

SEC to Fund Managers with Access to MNPI: Trade in Portfolio Company Securities at Your Peril

May 28, 2020

On May 26, 2020, private fund manager Ares Management LLC (“Ares”) paid a \$1 million penalty to settle charges brought by the U.S. Securities and Exchange Commission (“SEC”) alleging that the firm failed to implement and enforce its policies and procedures designed to prevent misuse of material, nonpublic information (“MNPI”) while a member of its deal team sat on a portfolio company’s board and while it was subject to confidentiality provisions in a loan agreement with the portfolio company.¹ Significantly, however, the SEC brought the case even though: (i) all trading occurred when the portfolio company’s trading window was open (suggesting at least that the portfolio company did not believe that its officers and directors were in possession of MNPI); and (ii) the SEC did not file any related insider trading charges against the firm or any individual or otherwise find that the firm had traded while in possession of MNPI.

This enforcement action underscores the importance of private fund managers adopting and implementing policies and procedures related to MNPI in a manner that minimizes the likelihood that the firm may be seen to be trading on the basis of MNPI obtained through confidentiality agreements and board membership. These issues could also arise in contexts where the firm otherwise has access to MNPI (e.g., through a credit fund).

Access to Potential MNPI. The SEC’s order alleges that, in 2016, Ares invested several hundred million dollars in a public company (“Portfolio Company”) in a combination of debt and equity. Due to its equity investment, Ares was entitled to appoint two directors, one of whom was a senior member of the deal team working on the investment (the “Director”). Ares was also bound by confidentiality provisions in its loan agreement with the Portfolio Company.

According to the SEC’s order, Ares received potential MNPI on multiple occasions in the course of the Director’s board service, and at least once pursuant to the loan agreement. The potential MNPI included potentially market-moving information

¹ *In the Matter of Ares Management LLC*, [IA Rel. No. 5510 \(May 26, 2020\)](#).

related to the Portfolio Company's management, divestitures, and equity issuance. While the Director sat on the Portfolio Company's board, Ares continued to purchase shares on the public market during the Portfolio Company's open trading windows, amassing 17% of the Portfolio Company's public float.

Compliance Policies Were Insufficient. Ares had adopted written policies and procedures to address its treatment of MNPI, including as portions of its ethics manual and compliance department trading procedures. These procedures included the establishment of a restricted list that included all public companies on which an Ares employee sat on the board of directors.

These procedures provided that compliance staff was required to pre-approve any firm trading in the restricted list securities and to document a reason for approval. In making that determination, the procedures required compliance staff to gather information from the relevant parties and to consider relevant factors such as whether Ares had MNPI, whether an information barrier was in place, any relevant confidentiality agreements, and confirmation from the Director that he or she did not possess MNPI.

The SEC noted that the compliance staff had wide discretion in implementing these policies. While the policy required compliance staff to "check with [the] Ares director for MNPI," it did not expressly require an assessment of whether the Director had shared information with others or an analysis of the full spectrum of employees who could have acquired the MNPI.

The SEC's order alleged that, consistent with confidentiality provisions of Ares' loan agreement with the Portfolio Company, the Director regularly shared information he learned with members of the deal team, but compliance staff inquired only with the Director "despite being aware that the Portfolio Company regularly treated Ares deal team members as generally bound by the same confidentiality obligations" as the Director.

The SEC also noted that Ares was inexperienced in having employees serve on boards of publicly listed companies, and failed to properly address the special circumstances presented by an employee-Director who remained involved in trading decisions concerning the public company's securities. The order did not, however, explain what, beyond observing the Portfolio Company's trading window, is required.

Documentation Is Critical. The SEC acknowledged that Ares placed the Portfolio Company on its restricted list and the compliance staff confirmed that the Portfolio Company's trading window was open prior to trading, but found that the firm failed in "numerous instances" to sufficiently document whether compliance staff had inquired with the Portfolio Company deal team as to whether anyone had received MNPI. The

SEC noted that to the extent such documentation existed, it lacked consistency and detail. The SEC's order further alleged that when compliance staff asked the Director or deal team members if they had potential MNPI, the inquiry called for these employees to self-evaluate whether particular information was material within the context of Ares' policies and for purposes of the federal securities laws. Again, the Order does not describe what additional steps would have been appropriate or necessary if others on the deal team had received the same or similar information as the director in light of the Portfolio Company's determination to open the trading window for directors and other insiders. Similarly, the Order does not describe why self-evaluation by investment professionals who, presumably, had the best understanding of the Portfolio Company was unreasonable or inappropriate.

As a result of this conduct, the SEC charged Ares with willful violations of Section 204A of the Investment Advisers Act of 1940 ("Advisers Act"), which requires investment advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI by associated persons. The SEC also charged Ares with willful violation of Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder, which requires registered investment advisers to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder.

Ares agreed to settle these allegations without admitting or denying the findings, along with sanctions requiring it to pay a \$1 million civil penalty and to cease and desist from future violations of these provisions.

For private fund managers with potential MNPI obtained through nondisclosure agreements or board membership, this settlement demonstrates the importance of:

- Systematically investigating trading approvals in situations that present a heightened risk of access to MNPI;
- Carefully and consistently documenting the inquiries and findings that support trading approvals; and
- Confirming that policies and procedures require compliance staff to conduct a holistic review, taking into consideration the firm's particular circumstances, prior to approving transactions in restricted securities.

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