

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**INVESTMENT ADVISERS ACT OF 1940**  
**Release No. 3705 / October 28, 2013**

**INVESTMENT COMPANY ACT OF 1940**  
**Release No. 30766 / October 28, 2013**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-15588**

**In the Matter of**

**Knelman Asset Management  
Group, LLC and Irving P.  
Knelman,**

**Respondents.**

**ORDER INSTITUTING ADMINISTRATIVE  
AND CEASE-AND-DESIST PROCEEDINGS  
PURSUANT TO SECTIONS 203(e), 203(f),  
AND 203(k) OF THE INVESTMENT  
ADVISERS ACT OF 1940, AND SECTION  
9(b) OF THE INVESTMENT COMPANY 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), 203(f) and 203(k) of the Investment Advisers Act of 1940 (“Advisers Act”), and Section 9(b) of the Investment Company Act of 1940 (“Investment Company Act”) against Knelman Asset Management Group, LLC (“KAMG” or “the firm”) and Irving P. Knelman (“Knelman”).

**II.**

In anticipation of the institution of these proceedings, Respondents KAMG and Knelman have submitted Offers of Settlement (the “Offers”) 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 them and the subject matter of these proceedings, which are admitted, Respondents KAMG and Knelman consent to the entry of this Order Instituting Administrative and Cease-and-Desist Proceedings Pursuant to

Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940, and Section 9(b) of the Investment Company 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 Respondent’s Offer, the Commission finds that:

#### Summary

1. This matter involves violations of the Advisers Act by KAMG, a Commission-registered investment adviser, and Knelman, KAMG’s managing director, chief executive officer (“CEO”) and chief compliance officer (“CCO”). First, KAMG, the manager of Rancho Partners I, LLC (“Rancho”), a fund of private equity funds, and Knelman violated Advisers Act Rule 206(4)-2 (the “Custody Rule”) by, among other things, failing to arrange annual surprise examinations of Rancho’s assets, or alternatively, failing to provide Rancho’s members with audited financial statements. Second, KAMG and Knelman used a distribution methodology that was contrary to Rancho’s limited liability company agreement (“LLC Agreement”) and private placement memorandum (“PPM”), and made improper discretionary cash distributions to some of Rancho’s members. Third, KAMG and Knelman violated Advisers Act Rule 206(4)-7 (the “Compliance Rule”) by failing to conduct annual reviews of the adequacy and effectiveness of KAMG’s compliance policies and procedures, and by failing to adopt and implement controls designed to safeguard Rancho’s assets. Fourth, KAMG and Knelman failed to accurately maintain certain books and records for Rancho mandated by the Advisers Act and its rules, and failed to maintain certain required proxy materials. Finally, KAMG and Knelman filed Forms ADV that falsely stated that the firm had no custody of client assets.

#### Respondents

2. **Knelman Asset Management Group, LLC**, a Delaware limited liability company founded in 2000 and based in Minneapolis, Minnesota, has been registered with the Commission as an investment adviser since September 2008. KAMG was also registered with the Commission from 2000 until September 2005, when it filed a Form ADV-W to withdraw its registration. KAMG provides discretionary investment management services to high net worth individuals, trusts, estates, and institutional clients and manages approximately \$106.5 million in assets. KAMG has been the sole managing member of, and has provided investment advisory services to, Rancho, a fund of private equity funds that Knelman formed in 2000, since Rancho’s inception.

3. **Irving P. Knelman**, age 64, is a resident of Edina, Minnesota. Knelman is KAMG’s managing director and CEO. During all relevant times, Knelman was also KAMG’s CCO.

### **Other Relevant Entity**

4. **Rancho Partners I, LLC**, a Minnesota limited liability company formed by Knelman in August 2000 and based in Minneapolis, Minnesota, is a pooled investment vehicle and a fund of private equity funds.<sup>1</sup> Rancho has nineteen members, including KAMG. Three of Rancho's members are also KAMG advisory clients. As of December 31, 2012, Rancho's assets were fair valued at \$1.3 million.

### **Background**

5. In 2000, Knelman formed KAMG. Later that same year, Knelman formed Rancho to allow its members to invest in private equity partnerships and funds. Each investor purchased membership interests in Rancho, which in turn, purchased membership interests in five private equity funds. KAMG has been Rancho's investment adviser since its inception.

### **KAMG's Custody Failures**

6. The Custody Rule – Rule 206(4)-2 under the Advisers Act – requires registered investment advisers with custody of client funds or securities to implement certain controls designed to protect those assets from loss, misappropriation, misuse, or the adviser's insolvency. Before the amendment of Rule 206(4)-2, effective March 12, 2010, the rule required these advisers to have a reasonable basis for believing that a qualified custodian was sending quarterly account statements to each of the clients for which it maintained funds or securities, or to send the quarterly account statements itself and obtain an annual surprise examination by an independent public accountant to verify all of the client assets. The amended rule generally requires these advisers to have a reasonable basis for believing that a qualified custodian is sending quarterly statements to clients and to be subject to an annual surprise examination. Both the pre- and post-amendment Rule 206(4)-2(b) provided exceptions to an adviser of a pooled investment vehicle from the quarterly account statement and surprise examination requirements if certain criteria are met, including an annual audit of the pool by a PCAOB registered and inspected independent public accountant and delivery to investors in the vehicle audited financial statements prepared in accordance with generally accepted accounting principles within 120 days of the fiscal year end.

7. As the managing member of Rancho, KAMG has custody of Rancho's assets and those assets were not maintained by a qualified custodian. From Rancho's formation in 2000 through August 2011, Rancho members did not receive quarterly account statements from a

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<sup>1</sup> Rancho qualifies as a pooled investment vehicle because it holds itself out as being engaged primarily in the business of investing in securities. Rancho was and is not registered as an investment company in reliance on the exclusion from the definition of "investment company" in Section 3(c)(1) of the Investment Company Act for an entity having no more than 100 beneficial owners of its securities and that is not making and does not propose to make a public offering of its securities.

qualified custodian, and Rancho's funds were not subject to an annual surprise examination. In addition, Rancho's financial statements were not audited or distributed to Rancho members.

8. Rancho's LLC Agreement required KAMG to distribute annual financial statements to Rancho's members. By not doing so, KAMG and Knelman violated the terms of the LLC Agreement.

9. In 2005, the Commission's staff notified KAMG and Knelman that KAMG had failed to comply with the Custody Rule. That year, the Commission's staff conducted an examination of KAMG and issued a deficiency letter dated September 8, 2005. The letter summarized the requirements of the custody rule, stated that KAMG, as managing member of Rancho and another private fund, Rancho Partners II, LLC ("Rancho II"), was deemed to have custody of client assets, and that KAMG was not a qualified custodian.<sup>2</sup> The letter further stated that because Rancho and Rancho II members did not receive account statements directly from a qualified custodian, and the Rancho and Rancho II financial statements were not audited, KAMG had violated the Custody Rule. Finally, the letter stated that KAMG had also violated the Custody Rule because it held a stock certificate owned by Rancho II in a safe deposit box. The letter warned, "[KAMG] should immediately take steps to ensure it is in compliance with Rule 206(4)-2 if it has not already done so."

10. KAMG responded to the staff with a letter dated September 26, 2005, signed by Knelman, stating that it had resolved the stock certificate issue by moving the stock certificate to a safe deposit box at US Bank. The safe deposit box was maintained in the name of Rancho Partners II. KAMG's response did not address the firm's other Custody Rule deficiencies. In fact, KAMG and Knelman did not take any steps to address the firm's other deficiencies.

11. In 2010, after KAMG reregistered with the Commission, the staff conducted another exam of KAMG and learned that KAMG, as managing member, still had custody of Rancho's assets. The staff also learned that KAMG was violating the Custody Rule because KAMG did not have a reasonable basis for believing that a qualified custodian was sending quarterly statements to Rancho members and KAMG had not arranged for annual surprise exams of Rancho's assets. Alternatively, KAMG had not arranged for Rancho's financial statements to be audited annually and distributed to Rancho's members. In June 2011, the staff issued another letter to KAMG identifying custody rule violations and other deficiencies.

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<sup>2</sup> Rancho Partners II was formed in June 2003 to invest in one company that ultimately went public. Rancho II was terminated in January 2008. Rancho II's members were not the same as Rancho's members.

## KAMG's Improper Distributions

12. Section 206(2) of the Advisers Act prohibits fraudulent conduct by an investment adviser on a client or prospective client. Section 206(4) of the Advisers Act and Rule 206(4)-8 promulgated thereunder prohibit fraudulent conduct by investment advisers to pooled investment vehicles.<sup>3</sup>

13. In making distributions to members, KAMG failed to abide by the terms of Rancho's LLC Agreement and PPM. From the time that Rancho received its first distribution from its venture capital partnership investments in April 2002, through July 2011, KAMG used the wrong methodology for making pro-rata distributions to Rancho members. KAMG also made improper discretionary cash distributions between 2007 and 2010 to some Rancho members. In 2011, KAMG performed a "true-up" exercise designed to correct the improper distributions, and reallocated \$119,381 of distributions among the members.

14. Under Rancho's LLC Agreement and PPM dated as of September 1, 2000, KAMG was to make distributions *pro rata* in accordance with the Rancho members' positive capital account balance. When Rancho received money from the partnerships in which it invested, KAMG made distributions in cash or in stock, as credits to members' capital contributions, or as credits to members' management fees due.

15. From April 2002 through July 2011, KAMG calculated all types of distributions based on the members' capital *commitments* rather than on their *capital account balances* as required. KAMG distributed a total of \$1,513,078 (\$850,163 in capital contribution credits and \$662,915 in cash) during this period utilizing this incorrect methodology.

16. In addition, on seven separate occasions between 2007 and 2010, KAMG made improper discretionary cash distributions totaling \$92,640 to some, but not all, of Rancho's nineteen members. In total, thirteen of the nineteen members received at least one discretionary cash distribution. Six members, including KAMG and one of the KAMG advisory clients, received none.

17. Knelman authorized all of the distributions and, as managing director of KAMG, was responsible for ensuring that all distributions were made in accordance with the LLC Agreement and PPM.

18. During the relevant period, all Rancho member activity, including distribution detail, was maintained on an electronic spreadsheet that KAMG's outside accountants

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<sup>3</sup> "[A] violation of Section 206(2) of the Advisers Act may rest on a finding of simple negligence." *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, 191 (1963)). "Proof of scienter is not required to establish a violation of Section 206(4) of the Advisers Act." *In the Matter of Wunderlich Securities, Inc.*, Investment Advisers Act Rel. No. 3211, 2011 WL 2098195, at \*8 (May 27, 2011) (citing *SEC v. Steadman*, 967 F.2d 636, 647 (D.C.Cir. 1992)).

created. Beginning in or around 2005, KAMG's outside accountants maintained the spreadsheet for KAMG. KAMG, Knelman and the outside accountants failed to recognize that some of the distributions were improper.

19. KAMG was most disadvantaged by the improper distributions and, as a result of the true-up exercise, received the largest reallocation – \$61,670. The next largest reallocation was \$10,125. All of KAMG's members were advised of the true-up exercise and the circumstances giving rise to it.

### **KAMG's Compliance Failures**

20. The Compliance Rule – Rule 206(4)-7 under the Advisers Act – requires investment advisers registered with the Commission (1) to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules adopted under the Act; (2) to review at least annually the adequacy of the policies and procedures and the effectiveness of their implementation; and (3) to designate a CCO, who is a supervised person, responsible for administering the policies and procedures.

21. KAMG's policies and procedures were not reasonably designed to prevent violations of the custody rule. The firm's compliance manual did not acknowledge that KAMG had custody over Rancho's assets. Thus, it had no written policies and procedures to ensure that it met the requirements of the custody rule regarding Rancho's assets. KAMG also failed to conduct annual reviews of its compliance policies and procedures and the effectiveness of their implementation and failed to institute a documented process to identify potential compliance risks and conflicts of interest.

22. KAMG designated Knelman as the firm's CCO, but he had no relevant experience in the compliance industry and failed to undergo any compliance training to become knowledgeable about that position. Knelman was ultimately responsible for making sure KAMG complied with the Custody Rule. Knelman knew or should have known that KAMG had not conducted any annual compliance reviews or instituted a documented process to identify potential compliance risks or conflicts of interest. Nevertheless, Knelman failed to establish written policies and procedures reasonably designed to prevent violations of the Advisers Act as they related to custody over Rancho's assets.

### **KAMG's Failure to Make and Keep Certain Books and Records**

23. Section 204 of the Advisers Act provides that investment advisers registered with the Commission who make use of the mails or interstate commerce in connection with its advisory business shall make and keep for prescribed periods those records that the Commission, by rule, may prescribe as necessary, and that all records are "subject at any time, or from time to time, to such reasonable periodic, special, or other examinations by representatives of the Commission as the Commission deems necessary or appropriate in the public interest or for the protection of investors." Rule 204-2(a) sets forth certain categories of books and records that registered investment advisers are required to "make and keep true, accurate and current" with

respect to their investment advisory business. Rule 204-2(b) sets forth categories of additional documents that must be maintained by registered investment advisers that have custody of client assets. Rule 204-2(c)(2) requires that registered investment advisers that exercise voting authority with respect to client securities shall make and retain certain documents.

24. From September 2008 through 2011, as required by Rule 204-2(b)(1), KAMG failed to make and keep an accurate journal or other record for Rancho showing all purchases, sales, receipts and deliveries of securities (including certificate numbers) and all other debits and credits.

25. From September 2008 through 2011, as required by Rule 204-2(b)(2), KAMG failed to make and keep accurate separate ledger accounts for each Rancho member showing all purchases, sales, receipts and deliveries of securities, the date and price of each purchase and sale, and all debits and credits.

26. From September 2008 through 2011, as required by Rule 204-2(c)(2), KAMG failed to make and keep a copy of each proxy statement it had received, a record of each vote cast on behalf of a client, and a copy of any document created by KAMG that was material to its voting decisions or that memorialized the basis for its voting decisions.

27. As managing director, CEO, and CCO, Knelman was responsible for ensuring that KAMG accurately made and kept such books and records. Knelman directed his clerical employees and KAMG's outside accountants to maintain and update the required records, but no one ensured their accuracy.

### **KAMG's False Form ADV Disclosures**

28. Section 207 of the Advisers Act makes it unlawful for any person willfully to make any untrue statement of a material fact in any registration application or report filed with the Commission, or willfully to omit to state in any such application or report any material fact which is required to be stated therein.<sup>4</sup>

29. KAMG's Form ADV, which was signed and filed by Knelman with the Commission on August 28, 2008, and all subsequent amendments to the Form ADV, which were signed and filed by Knelman from 2009 through 2011, contain untrue statements of material fact regarding KAMG's custody of client assets (Part IA, Item 9 and Part 2A, Item 15). Although KAMG had custody of Rancho's assets, KAMG stated in its Forms ADV that it did not maintain custody of client assets or securities.

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<sup>4</sup> Scienter is not required to establish liability under Section 207 of the Advisers Act; it merely requires willfulness. *SEC v. K.W. Brown & Co.*, 555 F. Supp. 2d 1275, 1309 (S.D. Fla. 2007).

### **Violations**

30. As a result of the conduct described above, KAMG and Knelman willfully<sup>5</sup> violated Sections 206(2) and 206(4) of the Advisers Act and Rule 206(4)-8 promulgated thereunder.

31. As a result of the conduct described above, KAMG willfully violated, and Knelman willfully aided and abetted and caused KAMG's violations of Section 206(4) of the Advisers Act and Rule 206(4)-2 promulgated thereunder.

32. As a result of the conduct described above, KAMG willfully violated, and Knelman willfully aided and abetted and caused KAMG's violations of Section 206(4) of the Advisers Act and Rule 206(4)-7 promulgated thereunder.

33. As a result of the conduct described above, KAMG willfully violated and Knelman willfully aided and abetted and caused KAMG's violations of Section 204 and Rules 204-2(b)(1), 204-2(b)(2), 204-2(c)(2).

34. As a result of the conduct described above, KAMG and Knelman willfully violated Section 207 of the Advisers Act.

### **KAMG's Remedial Efforts**

35. In determining to accept the Offer, the Commission considered remedial acts promptly undertaken by Respondent KAMG.

### **Undertakings**

Respondent has undertaken to:

36. **Compliance Training.** Within one year of the entry of this Order, Knelman shall complete, and KAMG shall require its new CCO to complete, thirty (30) hours of compliance training relating to the Advisers Act.

37. **Designation of a CCO.** Within thirty (30) days of the entry of this Order, KAMG shall designate someone other than Knelman to be its CCO.

38. **Continued Retention of Compliance Consultant.** During the Commission's investigation, KAMG hired a compliance consultant (the "Consultant") to conduct a comprehensive review of KAMG's compliance program. The Consultant completed its initial

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<sup>5</sup> A willful violation of the securities laws means merely "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)).



work and submitted a report detailing its work, findings, and recommendations to KAMG in February 2012, which KAMG shared with the Commission staff. KAMG has implemented all of the Consultant's recommendations. KAMG shall continue to retain, at its expense, the Consultant to conduct annual compliance reviews of KAMG for the years 2013 and 2014 as well quarterly compliance meetings and other services as detailed in a contract between KAMG and the Consultant dated August 19, 2013.

39. Recordkeeping. KAMG shall preserve for a period of no less than six (6) years from the end of the fiscal year last used, the first two (2) years in an easily accessible place, any record of KAMG's compliance with the undertakings set forth in this Order.

40. Notice to Rancho Members and Advisory Clients. Within thirty (30) days of the entry of this Order, KAMG shall provide a copy of the Order to each existing Rancho member and each of KAMG's existing advisory clients as of the entry of this Order via mail, email, or such other method as may be acceptable to the Commission staff, together with a cover letter in a form not unacceptable to the Commission staff. Furthermore, for a period of twelve (12) months from the entry of this Order, to the extent that KAMG is required to deliver a brochure to a client and/or prospective client pursuant to Rule 204-3 under the Advisers Act, KAMG shall also provide a copy of this Order to such client and/or prospective client at the same time that KAMG delivers the brochure.

41. Deadlines. For good cause shown, the Commission staff may 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.

42. Certification of Compliance. KAMG and Knelman shall certify, in writing, compliance with the undertakings set forth above. The certifications 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 KAMG and Knelman agree to provide such evidence. The certification and supporting material shall be submitted to Paul A. Montoya, Assistant Regional Director, Securities and Exchange Commission, 175 West Jackson Blvd., Suite 900, Chicago Illinois 60604, or such other address as the Commission staff may provide, with a copy to the Office of Chief Counsel of the Enforcement Division, no later than sixty (60) days from the date of the completion of all 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 Respondent KAMG's and Respondent Knelman's Offers.

Accordingly, pursuant to Sections 203(e), 203(f) and 203(k) of the Advisers Act, and Section 9(b) of the Investment Company Act, it is hereby ORDERED that:

A. Respondents KAMG and Knelman cease and desist from committing or causing any violations and any future violations of Sections 204, 206(2), 206(4) and 207 of the Advisers Act and Rules 204-2(b)(1), 204-2(b)(2), 204(2)(c)(2), 206(4)-2, 206(4)-7, and 206(4)-8 promulgated thereunder.

B. Respondent KAMG is censured.

C. Respondent Knelman be, and hereby is barred from acting as the chief compliance officer of any broker, dealer, investment adviser, municipal securities dealer, municipal advisor, transfer agent, or nationally recognized statistical rating organization with the right to apply for reentry after three (3) years to the appropriate self-regulatory organization, or if there is none, to the Commission; and prohibited from serving or acting as the chief compliance officer for a registered investment company or for an affiliated person of an investment adviser of, depositor of, or principal underwriter for, a registered investment company, with the right to apply for reentry after three (3) years to the appropriate self-regulatory organization, or if there is none, to the Commission.

D. Any reapplication for association by Respondent Knelman will be subject to the applicable laws and regulations governing the reentry process, and reentry may be conditioned upon a number of factors, including, but not limited to, the satisfaction of any or all of the following: (a) any disgorgement ordered against Respondent Knelman, whether or not the Commission has fully or partially waived payment of such disgorgement; (b) any arbitration award related to the conduct that served as the basis for the Commission order; (c) any self-regulatory organization arbitration award to a customer, whether or not related to the conduct that served as the basis for the Commission order; and (d) any restitution order by a self-regulatory organization, whether or not related to the conduct that served as the basis for the Commission order.

E. Respondent KAMG shall pay a civil money penalty in the amount of \$60,000 to the United States Treasury. Payment shall be made in the following installments: \$30,000 within ten (10) days of the entry of this Order, \$15,000 within sixty (60) days of the entry of this Order, and \$15,000 within ninety (90) days of the entry of this Order. If any payment is not made by the date the payment is required by this Order, the entire outstanding balance of civil penalties, plus any additional interest accrued pursuant to SEC Rule of Practice 600 or pursuant to 31 U.S.C. 3717, shall be due and payable immediately, without further application. Payment must be made in one of the following ways:

- (1) Respondent 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
- (2) Respondent 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 KAMG 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 Paul Montoya, Assistant Regional Director, Chicago Regional Office, Securities and Exchange Commission, 175 West Jackson Blvd., Suite 900, Chicago, IL 60604.

F. Respondent Knelman shall, within ten (10) days of the entry of this Order, pay a civil money penalty in the amount of \$75,000 to the United States Treasury. If timely payment is not made, additional interest shall accrue pursuant to 31 U.S.C. 3717. Payment must be made in accordance with Subsection E above, with the cover letter identifying Knelman as a Respondent in these proceedings.

G. Respondent KAMG shall comply with the undertakings enumerated in Sections 36 through 42 above. Respondent Knelman shall comply with the undertakings enumerated in Sections 36 and 42 above.

By the Commission.

Elizabeth M. Murphy  
Secretary