

STATE OF MINNESOTA  
OFFICE OF ADMINISTRATIVE HEARINGS  
FOR THE DEPARTMENT OF COMMERCE

In the Matter of the Proposed Rules of the  
Department of Commerce Governing the  
Regulation of Securities,  
Minnesota Rules, Chapter 2876

**ORDER ON REVIEW OF  
RULES UNDER MINNESOTA  
STATUTES, SECTION 14.26**

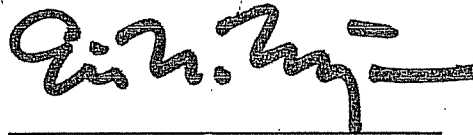
The Minnesota Department of Commerce ("Department") is seeking review and approval of the above-entitled rules, which were adopted by the Department without a hearing. This review and approval is governed by Minn. Stat. § 14.26. On August 10, 2009, the Office of Administrative Hearings received the documents that must be filed by the Department under Minn. Stat. § 14.26 and Minn. R. 1400.2310. Based upon a review of the written submissions and filings, and for the reasons set out in the Memorandum which follows,

**IT IS HEREBY ORDERED:**

1. The Department has the statutory authority to adopt the rules.
2. The rules were adopted in compliance with all procedural requirements of Minnesota Statutes, chapter 14, and Minnesota Rules, chapter 1400, with one exception as discussed below.
3. The rules are needed and reasonable, with the exception of the following rule parts: 2876.4050, subpart 2; 2876.4061, subpart 2; 2876.4114, subpart 1.E; 2876.4116, subpart 1.A, 1.F, 1.G, and 1.H; 2876.4117, subpart 1; 2876.4120, subparts 2 and 6; 2876.5023, subpart 1 and 1.K; and 2876.5025, subparts 2.B and 3.C. Accordingly, these rule parts are **DISAPPROVED** as not meeting the requirements of Minn. Stat. § 14.06 (a) and Minnesota Rules part 1400.2100, items A, D, E, and G.
4. The changes made to the rules based upon public comments received subsequent to publication in the State Register on January 20, 2009, do not make the rules substantially different.

5. Pursuant to Minnesota Statutes, section 14.26, subdivision 3(b), and Minnesota Rules, part 1400.2300, subpart 6, the rules will be submitted to the Chief Administrative Law Judge for review.

Dated: August 24, 2009



ERIC L. LIPMAN  
Administrative Law Judge

### MEMORANDUM

Pursuant to Minnesota Statutes, section 14.26, the agency has submitted these rules to the Administrative Law Judge for review. The rules of the Office of Administrative Hearings<sup>1</sup> identify several types of circumstances under which a rule must be disapproved by the Administrative Law Judge or the Chief Administrative Law Judge. These circumstances include situations in which a rule was not adopted in compliance with procedural requirements, unless the judge finds that the error was harmless in nature and should be disregarded; the rule is not rationally related to the agency's objectives or the agency has not demonstrated the need for and reasonableness of the rule; the rule is substantially different than the rule as originally proposed and the agency did not comply with required procedures; the rule grants undue discretion to the agency; the rule is unconstitutional<sup>2</sup> or illegal; the rule improperly delegates the agency's powers to another entity; or the proposal does not fall within the statutory definition of a "rule."

#### I. Procedural Defect

Effective August 1, 2009, pursuant to Minn. Stat. § 14.128, an agency "must determine if a local government will be required to adopt or amend an ordinance or other regulation to comply with a proposed agency rule." This determination must be made before the close of the hearing record or before the agency submits the record to the administrative law judge if there is no hearing. The administrative law judge must review the determination and approve or disapprove it.

When the Department made its rule submission on August 10, 2009, the record did not contain a determination under Minn. Stat. § 14.128. By way of an electronic mail

<sup>1</sup> Minn. R. 1400.2100 (2007).

<sup>2</sup> In order to be constitutional, a rule must be sufficiently specific to provide fair warning of the type of conduct to which the rule applies. See, *Cullen v. Kentucky*, 407 U.S. 104, 110 (1972); *Thompson v. City of Minneapolis*, 300 N. W.2d 763, 768 (Minn. 1980).

message dated August 19, 2009, the Administrative Law Judge (ALJ) requested that the Department make this determination and supplement the rule record. As of August 24, 2009, the Department had not yet made the determination. Accordingly, the rule record contains a procedural defect under Minn. R. 1400.2100, item A. To cure this defect, the Department must make a determination under Minn. Stat. § 14.128, and submit it to the ALJ within 30 days of the date of this Order.

## II. Defect in Part 2876.4050, subpart 2, and 2876.4061, subpart 2

Both of these subparts address the filing of Form ADV Part II and state that the administrator<sup>3</sup> *may* accept this form in one of two ways. As written, these subparts give the administrator discretion to accept the form in either of two methods, but do not require the administrator to accept the form at all. Such standard-less grants of discretion to itself are in excess of the Department's statutory authority and constitute defects in the proposed rules.<sup>4</sup>

To cure these defects, the Administrative Law Judge proposes that the Department delete the word *may* and add the phrase *shall either* to make clear that the Department is obligated to accept the form in one of the two alternative methods. If the Department anticipates that it may accept the form in some other manner, then it should list that option in the rule as well. This change, or a substantially similar one, is needed and reasonable and is not a substantial change from the rules as proposed.

## III. Defect in Part 2876.4114, subpart 1

Subpart 1 lists the recordkeeping requirements for investment advisers. Specifically, item E states that an investment adviser must maintain:

A file containing a copy of each document (other than any notices of general dissemination) that was filed with or received from any state or federal agency or self-regulatory organization and that pertains to the registrant or its investment adviser representatives which file *should* contain, *but is not limited to*, all applications, amendments, renewal filings, and correspondence.

(Emphasis added). As written, item E is impermissibly vague because it fails to provide adequate notice to the regulated public as to the items that must be contained in the file. Because the proposed language is open-ended and unspecific, it grants unduly broad discretion to the Department. Furthermore, use of the word "should" does not constitute rule language because it does not "make specific the law enforced or administered by [the] agency or govern its organization or procedure" as required by Minn. Stat. § 14.02, subd. 4.

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<sup>3</sup> "Administrator" is defined as the Commissioner of Commerce in Minn. Stat. § 80A.41 (2) (2008).

<sup>4</sup> See, Minn. R. 1400.2100 (D) (2007).

Accordingly, the Administrative Law Judge recommends the following language to correct the defects:

A file containing a copy of each document (other than any notices of general dissemination) that was filed with or received from any state or federal agency or self-regulatory organization and that pertains to the registrant or its investment adviser representatives ~~which file should contain, but is not limited to,~~ including all applications, amendments, renewal filings, and correspondence.

This change is needed and reasonable and is not a substantial change from the rules as proposed.

#### IV. Defect in Part 2876.4116, subpart 1

Subpart 1 states:

It is unlawful and deemed to be a fraudulent, deceptive, or manipulative act, practice, or course of business for an investment adviser to have custody of client funds or securities unless:

A. The investment adviser notifies the administrator promptly in writing that the investment adviser has *or may have* custody. The notification is required to be given on Form ADV.

(Emphasis added). As written, item A is impermissibly vague because it fails to provide adequate direction to the regulated public as to when it must advise the administrator regarding custody of client funds.

Accordingly, the Administrative Law Judge recommends the following changes to Item A to correct the defects and to provide additional clarity to the proposed rule language:

A. The investment adviser notifies the administrator promptly in writing that the investment adviser has *or may have* is authorized to have custody of client funds or securities. The notification is required to be given on Form ADV.

This change is needed and reasonable and is not a substantial change from the rules as proposed.

#### V. Defect – “and/or”

In several places throughout the proposed rules, the Department uses the phrase “and/or” at the end of a list with which a regulated party must comply. Use of this

phrase is impermissibly vague because it fails to provide adequate notice to the regulated public as to what is required under the proposed rule.

To correct this defect in the proposed rules, the Department should decide which of the two words is appropriate and delete the one that does not meet its intent. This language should be corrected in the following rule parts: 2876.4116, subp. 1.F (3), subp. 1.G. (4), and subp. 1.H. (3)(a)(iii) and (3)(b)(v).

Such changes would be needed and reasonable and would not be substantial changes from the rules as initially proposed.

#### **VI. Defect in Part 2876.4117, subpart 1**

Subpart 1 directs investment advisers to furnish each advisory client and prospective advisory client with a written disclosure statement containing the information required by Part II of its Form ADV, "or such other information as the *administrator may require*" (emphasis added).

As written, proposed subpart 1 grants the administrator unfettered discretion in determining what must be contained in the disclosure statement by the investment adviser. To correct this defect, the Department should modify this language in the following, or similar, manner: "or such other information as the administrator may require to protect advisory clients and prospective advisory clients against financial loss or fraud."

Such changes would be needed and reasonable and would not be substantial changes from the rules as initially proposed.

#### **VII. Defect in Part 2876.4120, subpart 2**

Subpart 2 states:

No person shall be registered as an investment adviser or a broker-dealer unless at least one person employed full time in a supervisory capacity, by the applicant for a license, was actively engaged in the securities business in a similar capacity for a minimum of three of the preceding five years, or has substantially equivalent experience, *satisfactory to the administrator* (emphasis added).

As written, proposed subpart 2 grants the administrator unfettered discretion in determining what is considered "substantially equivalent experience." To correct this defect, the Department should delete the above-italicized phrase and consider adding criteria regarding the type of experience that will be deemed "substantially equivalent."

Such changes would be needed and reasonable and would not be substantial changes from the rules as initially proposed.

## VIII. Defect in Part 2876.4120, subpart 6

Subpart 6 states:

No person shall be registered as an investment adviser or a broker-dealer if any employee of the person was an officer, supervisor, or owner of ten percent or more of the securities of any firm liquidated under the Securities Investor Protection Act of 1970, unless good cause, *satisfactory to the commissioner*, be shown that the issuance of the license would be in the public interest according to Minnesota Statutes, section 80A.85 (b) (emphasis added).

As written, proposed subpart 6 appears to grant the commissioner unfettered discretion in determining what is considered "good cause," when, in fact, that determination is made according to Minn. Stat. § 80A.85. To correct this defect, the Department should delete the above-italicized phrase. Such a change would be needed and reasonable and would not be a substantial change from the rules as initially proposed.

## IX. Defect – "Including, but not limited to"

In several places throughout the proposed rules, the Department uses the phrase, or similar phrase, "including, but not limited to" at the beginning of a list with which a regulated party must comply. Use of this phrase is generally disfavored in rulemaking because it introduces ambiguity into a proposed rule. This phrase is impermissibly vague because it fails to provide adequate notice to the regulated public as to what is included in the list and grants unduly broad discretion to the Department to import new items that are not listed in the regulatory definition.

To correct this defect in the proposed rules, the Department should delete the "but not limited to" portion of the phrase. This language should be deleted in the following rule parts: 2876.5022, subp. 6.B.; 2876.5023, subp. 1, and subp. 1.K; and 2876.5025, subp. 2.B, and subp. 3.C. (2).

Such changes would be needed and reasonable and would not be substantial changes from the rules as initially proposed.

## X. Recommended Technical Corrections

The Administrative Law Judge recommends several technical corrections to the rules. The technical corrections are not defects in the rules, but are recommendations for corrections to the rules that the agency may adopt if it chooses to do so to aid in the administration of the rule. Each of the changes recommended below is needed and reasonable and would not be a substantial change from the rules as originally proposed.

**1. Part 2876.4061, subpart 1**

Subpart 1 lists the required contents of an initial application for investment adviser registration. Item E requires the application to include “any other information the administrator may reasonably require.” While use of the word “reasonably” appropriately limits the discretion of the administrator so as to prevent the language from being defective, the ALJ suggests that the Department amend Item E as follows to more clearly restrict the administrator:

“any other information the administrator may reasonably require to facilitate processing of the application.”

Language similar to this appears in two other places in the proposed rules, and the ALJ recommends that the Department make this same recommended change in those rule parts as well. *Compare*, Minn. R. 2876.4062, subp. 1.A (3) and 1.B. (3);

**2. Part 2876.4112, subpart 4**

The ALJ recommends that the Department change the first sentence of subpart 4 as follows:

Unless otherwise exempted, as a condition of the right to transact business in this state, every investment adviser registered or required to be registered under the Minnesota Securities Act shall by the close of business on the next business day after discovery of the deficiency notify the administrator if such investment adviser’s net worth is less than the minimum required.

This recommended change helps clarify the meaning of the phrase “by the close of business on the next business day.”

**3. Part 2876.4116, subpart 1**

Change Subpart 1, item H (2) as follows:

(2) send to the grantor of the trust, the attorney for the trust if it is a testamentary trust, the cotrustee (other than the investment adviser or employee, director, or owner of the investment adviser); — or a defined beneficiary of the trust, at the same time that it sends any invoice to the qualified custodian, an invoice showing . . . .

This punctuation change corrects a typographical error and increases consistency within the proposed rules.

**4. Part 2876.4116, subpart 3**

Change Subpart 3 as follows:

“For purposes of this subpart ~~part~~, the following terms have the meanings given them.”

This change corrects a typographical error and increases consistency within the proposed rules.

**5. Part 2876.5022, subpart 2**

Change Subpart 2, item C as follows:

. . . that the investment adviser shall not be compensated on the basis of a share of capital gains ~~upon~~ or capital appreciation of the funds or any portion of the funds of the client, unless . . . .

This change deletes what appears to be an unnecessary word in item C of subpart 2.

**6. Part 2876.5024, subpart 3**

Change Subpart 3, item D as follows:

The license(s) entitles me to offer and sell the following products and/or services:

- (a) ... securities, specifically the following: [List],
- (b) ... real property,
- (c) ... insurance, or
- (d) ... other: [List].

This change corrects a typographical error and increases consistency within the proposed rules.

**E. L. L.**