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Fine for MNPI Failures at Investments Committee

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The failure of a registered investment adviser to establish and enforce policies to prevent the misuse of MNPI by the members of its Investments Committee was the subject of a recent [SEC order](#) against MIO Partners, Inc. (MIO), an affiliate of McKinsey. The SEC highlighted compliance failures which are relevant for all investment committees, not just those at a registered investment adviser. However, the SEC is more likely to identify deficiencies at registered advisers or at investment offices whose investment committee members include personnel affiliated with registered advisers.

This case involved McKinsey partners who served as members of MIO's Investments Committee. The order was issued even though, during the relevant period, MIO's chief investment officer and his team of portfolio managers maintained day-to-day responsibility over MIO's investments. However, the Board and the Investments Committee had responsibility to oversee investments. (At an earlier time, the Investments Committee also had the power to approve investment decisions, but apparently was no longer exercising this authority during the period covered by the SEC order.)

MIO generally used a "fund of funds" structure for its investments, but according to the order, about 10% of its assets were invested directly. Of the assets invested with third-party managers, slightly less than half was invested in separately managed accounts. "MIO maintained in its records information reflecting all of the securities held by the SMAs, as well as all transactions executed by the SMAs, MIO had full knowledge of all securities held by the SMAs, including the number of shares of each security." For investments held in a third-party manager's fund, MIO "did not typically possess information reflecting all securities holdings and transactions in these accounts" but it "frequently had access to securities holdings by way of public filings and communications with the third-party manager, including investor updates."

The SEC order notes that Investments Committee members obtained MNPI two ways: (i) from their consulting work on behalf of clients (this MNPI included "financial results, planned bankruptcy filings, mergers and acquisitions, product pipelines and funding efforts, and material changes in senior management"), and (ii) from their participation on the MIO Investments Committee (this MNPI included information concerning MIO investments, such as "MIO's investment strategies, concentration limits, risk limits, and third-party manager allocations, and ... MIO's holdings...").

The order does not allege that MNPI was used for any specific trades. However, in paragraphs 20-28, it details specific investments made by MIO when Investments Committee members had access to MNPI, and notes that MIO invested hundreds of millions in companies that McKinsey was advising over a five-year period. For example, McKinsey partners providing advice on bankruptcy matters had MNPI concerning Alpha Natural Resources (ANR) and SunEdison, at the time MIO invested in hedge funds that were investors in those companies. The SEC noted that McKinsey partners were aware that MIO had invested in a hedge fund that bought ANR's bonds, and this created "a risk that McKinsey.... could influence the reorganization plan in a way that favored MIO's investments." Also,

MIO was a direct investor in municipal bonds issued by Puerto Rico, while McKinsey was advising Puerto Rico's Financial Oversight and Management Board, which handled the island's bankruptcy plan.

Against this backdrop, the staff concluded that "Allowing ... individuals who had access to MNPI about issuers in which MIO funds were invested, to oversee and monitor MIO's investment decisions presented an ongoing risk of misuse of MNPI" for which MIO did not have reasonable policies and procedures. Specifically, MIO did not address "the fact that McKinsey personnel on the Investments Committee brought MNPI obtained in their jobs as consultants to public issuers to their roles on the MIO Board. In addition, prior to September 2020, none of MIO's written policies or procedures (i) effectively sought to identify whether Investments Committee members may have MNPI that was relevant to their involvement in MIO's investment decisions, or (ii) set forth a recusal procedure reasonably designed to guard against the misuse of McKinsey Client and MIO MNPI." Paragraph 31 of the order also notes that MIO did not prohibit Board and Investments Committee members from accessing MIO investment information, or consider the ways that MNPI about the investments MIO was making could be misused by Investments Committee members in the course of their other roles outside MIO.

Consideration of the potential for misuse of MNPI is important for all investment committees, and indeed, for all persons involved in investment management. While registered investment advisers are required to have reasonable policies on MNPI by virtue of Section 204A of the Advisers Act, investment offices, nonprofits, and their governing bodies are not subject to that provision. However, they are subject to federal and state prohibitions on the use of MNPI to trade. A failure to have adequate policies on this topic increases compliance risks for both the organization and its investment committee members. Further, enforcement agencies and the U.S. Sentencing [Guidelines](#) clearly state that organizations that have an appropriate compliance program will be "cut a break" when prosecutors consider whether to bring an enforcement action, and the penalties to seek if a violation occurs. On the other hand, those without an adequate program might find its absence cited as an aggravating factor. (For information on the statements of many U.S. federal financial agencies, see RFG Pathfinder® [here](#).)

[Dan Berick](#) of Squire Patton Boggs says, "Investment Committee members should be aware that this case shows the more aggressive posture the SEC is taking on insider trading. No one at McKinsey was charged with insider trading, but the firm was cited for an arrangement that created an 'ongoing risk of misuse of MNPI.' Similarly, the [Medivation case](#) from last summer also shows the SEC is using the issue of MNPI more broadly. In that instance, the Staff charged an employee with insider trading in advance of the acquisition of Medivation – the employee didn't trade in Medivation stock or the acquirer's, but the SEC claimed he used information about the acquisition to purchase securities in a comparable company, assuming the announcement of the Medivation acquisition would boost its share price."

[Michael Mann](#) of Crowell & Moring points to the case as “a powerful reminder that the SEC takes the topic of MNPI controls really seriously; and, if you don’t have the controls they may use any trading gains that raise a suspicion that MNPI has been obtained as a benchmark for determining the fine. The controls do not have to be complicated but they have to be comprehensive in addressing all of the risks that could arise where investment professionals also have positions that give them potential access to MNPI. For universities with research arms, the issue of MNPI should be clearly addressed. And it’s also a good warning to assess Investment Committee members; what do they do for a living and does that create a conflict?” Mann recommends that nonprofit investment offices “do a check up with internal or external counsel to review their policies and consider all of the potential issues—and make sure counsel or compliance talks to decision makers to ensure they are trained to spot the risks.”

As Shearman & Sterling [observes](#), “The Order highlights the risks and conflicts of interest inherent in investment committees that include individuals with broader business mandates. Although the SEC does not contend that it is improper for a company to structure an investment committee as MIO had (by including individuals on its investment committee who would otherwise have ongoing access to MNPI), it makes clear that consistent recusal policies are expected. Compliance officials at companies with such investment committees should thus take the opportunity to ensure that their written policies outline how the company identifies potential conflicts of interest and the procedure for eliminating or mitigating the risks associated with the conflict.”

The upshot for MIO? Even though no illegal trading is alleged, the SEC [fined](#) MIO \$18 million for failing to maintain adequate policies and procedures. Subsequently, MIO [changed](#) its policies to limit information sharing, and reconstituted its board with independent directors and retired McKinsey partners.