

PUBLIC PROTECTION CABINET
Kentucky Department of Financial Institutions
(Amendment)

808 KAR 10:440. Examples of dishonest or unethical practice for broker-dealers and agents.

RELATES TO: KRS 292.337, 292.480

STATUTORY AUTHORITY: KRS 292.336(5), (6), 292.500(3)

NECESSITY, FUNCTION, AND CONFORMITY: KRS 292.500(3) authorizes the commissioner of the Department of Financial Institutions to promulgate administrative regulations necessary to carry out the provisions of KRS Chapter 292. KRS 292.336(5) and (6) authorize the commissioner to promulgate administrative regulations prohibiting unreasonable charges, profits, commissions, or other compensation for broker-dealers and agents and prescribing standards for the conduct of business by broker-dealers and agents which the commissioner finds appropriate in the public interest and for the protection of investors. This administrative regulation provides examples of dishonest and unethical practices by broker-dealers and agents and states the consequences of engaging in unacceptable conduct or practices.

Section 1. Broker-dealers shall observe high standards of commercial honor and just and equitable principles of trade in their dealings with customers and the conduct of their business. The following acts~~[Acts]~~ and practices shall constitute violations of those standards and principles and~~[such as the following shall be considered contrary to these standards. Violations]~~ may result in a fine, suspension, or revocation in proportion to the seriousness of the offense, pursuant to KRS 292.337(1):

- (1) Engaging in a pattern of unreasonable and unjustifiable delays in the delivery of securities purchased by any of its customers or in the payment of free credit balances reflecting completed transactions of any of its customers;
- (2) Failing or refusing to furnish a customer, upon reasonable request, information to which the customer is entitled, or to timely respond to a formal written demand or complaint by a customer;
- (3) Attempting to enforce a condition, stipulation, or provision against a customer in Kentucky if the result would:
 - (a) Leave the customer without the choice of a forum for dispute resolution in the state of Kentucky; or
 - (b) Limit the timeliness of an action to a period less than that established in KRS 292.480;
- (4) Failing to segregate a customer's securities held in safekeeping;
- (5) Hypothecating a customer's securities without having a lien thereon unless the broker-dealer secures from the customer a properly executed written consent promptly after the initial transaction, except as permitted by rules of the Securities and Exchange Commission;
- (6) Charging unreasonable and inequitable fees for services performed, including~~[such as]~~:
 - (a) Collection of monies due for principal;
 - (b) Dividends or transfer of securities;
 - (c) Appraisals;
 - (d) Safekeeping; or
 - (e) Custody of securities and other services related to its securities business;
- (7) Offering to buy from or sell to any person any security at a stated price unless the broker-dealer is prepared to purchase or sell, as the case may be, at the price and under

the conditions as are stated when the offer is made;

(8) Representing that a security is being offered to a customer "at the market" or a price relevant to the market price unless the broker-dealer knows or has reasonable grounds to believe that a market for the a security exists other than that made, created, or controlled by the broker-dealer, or by any person for whom the broker-dealer is acting or with whom the broker-dealer is associated in the distribution, or any person controlled by, controlling, or under common control with the broker-dealer;

(9) Failing to disclose in writing that the broker-dealer is controlled by, controls, is affiliated with, or is under common control with the issuer of any security, the existence of this control before entering into any binding contract with or for a customer for the purchase or sale of the security;

(10) Failing to make a bona fide public offering of all the securities allotted to the broker-dealer for distribution, whether acquired directly as an underwriter or a selling group member or indirectly from an entity participating in the distribution as an underwriter or selling group member;

(11) Inducing trading in a customer's account which is excessive in size or frequency in view of the financial resources and character of the account;

(12) Switching, churning, overtrading, or reloading of a security in a customer's account for the purpose of accumulating or increasing a commission;

(13) Recommending to a customer the purchase, sale, or exchange of any security without reasonable grounds to believe that the transaction or recommendation is suitable for the customer based upon a reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and any other relevant information known by the broker-dealer;

(14) Failing to furnish to a customer purchasing securities in an offering, no later than the due date of confirmation of the transaction, either a formal prospectus or a preliminary prospectus and an additional document, which together include all information set forth in the final prospectus;

(15) Participating in the solicitation or offer for sale of a security without the use of an offering document or prospectus, if required, or making a statement contrary to or inconsistent with disclosure contained in the offering document or prospectus;

(16) Making a false, misleading, deceptive, or exaggerated representation or prediction in the solicitation or sale of a security, including:

(a) That the security will be resold or repurchased;

(b) That the security will be listed or traded on an exchange or established market;

(c) That the security will result in an assured, immediate, or material increase in value, future market price, or return on an investment;

(d) That there is a guarantee against risk of loss; or

(e) Any statement with respect to an issuer's financial condition, anticipated earnings, potential growth, or success not supportable by information in the offering document or prospectus;

(17) Engaging or aiding in boiler room operations such as use of high pressure tactics to promote a speculative offering or promotion of a security in an intensive campaign in which the prospective purchaser is encouraged to make a hasty decision to buy a security irrespective of the purchaser's investment needs, objectives, or understanding of the security being offered;

(18) Executing a transaction on behalf of a customer without authorization to do so;

(19) Exercising any discretionary power effecting a transaction for a customer's account without first obtaining written discretionary authority from the customer, unless the discretionary power relates solely to the time or price for the executing of orders;

(20) Executing any transaction in a margin account without securing from the customer a properly executed written margin agreement;

- (21) Entering into a transaction with or for a customer at a price not reasonably related to the current market price of the security or receiving an unreasonable commission or profit;
- (22) Effecting any transaction in, or inducing the purchase or sale of, any security by means of any manipulative, deceptive, or fraudulent device, practice, plan, program, design or contrivance, ~~including which may include any of the following~~:
- (a) Effecting any transaction in a security which involves no change in the beneficial ownership thereof;
 - (b) Entering an order or orders of substantially the same size, at substantially the same time and substantially the same price, for the sale of any security, that has been or will be entered by or for the same or different parties for the purpose of creating a false or misleading appearance of active trading in the security or a false or misleading appearance with respect to the market for the security; except, this subsection shall not prohibit a broker-dealer from entering bona fide agency cross transactions for its customers; or
 - (c) Effecting, alone or with one or more other persons, a series of transactions in any security creating actual or apparent active trading in the security or raising or depressing the price of the security, for the purpose of inducing the purchase or sale of the security by others;
- (23) Guaranteeing a customer against loss in any securities account of the customer carried by the broker-dealer or in any securities transaction effected by the broker-dealer;
- (24) Publishing or circulating, or causing the publication or circulation of, any notice, circular, advertisement, newspaper article, investment service, or communication of any kind which purports to report any transaction as a purchase or sale of any security unless the broker-dealer reasonably believes that the transaction was a bona fide purchase or sale of the security; or which purports to quote the bid price or asked price for any security, unless the broker-dealer reasonably believes that the quotation represents a bona fide bid or offer;
- (25) Using any advertising or conducting any sales practice in a deceptive or misleading manner;
- (26) Entering into an agreement for a concession, discount, commission, or allowance as consideration for a service in connection with the distribution or sale of a security in Kentucky with a broker-dealer, agent, investment adviser, or investment adviser representative who is not either:
- (a) Registered in Kentucky; or
 - (b) Exempted from the registration requirements for conducting a securities business in Kentucky;
- (27) Lying to or otherwise misleading representatives of the Department of Financial Institutions conducting an authorized examination or investigation;
- (28) Failing to make requested records available to or otherwise impeding a representative of the Department of Financial Institutions conducting an authorized examination or investigation;
- (29) Failing to respond within the specified time period to a written request from an authorized representative of the Department of Financial Institutions for:
- (a) Information
 - (b) An explanation of practices or procedures;
 - (c) A response to a complaint filed with the Department of Financial Institutions; or
 - (d) A response to a written statement of findings from an examination;~~and~~
- (30) Committing any act involving a customer, a customer's account, or any business records which would constitute a criminal offense;~~and~~
- (31) Failing to pay and fully satisfy any final order, final judgment, or arbitration award resulting from an investment-related, customer-initiated arbitration or court proceeding,

unless alternative payment arrangements are agreed to between the customer and the broker-dealer or broker-dealer agent, in writing, and the broker-dealer or broker-dealer agent complies with the terms of the alternative payment arrangement;

(32) Attempting to avoid payment of any final order, final judgment, or arbitration award resulting from an investment-related, customer-initiated arbitration or court proceeding, unless alternative payment arrangements are agreed to between the customer and the broker-dealer or broker-dealer agent, in writing, and the broker-dealer or broker-dealer agent complies with the terms of the alternative payment arrangements; or

(33) Failing to pay and fully satisfy any fine, civil penalty, order of restitution, order of disgorgement, or similar monetary payment obligation imposed upon the broker-dealer or agent by the Securities and Exchange Commission, the securities or other financial services regulator of any state or province, or any self-regulatory organization.

Section 2. Broker-dealer agents shall observe high standards of commercial honor and just and equitable principles of trade in their dealings with customers. The following acts and practices shall constitute violations of those standards and principles and ~~are considered contrary to these standards. Violations~~ may result in a fine, suspension, or revocation in proportion to the seriousness of the offense, pursuant to KRS 292.337(1):

(1) Sharing ~~directly or indirectly~~ in profits or losses in the account of a customer without the written authorization of the customer and the broker-dealer which the agent represents;

(2) Establishing or maintaining an account containing fictitious information in order to execute transactions which would otherwise be prohibited;

(3) Effecting securities transactions not recorded on the regular books and records of the broker-dealer which the agent represents, unless the transactions are authorized in writing by the broker-dealer prior to execution of the transaction;

(4) Engaging in the practice of lending to or borrowing from a customer either money or securities;

(5) Acting as custodian of a customer's money, securities, or an executed stock power; ~~or fund~~

(6) Engaging in conduct specified in Section 1(11) through ~~(33)~~~~(30)~~ of this administrative regulation.

Section 3. Issuer agents shall observe high standards of commercial honor and just and equitable principles of trade in their dealings with customers. The following acts and practices shall constitute violations of those standards and principles and ~~are~~~~considered contrary to these standards. Violations~~ may result in a fine, suspension, or revocation in proportion to the seriousness of the offense, pursuant to KRS 292.337(1):

(1) Engaging in conduct specified in Section 1(2), (13), (15) through (18), or (25) through ~~(33)~~~~(30)~~ of this administrative regulation; or

(2) Engaging in conduct specified in Section 2(3) or (4).

Section 4. The commissioner may determine that an activity not included in the examples identified in Sections 1 through 3 of this administrative regulation constitutes a dishonest or unethical practice if the activity is similar to an enumerated activity.

JUSTIN BURSE, Acting Commissioner

RAY PERRY, Secretary

APPROVED BY AGENCY: January 13, 2023

FILED WITH LRC: January 13, 2023 at 11:50 a.m.

PUBLIC HEARING AND COMMENT PERIOD: A public hearing on this administrative regulation shall be held on March 28, 2023, at 1:00 PM, at 500 Mero Street,

Frankfort Kentucky 40601. Individuals interested in being heard at this hearing shall notify this agency in writing by five workdays prior to the hearing, of their intent to attend. If no notification of intent to attend the hearing was received by that date, the hearing may be cancelled. A transcript of the public hearing will not be made unless a written request for a transcript is made. If you do not wish to be heard at the public hearing, you may submit written comments on the proposed administrative regulation. Written comments shall be accepted through March 31, 2023. Send written notification of intent to be heard at the public hearing or written comments on the proposed administrative regulation to the contact person.

CONTACT PERSON: Catherine Falconer; General Counsel; 500 Mero Street, 2 SW 19, Frankfort, Kentucky 40601; Phone: 502-782-9052; Fax: 502-573-8787; Email: Catherine.Falconer@ky.gov and Marni Gibson, Acting Deputy Commissioner, 500 Mero Street, 2SW19, Frankfort, Kentucky 40601; Phone: 502-782-9053; Fax: 502-573-8787; Email: Marni.Gibson@ky.gov

REGULATORY IMPACT ANALYSIS AND TIERING STATEMENT

Contact Person: Catherine Falconer

(1) Provide a brief summary of:

(a) What this administrative regulation does:

This administrative regulation provides examples of dishonest and unethical practices by broker-dealers and agents and states the consequences of engaging in unacceptable conduct or practices.

(b) The necessity of this administrative regulation:

KRS 292.336(5) and (6) authorize the commissioner to promulgate administrative regulations prohibiting unreasonable charges, profits, commissions, or other compensation for broker-dealers and agents and prescribing standards for the conduct of business by broker-dealers and agents which the commissioner finds appropriate in the public interest and for the protection of investors. This regulation is necessary to provide examples of dishonest and unethical practices by broker-dealers and agents and share the consequences of engaging in unacceptable conduct or practices.

(c) How this administrative regulation conforms to the content of the authorizing statutes:

KRS 292.500(3) authorizes the commissioner of the Department of Financial Institutions to promulgate administrative regulations necessary to carry out the provisions of KRS Chapter 292.

(d) How this administrative regulation currently assists or will assist in the effective administration of the statutes:

This regulation prohibits unreasonable charges, profits, commissions, or other compensation for broker-dealers and agents and prescribes standards for the conduct of business by broker-dealers and agents which the commissioner finds appropriate in the public interest and for the protection of investors. Furthermore, this regulation provides for standards of conduct of broker-dealers and agents regarding their interaction with clients, the public in general, adherence to the governing laws, and honestly and transparency in their conduct in order to promote confidence in the industry.

(2) If this is an amendment to an existing administrative regulation, provide a brief summary of:

(a) How the amendment will change this existing administrative regulation:

The amended regulation establishes an ethical violation for a broker-dealer or agent that fails to satisfy an investment-related, customer-initiated judgment or court order, attempts to avoid payment of referenced judgment or court order or fails to pay and fully satisfy any fine, civil penalty, order of restitution, order of disgorgement, or similar monetary payment obligation imposed on the broker-dealer or agent from a federal or state regulatory body.

(b) The necessity of the amendment to this administrative regulation:

The amendment is necessary to uphold ethical standards of participants in the financial industry, specifically a segment that works directly with clients and engages in transactions that involve the client's hard-earned capital. Failure to pay judgments or avoiding payment on court orders or judgments, related to investment-related activities, undermines the integrity of the securities industry, and allows for

broker-dealers and agents to continue to engage with customers in a position of trust when their standards are compromised.

(c) How the amendment conforms to the content of the authorizing statutes:

KRS 292.336(6) provides for the commissioner to prescribe rules for the conduct of business by broker-dealers and investment advisers which he or she finds appropriate in the public interest and for the protection of investors. This amendment will enhance and raise standards for broker-dealers and agents regarding payments for orders or judgments.

(d) How the amendment will assist in the effective administration of the statutes:

The amended language will allow the Department to hold broker-dealers and agents accountable for failure to uphold their obligations to the court or other governing body.

(3) List the type and number of individuals, businesses, organizations, or state and local governments affected by this administrative regulation:

All broker-dealers and agent participants in the securities industry in Kentucky will be held to this standard and potentially affected by this administrative regulation.

(4) Provide an analysis of how the entities identified in question (3) will be impacted by either the implementation of this administrative regulation, if new, or by the change, if it is an amendment, including:

(a) List the actions that each of the regulated entities identified in question (3) will have to take to comply with this administrative regulation or amendment:

Broker-dealers and agents will be required to pay all fees and fines resulting from court orders, judgments or arbitration awards resulting from an investment-related customer-initiated action or enter into a written payment plan for satisfaction of the judgment. In addition, the broker-dealer will be prohibited from actively avoiding payments or purposely failing to take action to make required payments.

(b) In complying with this administrative regulation or amendment, how much will it cost each of the entities identified in question (3):

The costs incurred will be a direct result of the actions of the broker-dealer and agent to comply with the judgment or orders and will be dependent upon their compliance. Imposing an enhanced ethical requirement will not directly incur additional business costs to the regulated entity.

(c) As a result of compliance, what benefits will accrue to the entities identified in question (3):

Compliance with the amendment language will promote higher ethical standards throughout the industry and increase client confidence in broker-dealers and their agents.

(5) Provide an estimate of how much it will cost the administrative body to implement this administrative regulation:

(a) Initially:

There will be no additional costs initially incurred by the agency for implementation.

(b) On a continuing basis:

There is no anticipated additional costs other than for enforcement actions resulting from a lack of compliance with this regulation.

(6) What is the source of the funding to be used for the implementation and enforcement of this administrative regulation:

Implementation and enforcement of this regulation will be funded by the current Department budget.

(7) Provide an assessment of whether an increase in fees or funding will be necessary to implement this administrative regulation, if new, or by the change if it is an amendment:

The Department does not anticipate a need to increase funding to implement this change.

(8) State whether or not this administrative regulation establishes any fees or directly or indirectly increases any fees:

This regulation amendment does not establish new fees or imposes additional fees for compliance.

(9) TIERING: Is tiering applied?

Tiering was not applied. The amended regulation language will not require tiering to be implemented.

FISCAL NOTE

(1) What units, parts, or divisions of state or local government (including cities, counties, fire departments, or school districts) will be impacted by this administrative regulation?

The Department of Financial Institutions

(2) Identify each state or federal statute or federal regulation that requires or authorizes the action taken by the administrative regulation.

KRS 292.336(5), (6), 292.500(3)

(3) Estimate the effect of this administrative regulation on the expenditures and revenues of a state or local government agency (including cities, counties, fire departments, or school districts) for the first full year the administrative regulation is to be in effect.

(a) How much revenue will this administrative regulation generate for the state or local government (including cities, counties, fire departments, or school districts) for the first year?

The regulation amendment will not impact the Department's budget. All revenue associated with this regulation are addressed in the current budget.

(b) How much revenue will this administrative regulation generate for the state or local government (including cities, counties, fire departments, or school districts) for subsequent years?

The regulation amendment will not impact the Department's budget in subsequent years. All revenue associated with this regulation are addressed in the current budget.

(c) How much will it cost to administer this program for the first year?

There will be no additional costs to administer this regulation amendment. All costs associated with this regulation are addressed in the current budget.

(d) How much will it cost to administer this program for subsequent years?

Note: If specific dollar estimates cannot be determined, provide a brief narrative to explain the fiscal impact of the administrative regulation.

Revenues (+/-):

Expenditures (+/-):

Other Explanation:

(4) Estimate the effect of this administrative regulation on the expenditures and cost savings of regulated entities for the first full year the administrative regulation is to be in effect.

Regulated entities will have no additional costs if they maintain compliance with the current regulatory provisions.

(a) How much cost savings will this administrative regulation generate for the regulated entities for the first year?

The Department does not anticipate cost savings for the regulated entities.

(b) How much cost savings will this administrative regulation generate for the regulated entities for subsequent years?

The Department does not anticipate cost savings for the regulated entities for subsequent years.

(c) How much will it cost the regulated entities for the first year?

There will be no additional costs to regulated entities.

(d) How much will it cost the regulated entities for subsequent years?

There will be no additional costs to regulated entities in subsequent years.

Note: If specific dollar estimates cannot be determined, provide a brief narrative to explain the fiscal impact of the administrative regulation.

Cost Savings (+/-):

Expenditures (+/-):

Other Explanation:

(5) Explain whether this administrative regulation will have a major economic impact, as defined below.

"Major economic impact" means an overall negative or adverse economic impact from an administrative regulation of five hundred thousand dollars (\$500,000) or more on state or local government or regulated entities, in aggregate, as determined by the promulgating administrative bodies. [KRS 13A.010(13)] The amendment to the regulation will not have a major economic impact on the administrative regulation of these entities.