

SEC SETTLEMENT HIGHLIGHTS AGENCY'S FOCUS ON PREVENTING MISUSE OF MATERIAL NON-PUBLIC INFORMATION BY PRIVATE FUND MANAGERS

On May 26, 2020, the U.S. Securities and Exchange Commission (the "**SEC**") announced a settlement with a private fund manager, who agreed to pay \$1,000,000 to settle charges that it failed to properly implement and enforce policies and procedures to prevent the misuse of potentially material non-public information ("**MNPI**"), which was obtained as a result of the participation of one of its employees (the "**Board Representative**") on the board of one of its publicly traded portfolio companies (the "**Portfolio Company**").ⁱ The settlement highlights the need for private fund managers to ensure that their policies and procedures properly account for the risks relating to the possession and dissemination of MNPI.

The SEC charged that there was a failure to implement and enforce certain policies and procedures reasonably designed to prevent the use of MNPI obtained (i) as an insider, resulting from such employee's board participation, and (ii) pursuant to communications covered by confidentiality provisions in a loan agreement that it had entered into with the Portfolio Company.

The Board Representative, according to the SEC, received potential MNPI as a result of its position as a director of the Portfolio Company. The potential MNPI included information related to changes in senior management, adjustments to the Portfolio Company's hedging strategy, the Portfolio Company's efforts to sell interests in an asset, the contemplated sale of equity and resulting use of proceeds, and the Portfolio Company's election (as provided by terms of the loan agreement) to pay interest in-kind. The Board Representative regularly shared this information with members of the deal team managing the investment in the Portfolio Company, communications that were covered by the confidentiality provisions in place under the loan agreement with the Portfolio Company.

The manager maintained written policies and procedures relating to the treatment of MNPI, including measures to be implemented when it has an employee-representative sitting on the board of a publicly listed company in its portfolio. The applicable procedures included placing the company's securities on a restricted list and making trades in such securities subject to preapproval by compliance staff. Additionally, and regardless of whether a company's stock was on the restricted list, these policies provided for the discretionary establishment of information walls.

Notwithstanding the fact that the Portfolio Company's stock was placed on the manager's restricted list in accordance with its policies, the SEC identified certain deficiencies relating to mitigation of the risks that MNPI could be misused. Specifically, the SEC charged that there was a failure to—

- address the special circumstances presented by an employee's dual role as a director on a portfolio company's board and an employee of the private fund manager, particularly where the employee had continued involvement in trading decisions regarding the portfolio company's stock;
- routinely establish information walls with respect to publicly-listed portfolio companies where there was an employee-representative on the board;
- include specific requirements in its policies and procedures for compliance staff with respect to (i) the identification of relevant parties with whom to inquire about possession of potential MNPI and (ii) the manner and degree to which the compliance staff should discuss MNPI issues with those parties; and
- enforce policies and procedures in a manner that would have resulted in compliance staff sufficiently documenting whether they had made proper inquiries with the Board Representative and deal team members, prior to approving potential trades, as to their potential receipt of MNPI from the Portfolio Company.

As a result of this conduct, the SEC determined that there was a violation of Sections 204A and 206(4) of the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act") and Rule 206(4)-7 thereunder.

This enforcement action underscores the need for private fund managers to maintain clear and adequately enforced policies and procedures relating to the possession and dissemination of MNPI, in order to prevent conduct that could give rise to Advisers Act violations or even insider trading charges potentially. Managers that pursue multiple investment strategies and may, for example, acquire MNPI in the course of executing a lending or distressed debt strategy that could be used in the course of executing a public equity strategy, are at particular risk.

Accordingly, private fund management firms should:

- Identify any potential or actual scenario involving the firm or any employee, such as the appointment of an employee to the board of a portfolio company or a confidentiality agreement with a portfolio company, that presents a heightened risk of the firm or any employee obtaining possession of MNPI.

- Review the firm's MNPI policies and procedures to ensure they provide for, in each such scenario, the non-discretionary establishment of information walls to prevent the sharing of MNPI among the firm's employees, and explicitly address any gaps in such policies that may result in the sharing of MNPI in violation of the policies and/or any securities laws.
- Ensure that staff performing compliance (or similar) functions are appropriately trained, in accordance with the manager's policies and procedures, on how to (i) identify the types of information that constitute MNPI and the employees who may possess MNPI of portfolio companies, (ii) properly inquire with the relevant employees whether they had received MNPI, and (iii) document such inquiries in a manner consistent with the firm's policies and procedures.

ⁱ *Ares Management LLC*, Investment Advisers Act of 1940 Release No. 5510 (May 26, 2020).

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