Quinn Emanuel Private Equity Litigation Practice Alert

SEC Fines Private Equity Firm $1 Million for Failure to Implement Effective Insider Trading Compliance Procedures Relating to Designated Directors on Portfolio Company Boards

On May 26, 2020, the SEC issued an order fining Ares Management LLC $1 million for failing to implement and enforce compliance policies and procedures to prevent the misuse of material, nonpublic information ("MNPI"). The order is notable because the compliance policies for most managed funds are not that different from the one found to be deficient by the SEC in *Ares*. The order reflects the SEC's novel and highly prescriptive view of what is required where a firm holds seats on the board of directors of a public company and also trades in that company's securities. The SEC's approach in *Ares* is one that should give pause to private equity and hedge fund advisers that appoint their employees to serve as portfolio company directors and that rely on compliance procedures similar those used by Ares. In this Client Alert, we provide some practical suggestions for how best to address the potential concerns that may arise from this recent development.

I. Background

In 2016, Ares made a large debt and equity investment in an unnamed, publicly traded company ("Portfolio Company"), and also appointed two directors to the Portfolio Company's board. Ares appointed a senior member of its deal team to one of the board seats. In addition, confidentiality provisions in a loan agreement between Ares and the Portfolio Company allowed the company to share information with the Ares deal team on an ongoing basis. According to the SEC, the Ares deal team received the kind of confidential information that private equity firms with board seats or credit rights would typically receive, such as "(i) potential changes to senior management; (ii) mid-quarter hedging adjustments; (iii) efforts to sell its passive interest in a specific asset; (iv) a desire to sell equity and use the proceeds to retire certain debt; and (v) a decision to pay quarterly loan interest 'in kind' versus in cash." The SEC contends that some of this information was shared beyond the deal team within Ares.

After its initial investment, Ares purchased over one million additional shares (about 17%) of the Portfolio Company's stock in the public market. At the recommendation of the deal team, the Ares investment committee approved an initial purchase plan and then several subsequent increases in the limit price for the orders. All purchases occurred during open trading windows at the Portfolio Company, and were approved by the compliance team.

II. Ares's Compliance Policies and Procedures

Ares maintained written policies and procedures governing the treatment of MNPI that will be familiar to many investment advisers. Among other things, Ares maintained a restricted list of companies, which included the Portfolio Company. Securities on the restricted list could only be traded with the approval of compliance staff. When Ares held a board seat, compliance staff were instructed to confirm that any applicable trading windows were open and to "check with the Ares director for potential MNPI." More generally, Ares compliance was required to determine whether the trade could be approved and to "follow up with the relevant parties to gather additional information." Ares's policies listed relevant factors that compliance staff could consider in their discretion in this inquiry, including whether Ares possessed MNPI, whether an information wall was in place, and the applicability of any relevant confidentiality agreements. The policies further generally required compliance staff to document the reason for the approval in Ares's electronic order management system. But specific guidelines were not set forth describing the steps necessary to approve the trades, leading to inconsistency in the discretion exercised by each member of the compliance team.

Ares also provided for information walls to be established on a discretionary basis to prevent personnel involved in trading decisions from accessing MNPI. But walls were not generally required or implemented when Ares controlled board seats on public companies, including with respect to the investment in the Portfolio Company.

III. The SEC's Findings

The SEC's finding that Ares had failed to implement and enforce its compliance policies and procedures can be broken into three components. First, the SEC alleges that in violation of Ares's own compliance policies, the compliance team failed to sufficiently document its inquiries into whether the Ares deal team was in possession of MNPI relating to the Portfolio Company. Among other shortcomings, (i) the entries in the order management system "lacked consistency and detail," (ii) the compliance team "failed to document properly whether they had assessed the extent" to which Ares had information that "had the risk of being MNPI," and in some cases, (iii) "there was insufficient documentation that Ares compliance staff inquired at all."

Second, the SEC finds fault with the discretion Ares's policies and procedures afforded to compliance staff in reviewing trades with MNPI risk, and with how compliance staff exercised that discretion. In particular, to whom the compliance staff spoke, how much they followed up, and how thoroughly they investigated was, according to the SEC, left to the "initiative, discretion, and interpretation" of the Ares compliance staff. The SEC alleges that the problem with this approach is that the policies did not direct compliance staff to ask whether the Portfolio Company board member had shared information with others, or identify which individuals within Ares should be questioned (which, according to the SEC, should have been "the full spectrum of employees" who may have received potential MNPI). In addition, the SEC criticized the Ares compliance staff for relying on the judgment of the deal team as to whether information received was material.

Finally, the SEC finds that Ares failed to "properly assess the heightened risks presented by trading in the public markets of the Portfolio company," to which the designated director from Ares owed a fiduciary duty. The SEC specifically highlights the failure to consider the "special circumstances" posed by the designated director's "dual role" as a member of the Portfolio Company's board and a member of the deal team involved in trading the Portfolio Company's securities, and finds that Ares failed to implement and enforce effective policies and procedures to avoid the misuse of MNPI in such situations. The SEC's order states that the policies' failure to "address this issue" could have stemmed from the fact that it rarely holds board seats of publicly listed companies.

IV. Violations and Sanctions

Based on its findings, the SEC determined that Ares had violated Section 204A of the Investment Advisers Act of 1940, which requires investment advisers to maintain compliance policies and procedures reasonably designed to prevent the misuse of MNPI. The SEC did not find that any insider trading had occurred as a result of Ares's compliance failures. Nevertheless, the SEC imposed a fine of $1 million, censured Ares, and ordered that Ares cease and desist from further violations.

V. Takeaways: What Is a Compliance Department to Do?

The SEC's order takes a rigid approach to compliance that raises important questions for investment firms that invest in publicly traded securities and highlights the unique challenges for firms when they also hold seats on the boards of those companies. The main thrust of the SEC's order is that Ares's policies and procedures should have been regimented, including by requiring compliance staff to conduct certain interviews with particular employees on particular topics and document those interviews in detail, and generally afford compliance personnel less discretion. These purported shortcomings seem to go beyond the language of Section 204A, which requires compliance policies and procedures only to be "reasonably designed" to prevent the misuse of MNPI, reading more specificity into the statute than is actually there. But more fundamentally, when constructing policies and procedures, it can be difficult to identify from the outset all the necessary steps that may be necessary to conduct an MNPI inquiry for any particular circumstance. Information gained through interviews can lead to additional employees who may have MNPI, or could make additional interviews unnecessary. Compliance staff need discretion and flexibility to conduct inquiries and to determine the scope as the situation dictates. In addition, curtailing the discretion of compliance staff into a series of pre-determined "box checks" can discourage the intellectual rigor and curiosity that a high-functioning compliance staff requires.

The SEC has previously encouraged investment advisers to develop robust compliance programs armed with significant discretion to investigate and block transactions that risk running afoul of the securities laws.[1] Indeed, the SEC's own guidance for newly registered investment advisers states that "your policies and procedures are not required to contain specific elements. Rather, you should analyze your individual operations and identify conflicts and other compliance factors that create risks for your firm and then design policies and procedures that address those risks."[2] By criticizing Ares for granting too much discretion to compliance staff, the SEC risks disempowering the compliance function it has worked so hard to build.

We offer below some suggestions for clients who face the challenge of evaluating their insider trading policies and procedures in light of this order.

- <u>Create specific policies to address handling of information received as a result of appointing employees to the boards of portfolio companies</u>. The *Ares* order shows that the SEC may demand that investment advisers spell out in detail the factors that will be considered in approving trades where there is a high risk of access to MNPI, like when a firm employee also sits as a board member. Following *Ares*, firms that actively trade public securities should re-evaluate how they manage the added compliance risk of holding a board seat and consider specific guidance in their MNPI policies, such as listing specific employees that should be interviewed for transactions involving those particular companies, which would need to be updated regularly, or requiring that compliance also check with the public company's compliance department to help evaluate the materiality of information received.

- <u>Implement information walls when employees sit on the board of a portfolio company</u>. This is the best defense. A firm should consider a policy that requires, where practicable, walling off the team that receives nonpublic information relating to a portfolio company from the team that makes trading decisions regarding that company. While information walls may not be practical in every situation, they can greatly reduce compliance risk when implemented effectively. And once implemented, walls

[1] *See, e.g.*, Commissioner Luis A. Aguilar, *The Role of Chief Compliance Officers Must Be Supported*, SEC.gov (June 29, 2015), https://www.sec.gov/news/statement/supporting-role-of-chief-compliance-officers.html.
[2] SEC, *Information for Newly-Registered Investment Advisers*, SEC.gov (Nov. 23, 2010), https://www.sec.gov/divisions/investment/advoverview.htm.

must be respected. Firms should be mindful of the physical layout of the office and the location of the relevant teams.

- Ensure that written policies are being followed. It is critical to communicate and reinforce the importance of following each of the steps — including any required documentation — of the firm's policies and procedures. While certain situations may not necessitate taking all the possible steps, the decision to deviate from the stated procedure should itself be documented. In addition, firms may consider periodically auditing documentation of trading approvals to ensure that they contain sufficient detail of the reasons supporting each approval where there is a risk of MNPI.

- Create MNPI approval templates. Creating templates of the information that needs be considered when approving trades in portfolio companies with MNPI risk can improve the consistency of documentation as well as the compliance staff's efficiency. Templates do not need to be overly detailed, but can include headings for common items such as the list of interviewees, nonpublic information reported, and the evaluation of the materiality of that information.

- When approving trades consider investigative risk in additional liability risk. Compliance staff are typically trained to evaluate whether a trade is legal — i.e. not made on the basis of MNPI. However, compliance departments should also consider the investigative risk of the trade — they should ask how likely is it that the circumstances around the trade may attract regulatory scrutiny. Fundamentally this means looking at the optics of the trade. For instance, is this a high-profile company, perhaps in distress, such that trade might attract press attention? Or is there a likelihood of a market-moving event close in time to the trade that might raise questions, even if the trade itself is technically appropriate? While firms must make commercially reasonable decisions, the SEC's recent order highlights the risk for firms even where there is no insider trading liability. Prolonged investigation by the SEC staff is highly disruptive, and once inside a firm, staff may find other issues, such as the policies and procedures violations highlighted here.

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We frequently help clients evaluate their compliance programs in light of the ever changing landscape, from an SEC examiner perspective, to help ensure they are well-positioned should an exam or investigation occur. In this manner, managers are better able to focus on running their business and can avoid the harm that comes from mere allegations of wrongdoing and the extreme diversion of time and attention caused by a protracted investigation or examination.

If you have any questions about the adequacy of your compliance policies and procedures or any of the topics addressed here please do not hesitate to contact us.

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