

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

INVESTMENT ADVISERS ACT OF 1940
Release No. 6098 / August 26, 2022

ADMINISTRATIVE PROCEEDING
File No. 3-21008

In the Matter of

KOVACK ADVISORS, INC.

Respondent.

**ORDER INSTITUTING ADMINISTRATIVE
AND CEASE-AND-DESIST PROCEEDINGS,
PURSUANT TO 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 Sections 203(e) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”) against Kovack Advisors, Inc. (“KAI” or “Respondent”).

II.

In anticipation of the institution of these proceedings, KAI 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, KAI consents to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings, Pursuant to 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 KAI's Offer, the Commission finds¹ that:

Summary

1. Kovack Advisors, Inc. ("KAI") failed to review the accounts of advisory clients in its wrap fee programs to determine whether such programs remained suitable for those clients, in accordance with KAI's disclosures to clients and its internal policies, and to adequately disclose certain fees to clients in its wrap fee programs. In general, the clients at issue paid an all-inclusive fee for asset management, trade execution, and other costs ("wrap clients"). At various times beginning in at least 2015, and continuing through August 2018 when it stopped offering wrap accounts, KAI failed to (i) review these advisory accounts for inactivity as required under its internal policies and external disclosures, to determine whether wrap accounts remained in the best interest of clients that traded infrequently, and (ii) adequately disclose to these wrap clients that they would be charged, in addition to the wrap account fee, for trade execution by certain clearing brokers participating in KAI's wrap program. As a result, certain KAI wrap clients remained in wrap accounts despite the lack of activity in their accounts, and/or paid transaction costs on top of the wrap account fee. KAI also failed to adopt and implement written policies and procedures reasonably designed to prevent the aforementioned violations, and to conduct annual compliance reviews. Through this conduct, KAI violated Sections 206(2) and 206(4) of the Advisers Act, and Rule 206(4)-7 thereunder.

Respondent

2. **Kovack Advisors, Inc.** is a registered investment adviser incorporated in Florida with its principal place of business in Fort Lauderdale, Florida that advises retail, high net-worth, and institutional clients. KAI has been registered with the Commission as an investment adviser since 2004. KAI is a wholly-owned subsidiary of Kovack Financial, LLC, and offers discretionary and non-discretionary asset management services. According to its Form ADV filed April 12, 2022, as of December 31, 2021 KAI had assets under management of approximately \$3,514,635,392 which it managed on a discretionary basis and \$1,032,646,181 which it managed on a non-discretionary basis.

KAI's Advisory Business

3. KAI has over 15,000 advisory client accounts and over 200 branch offices across the United States. KAI provides investment advisory services through individual investment adviser representatives ("IARs") who may either provide investment advice to clients on a discretionary or non-discretionary basis, or recommend various third-party managed portfolio strategies that clients ultimately select. From at least 2015 through August 2018, KAI offered advisory services through "wrap" accounts for its clients. Wrap fee programs typically offer

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

advisory clients several investment management services, including trade execution services, in return for one asset-based fee. KAI stated in its Form ADV Part 2A (“brochure”) in 2017 that:

[a] “wrap fee program” is a program under which investment advisory and brokerage execution services are provided for a single “wrapped” fee that is not based on the transactions in a client account. The client’s advisory fee may be higher in a Wrap Fee Program account than in a Non-Wrap Fee Program account, since the fee would include transaction costs.

While offering benefits to some clients, wrap fee programs are not in the best interest of all clients. Advisory clients with infrequent trading activity, for example, may pay higher fees on a wrap account than they would if they maintained their assets in a non-wrap account or brokerage account where the client would otherwise pay trading costs as incurred, but a lower advisory fee in a non-wrap account, or no advisory fee in a brokerage account.

4. In August 2018, KAI stopped offering wrap accounts to its clients, and updated its disclosures to that effect. Going forward, some but not all KAI IARs had agreements with their clients to cover certain transaction costs.

Failure to Review Wrap Accounts for Inactivity

5. From at least 2015, KAI’s brochures and certain of its client account agreements provided that KAI would review its advisory accounts. One of the purposes of the review was to determine whether wrap accounts remained suitable for clients, including identifying inactivity in wrap accounts. Where a client is charged a wrap fee that covers all advisory services and trading costs, yet the client trades infrequently, the client may be better suited to a non-wrap account.

6. KAI disclosed in its brochures in 2015 and 2016 that it “periodically reviews the accounts and financial plans on at least a semi-annual basis” and in 2017 and 2018 KAI’s brochures disclosed that it “periodically reviews client accounts.” Further, KAI’s 2018 brochure more specifically disclosed that KAI would “review accounts and transactions for account type suitability, in addition to investor suitability.” The purpose of the account reviews described in KAI’s disclosures was, among other things, to determine whether wrap fee accounts remained suitable for advisory clients with minimal trading activity, based on their current investment needs and objectives.

7. From at least 2015 through August 2018, KAI failed to adequately and timely conduct reviews for the wrap accounts it managed to evaluate whether wrap accounts continued to be in the clients’ best interests. As a result, wrap clients paid management fees to KAI despite having little to no trading activity in their accounts (the “wrap program fees charged to inactive accounts”).

Transaction Costs Charged to Wrap Clients

8. Certain of KAI's wrap clients were charged costs per transaction in their accounts, on top of the wrap program fee, for trade execution by sponsor-designated clearing brokers (*i.e.*, clearing brokers participating in KAI's wrap program). In addition, in certain instances KAI wrap clients were erroneously charged for transaction costs that were only applicable to non-wrap accounts. KAI did not receive these transaction costs, which were charged by and paid to the clearing brokers. However, because clients paid the transaction costs, KAI avoided paying those costs even though they were incurred in wrap accounts for which KAI disclosed the "'wrapped' fee" would cover "brokerage execution services."

9. KAI disclosed in its account agreements with wrap clients that they may incur additional trading costs for certain securities types; however, wrap clients incurred transaction costs on security types other than those listed in the disclosures. For example, certain wrap account agreements disclosed that clients could incur additional trading costs for trades in international securities, when they also incurred additional trading costs on domestic securities. From at least 2015 until KAI stopped offering wrap accounts in August 2018, KAI failed to adequately disclose that wrap clients could be subject to transaction costs in addition to the amount they paid to KAI as a wrap program fee.

Compliance Deficiencies

10. KAI failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder:

a. Reviewing Wrap Accounts for Inactivity. KAI's compliance policies and procedures required KAI to conduct reviews of client accounts, including for "volume of trading," but did not provide adequate procedures for conducting such reviews. Beginning in at least 2015, KAI failed to implement these policies and procedures. After the Commission's Division of Examinations began an examination of KAI in 2017, KAI conducted account reviews for the first time in almost two years. After the 2017 examination, KAI failed to adopt reasonably designed policies and procedures concerning inactive advisory account monitoring and review consistent with its representations to wrap clients. Among other things, KAI's policies and procedures provided inadequate details or parameters to IARs or their supervisors concerning how to assess whether a wrap account was and remained suitable for a client. In addition, KAI did not have policies and procedures in place reasonably designed to determine whether inactive wrap accounts were appropriate for conversion to a brokerage or other arrangement.

b. Accuracy of Disclosures. KAI failed to adopt written policies and procedures regarding the accuracy of its disclosures concerning (i) reviewing for inactivity in wrap accounts, and (ii) transaction costs to wrap clients that could accrue in addition to the wrap program fee.

c. Annual Compliance Reviews. KAI failed to complete its required annual compliance review for at least the years 2012 through 2015.

Violations

11. Section 206(2) of the Advisers Act 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. As a result of the conduct described above, KAI willfully² violated Section 206(2).³

12. Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder require a registered investment adviser to, among other things, adopt and implement written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder, and to review, no less frequently than annually, the adequacy of such compliance policies and procedures and the effectiveness of their implementation. As a result of the conduct described above, KAI willfully violated Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder.

Disgorgement

13. The disgorgement and prejudgment interest ordered in Section IV is consistent with equitable principles and does not exceed KAI's net profits from its violations, and will be distributed to harmed investors to the extent feasible. Upon approval of the distribution final accounting by the Commission, any amounts remaining that are infeasible to return to investors may be transferred to the general fund of the United States Treasury, subject to Section 21F(g)(3) of the Securities Exchange Act of 1934 ("Exchange Act").

KAI's Remedial Efforts

14. After being contacted by Division of Examinations staff, KAI hired outside counsel to assist with drafting improved disclosures, including in its brochures and client agreements, and hired an outside securities compliance professional, who assisted KAI in revising its written compliance policies and procedures. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by KAI.

² "Willfully," for purposes of imposing relief under Section 203(e) of the Advisers Act, "means no more than 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." *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965). The decision in *The Robare Group, Ltd. v. SEC*, which construed the term "willfully" for purposes of a differently structured statutory provision, does not alter that standard. 922 F.3d 468, 478-79 (D.C. Cir. 2019) (setting forth the showing required to establish that a person has "willfully omit[ted]" material information from a required disclosure in violation of Section 207 of the Advisers Act).

³ Proof of scienter is not required to establish a violation of Sections 206(2) and 206(4) of the Advisers Act, or the rules thereunder; rather, a violation may rest on a finding of 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, 194-95 (1963)).

Undertakings

KAI has undertaken the following:

15. Notice to Advisory Clients. Within 30 days of entry of the Order, KAI shall notify affected wrap clients (*i.e.*, those wrap clients who, during the relevant periods, paid (i) wrap program fees charged to inactive accounts and/or (ii) inadequately disclosed transaction costs) of the settlement terms of this Order by sending a copy of the Order to each affected wrap client 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.

16. Deadlines. The Commission staff shall have the authority, in its discretion, to 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 to be the last day.

17. Certificate of Compliance. KAI shall certify, in writing, 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 KAI agrees to provide such evidence. The certification and supporting material shall be submitted to Jeremy Pendrey, Assistant Regional Director, San Francisco Regional Office, Securities and Exchange Commission, 44 Montgomery Street, Suite 2800, San Francisco, CA 94104, 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 60 days from the date of 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 KAI's Offer.

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

A. KAI 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. KAI is censured.

C. KAI shall pay disgorgement, prejudgment interest, and a civil penalty, totaling \$899,513 as follows:

(i) KAI shall pay disgorgement of \$166,239 and prejudgment interest of \$33,274 consistent with the provisions of this Subsection C.

(ii) KAI shall pay a civil money penalty in the amount of \$700,000, consistent with the provisions of this Subsection C.

(iii) 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 described above for distribution to affected investors. 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, KAI 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 KAI's payment of a civil penalty in this action ("Penalty Offset"). If the court in any Related Investor Action grants such a Penalty Offset, KAI 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 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 KAI 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.

(iv) Respondent shall pay the disgorgement, prejudgment interest, and civil penalty ordered in this subsection in the following installments: (1) \$224,878.25, within 30 days of entry of the Order; (2) \$224,878.25 within 180 days of the entry of the Order; (3) \$224,878.25 within 270 days of the entry of the Order; and (4) \$224,878.25 within 364 days of the entry of the Order, plus all accrued interest. KAI shall deposit the payments of disgorgement, prejudgment interest, and the civil money penalty (the "Fair Fund"), into an escrow account at a financial institution not unacceptable to the Commission staff, and KAI shall provide evidence of such a deposit in a form acceptable to the Commission staff. The account holding the assets of the Fair Fund shall bear the name and taxpayer identification number of the Fair Fund. Payments shall be applied first to post order interest, which accrues pursuant to SEC Rule of Practice 600 and/or pursuant to 31 U.S.C. 3717. Prior to making the final payment set forth herein, Respondent shall contact the staff of the Commission for the amount due. If Respondent fails to make any payment by the date agreed and/or in the amount agreed according to the schedule set forth above, all outstanding payments under this Order, including post-order interest, minus any payments made, shall become due and payable immediately at the discretion of the staff of the Commission without further application to the Commission.

(v) KAI shall be responsible for administering the Fair Fund and may hire a professional at its own cost to assist it in the administration of the distribution. The costs and expenses of administering the Fair Fund, including any such professional services, shall be borne by KAI and shall not be paid out of the Fair Fund.

(vi) KAI shall distribute from the Fair Fund an amount representing: (a) the financial harm during each relevant period by the practices discussed above; and (b) if funds remain after paying all affected investors' harm amounts, reasonable interest paid on such fees, pursuant to a disbursement calculation (the "Calculation") that will be submitted to, reviewed, and approved by the Commission staff in accordance with this Subsection C. The Calculation shall be subject to a *de minimis* threshold. No portion of the Fair Fund shall be paid to any affected investor account in which KAI, or any of its current or former officers or directors, has a financial interest.

(vii) KAI shall, within 90 days from the date of this Order, submit a calculation to the Commission staff for review and approval. At or around the time of submission of the proposed Distribution Calculation to the staff, KAI shall make itself available, and shall require any third-parties or professionals retained by KAI to assist in formulating the methodology for its Calculation and/or administration of the distribution to be available, for a conference call with the Commission staff to explain the methodology used in preparing the proposed Calculation and its implementation, and to provide the staff with an opportunity to ask questions. KAI also shall provide the Commission staff such additional information and supporting documentation as the Commission staff may request for the purpose of its review. In the event of one or more objections by the Commission staff to KAI's proposed Calculation or any of its information or supporting documentation, KAI shall submit a revised Calculation for the review and approval of the Commission staff or additional information or supporting documentation within 10 days of the date that the Commission staff notifies KAI of the objection. The revised Calculation shall be subject to all of the provisions of this Subsection C.

(viii) KAI shall, within thirty (30) days of the written approval of the Calculation by the Commission staff, submit a payment file (the "Payment File") for review and acceptance by the Commission staff demonstrating the application of the methodology to each affected investor. The Payment File should identify, at a minimum: (1) the name of each affected investor; (2) the net amount of the payment to be made, less any tax withholding; (3) the amount of any *de minimis* threshold to be applied; and (4) the amount of reasonable interest paid. The Respondent shall exclude from the payee file all payments to payees that appear on the U.S. Treasury Department Specially Designated Nationals List.

(ix) KAI shall disburse all amounts payable to affected investors within ninety (90) days of the date the Commission staff accepts the Payment File unless such time period is extended as provided in Paragraph (xiii) of this Subsection C. KAI shall notify the Commission staff of the date and the amount paid in the initial distribution.

(x) If KAI is unable to distribute or return any portion of the Fair Fund for any reason, including an inability to locate an affected investor or a beneficial owner of an affected investor or any factors beyond KAI's control, KAI shall transfer any

such undistributed funds to the Commission for transmittal to the United States Treasury in accordance with Section 21F(g)(3) of the Exchange Act once the distribution of funds is complete and before the final accounting provided for in Paragraph (xii) of this Subsection C is submitted to the Commission staff. Payment must be made in one of the following ways:

- (1) KAI may transmit payment electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request;
- (2) KAI 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) KAI 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 KAI 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, San Francisco Regional Office, Securities and Exchange Commission, 44 Montgomery Street, Suite 2800, San Francisco, CA 94104.

(xi) A Fair Fund is a Qualified Settlement Fund ("QSF") under Section 468B(g) of the Internal Revenue Code ("IRC"), 26 U.S.C. §§1.468B.1-1.468B.5. KAI agrees to be responsible for all tax compliance responsibilities associated with the Fair Fund status as a QSF. These responsibilities involve reporting and paying requirements of the Fund, including but not limited to: (1) tax returns for the Fair Fund; (2) information return reporting regarding the payments to investors, as required by applicable codes and regulations; and (3) obligations resulting from compliance with the Foreign Account Tax Compliance Act (FATCA). Respondent may retain any professional services necessary. The costs and expenses of tax compliance, including any such professional services, shall be borne by Respondent and shall not be paid out of the Distribution Fund.

(xii) Within one hundred fifty (150) days after KAI completes the disbursement of all amounts payable to affected investors, KAI shall return all undisbursed funds to the Commission pursuant to the instruction set forth in this Subsection C. KAI

shall then submit to the Commission staff a final accounting and certification of the disposition of the Fair Fund for Commission approval, which final accounting and certification shall include, but not be limited to: (1) the amount paid to each payee, with the reasonable interest amount, if any, reported separately; (2) the date of each payment; (3) the check number or other identifier of money transferred; (4) the amount of any returned payment and the date received; (5) a description of the efforts to locate a prospective payee whose payment was returned or to whom payment was not made for any reason; (6) the total amount, if any, to be forwarded to the Commission for transfer to the United States Treasury; and (7) an affirmation that KAI has made payments from the Fair Fund to affected investors in accordance with the Calculation approved by the Commission staff. The final accounting and certification shall be submitted under a cover letter that identifies Respondent and the file number of these proceedings to Jeremy Pendrey, Assistant Regional Director, San Francisco Regional Office, Securities and Exchange Commission, 44 Montgomery Street, Suite 2800, San Francisco, CA 94104. KAI shall provide any and all supporting documentation for the accounting and certification to the Commission staff upon its request, and shall cooperate with any additional requests by the Commission staff in connection with the accounting and certification.

(xiii) The Commission staff may extend any of the procedural dates set forth in this Subsection C for good cause shown. Deadlines for dates relating to the Fair Fund shall be counted in calendar days, except if the last day falls on a weekend or federal holiday, the next business day shall be considered the last day.

D. KAI shall comply with the undertakings enumerated in Section III above.

By the Commission.

Vanessa A. Countryman
Secretary