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SEC Enforcement Action Underscores Need for MNPI Policies in CLO Trading

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In a significant enforcement action, the SEC sanctioned a private fund manager for failing to establish and maintain adequate policies and procedures to prevent the misuse of material nonpublic information (MNPI) while trading in securities issued by collateralized loan obligation vehicles (CLOs). This case highlights the agency's reach into the realm of credit managers and underscores the importance of strong compliance frameworks in mitigating the risks associated with trading securities while in possession of nonpublic borrower information.

Summary of the Case:

The case involves a private fund and CLO manager that traded tranches of debt and equity securities issued by CLOs that it managed directly, as well as by CLOs managed by third parties. CLO securities are typically collateralized by a pool of corporate loans, loan participations or credit default swaps tied to corporate liabilities, issued in tranches with varying levels of risk and priority, with the most subordinated tranche typically being referred to as the "equity" tranche. The SEC alleged that the fund manager failed to establish, maintain, and enforce adequate policies and procedures to prevent the misuse of MNPI during its trading of CLO tranches.

More specifically, the SEC found that the fund manager, through its participation in an ad hoc lender group, became aware of negative developments concerning a borrower. While in possession of this confidential information, the firm privately sold two CLO equity tranches containing the loans. Despite personnel being aware of the MNPI, the firm did not consider its materiality to those tranches before the sale. When the MNPI was publicly released shortly afterward, the value of these loans dropped by more than 50%, causing the sold CLO tranches to decrease in value by approximately 11%.

The SEC did not specifically allege insider trading, noting that the firm's portfolio manager had received compliance approval to sell the CLO tranches. However, the settlement imposed a $1.8 million civil penalty and instead focused on the fund manager's failure to establish and enforce appropriate policies and procedures to prevent the misuse of MNPI, in violation of Section 204A of the Advisers Act and Rule 206(4)-7 under the Act. The SEC highlighted that:

- At the time of the trades, the firm's insider trading policies did not contain any prohibitions on trading a CLO tranche[1] while in possession of MNPI about the underlying loans in that CLO.
- The firm lacked written policies and procedures specifically addressing MNPI obtained as holder of term loans or participation in ad hoc lender groups.
- The firm only began conducting pre-clearance reviews to assess the impact of loan related MNPI on trades in its managed CLOs in 2019 and did not formalize these reviews until July 2022.
- The firm had no policies in place relating to trading in third-party CLOs until 2024.

Borrower-Related Information as MNPI:

The underlying loans themselves would likely not be securities under the Second Circuit's recent Kirschner decision (holding that syndicated loans are not securities under the Securities Act and Exchange Act). Nevertheless, confidential information about a loan or a borrower can be MNPI relating to another security. In this case, the SEC's findings were premised on the fund manager being in possession of loan-related MNPI while trading securities issued by CLOs that held the loans.[2]

Private Securities Trades Based on MNPI:

In this matter, the trades in question were privately negotiated rather than public market trades. While it is more common for the SEC to allege insider trading in the context of public market trading, this is not the first time that the SEC has applied MNPI concepts to private securities trades. For example, the SEC has previously: brought an action alleging that a representative on creditors committees engaged in a pattern of insider trading of fixed-income securities; pursued a host of fraud cases involving privately offered securitized products; and brought antifraud charges against executives for repurchasing private company stock without disclosing inside information. Federal securities law antifraud provisions would generally apply to this conduct, and Section 204A of the Advisers Act requires reasonable policies "to prevent the misuse in violation of" the Exchange Act, encompassing MNPI related to private securities.

Takeaways:

Reasonably designed MNPI policies must be tailored to the particular nature of the adviser's business and the risks involved, and the compliance failures alleged in the SEC's settlement order appear to be driven by the particular facts and circumstances of the case. Nevertheless, using the findings in this order as a guide, one can infer that SEC staff would likely expect reasonably designed, risk-based policies and procedures considering the following elements:

1. When fund managers receive confidential borrower information, they should analyze that information before trading in the borrower's securities or other securities linked to those assets, regardless of whether those securities are privately-issued or publicly-traded.
2. Although policies should be reasonably designed in light of risks, and specific written policies referring to borrower information or CLO tranches are uncommon, where an adviser receives such information, the order implies that written policies or procedures are recommended.
3. Policies should provide for a repeatable MNPI review process and pre-clearance requirements before trades in related CLO securities are approved.
4. Where feasible and practicable, firms that have active CLO equity strategies may wish to consider information barriers between investment professionals.

While the SEC clearly expects firms to analyze the materiality of information received by firm personnel, materiality determinations can be challenging. The analysis may be different for an equity tranche compared to senior tranches. Fund managers may have to determine whether or not to approve trades where the loan in question is not broadly syndicated and subject to information cleansing, such as in the case of many loans held by middle market CLOs. In such cases, it is therefore often prudent to confer with knowledgeable counsel in assessing the related MNPI risk.

Conclusion

We have previously noted concerns about MNPI when participating in creditor groups, as well as the SEC's focus on 204A policies and procedures cases, which the enforcement staff has used to bring actions based on compliance violations, even without alleging insider trading.

This case highlights the SEC's stance that robust written policies are essential to prevent the misuse of MNPI in trading CLO tranches. The SEC's emphasis on compliance, rather than directly alleging insider trading, underscores the expectation that fund managers must proactively address risks tied to confidential borrower information.

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[1] Although all of the trades in this case involved CLO equity tranches, the SEC's findings regarding the fund manager's policies were not limited to CLO equity tranches, noting that the manager's policies were deficient because they "did not contain any prohibitions on trading a CLO tranche while in possession of MNPI".

[2] In addition to actions brought by the SEC, the failure to disclosure material information in a private securities transaction can also lead to third-party claims by the purchaser. The settlement order notes that one of the counterparties that purchased the CLO equity tranches threatened litigation and demanded either rescission of the sale or a reduction in the purchase price. The fund manager ultimately paid the counterparty the requested amount of approximately $350,000 (representing the decline in the value as a result of the MNPI becoming public).

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