SEC ENFORCEMENT ACTION HIGHLIGHTS PRIVATE CREDIT AND MNPI RISKS

The U.S. Securities and Exchange Commission ("SEC") issued an order on Monday instituting administrative and cease-and-desist proceedings against a registered investment adviser ("RIA") for failing to establish, maintain, and enforce policies and procedures to prevent the misuse of material nonpublic information ("MNPI") concerning the RIA's trading of collateralized loan obligations ("CLOs").[1]

According to the order, the RIA possessed MNPI relating to a company ("Company A") obtained from participating on an ad-hoc creditors committee. While in possession of that MNPI, the RIA sold two CLO equity tranches whose portfolios had exposure to Company A loans. The MNPI became public the day after the RIA completed the transaction, and the value of the Company A loans (as well the CLOs) dropped materially, leading at least one purchaser to threaten litigation and demand rescission or make-whole payments, which the RIA provided. The SEC found that by failing to implement and enforce policies and procedures reasonably designed to prevent the misuse of MNPI, the RIA violated Section 204A, Section 206(4) and Rule 206(4)-7 thereunder of the Investment Advisers Act of 1940 ("Advisers Act"). The SEC imposed a $1,800,000 civil monetary penalty, in addition to censuring the RIA and issuing a cease-and-desist order.

This enforcement action highlights two key risks for investment managers.

First, this action may evidence the SEC's increased focus on private credit managers. In June, the SEC's Division of Enforcement director, Gurbir Grewal, gave a wide-ranging interview to *Bloomberg*, in which he highlighted the potential risks of the ever-expanding private credit market, including the ability of bad actors to take advantage of the market's lack of transparency.[2] Director Grewal noted that the Enforcement Division wants to ensure that private credit managers "… are not abusing the lack of transparency."

---

1 Press Release, SEC, 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 Austin Weinstein, *SEC's Top Cop Concerned about Private Credit Valuations, Opacity*, BLOOMBERG (June 27, 2024, 11:27 AM), https://www.bloomberg.com/news/articles/2024-06-27/sec-s-top-cop-concerned-about-private-credit-valuations-opacity.

Second, this action highlights the need for strong policies, reasonably designed to prevent the misuse of MNPI. This is the latest in a line of cases where the SEC has alleged that an investment manager failed to have such policies reasonably designed to address the manager's specific MNPI risks. For example, in a May 2020 settlement, the SEC alleged an RIA had deficient MNPI policies and procedures because those policies did not address the MNPI that employees received by virtue of their close relationship with a listed portfolio company.[3] Similarly, in a November 2021 settlement, the SEC alleged that MIO Partners Inc. had deficient policies because they did not address the risk that McKinsey partners—who managed MIO Partners—had obtained MNPI in their roles as consultants to public companies and other McKinsey clients.[4]

These actions demonstrate the need for investment advisers to evaluate their potential sources of MNPI and to build processes to systematically mitigate the risks of abuse (or perceived abuse). For private credit managers, the current action demonstrates the potential risks of participating in ad-hoc creditor committees, particularly where multiple teams are trading at different levels of the capital stack or where funds have exposure to products related to the underlying issue. Further, investment advisers with exposure to security-based swaps should consider their potential exposure under Securities Exchange Act of 1934 Rule 9j-1, which prohibits the trading of security-based swaps while in possession of MNPI about the underlying security, and should ensure that restricted securities lists also prohibit trading in associated security-based swaps.

There are many sources of MNPI, and investment advisers are well advised to evaluate their business on a regular basis to determine whether any new sources have become relevant, particularly as the advisory business expands and new personnel are hired. With private credit, investment advisers should evaluate potential sources of MNPI specific to private credit investments, such as participation in ad-hoc creditors committees, and work to ensure that they have policies and procedures to prevent the misuse of MNPI. Finally, where investment advisers are advising on complex structured products or security-based swaps, they should ensure that their compliance policies and procedures anticipate and mitigate avenues for potential MNPI abuse in these products.

---

[3] Press Release, SEC, Private Equity Firm Ares Management LLC Charged with Compliance Failures (May 26, 2020), https://www.sec.gov/news/press-release/2020-123.

[4] Press Release, SEC, McKinsey Affiliate to Pay $18 Million for Compliance Failures in Handling of Nonpublic Information (Nov. 19, 2021), https://www.sec.gov/newsroom/press-releases/2021-241.

CLIFFORD
CHANCE

CONTACTS

Robert Houck
Partner

T +1 212 878 3224
E robert.houck
@cliffordchance.com

Vadim Avdeychik
Partner

T +1 212 878 3055
E vadim.avdeychik
@cliffordchance.com

Jeff Berman
Partner

T +1 212 878 3460
E jeffrey.berman
@cliffordchance.com

Cliff Cone
Partner

T +1 212 878 3180
E clifford.cone
@cliffordchance.com

Steven Gatti
Partner

T +1 202 912 5095
E steven.gatti
@cliffordchance.com

Jefferey LeMaster
Partner

T +1 212 878 3206
E jefferey.lemaster
@cliffordchance.com

Benjamin Berringer
Counsel

T +1 212 878 3372
E benjamin.berringer
@cliffordchance.com

Erica Lignell
Associate

T +1 212 878 8158
E erica.lignell
@cliffordchance.com

Andrew Nelson
Associate

T +1 212 878 8284
E andrew.nelson
@cliffordchance.com

www.cliffordchance.com

Clifford Chance, Two Manhattan West, 375 9th Avenue, New York, NY 10001, USA

Clifford Chance US LLP

Abu Dhabi • Amsterdam • Barcelona • Beijing • Brussels • Bucharest • Casablanca • Delhi • Dubai • Düsseldorf • Frankfurt • Hong Kong • Houston • Istanbul • London • Luxembourg • Madrid • Milan • Munich • Newcastle • New York • Paris • Perth • Prague • Riyadh* • Rome • São Paulo • Shanghai • Singapore • Sydney • Tokyo • Warsaw • Washington, D.C.

*AS&H Clifford Chance, a joint venture entered into by Clifford Chance LLP.

Clifford Chance has a best friends relationship with Redcliffe Partners in Ukraine.