Simpson Thacher

Regulatory and Enforcement Alert

SEC Charges Private Equity Adviser Over Inadequate Policies Where Personnel Discussed M&A Pipeline and Unapproved Performance Information

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At the end of December 2023, the SEC announced a settlement with a NY-based registered investment adviser to private equity funds on a no-admit/no-deny basis for violations stemming from the firm's failure to comply with its policies and procedures when communicating confidential information.[1] The settlement found that the adviser violated its policies and procedures, as demonstrated by senior personnel, without following the procedures specified in its compliance policies, communicating to potential and current investors and industry contacts two types of information from 2019 to 2022: (i) merger-related material nonpublic information ("MNPI") concerning public portfolio companies; and (ii) unauthorized valuation and performance-related claims. The SEC also asserted that the policies and procedures were deficient in that the adviser did not appropriately implement them. The adviser was censured and ordered to pay a $4 million civil monetary penalty. The settlement acknowledged the adviser's remedial efforts, including enhanced policies and trainings, and the adviser's cooperation with the staff. No individuals were charged and there were no allegations of insider trading by recipients of the MNPI.

As background, the SEC's order emphasized that a key component of the adviser's investment strategy was middle market M&A activity, and that certain portfolio companies were publicly listed. The order also indicated that the adviser's policies prohibited dissemination of MNPI and the funds' confidential information except where "necessary for legitimate business purposes." The order found that senior personnel violated this policy by unnecessarily disseminating—typically in a marketing context in unofficial update emails—M&A-related MNPI involving U.S.-listed and foreign-listed portfolio companies without documenting a determination that the disclosure was necessary for legitimate business purposes. As an example of a communication in violation of the policy, the settlement set forth the following email:

> *"Going to [location] to talk to our mgmt. team at [Public Company 1] to tell them we are sellers of our [dollar amount] stake;" "In OEP [Fund], we own 13 cos.… 4 of the 13 [including Public Companies 2 and 3] are in sale or combination processes;" and "[Private Company 1 will realize] as much as [dollar amount] of prospective synergies from [Public Company 4] merger yet to be announced for about 33 pc of equity.*

[1] The SEC found that the adviser violated Sections 204A and 206(4) of the Advisers Act and Rule 206(4)-7 thereunder. The Settlement is available at https://www.sec.gov/files/litigation/admin/2023/ia-6514.pdf.

The settlement also indicated that such information was disclosed to guests allowed to attend the adviser's weekly investment-update meetings, and such guests were at times provided meeting materials, again in violation of the adviser's own policies and procedures.

The settlement also referenced adviser policies requiring pre-approval of certain communications and also requiring valuation and performance information in communications with investors to be approved by the Valuation Committee and to be appropriately footnoted. The SEC found that senior personnel sent emails including unapproved performance information—such as information estimating "embedded gain" due to portfolio activity to date—and at times without using the required explanatory footnotes. The settlement set forth an example of such communication:

> *"We generally make 2-2.5x [return on investment] and 25-35 pc irr depending on the time it takes- OEP [Fund] will be high because it happened fast, but still in the 2- 2.2x range.... If we assume we can complete all the combinations in process [for OEP Fund], realize our usual synergies, and value the cos at a reasonable 8.25x [projected earnings], … an investor in OEP [Fund] could be looking at a [dollar amount] plus imbedded gain in the context of a [dollar amount] [F]und that is 40 pc plus invested;" "[OEP] Fund will be oversubscribed at [dollar amount] but will be 50 pc invested when we close on March.... [T]he [dollar amount] we've invested is fairly worth 1.7x so there's a [dollar amount] built in gain before you close on the [dollar amount] [F]und."*

Finally, the settlement acknowledged the adviser's routine use of NDAs, and implicitly the efficacy of NDAs generally, but found the adviser's practice a violation of its policies and procedures, which required a determination that the disclosure of MNPI was "necessary for legitimate business purposes," which the senior executives did not consistently document.

This settlement—and its substantial monetary penalty—represents a potent reminder of the SEC's ability to use internal policy violations as the basis for violations of the securities laws, here in the novel context of MNPI policy violations for personnel discussing its M&A pipeline for public portfolio companies. It serves as a good reminder of the need to carefully adhere (both as to form and substance) to a firm's formal compliance policies, whether dealing with MNPI or otherwise. Advisers might take this settlement as an opportunity to review their own MNPI policies with an eye towards ensuring their policies are operationally achievable in line with their particular business, and that any particular restrictions going beyond compliance with the securities laws (such as a "legitimate business purpose" standard) are followed and perhaps logged for good housekeeping.

More broadly, this settlement bears some high-level similarities with the SEC's settlement related to MNPI policy failures in May 2020.[2] The relevant facts differ in that the May 2020 settlement involved potential MNPI received through an adviser employee's position on a portfolio company board of directors and subsequent trading by the

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[2] Settlement available at https://www.sec.gov/files/litigation/admin/2020/ia-5510.pdf.

funds, but the violations charged were identical to those charged in the December 2023 settlement (*i.e.*, policy-based violations). The May 2020 settlement was accompanied by a press release and quotations from Enforcement Division staff,[3] while the recent settlement was announced without press release or staff quotation.[4] Despite the lack of fanfare in the announcement of the instant settlement, however, it should be noted that the December 2023 settlement was four times the size of the May 2020 settlement, notwithstanding no allegation of harm or any improper trading. The materially higher penalty may be tied to the order's repeated emphasis on conduct attributable to "senior personnel" of the adviser and is also a timely reminder of the increased tendency of the SEC to impose high penalties seemingly not correlated to relevant precedent.[5]

For further information regarding this Alert, please contact one of the following authors:

NEW YORK CITY

Nicholas S. Goldin
+1-212-455-3685
ngoldin@stblaw.com

Michael J. Osnato, Jr.
+1-212-455-3252
michael.osnato@stblaw.com

Michael W. Wolitzer
+1-212-455-7440
mwolitzer@stblaw.com

WASHINGTON, D.C.

David W. Blass
+1-202-636-5863
david.blass@stblaw.com

Meaghan A. Kelly
+1-202-636-5542
mkelly@stblaw.com

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[3] Press release available at https://www.sec.gov/news/press-release/2020-123.

[4] Administrative summary available at https://www.sec.gov/enforce/ia-6514-s.

[5] For an overview of the SEC's current approach to the imposition of monetary penalties, see https://www.law.com/newyorklawjournal/2023/12/01/the-importance-of-the-how-and-the-why-in-sec-settlement-penalty-calculations/.