UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 81169 / July 19, 2017

INVESTMENT ADVISERS ACT OF 1940
Release No. 4730 / July 19, 2017

ADMINISTRATIVE PROCEEDING
File No. 3-18068

In the Matter of **KMS FINANCIAL SERVICES, INC.,** **Respondent.**	**ORDER INSTITUTING ADMINISTRATIVE AND CEASE-AND-DESIST PROCEEDINGS, PURSUANT TO SECTION 15(b) OF THE SECURITIES EXCHANGE ACT OF 1934 AND SECTIONS 203(e) 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) and 203(k) of the Investment Advisers Act of 1940 ("Advisers Act"), against KMS Financial Services, Inc. ("KMS" or "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) 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 finds[1] that

Summary

This matter concerns KMS, a dually-registered investment adviser and broker dealer that failed, in its capacity as an investment adviser, to disclose to its advisory clients compensation it received from a third party broker-dealer ("Clearing Broker") for certain investments KMS selected for its advisory clients. Pursuant to the arrangement, the Clearing Broker agreed to share with KMS certain revenues that the Clearing Broker received from the mutual funds in the Clearing Broker's no-transaction-fee mutual fund program ("NTF Program"). These payments provided a financial incentive for KMS to favor the mutual funds in the NTF Program over other investments when giving investment advice to its advisory clients, and thus created a conflict of interest. In addition, in 2014, KMS negotiated a reduction in execution and clearing costs it paid the Clearing Broker but KMS neither passed on the reduction in brokerage costs to its advisory clients nor analyzed whether its clients were obtaining best execution. Finally, KMS made inaccurate statements in its Form ADV concerning best execution and omitted in its Form ADV disclosure of compensation it received through the NTF Program. As a result, KMS violated Sections 206(2) and 207 of the Advisers Act. In addition, by not adopting and implementing policies and procedures reasonably designed to ensure proper disclosure of conflicts of interest and to ensure KMS met its obligation to seek best execution as an investment adviser, KMS violated Section 206(4) of the Advisers Act and Rule 206(4)-7.

Respondent

1. **KMS Financial Services, Inc**. is a Seattle-based registered broker dealer and investment advisory firm serving clients through a network of more than 300 investment professionals located predominantly in the Pacific Northwest. KMS has been registered with the Commission as an investment adviser (File No. 801-11375) since April 6, 1976, and as a broker-dealer (File No. 008-15433) since January 16, 1970. KMS has been wholly-owned by Ladenburg Thalmann Financial Services, Inc., (NYSE MKT:LTS, LTS PrA), a publicly traded company, since October 2014.

Background

2. KMS provides investment advisory and brokerage services to individuals through a network of investment professionals. Its investment advisory services are offered to clients on both a non-discretionary and discretionary basis.

3. Since at least 2002, KMS has retained the Clearing Broker to provide clearing and custody services for approximately half of KMS's advisory clients. The Clearing Broker provides

[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.

execution of trades, custody of assets, and reporting services. For trades in advisory client accounts that use the Clearing Broker to provide clearing and custody services, KMS acts as the introducing broker. KMS disclosed its relationship with the Clearing Broker in its filings with the Commission and in other disclosures to advisory clients.

Mutual Fund Platform Revenue Stream to KMS

4. From at least 2002, the Clearing Broker offered its NTF Program to investment advisers. As part of the program, the Clearing Broker waived for KMS's advisory clients the transaction fees it and KMS would otherwise charge for purchases of certain mutual funds available on its platform. The NTF Program had two sub-programs, NTF A and NTF B. NTF A generally consisted of no-load mutual funds whereas NTF B was generally comprised of load mutual funds whose loads the Clearing Broker would waive if they were purchased in fee-based advisory accounts.

5. Since at least 2002, KMS has participated in the NTF Program. The terms of KMS's participation were set forth in the Addendum to Fully Disclosed Clearing Agreement ("Addendum") with the Clearing Broker. Under the Addendum, the Clearing Broker agreed to share with KMS a certain percentage of revenues the Clearing Broker received from the mutual funds in the NTF A Program. In particular, KMS waived transaction fees it and the Clearing Broker would otherwise charge clients for the purchase of certain mutual funds and instead would get a certain percentage of revenues the Clearing Broker received from certain mutual funds KMS recommended to its clients.

KMS Failed To Disclose That It Received Mutual Fund Service Fees From The Clearing Broker

6. KMS was required to file and did file Form ADV annual amendments with the Commission. Item 13.A of former Form ADV, Part II and Item 14.A of current Form ADV, Part 2A require advisers to disclose compensation received from third parties in connection with providing investment advisory services to clients.[2]

7. In its Forms ADV, Part II and Part 2A brochures filed with the Commission from 2003 to the present, KMS disclosed its relationship with the Clearing Broker. However, from 2003 through March 2014, KMS did not disclose that it received payments from the Clearing Broker based on KMS client assets invested in the NTF Program mutual funds or that these payments presented a conflict of interest. Nor did KMS otherwise disclose this conflict of interest to its advisory clients.

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[2] The Form ADV was amended in 2010, requiring most Commission-registered advisers to file and start using client disclosure brochures that met the requirements of new Part 2A early in 2011. *See* Amendments to Form ADV, Release No. IA-3060 (July 28, 2010), http://www.sec.gov/rules/final/2010/ia-3060.pdf.

8. From2002 to 2015, KMS did not have adequate written policies and procedures for disclosing all material conflicts of interest.

Reduced Clearing and Execution Costs Charged by Clearing Broker

9. In February 2014, KMS negotiated an amendment to its clearing agreement with the Clearing Broker ("2014 Amendment"). The 2014 Amendment reduced by $1 per trade the clearance and execution costs charged by the Clearing Broker for equity, options and fixed income transactions, thus decreasing total clearing and execution costs KMS had to pay the Clearing Broker for KMS clients utilizing the Clearing Broker. The 2014 Amendment did not alter the allocation of responsibilities between KMS as introducing broker and the Clearing Broker. KMS, however, did not pass this reduction in clearing and execution costs on to its advisory clients thereby providing KMS with $54,957 of additional revenue on certain transactions involving the Clearing Broker from April 2014 through December 2015.

KMS Failed to Seek Best Execution

10. When KMS entered into the 2014 Amendment, which ultimately increased KMS's revenue, KMS, in its capacity as an investment adviser, did not conduct an adequate analysis to consider whether those advisory clients continued to receive best execution in light of this increase. Thus, KMS failed to seek best execution for its advisory clients.[3]

11. Additionally, during the relevant period, KMS's written policies and procedures did not address best execution analysis regarding introducing, clearing, and execution brokerage costs charged to advisory clients as part of its overall best execution analysis.

Violations

12. Section 206(2) of the Advisers Act prohibits investment advisers from directly or indirectly engaging "in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." A violation of Section 206(2) of the Advisers Act may rest on a finding of simple negligence. *See 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, 195 (1963)). Proof of scienter is not required to establish a violation of Section 206(2) of the Advisers Act. *Id.* As a result of the conduct described above, KMS willfully violated Section 206(2) of the Advisers Act.[4]

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[3] KMS's Form ADV Part 2A states, "KMS seeks to obtain best execution for its Clients' transactions."

[4] A willful violation of the securities laws means merely "'that the person charged with the duty knows what he is doing.'" *Wonsover v, SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)). There is no requirement that the actor "'also be aware that he is violating one of the Rules or Acts.'" *Id.* (quoting *Gerhart & Otis, Inc. v. SEC*, 348 F.2d 798, 803 (D.C. Cir. 1965)).

13. Section 206(4) of the Advisers Act makes it "unlawful for any investment adviser . . . to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative." Rule 206(4)-7 under the Advisers Act requires registered investment advisers to, among other things, "[a]dopt and implement written policies and procedures, reasonably designed to prevent violation" of the Advisers Act and its rules. A violation of Section 206(4) and the rules thereunder do not require scienter. *Steadman*, 967 F.2d at 647. As a result of the conduct described above, KMS willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

14. Section 207 of the Advisers Act makes it unlawful for any person to make any untrue statement of a material fact in any registration application or report filed with the Commission, or to omit to state in any such application or report any material fact which is required to be stated therein. As a result of the conduct described above, KMS willfully violated Section 207 of the Advisers Act.

Undertakings

Respondent has undertaken to:

1. Notice to Advisory Clients. Within ten (10) days of entry of the Order, KMS shall post prominently on the homepage of its website, in a form and location acceptable to the Commission staff, a hyperlink to the entire Order, which shall remain prominently displayed on the homepage of the website for a period of six (6) months from the entry of the Order. Also, KMS shall include in the September 30, 2017 quarterly statement from its Clearing Broker to KMS clients a summary of the Order acceptable to the Commission staff, which summary shall prominently include a hyperlink to the entire Order. The quarterly statement from the Clearing Broker containing the summary and hyperlink to the entire Order shall be provided to all KMS clients who use the services of the Clearing Broker. KMS will also comply with all disclosure obligations under the Advisers Act concerning this Order, including providing a notification of this Order in the Item 2 "Material Changes Since Last Annual Update" section of any brochure required under Rule 204-3.

2. Certification of Compliance. KMS shall certify, in writing, its compliance with the undertakings set forth above. The certification shall identify the undertakings, 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 KMS agrees to provide such evidence. The certification and supporting material shall be submitted to Jeremy Pendrey, Assistant Regional Director, Asset Management Unit, Division of Enforcement, with a copy to the Office of Chief Counsel of the Division of Enforcement, no later than sixty (60) days from the completion of the undertakings.

IV.

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

Accordingly, pursuant to Sections 15(b) (4) of the Exchange Act and Sections 203(e) and 203(k) of the Advisers Act, it is hereby ORDERED that:

A. Respondent shall cease and desist from committing or causing any violations and any future violations of Sections 206(2), 206(4) and 207 of the Advisers Act and Rule 206(4)-7 thereunder.

B. Respondent is censured.

C. Respondent shall, within fourteen (14) days of the entry of this Order, pay disgorgement of $382,568.64 and prejudgment interest of $69,518.43 and a civil money penalty in the amount of $100,000.00 to the Securities and Exchange Commission for transfer to the general fund of the United States Treasury, subject to Section 21F(g)(3) of the Securities Exchange Act of 1934. If timely payment is not made, additional interest shall accrue pursuant to SEC Rule of Practice 600 and/or 31 U.S.C. §3717.

Payment must be made in one of the following ways:

(1) Respondent may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;

(2) 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

(3) 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 KMS Financial Services, Inc. as a 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 Jeremy Pendrey, Assistant Regional Director, Asset Management Unit, Division of Enforcement, Securities and Exchange Commission, 44 Montgomery Street, Suite 2800, San Francisco, CA 94104.

D. 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, it shall not argue that it is entitled to, nor shall it 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 it 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.

E. Respondent shall comply with the undertakings enumerated in Section III above.

By the Commission.

Brent J. Fields
Secretary