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Kentucky's Financial Services Industry in Transition

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In the wake of the largest financial crises in the nation's history, everyone is looking to the person next to them, with a knowing look, as we discuss exactly what happened. Certainly, recovery is the desired result with basic elements of a lower unemployment rate and increased consumer confidence. The disagreement, however, is how to achieve the ultimate goal of a stable and prosperous economy. Some say that the private sector should be left alone to correct itself. Others think some measure of private independence combined with limited government oversight is just the right cocktail. For now though, government regulation is king.

At the national level, the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act has resulted in sweeping regulation and oversight of the financial services industry. With the passage of the Fraud Enforcement and Recovery Act of 2009, President Obama created a Financial Crisis Inquiry Commission charged with the responsibility of "reporting" to Congress by December 15, 2010 on the "cause" of the crisis. Not to be excluded from a role in the "recovery," states from coast to coast are taking a fresh look at their regulatory framework as applied to the financial services industries they govern. Kentucky is no exception. During the last legislative session, several bills were passed that affect the state banking institutions, securities broker-dealers and investment advisors, just to name a few.

It is impossible to address all of the various pieces of legislation in this article; however, a few highlights from those affecting the financial services industry gives insight into the role state regulators anticipate taking in the coming years.

Kentucky's Senate Bill 117, signed into law on March 25, 2010, amends the statute governing financial services, which encompasses state-chartered banks. In general, the legislation clarifies various provisions in the existing law, but overall represents a direct response to the financial crisis of 2008. For example, the legislation raises the minimum capital stock of a newly organized state bank to $5 million from the previously required $2.5 million. Further, it prohibits a reduction of capital stock by any state bank to under $2.5 million without obtaining prior approval of the Department of Financial Institutions. Also, the official inclusion of a category for rating a financial institution – sensitivity to market risk – denoted by the "s" present in the CAMELS rating system used to assess the overall health of a bank.

While the legislation creates additional obligations and increased oversight, a few provisions do encourage the development of state-charted banks. For example, the procedures for chartering a bank or trust company, converting a national bank to a state bank, and for closing, consolidating or relocating branch offices have been streamlined. There is a new catchall provision to authorize banks to hold assets taken as security for debts previously contracted not otherwise covered by the statute. Recently, the Department also issued an opinion letter that authorizes de novo branching into Kentucky by out-of-state banks.

The securities industry in Kentucky was also affected by recent legislation. Kentucky's Senate Bill 130 was signed into law on April 7, 2010. This legislation seeks to protect "unknowing" investors from fraud. Over the past several years, the Department of Financial Institutions has increased its investigative and enforcement efforts to stop "unregistered" and fraudulent securities offerings. It seems Kentucky has been a hotbed for oil and gas schemes resulting in investor fraud totaling at least $100 million dollars over the past several years. Not surprisingly, the most significant changes to the statute involve investor protection. First, the legislation clarifies that all investors, regardless of financial status, must receive all material information in connection with the purchase of a security sold in a transaction that is exempt from registration in Kentucky. Second, the Department now may impose a maximum fine of $20,000 for each individual violation of the securities laws and doubles the maximum fine for violations involving harm to anyone over the age sixty. Lastly, the legislation created the "Securities Fraud Prosecution and Prevention Fund" to be funded with a portion of fees assessed for violations of the Securities Act.

In addition, the Dodd-Frank Act, with some exceptions, limits the SEC's regulatory authority to investment advisors with more than $100 million in assets under management rather than the previous $25 million floor. This drastically increases the role of the state regulator and the interaction many businesses will have with the compliance and enforcement arms of the state.

Finally, several changes impact those acting as guardians or conservators by limiting the fees that can be charged. The Office of the Attorney General increased its regulatory authority over "debt adjustors" by requiring that companies involved in "debt settlement" practices must register with their office. In addition to the fee limitations and contractual requirements with debtors, the Office can now pursue action against problem companies under the Consumer Protection Act. Finally, all of these statutes will be accompanied by administrative regulations which further clarify the factors to be considered by the regulatory authority in administering the statute.

Whether we are on the path to recovery is perhaps an open question. Much of it is wait, see, and hope. In the meantime, however, the financial services industry should prepare to meet its regulators as Kentucky clearly intends to have an increased role in the process.