SEC Targets Private Equity Advisor for Restricted List Failure

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Insider trading has always been a focus area for regulators. Historically, they have concentrated on sanctioning major cases of insider trading by advisors and their personnel, such as in the cases of S.A.C., Guttenberg, Galleon and others, with significant monetary, criminal and reputational damages for the firms and individuals involved. More recently, regulators have expanded their focus to include not only the perpetrators of insider trading, but also the advisory firms that failed to enforce proper compliance policies and procedures to prevent insider trading.

Section 206(4) of the Investment Advisers Act of 1940 (Advisers Act) and Rule 206(4)-7 require Registered Investment Advisors (RIAs) to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act. More specifically to insider trading, Section 204A of the Advisers Act requires RIAs to establish, maintain and enforce written policies and procedures that are reasonably designed, taking into consideration the nature of the advisor's business, to prevent the misuse of material, nonpublic information (MNPI) by the advisor firm or its employees. One major challenge for RIAs complying with this rule has been tailoring insider trading policies and procedures to account for the specific

circumstances and potential exposure related to the advisor's strategies and business model.

In a recent administrative order[i], the Securities and Exchange Commission (Commission) imposed a $1 million civil penalty on Ares Management, a large private equity advisor, for failing to properly implement and enforce policies and procedures related to the treatment of MNPI. Ares regularly received potential MNPI by virtue of having confidentiality provisions with a publicly traded portfolio company (the "Portfolio Company") and by holding a seat on the Portfolio Company's board of directors. Ares failed to implement insider trading procedures to account for this heightened exposure. The Commission's order sheds light on how advisors facing similar circumstances should effectively implement and enforce restricted lists and trade preapproval procedures.

In 2016, Ares invested several hundred million dollars in the Portfolio Company through debt and equity vehicles, which in turn enabled Ares to appoint a senior member of its investment team as director on the company's board. During the investment period, the Ares' employee received information from the Portfolio Company that posed a risk of being MNPI. The information received by the Ares director was shared with other members of the Ares deal team. Potential MNPI was also provided directly by the Portfolio Company to the Ares deal team under the confidentiality provisions of a loan agreement between the advisor and the Portfolio Company. Shared information covered, among other things, potential changes in senior management, adjustments to the company's hedging strategy, and decisions with respect to the Portfolio Company's assets, debt, and interest payments. Such information was nonpublic at the time and was later disclosed by the Portfolio Company in its regulatory filings and/or press releases. Throughout this period, Ares continued to purchase shares of the Portfolio Company, ultimately accounting for 17% ownership of the Portfolio Company's public float.

Ares placed the Portfolio Company securities on a restricted list in accordance with the firm's insider trading procedures. Potential trades in such securities required preapproval by the compliance team, which was instructed to consider the possession of any MNPI before approving them. However, the Commission found that Ares' compliance process was inadequate in at least two respects. First, Ares compliance staff failed to interview members of the deal team prior to approving the transactions (Compliance only spoke with the employee-director). Second, Ares' compliance process gave discretion to Ares' staff to determine whether certain information rose to the level of MNPI as opposed to Ares' compliance staff evaluating information on their own to make the determination.

It is important for the compliance teams of private equity, hedge fund and other advisors to identify the full spectrum of employees who could acquire potential MNPI as a result of either a board membership or pursuant to confidentiality provisions. Only after these employees have been fully identified can the compliance team begin the process of trade approval. Moreover, the specific approach by which trade preapproval procedures are implemented should not leave too much discretion on the employees subject to MNPI.

Consistent with the Commission’s findings on the Ares case, compliance teams should also properly and consistently document inquiries about MNPI as required by advisor’s own procedures. In the Ares case, MNPI inquiries were supposed to be documented in the advisor’s order management system but the Commission found them to be either missing or lacking details.

The Ares case demonstrates that simply having an insider trading policy that requires restricted list placement and trade preapprovals for public portfolio companies for which the advisor may possess MNPI is not enough. Advisors should consider all particular facts of such arrangements, as required by Section 204A, and then determine the best approach to ensure the effectiveness of such compliance controls in preventing misuses of MNPI.

[i] In the Matter of Ares Management LLC (IAA-5510, May 26, 2020)

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