

STATE OF MINNESOTA  
DEPARTMENT OF COMMERCE

IN THE MATTER OF THE PROPOSED )	<u>STATEMENT OF</u>
AMENDMENTS TO RULES REGARDING )	<u>NEED AND</u>
THE SCOPE AND APPLICATION )	<u>REASONABLENESS</u>
OF SECURITIES RULES AND )	
CERTAIN EXEMPTIONS FROM )	
REGISTRATION )	

STATEMENT OF AUTHORITY

Minnesota Statutes, Section 80A.25, subdivision 1 provides that:

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, whether or not used in Sections 80A.01 to 80A.31, insofar as the definitions are not inconsistent with the provisions of Sections 80A.01 to 80A.31.

Additional rulemaking authority provided in Minnesota Statutes Section 45.023 authorizes the Commissioner to "adopt, amend, suspend, or repeal rules ... whenever necessary or proper in discharging the Commissioner's official responsibilities."

The Commissioner finds the proposed rules to be necessary or for the protection of investors and consistent with the purposes fairly intended by the policies and provisions of Chapters 45 and 80A. The Commissioner further finds that the proposed amendments are consistent with the statutory policy set forth in Minnesota Statutes 80A.31.

### FACTS ESTABLISHING NEED AND REASONABLENESS

#### BACKGROUND

Minnesota Statutes 80A.25, subdivision 2 provides that "in prescribing rules and forms the commissioner may cooperate with securities administrators of other states and the Securities and Exchange Commission with a view to effectuating the policy of this statute to achieve maximum uniformity in the form and content of registration statements, application, and reports wherever practicable." (Underlining provided.) Minnesota Statutes 80A.31 states that "Sections 80A.01 to 80A.31 shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it and to coordinate the interpretation of Sections 80A.01 to 80A.31 with the related federal regulation." (Underlining provided.)

These rules are being proposed in keeping with the statutes' stated general purpose of uniformity of regulation of the Securities laws. Within the past fourteen months, the Securities and Exchange Commission has twice amended Regulation D, the rules which govern

the limited offer and sale of securities without registration under the Securities Act of 1933. The first amendment became effective April 11, 1988 and the second on April 19, 1989. The Minnesota Securities rules refer to Regulation D in several places. In order to maintain consistency with the federal law, the Minnesota rules must be amended to reflect the current status of Regulation D.

The Department is proposing changes to other rules to reflect additional changes in the federal law. The part dealing with isolated sales is being amended to conform to the amended statute, pursuant to which it was promulgated. The amendment to the Real Estate Investment Trust (REIT) rules comports with a change the Internal Revenue Service has made in their treatment of REITs. Certain amendments are proposed to reflect changes made by the SEC in filing requirements while other rules require amendment in order to bring greater consistency to the application of Minnesota Securities Laws and to adapt to the realities of the regulated industries.

**RULE PART 2875.0145**

This part defines "Regulation D" as used in Minnesota Statutes 80A.15, subdivision 2(h) as Regulation D promulgated by the Securities and Exchange Commission, Code of Federal Regulations, Title 17, Sections 230.501 to 230.508, as amended April 19, 1989.

Minnesota Statutes 80A.15, subdivision 2(h) provides an

exemption from Minnesota's securities regulation requirements for "limited offerings." It allows an issuer to make sales to 25 persons in Minnesota (or 35 if the sales are made in compliance with Regulation D) if the purchasers are purchasing for investment and no compensation, other than reasonable and customary broker-dealer commissions, is paid for soliciting any prospective buyer in Minnesota. An issuer making sales pursuant to Minnesota Statutes 80A.15, subdivision 2(h) is required to file a "Statement of the Issuer" with the Department of Commerce but the filing is not subject to the type of merit review which occurs when a registration application is made pursuant to Minnesota Statutes 80A.10 and 80A.11.

Although several changes were made to Regulation D by the April 11, 1988 amendment and the April 19, 1989 amendment the changes which are most important when taking advantage of Minnesota's exemption are as follows:

1. The \$500,000 ceiling for Rule 504 offering was raised to \$1,000,000 if at least \$500,000 of the offering is registered at the state level. Also, the amendment allows general solicitation in states where there is no registration procedure if the offering is also made in a registration state.
2. Where the offering is of \$2,000,000 or less, the disclosure requirements are the same as those under

Regulation A although the issuer must provide investors with a certified balance sheet, dated within 120 days the commencement of the offering.

Since the reference to Regulation D in Minnesota Statutes 80A.15, 2(h) is not tied to a specific cite, this amendment clarifies that sales under the statute must be made in compliance with the new Regulation D. The change is necessary to carry out the legislature's intent that Minnesota's exemption coordinate with the federal law.

#### **Rule Part 2875.0146**

This part defines "Rule 701" as used in Minnesota Rules, Chapter 2875 as Rule 701 promulgated by the Securities and Exchange Commission, Code of Federal Regulations, title 17, section 239.701, which became effective on May 20, 1988.

Rule 701, promulgated pursuant to Section 3(b) of the 1933 Act provides an exemption from registration for offers and sales of securities of certain employee benefit plans and compensation contracts.

#### **Rule Part 2875.0150**

The legislature amended Minnesota Statutes 80A.15 2(a) to provide that 10 sales rather than 5 sales could be made under

the exemption. However, Part 2875.0150, promulgated pursuant to Minnesota Statutes 80A.15, 2(a), refers to 5 sales and has never been amended. The proposed amendment to Minnesota Rule 2875.0150, Subpart 1 merely reflects the current provisions of Minnesota Statutes 80A.15 2(a).

The current reference to Rule 501(a) of Regulation D found in Subpart 2 is tied to a specific cite in the Code of Federal Regulations. The amendment to this subpart would replace this specific cite with "Rule 501(a) of Regulation D and would make the Minnesota rule consistent with the new federal Regulation D. The SEC revisions to Regulation D, which took effect on April 11, 1988, added to the definition of accredited investor, savings and loan associations, credit unions, broker-dealers, and certain trusts, partnerships and corporations with over \$5 million in total assets. The revisions permit a joint as well as an individual income test for natural persons and eliminate the \$150,00 purchaser of securities from the definition. The amendment to the definition of "accredited investor" which became effective on April 19, 1989 added those plans established and maintained by the governments of states and their political subdivisions, as well as their agencies and instrumentalities for the benefit of their employees, that have total assets in excess of \$5 million.

The Commissioner concurs in the SEC's view, as reflected its current definition of "accredited investor", that the above investors possess the requisite sophistication to make registration unnecessary.

Rule Part 2875.0160

This proposal adds Moody's International Manual to those currently recognized by the Commissioner.

Minnesota Statutes 80A.15, subdivision 2(b) (the "manual exemption") exempts from registration:

nonissuer distributions of outstanding securities if (1) either Moody's, Fitch's, or Standard & Poor's Securities Manuals, or other recognized manuals approved by the commissioner contains the names of the issuer's officers and directors, a balance sheet of the issuer as of a date not more than 18 months prior to the date of the sale, and a profit and loss statement for the fiscal year preceding the date of the balance sheet, and (2) the issuer or its predecessor has been in active, continuous business operation for the five-year period next preceding the date of sale, and (3) if the security has a fixed maturity or fixed interest or dividend provision, the issuer has not, within the three preceding fiscal years, defaulted in payment of principal, interest, or dividends on the securities.

Part 2875.0160 sets forth the manuals which are recognized by the Commissioner. Moody's International Manual was first published in 1981. Prior to that time, international companies were listed in Moody's Industrial Manual. These companies are now listed in Moody's International Manual a manual which has not been recognized by the Commissioner. Consequently, transactions in the securities of international companies which were once exempt pursuant to Minnesota Statutes 80A.15 2(b) are now subject to registration.

Minnesota Statutes 80A.15 2(b) gives the Commissioner authority

to recognize other manuals beyond those listed in the statute. The Commissioner, in adding Moody's International Manual to this part, is exercising that authority.

**Rule Part 2875.0170**

The terms financial institution or institutional buyer/investor are used, in Minnesota Statutes 80A.04, subdivision 3, 80A.14, subdivision 4, and 80A.15, subdivision 2(g). However, this part defines the term only for the purposes of Minnesota Statutes 80A.15, subdivision 2(g). The amendment extends the definition to Minnesota Statutes 80A.14, subdivision 3 and 80A.14, subdivision 4 clause (5), resulting in greater uniformity and fairness in the application of standards to licenses and registrants.

Minnesota Statutes 80A.04 provides that it is unlawful to transact business in this state as an investment adviser unless licensed as an investment adviser or broker-dealer unless that persons only Minnesota clients are:

investment companies as defined in the Investment Company Act of 1940, other investment advisers, broker-dealers, banks, trust companies, savings and loan associations, insurance companies, employee benefit plans, corporations with a class of equity securities registered under Section 12(g) of the Securities Exchange Act of 1934, small business investment companies, and government agencies or instrumentalities, whether acting for themselves or as trustees with investment control, or other institutional investors as are designated by rule or order of the commissioner.

The term, institutional investor has not been defined by rule or order for purposes of this statute. In order to achieve



consistency in the statutes, this part proposes that the definition used for purposes of Minn. Stat. 80A.15, subd. 2(g) will apply to Minn. Stat. 80A.04, subd. 3.

Minn. Stat. 80A.14, subd. 4, clause (5) excludes from the "broker-dealer" definition:

a person who has no place of business in this state if that person effects transactions in this state exclusively with or through (i) the issuers of the securities involved in the transactions, (ii) other broker-dealers, or (iii) banks, savings institutions, trust companies, insurance companies, investment companies as defined in the Investment Company Act of 1940, pension or profit sharing trusts, or other financial institutions or institutional buyers, or to broker-dealers, whether the purchaser is acting for itself or in some fiduciary capacity;

The terms "financial institutions or institutional buyers" are not defined in the rules. Again, in order to achieve uniformity, the amendment will include all accredited investors within the terms "financial institutions and institutional buyers."

#### **Rule Part 2875.0180**

Subpart 1 provides that when calculating the number of persons to whom sales have been made or will be made, the rules for calculation are those found in Rule 501(e). The reference is to a Federal Register cite and the amendment removes the specific cite, making it clear that the current 501(e) applies.

The amendment to Subpart 2 provides that if sales are made in compliance with rule 701, the number of sales made pursuant

to the exemption contained in Minnesota Statutes 80A.15, 2(h) is increased from 25 to 35 persons. The proposed amendment will offer parallel treatment to offerings made in compliance with Regulation D and Rule 701.

Minnesota Statutes 80A.15, subdivision 2(h) gives the commissioner authority "by rule or order as to any security or transaction or any type of security or transaction, withdraw or further condition this exemption, or increase the number of offers and sales permitted, or waive the conditions in clause (1), (2) or (3) with or without the substitution of a limitation or remuneration." Subpart 2a is being proposed pursuant to this authority. The Rule 701 exemption is available only for offers and sales of an issuer's securities pursuant to a written compensatory benefit plan established by the issuer for the participation of employees, directors, general partners, trustees (where the issuer is a business trust), officers, or consultants or advisers. The amount of securities offered and sold in reliance on Rule 701 is limited.

The offerees in a 701 offering are presumed to have knowledge regarding the issuer which other investors would not. Beyond that, the Federal rule requires that all participants be given a copy of the plan. Since the offerees possess adequate information about the issuer and the securities by virtue of their employment relationship with the issuer and the disclosure provided in the written plan, and since only 35 sales can be made in Minnesota, registration is not necessary.

The proposed changes to Subparts 3A and B merely remove the Code of Federal Regulations cite for Regulation D.

**Rule Part 2875.0400**

The amendment to Subpart 1 is a technical one which assigns letters to the various securities programs listed in the rule.

Proposed Subpart 2 provides that the real estate limited partnership rules shall apply to other limited partnerships to which no other specific rules apply. Under the proposed rule, non real estate limited partnerships must comply with Minnesota Securities Rules regarding sponsors, minimum investments, sales and leases to the program, completion bonds, and other rules relating to the rights of limited partners. The rule would allow for variance from parts 2875.4560 to 2875.4610, dealing with commissions and expenses and part 2875.5135, dealing with nonspecified property programs if the variance is justified and the investor receives protection equal to that provided by the rules.

There are no catch all provisions for the review of limited partnerships in the Minnesota Securities Rules. Therefore, in order to provide for a consistent review of limited partnership filings where there are no specific rules, proposed Subpart 2 requires non real estate limited partnerships to comply with

the real estate limited partnership rules. This results in greater fairness to registrants and provides equal protection to investors buying into real estate and nonreal estate limited partnerships.

**Rule Part 2875.0410**

This proposed amendment makes it clear that where a specific date is mentioned in reference to a statute, date, rule, decision, or opinion, that date applies rather than the general reference to December 1, 1980.

The amendment is a technical one, made necessary by the change in references to Regulation D.

**Rule Part 2875.0960**

The proposed change to Subpart 1 of the above rule requires that securities registrants file a balance sheet not more than 135 days old at the time of their application for registration. Currently the balance sheet cannot be more 90 days old.

Regulation S-X, an SEC regulation, provides that registrants must file a balance sheet as of a date within 135 days of the date of filing. Because the current Minnesota rule limits the age of the balance sheet to 90 days at the date of filing, issuers

are essentially prevented from filing an application for registration during the period after their most recent quarter has ended but before quarterly financial statements have been prepared. During this time, the balance sheet of the previous quarter is over 90 days old but new financial statements, which sometimes take weeks to prepare, are not available. Issuers should not be prohibited from filing registration statements so long as the balance sheet included is less than 135 days old. The amendment provides adequate protection for investors and also facilitates compliance by making the rule consistent with the SEC Rule.

The proposed change to Subpart 2 of the regulation requires the filing of updated financials if the financial statements initially filed become more than 134 days old as of the effective date of the registration statement.

The current law has a four month limitation. Regulations S-X requires the filing of updated financials if the financial statements initially filed are as of a date 135 days or more prior to the anticipated effective date. Assuming that "four months old" is approximately 120 days, the proposed change would permit financial statements that are 15 days older than currently allowed. This difference would not materially affect the quality of financial information provided to investors. The change would, however, make Minnesota's requirements consistent with those of the SEC thereby, facilitating compliance by registrants and helping registrants avoid inadvertent violation of the rule.

**Rule Part 2875.1010**

The proposed amendment to Subpart 1a would add an exception to the application of Subpart 1. Subpart 1 provides that it is unlawful for an investment adviser to enter into investment advisory contracts where compensation is based upon the profits accruing from recommended transactions or upon capital gains or capital appreciation of the funds.

Minnesota Statutes 80A.05, subdivision 1 gives the Commissioner specific authority to adopt rules setting forth the conditions under which an investment adviser may receive performance based compensation. The amendment which the Commissioner is proposing pursuant to that authority would allow compensation "on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds" if the client is one of those listed in Minnesota Statutes 80A.04, subdivision 3.

The legislature has determined that those clients listed in Minnesota Statutes 80A.04, subdivision 3 are considered to be sophisticated investors capable of bearing the risks associated with investment adviser contracts and that therefore, licensure is not necessary. Since an investment adviser is not required to be licensed to transact business with the clients listed in Minnesota Statutes 80A.04, subdivision 3, it is consistent

to remove the prohibition against performance based compensation where these clients are involved. Further, this proposal is consistent with federal law which provides that exempt advisers are not subject to the Investment Adviser Act restrictions on the charging of a performance fee.

**Rule Part 2875.3030**

This amendment to Item C would change the prohibition on the transfer of cheap stock from one year from the completion of the offering to one year from the effective date of the registration statement.

Minnesota' current rule provides that underwriters may not exercise options or warrants or transfer any cheap stock received in connection with the offering for a period of one year from the completion of the public offering. The completion of the public offering is deemed to be the closing date of the offering. The National Association of Securities Dealers (NASD), however, restricts the transfer or exercise of securities issued to the underwriter as compensation for a period of one year from the effective date of the offering. Revision of the Minnesota Rule is appropriate in order to promote uniformity. This change would have no material effect on most firm underwritings where the closing typically occurs within two weeks of the effective date of the offering.

The proposed change to Item D of Part 2875.3030 allows transfers to underwriters for compensation after one year. It is intended to make Minnesota's rule regarding transferability consistent with the NASD rule. The NASD rule prohibits transfer of securities received as underwriter's compensation except to members of the underwriting group or their officers or partners during the first year after the effective date. Thereafter, the underwriter may transfer securities received as compensation provided the securities are either registered or an applicable exemption is available under federal and state securities law.

#### **Rule Part 2875.3050**

This amendment would raise the selling expense limit for preferred stock from 10% to 15%.

The current rule allows selling expenses of 10% for preferred stock and 15% for common stock. Offerings of preferred stock or other equity senior to common are important financing alternatives which require no less effort and expense by underwriters than offerings of common stock. The current ten percent expense limitation for preferred stocks has, in some cases, prevented companies from undertaking an offering of preferred stock when such an offering would have been in the company's best interests. Given that preferred stock often carries liquidation or dividend preferences which may reduce the risk of investing in preferred



stock as compared to common, there appears to be no compelling public policy justifying this discrimination against preferred stock.

### Rule Part 2875.7100

This amendment would include corporations in the Real Estate Investment Trust definition.

Prior to 1976, the Internal Revenue Service definition of REITs did not include corporations. The federal law was amended in 1976. The amended definition is taken from the REIT Guidelines of the North American Securities Administrators Association, Inc. (NASAA). Therefore, the amendment will make Minnesota law consistent with federal law and also with those states which rely on the NASAA Guidelines.

### Small Business Considerations

Minnesota Section 14.115 requires that the impact of proposed rules on small business be considered in the rule making 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) through (c) involve the establishment of less stringent or simplified standards for small businesses. Each

of these methods for reducing the impact of the rule on small businesses has been considered. The rules which are being proposed will simplify compliance with securities regulation since Minnesota law will conform to federal law. The rules will, in fact, make it easier for small businesses to raise capital in Minnesota. Any further relaxation of these rules for small businesses pursuant to Minnesota Statutes 14.115, subdivision 2, clause (c) through (d) would destroy uniformity between the federal law and the state law and would weaken the statute's goal of investor protection to an unacceptable level.

Clause (d) is not applicable to this rule since 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 of investor protection.

In proposing these rules the Department met with the Executive Council of the Business Law Section of the Minnesota State Bar Association. These attorneys represent many small businesses including small corporations, investment advisers and broker-dealers. These attorneys have stated that the proposed rules will decrease legal costs and ease the regulatory burden on their clients.

The Department fully considered the impact of these rules on small businesses. The Department has concluded that the overall effect of the rules will be the easing of regulation on small business.