

Investment Adviser Guidelines

Office of the
Kansas Securities Commissioner

A division of the Kansas Insurance Department



An Overview of Rules and Regulations for Kansas Investment Advisers

Kansas Registered Investment Adviser Guidelines

JUNE 2020



The information contained in this guide is provided solely for educational and informational purposes, and may not be construed or relied upon as individual legal counsel.

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About the Office of the Kansas Securities Commissioner

Kansas Securities Regulation

In 1911, Kansas became the first state to pass a law regulating the sale of investments. According to J.N. Dolley, a driving force for the law's passage, it was an effort to prevent the sale of securities by promoters who promised rain, but delivered only "blue sky." In the next few years, other states passed similar laws and today, all states' securities laws are referred to as "blue sky laws". Following the great stock market crash of 1929, the federal government began to regulate investment activity with the passage of the Securities Act of 1933, and the creation of the U.S. Securities & Exchange Commission in 1934.

Role of the Office of the Kansas Securities Commissioner

The Office of the Kansas Securities Commissioner is a division of the Kansas Insurance Department and funded entirely by industry fees. The division regulates and monitors the offering of securities and financial services within Kansas by registering securities, broker-dealers and their agents, and investment advisers and their representatives. Division staff conduct periodic examinations to determine whether registered persons comply with

industry, legal and accounting standards specified by the Kansas Uniform Securities Act (KUSA) and Kansas Administrative Regulations (KARs). Staff also investigate potential violations of statutes and regulations under KUSA, and Special Agents with law enforcement powers conduct criminal investigations of alleged frauds or other unlawful acts. The staff has the authority to investigate any investment-related activity that occurs in Kansas, even when companies or individuals from outside of the state are involved.

Assistance

Division staff is available any time to assist you in understanding and complying with the provisions of the Kansas Uniform Securities Act or to make presentations to groups of industry professionals regarding regulatory issues pertaining to the securities industry in Kansas.

Ethical Standards

An investment adviser or investment adviser representative is a fiduciary and shall act primarily for the benefit of its clients.

K.A.R. 81-14-5(c); Each person registered as an investment adviser or investment adviser representative shall not fail to observe high standards of commercial honor and just and equitable principles of trade in the conduct of the person's business.

Regulatory Filings

Form ADV consists of Parts 1, 2A and 2B, all of which must be filed electronically through IARD.

Annual Renewal

A letter is sent annually from the KSC office reminding investment advisers of the renewal requirement. Questions related to electronic filing of the forms can be answered by the FINRA Call Center at 240-386-4848.

K.A.R. 81-14-1(b)(2); The application for annual renewal registration as an investment adviser shall be filed with the IARD along with the fee required by K.A.R. 81-14-2, which is currently \$100 for an investment adviser and \$60 for each investment adviser representative, and any reasonable fee charged by FINRA for filing through the IARD.

Annual Updating Amendments to Form ADV

Investment advisers are required to file an annual updating amendment to form ADV Parts 1 & 2A within 90 days after the end of the investment adviser's fiscal year. The annual updating amendment requires that the adviser review the information contained in each ADV filing to ensure that it is current and accurate. This filing must not be submitted until after the end of the adviser's fiscal year.

K.A.R. 81-14-1(b)(3)(B); Within 90 days after the end of an investment adviser's fiscal year, the investment adviser shall file with the IARD an annual updating amendment to form ADV.

ADV Updates and Amendments

Investment advisers are required to update their form ADV Part 1, in accordance with the ADV instructions and by submitting an "Other-than-annual" amendment on the IARD system. The instructions for Part 1 provide specific items that must be updated promptly if changes occur. If any information in Parts 2A or 2B becomes materially inaccurate, appropriate updates must be submitted on the IARD and delivered to clients promptly (within 30 days). Changes made to Parts 2A or 2B require that the date on the cover page be changed.

K.A.R. 81-14-1(b)(3)(A); Each investment adviser shall file with IARD, in accordance with the instructions in form ADV, any amendments to the investment adviser's form ADV. An amendment shall be considered to be filed promptly if the amendment is filed within 30 days of the event that requires the filing of the amendment.

Professional Liability Insurance Disclosure

Each investment adviser registered in Kansas is required to provide an addendum

or supplement to the form ADV, Part 2A for delivery to all clients or prospective clients disclosing the presence or absence of professional liability insurance coverage for its investment advisory services. If a client or prospective client requests proof of the professional liability insurance coverage, the investment adviser shall, within 30 days, provide a copy of the insurance agreement that is in effect.

Form U-4 Filings

K.A.R. 81-14-1(c)(3); Each investment adviser representative shall be under a continuing obligation to update the information required by form U-4 as changes occur. Each investment adviser representative and any associated investment adviser shall file promptly with CRD any amendments to the representative's form U-4. An amendment shall be considered to be filed promptly if the amendment is filed within 30 days of the event that requires the filing of the amendment.

Form U-5 Filings

K.A.R. 81-14-1(f)(2); When an investment adviser representative's association with an investment adviser is discontinued or terminated, the investment adviser shall immediately file a form U-5 with the CRD. If the investment adviser representative commences association with another investment adviser, that investment adviser shall file a form U-4 as an initial application for registration for the investment adviser representative.

Form ADV-W Filings

K.A.R. 81-14-1(f)(3); If an investment adviser desires to withdraw from registration or if registration is terminated by the administrator, the investment adviser shall immediately file a form ADV-W with the IARD. The form ADV-W shall be completed in accordance with the instructions to the form.

K.A.R. 81-14-1(f)(4); Termination of an investment adviser's registration for any reason shall automatically constitute cancellation of the registration of each investment adviser representative that is affiliated with the investment adviser.

Recordkeeping and Retention Requirements

Recordkeeping

K.A.R. 81-14-4; Investment advisers should review this regulation in detail periodically to ensure that records pertaining to their business model are being maintained as required. Generally, the following records must be maintained:

- Journals, including cash receipts and disbursements records;
- General ledgers reflecting asset, liability, equity, capital, income and expense accounts;
- Memoranda regarding orders, instructions, modifications or cancellations;

- Bank statements, canceled checks, and cash reconciliations;
- Bills or statements, paid or unpaid, regarding the business;
- Trial balances, financial statements and internal working papers;
- Written communications received and sent, including recommendations, orders, receipt/disbursement of funds/securities, and lists of persons receiving notices/advertisements;
- A list of discretionary accounts and evidence of discretionary authority;
- Client agreements and other agreements related to business of the firm;
- Copies of notices, circulars, advertisements, and articles sent to persons not connected to the adviser and reasons for any specific recommendations made;
- A record of every transaction in a security;
- Copies of the adviser's brochure, including amendments or revisions sent to clients or prospective clients;
- Documents related to clients obtained for the adviser by a solicitor to whom a cash fee was paid;
- Accounts, books, internal working papers and other documents that form the basis for or calculations of performance or rate of return for managed accounts;
- Communications regarding customer complaints and litigation;
- Written information about each client that is the basis for recommendations or investment advice given to the client;

- Written supervisory procedures;
- Copies of all documents filed with or received from any state or federal agency or self-regulatory organization that pertains to the firm or its representatives;
- Copies, with original signatures, of the initial form U-4 for investment adviser representatives and all amendments to the disclosure reporting pages filed; and
- Records related to inadvertent custody of securities or funds, records related to exceptions to the custody rules, as well as documents required to be kept if an adviser has custody.

Records Retention

K.A.R. 81-14-4(f); This subsection of the regulation specifies requirements for the preservation of records, which includes the length of time the records must be maintained in the principal office of the investment adviser and the length of time that they must be maintained and preserved in an easily accessible place.

Electronic Records

K.A.R. 81-14-4(h); The required records listed above may be maintained and preserved in electronic form. If in the ordinary course of the adviser's business, the records are created or copied by the adviser on electronic media or received by the adviser solely on electronic media or by electronic data transmission, criteria for maintenance of these records include:

- Arranging and indexing the records to permit the immediate location of that record;
- Being able to promptly provide a copy as requested by the Administrator;
- Storing, separately from the original, one other copy of each record for the time required;
- Creating procedures for the maintenance and preservation of, and access to, the records in order to safeguard them from loss, alteration or destruction; and
- Having the facilities available for immediate, readable projection of film and facsimile enlargements.

Examinations

The compliance staff conducts periodic examinations or examinations for cause of broker-dealer and investment adviser offices inside and outside of Kansas. An examination may be conducted at any time and without advance notice. The compliance staff may copy and remove for examination copies of all records that are determined to be reasonably necessary or appropriate to conduct the examination. Examinations by the compliance staff are authorized under the Kansas Uniform Securities Act.

K.S.A. 17-12a411(d); The records of every investment adviser or investment adviser representative are subject to such

reasonable periodic, special, or other audits or inspections by a representative of the Securities Commissioner, either inside or outside of Kansas, as the Commissioner considers necessary or appropriate in the public interest and for the protection of investors. An audit or inspection may be made at any time and without prior notice. The Commissioner's staff may copy, and remove for audit or inspection copies of, all records considered reasonably necessary or appropriate to conduct the audit or inspection. Any documents removed or copied during an audit or inspection will be maintained by the KSC staff and are not considered public records, however, the Commissioner has the discretion to disclose the records for the purposes of a civil, administrative, or criminal investigation, action or proceeding per K.S.A. 17-12a607.

Common Deficiencies Noted During Examinations:

- Failure to file timely updates to forms ADV and U-4;
- Discrepancies between disclosures in forms ADV, Part 1 and Part 2A;
- Failure to maintain financial statements according to GAAP;
- Failure to prepare a monthly balance sheet;
- Failure to disclosure Custody, as required by K.A.R. 81-14-9;
- Misrepresentations on advertising or marketing materials;
- Website not updated periodically;
- Failure to maintain updated suitability information for each client;
- Missing signed client agreements;

- Billing errors and incorrect fee calculations;
- Lack of documentation regarding yearly privacy policy dissemination and offering of the brochure;
- Supervisory procedures unrelated to the firm's investment activities and personnel;
- Failure to follow the firm's supervisory procedures;
- Failure to register or license investment adviser representatives; and
- Failure to conduct an internal annual review of the adviser's activities to ensure compliance with industry rules and regulations.

Audits and/or inspections are resolved by issuing a deficiency letter to the examinee with corrective action to be taken, or, for more egregious or substantive violations, a formal administrative action may be filed and disciplinary sanctions imposed.

Dishonest and Unethical Practices

K.A.R. 81-14-5 lists prohibited conduct considered to be dishonest or unethical practices of investment advisers and their representatives. Dishonest or unethical practices include, but are not limited to, the following:

Unsuitable Recommendations

It is unethical for an investment adviser or investment adviser representative to recommend the purchase or sale of a security without reasonable grounds to believe that the recommendation is suitable for the client.

K.A.R. 81-14-4(b)(18); Each investment adviser shall maintain written information about each investment advisory client that is the basis for making any recommendation or providing any investment advice to the client. At a minimum, such information should include:

- Date of Birth;
- Financial Information (i.e. liquid net worth, annual salary);
- Employment Information;
- Investment Objectives;
- Investment Experience;
- Risk Tolerance;
- Tax Bracket; and
- Anticipated Needs.

Improper Advisory Contract

An investment adviser may not enter into, extend or renew any investment advisory contract unless the contract is in writing and discloses the services to be provided, the term of the contract, the advisory fee, the formula for computing the fee, the amount of prepaid fee to be returned in the event of contract termination or nonperformance, an indication whether the contract grants discretionary power to

the adviser and that no assignment of the contract shall be made by the investment adviser without the consent of the other party to the contract.

Cash Payments for Client Solicitations

Paying a cash fee or other compensation, directly or indirectly, to a solicitor is not allowed unless the solicitation arrangements meet the specifications provided in K.A.R. 81-14-5(f). The solicitor must be registered as an investment adviser representative and a separate written disclosure document is required to be furnished to the client with detailed information regarding the parties involved, the nature of the relationships, and the fees charged. An investment adviser cannot pay an unregistered person any compensation for soliciting clients.

Other Prohibited Practices:

- Improper use of discretionary authority;
- Excessive trading;
- Unauthorized trading;
- Borrowing from or loaning to a client;
- Misrepresenting qualifications, services, or fees;
- Failure to disclose the source of a report;
- Unreasonable fees;
- Failure to disclose conflicts of interest;
- Guaranteeing performance;
- Deceptive advertising;
- Failure to protect confidential information;
- Indirect misconduct;

- Failure to disclose financial condition and disciplinary history; and
- Use of misleading senior-specific certifications and professional designations.

Operational Requirements

K.A.R. 81-14-4(b)(19); Each investment adviser shall maintain written procedures to supervise the activities of employees and investment adviser representatives that are reasonably designed to achieve compliance with the Kansas Uniform Securities Act and other applicable laws. These procedures are intended to govern the operations of the investment adviser, including sole proprietors.

An investment adviser has a duty to supervise its employees, as part of its overall duty to protect the interests of its clients and ensure compliance with regulatory requirements. Each adviser must create its own supervisory procedures, tailored to the needs of its business. A large adviser with multiple investment adviser representatives will have more procedures than a sole proprietor will need. The procedures should be an effective tool for conducting business on behalf of the firm, identifying conflicts of interest, and preventing violations of securities laws and regulations.

The investment adviser representatives of many advisers are also registered as agents of separate broker-dealers. All FINRA member firms must comply with the supervisory requirements spelled out in the FINRA Conduct Rules. FINRA Notice to Members 94-44 and 96-33 provide specific guidance on a broker-dealer's obligation to supervise the outside securities business of its agents, including investment advisory business. However, just because the broker-dealer's compliance department may be reviewing the investment adviser representative's conduct does not mean that the adviser can abdicate its own supervisory responsibilities.

K.A.R. 81-14-10(a)(2); Factors to be considered when determining whether supervisory procedures are reasonably designed are:

- The firm's size;
- The organizational structure;
- The scope of business activities;
- The number and location of the offices;
- The nature and complexity of products and services offered;
- The volume of business done;
- The number of investment adviser representatives assigned to a location;
- The specification of the office as a non-branch location; and
- The disciplinary history of the registered investment adviser representatives.

Guidelines for developing written supervisory procedures should include what needs to be done, who will be responsible for the task, how often it will be reviewed and what record will be maintained to evidence the review.

Areas of Consideration for Supervision

Hiring and Training, K.A.R. 81-14-1; Advisers with more than one employee should have procedures for hiring new personnel; Confirming qualifications and reviewing disciplinary history. Many advisers have minimum education and experience standards for investment adviser representatives. The adviser should develop a system for training new employees and keeping its other employees current on new regulations and other industry issues.

Investment Adviser Representative Registration, K.A.R. 81-14-1(c); Advisers should have procedures to ensure that all investment adviser representatives are properly registered. These procedures should provide for timely disclosure of disciplinary events and other material changes on form U-4, and the timely filing of form U-5 for terminated investment adviser representatives.

Transaction Review, K.A.R. 81-14-4(b)(3) (A); Advisers that execute securities trades for clients should conduct a periodic review of transactions for proper execution and suitability.

Correspondence Review, K.A.R. 81-14-4(b)(7)(A); Advisers with multiple investment adviser representatives should have procedures for monitoring incoming and outgoing correspondence. This review enables the adviser's management to detect evidence of unethical conduct, identify possible complaints and discover other

violations of the adviser's policies or regulatory requirements.

Advertising and Sales Literature Review, K.A.R. 81-14-5(d)(11); All advertising and sales literature used by the adviser should be approved by a supervisor prior to use. Testimonials must be prohibited. The supervisor should carefully review advertising using past recommendations and performance information to ensure that it is not misleading and contains the proper disclosures.

Keeping Disclosure Document Current, K.A.R. 81-14-1(b)(3)(A); The adviser's supervisory procedures should indicate who is responsible for keeping the form ADV up to date and for filing annual and other updates to its disclosure documents.

Distribution of Disclosure Document, K.A.R. 81-14-10(b)(3); The adviser should have procedures designed to ensure that new clients receive the adviser's disclosure document. An investment adviser shall, at least once a year and without charge, deliver or offer in writing to deliver to each of its clients the current brochure and any current brochure supplements. If a client accepts the written offer, the investment adviser shall send the current brochure and supplements to that client within seven days after the investment adviser is notified of the acceptance.

Remote Office Audits, K.A.R. 81-14-10(a); Advisers that maintain branch offices should conduct periodic audits of these offices. The adviser's procedures should include the audit schedule, a

description of the areas to be reviewed during an audit, and a system for maintaining internal audit records.

Investment Adviser Representative Securities Activity Review, K.A.R. 81-14-4(b)(12)(B); All advisers should have policies regarding the personal securities transactions of their investment adviser representatives. This is particularly important for advisers that execute trades for their clients. Advisers must be careful that their investment adviser representatives do not make personal trades ahead of client trades, or in any way seek to benefit from knowledge of the advice given to clients. Advisers should receive copies of statements for all investment adviser representatives with knowledge of advice given to clients. These statements should be reviewed, and this review should be documented.

Complaint Review, K.A.R. 81-14-4(b)(17); A supervisor should review all complaints against the adviser and/or adviser representatives. The complaint review procedure should indicate who conducts this review, how the adviser communicates with the client, how complaints are resolved, and how complaint-related records are maintained.

New Account Approval, K.A.R. 81-14-4(b)(19); Advisers should have specific procedures for review and approval of all new client accounts by a supervisor. The supervisor should review new account documents to ensure that sufficient financial background and investment objective information has been

gathered. A determination should be made as to whether the client is suitable for the services recommended, and whether the client meets the adviser's minimum net worth or account size standards.

Client Account Activity Review, K.A.R. 81-14-4(b)(7)(A); Advisers should periodically review the activity in each client account to be sure that it is consistent with the client's investment objectives and financial profile. The adviser's procedures should indicate the schedule for these reviews. These procedures should be consistent with the account review procedures disclosed on form ADV Part 2A, Item 13.

Handling of Client Funds and Securities, K.A.R. 81-14-9; All advisers should have detailed procedures for the handling of client funds and securities. For the protection of the client and of the adviser, these procedures should include internal controls appropriate for the size of the adviser and its business. At a minimum, the procedures should specify who is responsible for each step of the process, from receiving a deposit from a client to forwarding or depositing the item. The procedures should also indicate the records maintained to document this process. If possible, one person should not be responsible for the entire process.

Maintenance of Books and Records, K.A.R. 81-14-4; The adviser should have a system for maintaining its books and records.

The books and records procedures should specify who is responsible for each type of record, and how long the records are maintained. If possible, one person should not be responsible for creating, maintaining, and destroying records.

Segregation of Incompatible Duties, K.A.R. 81-14-10; To the greatest extent possible, duties pertaining to cash transactions, custody, recording and reconciling of client funds and securities, and the creation, maintenance and destruction of records should be performed by different persons so that one person is not responsible for all duties.

Misuse of Nonpublic Information, K.A.R. 81-14-5(d)(12); All advisers should establish, maintain, and enforce written procedures designed to prevent the misuse of material nonpublic information and prohibit trading on "inside information".

Supervisory System Review, K.A.R. 81-14-4(b)(19); One of the adviser's principals should be responsible for keeping the firm's supervisory procedures up to date. The adviser should document when revised procedures have been distributed to its investment adviser representatives.

Suitability, K.A.R. 81-14-4(b)(18); Each investment adviser shall maintain written information about each investment advisory client that is the basis for making any recommendation or providing any investment advice to the client.

Cybersecurity, K.S.A. 50-6, 139b;

Requires any person who, in the ordinary course of their business, collects, maintains, or possesses the personal information of any other person, to implement and maintain reasonable procedures and practices appropriate to protect the personal information from unauthorized access, use, modification or disclosure.

Elder Abuse; As financial services professionals, investment adviser representatives may become aware or suspect that a client could be the victim of abuse, neglect or exploitation. **K.S.A. 39-1431(c)** provides that any person having reasonable cause to suspect or believe that an adult is being or has been abused, neglected or exploited, or is in need of protective services, may report such information to the Kansas Department for Children and Families at 1-800-922-5330.

Annual Review

K.A.R. 81-14-10(a)(1); Each investment adviser shall conduct a review, at least annually, of the businesses in which the adviser engages, which shall be reasonably designed to assist in detecting and preventing violations of and achieving compliance with the Kansas Uniform Securities Act and regulations, and other applicable laws and regulations.

It is suggested that a record be maintained to document and support the review.

Financial Requirements

K.A.R. 81-14-9(c); This regulation subsection specifies financial reporting requirements for investment advisers based in Kansas and specifies that a balance sheet as required by K.A.R. 81-14-4(b)(6) shall be prepared monthly, dated the last day of the month, and completed within 10 business days after the end of the month. Upon request of the Commissioner's staff for any month, the investment adviser shall file the balance sheet within five days after the request.

K.A.R. 81-14-4(b)(6); Each investment adviser shall maintain all trial balances, financial statements and internal audit working papers relating to its investment adviser business.

"Financial Statements" means a balance sheet prepared in accordance with GAAP, an income statement and a cash flow statement. The income and cash flow statements should also be prepared in accordance with GAAP.

K.A.R. 81-14-9(d); Investment advisers based and registered in Kansas shall maintain a positive net worth at all times. If at any time an investment adviser determines that it is insolvent because its net worth is negative as determined in conformity with GAAP, it shall notify the Commissioner by the close of business on the next business day.

K.S.A. 17-12a412(d)(7); This statute subsection specifies that one of the grounds for discipline of an investment adviser is insolvency, either because the investment adviser's liabilities exceed its assets or because it cannot meet its obligations as they become due. However, an order against the investment adviser may not be entered without a finding of insolvency as a matter of due process, and correction of the insolvency within a reasonable timeframe may prevent a reportable action.

Custody

If an investment adviser has custody of client funds or securities, as defined by K.A.R. 81-14-9(a)(1), disclosure is required on form ADV, Parts 1 & 2A.

Investment advisers with custody must comply with several requirements for safekeeping of client funds and securities as specified in K.A.R. 81-14-9(b)(1), unless an exception provided by (b)(2) under that regulation is met.

Safekeeping requirements include the following which are specified in more detail within the regulation:

- A qualified custodian, as defined in K.A.R. 81-14-9(a)(4), is required to maintain funds and securities in separate accounts for each client, or in accounts that contain only funds and securities of the investment adviser's clients under the name of the investment adviser;
- A notice to clients with information about the qualified custodian is required at the time their account is established and whenever information changes;
- Account statements must be sent at least quarterly by the qualified custodian to each client or their independent representative, or by the investment adviser if an independent CPA is engaged annually to attest to the accuracy of the statements in comparison with the qualified custodian records and the CPA firm's report is filed with the Commissioner within 30 days after completion of the attest engagement;
- Investment adviser managers of pooled investment vehicles (PIVs) must send account statements to each participant in the PIV or their independent representative.
- Prior written authorization from clients is required for the investment adviser's fee to be directly deducted from their account held by a qualified custodian;
- Investment adviser managers of pooled investment vehicles must engage an independent party to review all fees, expenses and withdrawals from pooled accounts unless the pooled investment vehicle is subject to an annual audit and its audited financial statements presented in conformity with GAAP are sent to all participants in the pooled investment within 120 days after the end of its fiscal year; and
- Investment advisers subject to the safekeeping requirements shall notify the Commissioner on form ADV that they intend to comply with those requirements.

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K.A.R. 81-14-9 was amended in October 2013 to eliminate or modify various requirements for balance sheets, adjusted net worth and surety bonds.

Exemption from Registration

The Kansas Private Adviser Exemption under K.A.R. 81-14-11 provides an exemption from registration for investment adviser firms if they:

- Maintain their principal place of business in Kansas;
- Provide investment advice solely to fewer than 15 clients;
- Do not hold themselves out generally to the public as an investment adviser; and
- Do not act as an investment adviser to any investment company registered under the Investment Company Act of 1940 or a company that has elected and has not withdrawn its election to be a business development company pursuant to section 54 of the Investment Company Act of 1940.

In order to qualify for this exemption, neither the investment adviser nor any of its advisory affiliates or associated investment adviser representatives shall be subject to disqualification.

If a firm elects to use this exemption from registration and manages assets of no more than \$25 million on December 31 of each year, the identifying information required by form ADV, Part 1A, Item 1 must be completed and the printed form filed with the KSC office on or before February 1 of the following year. The notice filing should include a cover letter with reference to K.A.R. 81-14-11 and the investment adviser's claim of exemption as a private investment adviser. No filing fee is required with the notice. Firms that manage assets in excess of \$25 million and are registered with the SEC or have filed as an exempt reporting adviser with the SEC are exempt from this notice filing requirement.

Investment adviser representatives that are employed by or associated with an investment adviser that meets this exemption are also exempt from registration requirements if they are not subject to disqualification or otherwise act as an investment adviser representative.

Firms and investment adviser representatives that become ineligible for the exemption must comply with registration requirements within 90 days after the date of ineligibility.



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