

PUBLIC PROTECTION CABINET
Kentucky Department of Financial Institutions
(Amendment)

808 KAR 10:450. Examples of dishonest or unethical practice for investment advisers and investment adviser representatives.

RELATES TO: KRS Chapter 292, 17 C.F.R. 275.206(4), 15 U.S.C. 78, 80b

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 or other compensation of investment advisers and prescribing standards for the conduct of business by investment advisers and investment adviser representatives 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 investment advisers and investment adviser representatives and clarifies the consequences of engaging in unacceptable conduct or practices.

Section 1. Definitions.

(1) "Advertisement" means any notice, circular, letter, or other written communication addressed to more than one person, or any notice or other announcement in any electronic or paper publication, by radio or television, or by any other medium, that offers any one of the following:

- (a) Any analysis, report, or publication concerning securities;
- (b) Any analysis, report, or publication that is to be used in making any determination as to when to buy or sell any security or which security to buy or sell;
- (c) Any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell; or
- (d) Any other advisory service ~~regarding~~~~[with regard to]~~ securities.

(2) "Investment adviser solicitor" means a person or entity that, directly or indirectly, solicits a prospective client for, or refers a prospective client to, an investment adviser.

Section 2. A person who is an investment adviser or an investment adviser representative shall be a fiduciary and shall have a duty to act primarily for the benefit of its clients. An investment adviser or investment adviser representative shall not engage, either directly or indirectly, in unethical or dishonest practices. The following acts and practices shall ~~constitute~~~~[be considered either]~~ a breach of fiduciary duty or a dishonest and unethical practice, ~~and violations~~~~[. Violations]~~ may result in a fine, suspension, or revocation in proportion to the seriousness of the offense:

(1) Recommending to a client to whom investment advisory, management, or consulting services are provided the purchase, sale, or exchange of any security without reasonable grounds to believe that the recommendation is suitable for the client ~~based on~~ ~~[the basis of]~~ information furnished by the client after reasonable inquiry concerning the client's investment objectives, financial situation and needs, and any other information known by the investment adviser;

(2) Exercising any discretionary power in placing an order for the purchase or sale of securities for a client without obtaining written discretionary authority from the client within ten (10) business days after the date of the first transaction placed pursuant to oral discretionary authority, unless the discretionary power relates solely to the price at which, or the time when, an order involving a definite amount of a specified security shall be executed, or both;

(3) Inducing trading in a client's account that is excessive in size or frequency in view of the financial resources, investment objectives, and character of the account ~~considering in light of the fact~~ that an investment adviser or investment adviser representative ~~may in these situations can~~ directly benefit from the number of securities transactions effected in a client's account;

(4) Placing an order to purchase or sell a security for the account of a client without authority to do so;

(5) Placing an order to purchase or sell a security for the account of a client upon instruction of a third party without first having obtained a written third-party trading authorization from the client;

(6) Borrowing money or securities from a client unless the client is a broker-dealer, an affiliate of the investment adviser, or a financial institution engaged in the business of loaning funds;

(7) Loaning money or securities to a client unless the investment adviser is a financial institution engaged in the business of loaning funds or the client is an affiliate of the investment adviser;

(8)

(a) Misrepresenting to any advisory client, or prospective advisory client, the qualifications of the investment adviser or any employee of the investment adviser;

(b) Misrepresenting the nature of the advisory services being offered or fees to be charged for the service; or

(c) Omitting to state a material fact necessary to make the statements made regarding qualifications, services or fees, in light of the circumstances under which they were made, not misleading;

(9) Providing a report or recommendation to any advisory client prepared by someone other than the adviser without disclosing that fact;

(10) Charging a client an unreasonable advisory fee in light of the fee charged by other investment advisers providing similar services;

(11) Failing to disclose to clients in writing before any advice is rendered any material conflict of interest relating to the adviser, or any of its employees, including:

(a) Compensation arrangements connected with advisory services to clients which are in addition to compensation from these clients for advisory services; ~~or and~~

(b) The amount of any commissions to be received for executing transactions pursuant to advice given;

(12) Failing to disclose to clients in writing all potentially conflicting divisions of loyalty in connection with a transaction, and ~~failing to obtain~~~~obtaining~~ the written consent of the client to proceed with the transaction in accordance with the following requirements:

(a) Any transaction in which a person acts as an investment adviser for one (1) party to that transaction and in which the person (or any person controlling, controlled by, or under common control with the adviser) acts as a broker-dealer for both the advisory client and another person on the other side of the transaction is subject to this disclosure and consent requirement, and the client shall be provided a written confirmation for each such transaction which contains the following:

1. A statement of the nature of the transaction;

2. The date of the transaction;

3. An offer to furnish, upon written request, the time of the transaction; and

4. The source and amount of any other remuneration the adviser received or will receive in connection with the transaction. If the investment adviser is not participating in a distribution when the advisory client is purchasing the security or a tender offer when the advisory client is selling the security, the confirmation may state that the investment adviser has been or will be receiving other remuneration

and that the source and the amount of this remuneration will be furnished upon the client's written request;

(b) The disclosure and consent requirements of subsection (12)(a) of this section apply to each contemplated transaction and shall be complied with every time the transaction occurs unless the adviser complies with the provisions of subsection (12)(c) of this section;

(c) If the disclosure and consent requirements of subsection (12)(a) of this section prospectively cover more than one transaction, the adviser is responsible for ensuring that the client receives at least annually, with or as part of a written statement or summary of the client's account, written disclosure of the following:

1. The total number of these transactions since the date of the last statement or summary;
2. The total amount of all commissions or other remuneration the adviser received or will receive in connection with the transactions; and
3. A conspicuous statement that the client may revoke the written consent previously given by providing written notice of the revocation to the adviser; and

(d) Any transaction in which the same adviser recommended the transaction to both a seller and a purchaser of a security shall be a dishonest or unethical practice regardless of any disclosure and consent;

(13) Failing to disclose to clients in writing before any advice is rendered any material fact with respect to the financial and disciplinary information required to be disclosed by 17 C.F.R. 275.206(4)-4 (SEC Rule 206(4)4);

(14) Guaranteeing a client that a specific result will be achieved with advice which will be rendered;

(15) Using any advertisement that does ~~any of~~ the following:

(a) Refers to any testimonial of any kind concerning any advice, analysis, report, or other service rendered by the adviser or representative unless it meets the following requirements:

1. The testimonial clearly discloses whether the person giving the testimonial is a client or promoter;
2. The testimonial clearly discloses whether the person giving the testimonial is compensated;
3. An adviser or representative using a testimonial provided by a promoter has entered into a written agreement with a promoter; and
4. The adviser or representative and testimonial comply with all provisions of Rule 206(4)-1 of the Investment Advisers Act of 1940, commonly known as the SEC marketing rule, effective December 22, 2020;

(b) Refers to past specific recommendations of the adviser or representative that were or would have been profitable, except that an adviser or representative may furnish or offer to furnish a list of all recommendations made by the adviser or representative within the immediately preceding period of not less than one (1) year if the list also includes the following:

1. The name of each security recommended, the date and nature of each recommendation, the market price at that time, the price at which the recommendation was to be acted upon, and the most recently available market price of each security; and
2. A legend on the first page in prominent print or type that states that recommendations made in the future may not be as profitable as the securities on the list;

(c) Represents that any graph, chart, formula, or other device being offered can in and of itself be used to determine which securities to buy or sell, or when to buy or sell them; ~~or which represents, directly or indirectly, that any graph, chart, formula, or~~

~~other device being offered will assist any person in making that person's own decisions without prominently disclosing in the advertisement the limitations and the difficulties with respect to its use;~~

(d) Represents that any graph, chart, formula, or other device being offered will assist any person in making that person's own decisions without prominently disclosing in the advertisement the limitations and the difficulties with respect to its use;

~~(e)~~ ~~(d)~~ Represents that any report, analysis, or other service will be furnished for free or without charge, unless the report, analysis or other service actually is or will be furnished free and without any direct or indirect condition or obligation;

~~(f)~~ ~~(e)~~ Represents that the Department of Financial Institutions has approved any advertisement; or

~~(g)~~ ~~(f)~~ Contains any untrue statement or omission of a material fact, or that is otherwise false or misleading;

(16) Disclosing the identity, affairs, or investments of any client unless required by law to do so, or unless consented to in writing by the client;

(17) Taking any action, directly or indirectly, with respect to those securities or funds in which any client has any beneficial interest, if the investment adviser has custody or possession of the securities or funds when the adviser's action is subject to and does not comply with the provisions of 808 KAR 10:020 relating to the custody;

(18) Entering into, extending, or renewing an advisory contract unless the contract is in writing and discloses the following:

(a) The nature of the advisory services to be provided;

(b) The time period that the contract remains in effect;

(c) The advisory fee and the formula for computing the fee;

(d) The amount of the prepaid fee to be returned if there is contract termination or nonperformance;

(e) Whether the contract grants discretionary power to the adviser and, if so, the terms of the discretionary power;

(f) Whether the contract grants custody of client funds to the adviser and, if so, the terms of the custody; and

(g) That the adviser shall not assign the contract without the prior written consent of the client;

(19) Including in an advisory contract any condition, stipulation, or provision binding any client to waive compliance with any provision of the Securities Act of Kentucky, KRS Chapter 292, 808 Chapter 10, or of the Investment Advisors Act of 1940, 15 U.S.C. 80b;

(20) Paying compensation, directly or indirectly, to an investment adviser solicitor unless the investment adviser makes the payment in accordance with the requirements of 17 C.F.R. 275.206(4)-3) (SEC Rule 206(4)-3);

(21) Engaging in any act, practice, or course of business which is fraudulent, deceptive, or manipulative contrary to the provisions of Section 206(4) of the Investment Advisors Act of 1940, whether or not the investment adviser is registered or required to be registered under Section 203 of the Act;

(22) Failing to provide all material information with respect to any dealings with or recommendations to any advisory client in violation of KRS 292.320;

(23) Committing any act involving a client, the client's assets, or any business records which would constitute a criminal offense;

(24) Lying to or otherwise misleading a representative of the Department of Financial Institutions conducting an authorized examination or investigation;

(25) Failing to make requested records available to or otherwise impeding a representative of the Department of Financial Institutions conducting an authorized examination or investigation;~~and~~

(26) Failing to respond in a timely manner 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; or
- (d) A response to a written statement of findings from an examination.

(27) Failing to pay and fully satisfy any final order, judgment, or arbitration award resulting from an investment-related, client or customer-initiated arbitration or court proceeding, unless alternative payment arrangements are agreed to, in writing, and complied with between:

- (a) The client and the investment adviser or investment adviser representative; or
- (b) Between the customer and the broker-dealer or the broker-dealer agent;

(28) Attempting to avoid payment of any final order, judgment, or arbitration award resulting from an investment-related, client or customer-initiated arbitration or court proceeding, unless alternative payment arrangements are agreed to, in writing, and complied with between:

- (a) The client and the investment adviser or investment adviser representative; or
- (b) Between the customer and the broker-dealer or the broker-dealer agent; or

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

Section 3. The provisions of this administrative regulation shall apply to federally covered advisers operating in Kentucky to the extent that the conduct alleged is fraudulent, deceptive, or as otherwise permitted by the National Securities Market Improvement Act of 1996, 15 U.S.C. 78, and the Investment Advisors Act of 1940, 15 U.S.C. 80b.

Section 4. The commissioner may determine that an activity not included in the examples identified in Section 2 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 p.m. 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

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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 investment advisers and investment adviser representatives 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 Investment Advisers and Investment Adviser Representatives, and prescribing standards for the conduct of business by Investment Advisers and Investment Adviser Representatives which the commissioner finds appropriate in the public interest and for the protection of investors. This administrative regulation is necessary to provide examples of dishonest and unethical practices by investment advisers and investment adviser representatives and clarify 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 Investment Advisers and Investment Adviser Representatives, and prescribes standards for the conduct of business by Investment Advisers and Investment Adviser Representatives which the commissioner finds appropriate in the public interest and for the protection of investors. Furthermore, this regulation provides for standards of conduct of Investment Advisers and Investment Adviser Representatives regarding their interaction with clients and the public in general, for adherence to the governing laws, and for honesty 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 a 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

judgements or avoiding payment on court orders or judgments related to investment related activities undermines the integrity of the securities industry and allows for Investment Advisers and Investment Adviser Representatives 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) authorizes the commissioner to prescribe rules for the conduct of business by Investment Advisers 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 Investment Advisers and Investment Adviser Representatives 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 Investment Advisers and Investment Adviser Representatives 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 Investment Advisers 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:

Investment Advisers and Investment Adviser Representatives 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 to enter into a written payment plan for satisfaction of the judgement. In addition, the broker-dealer will be prohibited from actively avoiding payments or purposefully 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 judgement or orders and will be dependent upon their compliance. Imposing an enhanced ethical requirement will not directly result in 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 Investment Advisers and their Investment Adviser Representatives.

(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 standard.

(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 regulatory amendment will not impact the Department's 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 regulatory amendment will not impact the Department's budget in subsequent years.

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

There will be no additional costs to administer this regulatory amendment.

(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.