

Private Equity Fund Adviser Settles with SEC

December 22, 2014

Earlier this year, the Securities and Exchange Commission (SEC) announced plans to expand its task force examining private equity investment advisers. As discussed in the Spring 2014 issue of Expect Focus (“Private Equity: The Next Wave of SEC Enforcement Actions?”), the SEC identified what it believed were violations of law or material weaknesses in compliance controls regarding the collection and allocation of fees and expenses imposed by fund advisers in more than half of the investment fund manager examinations completed. On September 22, 2014, as a result of the first enforcement action under this heightened scrutiny, one fund adviser, Lincolnshire Management, Inc., agreed to pay approximately \$2.3 million (including \$450,000 in penalties) to settle a case arising from alleged simple carelessness in the allocation of fees and expenses to portfolio companies. Lincolnshire acquired two portfolio companies in 1997 and 2001, each for a different Lincolnshire-advised fund. Lincolnshire planned to integrate the two portfolio companies over time for an eventual combined sale. Beginning in 2009, the companies shared a joint management team and operated, in many respects, as one company – even while remaining distinct legal entities and maintaining separate financial statements. The SEC alleged that (1) certain expenses benefiting the portfolio companies were disproportionately allocated by Lincolnshire and (2) no written expense allocation policy existed, resulting in violations of the Investment Advisers Act based on Lincolnshire’s purported negligent breach of its fiduciary duty, and its failure to maintain an adequate compliance program. The alleged violations reached as far back as 2005, and many occurred before Lincolnshire became a registered investment adviser in March 2012. The Lincolnshire case is the first example of a likely trend toward growing SEC assertiveness in enforcement within the private equity industry. Previously, enforcement actions were generally reserved for more egregious legal violations, but **the SEC now appears willing to seek penalties in cases arising largely from apparent “bookkeeping” errors** that involve arguably small amounts of money that do not materially impact the performance of investments. Private equity industry compliance professionals are now officially on notice.

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