

STATE OF MINNESOTA
DEPARTMENT OF COMMERCE

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| IN THE MATTER OF THE PROPOSED) | <u>STATEMENT OF</u> |
| RULES REGARDING BONDS ISSUED) | <u>NEED AND</u> |
| BY GOVERNMENTAL ENTITIES) | <u>REASONABLENESS</u> |

STATEMENT OF AUTHORITY

Minnesota Statutes, section 80A.25, subd. 1 provides, in part :

The commissioner may from time to time make, amend, and rescind such rules... as are necessary to carry out the provisions of sections 80A.01 to 80A.31, including but not limited to rules and forms governing the conduct of business by broker-dealers, agents and investment advisers, registration statements, applications, and reports, and defining any terms... insofar as the definitions are not inconsistent with the provisions of sections 80A.01 to 80A.31.

Additional rulemaking authority pertaining to the proposed rules and amendments is found in Minnesota Statutes, section 45.023.

The Commissioner finds the proposed rules and 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, section 80A.01 to 80A.31.

FACTS ESTABLISHING NEED AND REASONABLENESS

Background

Minnesota Rules, part 2875.0115 is being proposed to define the term "guaranteed" as that term is contained in Minnesota Statutes, section 80A.15, subdivision 1, clause (a). That section provides an exemption from the securities registration and reporting requirements contained in chapter 80A for the following:

Any security, including a revenue obligation, guaranteed by the United States, any state, any political subdivision of a state or any corporate or other instrumentality of one or more of the foregoing; but this exemption shall not include any industrial revenue bond.

Prior to 1987 legislative changes, securities issued or guaranteed by one of the above governmental entities qualified for the exemption. In 1987, however, the statute was amended to provide that only securities "guaranteed" by one of the specified governmental entities qualify for

the exemption. Much confusion has subsequently arisen with respect to the definition of "guaranteed" for purposes of this section. Proposed Part 2875.0115 defines the term "guaranteed" to remove existing confusion.

Part 2875.3535 and amendments to Parts 2875.3500 and 2875.3530 are being proposed to provide necessary standards of review to be used in evaluating applications for registration of securities issued by governmental entities. The need for the rules and amendments arose out of changes made during the 1987 legislative session to Minnesota Statutes, section 80A.15, subdivision 1(a) and Minnesota Statutes, section 80A.09, subdivision 1(a).

As noted above, previously, under Minnesota Statutes, section 80A.15, subdivision 1(a), securities issued or guaranteed by specified governmental entities were exempt from the registration and reporting requirements of chapter 80A. Changes made during the 1987 legislative session modified that section to provide that the exemption applied only to securities guaranteed by a governmental entity. Accordingly, securities merely issued but not guaranteed by a governmental entity must be registered under Minnesota Statutes, section 80A.11, thus creating a need for standards to be applied in reviewing applications for registration

of such securities.

Minnesota Statutes, section 80A.09 was also amended during the 1987 legislative session. Prior to the amendment, that section permitted industrial revenue bonds issued by the State of Minnesota, or any of its political subdivisions, municipalities, governmental agencies or instrumentalities to be registered simply by filing a notice with the Department of Commerce. Section 80A.09, subdivision 1(a) was deleted during the legislative session, thus subjecting all applications for registration of industrial revenue bonds to merit review. As existing rules do not address municipal securities, new rules and amendments are necessary.

Finally, it must be noted that the Department is receiving an increasing number of complaints with regard to government bonds, particularly with respect to defaults under those obligations. Therefore, the proposed rules providing merit standards for review of applications for registration of government bonds are intended to provide additional protection to purchasers of such bonds.

Part 2875.0115

Part 2875.0115 defines the term "guaranteed" for purposes

of Minnesota Statutes, section 80A.15, subdivision 1, clause (a), with respect to a security guaranteed by the United States, any state, any political subdivision of a state, or any corporate or other instrumentality of one or more of the foregoing.

In defining the term "guaranteed", the Department worked with representatives of the public finance industry in Minnesota. The goal of the Department was to define the term in a manner as to ensure that the governmental entity issuing and guaranteeing the security backs the security with its full faith and credit or has adequate funds available or the authority to provide for adequate funds to pay the principal and interest on the bonds. A related consideration was ensuring that the purpose of the debt issuance is a public purpose, recognizing the importance of utilization of the exemption by small municipalities to finance public, not-for-profit projects.

With these considerations in mind, the Department is proposing that the term "guaranteed", with regard to securities issued by governmental entities, include a debt obligation which:

A. is a general obligation of the issuer, to which the

issuer has pledged to its full faith and credit (whether or not the issuer has general taxing powers); or

- B. the issuer is obligated to repay out of, and only out of, public funds, which funds are specifically allocated and sufficient to make all principal and interest payments on the obligation.

Public funds are defined in subpart 2 to include funds derived from taxation; special assessments; revenues or other service charges derived by the issuer from a public facility or enterprise owned and operated by or on behalf of and under control of the issuer; government grants or loans received by the issuer; if acceptable to the commissioner, the proceeds of any bond insurance, letter of credit, or other credit enhancement device obtained with respect to the security; or any other money subject to the control of and appropriation by the governing body of the issuer.

General obligations of a governmental entity are included in the definition of "guaranteed" securities because such obligations must be pledged by the full faith and credit of the governmental entity. And, even though the issuer need not have general taxing powers, it is certainly "backing" the obligation to ensure the payment of the debt.

Such backing may take the form of a special tax levy or the application of other funds subject to the control of and by appropriation by the governmental entity.

Obligations which are not general obligations will be deemed to be guaranteed if the governmental entity is obligated to repay the debt out of, and only out of, public funds. The term "public funds" is broadly defined to include funds available to a governmental entity from a variety of sources. Accordingly, if the funds available to the issuer or funds which will be available to the issuer in the future are allocated to pay the principal and interest on the obligation, the obligation will be deemed to be "guaranteed" by the governmental entity.

The only specified exclusion from the definition "public funds" is money received by the issuer from any person other than in the person's capacity as a member of the general public (other than funds identified in Subpart 2, items A(4) or (5)). This exclusion ensures that the governmental entity "guaranteeing" the obligation is not serving merely as a conduit for repayment of funds with the ultimate source of funds for repayment being an unrelated private entity with little or no connection with a public purpose project. The Department has noted many default

problems with such conduit financing. The merit rules which follow are specifically intended to apply to such conduit financing arrangements.

Part 2875.0116

This part provides an exemption from securities registration and reporting requirements for nonissuer transactions involving securities which were exempt under the provisions of Minn. Stat. § 80A.15, subdivision 1(a) prior to July 1, 1987 amendments.

Those former provisions exempted securities, other than industrial revenue bonds, which were issued or guaranteed by certain governmental entities. Many members of the public are presently holding securities which were exempt from registration at the time of purchase as securities issued by a governmental entity. Amendments to the statute which became effective July 1, 1987, limit the exemption to only securities guaranteed by governmental securities. Accordingly such securities held by the public are no longer exempt from registration and cannot be resold without registration or application of separate exemption.

The rule addresses this situation by providing that the

securities retain their exempt status for purposes of non-issuer transactions, provided that the securities are not sold in a public distribution. Thus, the rule facilitates limited purchases and sales of the securities without requiring holders of small amounts to register the securities. If the securities are to be sold in a public distribution, however, the securities would no longer be deemed to be exempt. This exception addresses the remarketing of an entire or significant portion of a bond issue. In such a case, public investors purchasing the bonds deserve the same protections afforded initial purchases of bonds under the amendments to the statute. Such protections are afforded by applying the following merit standards to new issuances of bonds and to public distributions, i.e. remarketings, of previously exempt securities.

Part 2875.3500

Subpart 2. Amendments to subpart 2 establish standards of review to be applied in reviewing applications for registration of bonds or similar interest-bearing securities issued by the United States, any state, any political subdivision of any state or any corporate or other instrumentality of one of those entities. Existing registration rules do not address the offering of securities by these

entities.

The first amendment to subpart 2 amends the current rule to clarify that it does not apply to bonds or similar interest-bearing securities issued by the United States, any state, any political subdivision, or any corporate or other instrumentality of one or more of those entities. While it is apparent from the substance of the rule that it was not intended to apply to securities issued by governmental entities, the clarifying language has been added to remove any confusion. Language has also been added to clarify that the cash flow of an issuer must be sufficient to cover deferred interest on a debt obligation. This is necessary because the cash flow requirements are used to determine the issuer's financial ability to repay the debt. The deferral of interest payments does not mean that the interest need not be covered by the issuer's cash flow because, as is obvious, the interest will have to be paid at some point.

Items B and C of subpart 2 provide specific standards to be applied in reviewing applications for registration of above securities issued by specified governmental entities. The substantive standards apply to all offerings of bonds or similar interest-bearing securities issued by the specified governmental entities except those which are exempt

from registration under Minnesota Statutes, section 80A.15 or those which are rated in one of the top four rating categories by Fitch Investors Service, Inc., Standard & Poor's Corporation or Moody's Investor Services, Inc. Exempt securities are excluded from the standards of review because there are typically no filing requirements or minimal requirements with respect to those securities and because the securities are of a nature that the legislature determined that registration and review by the Department is unnecessary or should be minimal. Securities rated in one of the top four rating categories by Fitch Investors Service, Inc., Standard & Poor's Corporation or Moody's Investor Services, Inc. are excluded from application of the proposed rules because those securities are "investment grade" and have been reviewed by an independent rating service which has determined that the likelihood of repayment of the obligation is high.

The proposed merit standards require that the cash flow of the person borrowing the offering proceeds from the governmental entity, the person obligated to make payment of principal and interest on the securities or the person making payments under a lease, sale or loan arrangement, for its last fiscal year prior to the proposed public offering or the average of its last three fiscal years prior

to the public offering, must be sufficient to cover the interest on the securities proposed to be offered to the public. Cash flow must be computed in accordance with generally accepted accounting principles and must exclude extraordinary income.

The same standard is currently applied with respect to debt offerings by commercial entities. The standard provides an indication of whether the person ultimately responsible to repay the debt has the financial ability to do so. A person's most recent fiscal year is perhaps the best indicator of that person's ability to honor future financial obligations. The rules provide an alternative test, i.e. average cash flow of the past three fiscal years, to address persons who may have had a financially difficult prior year, but whose financial performance averaged over the past three years has been strong.

The rules provide that if payment of interest and repayment of principal is unconditionally guaranteed, then the cash flow of the guarantor will be used in determining compliance with the cash flow requirements. Again, because the rules focus on the financial strength of the person ultimately responsible for repayment of the debt, it is appropriate that a guarantor may satisfy the cash flow requirements.

An alternative test is proposed with respect to the offering of bonds or similar interest-bearing securities issued by the State of Minnesota, its political subdivisions, governmental agencies or corporate or other instrumentalities, as those bonds are also filed or reviewed by the Minnesota Department of Energy and Economic Development or other state agency. With regard to the offering of securities by those entities, the application for registration must be accompanied by a financial forecast, examined by an independent certified public accountant in accordance with the Guide for Prospective Financial Statements as promulgated by the American Institute of Certified Public Accountants. The financial forecast must attest to the ability of the user, borrower, or other obligor to generate sufficient cash flow, computed in accordance with generally accepted accounting principles, to cover interest on securities proposed to be offered to the public.

This test permits local start-up ventures which are borrowing bond proceeds to obtain funds from a public offering even though the venture has no financial history from which to determine the adequacy of the venture's cash flow. To ensure that the financial forecast used in determining the adequacy of cash flow has been independently evaluated,

the forecast must be examined by an independent certified public accountant who must express an opinion on the financial statements. The Guide for Prospective Financial Statements is a comprehensive guide including, among other things, the procedure to be followed by certified public accountants when examining financial forecasts. The guide was prepared by the American Institute of Certified Public Accountants, a self-regulatory organization composed of certified public accountants. Through the submission of an independently evaluated financial forecast examined in accordance with the above, and provided that the forecast attests to the adequacy of the cash flow of the borrower to pay interest on the debt, offerings of which the proceeds are loaned to Minnesota ventures with no financial history will be permitted to go forward.

The proposed rules specify, however, that a financial forecast will not be accepted as evidence of satisfaction of cash flow requirements if the user or borrower of the offering proceeds or other obligor has had a material default during the past three years in payment of rentals under a lease or of principal, interest, dividend or sinking fund installments on preferred stock or indebtedness. This exception to the general acceptance of a financial forecast is necessary because an entity with a recent history

of defaulting on financial obligations is more likely to be unable to honor future obligations. Also, this restriction should guard against a Ponzi-type financing where proceeds of a new bond issue are used to repay bondholders from a previous issue and a third issue is offered to repay bondholders from the second issue, and so forth.

Subpart 4. Subpart 4 currently provides that the requirements of Part 2875.3500 do not apply to the offer or sale of securities of a nonprofit or community development issuer. The Department is proposing to delete subpart 4 with respect to the offer or sale of securities by nonprofit or community development issuers. Repeal is proposed because the issuance of securities by nonprofit entities is generally not subject to merit review as those issuers submit applications for registration under Minn. Stat. § 80A.09, which primarily imposes a notice requirement. Therefore, the language with respect to nonprofit organizations is unnecessary. However, the Department believes that the issuance of debt by community development issuers should be subject to the same standards applied to other governmental entities so that purchasers of bonds of community development corporations are afforded the same protections as purchasers of other debt securities. The same protections should be afforded to purchasers of similar securities, particularly

where a community development issuer is engaged in conduit financing. Accordingly, the Department is proposing repeal of subpart 4.

Part 2875.3530

Part 2875.3530 currently provides, among other things, that the indenture pursuant to which nonconvertible debt securities are proposed to be issued should normally include a sinking fund provision; a negative pledge or equal protection clause restricting the creation of liens on the property of the issuer; in certain instances, an appropriate restriction on the creation of other funded debt; and an appropriate restriction on the payment of dividends upon stock of the issuer.

The first proposed amendment provides issuers with an alternative with respect to the inclusion in the indenture of a sinking fund provision. The alternative specified is that of a serial maturity schedule, which is another means of retiring specified portions of an issue prior to maturity. A serial maturity schedule offers the same protections in ensuring that measures are taken prior to maturity to enable an issuer to repay the principal amount of the obligation while providing greater flexibility to an issuer.

The Department is also proposing that an additional subpart be added to Part 2875.3530. This subpart provides that, with respect to debt securities issued by governmental entities, except those which are exempt from registration under Minnesota Statutes, section 80A.15 or rated in one of the top four rating categories by Fitch Investors Service, Inc., Standard & Poor's Corporation or Moody's Investor Services, Inc., the protective provisions specified in subpart 1 apply to the user or borrower of the offering proceeds or other obligor under the bonds. This amendment affords purchasers of bonds issued by governmental entities the same protections currently afforded purchasers of commercial debt instruments through the establishment of indenture provisions noted above.

Part 2875.3531

Part 2875.3531 requires that with respect to certain offerings of debt instruments by specified governmental entities, the trustee must be granted, for the benefit of the bondholders or security holders, a mortgage and/or security interest of first priority in the facility to be constructed, land to be acquired, and/or other real or personal property to which the offering proceeds will be applied.

A mortgage and/or security must be provided if: (i) the cash flow requirements of Part 2875.3500 are satisfied on the basis of a financial forecast, (ii) funds to make principal or interest payments on the bond or securities arise under a lease arrangement where the lease is subject to termination or non-renewal prior to the maturity of the bonds or securities or (iii) funds to make principal and interest payments are subject to the risk of nonappropriation by a governmental entity.

With respect to the above three situations, purchasers of the bonds or securities bear an increased risk that principal and interest payments on the debt obligation may be impaired. Accordingly, in these cases where such increased risk exists, it is imperative for the trustee to be granted a first lien on the property to which the offering proceeds will be applied. In this manner, the trustee will be able to foreclose on the property should the obligor default in payments under the debt obligation.

Part 2875.3532

This part provides that offering proceeds resulting from the sale of bonds issued by certain governmental entities

may not be loaned to a person on a nonrecourse basis. The prohibition does not apply to exempt securities or those rated in one of the top four rating categories by Fitch Investors Service, Inc., Standard and Poor's Corporation, or Moody's Investor Services, Inc.

Nonrecourse loans are loans which would bar the trustee from taking action against the borrower if, for example, the borrower defaulted on the loan. Such a limitation is clearly not in the best interests of the bondholders as the bondholders are restricted in such cases to recovering their investment from the liquidation of any property securing the loan. The prohibition in the rule will prevent such loans, thus enabling a trustee to attempt to collect monies for bondholders directly from the borrower of the bond proceeds, thereby increasing the protections afforded bondholders.

Part 2875.3533

Proposed Part 2875.3533 establishes suitability standards with respect to purchasers of debt securities issued by specified governmental entities, except those securities exempt from registration under Minnesota Statutes, section 80A.15 or those rated in one of the top four rating cate-

gories by Standard & Poor's Corporation or Moody's Investor Services, Inc.

The standards require that a purchaser of the above securities have a minimum annual gross income of \$30,000 and a net worth of \$30,000, or in the alternative, a net worth of \$75,000. Net worth is determined exclusive of home, home furnishings and automobiles.

Suitability standards are proposed with respect to the purchase of the above securities because of the relative lack of transferability of the securities and because of the significant degree of risk involved in the purchase of the securities due to the frequently uncertain cash flow of the person responsible for the repayment of the obligation. Similar suitability requirements are currently applied with regard to purchasers of limited partnership interests where similar risks are present. Accordingly, the Department is proposing the suitability standards in an effort to ensure that purchasers of debt obligations of governmental entities have a certain degree of financial sophistication so that they are able to understand the financial risks associated with the investment.

Subpart 2 of the proposed rule provides that a purchaser

will be deemed to meet the above suitability standards if the purchaser has certified within the twenty-four month period preceding the purchase that he or she satisfies the standards. This provision is being proposed to make application of the rule by underwriters more workable.

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. Less stringent compliance standards were considered with respect to Minnesota small businesses, which are often the recipients of proceeds from municipal bond offerings. The less stringent compliance standards set forth in Part 2875.3500 permit a Minnesota small business to project cash flow sufficient to pay interest on the debt rather than requiring those businesses to have histor-

ical cash flow. In this manner, start-up ventures will still be able to obtain funds through municipal financing without relaxing investor protection.

Clause (b) requires the consideration of the establishment of less stringent schedules or deadlines for compliance or reporting requirements for small business. Because of the nature of the proposed rules and amendments, no less stringent schedules or deadlines for compliance or reporting requirements for small businesses were established. The proposals pertain to the offering of securities by certain governmental entities and the recipients of the proceeds. There are no reporting requirements. The only compliance requirements pertain to small businesses which, in the future, will receive bond offering proceeds. At the present time, it is unlikely that any of those small businesses have even been identified. Therefore, because the proposals require compliance only by small businesses which will receive benefits from future bond offerings and because there are no schedules or deadlines for compliance, no less stringent schedules or deadlines were established for small businesses.

Clause (c) of subdivision 2 requires the consideration of the consolidation or simplification of compliance or report-

ing requirements for small businesses. Again, no reporting requirements are imposed by the proposed rules and amendments. With respect to compliance with the rules, Part 2875.3500 was simplified with respect to compliance by small businesses in Minnesota. Further simplification of the requirements would likely decrease investor protection to an unacceptable level, 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 (c) is not feasible and would be contrary to statutory objectives of investor protection.

The Department fully considered small businesses as it developed the proposals. The proposed rules and amendments are intended to impose as light a regulatory burden as possible while still protecting investors to ensure that the activities regulated by the proposals could be undertaken by small as well as large organizations.