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Regulatory Scrutiny on Potential MNPI in the Credit Markets

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Over the past year, regulatory scrutiny of the credit markets has intensified, with the SEC investigating the potential use of material nonpublic information ("MNPI") relating to credit instruments. The SEC brought a number of enforcement actions against investment advisers involving the failure to maintain and enforce written MNPI policies involving trading in distressed debt and collateralized loan obligations, even in the absence of insider trading claims. We anticipate that these investigations of trading in private credit instruments and related MNPI policies will continue, as SEC enforcement staff has increased their focus on these markets.

Although insider trading investigations typically involve equity securities, in 2024 the Commission scrutinized ad hoc creditor committee participants and took action against distressed debt managers relating to MNPI. Many fund managers investing in distressed corporate bonds collaborate with financial advisors to form ad hoc creditors' committees, aiming to explore beneficial debt restructuring opportunities prior to bankruptcy. Managers often avoid receiving MNPI to avoid prolonged trading restrictions on company bonds. For example, a manager may wish to remain unrestricted until formally entering a non-disclosure agreement ("NDA") with the company and will notify external financial advisors and other committee members that it should only receive material prepared on the basis of public information. In other cases, managers will rely on information barriers, organizing their businesses into "public" and "private" sides. The SEC Staff has identified these situations as involving a heightened MNPI risk, emphasizing the need for clear written procedures to handle MNPI and mitigate risks of leakage or inadvertent receipt. While industry participants may struggle to draw specific compliance guidelines from these cases, the key takeaway is that the SEC expects heightened procedures for creditor committee participation and, more generally, consultants or advisers who may have access to MNPI.

The SEC also focused on MNPI when trading securities issued by collateralized loan obligation vehicles ("CLOs"). Last year the SEC settled a case against a New York-based private fund and CLO manager targeting the steps it took to ensure its analysts and advisers were not themselves misusing MNPI. The fund manager traded tranches of debt and equity securities issued by CLOs it directly managed as well as those managed by third parties. The SEC alleged that as a participant in an ad hoc lender group, the fund manager had become aware of negative developments that concerned a particular borrower, and privately sold CLO equity tranches while in possession of this confidential information. The CLO manager allegedly failed to consider the materiality of the negative information to the sold tranches before trading. While the SEC did not specifically allege insider trading, in part due to the firm obtaining internal compliance approval pre-sale, the matter led to a settlement focusing on the fund manager's failure to establish and enforce appropriate policies on the use and misuse of MNPI. As emphasized in other distressed debt and similar MNPI cases, MNPI policies and practices should be tailored to the nature of a firm's business. The failure to address information flow in these situations may lead to SEC scrutiny of the trading itself and the adviser's policies under Section 204A of the Advisers Act, which requires investment advisers to establish, maintain and enforce written policies to prevent misuse of MNPI, as well as Section 206(4) and Rule 206(4)-7 (the Compliance Rule). The SEC has been investigating trading in the credit markets and shown a willingness to bring these cases even in the absence of any alleged insider trading, although the Commission recently voted to dismiss the one litigated matter. Interestingly, both Republican SEC Commissioners, despite philosophical objections to enforcement settlements under the Compliance Rule, voted to approve the Section 204A charges in the creditors committee matter, and one voted to approve such claim in the CLO matter. Even with the change in administration, the SEC staff will continue to scrutinize these issues and look at similar risks in the credit markets.

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