

## Investment Management

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### **SEC Settles With RIA for MNPI-Related Compliance Failures Related to CLO Business**

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On August 26, 2024, the Securities and Exchange Commission (SEC) announced a settlement with a registered investment adviser (RIA)<sup>1</sup> for failing to establish, maintain and enforce adequate written policies and procedures reasonably designed to prevent the misuse of material nonpublic information (MNPI) as it relates to the trading of collateralized loan obligations (CLOs).<sup>2</sup> More specifically, this settlement related to trading a CLO while in possession of MNPI of a company whose loans were held in such CLO traded by the RIA. As we previously wrote, the SEC is focused on MNPI issues<sup>3</sup>, and this settlement is another example of how firms must think about and examine their business lines to ensure their compliance policies and procedures are sufficient. We examine the salient details of the settlement below.

#### **Background**

##### *Facts*

The RIA focused its investment strategies on, among other things, CLOs. As part of its business, the RIA often participated in ad hoc lender groups or creditor committees in order to explore debt restructuring opportunities with the issuer of an underlying loan prior to the issuer filing for bankruptcy, reorganizing or otherwise initiating formal restructuring proceedings.

##### *RIA sold CLO equity tranches while in possession of MNPI*

The RIA was a member of an ad hoc lender group to a media services company (the Company) and one of the largest holders of term loans issued to the Company. Through the RIA's participation in the ad hoc group, the RIA received MNPI about the Company that was not available to those outside the ad hoc group and that detailed the failure of an expected major asset sale by the Company and the Company's need for rescue financing. Personnel of the RIA became aware of the MNPI on June 27, 2019. After several weeks of exploring the possibility of reducing the RIA's exposure to the CLO equity tranches while in possession of the MNPI received from the ad hoc group, a co-portfolio manager for the RIA's CLO investments emailed the RIA's compliance team to request approval to sell portions of two equity tranches of the CLO investments that contained loans by the Company.

On July 30, 2019, the RIA sold two RIA-managed CLO equity tranches, which included loans made to the Company. When this MNPI was publicly released on July 31, 2019, one day after the CLO tranches were sold by the RIA, the value of the Company dropped by over 50 percent and materially decreased the value of the CLO tranches by approximately \$685,000, or 11 percent.

Thereafter, one of the counterparties to which the RIA had sold these CLO equity tranches contacted the RIA and demanded either a rescission of the sale or a reduction in the purchase price equal to the decline in the value of the CLO tranches. The RIA paid the amount requested by the counterparty in full.

Certain of the RIA's personnel recognized that the firm was in possession of MNPI about the Company at the time the sale was made but failed to consider whether such information was material with respect to the CLO tranches before it sold them. At the time of the sale, the RIA had in place an insider trading policy that prevented the RIA from trading in the

securities of a company while the RIA was in possession of MNPI about that company. As a part of this policy, the RIA's compliance department maintained a restricted list containing the names of issuers whose securities the RIA and its supervised persons could not trade, either in a business or a personal capacity. The RIA's insider trading policy, however, did not contain any prohibitions on trading a CLO tranche while in possession of MNPI about the underlying loans in that CLO.

### *RIA's deficient policies and procedures*

In July 2019, following the sale of the Company CLOs, the RIA began conducting compliance reviews prior to trades of the RIA's CLOs. However, the RIA did not establish, maintain or enforce written policies or procedures governing these pre-trade reviews as they related to the RIA's CLOs until July 2022.

Throughout this period, the RIA failed to establish, maintain or enforce any written policies or procedures concerning the possession of MNPI related to underlying loans held by third-party CLOs. The RIA also failed to establish barriers between its personnel responsible for the firm's credit investment decisions (including those potentially exposed to MNPI from the RIA's participation in ad hoc lender groups) and its personnel responsible for the firm's CLO trading.

In April 2024, following the SEC investigation, the RIA began conducting preclearance reviews for third-party CLOs and in June 2024 adopted written policies and procedures for such reviews to prevent the misuse of MNPI.

### *Violations*

As a result of the failure to establish, maintain or enforce adequate written policies or procedures concerning the misuse of MNPI, the RIA was found to have willfully violated Sections 204A and 206(4) of the Investment Advisers Act of 1940 and Rule 206(4)-7 promulgated thereunder. The RIA settled the charges by agreeing to a cease and desist order and censure and a civil penalty of \$1.8 million to be paid to the SEC.

## **Key Takeaways**

Investment adviser firms and legal and compliance professionals should consider reviewing their current compliance programs and further developing and refreshing compliance programs based on these new developments, as further explained below.

The current state of compliance programs typically utilizes securities watchlists and/or restricted lists in the implementation of their insider trading policies and procedures in conjunction with training. Such compliance programs often seek to evaluate and restrict their employees' contact points with MNPI and limit their opportunities to trade securities in those companies about which they directly possess MNPI. However, this settlement should serve as a reminder that these policies and procedures should take into account a firm's entire business model and various business lines.

As noted, the RIA's lending business caused the RIA to be in possession of MNPI with respect to a company whose loans were held in a CLO traded by the RIA, and a trade in the CLO itself is what led to the violation (while in possession of the MNPI known about the Company). Therefore, "fund managers – including those with multiple business lines or strategies – must consider how they may come into possession of material nonpublic information and then adopt and implement reasonable policies and procedures around those risks. Among other things, advisers must evaluate how their roles as lenders could expose them to MNPI that may relate to their CLO trading positions."<sup>4</sup> This settlement's concepts can be extended to, for example, trading an index fund while in possession of MNPI about a security underlying such fund.

As a result, compliance policies should flag possession of MNPI about a security or issuer and restrict trading not only in that security or issuer but also in derivative securities related to that security or issuer, economically linked securities or issuers, or securities or other instruments that derive material value from that security or issuer to at least allow proper

analysis by compliance professionals prior to trading.

## Next Steps

For further information, guidance and clarity on how advisers can approach and tailor their policies and procedures related to MNPI (including, but not limited to, personnel training) and/or factor the foregoing into their annual compliance review and periodic risk/conflict assessment, please contact any of the listed authors of this Client Alert or your usual Lowenstein Sandler contact. Please reach out to us if you have any questions with respect to this settlement, MNPI or other related matters.

<sup>1</sup> <https://www.sec.gov/newsroom/press-releases/2024-106>.

<sup>2</sup> <https://www.sec.gov/files/litigation/admin/2024/ia-6666.pdf>.

<sup>3</sup> <https://www.lowenstein.com/news-insights/publications/client-alerts/shadow-trading-is-insider-trading-jury-establishes-liability-in-historic-shadow-trading-case-im>.

<sup>4</sup> <https://www.sec.gov/newsroom/press-releases/2024-106>.

## Contacts

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