

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 95047 / June 6, 2022

INVESTMENT ADVISERS ACT OF 1940
Release No. 6045 / June 6, 2022

ADMINISTRATIVE PROCEEDING
File No. 3-20882

In the Matter of

**JOHN PAUL HARNISH,
d/b/a KM ADVISORY
SERVICES,**

Respondent.

**CORRECTED ORDER INSTITUTING
ADMINISTRATIVE AND CEASE-AND-
DESIST PROCEEDINGS, PURSUANT
TO SECTION 15(b) OF THE
SECURITIES EXCHANGE ACT OF 1934
AND SECTIONS 203(e), 203(f) AND 203(k)
OF THE INVESTMENT ADVISERS ACT
OF 1940, MAKING FINDINGS, AND
IMPOSING REMEDIAL SANCTIONS
AND A CEASE-AND-DESIST ORDER**

I.

The Securities and Exchange Commission (“Commission”) deems it appropriate and in the public interest that public administrative and cease-and-desist proceedings be, and hereby are, instituted pursuant to Section 15(b) of the Securities Exchange Act of 1934 (“Exchange Act”) and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”) against John Paul Harnish d/b/a KM Advisory Services (“Respondent”).

II.

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the findings herein, except as to the Commission’s jurisdiction over it and the subject matter of these proceedings, which are admitted, Respondent consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to Section 15(b) of the Securities Exchange Act of 1934 and Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order (“Order”), as set forth below.

III.

On the basis of this Order and Respondent's Offer, the Commission finds¹ that:

Summary

1. These proceedings arise out of breaches of fiduciary duties by former registered investment adviser KM Advisory Services ("KMA"), an unincorporated sole-proprietorship purchased by John Paul Harnish ("Harnish") in February 2020, in connection with KMA and Harnish's receipt of mutual fund fees pursuant to Rule 12b-1 under the Investment Company Act of 1940 ("12b-1 fees") and commissions in the form of sales "loads" from advisory client investments without fully and fairly disclosing its related conflicts of interest. Since at least January 2016, and continuing from the date Harnish purchased KMA in February 2020 and through December 2020, KMA invested the vast majority of clients' assets in certain mutual funds that paid 12b-1 fees and charged sales load commissions exclusively through an introducing broker-dealer (the "Introducing Broker-Dealer") with whom Harnish was a registered representative. As a result, KMA's clients paid 12b-1 fees and commissions to the Introducing Broker-Dealer, a portion of which were shared with KMA and Harnish. KMA failed to fully and adequately disclose this arrangement and the conflicts of interest arising therefrom. KMA also breached its duty of care by not routinely comparing the Introducing Broker-Dealer's order execution with other broker-dealers, which KMA's advisory relationship with its clients required. KMA therefore caused its advisory clients to invest through the Introducing Broker-Dealer and in share classes of mutual funds that charged 12b-1 fees when other broker-dealers made available share classes of the same funds to their customers that may have presented a more favorable value for KMA's clients under the particular circumstances in place at the time of the transactions. Furthermore, KMA failed to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder in connection with its mutual fund share class and broker-dealer selection practices. As a result of the conduct described above, KMA willfully violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

Respondent

2. KM Advisory Services was an investment adviser operating as a sole proprietorship with a primary place of business in Victor, New York. KMA's prior owner (the "Prior Owner") founded KMA in 1994 and sold it to Harnish in February 2020. KMA was registered with the Commission as an investment adviser from 1996 until August 2021, when it ceased operation and filed a Form ADV-W. As of March 2021, the date of KMA's most recent annual amendment to its Form ADV, KMA managed 177 advisory clients with over \$172 million in assets. Harnish, 47 years old, resides in Pittsford, New York and was an investment adviser representative ("IAR") of KMA, its director of financial planning and its chief compliance officer from 2004 through August 2021. Harnish holds Series 7, 24 and 63 licenses and has been a registered representative of the Introducing Broker-Dealer since 2004.

¹ The findings herein are made pursuant to Respondent's Offer and are not binding on any other person or entity in this or any other proceeding.

Facts

Background on Mutual Fund Share Classes

3. Mutual funds offer investors different “share classes.” Each share class represents an interest in the same portfolio of securities with the same investment objective. The primary difference among the share classes is the fee structure. For example, some mutual fund share classes charge 12b-1 fees or shareholder servicing fees to cover fund distribution or sometimes shareholder services (hereinafter, “Retail Class”). The Retail Class 12b-1 fees are recurring, are included in a mutual fund’s total annual fund operating expenses for that class, vary by fund and by share class within a fund, and typically range from 0.25% to 1%. The 12b-1 fees are deducted from the mutual fund’s assets attributed to that class on an ongoing basis and paid to the fund’s distributor or principal underwriter, which generally remits the 12b-1 fees to the broker-dealer that distributed or sold the shares. Certain Retail Class share classes also charge a sales load that is calculated as a percentage of the purchase amount when investors buy shares of the fund (a “front-end load”). Front-end loads may have discounts (referred to as “breakpoints”) available to the investor as a result of the total amount invested. Another type of Retail Class charges a contingent deferred sales charge (“CDSC”), a deferred sales charge the purchaser pays if the purchaser sells the shares during a specified time period following the purchase.

4. Many mutual funds also offer share classes that charge lower fees overall and that do not charge 12b-1 or shareholder servicing fees (e.g., “Institutional Class” or “Class I” shares (collectively, “Class I shares”)) or that waive sales loads (“Load-Waived shares”). An investor who holds Class I shares of a mutual fund will usually pay lower total annual fund operating expenses – and thus will almost always earn higher returns over time – than one who holds a Retail Class of the same fund. Therefore, if a mutual fund offers a Class I share, and an investor is eligible to own it, it is often, though not always, better for the investor to purchase or hold the Class I share. Similarly, if a mutual fund offers Load-Waived shares, and an investor is eligible to own them, it is often, though not always, better for the investor to purchase the Load-Waived shares instead of the share class that charges sales loads. The cost of owning shares of a mutual fund will depend on the expense ratio of the particular share class and any sales loads or charges.

KMA’s Business

5. KMA’s Prior Owner established KMA as a sole proprietorship in 1994 to provide financial planning services (e.g. retirement planning, estate planning and tax consulting services) and also investment advisory services on a discretionary basis to individual clients. Except for its services rendered to retirement plan clients, which accounted for roughly 10-20% of KMA’s business, KMA used the Introducing Broker-Dealer. The Introducing Broker-Dealer used a clearing broker that provided the Introducing Broker-Dealer with access to a variety of mutual fund share classes, including Class I shares and Load-Waived shares for advisory clients. However, the Introducing Broker-Dealer, which is dually-registered as a broker-dealer and investment adviser with its own advisory platform, limited access to Class I shares and Load-Waived shares to clients with accounts on its advisory platform; the Introducing Broker-Dealer provided only Retail Class shares to brokerage account holders. As such, the Introducing Broker Dealer did not allow KMA to select I Class shares and Load-Waived shares for its clients.

6. From the date Harnish purchased KMA in February 2020 through December 2020 (the “Relevant Period”), KMA’s non-retirement plan advisory clients with mutual fund assets under KMA’s management were required to maintain brokerage accounts at the Introducing Broker-Dealer with Harnish as the Introducing Broker-Dealer’s registered representative. Because of this arrangement, only Retail Class shares were available to these advisory clients.

7. KMA and Harnish derived their revenue from four sources: (1) a disclosed advisory fee of 0.5% of clients’ AUM; (2) financial planning fees paid by clients; (3) 12b-1 fees that its clients paid from their mutual fund holdings; and (4) sales loads its clients paid on mutual fund purchases. During the Relevant Period, KMA received advisory fee revenue directly in a bank account in Harnish’s and KMA’s name, and the Introducing Broker-Dealer received 12b-1 fee payments and sales loads from KMA’s clients’ accounts. Per agreement between Harnish and the Introducing Broker-Dealer, the Introducing Broker-Dealer shared with Harnish the 12b-1 fee payments and sales loads in his capacity as a registered representative. Harnish’s portion of the 12b-1 fees and sales load commissions were remitted to a bank account held by KMA’s business operating entity, which Harnish owned. The Introducing Broker-Dealer retained a portion the 12b-1 fee payments and sales loads for itself.

8. During the Relevant Period, the vast majority of advisory assets that KMA recommended that its clients purchase were mutual fund share classes that charge sales loads and/or 12b-1 fees. Specifically, during the Relevant Period, KMA placed the majority of client assets in C Class shares, which typically charge 12b-1 fees of 1% on client holdings and charge a 1% CDSC for a specified time period. KMA placed the remaining client assets in A Class shares, which typically charge sales loads of 5% at the time of purchase and 12b-1 fees of 0.25% per year on client holdings. In most instances, KMA recommended A Class shares only when the client was eligible for a discount due to a breakpoint, which reduced the cost to the client of holding A Class shares. Most clients paid sales loads of 3.5% or less, and some paid sales loads of 0%.

9. During the Relevant Period, KMA stated to its clients that it would “routinely” compare the Introducing Broker Dealer’s order execution with other broker-dealers to “ensure” that the Introducing Broker-Dealer remained competitive in providing best execution for KMA’s clients, but KMA did not routinely do so. For most of the Relevant Period, KMA did not recommend that its clients open accounts with another broker-dealer that would provide clients with access to Load-Waived shares or share classes that do not charge 12b-1 fees.

10. During the Relevant Period, KMA and Harnish received a significant percentage of their total compensation from 12b-1 fees and sales loads that the Introducing Broker-Dealer charged KMA’s advisory clients.

KMA's Disclosures Failures

Disclosures Regarding KMA's Receipt of 12b-1 Fees

11. KMA represented in its Form ADV Part 2A Brochures ("Brochures") from at least January 2016 through March 2019 that:

"Although not a material consideration in recommending and/or selecting a particular mutual fund for the Account, KMA and its Advisors may receive a portion of the 12b-1 distribution fees or other fees imposed by the mutual fund and paid by the mutual fund or one of their affiliates..."

Elsewhere the Brochures stated "[Introducing Broker-Dealer], as well as KMA's Advisors, may receive additional ongoing 12b-1 trail commissions on mutual fund purchases during the period that the client maintains the mutual fund investment." Harnish reviewed and adopted the above disclosure language, which was drafted with the assistance of KMA's compliance consultant.

12. These disclosures did not adequately disclose all material facts regarding the conflicts of interest that arose when it invested advisory clients through the Introducing Broker-Dealer in a mutual fund share class that would generate and pay 12b-1 fees to KMA's advisers while share classes of the same funds were available through other broker-dealers that did not pay or paid less 12b-1 fees. In addition, KMA's disclosures stated that it and its advisers "may receive a portion of the 12b-1 distribution fees" when KMA and its advisers actually did and would receive a portion of the 12b-1 fees KMA's clients paid.

Disclosures Regarding KMA's Receipt of Commissions and Selection of the Introducing Broker-Dealers

13. KMA's advisory agreements during the Relevant Period stated that:

"You have no obligation to implement recommendations by executing transactions through [Introducing Broker-Dealer]. The Financial Advisor generally seeks competitive commission rates. . . If you choose to effect transactions with [Introducing Broker-Dealer], the Financial Advisor may act as a Registered Representative of [Introducing Broker-Dealer]. In connection with those transactions, [Introducing Broker-Dealer] may collect transaction fees, and the Financial Advisor may receive commissions."

14. KMA similarly stated in its Brochures during the Relevant Period that:

"Should the client desire to implement investment recommendations, they could engage KMA's advisor in his capacity as a registered representative of [Introducing Broker-Dealer] to process investment recommendations. Clients choosing to purchase investment products through [Introducing Broker-Dealer] will be charged brokerage commissions, a portion of which is paid to the advisor, to affect these securities transactions."

15. KMA's Brochures during the Relevant Period further stated that "KMA's Advisor may recommend other broker/dealers to their advisory clients." However, for most of the Relevant Period, KMA required its non-retirement plan advisory clients with mutual fund assets to maintain brokerage accounts at the Introducing Broker-Dealer and KMA never recommended any other broker-dealer besides the Introducing Broker-Dealer to its non-retirement plan advisory clients with mutual fund assets. In addition, KMA's disclosures in its advisory agreements stated that it "may receive commissions" when KMA and its advisers actually did and would receive commissions in the form of sales loads.

KMA's Examinations by the Introducing Broker-Dealer and Subsequent Disclosure Amendments

16. In November 2016 and May 2017, the Introducing Broker-Dealer's independent registered investment adviser compliance unit issued examination reports to KMA, addressed to Harnish, that identified concerns related to KMA's disclosures regarding its and its advisers' receipt of 12b-1 fees and commissions.

17. In October 2019, following Harnish's discussion of the Introducing Broker-Dealer's examination findings with KMA's compliance consultant, KMA amended its Brochure disclosures related to 12b-1 fee revenue to state the following:

"Through [Introducing Broker-Dealer], mutual fund investments can be invested in various share classes: A, B, C, and M. These share classes have different [characteristics] that can include up-front commission charges and back-end sales charges. In addition, these share classes include 12b-1 fees that are paid to the broker dealer and the advisor. The full detail of mutual funds fees and expenses can be found in the prospectus for each fund. KMA's advisors will recommend the share class that they feel is in the client's best interest based on their needs, investment objectives, time horizons, current holdings and available breakpoints. While it will be the advisors' intent to select the lowest cost share class, the client may have a higher total cost of ownership based on the actual holding period of the investment.

Clients are able to purchase the same or similar products through other brokers and investment advisors. Other brokers and investment advisors may offer shares class options that have a lower cost. For example, KMA does not have access to institutional, advisor or clean share classes. Similarly, investment advisory service fees charged by other investment advisors may be similar to or lower than the fees that KMA charges."

KMA's revised disclosures, while an improvement, still did not adequately disclose all material facts regarding the conflicts of interest that arose when it invested advisory clients through the Introducing Broker-Dealer in a mutual fund share class that would generate and pay 12b-1 fees to KMA and Harnish while share classes of the same funds were available through other broker-dealers that did not pay or paid less 12b-1 fees. Harnish reviewed and adopted the amended disclosure language, which was drafted with the assistance of KMA's compliance consultant.

18. In or about October 2020, Harnish began transitioning KMA's advisory clients to a new investment adviser he created, which registered with the Commission on October 13, 2020.

Duty of Care Failures

19. An investment adviser's fiduciary duty also includes a duty of care. To fulfill this obligation, an adviser, among other things, must provide investment advice in the best interest of its client based on the client's objectives and seek best execution for client transactions.

20. KMA's advisory relationship with its clients specifically required it to "routinely compare the order execution disclosure information of [Introducing Broker-Dealer] and [its clearing firm] to other broker/dealers to ensure that [Introducing Broker-Dealer] and [its clearing firm] remain competitive in providing best execution for their clients." During the Relevant Period, KMA did not routinely conduct comparisons of the Introducing Broker-Dealer's execution with other broker-dealers.

Compliance Deficiencies

21. During the Relevant Period, KMA failed to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder in connection with either (1) the disclosure of the conflicts of interest that arose from its mutual fund and mutual fund share class selection practices or (2) seeking best execution for client transactions in connection with selecting a broker-dealer for its advisory clients.

Disgorgement

22. The disgorgement and prejudgment interest ordered in Section IV is consistent with equitable principles and does not exceed the Respondent's net profits from the violations, and will be distributed to harmed investors to the extent feasible. The Commission will hold funds paid pursuant to Section IV in an account at the United States Treasury pending distribution. Upon approval of the distribution final accounting by the Commission, any amounts remaining that are infeasible to return to investors, and any amounts returned to the Commission in the future that are infeasible to return to investors, may be transferred to the general fund of the U.S. Treasury, subject to Section 21F(g)(3) of the Exchange Act.

Violations

23. As a result of the conduct described above, Respondent willfully violated Section 206(2) of the Advisers Act, which makes it unlawful for any investment adviser, directly or indirectly, to "engage in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client." Scierter is not required to establish a violation of Section 206(2), but rather a violation may rest on a finding of negligence. *SEC v. Steadman*, 967 F.2d 636, 643 n.5 (D.C. Cir. 1992) (citing *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194-95 (1963)).

24. As a result of the conduct described above, Respondent willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which require a registered investment adviser to adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder.

Undertakings

25. Harnish has undertaken to:

Steps Taken to Date

- a. Harnish has certified that he reviewed and corrected as necessary all relevant disclosure documents concerning mutual fund share class selection, commissions, and 12b-1 fees for any registered investment adviser for which Harnish is the owner or control person.
- b. Harnish has certified that he has evaluated whether existing clients for which Harnish is an investment advisory representative should be moved to a lower-cost share class and move clients as necessary.
- c. Harnish has certified that he has evaluated, updated (if necessary), and reviewed for the effectiveness of their implementation, the policies and procedures for any registered investment adviser for which Harnish is the owner or control person, so that the policies and procedures are reasonably designed to prevent violations of the Advisers Act in connection with mutual fund share class selection practices and practices with respect to recommendations of broker-dealers to clients and the adviser's evaluation of the execution of client trades.
- d. In determining whether to accept the Offer, the Commission has considered the undertakings set forth in paragraphs 25.a through 25.c above.

Steps to be Taken

- e. Within 40 days of the entry of this Order, notify affected investors (i.e., those former and current clients who were financially harmed by the practices discussed above (hereinafter, "affected investors")) of the settlement terms of this Order by sending a copy of this Order to each affected investor via mail, email, or such other method not unacceptable to the Commission staff, together with a cover letter in a form not unacceptable to the Commission staff.
- f. Certify, in writing, compliance with the undertaking set forth above. The certification shall provide written evidence of compliance in the form of a narrative, and be supported by exhibits sufficient to demonstrate compliance. The Commission staff may make reasonable requests for further evidence of compliance, and Harnish agrees to provide such evidence. The certification and supporting material shall be submitted to Andrew B. Dean, Assistant Regional

Director, Division of Enforcement, Securities and Exchange Commission, 100 Pearl Street, Suite 20-100, New York, NY 10004, or such other address as the Commission staff may provide, with a copy to the Office of Chief Counsel of the Division of Enforcement, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549, no later than forty-five (45) days from the date of the completion of the undertakings.

- g. For good cause shown, the Commission staff may extend any of the procedural dates relating to the undertakings. Deadlines for procedural dates shall be counted in calendar days, except that if the last day falls on a weekend or federal holiday, the next business day shall be considered the last day.

IV.

In view of the foregoing, the Commission deems it appropriate, and in the public interest to impose the sanctions agreed to in Respondent's Offer.

Accordingly, pursuant to Section 15(b) of the Exchange Act and Sections 203(e), 203(f) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent cease and desist from committing or causing any violations and any future violations of Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder.

B. Respondent is censured.

C. Respondent shall, within 10 days of the entry of this Order, pay disgorgement, prejudgment interest and civil money penalties as follows:

- (1) Respondent shall, within 10 days of the entry of this order, pay disgorgement of \$220,097.30 and prejudgment interest of \$5,549.69 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600.
- (2) Respondent shall, within 10 days of the entry of this order, pay a civil money penalty in the amount of \$75,000 to the Securities and Exchange Commission. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. § 3717.
- (3) Payment must be made in one of the following ways:
 - (a) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

- (b) Respondent may make direct payment from a bank account via Pay.gov through the SEC website at <http://www.sec.gov/about/offices/ofm.htm>; or
- (c) Respondent may pay by certified check, bank cashier's check, or United States postal money order, made payable to the Securities and Exchange Commission and hand-delivered or mailed to:

Enterprise Services Center
Accounts Receivable Branch
HQ Bldg., Room 181, AMZ-341
6500 South MacArthur Boulevard
Oklahoma City, OK 73169

Payments by check or money order must be accompanied by a cover letter identifying John Paul Harnish d/b/a KM Advisory Services as Respondent in these proceedings, and the file number of these proceedings; a copy of the cover letter and check or money order must be sent to Andrew B. Dean, Assistant Regional Director, Division of Enforcement, Securities and Exchange Commission, 100 Pearl Street, Suite 20-100, New York, NY 10004.

- (5) Pursuant to Section 308(a) of the Sarbanes-Oxley Act of 2002, as amended, a Fair Fund is created for the penalties, disgorgement, and prejudgment interest referenced in this Section IV, paragraph C and combined with the Fair Fund established in the Commission's simultaneously instituted related proceeding, In the Matter of Kathryn Jane Meredith, d/b/a KM Advisory Services, Admin. Proc. No. 3-20881 (June 6, 2022) to form the KM Advisory Fair Fund. Amounts ordered to be paid as civil money penalties pursuant to this Order shall be treated as penalties paid to the government for all purposes, including all tax purposes. To preserve the deterrent effect of the civil penalty, Respondent agrees that in any Related Investor Action, he shall not argue that he is entitled to, nor shall he benefit by, offset or reduction of any award of compensatory damages by the amount of any part of Respondent's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, Respondent agrees that he shall, within 30 days after entry of a final order granting the Penalty Offset, notify the Commission's counsel in this action and pay the amount of the Penalty Offset to the Securities and Exchange Commission. Such a payment shall not be deemed an additional civil penalty and shall not be deemed to change the amount of the civil penalty imposed in this proceeding. For purposes of this paragraph, a "Related Investor Action" means a private damages action brought against Respondent by or on

behalf of one or more investors based on substantially the same facts as alleged in the Order instituted by the Commission in this proceeding.

D. Harnish shall comply with the undertakings enumerated in Section III, paragraphs 25.e through 25.f above.

V.

It is further Ordered that, solely for purposes of exceptions to discharge set forth in Section 523 of the Bankruptcy Code, 11 U.S.C. § 523, the findings in this Order are true and admitted by Respondent Harnish, and further, any debt for disgorgement, prejudgment interest, civil penalty or other amounts due by Respondent Harnish under this Order or any other judgment, order, consent order, decree or settlement agreement entered in connection with this proceeding, is a debt for the violation by Respondent Harnish of the federal securities laws or any regulation or order issued under such laws, as set forth in Section 523(a)(19) of the Bankruptcy Code, 11 U.S.C. § 523(a)(19).

By the Commission.

Vanessa A. Countryman
Secretary