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LENDING STRATEGIES

Simultaneous Management of PE and Private Credit Funds: Use of Walls and Other Tactics to Manage MNPI Risks (Part One of Two)

By Rorie A. Norton, *Private Equity Law Report*

One of the defining factors that leads to success among fund managers is their ability to obtain and digest information about different companies and industries. Although fund managers always need to be mindful to not improperly divulge or act upon material nonpublic information (MNPI), that risk increases significantly where a manager has both PE and private credit funds investing in the same business or industry. As the unfettered spread of MNPI can stifle business opportunities and introduce regulatory risks, it is critical for fund managers to diligently implement safeguards where possible.

To help fund managers simultaneously operating PE and private credit funds, the Private Equity Law Report interviewed several experts about risks to avoid when managing those funds in parallel. This first article in a two-part series identifies several measures that can curb the internal spread of MNPI, with particular emphasis on whether and how information barriers (*i.e.*, walls) can be used by managers. The second article will set forth considerations for properly allocating investment opportunities, expenses and employees' time between parallel PE and private credit funds.

See our two-part series on forming private credit funds: "Key Differences in Fund Lifecycle and the Use of Subscription Facilities Versus PE Funds" (May 12, 2020); and "How Material Variations in Fee Structures and Recycled Proceeds Compare to PE Funds" (May 19, 2020).

MNPI Risks

Private funds investing in the debt or equity of a company are privy to legitimately obtained MNPI in the ordinary course of managing their investments. "Managers typically receive confidential information about the health and wellbeing of a particular company or issuer while invested," stated Schulte Roth partner Daniel F. Hunter.

There are, of course, regulatory risks if a fund manager fails to properly safeguard MNPI from spreading internally or externally, as evidenced by the SEC's recent action against Ares Management. Beyond the risk of regulatory scrutiny, however, a pressing concern is how the spread of MNPI throughout a fund manager can ultimately prevent one or more of its private funds from pursuing an investment.

See "SEC Fines Ares Management for Inadequate MNPI Policies and Procedures for Employees on Portfolio Company Boards" (Jun. 30, 2020).

"The marketing pitch for a fund manager's credit strategy is often, 'We develop specialized knowledge from researching and diligencing companies and industries on the PE platform, and we capitalize on that information flow to make credit investments, whether or not they are investing in the companies the PE funds own.'" noted Kirkland & Ellis partner Stephanie W. Berdik. At some point, however, that flow of information to the credit platform could affect its ability to make certain investments, she explained.

Fundamental Safeguards

At a basic level, there are various measures fund managers can implement to prevent MNPI acquired by one fund from ultimately contaminating the business opportunities being pursued by its other funds.

Monitor Transmission

One essential step for compliance departments to guard against the misuse of MNPI is to track its entry into, and spread throughout, their firms. When MNPI is somewhat foisted unwittingly on a fund manager, then it may find itself on the defensive when preventing its spread. "Sometimes, the MNPI is inbound, and it's hard to lock out that information, particularly if a borrower is seeking more credit or an equity issuer is seeking some additional equity," Hunter observed.

One option is for a fund manager's compliance staff to chaperone calls or meetings between its investment team and senior management at its portfolio company to monitor for MNPI. Chaperoning can ensure the firm is aware of disseminated MNPI and allow a hands-on effort to verify members do not improperly share that information with others in the firm. In addition, compliance staff can chaperone calls – regardless of whether a wall is in place, as discussed later – between the credit and PE teams about a specific industry or company, suggested Simpson Thacher partner Jason Herman. "Chaperoning could allow those discussions to occur while ensuring they don't stray into any disclosure of MNPI," he reasoned.

Chaperoning can be a bit cumbersome, however, both on the productivity of conversations internally, while also taxing the resources of a firm's compliance department. "Aside from creating a bit of an operational strain at times, it can also make it more difficult to have discussions between two sides if you need to secure clearance each time," Herman noted.

Maintain a Restricted List

As a sort of firewall in conjunction with safeguards against the spread of MNPI, a firm can also adopt a watch list or restricted list of companies in which certain individuals and teams at the firm are barred from investing. "As soon as someone is interested in potentially buying a security, it's automatically added to certain tracking lists internally by compliance," explained Akin Gump partner Dennis P. Pereira.

Regardless of the other safeguards (*i.e.*, a wall or information barrier) a firm has in place, a restricted list can be useful for supplementing and reinforcing those measures. "We have restricted lists that can apply on either side, where we may be walled off early based on a conversation or information already received from a company," said Steven Schwab, director of legal and CCO at Thoma Bravo. "That restricted list is facilitated by compliance and has companies that should not cross over a wall, even if we only have a short or permeable wall," he explained.

See "[2015 Compliance Survey Covers SEC Exams, MNPI and Restricted Lists (Part One of Two)]" (Sep. 17, 2015).

Information Barriers

Although the aforementioned safeguards are extremely helpful for mitigating MNPI risks, another central question for fund managers to weigh is whether to have walls and information barriers in place to prevent the spread of MNPI between investment teams. As the name suggests, a wall is a virtual – and at times physical – information barrier erected between two teams to prevent the exchange of MNPI and creation of conflicts of interest.

Whether to Have Walls

Walls are hardly ubiquitous in the industry, as each fund manager needs to decide whether the benefits of a wall outweigh its relative costs. On that basis, Schwab identified a number of factors that feed into that decision, including "the size of each respective private fund, the philosophical choices an organization makes and whether the credit arm is operationally separate from the equity arm for the purpose of the conversation."

Although hardly determinative, Herman anecdotally noted that "large sponsors tend to have walls in place with chaperones sitting at the top to facilitate discussions between the teams, whereas smaller sponsors and emerging managers often do not." Beyond size, however, the decision depends on how managers intend to have their fund managers interact, said Ropes & Gray partner Jason E. Brown. "There is a tension there, and you have to pick your poison. Do you want to share ideas with each other? Do you want to sit in research meetings together? Then the wall probably does not work."

Those same business reasons (*i.e.*, maximizing synergies and information flow) to justify forgoing walls at the outset of launching a fund can also, ironically, spur the need for eventually retrofitting walls into the dynamic as the spread of MNPI limits investment opportunities for a fund, noted Ropes & Gray partner Jessica Taylor O'Mary. "We often hear the question, 'How do we know we should have a wall?' The answer is basically when your business people start saying that sharing information is really impeding them from the investments they want to be making for their portfolio companies."

Ultimately, both approaches – *i.e.*, having walls or not – are widespread in the industry, and neither is necessarily correct or incorrect, Brown emphasized. He added, however, that regardless of a manager's approach, "a key is obviously what you've disclosed, with respect to not just the conflict but how you might handle it." Echoing that point, Schulte Roth partner Stephanie R. Breslow added, "if you are operating with the same team, you need to be articulate about limitations it puts on what you can do; if you operate with different teams, you need to make sure that actually turns out to be true."

See "[ACA Panel Examines Compliance Issues Faced by Credit Managers]" (Nov. 15, 2018).

Putting Walls in Place

Structure of a Wall

In its most traditional form, a wall operates as a two-way barrier such that "each team acts independently in its own best interests on the theory that they are not interacting with each other," Brown said. The compliance department will serve as a mediator of sorts that sits atop other," Brown said. The compliance department will serve as a mediator of sorts that sits atop the wall to monitor the actions of each fund, facilitate conversations as needed and identify potential conflicts as they arise.

To illustrate how a two-way wall works, Pereira described a situation where a PE deal team identifies a company it is interested in acquiring. "Step one is notifying compliance. A junior-level compliance person should automatically follow-up and say, 'The credit fund has exposure to the portfolio company you're interested in purchasing. Let's talk about it,'" he explained. "Before things go to the investment committee, you flesh out everything going on. Simultaneously, the legal department thinks about any potential conflicts and whether they want to loop in fund counsel, tell the LP advisory committee, etc."

Although the most common approach, a two-way wall may not be viable where, for example, a fund manager operates a PE fund that is substantially larger than its credit fund, Schwab suggested. "In that scenario, the smaller credit fund could receive information about a potential investment under a non-disclosure agreement (NDA) that says, 'If you do not complete the debt side of the deal, you are precluded from engaging in any other transaction associated with the company,'" he explained. "That could preclude the larger PE fund from a separate deal with the same company, which might cause a problem and might not be consistent with fund agreements and duties."

See "Mitigating Insider Trading Risks: Relevant Laws and Regulations; Internal Controls; Restricted Lists; Confidentiality Agreements; Personal Trading; Testing; and Training (Part One of Two)" (Sep. 27, 2018).

Continuing on that point, Schwab noted that the fund manager may be fine with the larger PE fund maximizing its investment opportunities at the expense of the smaller credit fund. "In that case, a one-way information barrier may be advisable where the credit side is restricted from sharing information with the equity side of the house. The PE fund would, however, generally be able to share information with the team managing the credit fund," he explained. "In addition, NDAs signed by the credit fund would specifically exclude the part of the business walled off from the information it receives."

As the explanations of two-way and one-way approaches indicate, there is no one-size-fits-all solution to a wall. "You look at the current setup and analyze potential issues, then tailor the approach – which may include a wall – to target those potential issues," Berdik recommended. Further to that point, O'Mary noted that "despite it being a very legal- and compliance-intensive process to have a wall, it tends to be highly tailored to a firm's business goals." No matter what form the wall takes, Pereira emphasized that "there needs to be a good paper trail about how the wall operates and thoughtful decisions about how strict you want it to be internally."

Necessary Resources

Although walls can be an ideal approach for managing MNPI risks, they introduce material resource strains that not every fund manager is equipped to shoulder. "Certain attributes of how other people manage their walls may not be possible depending on how the firm is structured, its size or how people fit together," Berdik said. "For example, if it's a small shop with everyone on one or two floors, complete separation is not possible."

See "Mitigating Insider Trading Risks: Expert Networks, Political Intelligence, Meetings With Management, Data Rooms, Information Barriers and Office Sharing (Part Two of Two)" (Oct. 11, 2018).

One issue is that managing an effective wall requires a robust compliance department for oversight purposes. "A wall may seem easier for the compliance team to implement, but it is probably more difficult in practice," Berdik suggested. That is because "compliance needs to track all the deals by each team; figure out which people are restricted from trading; keep people separated physically and digitally; identify and restrict access to certain information electronically; and ensure the wall's conditions are satisfied. That all can put a pretty big burden on them."

In addition to ensuring the wall restricts certain information as intended, the compliance department also needs to vet all possible situations where exceptions should apply to allow the right information to be shared so that the internal deal teams can still access and benefit from a larger pool of contacts, sourcing and specialized knowledge, Berdik noted. "Overseeing that exception process also requires determining how flexible the wall is, which takes a lot of time," she added. In light of those burdens, operating a wall may require more compliance resources than many fund managers have at their disposal.

Beyond the size of a firm's compliance department, it may lack sufficient personnel on its investment teams to operate a wall. "The optimal situation is to have two completely different teams operating with two completely different sets of information," Breslow noted. Echoing that point, Schwab provided the practical example that "many firms have Monday morning staff meetings to talk about pending and upcoming deals. A strict information barrier would require two separate staff meetings, and the credit teams would not participate in the equity teams' meetings and vice versa."

Another hallmark of a successful information barrier is a physical separation of the respective PE and credit deal teams within a firm. That requires both sufficient physical space to appropriately separate the teams, as well as other measures, Schwab noted. "If you have an office with two floors, put the credit fund on another floor. Do not invite them to meetings where information could be shared with the PE team. Also, use code names – *i.e.*, Project X, Project Y – for deals as opposed to the actual company name," he advised.

Also, in certain instances physical separation is not always enough, as fund managers need total data separation (*i.e.*, totally different servers) for teams on each side of a wall, Berdik observed. "On the electronic side, separation involves limiting access to data drives to ensure information isn't shared," Schwab added. "Firms can also electronically monitor their data to ensure information isn't flowing from one team to the other," he continued.

Timing of Walls

Adding to the highly bespoke nature of walls, there is even some debate in the industry about when and how they are adopted by a PE firm vis-à-vis its launch of an additional private credit strategy.

Many fund managers decide not to wall off their existing PE platforms when they first launch their private credit strategies, Berdik said. That is often because the credit strategy is conceived and marketed as an outgrowth of the specialized knowledge and expertise cultivated on the PE side, she noted. "Managers launching a new strategy often market their ability to access and capitalize on specialized knowledge and a flow of information. Putting a rigid wall in place means they wouldn't be able to market or benefit from those internal synergies."

For more on information walls in another context, see "Sponsor-Appointed Directors on Portfolio Company Boards: Best Practices to Mitigate Risk in Multiple Scenarios (Part Two of Three)" (Aug. 11, 2020).

That reality is coupled with the desire of firms to "live with" their no-wall approach for a while to get a better feel for how the strategies operate together and where problems are that need to be addressed, Berdik suggested. "Certainly, you need to be mindful of MNPI limitations, but before actually adopting a wall, explore the right answer is for how it should work – is it a full wall, a partial wall, how do people get over the wall, who's on what side of the wall, etc.?" she reasoned.

"As information starts to flow and a firms' PE and credit strategies start to simultaneously operate, the sponsor may identify some real synergies and really want to share information," Schwab added. "Most firms eventually recognize, however, that some barriers or information limitations need to be put in place to ensure both strategies can operate in their intended capacity."

There are others in the industry, however, that eschew that organic approach to identifying and adopting information controls, and instead favor establishing a wall from the outset of launching a separate investment strategy. "A PE sponsor should really figure out the right measures at the start and put the wall in place from the beginning of launching its credit strategy," Breslow asserted.

Part of the appeal of addressing walls correctly from the outset is that it can be less complicated than trying to untangle the complications from a no-wall system by retrofitting it with controls, Breslow suggested. "Retrofitting seems a little challenging because you'd already have offered the credit fund with a great synergistic approach and a list of certain personnel but then be forced to unwind those things by putting a wall in the middle," she reasoned.

Absence of Walls

As described above, a number of factors prompt fund managers to forgo having a wall between their PE and private credit teams, many of which relate back to the personnel and resource strains it can create. Arguably the most significant reason, however, is that a wall can disrupt the synergies that make a credit strategy appealing and potentially lucrative in the first place. "If a firm wants to truly reap the benefit of all the synergies associated with ideas from both sides of the business, then they would not want a wall in place," Herman suggested.

For more on lending strategies, see "Is It Time to Become a Distressed Lender? How PE Sponsors Can Pivot to a Bankruptcy-Lending Strategy While Managing Attendant Risks" (Jun. 23, 2020); and "What Must a PE Sponsor Consider Before Launching a Private Credit Strategy? (Part One of Two)" (Feb. 4, 2020).

Firms without walls often lean on some of the other preventative measures highlighted above – *i.e.*, chaperoning, maintaining restricted lists, etc. – to limit their MNPI risks. An additional measure, Herman noted, is for firms to enact temporary walls to keep certain MNPI from being imputed to another team of individuals. "That tends to be subject to very restrictive procedures and limiting the information to a small group of people, usually when a team accidentally receives MNPI," he explained. "It's more reactive to a specific situation than proactive, so you wouldn't create temporary investment barriers every time you possess MNPI," he clarified.

Although some of the safeguards in a no-wall environment can help manage the flow of MNPI, it may be insufficient to fully mitigate all of the associated risks while also potentially introducing others. One issue is that not having a wall can cause one or both of the private funds to be so hamstrung by limitations from the spread of MNPI that they are unable to generate the returns marketed to investors, Herman noted. "Not having walls could cause the PE team to restrict the NDAs it signs up to avoid MNPI, which would restrict certain activities on the equity side."

Finally, a risk is that teams capitalize on the synergies and information flow of captive investing in a no-wall environment until they end up pitted against each other, Hunter cautioned. "Funds can leverage the benefits well until they end up in a reorganization or forming a creditors committee. Everything is fine until a real crisis occurs."