

808 KAR 10:200. Investment advisers' minimum liquid capitalization; bond.

RELATES TO: KRS 292.331(4), 292.336(6), 7 U.S.C. 6f

STATUTORY AUTHORITY: KRS 292.331(4), 292.336(6), 292.500(3)

NECESSITY, FUNCTION, AND CONFORMITY: KRS 292.500(3) authorizes the commissioner to promulgate administrative regulations necessary to carry out the provisions of KRS Chapter 292. KRS 292.331(4) authorizes the commissioner to require a minimum liquid net capital for investment advisers. KRS 292.336(6) authorizes the commissioner to prescribe rules for the conduct of business by investment advisers. This administrative regulation establishes the requirements for minimum liquid capitalization and bonding for an investment adviser.

Section 1. Definitions.

- (1) "Custody" means holding, directly or indirectly, client funds or securities, or having any authority to appropriate them or obtain possession, in accordance with the requirements established in Section 2 of this administrative regulation.
- (2) "Independent party" means a person that:
 - (a) Is engaged by the adviser to act as a gatekeeper for the payment of fees, expenses and capital withdrawals from the pooled investment;
 - (b) Does not control, is not controlled by, and is not under common control with the adviser; and
 - (c) Does not have, and has not had within the past two (2) years, a material business relationship with the adviser.
- (3) "Independent representative" means a person who:
 - (a)
 1. For an advisory client, acts as an agent; or
 2. For a pooled investment vehicle:
 - a. Acts as an agent for the limited partners of a limited partnership, for members of a limited liability company, or for other beneficial owners of another type of pooled investment vehicle; and
 - b. By law or contract is obligated to act in the best interests of the advisory client or the limited partners, members, or other beneficial owners;
 - (b) Does not control, is not controlled by, and is not under common control with the adviser; and
 - (c) Does not have, and has not had within the past two (2) years, a material business relationship with the adviser.
- (4) "Net worth" means an excess of assets over liabilities as determined by generally-accepted accounting principles, but shall not include as assets:
 - (a) Deferred charges, goodwill, franchise rights, organizational expenses, patents, copyrights, marketing rights, unamortized debt discount and expense, or any other intangible asset;
 - (b) Home, home furnishings, automobiles, and any other items not readily marketable, if the adviser is an individual;
 - (c) Advances or loans to stockholders and officers or related parties of stockholders or officers, if the adviser is a corporation;
 - (d) Advances or loans to partners or related parties of partners, if the adviser is a partnership; and
 - (e) Advances or loans to members or related parties of members, if the adviser is a limited liability company.
- (5) "Qualified custodian" means any of the following institutions or entities not controlling and not controlled by, nor under common control with, the adviser:

- (a) A bank or savings association that has deposits insured by the Federal Deposit Insurance Corporation;
- (b) A registered broker-dealer holding the client assets in customer accounts;
- (c) A registered futures commission merchant under Section 4f(a) of the Commodity Exchange Act, 7 U.S.C. 6f(a), holding the client funds in customer accounts, but only with respect to the client funds and futures contracts in those accounts or other securities incidental to transactions in the purchase or sale of a commodity for future delivery or options thereon; and
- (d) A foreign financial institution that customarily holds financial assets for its customers, if the foreign financial institution keeps the advisory client's assets in customer accounts segregated from the institution's proprietary assets.

Section 2. Custody Standards.

(1) Custody shall include:

- (a) Possession of client funds or securities unless the funds or securities are:
 - 1. Received inadvertently; and
 - 2. Returned to the sender within three (3) business days of the receipt of the funds or securities;
- (b) Receipt of a check drawn by a client and made payable to an unrelated third party unless:
 - 1. The check is forwarded to the third party within twenty-four (24) hours of receipt; and
 - 2. The adviser maintains appropriate records to document the preceding;
- (c) Any arrangement, including a general power of attorney, under which the adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian that are not excluded under subsection (2) of this section;
- (d) Any capacity that gives the adviser access or legal ownership to client funds or securities, including if the adviser is a general partner of a limited partnership, managing member of a limited liability company, or holds a comparable position for another type of pooled investment vehicle, or is trustee of a trust; or
- (e) Any advance fee arrangement in which an adviser receives payment in excess of \$500 for work not to be completed within six (6) months of receipt of the payment from the client.

(2) Custody shall not include an arrangement for direct deduction of fees from a client account held with a qualified custodian if the adviser provides the following safeguards:

- (a) The adviser has written authorization from the client to deduct advisory fees from the account;
- (b) Each time a fee is directly deducted from a client account, the adviser concurrently:
 - 1. Sends the qualified custodian notice of the amount of the fee to be deducted; and
 - 2. Sends the client an invoice itemizing the fee, including the formula used to calculate the fee, the amount of assets under management that the fee is based on, and the time period covered by the fee; and
- (c) At least quarterly, the qualified custodian sends to the client an account statement identifying the amount of funds and each security in the account at the end of the period and setting forth all transactions in the account during that period.

Section 3. Capital Requirements. An investment adviser registered or required to register pursuant to the Securities Act of Kentucky, KRS Chapter 292, shall meet the net worth requirements established in this section:

- (1) An adviser who has custody of client funds or securities, except an adviser having custody due entirely to advising pooled investment vehicles and complying with Section 4(5) or 5(3) of this administrative regulation, shall maintain a minimum net worth as follows:

- (a) For advisers with assets under management of \$25,000,000 or less, the minimum net worth required shall be \$35,000.
 - (b) For advisers with assets under management in excess of \$25,000,000, the minimum net worth required shall be fifteen-hundredths of one percent (.0015) of assets under management.
 - (c) An adviser may substitute all but \$10,000 of the net worth required under paragraphs (a) and (b) of this subsection with a surety bond for the substituted amount issued by a bonding company that is qualified to do business in Kentucky.
- (2) An adviser who requires prepayment of advisory fees six (6) months or more in advance and in excess of \$500 per client shall also maintain capital as required in subsection (1) of this section.
- (3) An adviser who has discretionary authority over client funds or securities, but does not have custody of client funds or securities shall maintain a net worth as follows:
- (a) For advisers with assets under management of \$25,000,000 or less, the minimum net worth required shall be \$10,000.
 - (b) For advisers with assets under management in excess of \$25,000,000, the minimum net worth required shall be one-tenth of one percent (.001) of assets under management.
 - (c) An adviser may substitute, for any part of the net worth required under paragraphs (a) and (b) of this subsection, a surety bond for the substituted amount issued by a bonding company that is qualified to do business in Kentucky.
- (4) An adviser shall maintain a positive net worth at all times.
- (5) The commissioner may require that a current appraisal be submitted to establish the value of any material asset.
- (6) An adviser shall compute its net worth at least once every month at the end of the month and shall maintain a record of each computation along with supporting documentation for a period of two (2) years. Each computation shall be accompanied by documentation of the assets under management for the adviser at that point in time.
- (7) If the computation of net worth results in an amount that is less than required by subsections (1) through (4) of this section, the adviser shall by the close of business on the next business day following the determination of a deficiency, notify the commissioner by facsimile or electronic mail. After transmittal of this notice, the adviser shall promptly file with the commissioner a report of its financial condition, including a balance sheet, a year-to-date income statement and copies of supporting documentation.
- (8) An adviser shall not be deemed to be exercising discretion if the adviser places trade orders with a broker-dealer pursuant to a third party trading agreement if:
- (a) The investment advisory contract specifically states that the client does not grant discretionary authority to the adviser and the adviser in fact does not exercise discretion with respect to the account; and
 - (b) A third party trading agreement is executed between the client and a broker-dealer which specifically limits the adviser's authority in the client's broker-dealer account to the placement of trade orders and deduction of adviser fees.
- (9) An adviser that has its principal place of business in a state other than Kentucky shall maintain the minimum capital as required by the state in which the adviser maintains its principal place of business, if the adviser is licensed in that state and is in compliance with that state's minimum capital requirement.

Section 4. Custody of Client Funds or Securities. An investment adviser registered or required to register pursuant to the Securities Act of Kentucky, KRS Chapter 292, shall comply with the requirements established in this section, if the adviser has custody of client funds or securities.

- (1) The funds and securities shall be maintained by a qualified custodian:

- (a) In a separate account for each client under that client's name; or
 - (b) In accounts that contain only the client's funds and securities, under the adviser's name as agent or trustee for the client.
- (2) The adviser shall notify the client in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained promptly when the account is opened and following any changes to this information.
- (3)
- (a) Account statements shall be sent to the client, either:
 - 1. By the qualified custodian and the adviser shall have a reasonable basis for believing that the custodian sent an account statement, at least quarterly, to each of the adviser's clients for which it maintains funds or securities, identifying the amount of funds and each security in the account at the end of the period and setting forth all transactions in the account during that period; or
 - 2. By the adviser, if the following conditions are met:
 - a. The adviser shall send an account statement, at least quarterly, to each client for whom the adviser has custody of funds or securities, identifying the amount of funds and each security of which it has custody at the end of the period and setting forth all transactions during the period;
 - b. An independent certified public accountant shall verify all client funds and securities by actual examination on an annual basis. The adviser shall file a copy of the accountant report and financial statements with the commissioner within thirty (30) days of the completion of the examination, along with a letter from the accountant stating that it has examined the funds and securities and describing the nature and extent of the examination; and
 - c. The adviser, upon notice from the certified public accountant of finding any material discrepancies during the course of the examination, shall notify the commissioner within one (1) business day of the finding, by means of a facsimile transmission or electronic mail, followed by certified first class mail.
 - (b) If the adviser is a general partner of a limited partnership, managing member of a limited liability company, or holds a comparable position for another type of pooled investment vehicle, the account statement required by paragraph (a) of this subsection shall be sent to each limited partner, member, other beneficial owner, or their independent representative.
- (4) A client may designate an independent representative to receive on his behalf notices and account statements as required under subsections (2) and (3) of this section.
- (5) An adviser who has custody and who does not meet the exception established in Section 5(3) of this administrative regulation shall, in addition to the safeguards established in subsections (1) through (4) of this section, comply with the following:
- (a) Hire an independent party to review all fees, expenses, and capital withdrawals from the pooled accounts; and
 - (b) Send all invoices or receipts to the independent third party detailing the amount of the fees, expenses, or capital withdrawals and the method of calculation so that the independent party can:
 - 1. Determine that the payment is in accordance with the pooled investment vehicle standards; and
 - 2. Present to the qualified custodian approval for payment of the invoice with a copy provided to the adviser.

Section 5. Exceptions to Custody Requirements. The custody requirements in Section 4 of this administrative regulation shall not apply to the exceptions listed in this section:

- (1) Shares of mutual funds. With respect to shares of an open-end company as defined in Section 5(a)(1) of the Investment Company Act of 1940, 15 U.S.C. 80a-5(a)(1), the

adviser may use the company's transfer agent in lieu of a qualified custodian for purposes of complying with Section 4 of this administrative regulation.

(2) Certain privately offered securities.

(a) An adviser shall not be required to comply with the custody requirements with respect to securities that are:

1. Acquired from the issuer in a transaction or chain of transactions not involving a public offering;
2. Uncertificated, and ownership thereof is recorded on the books of the issuer or its transfer agent in the name of the client; and
3. Transferable only with prior consent of the issuer or holders of the outstanding securities of the issuer.

(b) The exception provided in paragraph (a) of this subsection shall not be available with respect to securities held for the account of a limited partnership, limited liability company, or other pooled investment vehicle, unless the entity is audited on an annual basis. The adviser shall distribute the audited financial statements as required by subsection (3) of this section.

(3) Limited partnerships subject to annual audit. An adviser shall not be required to comply with Section 4(5) of this administrative regulation with respect to the account of a limited partnership, limited liability company, or other type of pooled investment vehicle that is subject to an annual audit and distributes its audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners, members, or other beneficial owners, within 120 days of the end of its fiscal year.

(4) Registered investment companies. The adviser shall not be required to comply with Section 4 of this administrative regulation with respect to the account of an investment company registered under the Investment Company Act of 1940, 15 U.S.C. 80a-1 to 80a-64.

(5) Beneficial trusts. An adviser having custody due entirely to serving as trustee for a trust, the beneficial owner of the trust being a parent, grandparent, spouse, sibling, child, or grandchild of that person, including blood or step relationships in these categories, shall not be deemed as having custody of the trust funds for purposes of being required to comply with the safekeeping requirements of Section 4 of this administrative regulation or the net worth requirements of Section 3(1) of this administrative regulation. This exclusion shall not apply to any other trust not expressly excepted for which this person is serving as trustee. Any trust not expressly exempted and its trustees shall be in compliance with this administrative regulation. This exclusion shall inure to the benefit of the employer of the registered person while an employment relationship exists.

(8 Ky.R. 579; eff. 3-1-82; Am. 24 Ky.R. 2185; 25 Ky.R. 91; eff. 6-25-98; 32 Ky.R. 1482; 2017; eff. 6-2-2006; 3 Ky.R. 2488; 2842; eff. 7-1-11; Crt eff. 2-27-2020.)