

INSIDER TRADING & DISCLOSURE UPDATE

SEC Order Provides Warning to Fund Managers with Access to CLO-Related MNPI

Introduction

On August 26, 2024, the Securities and Exchange Commission (“SEC”) announced settled charges against registered investment adviser Sound Point Capital Management, LP (“Sound Point”) for violating Sections 204A and 206(4) of the Investment Advisers Act of 1940 (“Advisers Act”) and Rule 206(4)-7 thereunder. According to the order, Sound Point failed to establish, maintain or enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information (“MNPI”) concerning its trading of collateralized loan obligations (“CLOs”) that contained loans for which Sound Point was a lender.¹ Andrew Dean, Co-Chief of the SEC Enforcement Division’s Asset Management Unit, issued a statement on the same day reminding fund managers that they “must evaluate how their roles as lenders could expose them to MNPI that may relate to their CLO trading positions.”² These issues could also arise in contexts where the firm otherwise has access to MNPI.

Access to MNPI

According to the SEC’s order, a significant component of Sound Point’s business is managing CLOs and trading tranches of CLOs that it manages or that are managed by third-parties.³ In addition, as part of its credit business, Sound Point regularly participated in ad hoc lender groups or creditors’ committees, in which Sound Point, together with other large creditors, considered debt restructuring opportunities with the borrower of a loan—including loans also packaged in CLOs—prior to the issuer filing for bankruptcy or initiating restructuring proceedings.⁴

By 2019, through its CLOs and hedge fund vehicles, Sound Point was one of the largest holders of term loans issued to Company A, a media services company.⁵ Early the same year, Sound Point became a member of an ad hoc lender group to Company A, a position through which Sound Point was provided with information about Company A that it understood to be confidential and was not available to those outside of the ad hoc lender group.⁶

The SEC alleges that on June 27, 2019, Sound Point, through its role as a member of the ad hoc lender group to Company A, was informed of the likely failure of a significant asset sale by Company A and Company A’s need for emergency financing, which the SEC determined in its order to be MNPI.⁷ On July 30, 2019, Sound Point sold portions of two equity tranches of Sound Point CLOs that contained loans to Company A.⁸

Prior to the sale, a Sound Point co-portfolio manager for its CLO investments requested approval from Sound Point’s compliance department, which had been previously notified of the MNPI possessed by Sound Point investment personnel.⁹

Notwithstanding that Sound Point did not maintain information barriers between credit investment personnel and the personnel responsible for CLO trades¹⁰, the trade was approved.

The price of Company A’s loans dropped by more than 50% the following day after Company A’s need for emergency financing became public, and the value

of the two CLO tranches sold declined by 11%, or \$685,000.¹¹

Insider Trading Policies Were Inadequate

According to the SEC's order, at the time of the sale, Sound Point's compliance manual, which set out the insider trading policy, prevented Sound Point personnel from trading in the securities of a company while in possession of MNPI, but lacked any prohibitions on trading CLO tranches while in possession of MNPI regarding the loans included in the CLOs.¹² After the events of July 2019, Sound Point began to conduct compliance reviews prior to trades of Sound Point CLOs, which took into consideration the individual loan exposure of the relevant CLO tranches and potential MNPI possessed by Sound Point about the relevant borrowers.¹³ However, according to the SEC, Sound Point did not establish, maintain or enforce written policies or procedures relating to such pre-trade reviews until July 2022.¹⁴

Further, Sound Point did not establish, maintain, or enforce written policies or procedures relating to the possession of MNPI relating to loans underlying CLOs that were managed by third parties until June 2024.¹⁵

SEC's Order

The SEC charged Sound Point with willful violations of (i) Section 204A of the Advisers Act for failure to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of MNPI in violation of the Advisers Act or the Securities Exchange Act of 1934, as amended, or the rules thereunder and (ii) Section 206(4) of the Advisers Act and Rule 206(4)-7 thereunder for failure to adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and rules thereunder.¹⁶

Sound Point agreed to settle the allegations without admitting or denying the SEC's findings, along with a \$1.8 million civil penalty and a censure.

Takeaways

For fund managers—especially those with multiple business lines or strategies—this settlement is a reminder of the importance of:

- Adopting written policies and procedures relating to MNPI that address the ways in which the manager might come into the possession of MNPI, and actively maintaining and enforcing those policies. As the SEC's order highlights, generalized insider trading policies or procedures that merely restrict trades on the basis of MNPI or refer to a restricted list may not be sufficient, especially if there are particular sources or types of MNPI that present risks in light of a firm's investment practices or strategies. Policies and procedures should be tailored to the fund manager's business practices. Going forward, we expect the SEC to continue to focus on the adequacy of firms' policies and procedures relating to MNPI.
- Implementing adequate information barriers between (i) personnel that may have access to nonpublic information and (ii) personnel purchasing or selling securities or making other investment decisions where that information could be material. Review processes and internal controls should supplement the information barriers and should be frequently reviewed and updated to ensure proper functioning and design in the context of the fund manager's business practices.
- Documenting the process by which compliance staff assess trading approvals, including confirming that compliance staff are required to conduct a holistic view of nonpublic information in the context of the firm's business.

Notes

- 1 SEC Press Release, *SEC Charges Sound Point Capital Management for Compliance Failures in Handling of Nonpublic Information* (Aug. 26, 2024), <https://www.sec.gov/newsroom/press-releases/2024-106>.
- 2 *Id.*
- 3 See Order at ¶ 1, *In the Matter of Sound Point Capital Management, LP*, File No. 3-22032, <https://www.sec.gov/files/litigation/admin/2024/ia-6666.pdf>.
- 4 *Id.* at ¶ 9.
- 5 *Id.* at ¶ 11.
- 6 *Id.* at ¶¶ 11-12.
- 7 *Id.* at ¶ 15.
- 8 *Id.* at ¶¶ 16-18.
- 9 *Id.* at ¶ 16.
- 10 *Id.* at ¶ 23.
- 11 *Id.* at ¶ 19.
- 12 *Id.* at ¶¶ 13-14.
- 13 *Id.* at ¶ 22.
- 14 *Id.* at ¶¶ 21-22.
- 15 *Id.* at ¶ 24.
- 16 *Id.* at ¶¶ 25-26.

**Insider Trading & Disclosure Update is a
publication of**

Debevoise & Plimpton LLP

New York

66 Hudson Boulevard
New York, New York 10001
+1 212 909 6000
www.debevoise.com

Washington, D.C.

801 Pennsylvania Avenue N.W.
Washington, D.C. 20004
+1 202 383 8000

San Francisco

+1 415 738 5700

London

+44 20 7786 9000

Paris

+33 1 40 73 12 12

Frankfurt

+49 69 2097 5000

Luxembourg

+352 28 5795 33 00

Hong Kong

+852 2160 8900

Shanghai

+86 21 5047 9800

Editorial Board

Jonathan R. Tuttle

Co-Editor-In-Chief

Matthew E. Kaplan

Co-Editor-In-Chief

Benjamin R. Pedersen

Managing Editor

Anna Moody

Executive Editor

Amy Pereira

Associate Editor

Nicholas Vota

Associate Editor

All content © 2023 Debevoise & Plimpton LLP. All rights reserved. The articles appearing in this publication provide summary information only and are not intended as legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed herein. Any discussion of U.S. federal tax law contained in these articles was not intended or written to be used, and it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under U.S. federal tax law.