

Minnesota Attorney General: Administrative Rules Proceedings

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Version 3
August 20, 2018

RULE REVIEW CHECKLIST

File No. 1412 Docket No. 05.0009.0081

DATE RECEIVED 10/22/87 ADOPTED W/O HEARING X

REVIEW DATE 10/31/87 EMERGENCY RULE

DUE DATE 11/5/87

REVISOR APPROVED ✓

APPROVED ✓ 10/5/87 JMZ REVISOR DISAPPROVED

DISAPPROVED FILED W/SEC.STATE

WITHDRAWN RETURNED TO AGENCY

✓ Rule as adopted (4 copies)

✓ Notice to Solicit Outside Information/Opinion

yes Date published in State Register

6/22/87 Comments

~~Petition for Adoption of a Rule~~

~~Board's Authorizing Resolution~~

✓ Proposed rule

yes Revisor's Certificate

✓ Notice of Intent to Adopt Rule

45.023, 80A.06, 80A.25 Statutory Authority

yes Small Business Statement

no Expenditure of public money statement

yes Signature

✓ Statement of Need and Reasonableness

yes Small Business Statement

Fees - § 16A.128

✓ Affidavit of Mailing Notice of Intent to Adopt Rule

9/10/87 Date 30/25 days before adoption

✓ Publication in State Register

9/21/87 Date 30/25 days before adoption

~~Resolution Adopting~~

✓ Findings of Fact, Conclusions & Order Adopting

10/22/87 Date

✓ Written requests, submissions or comments

✓ Declaration of attorney

Erica Jacobson Name of SAAG representing agency

~~Notice of Submission to Attorney General~~

~~Affidavit of Mailing Notice to Attorney General~~

SF-00006-05 (4/86)

STATE OF MINNESOTA

Office Memorandum

DEPARTMENT : ATTORNEY GENERAL

DATE : November 10, 1987

TO : RICHARD G. GOMSRUD
Commerce Division

FROM : JULIE A. LEPPINK
Special Assistant
Attorney General

PHONE : 7-3493

SUBJECT : In the Matter of the Adopted Rules Relating to Securities

The above-referenced rule has been approved as to its legality by the Attorney General on November 5, 1987.

Enclosed is the agency's copy of the approved rule. This office has already filed two copies with the Secretary of State, who will forward one copy to the Revisor of Statutes. The fourth is being retained by this division of the Attorney General's Office for its records.

Also enclosed are any petitions, requests, submission or comments received by the agency and any extra copies of documents which the agency submitted to the Attorney General.

In order for a permanent rule without a hearing to become effective, your agency must publish a notice of adoption in the State Register in accordance with Minn. Stat. § 14.27. An emergency rule becomes effective five working days after approval by the Attorney General; however, the agency must publish a notice in the State Register in accordance with Minn. Stat. § 14.34.

If you have any questions in this regard, please contact me.

JAL:nah

Enclosures

cc: Maryanne Hruby
Executive Director
Legislative Commission to Review
Adminsitrative Rules

Duane Harves
Chief Administrative Law Judge
Office of Administrative Hearings

Department of Commerce

Adopted Permanent Rules Relating to Securities

Rules as Adopted

2875.1010 INVESTMENT ADVISORY CONTRACTS.

Subpart 1. [Unchanged.]

Subp. 1a. **Exception.** Subpart 1, item A, does not apply to an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, of a client if all the conditions in items A to D are satisfied.

A. ~~Nature-of-the-client:~~

~~(1)~~ The client entering into the contract subject to this subpart must be:

(1) a natural person or a company, as defined in subpart 2, who immediately after entering into the contract has at least $500,000 under the management of the investment adviser; or

(2) a person who the investment adviser and any person acting on behalf of the adviser entering into the contract reasonably believes, immediately before entering into the contract, is a natural person or a company, as defined in subpart 2, whose net worth at the time the contract is entered into exceeds $1,000,000. The net worth of a natural person may include assets held jointly with the person's spouse.

B. The compensation paid to the investment adviser under this subpart with respect to the performance of any securities over a given period must be based on a formula which:

(1) includes, in the case of securities for which market quotations are readily available, the realized capital gains and losses and unrealized capital appreciation and depreciation of the securities over the period;

(2) includes, in the case of securities for which

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market quotations are not readily available, (i) the realized capital gains and losses of securities over the period; and (ii) if the unrealized capital appreciation of the securities over the period is included, the unrealized capital depreciation of the securities over the period; and

(3) provides that any compensation paid to the investment adviser under this subpart is based on the gains less the losses computed in accordance with item B, subitems (1) and (2), in the client's account for a period of not less than one year.

C. The investment adviser shall disclose to the client, or the client's independent agent, before entering into an advisory contract under this subpart, all material information concerning the proposed advisory arrangement including the following:

(1) that the fee arrangement may create an incentive for the investment adviser to make investments that are riskier or more speculative than would be the case in the absence of a performance fee;

(2) where relevant, that the investment adviser may receive increased compensation with regard to unrealized appreciation as well as realized gains in the client's account;

(3) the periods which will be used to measure investment performance throughout the contract and their significance in the computation of the fee;

(4) the nature of any index which will be used as a comparative measure of investment performance, the significance of the index, and the reason the investment adviser believes the index is appropriate; and

(5) where an investment adviser's compensation is based in part on the unrealized appreciation of securities for which market quotations are not readily available, how the securities will be valued, and the extent to which the valuation will be independently determined.

D. The investment adviser and any person acting on behalf of the adviser who enters into the contract must

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reasonably believe, immediately before entering into the contract, that the contract represents an arm's-length arrangement between the parties and that the client, or in the case of a client which is a company as defined in subpart 2, the person representing the company, alone or together with the client's independent agent, understands the proposed method of compensation and its risks. The representative of a company may be a partner, director, officer, or an employee of the company or the trustee, where the company is a trust, or any other person designated by the company or trustee, but must satisfy the definition of client's independent agent in subpart 2, item C.

Subp. 2. **Definitions.** As used in this part:

A. "Assignment" includes any direct or indirect transfer or hypothecation of an investment advisory contract by the assignor or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but, if the investment adviser is a partnership, no assignment of an investment advisory contract is considered to result from the death or withdrawal of a minority of the members of the investment adviser having only a minority interest in the business of the investment adviser, or from the admission to the investment adviser of one or more members who, after admission, will be only a minority of the members and will have only a minority interest in the business.

B. "Affiliate" has the same meaning as in section 2(a)(3) of the Investment Company Act. 80A

C. "Client's independent agent" means a person agreeing to act as the client's agent in connection with the contract other than:

(1) The investment adviser acting in reliance upon this part, an affiliated person of the investment adviser, an affiliated person of an affilated person of the investment adviser, or an interested person of the investment adviser as defined in item E.

(2) A person who receives, directly or

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indirectly, any compensation in connection with the contract from the investment adviser, an affiliated person of the investment adviser, an affiliated person of an affiliated person of the investment adviser, or an interested person of the investment adviser as defined in item E.

(3) A person with any material relationship between himself or herself, or an affiliated person of the person, and the investment adviser, or an affiliated person of the investment adviser, that exists or has existed at any time during the previous two years.

D. "Company" has the same meaning as in section 202(a)(5) of the Investment Advisers Act of 1940, but does not include a company that is required to be registered under the Investment Company Act of 1940, but is not registered. Further, the term "company" as used in subpart 1a, item A, does not include (i) a private investment company as defined in item G, (ii) an investment company registered under the Investment Company Act of 1940, or (iii) a business development company, as defined in section 202(a)(22) of the Investment Advisors Act of 1940, unless each of the equity owners other than the investment adviser entering into a contract under subpart 1a of any such company is a natural person or company described in this item.

E. "Interested person" as used in item C means:

(1) Any member of the immediate family of any natural person who is an affiliated person of the investment adviser.

(2) Any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued by the investment adviser or by a controlling person of the investment adviser if the beneficial or legal interest of the person in any security issued by the investment adviser or by a controlling person of the investment adviser (a) exceeds one-tenth percent of any class of outstanding securities of the investment adviser or a controlling person of the investment adviser; or (b) exceeds five percent of the total

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assets of the person seeking to act as the client's independent agent.

(3) Any person, partner, or employee of any person who at any time since the beginning of the last two years has acted as legal counsel for the investment adviser.

F. "Investment advisory contract" means any contract or agreement where a person agrees to act as an investment adviser or to manage any investment or trading account for a person other than an investment company as defined in the Investment Company Act of 1940.

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

H. "Securities for which market quotations are readily available" in subpart 1a, item B, have the same meaning as in Rule 2a-4(a)(1) under the Investment Company Act of 1940.

I. "Securities for which market quotations are not readily available" in subpart 1a, item B, means securities not described in item H.

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STATE OF MINNESOTA
DEPARTMENT OF STATE
FILED
9:03 AM
MEH
NOV 10 1987
Joan Anderson Growe
Secretary of State

APPROVED AS TO FORM AND LEGALITY
November 5 1987
HUBERT H. HUMPHREY, III
ATTORNEY GENERAL
BY Julie A Leppink
SPECIAL ASSISTANT ATTORNEY GENERAL

Department of Commerce

Proposed Permanent Rules Relating to Securities

Rules as Proposed

2875.1010 INVESTMENT ADVISORY CONTRACTS.

Subpart 1. [Unchanged.]

Subp. 1a. **Exception.** Subpart 1, item A, does not apply to an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, of a client if all the conditions in items A to D are satisfied.

A. Nature of the client:

(1) the client entering into the contract subject to this subpart must be a natural person or a company, as defined in subpart 2, who immediately after entering into the contract has at least $500,000 under the management of the investment adviser; or

(2) a person who the investment adviser and any person acting on behalf of the adviser entering into the contract reasonably believes, immediately before entering into the contract, is a natural person or a company, as defined in subpart 2, whose net worth at the time the contract is entered into exceeds $1,000,000. The net worth of a natural person may include assets held jointly with the person's spouse.

B. The compensation paid to the investment adviser under this subpart with respect to the performance of any securities over a given period must be based on a formula which:

(1) includes, in the case of securities for which market quotations are readily available, the realized capital gains and losses and unrealized capital appreciation and depreciation of the securities over the period;

(2) includes, in the case of securities for which market quotations are not readily available, (i) the realized

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capital gains and losses of securities over the period; and (ii) if the unrealized capital appreciation of the securities over the period is included, the unrealized capital depreciation of the securities over the period; and

(3) provides that any compensation paid to the investment adviser under this subpart is based on the gains less the losses computed in accordance with item B, subitems (1) and (2), in the client's account for a period of not less than one year.

C. The investment adviser shall disclose to the client, or the client's independent agent, before entering into an advisory contract under this subpart, all material information concerning the proposed advisory arrangement including the following:

(1) that the fee arrangement may create an incentive for the investment adviser to make investments that are riskier or more speculative than would be the case in the absence of a performance fee;

(2) where relevant, that the investment adviser may receive increased compensation with regard to unrealized appreciation as well as realized gains in the client's account;

(3) the periods which will be used to measure investment performance throughout the contract and their significance in the computation of the fee;

(4) the nature of any index which will be used as a comparative measure of investment performance, the significance of the index, and the reason the investment adviser believes the index is appropriate; and

(5) where an investment adviser's compensation is based in part on the unrealized appreciation of securities for which market quotations are not readily available, how the securities will be valued, and the extent to which the valuation will be independently determined.

D. The investment adviser and any person acting on behalf of the adviser who enters into the contract must reasonably believe, immediately before entering into the

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contract, that the contract represents an arm's-length arrangement between the parties and that the client, or in the case of a client which is a company as defined in subpart 2, the person representing the company, alone or together with the client's independent agent, understands the proposed method of compensation and its risks. The representative of a company may be a partner, director, officer, or an employee of the company or the trustee, where the company is a trust, or any other person designated by the company or trustee, but must satisfy the definition of client's independent agent in subpart 2, item C.

Subp. 2. **Definitions.** As used in ~~subpart 1~~ this part:

A. "Assignment" includes any direct or indirect transfer or hypothecation of an investment advisory contract by the assignor or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but, if the investment adviser is a partnership, no assignment of an investment advisory contract is considered to result from the death or withdrawal of a minority of the members of the investment adviser having only a minority interest in the business of the investment adviser, or from the admission to the investment adviser of one or more members who, after admission, will be only a minority of the members and will have only a minority interest in the business.

B. "Affiliate" has the same meaning as in section 2(a)(3) of the Investment Company Act.

C. "Client's independent agent" means a person agreeing to act as the client's agent in connection with the contract other than:

(1) The investment adviser acting in reliance upon this part, an affiliated person of the investment adviser, an affiliated person of an affilated person of the investment adviser, or an interested person of the investment adviser as defined in item E.

(2) A person who receives, directly or indirectly, any compensation in connection with the contract

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from the investment adviser, an affiliated person of the investment adviser, an affiliated person of an affiliated person of the investment adviser, or an interested person of the investment adviser as defined in item E.

(3) A person with any material relationship between himself or herself, or an affiliated person of the person, and the investment adviser, or an affiliated person of the investment adviser, that exists or has existed at any time during the previous two years.

D. "Company" has the same meaning as in section 202(a)(5) of the Investment Advisers Act of 1940, but does not include a company that is required to be registered under the Investment Company Act of 1940, but is not registered. Further, the term "company" as used in subpart 1a, item A, does not include (i) a private investment company as defined in item G, (ii) an investment company registered under the Investment Company Act of 1940, or (iii) a business development company, as defined in section 202(a)(22) of the Investment Advisors Act of 1940, unless each of the equity owners other than the investment adviser entering into a contract under subpart 1a of any such company is a natural person or company described in this item.

E. "Interested person" as used in item C means:

(1) Any member of the immediate family of any natural person who is an affiliated person of the investment adviser.

(2) Any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued by the investment adviser or by a controlling person of the investment adviser if the beneficial or legal interest of the person in any security issued by the investment adviser or by a controlling person of the investment adviser (a) exceeds one-tenth percent of any class of outstanding securities of the investment adviser or a controlling person of the investment adviser; or (b) exceeds five percent of the total assets of the person seeking to act as the client's independent

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agent.

(3) Any person, partner, or employee of any person who at any time since the beginning of the last two years has acted as legal counsel for the investment adviser.

F. "Investment advisory contract" means any contract or agreement ~~whereby~~ where a person agrees to act as an investment adviser or to manage any investment or trading account for a person other than an investment company as defined in the Investment Company Act of 1940.

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

H. "Securities for which market quotations are readily available" in subpart 1a, item B, have the same meaning as in Rule 2a-4(a)(1) under the Investment Company Act of 1940.

I. "Securities for which market quotations are not readily available" in subpart 1a, item B, means securities not described in item H.

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Office of the Revisor of Statutes

Administrative Rules

TITLE: Proposed Permanent Rules Relating to Securities

AGENCY: Department of Commerce

MINNESOTA RULES: Chapter 2875

The attached rules are approved for publication
in the State Register

Paul M. Marinac
Assistant Deputy Revisor

STATE OF MINNESOTA

DEPARTMENT OF COMMERCE
500 METRO SQUARE BUILDING
ST. PAUL, MN 55101

ATTENTION:
RULE RELATED MATERIAL

FIRST CLASS MAIL

State of Minnesota
Department of Commerce

In the Matter of the Proposed Adoption of Rules Relating to Securities

Notice of Intent to Adopt Rules Without a Public Hearing

Notice is hereby given that the Department of Commerce intends to adopt the above-entitled rules without a public hearing following the procedures set forth in the Administrative Procedures Act for adopted rules without a public hearing in Minnesota Statutes, section 14.22-14.28. Authority for the adoption of these rules is contained in Minnesota Statutes, Sections 45.023 and 80A.06 subd. 5 and 80A.25.

All persons have 30 days to submit comments in support of or in opposition to the proposed rule or any part or subpart of the rule. Comment is encouraged. Each comment should identify the portion of the proposed rule addressed, the reason for the comment, and any change proposed. The proposed rules may be modified if the modifications are supported by the data and views submitted to the Department and do not result in a substantial change.

Any person may make a written request for a public hearing within the 30 day comment period. If 25 or more persons submit a written request for a public hearing within the 30 day comment period, a public hearing will be held unless a sufficient number withdraw their request in writing. Any person requesting a hearing should state his or her name and address, and is encouraged to identify the portion of the proposed rule addressed, the reason for the request, and any change proposed. If a public hearing is required, the department will proceed pursuant to Minnesota Statutes, sections 14.13 to 14.20.

Persons who wish to submit comments or a written request for a public hearing should submit them to:

Kristine Eiden
Deputy Commissioner
Department of Commerce
500 Metro Square Building
St. Paul, MN 55101
(612) 296-6329

A Statement of Need and Reasonableness that describes the need for and reasonableness of each provision of the proposed rule and identifying the data and information relied upon to support the proposed rules has been prepared and is available upon request from Richard Gomsrud.

Pursuant to Minnesota Statutes Section 14.115, subdivision 2, the impact on small business has been considered in the promulgation of the rules. Anyone wishing to present evidence or argument as to the rules' effect on small business may do so. The Department's position regarding the impact of the rules on small business is set forth in the Statement of Need and Reasonableness.

Upon adoption of the final rules without a public hearing, the proposed rules, this Notice, the Statement of Need and Reasonablenss, all written comments received, and the final Rules as Adopted will be delivered to the Attorney General for review as to form and legality, including the issue of substantial change. Persons who wish to be advised of the submission of this material to the Attorney General, or who wish to receive a copy of the final rules as proposed for adoption, should submit a written statement of such request to Richard G. Gomsrud, Department Counsel, Department of Commerce, 500 Metro Square Bldg., St. Paul, MN 55101.

A copy of the proposed rules is attached to this Notice. Copies of this Notice and proposed rules are available and may be obtained by contacting Richard G. Gomsrud at the above address.

Michael A. Hatch
Commissioner of Commerce

Department of Commerce

Proposed Permanent Rules Relating to Securities

Rules as Proposed

2875.1010 INVESTMENT ADVISORY CONTRACTS.

Subpart 1. [Unchanged.]

Subp. 1a. **Exception.** Subpart 1, item A, does not apply to an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, of a client if all the conditions in items A to D are satisfied.

A. Nature of the client:

(1) the client entering into the contract subject to this subpart must be a natural person or a company, as defined in subpart 2, who immediately after entering into the contract has at least $500,000 under the management of the investment adviser; or

(2) a person who the investment adviser and any person acting on behalf of the adviser entering into the contract reasonably believes, immediately before entering into the contract, is a natural person or a company, as defined in subpart 2, whose net worth at the time the contract is entered into exceeds $1,000,000. The net worth of a natural person may include assets held jointly with the person's spouse.

B. The compensation paid to the investment adviser under this subpart with respect to the performance of any securities over a given period must be based on a formula which:

(1) includes, in the case of securities for which market quotations are readily available, the realized capital gains and losses and unrealized capital appreciation and depreciation of the securities over the period;

(2) includes, in the case of securities for which market quotations are not readily available, (i) the realized

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capital gains and losses of securities over the period; and (ii) if the unrealized capital appreciation of the securities over the period is included, the unrealized capital depreciation of the securities over the period; and

(3) provides that any compensation paid to the investment adviser under this subpart is based on the gains less the losses computed in accordance with item B, subitems (1) and (2), in the client's account for a period of not less than one year.

C. The investment adviser shall disclose to the client, or the client's independent agent, before entering into an advisory contract under this subpart, all material information concerning the proposed advisory arrangement including the following:

(1) that the fee arrangement may create an incentive for the investment adviser to make investments that are riskier or more speculative than would be the case in the absence of a performance fee;

(2) where relevant, that the investment adviser may receive increased compensation with regard to unrealized appreciation as well as realized gains in the client's account;

(3) the periods which will be used to measure investment performance throughout the contract and their significance in the computation of the fee;

(4) the nature of any index which will be used as a comparative measure of investment performance, the significance of the index, and the reason the investment adviser believes the index is appropriate; and

(5) where an investment adviser's compensation is based in part on the unrealized appreciation of securities for which market quotations are not readily available, how the securities will be valued, and the extent to which the valuation will be independently determined.

D. The investment adviser and any person acting on behalf of the adviser who enters into the contract must reasonably believe, immediately before entering into the

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contract, that the contract represents an arm's-length arrangement between the parties and that the client, or in the case of a client which is a company as defined in subpart 2, the person representing the company, alone or together with the client's independent agent, understands the proposed method of compensation and its risks. The representative of a company may be a partner, director, officer, or an employee of the company or the trustee, where the company is a trust, or any other person designated by the company or trustee, but must satisfy the definition of client's independent agent in subpart 2, item C.

Subp. 2. **Definitions.** As used in ~~subpart 1~~ this part:

A. "Assignment" includes any direct or indirect transfer or hypothecation of an investment advisory contract by the assignor or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but, if the investment adviser is a partnership, no assignment of an investment advisory contract is considered to result from the death or withdrawal of a minority of the members of the investment adviser having only a minority interest in the business of the investment adviser, or from the admission to the investment adviser of one or more members who, after admission, will be only a minority of the members and will have only a minority interest in the business.

B. "Affiliate" has the same meaning as in section 2(a)(3) of the Investment Company Act.

C. "Client's independent agent" means a person agreeing to act as the client's agent in connection with the contract other than:

(1) The investment adviser acting in reliance upon this part, an affiliated person of the investment adviser, an affiliated person of an affilated person of the investment adviser, or an interested person of the investment adviser as defined in item E.

(2) A person who receives, directly or indirectly, any compensation in connection with the contract

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from the investment adviser, an affiliated person of the investment adviser, an affiliated person of an affiliated person of the investment adviser, or an interested person of the investment adviser as defined in item E.

(3) A person with any material relationship between himself or herself, or an affiliated person of the person, and the investment adviser, or an affiliated person of the investment adviser, that exists or has existed at any time during the previous two years.

D. "Company" has the same meaning as in section 202(a)(5) of the Investment Advisers Act of 1940, but does not include a company that is required to be registered under the Investment Company Act of 1940, but is not registered. Further, the term "company" as used in subpart 1a, item A, does not include (i) a private investment company as defined in item G, (ii) an investment company registered under the Investment Company Act of 1940, or (iii) a business development company, as defined in section 202(a)(22) of the Investment Advisors Act of 1940, unless each of the equity owners other than the investment adviser entering into a contract under subpart 1a of any such company is a natural person or company described in this item.

E. "Interested person" as used in item C means:

(1) Any member of the immediate family of any natural person who is an affiliated person of the investment adviser.

(2) Any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued by the investment adviser or by a controlling person of the investment adviser if the beneficial or legal interest of the person in any security issued by the investment adviser or by a controlling person of the investment adviser (a) exceeds one-tenth percent of any class of outstanding securities of the investment adviser or a controlling person of the investment adviser; or (b) exceeds five percent of the total assets of the person seeking to act as the client's independent

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agent.

(3) Any person, partner, or employee of any person who at any time since the beginning of the last two years has acted as legal counsel for the investment adviser.

F. "Investment advisory contract" means any contract or agreement ~~whereby~~ where a person agrees to act as an investment adviser or to manage any investment or trading account for a person other than an investment company as defined in the Investment Company Act of 1940.

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

H. "Securities for which market quotations are readily available" in subpart 1a, item B, have the same meaning as in Rule 2a-4(a)(1) under the Investment Company Act of 1940.

I. "Securities for which market quotations are not readily available" in subpart 1a, item B, means securities not described in item H.

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by Revisor _____

STATE OF MINNESOTA
DEPARTMENT OF COMMERCE

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

STATEMENT OF AUTHORITY

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

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

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

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

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

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

FACTS ESTABLISHING NEED AND REASONABLENESS

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

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

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

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

Part 2875.1010, subpart 1a

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

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

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

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

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

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

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

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

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

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

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

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

pertaining to incentive fees.

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

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

2875.1010, subpart 2.

Subpart 2 defines terms contained in subparts 1 and 2.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Item I provides that "securities for which market quotations

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

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

Small Business Considerations

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

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

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

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

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

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

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

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

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

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

In the Matter of the Proposed Rules
Regarding Securities

STATE OF MINNESOTA)
) ss
COUNTY OF RAMSEY)

AFFIDAVIT OF
MAILING

Jane Schaub, being first duly sworn, deposes and says:

I hereby certify that the list of persons, associations, and other interested groups who have requested, pursuant to Minnesota Statutes, section 14.14, subd. 1a, that their names be placed on file with and maintained by the Department of Commerce for the purpose of receiving notice of the proposed adoption of rules is accurate and complete as of 12:00 P.M., this day 10th day of September 1987.

That on the 10th day of September 1987, at the City of St. Paul, County of Ramsey, State of Minnesota, the attached Notice of Intent to Adopt Rules Without a Public Hearing was served by depositing in the State of Minnesota Central Mail System for United States mailing at said City of St. Paul, a copy properly prepared with first-class postage prepaid, on all persons and associations who have requested that their names be placed on file with the Minnesota Department of Commerce for the purpose of receiving notice of the proposed adoption of rules by the department.

Jane Schaub
Jane Schaub

Subscribed and sworn to before me
this 29th day of October 1987.

Cynthia L Claason
Notary Public

CYNTHIA L. CLAASON
NOTARY PUBLIC-MINNESOTA
RAMSEY COUNTY
MY COMMISSION EXPIRES FEBRUARY 11, 1992

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Minnesota League of Credit Unions
575 University Ave.
St. Paul, MN 55103

MN Truckers Association
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STATE OF MINNESOTA

DEPARTMENT OF COMMERCE
500 METRO SQUARE BUILDING
ST. PAUL, MN 55101

ATTENTION:

RULE RELATED MATERIAL

FIRST CLASS MAIL

State of Minnesota
Department of Commerce

In the Matter of the Proposed Adoption of Rules Relating to Securities

Notice of Intent to Adopt Rules Without a Public Hearing

Notice is hereby given that the Department of Commerce intends to adopt the above-entitled rules without a public hearing following the procedures set forth in the Administrative Procedures Act for adopted rules without a public hearing in Minnesota Statutes, section 14.22-14.28. Authority for the adoption of these rules is contained in Minnesota Statutes, Sections 45.023 and 80A.06 subd. 5 and 80A.25.

All persons have 30 days to submit comments in support of or in opposition to the proposed rule or any part or subpart of the rule. Comment is encouraged. Each comment should identify the portion of the proposed rule addressed, the reason for the comment, and any change proposed. The proposed rules may be modified if the modifications are supported by the data and views submitted to the Department and do not result in a substantial change.

Any person may make a written request for a public hearing within the 30 day comment period. If 25 or more persons submit a written request for a public hearing within the 30 day comment period, a public hearing will be held unless a sufficient number withdraw their request in writing. Any person requesting a hearing should state his or her name and address, and is encouraged to identify the portion of the proposed rule addressed, the reason for the request, and any change proposed. If a public hearing is required, the department will proceed pursuant to Minnesota Statutes, sections 14.13 to 14.20.

Persons who wish to submit comments or a written request for a public hearing should submit them to:

Kristine Eiden
Deputy Commissioner
Department of Commerce
500 Metro Square Building
St. Paul, MN 55101
(612) 296-6329

A Statement of Need and Reasonableness that describes the need for and reasonableness of each provision of the proposed rule and identifying the data and information relied upon to support the proposed rules has been prepared and is available upon request from Richard Gomsrud.

Pursuant to Minnesota Statutes Section 14.115, subdivision 2, the impact on small business has been considered in the promulgation of the rules. Anyone wishing to present evidence or argument as to the rules' effect on small business may do so. The Department's position regarding the impact of the rules on small business is set forth in the Statement of Need and Reasonableness.

Upon adoption of the final rules without a public hearing, the proposed rules, this Notice, the Statement of Need and Reasonablenss, all written comments received, and the final Rules as Adopted will be delivered to the Attorney General for review as to form and legality, including the issue of substantial change. Persons who wish to be advised of the submission of this material to the Attorney General, or who wish to receive a copy of the final rules as proposed for adoption, should submit a written statement of such request to Richard G. Gomsrud, Department Counsel, Department of Commerce, 500 Metro Square Bldg., St. Paul, MN 55101.

A copy of the proposed rules is attached to this Notice. Copies of this Notice and proposed rules are available and may be obtained by contacting Richard G. Gomsrud at the above address.

Michael A. Hatch
Commissioner of Commerce

Department of Commerce

Proposed Permanent Rules Relating to Securities

Rules as Proposed

2875.1010 INVESTMENT ADVISORY CONTRACTS.

Subpart 1. [Unchanged.]

Subp. 1a. **Exception.** Subpart 1, item A, does not apply to an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, of a client if all the conditions in items A to D are satisfied.

A. Nature of the client:

(1) the client entering into the contract subject to this subpart must be a natural person or a company, as defined in subpart 2, who immediately after entering into the contract has at least $500,000 under the management of the investment adviser; or

(2) a person who the investment adviser and any person acting on behalf of the adviser entering into the contract reasonably believes, immediately before entering into the contract, is a natural person or a company, as defined in subpart 2, whose net worth at the time the contract is entered into exceeds $1,000,000. The net worth of a natural person may include assets held jointly with the person's spouse.

B. The compensation paid to the investment adviser under this subpart with respect to the performance of any securities over a given period must be based on a formula which:

(1) includes, in the case of securities for which market quotations are readily available, the realized capital gains and losses and unrealized capital appreciation and depreciation of the securities over the period;

(2) includes, in the case of securities for which market quotations are not readily available, (i) the realized

Approved by Revisor

capital gains and losses of securities over the period; and (ii) if the unrealized capital appreciation of the securities over the period is included, the unrealized capital depreciation of the securities over the period; and

(3) provides that any compensation paid to the investment adviser under this subpart is based on the gains less the losses computed in accordance with item B, subitems (1) and (2), in the client's account for a period of not less than one year.

C. The investment adviser shall disclose to the client, or the client's independent agent, before entering into an advisory contract under this subpart, all material information concerning the proposed advisory arrangement including the following:

(1) that the fee arrangement may create an incentive for the investment adviser to make investments that are riskier or more speculative than would be the case in the absence of a performance fee;

(2) where relevant, that the investment adviser may receive increased compensation with regard to unrealized appreciation as well as realized gains in the client's account;

(3) the periods which will be used to measure investment performance throughout the contract and their significance in the computation of the fee;

(4) the nature of any index which will be used as a comparative measure of investment performance, the significance of the index, and the reason the investment adviser believes the index is appropriate; and

(5) where an investment adviser's compensation is based in part on the unrealized appreciation of securities for which market quotations are not readily available, how the securities will be valued, and the extent to which the valuation will be independently determined.

D. The investment adviser and any person acting on behalf of the adviser who enters into the contract must reasonably believe, immediately before entering into the

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contract, that the contract represents an arm's-length arrangement between the parties and that the client, or in the case of a client which is a company as defined in subpart 2, the person representing the company, alone or together with the client's independent agent, understands the proposed method of compensation and its risks. The representative of a company may be a partner, director, officer, or an employee of the company or the trustee, where the company is a trust, or any other person designated by the company or trustee, but must satisfy the definition of client's independent agent in subpart 2, item C.

Subp. 2. **Definitions.** As used in ~~subpart 1~~ this part:

A. "Assignment" includes any direct or indirect transfer or hypothecation of an investment advisory contract by the assignor or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but, if the investment adviser is a partnership, no assignment of an investment advisory contract is considered to result from the death or withdrawal of a minority of the members of the investment adviser having only a minority interest in the business of the investment adviser, or from the admission to the investment adviser of one or more members who, after admission, will be only a minority of the members and will have only a minority interest in the business.

B. "Affiliate" has the same meaning as in section 2(a)(3) of the Investment Company Act.

C. "Client's independent agent" means a person agreeing to act as the client's agent in connection with the contract other than:

(1) The investment adviser acting in reliance upon this part, an affiliated person of the investment adviser, an affiliated person of an affilated person of the investment adviser, or an interested person of the investment adviser as defined in item E.

(2) A person who receives, directly or indirectly, any compensation in connection with the contract

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from the investment adviser, an affiliated person of the investment adviser, an affiliated person of an affiliated person of the investment adviser, or an interested person of the investment adviser as defined in item E.

(3) A person with any material relationship between himself or herself, or an affiliated person of the person, and the investment adviser, or an affiliated person of the investment adviser, that exists or has existed at any time during the previous two years.

D. "Company" has the same meaning as in section 202(a)(5) of the Investment Advisers Act of 1940, but does not include a company that is required to be registered under the Investment Company Act of 1940, but is not registered. Further, the term "company" as used in subpart 1a, item A, does not include (i) a private investment company as defined in item G, (ii) an investment company registered under the Investment Company Act of 1940, or (iii) a business development company, as defined in section 202(a)(22) of the Investment Advisors Act of 1940, unless each of the equity owners other than the investment adviser entering into a contract under subpart 1a of any such company is a natural person or company described in this item.

E. "Interested person" as used in item C means:

(1) Any member of the immediate family of any natural person who is an affiliated person of the investment adviser.

(2) Any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued by the investment adviser or by a controlling person of the investment adviser if the beneficial or legal interest of the person in any security issued by the investment adviser or by a controlling person of the investment adviser (a) exceeds one-tenth percent of any class of outstanding securities of the investment adviser or a controlling person of the investment adviser; or (b) exceeds five percent of the total assets of the person seeking to act as the client's independent

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agent.

(3) Any person, partner, or employee of any person who at any time since the beginning of the last two years has acted as legal counsel for the investment adviser.

F. "Investment advisory contract" means any contract or agreement ~~whereby~~ where a person agrees to act as an investment adviser or to manage any investment or trading account for a person other than an investment company as defined in the Investment Company Act of 1940.

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

H. "Securities for which market quotations are readily available" in subpart 1a, item B, have the same meaning as in Rule 2a-4(a)(1) under the Investment Company Act of 1940.

I. "Securities for which market quotations are not readily available" in subpart 1a, item B, means securities not described in item H.

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STATE OF MINNESOTA

COUNTY OF RAMSEY

CERTIFICATE

In the Matter of the Proposed Rules
Regarding Securities

I hereby certify that the list of persons, associations, and other interested groups who have requested, pursuant to Minnesota Statutes, section 14.14, subd. 1a, that their names be placed on file with and maintained by the Department of Commerce for the purpose of receiving notice of the proposed adoption of rules is accurate and complete as of 12:00 P.M., this 10th day of September 1987.

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Jane Schaub

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575 University Ave.
St. Paul, MN 55103

MN Truckers Association
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400 North Robert Street
St. Paul, MN 55101-2092

In the Matter of the Proposed Rules
Regarding Securities

STATE OF MINNESOTA)
) ss
COUNTY OF RAMSEY)

AFFIDAVIT OF
MAILING

Jane Schaub, being first duly sworn, deposes and says:

That on the 10th day of September 1987, at the City of St. Paul, County of Ramsey, State of Minnesota, the attached Notice of Hearing was served by depositing in the State of Minnesota Central Mail System for United States mailing at said City of St. Paul, a copy properly prepared with first-class postage prepaid, on all persons and associations who have requested that their names be placed on file with the Minnesota Department of Commerce for the purpose of receiving notice of the proposed adoption of rules by the department.

Jane Schaub

Jane Schaub

Subscribed and sworn to before me
this 10th day of September 1987.

Cynthia L. Claason

Notary Public

CYNTHIA L. CLAASON
NOTARY PUBLIC-MINNESOTA
RAMSEY COUNTY
MY COMMISSION EXPIRES FEBRUARY 11, 1992

STATE OF MINNESOTA

DEPARTMENT OF COMMERCE
500 METRO SQUARE BUILDING
ST. PAUL, MN 55101

ATTENTION:
RULE RELATED MATERIAL

FIRST CLASS MAIL

State of Minnesota
Department of Commerce

In the Matter of the Proposed Adoption of Rules Relating to Securities

Notice of Intent to Adopt Rules Without a Public Hearing

Notice is hereby given that the Department of Commerce intends to adopt the above-entitled rules without a public hearing following the procedures set forth in the Administrative Procedures Act for adopted rules without a public hearing in Minnesota Statutes, section 14.22-14.28. Authority for the adoption of these rules is contained in Minnesota Statutes, Sections 45.023 and 80A.06 subd. 5 and 80A.25.

All persons have 30 days to submit comments in support of or in opposition to the proposed rule or any part or subpart of the rule. Comment is encouraged. Each comment should identify the portion of the proposed rule addressed, the reason for the comment, and any change proposed. The proposed rules may be modified if the modifications are supported by the data and views submitted to the Department and do not result in a substantial change.

Any person may make a written request for a public hearing within the 30 day comment period. If 25 or more persons submit a written request for a public hearing within the 30 day comment period, a public hearing will be held unless a sufficient number withdraw their request in writing. Any person requesting a hearing should state his or her name and address, and is encouraged to identify the portion of the proposed rule addressed, the reason for the request, and any change proposed. If a public hearing is required, the department will proceed pursuant to Minnesota Statutes, sections 14.13 to 14.20.

Persons who wish to submit comments or a written request for a public hearing should submit them to:

Kristine Eiden
Deputy Commissioner
Department of Commerce
500 Metro Square Building
St. Paul, MN 55101
(612) 296-6329

A Statement of Need and Reasonableness that describes the need for and reasonableness of each provision of the proposed rule and identifying the data and information relied upon to support the proposed rules has been prepared and is available upon request from Richard Gomsrud.

Pursuant to Minnesota Statutes Section 14.115, subdivision 2, the impact on small business has been considered in the promulgation of the rules. Anyone wishing to present evidence or argument as to the rules' effect on small business may do so. The Department's position regarding the impact of the rules on small business is set forth in the Statement of Need and Reasonableness.

Upon adoption of the final rules without a public hearing, the proposed rules, this Notice, the Statement of Need and Reasonablenss, all written comments received, and the final Rules as Adopted will be delivered to the Attorney General for review as to form and legality, including the issue of substantial change. Persons who wish to be advised of the submission of this material to the Attorney General, or who wish to receive a copy of the final rules as proposed for adoption, should submit a written statement of such request to Richard G. Gomsrud, Department Counsel, Department of Commerce, 500 Metro Square Bldg., St. Paul, MN 55101.

A copy of the proposed rules is attached to this Notice. Copies of this Notice and proposed rules are available and may be obtained by contacting Richard G. Gomsrud at the above address.

Michael A. Hatch
Commissioner of Commerce

Department of Commerce

Proposed Permanent Rules Relating to Securities

Rules as Proposed

2875.1010 INVESTMENT ADVISORY CONTRACTS.

Subpart 1. [Unchanged.]

Subp. 1a. **Exception.** Subpart 1, item A, does not apply to an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, of a client if all the conditions in items A to D are satisfied.

A. Nature of the client:

(1) the client entering into the contract subject to this subpart must be a natural person or a company, as defined in subpart 2, who immediately after entering into the contract has at least $500,000 under the management of the investment adviser; or

(2) a person who the investment adviser and any person acting on behalf of the adviser entering into the contract reasonably believes, immediately before entering into the contract, is a natural person or a company, as defined in subpart 2, whose net worth at the time the contract is entered into exceeds $1,000,000. The net worth of a natural person may include assets held jointly with the person's spouse.

B. The compensation paid to the investment adviser under this subpart with respect to the performance of any securities over a given period must be based on a formula which:

(1) includes, in the case of securities for which market quotations are readily available, the realized capital gains and losses and unrealized capital appreciation and depreciation of the securities over the period;

(2) includes, in the case of securities for which market quotations are not readily available, (i) the realized

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capital gains and losses of securities over the period; and (ii) if the unrealized capital appreciation of the securities over the period is included, the unrealized capital depreciation of the securities over the period; and

(3) provides that any compensation paid to the investment adviser under this subpart is based on the gains less the losses computed in accordance with item B, subitems (1) and (2), in the client's account for a period of not less than one year.

C. The investment adviser shall disclose to the client, or the client's independent agent, before entering into an advisory contract under this subpart, all material information concerning the proposed advisory arrangement including the following:

(1) that the fee arrangement may create an incentive for the investment adviser to make investments that are riskier or more speculative than would be the case in the absence of a performance fee;

(2) where relevant, that the investment adviser may receive increased compensation with regard to unrealized appreciation as well as realized gains in the client's account;

(3) the periods which will be used to measure investment performance throughout the contract and their significance in the computation of the fee;

(4) the nature of any index which will be used as a comparative measure of investment performance, the significance of the index, and the reason the investment adviser believes the index is appropriate; and

(5) where an investment adviser's compensation is based in part on the unrealized appreciation of securities for which market quotations are not readily available, how the securities will be valued, and the extent to which the valuation will be independently determined.

D. The investment adviser and any person acting on behalf of the adviser who enters into the contract must reasonably believe, immediately before entering into the

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contract, that the contract represents an arm's-length arrangement between the parties and that the client, or in the case of a client which is a company as defined in subpart 2, the person representing the company, alone or together with the client's independent agent, understands the proposed method of compensation and its risks. The representative of a company may be a partner, director, officer, or an employee of the company or the trustee, where the company is a trust, or any other person designated by the company or trustee, but must satisfy the definition of client's independent agent in subpart 2, item C.

Subp. 2. **Definitions.** As used in ~~subpart 1~~ this part:

A. "Assignment" includes any direct or indirect transfer or hypothecation of an investment advisory contract by the assignor or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but, if the investment adviser is a partnership, no assignment of an investment advisory contract is considered to result from the death or withdrawal of a minority of the members of the investment adviser having only a minority interest in the business of the investment adviser, or from the admission to the investment adviser of one or more members who, after admission, will be only a minority of the members and will have only a minority interest in the business.

B. "Affiliate" has the same meaning as in section 2(a)(3) of the Investment Company Act.

C. "Client's independent agent" means a person agreeing to act as the client's agent in connection with the contract other than:

(1) The investment adviser acting in reliance upon this part, an affiliated person of the investment adviser, an affiliated person of an affilated person of the investment adviser, or an interested person of the investment adviser as defined in item E.

(2) A person who receives, directly or indirectly, any compensation in connection with the contract

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from the investment adviser, an affiliated person of the investment adviser, an affiliated person of an affiliated person of the investment adviser, or an interested person of the investment adviser as defined in item E.

(3) A person with any material relationship between himself or herself, or an affiliated person of the person, and the investment adviser, or an affiliated person of the investment adviser, that exists or has existed at any time during the previous two years.

D. "Company" has the same meaning as in section 202(a)(5) of the Investment Advisers Act of 1940, but does not include a company that is required to be registered under the Investment Company Act of 1940, but is not registered. Further, the term "company" as used in subpart 1a, item A, does not include (i) a private investment company as defined in item G, (ii) an investment company registered under the Investment Company Act of 1940, or (iii) a business development company, as defined in section 202(a)(22) of the Investment Advisors Act of 1940, unless each of the equity owners other than the investment adviser entering into a contract under subpart 1a of any such company is a natural person or company described in this item.

E. "Interested person" as used in item C means:

(1) Any member of the immediate family of any natural person who is an affiliated person of the investment adviser.

(2) Any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued by the investment adviser or by a controlling person of the investment adviser if the beneficial or legal interest of the person in any security issued by the investment adviser or by a controlling person of the investment adviser (a) exceeds one-tenth percent of any class of outstanding securities of the investment adviser or a controlling person of the investment adviser; or (b) exceeds five percent of the total assets of the person seeking to act as the client's independent

Approved by Revisor _____

agent.

(3) Any person, partner, or employee of any person who at any time since the beginning of the last two years has acted as legal counsel for the investment adviser.

F. "Investment advisory contract" means any contract or agreement ~~whereby~~ where a person agrees to act as an investment adviser or to manage any investment or trading account for a person other than an investment company as defined in the Investment Company Act of 1940.

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

H. "Securities for which market quotations are readily available" in subpart 1a, item B, have the same meaning as in Rule 2a-4(a)(1) under the Investment Company Act of 1940.

I. "Securities for which market quotations are not readily available" in subpart 1a, item B, means securities not described in item H.

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State of Minnesota

STATE REGISTER

Department of Administration—Documents Division



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Proposed Rules

Pursuant to Minn. Stat. of 1984, §§ 14.22, an agency may propose to adopt, amend, suspend or repeal rules without first holding a public hearing, as long as the agency determines that the rules will be noncontroversial in nature. The agency must first publish a notice of intent to adopt rules without a public hearing, together with the proposed rules, in the *State Register*. The notice must advise the public:

1. **that they have 30 days in which to submit comment on the proposed rules;**
2. **that no public hearing will be held unless 25 or more persons make a written request for a hearing within the 30-day comment period;**
3. **of the manner in which persons shall request a hearing on the proposed rules; and**
4. **that the rule may be modified if the modifications are supported by the data and views submitted.**

If, during the 30-day comment period, 25 or more persons submit to the agency a written request for a hearing of the proposed rules, the agency must proceed under the provisions of §§ 14.14-14.20, which state that if an agency decides to hold a public hearing, it must publish a notice of intent in the *State Register*.

Pursuant to Minn. Stat. §§ 14.29 and 14.30, agencies may propose emergency rules under certain circumstances. Proposed emergency rules are published in the *State Register* and, for at least 25 days thereafter, interested persons may submit data and views in writing to the proposing agency.

Department of Commerce

Proposed Permanent Rules Relating to Securities

Notice of Intent to Adopt Rules Without a Public Hearing

Notice is hereby given that the Department of Commerce intends to adopt the above-entitled rules without a public hearing following the procedures set forth in the Administrative Procedures Act for adopted rules without a public hearing in *Minnesota Statutes*, Sections 45.023 and 80A.06 subd. 5 and 80A.25.

All persons have 30 days to submit comments in support of or in opposition to the proposed rule or any part or subpart of the rule. Comment is encouraged. Each comment should identify the portion of the proposed rule addressed, the reason for the comment, and any change proposed. The proposed rules may be modified if the modifications are supported by the data and views submitted to the Department and do not result in a substantial change.

Any person may make a written request for a public hearing within the 30 day comment period. If 25 or more persons submit a written request for a public hearing within the 30 day comment period, a public hearing will be held unless a sufficient number withdraw their request in writing. Any person requesting a hearing should state his or her name and address, and is encouraged to identify the portion of the proposed rule addressed, the reason for the request, and any change proposed. If a public hearing is required, the department will proceed pursuant to *Minnesota Statutes*, sections 14.13 to 14.20.

Persons who wish to submit comments or a written request for a public hearing should submit them to:

Kristine Eiden
Deputy Commissioner
Department of Commerce
500 Metro Square Building
St. Paul, MN 55101
(612) 296-6329

A Statement of Need and Reasonableness that describes the need for and reasonableness of each provision of the proposed rule and identifying the data and information relied upon to support the proposed rules has been prepared and is available upon request from Richard Gomsrud.

Pursuant to *Minnesota Statutes* Section 14.115, subdivision 2, the impact on small business has been considered in the promulgation of the rules. Anyone wishing to present evidence or argument as to the rules' effect on small business may do so. The Department's position regarding the impact of the rules on small business is set forth in the Statement of Need and Reasonableness.

Upon adoption of the final rules without a public hearing, the proposed rules, this Notice, the Statement of Need and Reasonableness, all written comments received, and the final Rules as Adopted will be delivered to the Attorney General for review as to form and legality, including the issue of substantial change. Persons who wish to be advised of the submission of this material to the Attorney General, or who wish to receive a copy of the final rules as proposed for adoption, should submit a written statement of such request to Richard G. Gomsrud, Department Counsel, Department of Commerce, 500 Metro Square Bldg., St. Paul, MN 55101.

A copy of the proposed rules is attached to this Notice. Copies of this Notice and proposed rules are available and may be obtained by contacting Richard G. Gomsrud at the above address.

Michael A. Hatch
Commissioner of Commerce

Rules as Proposed

2875.1010 INVESTMENT ADVISORY CONTRACTS.

Subpart 1. [Unchanged.]

Subp. 1a. **Exception.** Subpart 1, item A, does not apply to an investment advisory contract that provides for compensation to the investment adviser on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, of a client if all the conditions in items A to D are satisfied.

A. Nature of the client:

(1) the client entering into the contract subject to this subpart must be a natural person or a company, as defined in subpart 2, who immediately after entering into the contract has at least $500,000 under the management of the investment adviser; or

(2) a person who the investment adviser and any person acting on behalf of the adviser entering into the contract reasonably believes, immediately before entering into the contract, is a natural person or a company, as defined in subpart 2, whose net worth at the time the contract is entered into exceeds $1,000,000. The net worth of a natural person may include assets held jointly with the person's spouse.

B. The compensation paid to the investment adviser under this subpart with respect to the performance of any securities over a given period must be based on a formula which:

(1) includes, in the case of securities for which market quotations are readily available, the realized capital gains and losses and unrealized capital appreciation and depreciation of the securities over the period;

(2) includes, in the case of securities for which market quotations are not readily available, (i) the realized capital gains and losses of securities over the period; and (ii) if the unrealized capital appreciation of the securities over the period is included, the unrealized capital depreciation of the securities over the period; and

(3) provides that any compensation paid to the investment adviser under this subpart is based on the gains less the losses computed in accordance with item B, subitems (1) and (2), in the client's account for a period of not less than one year.

C. The investment adviser shall disclose to the client, or the client's independent agent, before entering into an advisory contract under this subpart, all material information concerning the proposed advisory arrangement including the following:

(1) that the fee arrangement may create an incentive for the investment adviser to make investments that are riskier or more speculative than would be the case in the absence of a performance fee;

(2) where relevant, that the investment adviser may receive increased compensation with regard to unrealized appreciation as well as realized gains in the client's account;

(3) the periods which will be used to measure investment performance throughout the contract and their significance in the computation of the fee;

(4) the nature of any index which will be used as a comparative measure of investment performance, the significance of the index, and the reason the investment adviser believes the index is appropriate; and

(5) where an investment adviser's compensation is based in part on the unrealized appreciation of securities for which market quotations are not readily available, how the securities will be valued, and the extent to which the valuation will be independently determined.

D. The investment adviser and any person acting on behalf of the adviser who enters into the contract must reasonably believe, immediately before entering into the contract, that the contract represents an arm's-length arrangement between the parties and that the client, or in the case of a client which is a company as defined in subpart 2, the person representing the company, alone or together with the client's independent agent, understands the proposed method of compensation and its risks. The repre-

KEY: PROPOSED RULES SECTION — Underlining indicates additions to existing rule language. ~~Strike outs~~ indicate deletions from existing rule language. If a proposed rule is totally new, it is designated "all new material." ADOPTED RULES SECTION — Underlining indicates additions to proposed rule language. ~~Strike outs~~ indicate deletions from proposed rule language.

sentative of a company may be a partner, director, officer, or an employee of the company or the trustee, where the company is a trust, or any other person designated by the company or trustee, but must satisfy the definition of client's independent agent in subpart 2, item C.

Subp. 2. **Definitions.** As used in ~~subpart~~ this part:

A. "Assignment" includes any direct or indirect transfer or hypothecation of an investment advisory contract by the assignor or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but, if the investment adviser is a partnership, no assignment of an investment advisory contract is considered to result from the death or withdrawal of a minority of the members of the investment adviser having only a minority interest in the business of the investment adviser, or from the admission to the investment adviser of one or more members who, after admission, will be only a minority of the members and will have only a minority interest in the business.

B. "Affiliate" has the same meaning as in section 2(a)(3) of the Investment Company Act.

C. "Client's independent agent" means a person agreeing to act as the client's agent in connection with the contract other than:

(1) The investment adviser acting in reliance upon this part, an affiliated person of the investment adviser, an affiliated person of an affiliated person of the investment adviser, or an interested person of the investment adviser as defined in item E.

(2) A person who receives, directly or indirectly, any compensation in connection with the contract from the investment adviser, an affiliated person of the investment adviser, an affiliated person of an affiliated person of the investment adviser, or an interested person of the investment adviser as defined in item E.

(3) A person with any material relationship between himself or herself, or an affiliated person of the person, and the investment adviser, or an affiliated person of the investment adviser, that exists or has existed at any time during the previous two years.

D. "Company" has the same meaning as in section 202(a)(5) of the Investment Advisers Act of 1940, but does not include a company that is required to be registered under the Investment Company Act of 1940, but is not registered. Further, the term "company" as used in subpart 1a, item A, does not include (i) a private investment company as defined in item G, (ii) an investment company registered under the Investment Company Act of 1940, or (iii) a business development company, as defined in section 202(a)(22) of the Investment Advisors Act of 1940, unless each of the equity owners other than the investment adviser entering into a contract under subpart 1a of any such company is a natural person or company described in this item.

E. "Interested person" as used in item C means:

(1) Any member of the immediate family of any natural person who is an affiliated person of the investment adviser.

(2) Any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued by the investment adviser or by a controlling person of the investment adviser if the beneficial or legal interest of the person in any security issued by the investment adviser or by a controlling person of the investment adviser (a) exceeds one-tenth percent of any class of outstanding securities of the investment adviser or a controlling person of the investment adviser; or (b) exceeds five percent of the total assets of the person seeking to act as the client's independent agent.

(3) Any person, partner, or employee of any person who at any time since the beginning of the last two years has acted as legal counsel for the investment adviser.

F. "Investment advisory contract" means any contract or agreement ~~whereby~~ where a person agrees to act as an investment adviser or to manage any investment or trading account for a person other than an investment company as defined in the Investment Company Act of 1940.

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

H. "Securities for which market quotations are readily available" in subpart 1a, item B, have the same meaning as in Rule 2a-4(a)(1) under the Investment Company Act of 1940.

I. "Securities for which market quotations are not readily available" in subpart 1a, item B, means securities not described in item H.

STATE OF MINNESOTA
DEPARTMENT OF COMMERCE

In the Matter of the Proposed Adoption of Rules Relating to Securities

FINDINGS OF FACT, CONCLUSIONS, AND ORDER ADOPTING RULE WITHOUT A PUBLIC HEARING

Notice of the Commissioner's intent to adopt the above-entitled rule was published in the State Register on September 21, 1987 and was sent by United States mail to all persons on the list maintained by the department pursuant to Minnesota Statutes, section 14.14, subdivision 1a and 14.22 on September 10, 1987. The statement of need and reasonableness was prepared before the notice of intent to adopt a rule without a public hearing was mailed to all persons on the rulemaking list and published in the State Register and was available to the public.

All persons were given the apportunity to submit comment on the rule for 30 days after notice of proposed rulemaking. No requests for a public hearing on the rule were received by the department.

Based on the comments and evidence in the record before the agency, I find the following:

That item A in Subpart 1a of part 2875.1010 requires clarification. Sub item 1 of item A contains the phrase "the client entering into the contract subject to this agreement must be" prior to setting forth the conditions to be satisfied. This phrase should have not been a part of this sub item but rather should have been a separate phrase in item A so that it was clear that the conditions of both sub items 1 and 2 must be met by clients entering into contracts subject to this agreement. With this clarification the descriptive title "Nature of the client" in the current rule is no longer necessary.

Therefore the rule shall be modified as follows: The phrase "Nature of the client" shall be deleted from item A and the phrase "the client entering into the contract subject to this subpart must be" inserted in its place. The inserted phrase shall be deleted from sub item (1).

That the modifications are not substantial but merely clarify the rule.

The above-captioned rule, as modified, is needed and reasonable.

NOW, THEREFORE, IT IS ORDERED that the rule identified as Rules Relating to Securities as modified is adopted this 22nd day of October 1987 pursuant to authority vested in me by Minnesota Statutes, sections 45.023, 80A.06, subd. 5 and 80A.25.

MICHAEL A. HATCH
Commissioner of Commerce

Dated this 22nd day of
October 1987.

STATE OF MINNESOTA
DEPARTMENT OF COMMERCE

In the Matter of the Proposed Adoption of Rules Relating to Securities

FINDINGS OF FACT, CONCLUSIONS, AND ORDER ADOPTING RULE WITHOUT A PUBLIC HEARING

Notice of the Commissioner's intent to adopt the above-entitled rule was published in the State Register on September 21, 1987 and was sent by United States mail to all persons on the list maintained by the department pursuant to Minnesota Statutes, section 14.14, subdivision 1a and 14.22 on September 10, 1987. The statement of need and reasonableness was prepared before the notice of intent to adopt a rule without a public hearing was mailed to all persons on the rulemaking list and published in the State Register and was available to the public.

All persons were given the apportunity to submit comment on the rule for 30 days after notice of proposed rulemaking. No requests for a public hearing on the rule were received by the department.

Based on the comments and evidence in the record before the agency, I find the following:

That item A in Subpart 1a of part 2875.1010 requires clarification. Sub item 1 of item A contains the phrase "the client entering into the contract subject to this agreement must be" prior to setting forth the conditions to be satisfied. This phrase should have not been a part of this sub item but rather should have been a separate phrase in item A so that it was clear that the conditions of both sub items 1 and 2 must be met by clients entering into contracts subject to this agreement. With this clarification the descriptive title "Nature of the client" in the current rule is no longer necessary.

Therefore the rule shall be modified as follows: The phrase "Nature of the client" shall be deleted from item A and the phrase "the client entering into the contract subject to this subpart must be" inserted in its place. The inserted phrase shall be deleted from sub item (1).

That the modifications are not substantial but merely clarify the rule.

The above-captioned rule, as modified, is needed and reasonable.

NOW, THEREFORE, IT IS ORDERED that the rule identified as Rules Relating to Securities as modified is adopted this 22nd day of October 1987 pursuant to authority vested in me by Minnesota Statutes, sections 45.023, 80A.06, subd. 5 and 80A.25.

MICHAEL A. HATCH
Commissioner of Commerce

Dated this 22nd day of
October 1987.

STATE OF MINNESOTA
DEPARTMENT OF COMMERCE

In the Matter of the Proposed Adoption of Rules Relating to Securities

DECLARATION OF ATTORNEY GENERAL

I, Erica Jacobson, Special Assistant Attorney General, do hereby declare that I have examined the rules and all related documents and that, I have examined the above-captioned rule, and the supporting rulemaking record, and that, based on my examination, the Administrative Procedure Act and Minnesota Rules, chapter 2010 have been followed. Any exceptions are listed below. For Attorney General billing purposes, the four-digit docket client code is 0081.

Erica Jacobson
Special Assistant Attorney General

Dated: 10/29/87

SF-00006-05 (4/86)

DEPARTMENT : of Commerce

STATE OF MINNESOTA

Office Memorandum

Recd 10/22/87

DATE : 10/22/87

TO : Rita Desmond
Admin A. G.

FROM : Richard G. Gomsrud

PHONE : 296-5689

SUBJECT : Rules Relating to Securities (Investment Adviser Fees)

Enclosed are copies of the following materials regarding the above captioned rules:

1. Notice of Intent to Solicit Outside Opinion as published in State Register (2010.0300 A)
2. Copy of the Proposed Rules with Revisor's Certificate (2010.0300 D)
3. Notice of Intent to Adopt Rule Without Public Hearing (2010.0300 E)
4. Statement of Need and Reasonableness (2010.0300 F)
5. Affidavit of Mailing Notice of Intent to Adopt Rule Without Public Hearing (2010.0300 G)
6. Copy of Notice of Intent to Adopt Rule Without Public Hearing and Rules as published in the State Register (2010.0300 H)
7. Four copies of Rule as adopted (2010.0300 I)
8. Findings of Fact, Conclusions & Order Adopting Rule (2010.0300 K)
9. Written Comments, Submission & Requests on Rule (2010.0300 L)
10. Declaration of Attorney General (2010.0300 M) – will be submitted by Brenner A.G.
11. * Notice of Submission to Attorney General (2010.0300 N)
12. * Affidavit of Mailing Notice of Submission to Attorney General (2010.0300 O)

* No requests for Notice of Submission received – see Findings.

SF-00006-05 (4/86)

STATE OF MINNESOTA

Office Memorandum

DEPARTMENT : ATTORNEY GENERAL - BREMER TOWER

DATE : October 30, 1987

TO : HUBERT H. HUMPHREY, III
Attorney General
c/o Rita Desmond
204 Administration Building

FROM : ERICA JACOBSON EJ
Special Assistant
Attorney General

PHONE : 6-9701

SUBJECT : RULES RELATING TO SECURITIES
(FINANCIAL ADVISOR FEES)

Enclosed please find a copy of the Declaration of the Attorney General.

I understand that all other documents necessary for review of this rule have already been submitted to you by Richard Gomsrud of the Department of Commerce. If you need any additional information or notice any problems, please contact Mr. Gomsrud at 296-5689 or me at 296-9701.

Thank you.

ew
cc: Richard Gomsrud

RECEIVED
ATTORNEY GENERAL'S OFFICE
NOV 02 1987
204 ADMINISTRATION BLDG.
50 SHERBURNE AVENUE
ST. PAUL, MN 55155

[¶ 83,939] Exemption to Allow Registered Investment Advisers to Charge Fees Based Upon a Share of Capital Gains Upon or Capital Appreciation of a Client's Account.

Investment Advisers Act Release No. 996. November 14, 1985. Release in full text.

Investment Advisers—Performance Fees—Rule Adoptions.—The SEC has adopted a general exemptive rule allowing investment advisers to receive performance fees under limited circumstances. Rule 205-3 permits an adviser to be compensated on the basis of a share of the

capital gains on, or capital appreciation of, a client's assets. The rule takes effect on *Federal Register* publication.

See ¶ 56,350, "Investment Advisers Act" division, Volume 5.

ACTION: Adoption of Rule.

SUMMARY: The Commission is adopting a rule under the Investment Advisers Act of 1940 to permit registered investment advisers to charge certain clients performance or incentive fees. Under the Advisers Act, registered investment advisers may not enter into performance fee contracts except under the limited circumstances set forth in the Act or under a Commission exemptive order or rule. The rule as adopted, which reflects certain changes made as a result of comments on the proposed rule, will provide registered investment advisers and their clients significantly more flexibility in negotiating their compensation arrangements.

EFFECTIVE DATE: [Upon publication in the Federal Register].

FOR FURTHER INFORMATION CONTACT: Forrest R. Foss, Special Counsel (202-272-2105), or John Banks-Brooks, Attorney Adviser (202-272-7313), Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. After the effective date, questions should be directed to: Office of the Chief Counsel (202-272-7308), Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission ("Commission") is today adopting Rule 205-3 under the Investment Advisers Act of 1940 ("the Advisers Act"). The rule, which was proposed for public comment on March 15, 1985,[1] permits a registered investment adviser to be compensated on the basis of a share of the capital gains on or capital appreciation of client assets. Compensation of this type, generally referred to as a "performance" or "incentive" fee, is prohibited by Section 205 of the Advisers Act with certain limited exceptions. Under the general exemptive authority of Section 206A of the Act, however, the Commission has issued a number of orders permitting registered investment advisers to charge performance fees. The Commission has now determined to adopt a general exemptive rule which will permit investment advisers subject to registration under the Act to receive performance fees under certain limited circumstances.

Under the rule as adopted, a registered investment adviser may enter into an advisory contract calling for a performance fee if: (a) the client (i) has at least $500,000 under the management of the adviser; or (ii) the adviser reasonably believes the client has a net worth of at least $1,000,000; (b) the adviser's compensation is based on a formula which includes realized capital losses and, under certain circumstances, unrealized capital depreciation; (c) the compensation paid to the adviser under the rule is based on performance over a period of not less than one year; (d) the adviser discloses certain information to the client; and (e) the adviser reasonably believes that the contract represents an arm's-length arrangement between the parties and that the client, alone or together with the client's independent agent, understands the performance fee contract and its risks.

Where the client entering into a performance fee contract is a registered investment company, business development company or a certain type of pooled investment vehicle, defined in the rule as a "private investment company," the eligibility requirements of the rule are modified. These entities may enter into contracts under the rule only if each of their equity owners individually satisfies the rule's eligibility conditions. Finally, the rule provides a limited degree of transitional relief for certain performance fee contracts in existence prior to November 14, 1985.

I. *BACKGROUND*

A. *General*

Section 205(1) of the Advisers Act prohibits an investment adviser subject to registration from entering into, extending, renewing or performing any investment advisory contract which provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of a client. The prohibition against performance-based compensation does not apply to (i) advisory contracts which provide for compensation based on the total value of the client's account averaged over a definite period, or as of definite dates, or taken as of a definite date; (ii) contracts with investment companies registered under the Investment Company Act of 1940 ("Investment Company Act") provided that an appropriate fulcrum fee is used;[2] (iii) contracts relating to the investment of assets in excess of $1,000,000

[1] Investment Advisers Act Release No. 961 (50 FR 11718).

[2] A fulcrum fee is one in which the adviser's fee is averaged over a specified period and increases and decreases proportionately with the investment performance of the account in relation to the investment record of an appropriate index of securities prices.

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with persons other than trusts, collective trust funds, or separate accounts referred to in section 3(c)(11) of the Investment Company Act [15 U.S.C. § 80a-3(c)(11)] provided that an appropriate fulcrum fee is used; and (iv) advisory contracts involving business development companies provided the conditions set forth in Section 205(C) of the Advisers Act [15 U.S.C. 80b-5(C)] are met.

Congress enacted the prohibition of Section 205(1) against performance fees in 1940 to protect clients of investment advisers from fee arrangements which in Congress' view could encourage advisers to engage in speculative trading practices while managing client funds in order to realize or increase an advisory fee.[3] In 1970, Congress enacted Section 206A of the Advisers Act which authorizes the Commission to exempt any person or transaction from any provision af the Act, provided the exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the Advisers Act. At the time it enacted Section 206A, Congress specifically indicated that Commission action would be appropriate in certain cases "to exempt persons . . . from the bar on performance [compensation]."[4] Beginning in 1975, the Commission began granting exemptive orders from the Section 205(1) prohibition.[5]

B. *The 1983 Proposal*

Prompted by criticism from the investment advisory industry that the general ban on performance fees was unnecessary for certain clients, the Commission undertook a review of the propriety of providing more general relief from the prohibition than was possible through the individual exemptive order process. This review resulted in a June, 1983 proposed rule.[6] Subject to certain conditions, the 1983 proposal would have provided general exemptive relief for registered advisers to enter into contracts with persons who, because of their wealth and financial knowledge and experience, were considered to be less dependent on the protections which the performance fee prohibition is intended to provide.[7]

The 1983 proposal generated a varied response from members of the public, and, in May, 1984, it was withdrawn.[8] After withdrawal of the proposal, however, the Commission continued to grant individual orders permitting registered investment advisers to charge certain clients performance fees. Since 1975, the Commission has granted a total of 22 orders, with 13 granted since the 1983 proposal.

C. *The 1985 Proposal*

The conditions of the 1985 proposal were based on the specific provisions of Section 205 of the Act, a review of the legislative history of that section, Congressional intent with regard to the limitations on performance fees and individual exemptive orders granting relief from the prohibition of Section 205(1).[9] In response to the 1985 proposed rule, the Commission received 49 comment letters. Forty-three commentators either supported the rule as proposed or with certain modifications. Six opposed adoption of a general performance fee exemption.[10]

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[3] H.R. Rep. No. 2639, 78th Cong. 3d Sess. 29 (1940). Performance fees were characterized as, "heads I win, tails you lose," arrangements in which the adviser had everything to gain if successful and little, if anything to lose, if not. S. Rep. No. 1775, 76th Cong., 3d Sess. 22 (1940). *See also*, Report of the Securities and Exchange Commission on Investment Counsel Investment Management, Investment Supervisory and Investment Advisory Services, H.R. Doc. No. 477, 76th Cong., 3d Sess. 30 (1939).

[4] S. Rep. No. 91-184, 91st Cong., 1st Sess. 46 (1969); H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 42 (1970).

[5] *See* Investment Advisers Act Release Nos. 459 and 461, May 7, 1975, and June 5, 1975, respectively.

[6] The Commission initially proposed an exemptive rule under Section 205 in 1979 (Investment Advisers Act No. 680, June 19, 1979). The rule, however, was limited to investment advisers to business development companies. Prior to fianl action by the Commission, Congress enacted Section 205(C) which, as noted, permits investment advisers to business development companies to receive performance compensation limited to not more than 20% of net realized capital gains of the business development company. The proposed exemptive rule was withdrawn in Investment Advisers Act Release No. 750 (February 20, 1981).

[7] Investment Advisers Act Release No. 865; (48 FR 27771, June 17, 1983). The 1983 proposal set forth in two-part test to determine client eligibility to enter into a performance fee contract. The first part required that the adviser make a finding that the client or his representative was sufficiently knowledgeable about and experienced in financial and business matters to understand the merits and risks of the performance fee contract. The second part required the performance fee contract to relate to a minimum of 150,000 in assets. The proposal also set forth certain information to be disclosed by the adviser to the client.

[8] Investment Advisers Act Release No. 911, May 2, 1984; (49 FR 19524, May 8, 1984).

[9] For a full discussion of the rationale underlying the 1985 proposal, see IA Release No. 961, March 15, 1985 (50 FR 11718). For a similar discussion, see the 1983 proposing release (IA Release No. 865) which also refers to the experience of other regulatory authorities in areas where performance fees are allowed.

[10] Opponents of the rule argued that performance fees would lead to conflicts of interest between advisers and clients and to unnecessary speculation by advisers. They also disagreed that any widespread demand by clients for performance fees exists. Some commentators opposing the rule acknowledged that incentive fees might be appropriate in certain areas where they have been customary (i.e., venture capital and real estate), but argued these fees would

After considering the comment letters and its reasons for proposing the rule, the Commission has decided to adopt the rule with certain changes. The Commission believes that permitting the use of performance fees in the limited circumstances allowed by the rule is in the public interest and consistent with the protection of investors and the purposes fairly intended by the Advisers Act. The Commission's decision to provide generic relief for performance fees under certain limited circumstances is based on its experience in granting individual exemptive orders, its review of the legislative history of Section 205(1) and Section 206(A), and the experience of other regulatory authorities in areas where performance fees are allowed. The Commission has concluded that it is consistent with the protection of investors and the purposes of the Act to permit clients who are financially experienced and able to bear the risks associated with performance fees to have the opportunity to negotiate compensation arrangements which they and their advisers consider appropriate. The Commission believes that the conditions of the rule provide alternative safeguards to the statutory prohibition. The rule should result in more competition among advisers and more flexibility for investors without sacrificing investor protections. As noted, however, the Commission is modifying the proposed rule in certain respects. These changes and the specific provisions of the final rule are discussed in detail below.

II. *GENERAL PROVISIONS OF THE RULE*

A. *Exemption*

Paragraph (a) of the rule as adopted is identical to paragraph (a) of the proposed rule. It provides relief from the general prohibition of Section 205(1) of the Advisers Act to permit a registered investment adviser to enter into and perform an advisory contract which provides for a performance fee provided all of the conditions of the rule are met.

B. *Eligible Clients*

Paragraph (b) sets forth alternative objective tests for measuring client eligibility to enter into a performance fee contract under the rule. Commentators expressed widespread support for the proposed tests as appropriate means of determining client capacity to understand and bear the risks associated with performance fee contracts. Several commentators, however, urged the Commission to revise the eligibility standards of the paragraph or clarify their applicability.

A number of commentators, referring to Regulation D under the Securities Act of 1933, urged the Commission to extend client eligibility to any natural person who had an individual income in excess of $200,000 in each of the two most recent years and who reasonably expects an income in excess of $200,000 in the current year.[11] Two commentators argued that clients be required to have both $1,000,000 in net worth and at least $500,000 under the adviser's management.

Several commentators addressed the proposal's condition that, in measuring net worth, the net worth of a natural person may include assets held jointly with the person's spouse. One commentator argued that the emphasis on joint ownership is unduly restrictive and that it should be permissible for assets owned individually by a single spouse, that is, not in any joint capacity, to be counted toward the other spouse's net worth for purposes of the rule. Other commentators advocated expanding the net worth standard to permit the aggregation of assets of all family members, whether or not a spousal relationship exists, or to permit the aggregation of assets of employee benefit plans with a common sponsor.

The rule, as adopted, does not incorporate these suggestions. In the Commission's view, the proposed alternative eligibility tests—$500,000 under the adviser's management or $1 million net worth (including assets held jointly with the client's spouse)—will provide sufficient flexibility to advisers and clients while adequately protecting investors within the policies and purposes of the Advisers Act.

In response to concern over how an adviser could verify the net worth of a client so as to be certain that the client was eligible to enter into a performance fee contract under the rule, the rule as adopted provides that an eligible client includes any person who the adviser, immediately prior to entering into the contract, reasonably believes satisfies the net worth test. The Commission emphasizes however, that an adviser would be required to make whatever inquiry is necessary to satisfy this test.

C. *Contractual Provisions*

1. *Compensation Formula*

Paragraphs (c)(1) and (2) of the rule as adopted are identical to the proposal. These two

(Footnote Continued)

not be appropriate for managing a traditional securities portfolio. Opponents also argued that performance compensation would not lead advisers to work harder or give better advice inasmuch as advisers presumably perform to the best of their ability now under traditional fee arrangements.

[11] Regulation D under the Securities Act of 1933 uses this $200,000 income test in defining one of the categories of persons considered to be accredited investors. *See* 17 CFR 230.501(a)(7).

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paragraphs set forth different methods of calculating the compensation paid to an adviser for a given period depending on the nature of the securities being managed. With respect to securities for which market quotations are readily available, the compensation formula must include the realized capital losses and unrealized capital depreciation of the securities over the period. For securities for which market quotations are not readily available, the formula must include the realized capital losses of the securities over the period and, if the unrealized capital appreciation of the securities over the period is included, the unrealized capital depreciation of the securities over the period must be included.

In response to several comments, the Commission wishes to emphasize that the factors referred to in paragraphs (c)(1) and (2), namely realized *capital* gains and losses and unrealized *capital* appreciation and depreciation, are only the minimum elements which any compensation formula under the rule must contain. Other factors also may be included, as appropriate. For example, paragraphs (c)(1) and (2) do not prohibit a compensation formula which includes income derived from interest and dividends in the determination of an advisory fee under the rule.[12]

In a related manner, in the proposing release, the Commission requested comment on whether a twenty percent (or some other percentage) limitation on the amount of performance fees would be appropriate. Commentators overwhelmingly were opposed to the imposition of a maximum percentage limitation on the amount of a performance fee under the rule. Because the Commission believes that the appropriate level of a performance fee is a matter best decided by the parties to the contract, and because of the various protections of the rule designed to prevent overreaching by the adviser, it has decided not to incorporate a mandatory percentage limitation on fees into the rule.

2. Cumulative Losses

Paragraph (c)(3) of the proposed rule required that any compensation paid to the adviser for a given period under the rule based on the lesser of (i) the gains in the client's account for that period; or (ii) the cumulative gains less the cumulative losses, in the client's account for that period and all prior periods. The conditions of paragraph (c)(3) were modelled largely on prior Section 205 exemptive orders to require that performance fees be based on an adviser's over-all performance over the term of a contract.[13]

A sizeable majority of persons commenting on paragraph (c)(3) characterized its cumulative loss provisions as unnecessary or unworkable and urged that the paragraph be modified or eliminated. Many argued that a cumulative loss requirement is inappropriate in light of the other conditions of the rule, especially the eligibility standards which are designed to limit performance fee contracts to persons capable of bearing and understanding their risks. Several claimed that it would increase the likelihood that an adviser would take undue risks in managing an account, particularly if an adviser were in a net loss position because the chance of obtaining a gain would be the only way of earning a fee. Others pointed to possible problems in the mechanical operation of the provision. A suggested alternative proposed by two commentators was the use of a minimum one year measurement period in any performance fee contract.

Upon consideration of these comments, the Commission has decided to revise paragraph (c)(3). As adopted, paragraph (c)(3) requires that any compensation paid to the adviser under the rule be based on the gains less the losses (computed in accordance with paragraphs (c)(1) and (2)) in the client's account for a period of not less than one year.[14] Contracts which measure performance for a period of less than one year would not be exempt under the rule. Performance fee contracts which terminate prior to the expiration of a one year period could provide for compensation to the adviser only if the compensation were not based on the capital gains or appreciation in the client's account.[15]

In the Commission's view, a one year period is sufficiently long generally to achieve the pur-

[12] The traditional position of the staff has been that the Section 205(1) prohibition against performance fees does not prohibit a fee based on income derived from dividends and interest. Investment Advisers Act Release No. 721 at note 5 (May 16, 1980).

[13] *See*, for example, *Shaw Management Co., Inc.* (Investment Advisers Act Release Nos. 875 and 878, July 29, 1983 and August 24, 1983, respectively); and *Maier & Siebel, Inc.* (Investment Advisers Act Release Nos. 829 and 830, October 20, 1982 and November 16, 1982, respectively).

[14] Advisers could use any method for receiving payment of the performance fee provided it is consistently applied and fully disclosed to the client. For example, the fee could be paid annually after each year's performance, or the fee could be paid on a rolling basis beginning at the end of a year's performance. However, regardless of the method chosen, no part of the performance fee may be paid for any period of less than one year.

[15] Rule 205-3 does not prohibit an adviser from charging a non-performance related fee, for example a fee based on the percentage of assets under management, in addition to the performance fee. However, the anti-fraud provisions of Section 206 of the Advisers Act may be violated where the total advisory fee charged is higher than the total fee normally charged for similar services without disclosure to

pose of the proposed cumulative loss provision—precluding an adviser from basing an incentive fee on short term fluctuations in securities prices. At the same time, the flexibility afforded by the one year provision is more appropriate in the context of a general exemption rule. Finally, use of at least a one year period for measuring performance is common among advisers relying on the statutory exemption for fulcrum fees. Thus, the Commission anticipates that the problems commentators perceived with the proposal's use of an open-ended cumulative loss period will be avoided.[16]

D. *Disclosure*

The disclosure provisions of the rule as adopted are substantially identical to those of the proposal. Paragraph (d)(3) of the rule regarding disclosure of periods used to measure performance has been amended to reflect the changes made in the cumulative loss provision of the proposal. The amended paragraph now requires disclosure of the periods used throughout the contract as well as the practical effect of these periods on the amount of the performance fee paid to the adviser and the intervals at which the fee is paid.

Several commentators described various factual situations with which advisers might be faced and suggested that the Commission specify in the rule the information which must be disclosed with respect to them. The Commission has decided not to adopt this approach. As stated in the proposing release, the disclosure requirements specifically referred to in paragraph (d) of the rule constitute minimum obligations of the adviser. They have been included because of the braod exemptive nature of the rule and because the Commission believes they reflect matters which may often arise in the context of performance fee contracts. However, the requirements of paragraph (d) should not be read as narrowing, in any manner, the disclosure obligations of investment advisers under the Act or other applicable law. In this regard, advisers are reminded of their duty under Section 206 of the Act of " 'utmost good faith and full and fair' disclosure of all material facts" (*SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 194 (1963)) and of the requirements of Form ADV regarding the disclosure of advisory fees.[17]

E. *Arm's-Length Transaction*

Paragraph (e) of the proposed rule required that an investment adviser seeking to enter into a performance fee contract under the rule reasonably believe, immediately prior to entering into the contract, that the contract represents an arm's-length arrangement between the parties, and that the client, alone or together with the client's independent agent, fully understand the risks of the proposed method of compensation. One commentator recommended that the language of the proposal requiring that a client "understand the risks of the proposed method of compensation" be amended to state that the client "understand the proposed method of compensation and its risks." The rule as adopted reflects this slight modification. In the Commission's view, the new language better reflects the requirement that the client understand the performance fee arrangement in its totality, not just its risks.

Other commentators were uncertain as to the correct application of the arm's-length standard. They noted many advisers have developed standard contracts and expressed concern that the arm's length requirement may suggest that the terms of each fee arrangement between the adviser and client must be negotiated. The commentators were uncertain whether acceptance by a client of a non-negotiable advisory contract would satisfy the arm's-length requirement. In the commission's view an arm's length arrangement between the parties is one whose terms correspond to those which independent parties of equal bargaining position would arrive at after negotiation and without overreaching by either party. Use by an adviser of a standard performance fee contract would not preclude the contract from representing "an arm's-length arrangement between the parties" within the meaning of the rule. As noted in the proposing release, paragraph (e) is intended to supplement the disclosure obligations of paragraph (d) of the rule in a manner intended to ensure that the adviser satisfies his affirmative duty of finding that the client thoroughly appreciates the nature of the performance fee contract. In addition, the Commission believes the paragraph (e) provides an important and necessary safeguard in that the effect of this condition is to place on the adviser the burden of demonstrating that its performance fee contracts do not involve over-

(Footnote Continued)

clients that similar services may be available elsewhere at a lower fee. *See* Alan D. Pekelner (pub. avail. June 6, 1977).

[16] The use of a minimum one year measurement period under the rule does not affect the staff's general position on termination provisions of advisory contracts. In this regard, in *Robert D. Brown Investment Counsel, Inc.* (July 19, 1984) the staff took the position that an adviser would breach "its fiduciary duty and violate section 206(2) of the Act by entering into a contract for the provision of investment supervisory services which purported to bar a client from terminating the relationship except annually." Advisers relying on Rule 205-3 are expected to comply with this position.

[17] Registered advisers entering into performance fee contracts under the rule would be required to promptly amend Form ADV to reflect their new fee arrangements.

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reaching and are limited to clients who can fend for themselves.

G. *Transition Rule*

Paragraph (f) of the rule as adopted is new. It was added as a result of comments suggesting the need to address the problem created if an adviser not subject to registration, with preexisting performance fee arrangements with clients, later registers with the Commission. Under paragraph (f), paragraphs (b), (c) and (e) of the rule will not apply to an advisory contract between an investment adviser and a client provided the contract was first entered into prior to November 14, 1985 and continues in force after the effective date of the rule. The disclosure provisions of paragraph (d) of the rule, however, would apply with respect to preexisting clients who were parties to any such contract. In addition, the provisions of paragraph (e) would apply to any renewal or extension of such a contract. The transitional relief provided by paragraph (f) would be limited to advisory contracts with advisers who were, at the time the contracts were entered into, not registered or required to be registered as advisers under the Act. Finally, all provisions of the rule would apply to persons who become a party to a performance fee contract with a registered investment adviser after the effective date of the rule.

H. *Definitions*

Paragraph (g) contains definitions of terms used in the rule. Paragraph (g)(4) defines the term "client's independent agent" to exclude persons whose independence could be comprised because of direct or indirect conflicts of interest.

Several commentators argued that the proposal unnecessarily excluded certain persons from acting as the client's independent agent. It was asserted, for example, that the proposed definition would effectively bar a bank or the trustee of a trust, which held a single share of a publicly held advisory company, from acting as the independent agent of any client who entered into a performance fee contract with the advisory company. A suggested approach was to provide an exception in the rule so that, in the situation referred to above, the bank or trustee would not be prohibited from acting as the client's independent agent if the bank or trust's interest in the adviser was less than a certain *de minimis* account. The Commission believes that the definition of client's independent agent may be modified in the manner suggested by the comments without compromising investor protections. Paragraph (g)(5)(ii) of the rule as adopted provides that a person may still qualify as an independent agent where his interest in the investment adviser constitutes less than $1/10$ of 1% of any class of outstanding securities of the adviser and the interest represents less than 5% of the total assets of the agent.

Another commentator pointed out that the definition would prohibit a relative of a client from acting as the independent agent of the client if the relative were affiliated with the adviser. It was argued that this could be unfair in situations where, for example, the relative was generally responsible for making investments decisions for his parents or children. The Commission is not persuaded that it is appropriate to eliminate the protections provided by the "independent agent" requirement for relatives of persons affiliated with the adviser.

Finally, several commentators urged the Commission to amend the definition to allow the limited partner of an investment partnership (or a representative of the limited partner) to act as the independent agent of the partnership. The Commission has decided not to incorporate this suggestion into the rule as adopted. In the Commission's view, a limited partner in a limited partnership may not be in a position to provide the type of objective advice to other potential limited partners that the rule seeks to ensure from client agents.

I. *Other Matters*

One commentator noted that a number of the individual exemptive orders granted under Section 205 have extended exemptive relief to the books and records requirements of Rules 204-2(b) and (c) under the Advisers Act.[18] The relief has been provided to the extent the provisions of that rule might require an investment adviser, acting as the general partner of an investment limited partnership, to maintain separate books and records of the underlying interests of each limited partner in the partnership. Advisers obtaining these exemptions have typically represented that they will maintain a capital account for each limited partner which reflects capital contributions, and all income, gains, expenses, losses, withdrawals and distributions.

Upon review of this matter, the Commission has determined that, for purposes of performance fee contracts entered into under Rule 205-3, exemptive relief from the provisions of Rules 204-2(b) and (c) is not necessary. Rules 204-2(b) and (c) require that books and records be maintained by advisers on behalf of certain *clients*. Thus, for purposes of this rule, where the client entering into the performance fee contract is an investment limited partnership (or other private investment company), Rules 204-2(b)

[18] Rule 204-2(b) sets forth specific books and record requirements for registered investment advisers with custody or possession of client securities or funds and Rule 204-2(c) sets forth specific requirements for advisers rendering investment supervisory or management services to clients.

and (c) would require that the designated books and records be maintained only for the client limited partnership (or other entity) and not the limited partners of the partnership (or equity owners of the private investment company).

A number of commentators pointed out that many states have adopted laws or imposed requirements generally prohibiting advisers from receiving performance fees. The Commission believes that successful operation of a performance fee exemption at the federal level may encourage these states to reexamine their requirements. However, adoption of Rule 205-3 by the Commission does not in any way affect an adviser's obligation to comply with applicable state requirements.

In a related context, a number of commentators expressed concern over the effect of the rule on advisers to employee benefit plans, subject to the requirements of the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1001 et seq. The Commission emphasizes that adoption of Rule 205-3 in no way affects an adviser's obligation to comply with ERISA. Issues involving performance fee arrangements under ERISA are within the jurisdiction of the Department of Labor which is responsible for administering ERISA's fiduciary provisions.

Several commentators suggested that the Commission should amend Rules 205-1 and 205-2, which set forth requirements for fulcrum fee compensation arrangements. The Commission is not adopting changes in these rules at this time. The Commission's staff will consider, however, whether, in light of the comments received, changes in these rules are necessary.

SUMMARY OF THE FINAL REGULATORY FLEXIBILITY ANALYSIS

A summary of the Initial Regulatory Flexibility Act Analysis, which the Commission prepared in accordance with 5 U.S.C. 603 regarding proposed Rule 205-3, was published in Investment Advisers Act Release No. 961. No comments were received on the analysis and the Commission has prepared a Final Regulatory Flexibility Analysis.

A copy of the Final Regulatory Flexibility Analysis may be obtained by contacting John Banks-Brooks, Attorney, Division of Investment Management, Securities and Exchange Commission, Room 5130, 450 Fifth Street, N.W., Washington, D.C. 20549.

List of Subjects in 17 CFR Part 275

Investment Advisers, Reporting and Recordkeeping Requirements, Securities

TEXT OF RULE

Part 275 of Chapter II of Title 17 of the Code of Federal Regulations under the Investment Advisers Act of 1940 is amended as follows:

PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

§ 275.205-3 Exemption from the compensation prohibition of section 205(1) for registered investment advisers.

1. The authority citation for Part 275 continues to read in part as follows:

Authority: Secs. 203, 204, 211, 54 Stat. 850, as amended, 852 as amended, 855, as amended; 15 U.S.C. 80b-3, 80b-4, 80b-11 * * *; Section 275.205-3 is also issued under Section 206A (15 U.S.C. 80b-6A).

2. By adding § 205-3 as follows: * * *

[Reproduced at ¶ 56,350, CCH.]

By the Commission.

STATE OF MINNESOTA

STATE REGISTER

DEPARTMENT OF ADMINISTRATION—DOCUMENTS DIVISION



Monday 22 June 1987

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Michael A. Hatch
Commissioner of Commerce

Department of Commerce

Notice to Solicit Outside Opinion Regarding Proposed Rules and Amendments to Rules Relating to Securities Including the Impact of the Rules on Small Business

Notice is hereby given that the Department of Commerce is seeking information or opinions from persons outside the agency in preparing to promulgate new rules regarding securities with primary emphasis on those regarding investment advisor fees. Promulgation of these rules is authorized by Minnesota Statutes, Sections 80A.06 subd. 5, 80A.25 and 45.023.

Outside opinion is also being solicited as to how these rules will affect small businesses as defined by Minnesota Statutes § 14.115, subdivision 1.

The Department of Commerce requests information and opinions concerning the subject matter of these rules. Interested or affected persons or groups may submit statements of information or comment orally or in writing to: Deputy Commissioner Kristine Eiden, Department of Commerce, 500 Metro Square Building, St. Paul, MN 55101. Oral statements will be received during regular business hours over the telephone at (612) 296-6325.

All statements of information and opinion shall be accepted until July 29, 1987. Any written material received by the Department of Commerce shall become part of the record in the event that the rules are adopted.

Michael A. Hatch
Commissioner of Commerce

Department of Commerce

Notice to Solicit Outside Opinion Regarding Proposed Amendments and Rules Relating to Workers Compensation Self-Insurance Including the Impact of the Rules on Small Business

Notice is hereby given that the Department of Commerce is seeking information or opinions from persons outside the agency in preparing to promulgate new rules and amendments to existing rules relating to worker's compensation self-insurance. Promulgation of these rules is authorized by Minnesota Statutes, Sections 176.181 and 45.023.

Outside opinion is also being solicited as to how these rules will affect small businesses as defined by Minnesota Statutes § 14.115, subdivision 1.

The Department of Commerce requests information and opinions concerning the subject matter of these rules. Interested or affected persons or groups may submit statements of information or comment orally or in writing to: Richard G. Gomsrud, Department of Commerce, 500 Metro Square Building, St. Paul, MN 55101. Oral statements will be received during regular business hours over the telephone at (612) 296-5689.

All statements of information and opinion shall be accepted until July 29, 1987. Any written material received by the Department of Commerce shall become part of the record in the event that the rules are adopted.

Michael A. Hatch
Commissioner of Commerce

Department of Commerce

Order Approving Abstract of Title Disclosure and Notice Form

The Commissioner of Commerce Michael A. Hatch (hereinafter "Commissioner") has determined as follows:

1. Minn. Stat. § 386.375, subd. 3 (1987) directs the Commissioner to prepare and approve a notice providing basic information in plain English about abstracts of title.

2. Pursuant to Minn. Stat. § 386.375, subd. 3, the Commissioner has prepared the following disclosure and notice form:

SF-00006-05 (4/86)

STATE OF MINNESOTA

Office Memorandum

DEPARTMENT : of Commerce

DATE : November 2, 1987

TO : Rita Desmond

FROM : Richard G. Gomsrud

PHONE : 296-5689

SUBJECT : Securities Rules (Financial Advisor Fees)

Enclosed please find a corrected Affidavit of Mailing and Mailing Certificate in regard to the above captioned rules. I hope that our inadvertant oversight did not create a problem for you.

Declaration of Atty:
Not yet received. rec'd

Authority
45.023
80A.06 subd 5
80A.25 OK - subd 1

Rule
Changes made on adopted Rule.