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STATE OF MINNESOTA

DEPARTMENT OF COMMERCE

IN THE MATTER OF THE PROPOSED AMENDMENTS TO SECURITIES RULES REGULATING THE SECURITIES PRACTICES OF FINANCIAL INSTITUTIONS, INCLUDING BANKS, SAVINGS INSTITUTIONS AND SAVINGS AND LOAN ASSOCIATIONS

STATEMENT OF NEED AND REASONABLENESS

STATEMENT OF AUTHORITY

Minnesota Statutes Section 80A.14, subd. 4 contains the definition of "broker-dealer". This section provides that "broker-dealer" does not include "... a bank, savings institution, savings and loan association acting for the account of others, provided that such activities are conducted in compliance with such rules and regulations as may be adopted by the commissioner."

Additional rulemaking authority pertaining to the proposed amendments is found at Minnesota Statutes Section 80A.25, subd. 1, Minnesota Statutes Section 80A.05, and Minnesota Statutes Section 45.023.

The Commissioner finds the proposed rule 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 REASONABLENESS

Minnesota Rule, part 2875.1590 is proposed in response to a 1984 amendment to Minnesota Statutes Section 80A.14, subd. 4 which expressly grants the Commissioner rule-making authority to determine when banks, savings institutions, or savings and loan associations can act for the account of others in securities transactions without being licensed as broker-dealers. 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 accomodation functions contemplated by the drafters of the Uniform Securities Act, upon which Chapter 80A is based, which contained an exclusion for such financial institutions from the definition of broker-dealer. Today, financial institutions have become aggressively involved in the securities business. Advertising and public solicitations urge consumers to become brokerage customers of financial institutions. Employees of financial institutions take orders and hold funds and securities, and then forward these to a clearing broker. The expansion of securities activities by financial institutions has brought about a need for this rule to assure an adequate level of investor protection. The rule closely resembles Rule 3b-9 under the Securities Exchange Act of 1934 which was recently adopted by the Securities

and Exchange Commission (SEC) to resolve parallel concerns at the federal level.

Without proposed Part 2875.1590, the increase in securities activities of financial institutions raises substantial investor protection concerns. The securities laws, as administered by the Department of Commerce and the SEC, provide for a comprehensive and coordinated system of regulation of securities activities specifically and uniquely designed to assure the protection of investors. The securities laws are also designed to assure fair competition among all participants in the securities markets. Broker-dealer licensing is an important part of this regulatory system. Absent broker-dealer licensing, the securities activities of financial institutions are regulated only under federal and state banking laws which were enacted primarily to protect depositors and to preserve the financial soundness of these institutions. Such bank regulation takes place outside the coordinated system of securities regulation and does not focus on the concerns the securities laws were intended to address. Regulators of financial institutions do not have the expertise nor equivalent authority to regulate securities activities in such a way as to provide investors the same protection provided under the securities laws.

For example, all persons associated with a broker-dealer (other than employees with purely clerical or ministerial

duties) are required to pass qualification examinations covering their knowledge of substantive aspects of the securities business in order to become licensed to sell securities. These qualification requirements are supplemented by the broker-dealer's affirmative duty to supervise its employees in order to prevent violations of the securities laws. Minn. Stat. Sec. 80A.07, subd. 1(b)(10)(1984). In contrast, personnel of financial institutions are not subject to any licensing to test their knowledge of securities laws and the securities business.

Further, financial institutions which engage in securities activities are not subject to compliance with suitability rules. Minn. Rules, part 2875.1050 (1985). Suitability rules govern the activities of individuals as well as entities engaged in the securities business and are intended to ensure that a particular investment is appropriate for a client based on the client's financial condition, sophistication and investment objectives. Individuals effecting securities transactions on behalf of a financial institution are not subject to such regulations. State and federal laws governing financial institutions regulate institutions, not the conduct and activities of individuals. Indeed, the Department has encountered problems with regard to the limitations of its authority over individuals under the banking laws when, during the course of a regular examination of a bank, it uncovered criminal activity on the part of a bank officer. Under the authority of state banking law, the Department revoked the bank's charter. The Department has no authority

under banking law or any of the laws regulating financial institutions, however, to take any action against the officer of a finanical institution.

Additionally, many rural banks are suffering due to difficult economic times. In some cases, severe economic problems have driven normally honest, hard-working individuals to commit dishonest and illegal acts. Generally, when illegal activity occurs in the context of banking, the financial stability of the bank is adversely affected. Depositors face little risk of loss because their funds are insured by the FDIC. No comparable protections are provided to consumers when illegal activities are committed by financial institutions in the securities area. The purpose of the securities laws is to protect the consumer, and as a necessary means of carrying out this purpose, the laws provide the commissioner with the requisite authority to take administrative action against individuals as well as organizations.

Financial institution and securities regulations are also different in the area of advertising. Broker-dealers must comply with specific guidelines concerning the content and review of advertisements. Minn. Rules, parts 2875.0501-0550(1985). There are no equivalent rules governing the advertising of securities activities of financial institutions.

Recognizing the expansion of the activities of financial institutions into the securities business, the Legislature

enacted an amendment to the previous exemption for banks, savings institutions, and savings and loan associations from the definition of "broker-dealer" contained in Minnesota Statutes Section 80A.14, subd. 4. The amended statute allows banks, savings institutions and savings and loan associations to (1) act for its own account, (2) act in certain fiduciary capacities, and (3) act for the account of others when those activities are in compliance with rules adopted by the Commissioner. Minnesota Rules, part 2875.1590 defines the scope of item (3).

Part 2875.1590, subpart 1

Part 2875.1590, subpart 1, paragraph A provides that a bank, savings institution or savings and loan association may not solicit brokerage business for which it receives transaction-related compensation unless the financial institution enters into a contractual or other arrangement with a broker-dealer licensed under Minnesota Statutes Chapter 80A and certain other specific requirements discussed below are met.

This subpart will not disturb the existing arrangements between some financial institutions and broker-dealers where the financial institution advertises the services of the broker-dealer, and the broker-dealer performs all brokerage functions. In such situations the presence of a licensed broker-dealer adequately addresses investor protection concerns. If, on the other hand, the financial institution solicits

brokerage services not conducted by a licensed broker-dealer, then it must be licensed as a broker-dealer, or an affiliate or subsidiary of it must be licensed.

This provision is intended to permit financial institutions to engage in so-called "networking" arrangements with licensed broker-dealers. For example, a financial institution may contract to advertise the availability of the services of a licensed broker-dealer through promotional literature that provides a telephone number for the placement of orders by customers directly with the broker-dealer. If the requirements of paragraph A, items 1-4 are met, and if the financial institution's brokerage services are being performed through a licensed broker-dealer, no separate broker-dealer licensure would be required.

Paragraph A, item 1 requires that the licensed broker-dealer be clearly identified as the person performing the brokerage services. This would allow the financial institution to work with the broker-dealer to develop literature promoting the services, but require that such literature be approved by the broker-dealer and be viewed as that of the broker-dealer. In this manner, consumers will be informed as to who is responsible for the brokerage services. Additionally, the content of advertising literature will be required to comply with state securities laws.

Under paragraph A, item 2, employees of the financial institution may perform only clerical and ministerial functions in connection

with brokerage transactions unless they are licensed as securities agents with the broker-dealer. If an individual performs purely clerical or ministerial functions, there is no need for the protections and safeguards afforded by the licensing requirements of Minnesota Statutes Chapter 80A because of this individual's limited role in the transaction. The financial institution's employee may distribute advertising materials and assist customers in completing basic information on account opening forms. However, the handling of customers' orders, funds or securities is not considered to be purely clerical or ministerial and cannot be performed without separate licensure.

Under paragraph A, item 3, the financial institution's employee may not receive compensation for brokerage activities unless the employee is a licensed securities agent. If employees perform activities which are more than clerical and ministerial in nature in connection with brokerage transactions or if the financial institution permits employees to receive compensation related to the volume of securities transactions, such employees must be licensed as securities agents pursuant to Minnesota Statutes Chapter 80A.

To ensure that the Commissioner has access to all customer records to facilitate the examination of the broker-dealer's records and detect any potential violations of the securities laws regarding financial institution-related accounts, paragraph A, item 4 requires the broker-dealer to perform services

on a basis in which all customers are fully disclosed. Accounts maintained on a fully-disclosed basis are maintained in only the name of the individual client, rather than in the name of the broker-dealer.

Subpart 1, paragraph B requires a financial institution to be licensed as a broker-dealer if it receives transaction related compensation for providing brokerage services for trust accounts or other accounts to which the financial institution provides investment advice. Investment advice includes individualized advice as well as investment seminars and research on particular securities. Licensing is not required if the financial institution executes transactions through a licensed broker-dealer and the provisions of paragraph B, items 1-3 are met.

Financial institutions that provide investment advice to accounts from which they also generate profits through the execution of transactions are performing activities that are no different from those of full service broker-dealers. The availability of transaction related compensation can provide the inducement for a variety of illegal conduct, including churning (excess trading through which a broker-dealer advances his own interests by generating unnecessary commissions) and unsuitable recommendations. The anti-fraud provisions of the Minnesota Securities Law and rules prohibit broker-dealers from engaging in churning and from recommending securities transactions which are not suitable for the customer, in addition to prohibiting the broker-dealer from engaging

in a variety of other illegal acts. Minn. Stat. Sec. 80A.02-03 (1984); Minn. Rules parts 2875.1030-1150 (1985). This rule assures that financial institutions that act as though they were broker-dealers in virtually all respects are subject to the same requirements as licensed broker-dealers. The clients of both thus have the necessary protections.

However, under paragraph B, the financial institution engaged in the specified securities activities will not be required to obtain a broker-dealer license if (1) the customer is free to choose the executing broker-dealer in an affirmative way, with no provision that sends trades automatically any particular broker-dealer if the customer makes no choice; (2) bank personnel do not receive any compensation for trades executed for accounts to which the financial institution provides investment advice or compensation related to the number of accounts choosing to use the broker-dealer; and (3) the executing broker-dealer carries the accounts on a fully disclosed basis.

Subpart 1, paragraph C provides that the exclusion contained in Minnesota Statutes Section 80A.14, subd. 4 is unavailable to a bank, savings institution or savings and loan association that deals in or underwrites securities. For purposes of the rule, the Commissioner interprets "underwrite" consistent with the definition of the term "underwriter" in §2(11) of the Federal Securities Act of 1933, which provides that "underwriter" means: "any person who has purchased from an issuer with a view to, or offers or sells for an in connection

with, the distribution of any security or participates or has a direct or indirect participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributor's or seller's commission." The exclusion is not available to a financial institution which engages in underwriting because underwriting inherently involves a risk of a large degree of self-interest on the part of the underwriter and also is the primary means of publicly distributing large amounts of securities. Therefore, as the protections afforded by Minnesota Statutes Chapter 80A are necessary, a financial institution which engages in underwriting must obtain a broker-dealer license.

Subpart 2, paragraph C provides an exception for financial institutions that operate certain sweep accounts. Specifically, the exception permits a financial institution to direct the customer's deposit funds into investment companies registered pursuant to the Investment Company Act of 1940 which do not impose a sales charge and which attempt to maintain a constant net asset value. Given the automatic nature of these activities, the high level of regulation of investment companies and the constant net asset value of the shares, there is no serious risk of abuse in this area.

Under subpart 2, paragraph D, an exception from broker-dealer licensure for financial institutions that effect transactions

as part of a variety of shareholder and employee plans. This exception recognizes that financial institutions have been engaging in such securities activities for many years without raising significant investor protection concerns.

Subpart 2, paragraph E provides an exception for financial institutions that effect transactions only with other financial institutions or institutional buyers. Because these institutions employ professionals who are knowledgeable and skilled in the area of securities and also because they possess the financial wherewithal to take risks in the securities market, the protections afforded by the securities laws are not deemed to be necessary.

Part 2875.1590, subpart 2

Subpart 2 excepts from the scope of the rule banks, savings institutions, and savings and loan association which effect transactions in certain securities under certain circumstances where the requirement of licensure is unnecessary to assure adequate investor protection.

Under subpart 2, paragraph A, a bank, savings institution or savings and loan association may effect transactions in commercial paper, bankers' acceptance or commercial bills without being required to obtain a broker-dealer license. Minnesota Statutes Section 80A.15 exempts these securities from registration and filing requirements. Additionally, as a financial institution's involvement in these securities

is of a more traditional and accomodational nature, a financial institution which effects transactions in only those securities specified in paragraph A is performing the traditional functions of a financial institution. Financial institutions have effected transactions in these securities for many years without creating a need for additional consumer protections. Hence, no licensure is deemed necessary.

Under subpart 2, paragraph B, banks, savings institutions or savings and loan associations which effect transactions for the investment portfolio of affiliated companies only would be excepted from the broker-dealer licensing requirement. These transactions are a logical outgrowth of the investment purchases a financial institution is permitted to make for its own investment portfolios and therefore, this exception is appropriate. Additionally, the need for consumer protection is not present when a financial institution engages in these limited activities.

Part 2875.1590, subpart 3

Subpart 3 of the rules allows the Commissioner to exempt financial institutions from the broker-dealer licensing requirements of the rule when he deems that the activities of the financial institution are not within the intended meaning and purpose of the rule. This subpart may permit financial institutions to continue certain present securities activities which do not pose a threat of harm to investors

without being licensed as broker-dealers.

Part 2875.1590, subpart 4

Subpart 4 defines "transaction related compensation" as "monetary profit in excess of cost recovery for providing brokerage execution services". The definition includes, among other things, a percentage of commissions and brokerage fees from accounts to which a financial institution provides investment advice if the fees exceed the cost of execution.

In summary, the purpose of Minnesota Rules, part 2875.1590 is to establish boundaries for financial institution activity without broker-dealer licensure in order to achieve the fundamental goal of providing an acceptable level of investor protection.

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.

Item (a) of subdivision 2 requires the consideration of

less stringent compliance or reporting requirements for small businesses. The goal of proposed part 2875.1590 is the protection of individual investors who transact securities business with financial institutions. A lesser compliance standard for small businesses would result in reduced protection for the investor. This is inconsistent with the goal of consumer protection. Further, if it is perceived that there is less consumer protection if a small financial institution offers securities services, investors may choose to deal with large institutions to achieve the most security.

Items (b) and (c) are not applicable to the proposed rule as there are no new reporting requirements, and the only compliance schedule that arguably exists is that a financial institution must comply with the provisions of the rule before it engages in securities activities. No other standard is acceptable if the investor is to be protected.

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

Item (e) is inapplicable for the reasons discussed with regard to item (a).

Despite the foregoing, the Department did consider small businesses as it developed the rule. The rule is intended to impose as light a regulatory burden as possible while still protecting the consumer to ensure that the activities which the rule regulates could be undertaken by small as

well as large organizations.

Also, the concept of "networking" allows even the smallest financial institution to provide a wide array of securities products to its customers without being required to become licensed as a broker-dealer. If financial institutions which are involved in "networking" arrangements were required to become licensed as broker-dealers, all but the larger financial institutions might be precluded from engaging in securities activities.

STATE OF MINNESOTA

DEPARTMENT OF COMMERCE

IN THE MATTER OF THE PROPOSED AMENDMENTS) TO SECURITIES RULES REGULATING THE SEC-) URITIES PRACTICES OF FINANCIAL INSTITU-) TIONS, INCLUDING BANKS, SAVINGS INSTITU-) TIONS AND SAVINGS AND LOAN ASSOCIATIONS)

AMENDED STATEMENT OF NEED AND REASONABLENESS

STATEMENT OF AUTHORITY

Minnesota Statutes Section 80A.14, subd. 4 contains the definition of "broker-dealer". This section provides that "broker-dealer" does not include "... a bank, savings institution, savings and loan association acting for the account of others, provided that such activities are conducted in compliance with such rules and regulations as may be adopted by the commissioner."

Additional rulemaking authority pertaining to the proposed amendments is found at Minnesota Statutes Section 80A.25, subd. 1, Minnesota Statutes Section 80A.05, and Minnesota Statutes Section 45.023.

The Commissioner finds the proposed rule 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

Minnesota Rule, part 2875.1590 is proposed in response to a 1984 amendment to Minnesota Statutes Section 80A.14, subd. 4 which expressly grants the Commissioner rule-making authority to determine when banks, savings institutions, or savings and loan associations can act for the account of others in securities transactions without being licensed as broker-dealers. 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 accomodation functions contemplated by the drafters of the Uniform Securities Act, upon which Chapter 80A is based, which contained an exclusion for such financial institutions from the definition of broker-dealer. Today, financial institutions have become aggressively involved in the securities business. Advertising and public solicitations urge consumers to become brokerage customers of financial institutions. Employees of financial institutions take orders and hold funds and securities, and then forward these to a clearing broker. The expansion of securities activities by financial institutions has brought about a need for this rule to assure an adequate level of investor protection.

The rule closely resembles Rule 3b-9 under the Securities

Exchange Act of 1934 which was recently adopted by the Securities and Exchange Commission (SEC) to resolve parallel concerns at the federal level.

Without proposed Part 2875.1590, the increase in securities activities of financial institutions raises substantial investor protection concerns. The securities laws, as administered by the Department of Commerce and the SEC, provide for a comprehensive and coordinated system of regulation of securities activities specifically and uniquely designed to assure the protection of investors. The securities laws are also designed to assure fair competition among all participants in the securities markets. Broker-dealer licensing is an important part of this regulatory system. Absent broker-dealer licensing, the securities activities of financial institutions are regulated only under federal and state banking laws which were enacted primarily to protect depositors and to preserve the financial soundness of these institutions. Such bank regulation takes place outside the coordinated system of securities regulation and does not focus on the concerns the securities laws were intended to address. Regulators of financial institutions do not have the expertise nor equivalent authority to regulate securities activities in such a way as to provide investors the same protection provided under the securities laws.

For example, all persons associated with a broker-dealer (other than employees with purely clerical or ministerial duties) are required to pass qualification examinations

covering their knowledge of substantive aspects of the securities business in order to become licensed to sell securities. These qualification requirements are supplemented by the broker-dealer's affirmative duty to supervise its employees in order to prevent violations of the securities laws. Minn. Stat. Sec. 80A.07, subd. 1(b)(10)(1984). In contrast, personnel of financial institutions are not subject to any licensing to test their knowledge of securities laws and the securities business.

Further, financial institutions which engage in securities activities are not subject to compliance with suitability rules. Minn. Rules, part 2875.1050 (1985). Suitability rules govern the activities of individuals as well as entities engaged in the securities business and are intended to ensure that a particular investment is appropriate for a client based on the client's financial condition, sophistication and investment objectives. Individuals effecting securities transactions on behalf of a financial institution are not subject to such regulations. State and federal laws governing financial institutions regulate institutions, not the conduct and activities of individuals. Indeed, the Department has encountered problems with regard to the limitations of its authority over individuals under the banking laws when, during the course of a regular examination of a bank, it uncovered criminal activity on the part of a bank officer. Under the authority of state banking law, the Department revoked the bank's charter. The Department has extremely restricted authority under banking law or any of the laws regulating financial institutions, however, to take any

action against the officer of a financial institution. There is considerable doubt whether, under state laws regulating financial institutions, the department could take administrative action against a financial institution officer or employee for misconduct or wrongdoing in the area of securities.

Additionally, many rural banks are suffering due to difficult economic times. In some cases, severe economic problems have driven normally honest, hard-working individuals to commit dishonest and illegal acts. Generally, when illegal activity occurs in the context of banking, the financial stability of the bank is adversely affected. Depositors face little risk of loss because their funds are insured by the FDIC. No comparable protections are provided to consumers when illegal activities are committed by financial institutions in the securities area. The purpose of the securities laws is to protect the consumer, and as a necessary means of carrying out this purpose, the laws provide the commissioner with the requisite authority to take administrative action against individuals as well as organizations.

Financial institution and securities regulations are also different in the area of advertising. Broker-dealers must comply with specific guidelines concerning the content and review of advertisements. Minn. Rules, parts 2875.0501-0550(1985). There are no equivalent rules governing the advertising of securities activities of financial institutions.

Recognizing the expansion of the activities of financial

institutions into the securities business, the Legislature enacted an amendment to the previous exemption for banks, savings institutions, and savings and loan associations from the definition of "broker-dealer" contained in Minnesota Statutes Section 80A.14, subd. 4. The amended statute allows banks, savings institutions and savings and loan associations to (1) act for their own account, (2) act in certain fiduciary capacities, and (3) act for the account of others when those activities are in compliance with rules adopted by the Commissioner. Minnesota Rules, part 2875.1590 defines the scope of item (3).

Part 2875.1590, subpart 1

Part 2875.1590, subpart 1, paragraph A provides that a bank, savings institution or savings and loan association may not solicit brokerage business for which it receives transaction-related compensation unless the financial institution enters into a contractual or other arrangement with a broker-dealer licensed under Minnesota Statutes Chapter 80A and certain other specific requirements discussed below are met.

This subpart will not disturb the existing arrangements between some financial institutions and broker-dealers where the financial institution advertises the services of the broker-dealer, and the broker-dealer performs all brokerage functions. In such situations the presence of a licensed broker-dealer adequately addresses investor protection concerns. If, on the other hand, the financial institution solicits

brokerage services not conducted by a licensed broker-dealer, then it must be licensed as a broker-dealer, or an affiliate or subsidiary of it must be licensed.

This provision is intended to permit financial institutions to engage in so-called "networking" arrangements with licensed broker-dealers. For example, a financial institution may contract to advertise the availability of the services of a licensed broker-dealer through promotional literature that provides a telephone number for the placement of orders by customers directly with the broker-dealer. If the requirements of paragraph A, items 1-4 are met, and if the financial institution's brokerage services are being performed through a licensed broker-dealer, no separate broker-dealer licensure would be required.

Paragraph A, item 1 requires that the licensed broker-dealer be clearly identified as the person performing the brokerage services. This would allow the financial institution to work with the broker-dealer to develop literature promoting the services, but require that such literature be approved by the broker-dealer and be viewed as that of the broker-dealer. In this manner, consumers will be informed as to who is responsible for the brokerage services. Additionally, the content of advertising literature will be required to comply with state securities laws.

Under paragraph A, item 2, employees of the financial institution may perform only clerical and ministerial functions in connection

with brokerage transactions unless they are licensed as securities agents with the broker-dealer. If an individual performs purely clerical or ministerial functions, there is no need for the protections and safeguards afforded by the licensing requirements of Minnesota Statutes Chapter 80A because of this individual's limited role in the transaction. The financial institution's employee may distribute advertising materials and assist customers in completing basic information on account opening forms. However, the handling of customers' orders, funds or securities is not considered to be purely clerical or ministerial and cannot be performed without separate licensure.

Under paragraph A, item 3, the financial institution's employee may not receive compensation for brokerage activities unless the employee is a licensed securities agent. If employees perform activities which are more than clerical and ministerial in nature in connection with brokerage transactions or if the financial institution permits employees to receive compensation related to the volume of securities transactions, such employees must be licensed as securities agents pursuant to Minnesota Statutes Chapter 80A.

To ensure that the Commissioner has access to all customer records to facilitate the examination of the broker-dealer's records and detect any potential violations of the securities laws regarding financial institution-related accounts, paragraph A, item 4 requires the broker-dealer to perform services on a basis in which all customers are fully disclosed.

Accounts maintained on a fully-disclosed basis are maintained in only the name of the individual client, rather than in the name of the broker-dealer.

Subpart 1, paragraph B requires a financial institution to be licensed as a broker-dealer if it receives transaction related compensation for providing brokerage services for trust accounts or other accounts to which the financial institution provides investment advice. Investment advice includes individualized advice as well as investment seminars and research on particular securities. Licensing is not required if the financial institution executes transactions through a licensed broker-dealer and the provisions of paragraph B, items 1-3 are met.

Financial institutions that provide investment advice to accounts from which they also generate profits through the execution of transactions are performing activities that are no different from those of full service broker-dealers. The availability of transaction related compensation can provide the inducement for a variety of illegal conduct, including churning (excess trading through which a broker-dealer advances his own interests by generating unnecessary commissions) and unsuitable recommendations. The anti-fraud provisions of the Minnesota Securities Law and rules prohibit broker-dealers from engaging in churning and from recommending securities transactions which are not suitable for the customer, in addition to prohibiting the broker-dealer from engaging in a variety of other illegal acts. Minn. Stat. Sec. 80A.02-03

(1984); Minn. Rules parts 2875.1030-1150 (1985). This rule assures that financial institutions that act as though they were broker-dealers in virtually all respects are subject to the same requirements as licensed broker-dealers. The clients of both thus have the necessary protections.

However, under paragraph B, the financial institution engaged in the specified securities activities will not be required to obtain a broker-dealer license if (1) the customer is free to choose the executing broker-dealer in an affirmative way, with no provision that sends trades automatically to any particular broker-dealer if the customer makes no choice; (2) bank personnel do not receive any compensation for trades executed for accounts to which the financial institution provides investment advice or compensation related to the number of accounts choosing to use the broker-dealer; and (3) the executing broker-dealer carries the accounts on a fully disclosed basis.

Subpart 1, paragraph C provides that the exclusion contained in Minnesota Statutes Section 80A.14, subd. 4 is unavailable to a bank, savings institution or savings and loan association that deals in or underwrites securities. For purposes of the rule, the Commissioner interprets "underwrite" consistent with the definition of the term "underwriter" in §2(11) of the Federal Securities Act of 1933, which provides that "underwriter" means: "any person who has purchased from an issuer with a view to, or offers or sells for an in connection with, the distribution of any security or participates or

has a direct or indirect participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributor's or seller's commission." The exclusion is not available to a financial institution which engages in underwriting because underwriting inherently involves a risk of a large degree of self-interest on the part of the underwriter and also is the primary means of publicly distributing large amounts of securities. Therefore, as the protections afforded by Minnesota Statutes Chapter 80A are necessary, a financial institution which engages in underwriting must obtain a broker-dealer license.

Part 2875.1590, subpart 2

Subpart 2 excepts from the scope of the rule banks, savings institutions, and savings and loan associations which effect transactions in certain securities under circumstances where the requirement of licensure is unnecessary to assure adequate investor protection.

Under subpart 2, paragraph A, a bank, savings institution or savings and loan association may effect transactions in commercial paper, bankers' acceptance or commercial bills without being required to obtain a broker-dealer license. Minnesota Statutes Section 80A.15 exempts these securities from registration and filing requirements. Additionally, as a financial institution's involvement in these securities

is of a more traditional and accomodational nature, a financial institution which effects transactions in only those securities specified in paragraph A is performing the traditional functions of a financial institution. Financial institutions have effected transactions in these securities for many years without creating a need for additional consumer protections. Hence, no licensure is deemed necessary.

Under subpart 2, paragraph B, banks, savings institutions or savings and loan associations which effect transactions for the investment portfolio of affiliated companies only would be excepted from the broker-dealer licensing requirement. These transactions are a logical outgrowth of the investment purchases a financial institution is permitted to make for its own investment portfolios and therefore, this exception is appropriate. Additionally, the need for consumer protection is not present when a financial institution engages in these limited activities.

Subpart 2, paragraph C provides an exception for financial institutions that operate certain sweep accounts. Specifically, the exception permits a financial institution to direct the customer's deposit funds into investment companies registered pursuant to the Investment Company Act of 1940 which do not impose a sales charge and which attempt to maintain a constant net asset value. Given the automatic nature of these activities, the high level of regulation of investment companies and the constant net asset value of the shares, there is no serious risk of abuse in this area.

Under subpart 2, paragraph D, an exception from broker-dealer licensure is provided for financial institutions that effect transactions as part of a variety of shareholder and employee plans. This exception recognizes that financial institutions have been engaging in such securities activities for many years without raising significant investor protection concerns.

Subpart 2, paragraph E provides an exception for financial institutions that effect transactions only with other financial institutions or institutional buyers. Because these institutions employ professionals who are knowledgeable and skilled in the area of securities and also because they possess the financial wherewithal to take risks in the securities market, the protections afforded by the securities laws are not deemed to be necessary.

Part 2875.1590, subpart 3

Subpart 3 of the rules allows the Commissioner to exempt financial institutions from the broker-dealer licensing requirements of the rule when he deems that the activities of the financial institution are not within the intended meaning and purpose of the rule. This subpart may permit financial institutions to continue certain present securities activities which do not pose a threat of harm to investors without being licensed as broker-dealers.

Part 2875.1590, subpart 4

Subpart 4 defines "transaction related compensation" as "monetary profit in excess of cost recovery for providing brokerage execution services". The definition includes, among other things, a percentage of commissions and brokerage fees from accounts to which a financial institution provides investment advice if the fees exceed the cost of execution.

In summary, the purpose of Minnesota Rules, part 2875.1590 is to establish boundaries for financial institution activity without broker-dealer licensure in order to achieve the fundamental goal of providing an acceptable level of investor protection.

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.

Item (a) of subdivision 2 requires the consideration of less stringent compliance or reporting requirements for

small businesses. The goal of proposed part 2875.1590 is the protection of individual investors who transact securities business with financial institutions. A lesser compliance standard for small businesses would result in reduced protection for the investor. This is inconsistent with the statutory goal of consumer protection which is the basis for the rule. Further, if it is perceived that there is less consumer protection if a small financial institution offers securities services, investors may choose to deal with large institutions to achieve the most security.

Items (b) and (c) require the consideration of the establishment of less stringent schedules or deadlines for compliance or reporting requirements for small business and the consideration of the consolidation or simplification of compliance or reporting requirements for small businesses, respectively. The proposed rule requires small financial institutions to comply with broker-dealer reporting requirements. The broker-dealer reporting provisions require broker-dealers to submit an annual report with audited financial statements. Because this annual reporting requirement provides the Commissioner with financial information necessary to monitor the protection of customer funds, any lesser reporting requirements or less frequent reporting requirements for small financial institutions are not feasible and contrary to the statutory objectives which are the bases for the proposed rule. Additionally, with regard to compliance schedules and requirements, such requirements are necessary to ensure an adequate level of investor protection. No other standard would fulfill statutory objectives.

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

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

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

Also, the concept of "networking" allows even the smallest financial institution to provide a wide array of securities products to its customers without being required to become licensed as a broker-dealer. If financial institutions which are involved in "networking" arrangements were required to become licensed as broker-dealers, all but the larger financial institutions might be precluded from engaging in securities activities.