional rulemaking authority pertaining to the proposed amendments is found at Minnesota Statutes section 80A.25, subd. 1 and Minnesota Statutes section 45.023.

The Commissioner finds the proposed amendments necessary and appropriate in the public interest or for the protection

of investors and consistent with the purposes fairly intended by the policy and provisions of Minnesota Statutes sections 80A.01 to 80A.31.

The Commissioner further finds that the proposed amendments are consistent with the statutory policy of Minnesota Statutes section 80A.31, which calls for the coordination of interpretations of Minnesota Statutes chapter 80A with the related federal regulation.

FACTS ESTABLISHING NEED AND REASONABLENESS

The amendments to Minnesota Rules, part 2875.1010 are proposed in response to a 1987 amendment to Minnesota Statutes, section 80A.06, subdivision 5 which expressly grants the Commissioner rule-making authority to determine when charges by an investment adviser or licensed broker-dealer may be based upon or measured by profits accrued or to accrue from transactions recommended or carried out by an investment adviser or licensed broker-dealer.

The statute was modified to permit the Commissioner to adopt rules consistent with those previously adopted by the Securities and Exchange Commission (SEC) which permit investment advisers to receive performance-based compensation in certain limited situations.

As recognized by the SEC in the attached Investment Advisers Act Release No. 996, there are limited instances where performance-based compensation may not be inappropriate, specifically where

the person to whom the investment adviser is offering services is sophisticated and financially able to bear the risks associated with performance fees. These sophisticated persons are financially experienced and should be given the opportunity to negotiate compensation arrangements with an investment adviser. While permitting fee arrangements to be negotiated, the proposed amendments contain various protections and disclosure requirements to ensure that investor protection is not sacrificed.

Part 2875.1010, subpart 1a

Part 2875.1010, subpart 1a contains an exception from the general prohibition contained in subpart 1 and permits an investment adviser to enter into an advisory contract which provides for a performance fee provided that all the conditions contained in items A through D are satisfied.

Item A sets forth the financial criteria which a person must satisfy in order to enter into a performance fee contract with an investment adviser. The SEC found, (see Investment Advisers Act Release No. 961) and the Commissioner concurs, that an objective financial means test is necessary to ensure that persons entering into performance fee contracts are financially able to bear the risks associated with those contracts.

Item A contains alternate tests, one of which a person must

satisfy in order to enter into a performance fee contract. Under item A(1), an individual or company must have $500,000 under the adviser's management. Under item A(2), an individual or company must have a net worth of $1,000,000 at the time the contract is entered.

The SEC findings in which the Commissioner concurs note that the above financial tests should adequately ensure that clients who enter into performance fee contracts are limited to those persons who are capable of bearing the risks associated with the contracts.

Item B requires that the compensation paid to an adviser under the exception contained in this subpart be based on a specified formula. Item B(1) pertains to securities for which market quotations are readily available and requires that the compensation formula include the realized capital losses and unrealized capital depreciation of such securities over the period. Item B(2) provides, with respect to securities for which market quotations are not readily available, that the formula include the realized capital losses of the securities over the period and, if the unrealized capital appreciation of the securities over the period is included, the unrealized capital depreciation of the securities over the period must be included.

The SEC believed and the Commissioner agrees that, with respect to securities for which market quotations are readily

available, the formula must include realized losses and unrealized depreciation. This formula will disspel the incentive that an adviser may have under a formula which took into account only realized losses and gains to sell assets in order to realize gain, and thus increase his or her compensation, even though the asset sale may not be in the best interest of the client.

More flexibility regarding the formula pertaining to securities for which market quotations are not readily available is provided by the SEC rules, and the Commissioner believes that this added flexibility is warranted. With respect to securities for which market quotations are not readily available, unrealized depreciation need be included in the calculation only if unrealized appreciation is included. This flexibility seems appropriate because the calculation of unrealized appreciation and depreciation of securities for which market quotations are not readily available may require the use of costly valuation procedures.

Item B(3) of subpart 1a requires that compensation paid to an adviser be based on the gains less the losses (computed in accordance with items B(1) and (2)) in the client's account for a period of not less than one year. The SEC believed and the Commissioner agrees that a one year period is sufficently long to preclude an adviser from basing an incentive fee on short term fluctuations in securities prices.

Item C requires that, prior to entering into an investment advisory contract under subpart 1a, an investment adviser disclose to the client or the client's independent agent, all material information concerning the proposed advisory arrangement include the following: (1) that the fee arrangement may create an incentive for the investment adviser to make investments that are riskier or more speculative than would be the case in the absence of a performance fee; (2) where relevant, that the investment adviser may receive increased compensation with regard to unrealized appreciation as well as realized gains in the client's account; (3) the periods which will be used to measure investment performance throughout the contract and their significance in the computation of the fee; (4) the nature of any index that will be used as a comparative measure of investment performance, the significance of the index, and the reason the investment adviser believes the index is appropriate; and (5) where an investment adviser's compensation is based in part on the unrealized appreciation of securities for which market quotations are not readily available, how the securities will be valued and the extent to which the valuation will be independently determined.

The above disclosures will provide prospective clients with the information necessary to make an informed decision prior to entering into a performance fee contract with an investment adviser. The bases for the fee and the risks associated with performance fees are required to be disclosed so that the prospective client is made aware of the material facts

pertaining to incentive fees.

Item D of subpart 1a requires that an investment adviser seeking to enter into a performance fee contract under the subpart reasonably believe, immediately prior to entering into the contract, that the contract represents an arm's-length arrangement between the parties, and that the client, alone or together with the client's independent agent, fully understands the risks of the proposed method of compensation.

Item D supplements the disclosure requirements of item C to ensure that the investment adviser satisfies his or her affirmative duty of finding that the client thoroughly appreciates the nature of the performance fee contract. Further, the requirement that the contract be an arm's length contract is intended to ensure that the arrangement between the parties is one whose terms parallel to those which independent parties of equal bargaining position would arrive at after negotiation and without overreaching by either party.

<u>2875.1010, subpart 2.</u>

Subpart 2 defines terms contained in subparts 1 and 2.

Subpart 2, item B provides that the term "affiliate" has the same meaning as in section 2(a)(3) of the Investment Company Act. That section defines "affiliate" as

> (A) any person directly or indirectly owning, controlling, or holding with power to vote,

5 per centum or more of the outstanding voting securities of such other person; (b) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

Because one of the purposes in amending Part 2875.1010 is to enhance uniformity between Minn. Stat. chapter 80A and the rules adopted thereunder and federal regulation, and because the above definition of "affiliate" is reasonable and comprehensive, the Commissioner believes that it is appropriate to adopt the definition of "affiliate" as contained in the Investment Company Act.

Item C defines "client's independent agent" to include any person agreeing to act as the client's agent in connection with the contract but excludes (1) the investment adviser

seeking to rely on the rule, his affiliates, affiliates of his affiliates, and certain interested persons (2) any person who receives directly or indirectly, from the investment adviser or his affiliates any compensation in connection with the contract; and (3) any person with a material relationship between himself or his affiliates and the adviser or its affiliates that then exists, that is mutually understood to be contemplated, or that has existed at any time during the previous two years. The Commissioner, like the SEC, finds this restrictive definition necessary in order to ensure that the "client's independent agent" is, in fact, independent.

Item D provides that the term "company" has the same meaning as in section 202(a)(5) of the Investment Adviser's Act of 1940. That section defines "company" as follows:

> "Company" means a corporation, a partnership, an association, a joint-stock company, a trust, or any organized group of persons whether incorporated or not; or any receiver, trustee in a case under title 11 of the United States Code, or similar official, or any liquidating agent for any of the foregoing in his capacity as such.

The definition contained in item D excludes a company that is required to be registered under the Investment Company Act of 1940 but is not so registered. This exclusion is

intended to ensure that the safe harbor provided in subpart 1a is not extended to companies currently in violation of the registration laws administered by the SEC.

Further, the term "Company" as used in subpart 1a, item A does not include (1) a private investment company, (2) an investment company registered under the Investment Company Act of 1940, or (3) a business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940, unless each of the equity owners is a natural person or company meeting the eligibility requirements contained in Subpart 1a, item A. The purpose of this exclusion is to ensure that, with regard to the above companies, which oftentimes utilize the services of an investment adviser, the purpose of the rule is not circumvented by the creation of a company whose shareholders do not meet the eligibility standards contained in subpart 1a, item A.

Item E defines "interested person" as (1) a member of the immediate family of an individual who is an affiliated person of the investment adviser, (2) a person has any direct or indirect beneficial interest or legal interest if the beneficial or legal interest of the person in any security issued by the investment adviser or by a controlling person of the investment adviser exceeds 1/10 of 1% of any class of outstanding securities of the adviser or exceeds 5% of the total assets of the person seeking to act as the client's independent agent; or (3) any person, partner or employee of any person

who as acted as legal counsel for the investment adviser within the past two years.

This definition, in concert with that of "client's independent agent" is intended to remove potential conflicts of interest and ensure the independence of the person acting on behalf of a client.

Item G provides that the term "private investment company" means a company which would be defined as an investment company under section 3(a) of the Investment Company Act of 1940 but for the exception provided from that definition by section 3(c)(1) of the Act.

Section 3(a) of the Investment Company Act provides, in part:

> "Investment Company" means any issuer which -- (1) is or holds itself out as being engaged primarily, in the business of investing, reinvesting or trading in securities; (2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities

having a value exceeding 40 per centum of
the value of such issuer's total assets (exclusive
of Government securities and cash items) on
an unconsolidated basis.

Section 3(c)(1) of the Investment Company Act provides an execption from the definition of "investment company" for: "[a]ny issuer whose outstanding securities (other than short-term paper) are benefically owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities".

The Commissioner finds that the adoption of the federal definitions is consistent with the statutory policy to coordinate interpretations of Minnesota chapter 80A with the related federal regulations. Further, the regulation of investment companies is conducted primarily at the federal level, and therefore adoption of the federal definition of "investment company" and the exclusions therefrom appears appropriate.

Item H provides that the term "securities for which market quotations are readily available" has the same meaning as in Rule 2a-4(a)(i) under the Investment Company Act of 1940. That rule provides, in part: "Portfolio securities with respect to which market quotations are readily available shall be valued at current market value..."

Item I provides that "securities for which market quotations

are not readily available" means those securities not described in item H.

The terms contained in items H and I are terms of art in the securities area, and the Commissioner believes that it is appropriate to encompass the interpretations of those terms as they have developed over the years by incorporating the federal definitions.

Small Business Considerations

Minnesota Statutes Section 14.115 requires that the impact of proposed rules on small business be considered in the rulemaking process.

Subdivision 2 of that section specifies a number of methods for reducing the impact of the rules. The department has considered these methods in the preparation of the rules.

Clause (a) of subdivision 2 requires the consideration of less stringent compliance or reporting requirements for small businesses. The purpose of the proposed amendments to Part 2875.1010 is to permit investment advisers to receive performance fees in limited situations where the potential for abuse is nominal. Further, the proposed amendments provide an exception from the absolute prohibition against performance fees currently in effect. Therefore, the only compliance requirements are those which must be satisfied

in order to qualify for the exception from the general prohibition with respect to performance fee contracts. As previously indicated, the amendments were proposed in an effort to make Minnesota rules consistent with SEC rules while maintaining an adequate level of investor protection. If the standards were relaxed further with regard to small businesses, Minnesota rules would be inconsistent with federal regulation and investor protection would be weakened to an unacceptable level.

Clause (b) requires the consideration of the establishment of less stringent schedules or deadlines for compliance or reporting requirements for small businesses. As noted previously, the proposed amendments contain no reporting requirements and the only compliance requirements are those which must be met by an investment adviser to qualify for the exception from the present absolute prohibition against performance fee contracts. Therefore, an investment adviser need not ever comply with the proposed rules provided that it does not receive performance-based compensation.

Clause (c) of subdivision 2 requires the consideration of the consolidation or simplification of compliance or reporting requirements for small businesses. As previously noted, the proposed amendments contain no reporting requirements. Simplification of the compliance requirements is not acceptable as the requirements contained in the proposed amendments are consisted with federal regulation and any change made

would result in the lack of uniformity. Further, the compliance requirements imposed on a small investment advisers are not onerous, and generally simply require that the adviser fairly calculate the basis of its fees, disclose material information to his or her client in such a fashion that the client understands the information, ensure that the client meets the eligibility requirements, and negotiate the contract in an arms-length manner. These requirements are necessary to ensure that investor protection is not weakened to an unacceptable level, and any simplification of the compliance requirements could so result, contrary to statutory objectives.

Clause (d) is not applicable to this rule as performance, design or operational standards are not involved.

Exemption of small businesses under clause (e) is not feasible and would be contrary to statutory objectives for the reasons discussed with regard to clauses (a) and (c).

Despite the foregoing, the Department did consider small businesses as it developed the amendments. The amendments are intended to impose as light a regulatory burden as possible while still protecting the consumer to ensure that the activities regulated by the amendments could be undertaken by small as well as large organizations.