

SEC Enforcement Case Summary Misuse of Fund & Portfolio Company Assets & Custody Rule Failures

On March 7, 2025, the Securities and Exchange Commission (**SEC**) settled charges against a private fund manager, its former managing partner, and former Chief Operating Officer (**COO**) for breach of fiduciary duties when they misused fund and portfolio company assets for their own personal benefit. The managing partner also served as the firm's Chief Compliance Officer (**CCO**) and was faulted for both compliance and supervisory failures. The SEC further charged the adviser with custody rule violations. The firm managed a private fund which was formed to purchase and develop franchise businesses, including dry cleaner businesses. According to the SEC order, the violations consisted of three elements as follows.

First, from at least August 2021 through February 2024, the COO allegedly misappropriated approximately \$223,000 from portfolio companies in which the fund had invested. The COO played an active role in the day-to-day management of the portfolio companies and opened business checking accounts and held debit cards for several portfolio companies to use for business expenses. However, she allegedly misused portfolio company debit cards in more than 100 transactions to pay for personal purchases, clothing, and vacations for herself and caused herself to be paid compensation in excess of her authorized salary. The COO reportedly concealed this misappropriation from the managing partner and adviser, as well as the portfolio companies' bookkeeper, and SEC staff. In documents produced to the SEC by the firm, the COO falsely represented that tens of thousands of dollars of expenses paid for by the portfolio companies relating to her personal vacations were legitimate business travel expenses. She also falsely represented that certain of the portfolio companies' purchases of designer clothing were legitimate business expenses in which the portfolio companies had replaced customer garments that had been damaged by the dry cleaners, when in fact, these purchases were made by COO for her own personal use. The SEC noted that the firm failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act of 1940 (**Advisers Act**) arising from such misappropriation and that the managing partner failed reasonably to supervise the COO's activities to prevent such violations.

Second, in 2020, in connection with the fund's purchase of two franchise businesses jointly owned by a third party and former business partner of the managing partner and COO and by an affiliated entity controlled by the managing partner and COO, the managing partner caused the fund to pay a business debt that should have been paid by the affiliated entity. Specifically, in connection with buying the third party's ownership interest in the businesses, the managing partner caused the fund to satisfy the entire outstanding obligation on two loans provided to the businesses. Because the affiliated entity owned 45% of the businesses, it should have contributed on a pro rata basis to satisfy the outstanding loans, but it did not, resulting in an unearned benefit of \$346,904. According to the SEC order, after the completion of an SEC examination, and just after the SEC's staff's investigation had begun, the firm and its managing partner initiated an investigation that discovered this issue, and they subsequently disclosed the fund's overpayments to SEC staff. The managing partner promptly signed a promissory note on behalf of the affiliated entity, pursuant to which the fund has been reimbursed for the unearned benefit, plus interest.

Finally, the adviser was charged with violating the Custody Rule, 206(4)-2 under the Advisers Act, by failing to obtain and timely distribute annual audited financial statements prepared in accordance with Generally Accepted Accounting Principles to investors in the Fund, which it advised. The firm purported

to rely on the audit provisions within the Custody Rule and did retain independent public accountants, but the audits were never completed and the firm failed to timely deliver the audited financial statements to fund investors. Audits for fiscal years 2020-2022 were all delivered in October 2024 with the 2023 audit in progress as of the date of the order. The SEC noted that the firm did not comply with the other provisions under the Custody Rule as required when funds do not meet the audit exception.

The firm agreed to pay a \$235,000 civil penalty; the managing partner agreed to pay an \$80,000 penalty and a 12-month supervisory suspension, and the COO agreed to pay a \$200,000 penalty and be barred from association with an investment adviser, broker-dealer or other financial industry participants. This case highlights the risk that is raised when private fund personnel are actively involved in portfolio company activities and have access to portfolio company bank accounts. In a continued theme over multiple years, SEC private fund exam staff focuses on the allocation of expenses to the fund and potential instances of funds bearing a disproportionate share and related persons failing to pay their fair share of relevant expenses. Accordingly, private fund managers and their compliance teams should similarly focus on such activities. When a member of a firm's most senior leadership serves in a compliance capacity or simply places too much trust in other senior leaders and fails to adequately oversee their activities, misuse of assets may occur and go undetected for extended periods. The Custody Rule failures are consistent with those brought in other private fund cases, but were particularly egregious in this case because they may have led, in part, to the misuse of assets having been undetected for an extended period.

See SEC Summary - <https://www.sec.gov/newsroom/press-releases/2025-53>