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8
9 **UNITED STATES DISTRICT COURT**
10 **CENTRAL DISTRICT OF CALIFORNIA**

11
12
13 SECURITIES AND EXCHANGE
COMMISSION,

14 Plaintiff,

15 vs.

16
17 STUART FROST and FROST
MANAGEMENT COMPANY, LLC,

18 Defendants.
19

Case No.

COMPLAINT

20
21 Plaintiff Securities and Exchange Commission (“SEC”) alleges:

22 **JURISDICTION AND VENUE**

23 1. The Court has jurisdiction over this action pursuant to Sections 209(d),
24 209(e)(1) and 214 of the Investment Advisers Act of 1940 (“Advisers Act”) [15
25 U.S.C. §§ 80b-9(d), 80b-9(e)(1) & 90b-14].

26 2. Defendants have, directly or indirectly, made use of the means or
27 instrumentalities of interstate commerce, of the mails, or of the facilities of a national
28 securities exchange in connection with the transactions, acts, practices and courses of

1 business alleged in this complaint.

2 3. Venue is proper in this district pursuant to Section 214 of the Advisers
3 Act [15 U.S.C. § 90b-14] because certain of the transactions, acts, practices and
4 courses of conduct constituting violations of the federal securities laws occurred
5 within this district. In addition, venue is proper in this district because Defendant
6 Stuart Frost resides in this district and Defendant Frost Management Company, LLC
7 has its principal place of business in this district.

8 **SUMMARY**

9 4. From 2012 through 2016, Frost Management Company, LLC (“FMC”),
10 an investment adviser to five private venture capital funds, and its sole owner, Stuart
11 Frost (“Frost”), defrauded the funds and their investors of over \$14 million by
12 charging undisclosed and excessive incubator fees to start-up companies in which the
13 funds invested, in violation of their fiduciary duties as investment advisers.

14 5. During that five-year period, Defendants raised nearly \$63 million for
15 the funds, mostly from high net worth individuals and trusts. The funds were invested
16 in a portfolio of start-up companies (“portfolio companies”), using the so-called “Frost
17 incubator model,” in which a Frost-owned company, Frost Data Capital (“FDC”),
18 purportedly provided operational support and other services to help “incubate” the
19 portfolio companies in anticipation of those companies maturing and ultimately being
20 sold or acquired by another company. In return for those support services, the
21 portfolio companies paid incubator fees to FDC.

22 6. In reality, a significant portion of the incubator fees charged to the
23 portfolio companies was used to cover FDC’s overhead and to pay Frost’s exorbitant
24 salary and extravagant personal expenses.

25 7. When Frost needed more cash to fund his lavish lifestyle, he created new
26 portfolio companies and, after investing more fund capital into the new companies,
27 FDC then extracted even more incubator fees.

28 8. At the same time, Frost and FMC failed to disclose to the funds either

1 the existence of or the actual amount of incubator fees being paid by the portfolio
2 companies, and also charged the funds undisclosed and improper management fees.

3 9. By engaging in this conduct, Defendants have violated the antifraud
4 provisions of Sections 206(1)-(2) and 206(4) of the Advisers Act [15 U.S.C. §§ 80b-
5 6(1),(2) and (4)], and Rule 206(4)-8(a)(1)-(2) thereunder [17 C.F.R. § 275.206(4)-8].

6 10. The SEC seeks permanent injunctions, disgorgement with prejudgment
7 interest on a joint and several basis, and civil penalties against Defendants.

8 **THE DEFENDANTS**

9 11. Defendant Stuart Frost, age 57 and a resident of Laguna Niguel,
10 California, is the sole owner and sole manager of FMC and sole manager of FDC.

11 12. Defendant Frost Management Company, LLC, a Delaware limited
12 liability company, was an exempt reporting investment adviser formerly located in
13 San Juan Capistrano, California. As of December 31, 2018, FMC failed to renew its
14 status as an exempt reporting adviser. It was the adviser to the five private venture
15 capital funds described below. FMC had assets under management of \$49.9 million
16 at year-end 2016, the last year for which information is available. The last Form ADV
17 filed by FMC was dated February 8, 2017.

18 **RELATED PARTIES**

19 13. Frost Data Capital, LLC (“FDC”), formerly known as Frost Venture
20 Partners, LLC, is a Delaware limited liability company located in Orange County,
21 California. Frost’s family trust is the sole member, and Frost is the sole manager of
22 FDC.

23 14. Frost VP Seed, LLC (“Seed Fund”) is a Delaware limited liability
24 company formed in 2011. During the relevant time period, its manager was FMC.

25 15. Frost VP Seed International, LLC (“International Seed Fund”) is a
26 Delaware limited liability company formed in 2012. Its manager is FMC.

27 16. Frost VP Early Stage Fund II, LP (“Fund II”) is a Delaware limited
28 partnership formed in 2013. During the relevant time period, its general partner was

1 Frost Venture Partners GP, LLC. As of October 21, 2016, Frost was the sole member
2 of the general partner (at inception in May 2013, Frost was a 62.5% member).

3 17. FVP International Feeder Fund L.P. (“International Feeder Fund”) is a
4 Cayman Islands limited partnership formed in 2013. Its general partner is FMC.

5 18. Frost Fund III, L.P. (“Fund III”) is a Delaware limited partnership
6 formed in 2015. During the relevant time period, its general partner was Frost Fund
7 III, GP, LLC. As of December 31, 2016, Frost was the sole member of the general
8 partner (at inception in August 2015, Frost was an 81% member).

9 19. Collectively, the Seed Fund, International Seed Fund, Fund II,
10 International Feeder Fund, and Fund III are referred to herein as “the Funds.”

11 20. At all relevant times, each of the Funds was a “pooled investment
12 vehicle” within the meaning of Rule 206(4)-8 of the Advisers Act [17 C.F.R. §
13 275.206(4)-8].

14 THE ALLEGATIONS

15 21. Frost formed both FMC and FDC in 2011.

16 22. FMC was an exempt reporting investment adviser pursuant to Section
17 203(l) of the Advisers Act [15 U.S.C. §§ 80b-3(l)], which provides for exemption
18 from registration to investment advisers who act solely as an adviser to venture capital
19 funds.

20 23. Frost, who had no prior experience as an investment adviser or a fund
21 manager, owned and controlled both FMC and FDC.

22 **A. FMC’s and Frost’s “Incubator Model”**

23 24. From 2012 through 2016, FMC raised nearly \$63 million from high net
24 worth individuals and trusts, who invested in the Funds as follows:

25 (a) The Seed Fund raised approximately \$7,570,000 from roughly 30
26 investors in 2012.

27 (b) The International Seed Fund raised approximately £412,750
28 (\$636,798) from roughly 45 investors in 2012.

1 (c) Fund II raised approximately \$41,189,521 from roughly 74
2 investors in 2013-2014.

3 (d) The International Feeder Fund raised approximately \$5,250,000
4 from roughly two investors in 2013-2015, which was then invested in Fund II.

5 (e) Fund III raised approximately \$13,440,000 from roughly 11
6 investors in 2015-2016.

7 25. FMC had no advisory clients aside from the Funds.

8 26. The Funds invested in portfolio companies created by FDC that had a
9 purported emphasis on big data analytics and cloud computing and later, the “internet
10 of things.”

11 27. FDC started 24 portfolio companies between 2012 and 2016.

12 28. In addition to the Funds, other investors in the portfolio companies
13 included high net worth individuals, trusts, non-Frost funds, and affiliates of public
14 companies.

15 29. FDC started, incubated, and provided support and services to the
16 portfolio companies.

17 30. The portfolio companies, in turn, paid FDC monthly fees for those
18 services.

19 31. Frost never capitalized FDC and operated it on a break-even basis.

20 32. FDC was financially dependent upon the incubator fees paid by the
21 portfolio companies because these fees were FDC’s only source of cash. In turn, the
22 portfolio companies were dependent upon the Funds and other investors to pay FDC’s
23 incubator fees.

24 33. Frost’s incubator model has not been successful. There have been no
25 returns to the Funds or their respective investors. As of early 2018, only a few of the
26 portfolio companies remained active.

27 **1. The Funds’ Investment Committees**

28 34. The Seed Fund’s operating agreement provided for the creation of an

1 investment committee, which generally consisted of no more than five (5) persons,
2 selected by Frost in his capacity as manager of FMC.

3 35. The Seed Fund's investment committee was responsible for approving
4 all investments presented to it by Frost, in his capacity as manager of FMC.

5 36. The Seed Fund's investment committee membership varied over time,
6 but always consisted exclusively of FDC insiders, and always included Frost.

7 37. Members of the Seed Fund's investment committee could be removed
8 by Frost, in his capacity as manager of FMC, at his sole discretion.

9 38. All actions of the Seed Fund's investment committee required at least a
10 majority vote of its members, provided, however, in the event of a tie vote, the
11 investment decision would be made by Frost, in his capacity as manager of FMC, in
12 his sole discretion, and all members of the investment committee would be required to
13 vote in accordance with the determination of the manager, *i.e.*, Frost.

14 39. Fund II and Fund III also created investment committees. Membership
15 varied over time, but always consisted exclusively of FDC insiders, and always
16 included Frost.

17 **2. The Funds' Advisory Committees**

18 40. The governing documents for each Fund also provided for the creation
19 of an advisory committee, generally consisting of three (3) to five (5) members,
20 appointed by Frost, in his capacity as manager of FMC, which was the manager of the
21 Seed Fund, the International Seed Fund, and the general partner of the International
22 Feeder Fund and in his capacity as the majority owner of the general partner of Fund
23 II. The governing document for Fund III provided that the limited partners,
24 representing a majority interest, may appoint an advisory committee.

25 41. According to the governing documents for the Funds, the duties of the
26 advisory committees were substantially the same, and included: (a) consideration of
27 any approvals sought by the manager or general partner; (b) advise regarding matters
28 pertaining to conflicts of interest between or among the manager or general partner,

1 any members of the manager or general partner; and (c) rendering such other advice
2 and counsel as requested by the manager or general partner.

3 42. Notwithstanding the duties of the advisory committees, Frost, in his
4 capacity as manager of FMC, which was the manager of the Seed Fund, the
5 International Seed Fund, and the general partner of the International Feeder Fund, or
6 as the majority owner of the general partner of Fund II and Fund III, retained ultimate
7 responsibility for making all investment decisions.

8 43. While the Funds' governing documents called for the establishment of
9 advisory committees, in reality, only Fund II established an advisory committee. It
10 met on only two or three occasions, but no conflicts of interest were presented to Fund
11 II's Advisory Committee.

12 3. Frost's Solicitation of Investors and Prospective Investors

13 44. Frost solicited investors and prospective investors through the use of the
14 Internet, wire and other electronic means of communication, and at in-person and
15 group presentations.

16 45. Frost also made and used PowerPoint marketing presentations in
17 soliciting investors and prospective investors. Frost's PowerPoint presentation for the
18 Seed Fund touted the "no fee" "no carry" opportunity to invest in "big data" analytics,
19 and specifically in start-up ideas and start-up companies, approved by a majority of a
20 fund's investment committee, and then incubated by FDC, with exits projected from
21 2-5 years from startup by way of an acquisition by a "major player" in the computer
22 industry.

23 46. Investors in the Funds also signed operating and partnership agreements
24 that were countersigned by Frost, on behalf of the Funds' manager or general partner.

25 47. Frost also provided investor executive summaries to investors and
26 prospective investors, which provided a high level summary of the Frost incubator
27 model, the investment focus of the particular fund, the deal structure, Frost's
28 background and qualifications, and a short description of some of the companies then

1 being incubated.

2 48. Frost also provided Fund investors with quarterly status reports that
3 generally described that quarter's acquisitions, the status or activities of the portfolio
4 companies in which the Fund had invested, and a valuation of the investments then
5 held.

6 49. Frost represented to investors and prospective investors that he
7 envisioned a highly-focused incubator model in which he would come up with ideas
8 or identify the needs of big data companies and pass them through FDC, the incubator.
9 FDC would then write up a business plan and pass that plan onto a newly created
10 portfolio company, which would obtain seed investments from the Funds or other
11 investors. The portfolio company would then incubate ideas into software that,
12 ideally, would eventually lead to an "exit," either through sale of the software or the
13 company.

14 **B. The Fraud**

15 50. FMC and Frost defrauded the Funds and the investors in the Funds by:
16 (1) charging the portfolio companies, in which the Funds invested, undisclosed and
17 excessive incubator fees that were paid to Frost's company, FDC; (2) not disclosing
18 the actual amount of incubator fees that the portfolio companies paid to FDC;
19 (3) creating more portfolio companies to generate even more excessive fees; and
20 (4) charging some Funds undisclosed management fees that were not earned and were
21 paid to FMC and Frost.

22 **1. Undisclosed and Excessive Incubator Fees**

23 51. FDC charged the portfolio companies over \$14 million in undisclosed
24 and excessive incubator fees.

25 52. Although the Funds did not directly pay these fees, because the Funds
26 invested in the portfolio companies, the payment of these fees by the portfolio
27 companies weakened their financial condition and prospects for success, which, in
28

1 turn, harmed the Funds' investments in those companies.

2 53. FDC charged a monthly incubator fee for operational support provided
3 to the portfolio companies.

4 54. However, in the Funds' operating and partnership agreements, and in the
5 executive summaries given to Fund investors, FMC and Frost either completely failed
6 to disclose the existence of the FDC incubator fees (in the case of certain Funds) or
7 misleadingly represented that FDC would charge incubator fees on a case-by-case
8 basis or at or below market rates (in the case of the remaining Funds).

9 55. Similarly, none of the PowerPoint marketing presentations to investors
10 and prospective investors in the Funds disclosed the incubator fees.

11 56. In particular, both the governing documents and the PowerPoint
12 disclosure for the Seed Fund were completely silent on and failed to disclose the
13 existence of FDC incubator fees.

14 57. In addition, the executive summary for the Seed Fund stated:

15 *Note that the [Seed Fund] will not be expected to cover expenses and*
16 *salaries incurred by FDC, which is a completely separate corporate*
17 *entity. It is expected that services provided from the incubator to the*
18 *startup companies will be agreed to between the boards of each*
19 *individual company and FDC on a case-by-case basis and expected to*
20 *be adjusted based on the individual needs of each company as their*
21 *business matures. FDC's policy will be to only charge for services that*
22 *the startup companies would require in the normal course of business.*
23 *In general, this should mean that the startups receive higher quality*
24 *services at a lower price than they would otherwise be able to afford*
25 *(due to Frost VP's ability to provide economies of scale)."*

26 58. This disclosure was false and misleading. FDC did not charge the
27 portfolio companies in which the Seed Fund had invested incubator fees on an agreed,
28 case-by-case, individual needs basis, or at or below market rates.

1 59. In addition, by charging incubator fees to the portfolio companies in
2 which the Seed Fund had invested, the Seed Fund covered the expenses and salaries
3 incurred by FDC, contrary to what had been represented in the executive summary.

4 60. The governing documents for the International Seed Fund were also
5 completely silent on and failed to disclose the existence of FDC incubator fees.

6 61. The governing documents for Fund II disclosed that FDC “may” receive
7 a monthly service fee from the companies in which the partnership holds an
8 investment in exchange for certain shared advisory and support services provided by
9 FDC.

10 62. This partial disclosure was false and misleading, as the disclosure further
11 provided that the service fee would not reduce the 2% management fee payable to the
12 general partner so long as the fee does not exceed reasonable market rates.

13 63. In fact, the so-called “service” fee was neither based on reasonable
14 market rates, nor did it reduce the 2% management fees payable to the general partner.

15 64. Also, the PowerPoint disclosure for Fund II was silent regarding
16 incubator fees.

17 65. In addition, the executive summary for Fund II contained the same
18 misleading disclosure as the Seed Fund, quoted above in paragraph 57 above.

19 66. The governing documents for the International Feeder Fund disclosed
20 that FDC had been formed to provide an operating infrastructure to incubate and
21 develop new business, but those documents were silent regarding incubator fees.

22 67. Also, the PowerPoint disclosure for the International Feeder Fund was
23 silent regarding incubator fees.

24 68. In addition, the executive summary for the International Feeder Fund
25 stated that the portfolio companies would be provided with a variety of services, the
26 costs of which would be split between the various “ideas being incubated,” thereby
27 “lowering the cost to each incubated idea/company.”

28 69. This disclosure was false and misleading, as the manner in which the

1 incubator fees were charged did not lower the cost to each portfolio company.

2 70. Finally, the governing documents for Fund III disclosed that the
3 portfolio companies in which the fund invested would enter into agreements with FDC
4 pursuant to which each of the companies would reimburse FDC a monthly amount for
5 its share of the cost of resources provided by FDC for shared facilities, shared
6 personnel, and other shared resources.

7 71. This disclosure was false and misleading as fees charged to the portfolio
8 companies were not based on the company's share of the cost of resources provided
9 by FDC for shared facilities, shared personnel and other shared resources; and, in fact,
10 the fees were excessive.

11 72. Both the PowerPoint and the executive summary for Fund III were silent
12 on incubator fees.

13 73. Rather than charge for services that the portfolio companies would
14 require in the normal course of business, FDC charged incubator fees from the
15 moment a portfolio company was formed, even if the company had no employees.

16 74. The fees also were not negotiated on a case-by-case basis. Rather, they
17 were fixed at a flat rate, typically about \$30,000 to \$40,000 per month, regardless of
18 the level of development of a portfolio company.

19 75. The incubator fees were not adjusted as the number of a portfolio
20 company's employees increased or decreased. Portfolio companies that moved out of
21 FDC's offices paid the same as portfolio companies that used FDC's space.

22 76. No effort was made to allocate the time FDC's staff spent working on
23 tasks for the different portfolio companies.

24 77. In most instances, the service agreements providing for the payment of
25 the incubator fees were signed by Frost, as CEO of the portfolio company, and by
26 FDC's CFO, before the portfolio company was officially formed.

27 78. Cancellation of the service agreements required 180 days' notice. As a
28 result, once a CEO was hired for a new portfolio company, the company was burdened

1 with a non-negotiable, non-cancellable fee for at least six months.

2 79. These fees caused the portfolio companies to burn through their cash
3 quickly, thereby shortening their “runway” and reducing the likelihood of a successful
4 exit.

5 80. Several CEOs of the portfolio companies voiced their concern to Frost
6 and other members of FDC’s management over the exorbitant incubator fees.

7 81. Some of the CEOs of the portfolio companies attempted to negotiate the
8 amount of the incubator fees.

9 82. Frost refused to negotiate the amount of the incubator fees, and
10 informed at least one CEO that the incubator fees were “prix fixe,” not “a la carte.”

11 83. Frost also was part owner of a second incubator-related company, Snow
12 Data Capital (“SDC”).

13 84. SDC was created in 2014, ostensibly to provide marketing services to
14 the portfolio companies.

15 85. In fact, SDC was created to provide employment to one of Frost’s
16 friends who needed to qualify for a green card for immigration purposes. Rather than
17 making his friend an employee of FDC, which already provided marketing services,
18 Frost created SDC, which then began charging the portfolio companies an additional
19 \$5,100 per month for marketing.

20 86. FDC’s overall incubator fees included SDC’s marketing fees.

21 87. Frost never disclosed to the Funds or to the Funds’ investors the
22 existence of SDC or its fees.

23 88. Of the \$21.69 million in incubator fees charged to the portfolio
24 companies in which the Funds had invested, over \$14 million of FDC’s fees exceeded
25 reasonable incubator fees and thus were excessive.

26 **2. Undisclosed Incubator Fee Amounts**

27 89. FMC and Frost failed to disclose the incubator fees paid by the portfolio
28

1 companies or their amounts in the Funds' quarterly status reports which were
2 distributed to the Funds' investors.

3 90. FMC and Frost also failed to disclose the incubator fees paid by the
4 portfolio companies or their amounts to the Fund II advisory committee, the only fund
5 that had an advisory committee.

6 91. The Fund II advisory committee met on two or three occasions, and
7 incubator fees were not disclosed, discussed, or consented to at any of those meetings.

8 **3. Generation of Additional Incubator Fees**

9 92. As Frost's and FDC's expenses grew, Frost created new portfolio
10 companies to generate additional incubator fees.

11 93. Although Frost disclosed to potential investors in the PowerPoint
12 marketing materials that he contemplated starting only two to four portfolio
13 companies per year, in fact, Frost created 12 of the 24 portfolio companies between
14 April 2014 and February 2015, when Frost and his family temporarily moved to Italy
15 and charged many personal expenses to FDC.

16 94. Frost's apparent need for cash, as opposed to new start-up ideas, led to
17 the creation of many of the new portfolio companies.

18 95. One of the reasons FDC's costs kept growing was because Frost paid
19 himself a generous salary (approximately \$3.4 million from 2012 through 2016) and
20 also charged extensive personal expenses to FDC (over \$867,000 from 2012 through
21 2016).

22 96. Personal expenses charged to FDC included Frost's personal chef,
23 housekeeper, wine locker, archery range, boat payments and maintenance, beach club
24 membership, lease payments for luxury cars, and payments of charges (averaging a
25 total of \$18,000 per month) made on three personal credit cards.

26 97. In addition, emails show Frost and FDC's CFO discussing that new
27 companies and the resultant incubator fees were needed to make ends meet.
28

1 98. For example, in an email dated June 10, 2016, Frost told FDC's CFO
2 that it was "critically important to get the incubator to break even ASAP." Frost also
3 told FDC's CFO that "to achieve this we need to ... start a few new companies
4 ASAP" and also "move costs to the newcos [new portfolio companies] by assigning
5 some of our incubator execs as CEO/CTO."

6 99. Once Frost decided to start a new portfolio company, the matter would
7 be submitted to a fund's investment committee, which determined how many portfolio
8 companies would be created and how much a fund would invest in each newly created
9 company.

10 100. A fund's investment committee, which was controlled by Frost, would
11 typically approve the creation of the company and the amount to be invested.

12 101. In addition, Frost was the only member of Fund III's investment
13 committee in late 2016, and was thus solely responsible for approving the fund's
14 investment in the last two newly formed portfolio companies.

15 **4. Undisclosed and Unearned Management Fees**

16 102. FMC and Frost also collected undisclosed management fees from the
17 Seed Fund and International Seed Fund.

18 103. The governing documents for these two funds did not disclose or
19 authorize the payment of management fees.

20 104. Nevertheless, from 2012 to 2014, FMC charged the Seed Fund \$378,000
21 in management fees and the International Seed Fund \$24,875 in management fees.

22 105. In addition, FMC and Frost collected unearned management fees from
23 Fund II that should have been offset by incubator fees that exceeded market rates.

24 106. Fund II's governing document allowed its general partner to collect a 2%
25 management fee. The governing document also provided that incubator fees paid to
26 FDC would not reduce the management fee "so long as such [incubator] fees [do] not
27 exceed reasonable market rates."

28 107. Fund II paid management fees of over \$1.7 million. The excess

1 incubator fees charged to Fund II should have been used to offset those management
2 fees.

3 **C. Materiality**

4 108. The Funds and their investors and prospective investors would have
5 considered it important to know that the portfolio companies in which they had
6 invested were paying undisclosed and excessive incubator fees that depleted the
7 portfolio companies' assets.

8 109. The Funds and their investors and prospective investors would also have
9 considered it important to know that some of the portfolio companies in which they
10 had invested were created for the principal purpose of generating additional
11 incubator fees to cover Frost's extravagant personal expenses.

12 110. The Seed Fund, the International Seed Fund, and their investors and
13 prospective investors would have considered it important to know that that these two
14 funds were paying undisclosed management fees that directly impacted the Funds'
15 assets.

16 111. Fund II and its investors and prospective investors would have
17 considered it important to know that the fund had paid unearned management fees
18 that directly impacted the Fund's assets.

19 **D. Frost Acted Knowingly or, at a Minimum, Negligently**

20 112. Because Frost was FMC's sole owner and manager, majority or sole
21 owner of the Funds' managing members and general partners, and FDC's sole owner
22 and managing member, Frost knew, or was reckless in not knowing, that it was a
23 breach of his fiduciary duty to charge undisclosed and excessive incubator and
24 management fees.

25 113. At a minimum, Frost acted negligently by falling below the standard of
26 care expected of an investment adviser by charging and not disclosing these
27 undisclosed and excessive fees. For an investment adviser, the standard of care is
28 based on its fiduciary duty. As a fiduciary, Frost owed his clients undivided loyalty

1 and should not have engaged in activity that conflicted with his clients' interest.

2 114. Because Frost controlled FMC, his scienter and/or negligence can be
3 imputed to FMC.

4 **E. Frost and FMC Acted as Investment Advisers**

5 115. At all relevant times, both Frost and FMC were investment advisers
6 within the meaning of Section 202(a)(11) of the Advisers Act [15 U.S.C. §§ 80b-
7 2(a)11)], as they both, for compensation, engaged in the business of advising others,
8 either directly or through publications and writings, as to the value of securities or as
9 to the advisability of investing in, purchasing or selling securities.

10 116. FMC provided investment advice for compensation, and also filed
11 reports with the SEC as an exempt reporting adviser.

12 117. Frost was the sole owner and manager of FMC, and he received
13 compensation for giving advice to the Funds.

14 118. The limited partnership and membership interests in the Funds, as well
15 as the shares of stock of the portfolio in which the Funds invested, are securities.

16 **F. Defendants' Tolling Agreements**

17 119. Frost and FMC have each entered into tolling agreements with the SEC
18 to toll the running of any statute of limitations for an action or proceeding against
19 them which permits any sanctions or relief that may be sought or imposed in such
20 action or proceeding starting January 1, 2014.

21 **FIRST CLAIM FOR RELIEF**

22 **Fraud by an Investment Adviser**

23 **Violations of Sections 206(1) and 206(2) of the Advisers Act**

24 **(against Defendants Frost and FMC)**

25 120. The SEC realleges and incorporates by reference paragraphs 1 through
26 119 of this Complaint as if fully set forth herein.

27 121. Defendants Frost and FMC, at all relevant times, were investment
28 advisers within the meaning of Section 202(a)(11) of the Advisers Act [15 U.S.C. §

1 80b-2(a)(11)].

2 122. Among other things, Frost and FMC made material misstatements and
3 omissions, and breached their fiduciary duties to the Funds, by failing to disclose
4 material information and conflicts of interest regarding the incubator fees charged by
5 FDC, including:

6 (a) failing to disclose to the Seed Fund, International Seed Fund, and
7 International Feeder Fund that the portfolio companies in which they invested would
8 be charged incubator fees;

9 (b) failing to disclose to the Funds that the portfolio companies would
10 be charged flat-rate incubator fees as opposed to incubator fees charged on a case-by-
11 case basis, or at or below market rates;

12 (c) failing to disclose the amount of incubator fees actually charged to
13 the portfolio companies in quarterly status reports provided to the Funds' investors;

14 (d) failing to disclose the existence or the amount of incubator fees
15 actually charged to the portfolio companies to the Funds' advisory committees;

16 (e) failing to disclose to the Funds that Frost created some of the new
17 portfolio companies for the principal purpose of generating additional incubator fees
18 to cover FDC's overhead and Frost's extravagant personal expenses; and

19 (f) charging the portfolio companies in which the Funds invested
20 over \$14 million in excessive incubator fees.

21 123. In addition, FMC and Frost charged the Seed Fund and International
22 Seed Fund undisclosed management fees of \$402,875 and improperly charged Fund II
23 over \$1.7 million in management fees that should have been offset by the excessive
24 incubator fees charged.

25 124. By engaging in the conduct described above, Frost and FMC, and each
26 of them, directly or indirectly, by use of the mails or means and instrumentalities of
27 interstate commerce, knowingly and/or recklessly: (a) employed or are employing
28 devices, schemes or artifices to defraud clients or prospective clients; and knowingly,

1 recklessly and/or negligently (b) engaged in or are engaging in transactions, practices,
2 or courses of business which operated as a fraud or deceit upon clients or prospective
3 clients.

4 125. By engaging in the conduct described above, Frost and FMC, and each
5 of them, have violated, and unless restrained and enjoined, are reasonably likely to
6 continue to violate, Sections 206(1) and (2) of the Advisers Act [15 U.S.C. §§ 80b-
7 6(1) & 80b-6(2)].

8 **SECOND CLAIM FOR RELIEF**

9 **Fraud Involving a Pooled Investment Vehicle**

10 **Violations of Section 206(4) of the Advisers Act and Rule 206(4)-8(a)(1)-(a)(2)**
11 **(against Defendants Frost and FMC)**

12 126. The SEC realleges and incorporates by reference paragraphs 1 through
13 119 above.

14 127. FMC and Frost repeatedly defrauded investors in the Funds by failing to
15 disclose the existence of and/or the amount of incubator fees and management fees,
16 thus making the Funds' governing agreements, pitch materials, and quarterly status
17 reports misleading.

18 128. FMC and Frost engaged in multiple years of deceptive conduct by
19 charging undisclosed, excessive and/or improper incubator and management fees and
20 by starting new portfolio companies to generate additional incubator fees to cover
21 FDC's overhead and Frost's personal expenses.

22 129. By engaging in the conduct described above, Defendants Frost and
23 FMC, and each of them, directly or indirectly, by engaging in the conduct described
24 above, while acting as an investment adviser to a pooled investment vehicle, directly
25 or indirectly, by use of the mails or means or instrumentalities of interstate commerce,
26 knowingly, recklessly and/or negligently: (a) made untrue statements of a material
27 fact or omitted to state a material fact necessary in order to make the statements made,
28 in the light of the circumstances under which there were made, not misleading, to any

1 investor or prospective investor in the pooled investment vehicle; or (b) engaged in
2 acts, practices, or courses of business that were fraudulent, deceptive, or manipulative
3 with respect to any investor or prospective investor in the pooled investment vehicle.

4 130. By engaging in the conduct described above, Defendants Frost and
5 FMC, and each of them, have violated, and unless restrained and enjoined, are
6 reasonably likely to continue to violate, Section 206(4) of the Advisers Act [15 U.S.C.
7 § 80b-6(4)] and Rule 206(4)-8 thereunder [17 C.F.R. § 275.206(4)-8].

8 **PRAYER FOR RELIEF**

9 WHEREFORE, the SEC respectfully requests that the Court:

10 **I.**

11 Issue findings of fact and conclusions of law that Defendants committed the
12 alleged violations.

13 **II.**

14 Issue judgments, in forms consistent with Rule 65(d) of the Federal Rules of
15 Civil Procedure, permanently enjoining Frost and FMC, and their officers, agents,
16 servants, employees and attorneys, and those persons in active concert or
17 participation with any of them, who receive actual notice of the judgment by personal
18 service or otherwise, and each of them, from violating Sections 206(1), 206(2) and
19 206(4) of the Advisers Act [15 U.S.C. §§ 80b-6(1), 80b-6(2), and 80b-6(4)] and Rule
20 206(4)-8 thereunder [17 C.F.R. § 275.206(4)-8].

21 **III.**

22 Order Defendants to disgorge all funds received from their illegal conduct,
23 together with prejudgment interest thereon, on a joint and several basis.

24 **IV.**

25 Order Defendants to pay civil penalties under Section 209(e) of the Advisers
26 Act [15 U.S.C. § 80b-9(e)].

27 **V.**

28 Retain jurisdiction of this action in accordance with the principles of equity and

1 the Federal Rules of Civil Procedure in order to implement and carry out the terms of
2 all orders and decrees that may be entered, or to entertain any suitable application or
3 motion for additional relief within the jurisdiction of this Court.

4 **VI.**

5 Grant such other and further relief as this Court may determine to be just and
6 necessary.

7 Dated: August 13, 2019

8
9 */s/ Donald W. Searles*

10 DONALD W. SEARLES

11 Attorney for Plaintiff

12 Securities and Exchange Commission
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Complaints and Other Initiating Documents

[8:19-cv-01559 Securities and Exchange Commission v. Frost et al](#)

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

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Document Number: [1](#)

Docket Text:

COMPLAINT No Fee Required - US Government, filed by Plaintiff Securities and Exchange Commission. (Attorney Donald W Searles added to party Securities and Exchange Commission(pty:pla))(Searles, Donald)

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