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Practice Update

Middle Market Private Equity Firm Settles With SEC for Sharing Insider Information

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On December 26, 2023, the Securities and Exchange Commission (the SEC) issued an administrative cease and desist order against a middle market private equity firm (the Private Equity Firm) for failure to enforce its own policies to prevent the misuse of material, nonpublic information (MNPI) despite no specific finding by the SEC that any party had misused the MNPI (i.e., there was no finding that anyone illegally traded on the insider information). In addition, the SEC found the Private Equity Firm failed to implement policies to prevent misleading communications. Specifically, the SEC determined that senior personnel of the Private Equity Firm improperly disclosed MNPI to investors and industry contacts. Although the Private Equity Firm utilized non-disclosure agreements (NDAs) with such investors and industry contacts, the SEC determined that such disclosure had not been deemed "necessary for legitimate business purposes," as required by the firm's policies. Further, the SEC found the Private Equity Firm's senior personnel communicated performance-related claims to investors and contacts based on unapproved valuations. In anticipation of the proceedings described in this order, the Private Equity Firm submitted an Offer of Settlement (the Settlement), without admitting or denying the SEC's findings, which the SEC accepted. The Settlement includes sanctions against the Private Equity Firm,

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including a cease and desist, a censure, and a civil money penalty in the amount of $4 million.

This order highlights the SEC's continued focus on MNPI compliance even if the shared MNPI is not traded upon. The SEC issued an order against another major private equity firm in 2020 for failing to implement and enforce certain of its written policies and procedures to prevent the misuse of MNPI even though the SEC did not find any evidence of the manager misusing MNPI or otherwise performing insider trading. The SEC has previously alerted the industry about their continued focus on MNPI compliance. In April 2022, the SEC staff issued a risk alert to investment advisers and investors covering three examples of deficiencies related to Section 204A of the Advisers Act, which requires "all investment advisers…to establish, maintain, and enforce written policies and procedures that are reasonably designed, taking into consideration the nature of the adviser's business, to prevent the misuse of [MNPI]…by the adviser or any person associated with the advisor." In addition, in June 2020, the SEC staff published a risk alert discussing deficiencies in "policies and procedures relating to MNPI." The Settlement further highlights the significant risk involved with failing to meet MNPI compliance requirements even if the MNPI is not misused.

Failure to Enforce Policies Designed to Prevent Misuse of MNPI

According to the SEC's order, from at least 2019 through 2022 (the Relevant Period), the Private Equity Firm's policies prohibited disclosure of MNPI and other confidential information "except as may be necessary for legitimate business purposes." This policy was reiterated in the Private Equity Firm's compliance manual: "inside information…must be kept strictly confidential. Supervised Persons should not act upon or disclose to any person material non-public or inside information except as may be necessary for legitimate business purposes."

Nevertheless, senior personnel of the Private Equity Firm disclosed mergers and acquisitions-related MNPI and other confidential, strategic information concerning M&A activity involving U.S. and foreign-listed public companies to current and potential investors, as well as industry contacts.

Throughout the Relevant Period, the Private Equity Firm used NDAs to protect MNPI and confidential information, but failed to restrict such disclosure of information to meet the Private Equity Firm's existing policy, requiring a determination that disclosure was "necessary for legitimate business purposes." In multiple instances, senior personnel of the Private Equity Firm disclosed MNPI through unofficial update emails "to specific large, current investors, sometimes in the context of soliciting additional investment." Other disclosures of MNPI were made in emails to potential new investors and industry contacts. Disclosures of MNPI were also made in "internal, weekly investment-update meetings when certain guests, who had signed NDAs, attended without an appropriate determination having been made that their doing so was 'necessary for legitimate business purposes.'" By failing to make this determination, the disclosure of such information violated the Private Equity Firm's policies even though NDAs were utilized.

Failure to Implement Policies Designed to Prevent Misleading Communications

During the Relevant Period, the Private Equity Firm's policies "prohibited use of Fund asset and securities holdings valuations, other than those approved by [the Private Equity Firm's] valuation committee, in communications with current or potential investors and in valuation-based performance statements." Further, the Private Equity Firm's compliance manual provided that written communication "addressed to more than one person" was subject to prior approval as an "advertisement," and in any such advertisement performance data must be "fairly" presented "in a non-misleading manner" with an “appropriate explanatory footnote” supplied by the Private Equity Firm’s compliance personnel.

Senior personnel of the Private Equity Firm sent emails with performance claims based on estimated and current value calculations of portfolio companies, which had not been approved by the Private Equity Firm’s valuation committee, to current investors, potential investors, and industry contacts, soliciting investment capital for the Private Equity Firm’s funds and often asserting that a particular fund of the Private Equity Firm already had generated a substantial “embedded [or ‘built in’] gain” from which investors could benefit. Further, these unapproved valuations were disseminated without the explanatory footnote on advertisements mandated by the firm’s compliance policy.

Takeaways

Investment advisers should be mindful that the SEC continues to look for the sharing of MNPI contrary to applicable law and/or a firm’s policies and procedures even in instances where the MNPI is not misused. Advisers should review their policies and procedures and update their training programs to help ensure that MNPI is protected in even unofficial emails and internal meetings when guests are present. In addition, communications to investors, including emails sent from senior personnel, should be monitored for compliance to prevent a similar result to that discussed here.

For additional information please contact Paul Foley, John Faust, Kiki Scarff, or your typical contact in Akerman’s Investment Management Group.
