Investment Management Regulatory Update

January 24, 2019

Rules and Regulations

- SEC Proposes Significant Changes to Rules for Funds of Funds
- SEC Staff Grants No-Action Relief to Madison Capital Funding LLC Under Section 206(4) and Rule 206(4)-2 of the Investment Advisers Act of 1940
- Bill Enacted to Exempt Investment Advisers of Rural Business Investment Companies from Registration Under the Advisers Act

Industry Update

- SEC's National Examination Program Releases Examination Priorities for 2019

Litigation

- SEC Settles Enforcement Actions Against Robo-Advisers Wealthfront and Hedgeable
- SEC Settles with Two Investment Advisory Firms and CEO for Mutual Fund Share Class Disclosure Violations
- SEC Settles Fee and Expense Allocation Enforcement Action With Private Equity Fund Manager

Rules and Regulations

SEC Proposes Significant Changes to Rules for Funds of Funds

In a December 19, 2018 release, the Securities and Exchange Commission (the "**SEC**") proposed new rule 12d1-4 (the "**Proposed Rule**") under the Investment Company Act of 1940, as amended (the "**Investment Company Act**"), to "streamline and enhance the regulatory framework applicable to funds that invest in other funds." In connection with the Proposed Rule, the SEC proposed: (i) related amendments to Rule 12d1-1 under the Investment Company Act and to Form N-CEN; and (ii) to rescind Rule 12d1-2 under the Investment Company Act and most exemptive orders granting relief from sections 12(d)(1)(A), (B), (C), and (G) of the Investment Company Act. For a detailed discussion of the Proposed Rule, please see the January 22, 2019 Davis Polk Client Memorandum, **SEC Proposes Rule Changes for Fund of Funds Arrangements**.

SEC Staff Grants No-Action Relief to Madison Capital Funding LLC Under Section 206(4) and Rule 206(4)-2 of the Investment Advisers Act of 1940

On December 20, 2018, the Division of Investment Management of the SEC issued a no-action letter (the "**Letter**") to Madison Capital Funding LLC ("**Madison**"), an SEC-registered investment adviser, granting conditional assurance that it would not recommend enforcement action for violations of Section 206(4) of the Investment Advisers Act of 1940, as amended (the "**Advisers Act**") and Rule 206(4)-2 (the "**Custody Rule**") thereunder, in connection with administrative agent services Madison performs for its loan syndication business, provided that Madison satisfies certain specified conditions.

According to the Letter, the Custody Rule requires a registered investment adviser that has custody of client funds or securities to satisfy certain requirements, including, among other things, that: (1) a

qualified custodian maintain such funds or securities (i) in a separate account for each client under the client's name; or (ii) in accounts that contain only the investment adviser's clients' funds and securities, under the investment adviser's name as agent or trustee for the clients; and (2) the investment adviser have a reasonable basis, after due inquiry, for believing that the qualified custodian sends account statements to its clients at least quarterly.

The Letter stated that under the Custody Rule, an investment adviser is deemed to have custody of client funds or securities where it (or its related person) "holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them, in connection with advisory services [it] provide[s] to clients." The Letter further stated that custody includes any arrangement under which an adviser is "authorized or permitted to withdraw client funds or securities maintained with a custodian upon [its] instruction to the custodian."

According to the incoming letter (the "**Incoming Letter**"), Madison is a non-bank lender providing senior loans to middle market companies and often acts as an administrative agent for loans that are syndicated to other bank and non-bank lenders, including pooled investment vehicles and separately managed accounts for which Madison or an affiliate may act as a registered investment adviser. In the Incoming Letter, Madison noted that in its capacity as administrative agent, it typically established a single bank account for all participants in a loan syndicate and its bank custodian did not send quarterly account statements to each participant in the loan syndicate. According to the Incoming Letter, Madison believed these practices could violate the Custody Rule requirements that: (i) client assets be maintained with a qualified custodian in a separate account in each client's name or in an account that contains only client assets; and (ii) the investment adviser have a reasonable basis, after due inquiry, to believe that the qualified custodian sends account statements to its clients on at least a quarterly basis.

In the Letter, the SEC granted conditional relief to Madison from these requirements under the Custody Rule, provided that Madison satisfies the following conditions:

1. The single bank account (the "**Agency Account**") established by Madison will be maintained by a bank that meets the definition of a qualified custodian under Custody Rule;

2. Only the assets of the participants (the "**Loan Syndicate Participants**") in the syndicated loan (the "**Loan Syndicates**") will be placed in the Agency Account;

3. No cash will be deposited in or withdrawn from the Agency Account except pursuant to credit agreements for the Loan Syndicates;

4. Madison will receive payments from Loan Syndicate Participants or underlying obligors only as agent for the Loan Syndicate Participants;

5. In addition to disclosing on its Form ADV Part 1A the advisory client assets over which Madison has custody and each qualified custodian with which such assets are maintained, Madison will provide disclosure in Form ADV Part 2A to reflect its custody of assets in the Agency Account and that the account commingles the assets of advisory clients and third parties;

6. Madison will develop and implement controls for its administrative agent services to ensure that: (i) assets of the Loan Syndicate Participants are safeguarded from loss or misappropriation; (ii) assets in the Agency Account are distributed in a timely manner, accurately and in accordance with applicable credit agreements; and (iii) the administrative agent services are, and the Agency Account is, operated in a manner consistent with the credit agreements for the relevant loans (the "**Control Objectives**");

7. Madison will obtain a written internal control report (the "**Control Attestation**") at least annually and prepared by an independent public accountant, meeting the following requirements:

a) The report must include an opinion of the accountant as to whether controls have been in place as of a specific date, and whether such controls are suitably designed and operating effectively to meet the Control Objectives;

b) The accountant must verify that the assets in the Agency Account are reconciled to a custodian other than Madison or a related person; and

c) The accountant must be registered with, and subject to regular inspection as of the commencement of the professional engagement, and as of each calendar year-end, by the Public Company Accounting Oversight Board in accordance with its rules;

8. Madison will promptly seek to resolve any control exceptions identified in the Control Attestation on the part of Madison or its employees in order to meet the Control Objectives;

9. Madison will include the annual Control Attestation as part of its books and records under Rule 204-2 under the Advisers Act;

10. If the accountant issues a qualified opinion with respect to the Control Attestation, Madison will promptly notify its advisory clients that are Loan Syndicate Participants and inform them of any issues that resulted in such qualified opinion and how such issues will be avoided in the future; and

11. Madison will detail the controls developed and implemented to achieve the Control Objectives and the Control Attestation process in its policies and procedures adopted, implemented and subject to annual review under Rule 206(4)-7 of the Advisers Act.

The SEC noted that third parties may rely on Madison's no-action letter "to the extent that their facts and circumstances are substantially similar to those" detailed in the Letter. The Letter also stated that the SEC is "willing to entertain other no-action request where investment advisers serving as administrative agents have similarly taken or propose to take steps to minimize that risk that client funds or securities could be lost or withdrawn or misappropriated by the investment adviser."

- **See a copy of the Letter**
- **See a copy of the Incoming Letter**

Bill Enacted to Exempt Investment Advisers of Rural Business Investment Companies from Registration Under the Advisers Act

On January 3, 2019, President Trump signed into law the RBIC Advisers Relief Act of 2018 (the "**Act**"). The Act amends the Advisers Act by providing an exemption from the requirement to register with the SEC to investment advisers who solely advise Rural Business Investment Companies ("**RBICs**") or companies applying for an RBIC license. A "rural business investment company" is defined as a company that has been granted final approval by the Secretary of Agriculture (the "**Secretary**") and has entered into a participation agreement with the Secretary. RBICs are licensed under the Rural Business Investment Program.

Specifically, the Act amends Section 203(b) of the Advisers Act, which provides other exemptions from registration. Notably, the Act mirrors the exemption provided to advisers solely to small business investment companies in Section 203(b)(7). Among other things, the Act also amends Section 203(l) to treat RBICs as venture capital funds for the purposes of the registration exemption for venture capital fund advisers. The Act also amends Section 203(m) to exempt the assets of advised RBICs from

counting towards the $150,000,000 private fund assets under management threshold, under which a private fund manager may be exempt from registration with the SEC.

- See a copy of the Act

Industry Update

SEC's National Examination Program Releases Examination Priorities for 2019

On December 20, 2018, the National Examination Program (the "**NEP**"), administered by the Office of Compliance Inspections and Examinations ("**OCIE**"), published its examination priorities for 2019 (the "**Exam Priorities**"). The Exam Priorities fall into six categories: (i) matters of importance to retail investors, including seniors and those saving for retirement; (ii) compliance and risks in critical market infrastructure; (iii) select areas and programs of the Financial Industry Regulatory Authority and the Municipal Securities Rulemaking Board ("**MSRB**"); (iv) digital assets; (v) cybersecurity; and (vi) anti-money laundering programs. For a discussion of the 2018 NEP Exam Priorities, please see the February 28, 2018 **Investment Management Regulatory Update**.

Retail Investors, Including Seniors and Those Saving for Retirement

According to the Exam Priorities, the NEP plans to focus on seniors and individuals saving for retirement, including examining firms that provide products and services to those investors. Specific areas of focus will include:

Disclosure of the Costs of Investing. The NEP plans to assess, among other things, whether fees and expenses are calculated and charged in accordance with the disclosures provided to investors. According to the Exam Priorities, the NEP will review firms with practices that may create increased risks of inadequately disclosed fees. With respect to mutual fund share classes, the NEP will continue to evaluate financial incentives for financial professionals. Finally, the Exam Priorities notes a continued focus on advisers participating in wrap fee programs, adequacy of disclosures and brokerage practices.

Conflicts of Interest. Further, the NEP plans to focus on conflicts of interest of investment advisers, examining whether investment advisers are acting in a manner consistent with their fiduciary duty and contractual obligations. Examinations will review policies and procedures related to the following:

- Use of Affiliated Service Providers and Products: The NEP will examine arrangements in which advisers use services or products provided by affiliated entities, focusing on the impact to clients and related disclosures.
- Securities Backed Non-Purpose Loans and Lines of Credit: OCIE will assess the practice of advisers, broker-dealers and their employees receiving incentives to recommend certain non-purpose loans or lines of credit to clients. According to the Exam Priorities, these loans allow borrowers to use brokerage securities as collateral, the proceeds of which cannot be used for purchasing or trading securities. OCIE will assess this practice, focusing on whether registrants are adequately disclosing the risks and conflicts of interest of these recommendations.
- Borrowing Funds from Clients: According to the Exam Priorities, where an investment adviser borrows funds from a client, examiners will investigate whether adequate disclosures are made to the client, including those about the potentially poor financial condition of the adviser, and whether the "investment adviser has acted consistently with these disclosures."

Senior Investors and Retirement Accounts and Products. The NEP will focus on how broker-dealers oversee their interactions with senior investors, including the services and products offered to seniors. Examinations will focus on, among other things, "compliance programs of investment advisers, the

appropriateness of certain investment recommendations to seniors, and the supervision by firms of their employees and independent representatives."

Portfolio Management and Trading. The NEP will focus on "firms' practices for executing investment transactions on behalf of clients, fairly allocating investment opportunities among clients, ensuring consistency of investments with the objectives obtained from clients, disclosing critical information to clients, and complying with other legal restrictions." The assessments of portfolio recommendations will focus on whether the trading strategies of advisers are: "(1) suitable for and in the best interests of investors based on their investment objectives and risk tolerance; (2) contrary to, or have drifted from, disclosures to investors; (3) venturing into new, risky investments or products without adequate risk disclosure; and (4) appropriately monitored for attendant risks."

Never-Before-Examined Investment Advisers. The NEP will continue to take a risk-based approach to identify newly registered or never-before-examined investment advisers. The NEP will also prioritize examination of certain investment advisers that may have substantially grown or changed business models.

*Mutual Funds and Exchange-Traded Funds ("**ETFs**")*. The NEP plans to focus on risks associated with the following: "(1) index funds that track custom-built or bespoke indexes; (2) ETFs with little secondary market trading volume and smaller assets under management; (3) funds with higher allocations to certain securitized assets; (4) funds with aberrational underperformance relative to their peer groups; (5) funds managed by advisers that are relatively new to managing Registered Investment Companies ("**RICs**"); and (6) advisers that provide advice to both RICs and private funds with similar investment strategies." The NEP will review "these funds, the activities of their advisers, and oversight practices of their boards of directors."

Municipal Advisors. The NEP will continue to examine municipal advisors, focusing on their compliance with registration, professional qualification and continuing education requirements. The NEP will also examine whether municipal advisors provided appropriate disclosures regarding conflicts of interests. Examinations will review compliance with recently effective MSRB rules, including those relating to advertising and standards of conduct for municipal advisors obtaining CUSIP numbers on behalf of issuers.

Broker-Dealers Entrusted with Customer Assets. Examinations of select broker-dealers will focus on adherence to the Customer Protection Rule (Rule 15c3-3 under the Securities Exchange Act of 1934 (the "**Exchange Act**")), which restricts the use of customer assets.

Microcap Securities. The NEP will continue to examine broker-dealers involved in selling stocks of companies with a market capitalization of under $250 million, focusing on manipulative schemes, compliance with Regulation SHO (governing short sales) and compliance with Exchange Act Rule 15c2-11 (governing "the submission and publication of quotations by broker-dealers for certain over-the-counter equity securities").

Digital Assets

The NEP will continue to "monitor the offer and sale, trading, and management of digital assets . . . ." Additionally, where the products are securities, the NEP will examine for regulatory compliance, identifying "market participants offering, selling, trading, and managing these products or considering or actively seeking to [do so] . . . ." For firms actively engaged in the digital asset market, the NEP's examination will focus on, among other things, portfolio management, trading, safety of client funds/assets, pricing of client portfolios, compliance and internal controls.

Cybersecurity

Examinations will focus on "proper configuration of network storage devices, information security governance generally, and policies and procedures related to retail trading information security." The

NEP will also continue to focus on governance and risk assessment, access rights and controls, data loss prevention, vendor management, training and incident response, among other things.

Anti-Money Laundering ("AML") Programs

The NEP will continue to focus on examining broker-dealers for compliance with their AML obligations, including whether they are: (i) meeting their filing obligations with respect to suspicious activity reports; (ii) implementing all parts of the AML program; and (iii) "robustly and timely conducting independent tests of their AML program."

According to OCIE, the areas of focus in the Exam Priorities are not comprehensive, and they remain open to addressing emerging and exigent risks to investors and the financial markets as they arise.

- **See a copy of the Press Release**
- **See a copy of the Exam Priorities**

Litigation

SEC Settles Enforcement Actions Against Robo-Advisers Wealthfront and Hedgeable

On December 21, 2018, the SEC settled proceedings against two robo-advisers for allegedly false and misleading statements about performance and other violations of the Advisers Act advertising rules. These enforcement actions serve as a reminder that investment advisers must ensure that social media campaigns and other forms of social marketing comply with the Advisers Act advertising rules, and, of course, are accurate and not misleading.

Wealthfront Advisers LLC ("**Wealthfront**") is a robo-adviser that provides software-based, automated portfolio management services. According to the SEC, Wealthfront engaged in several forms of social media marketing that did not disclose that third parties recommending or otherwise making positive statements about Wealthfront had an economic interest in promoting Wealthfront. For example, the SEC alleges that Wealthfront retweeted positive posts about Wealthfront by Wealthfront employees, investors in Wealthfront, and Wealthfront clients who would receive free services in exchange for referrals. Wealthfront did not disclose in these tweets that the positive tweet that Wealthfront retweeted was made by someone with an interest in Wealthfront (i.e., an employee or investor). Wealthfront also allegedly paid bloggers for soliciting new clients to open Wealthfront accounts without providing the solicited client with disclosures required by the Advisers Act.

The SEC further alleged that both of these practices—retweeting positive tweets and paying bloggers—were not adequately reviewed or policed by Wealthfront's compliance function: some of the tweets at issue were not reviewed by compliance before being issued, not all such tweets were preserved as required by the Advisers Act, and Wealthfront's compliance department did not review Wealthfront's agreements with paid bloggers, ensure that the paid referrals complied with the Advisers Act cash solicitation rule (Rule 206(4)-3) or comply with Wealthfront's solicitation policy outlined in its Form ADV Part 2A.

In addition to these marketing issues, the SEC alleged that Wealthfront made false and misleading disclosures about a tax-loss harvesting strategy it offered to clients. According to the SEC, Wealthfront falsely told clients employing its tax-loss harvesting strategy that it would monitor all client accounts for any transactions that might trigger a wash sale. The SEC alleges that wash sales, which could prevent clients from offsetting some income or capital gains for tax purposes, occurred in 31 percent of accounts enrolled in Wealthfront's tax-loss harvesting strategy over a period of over three years during which Wealthfront made this disclosure.

In a separate order issued the same day, the SEC alleged that Hedgeable Inc. ("**Hedgeable**"), a robo-adviser with $81 million in assets under management, made misleading statements and omissions in

performance comparisons against competing robo-advisers. According to the SEC, Hedgeable created a "Robo-Index" based on public data for other robo-advisers, but failed to adjust that model to reflect the actual performance of the competing robo-advisers. Hedgeable also calculated its own performance based on 22 accounts in 2014 and 38 accounts in 2015, excluding over 1,000 accounts invested in these years and failed to disclose that Hedgeable excluded many client accounts and that the exclusion of these accounts likely reflected survivorship bias and inflated Hedgeable's results. Hedgeable also provided investors with fact sheets that contained materially false or misleading information, including the erroneous indexing and comparisons to competitors returns, incorrect calculation of returns for certain ETFs used as benchmarking (which made Hedgeable's returns appear greater in comparison) and improper returns calculations for model Hedgeable portfolios. The SEC further alleged that until October 2017, Hedgeable had no written compliance policies and procedures governing approval of digital media marketing material, and accordingly, that Hedgeable's compliance function did not review Hedgeable's social media postings or approve of these postings before they were made. In October 2017, Hedgeable amended its compliance policies and procedures to require that all advertisements and promotional materials, including digital marketing materials, be reviewed by the CCO or a CCO designee.

Each of the Wealthfront and Hedgeable orders found that the advisers violated the antifraud, advertising, and compliance provisions of the Advisers Act, with Hedgeable additionally violating the books and records provision. Both advisers consented to the entry of the orders requiring them to cease and desist from further violations, and to pay civil penalties; Wealthfront agreed to pay civil penalties of $250,000, and Hedgeable agreed to pay civil penalties of $80,000.

While these orders specifically addressed robo-advisers, the lessons of these actions apply to any adviser given the prevalence of social media and digital media marketing. Compliance policies and procedures should ensure that social media and digital media marketing are subject to the same kinds of compliance oversight and review as other forms of media, and that such marketing materials comply with applicable provisions of the Advisers Act and the rules thereunder.

- **See a copy of the Wealthfront Order**
- **See a copy of the Hedgeable Order**

SEC Settles with Two Investment Advisory Firms and CEO for Mutual Fund Share Class Disclosure Violations

On December 21, 2018, the SEC announced settlements with two investment advisory firms, American Portfolio Advisors, Inc. ("**APA**") and PPS Advisors, Inc. ("**PPS**"), and PPS's CEO, Lawrence Passaretti ("**Passaretti**"), for allegedly investing advisory clients in mutual fund share classes that charged 12b-1 fees when less expensive share classes of the same funds were available. These settlements are the latest in the SEC's continued industry sweep targeting advisers that have failed to adequately disclose conflicts of interest associated with the receipt of 12b-1 fees.

According to the SEC's orders, APA, PPS and Passaretti failed to disclose the conflicts of interest presented by the share class selection practices. The SEC alleged that these advisers would have been able to invest their clients' funds in lower-cost share classes for the same mutual funds, but nonetheless invested their clients in more expensive share classes with steeper fees without adequately informing the clients of the conflict of interest inherent in that investment decision. At PPS, Passaretti received a significantly greater portion of 12b-1 fees than those received by PPS's other investment adviser representatives. The SEC also alleged that PPS failed to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and the rules thereunder in connection with the mutual fund share class selection practices. As for APA, the SEC alleged that APA did maintain written policies and procedures instructing advisers to review 12b-1 fees and select the lower-cost classes, but that APA failed to implement those policies and procedures and made investment decisions contrary to those policies. While the SEC's language is very similar in both the APA and PPS

orders, it is notable that the SEC alleges that APA's improper practices resulted in APA receiving $850,000 in 12b-1 fees that its clients could have avoided had APA invested them in less expensive share classes. The SEC did not allege a specified amount of avoidable fees received by PPS.

Without admitting or denying the findings, PPS, APA and Passaretti consented to cease-and-desist orders and will collectively pay over $1.8 million to harmed investors. PPS and APA further consented to censures. With respect to the SEC's findings that APA and PPS violated the antifraud and compliance provisions of federal securities laws and that Passaretti caused PPS's violations, APA agreed to pay $895,353 in disgorgement and prejudgment interest and a civil penalty of $250,000, while PPS and Passaretti agreed to pay $631,746 in disgorgement and prejudgment interest and a civil penalty of $75,000.

Because the SEC had contacted PPS and APA about their purported violations before the SEC's Share Class Selection Disclosure Initiative ("**SCSD Initiative**") was announced last February, neither firm was eligible to self-report under the initiative. The SCSD Initiative, which ended on June 12, 2018, offered favorable settlement terms to firms that self-reported their failure to disclose conflicts of interest associated with 12b-1 fees. For more information on the SCSD Initiative, please see the March 15, 2018 Client Memorandum, **SEC Announces Self-Reporting Initiative for Rule 12b-1 Fee Disclosures**. In recent months, several firms have told their investors that they opted to self-report under the SCSD Initiative. With settlements not yet announced for all firms that are known to have participated in the SCSD Initiative and the SEC's continued crackdown on failures to disclose conflicts of interest, it is likely that more settlements concerning share class disclosure violations will be announced in the coming months.

- **See a copy of the APA Order**
- **See a copy of the PPS/Passaretti Order**

SEC Settles Fee and Expense Allocation Enforcement Action With Private Equity Fund Manager

On December 13, 2018, the SEC issued one of its latest in a long series of settlements with private equity managers regarding allocation of fees and expenses.[1] In the order (the "**Yucaipa Order**"), the SEC instituted and settled cease-and-desist proceedings against Yucaipa Master Manager, LLC ("**Yucaipa**"), for alleged violations of the Advisers Act arising out of conflicts of interest regarding the allocation of fees and expenses to their managed private equity funds.

According to the Yucaipa Order, the limited partnership agreements ("**LPAs**") of Yucaipa funds provided that the fund manager would be responsible for its "normal operating overhead, including salaries, [and] other compensation," whereas the funds would be responsible for bearing certain costs, including the costs relating to the funds' investments and in preparing the funds' tax returns. In addition, the LPAs provided that Yucaipa would disclose issues involving a known "material conflict of interest" to the funds' advisory boards.

The SEC alleged that Yucaipa failed to disclose that certain employee expenses were allocated to the funds, and failed to disclose certain conflicts of interest to the funds' advisory boards. Between 2010 and 2015, Yucaipa had the funds pay $570,198, which was a portion of the costs of two of its employees, an in house-tax partner and in-house tax manager. During this time, the SEC alleged that Yucaipa failed to

[1] For an in-depth overview of the SEC's settlements with investment advisers regarding fee and expense allocation, see ***Allocating Fees and Expenses: The SEC Is Paying Close Attention***, The International Comparative Legal Guide to: Alternative Investment Funds 2017, 5th Edition.

disclose both that it would charge the funds part of the cost for its employees who assisted in preparing the tax returns, and also, how it allocated the costs of its in-house tax personnel.

The SEC also alleged that Yucaipa also failed to disclose its arrangements with two third-party service providers ("**Consulting Firm A**") and ("**Consulting Firm B**"), which ultimately resulted in the misallocation of fees and expenses that posed a conflict of interest to the funds. According to the SEC, Consulting Firm A provided services to two of the Yucaipa managed private equity funds, as well as general deal sourcing services to Yucaipa, but in several instances, Yucaipa allocated all of the fees charged by the firm to the managed private equity funds, totaling around $1.1 million, rather than allocating to themselves a portion of the fees that were attributable to Yucaipa. Similarly, Consulting Firm B, a talent management and marketing company, while being paid for its services by one of the funds (and its portfolio companies), was also engaged by Yucaipa's principals for unrelated personal ventures. The SEC again alleged that portions of the fees that were paid by the funds, totaling $940,000, should have been paid by Yucaipa, but that Yucaipa failed to allocate the appropriate portion to themselves. Furthermore, the SEC found that Yucaipa failed to disclose multiple conflicts of interest that arose from a Yucaipa principal personally loaning $215,000 to a principal of Consulting Firm A, which was secured by money that Yucaipa, or its managed private equity funds, might owe to the firm, and repaid through fees paid by one of the funds, as well as from a personal investment in Consulting Firm B by Yucaipa's principal, which allowed the principal to receive a right to 25% of its profits. Yucaipa voluntarily reimbursed the funds for $940,244 in expenses that should not have been charged to the funds, expanded the size of its compliance department and enhanced its policies and procedures.

Based on the conduct described above, the SEC found that Yucaipa violated Sections 206(2) and 206(4) of the Advisers Act and Rules 206(4)-7 and 206(4)-8, thereunder. Yucaipa agreed to pay $1.9 million in disgorgement, including prejudgment interest and a civil money penalty of $1.0 million. Furthermore, Yucaipa consented to the entry of the order and agreed to cease and desist from future violations.

While the number of fee and expense settlements in 2018 was significantly lower than the numbers in 2015-2016, the Yucaipa Order stands as a reminder that the SEC is still paying attention to the allocation of fees and expenses, and likely expects that advisers will carefully design and implement written policies regarding expense allocation after the years of SEC attention to the issue.

- **See a copy of the Yucaipa Order**

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Nora M. Jordan	**212 450 4684**	**nora.jordan@davispolk.com**
James H.R. Windels	**212 450 4978**	**james.windels@davispolk.com**
John G. Crowley	**212 450 4550**	**john.crowley@davispolk.com**
Amelia T.R. Starr	**212 450 4516**	**amelia.starr@davispolk.com**
Leor Landa	**212 450 6160**	**leor.landa@davispolk.com**
Gregory S. Rowland	**212 450 4930**	**gregory.rowland@davispolk.com**
Michael S. Hong	**212 450 4048**	**michael.hong@davispolk.com**
Lee Hochbaum	**212 450 4736**	**lee.hochbaum@davispolk.com**
Marc J. Tobak	**212 450 3073**	**marc.tobak@davispolk.com**
Matthew R. Silver	**212 450 3047**	**matthew.silver@davispolk.com**

© 2019 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's **privacy policy** for further details.