SEC Enforcement Case Summary
Compliance Failures in Handling Material Nonpublic Information Related to CLOs

On August 26, 2024, the SEC brought charges against Sound Point Capital Management, LP for failing to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information (MNPI) concerning its trading of collateralized loan obligations (CLOs). The SEC order noted that the firm did maintain a policy regarding insider trading, which included the maintenance of a restricted list of companies in which the firm and its supervised persons were prohibited from trading. However, the SEC faulted the firm for not adequately addressing in its policies and procedures the possibility of how Sound Point might obtain MNPI in connection with its business practices.

Sound Point managed more than $38 billion in regulatory assets under management for hedge funds, separately managed accounts, registered investment companies, and CLOs. CLOs are actively managed vehicles that are typically collateralized with a pool of corporate loans, loan participations, or credit default swaps tied to corporate liabilities. After a CLO is issued, there is generally a four to five year "reinvestment" period during which the manager can sell existing loans and buy new ones for the portfolio, within the parameters of the CLO's governing documents.

The SEC order explains the features of a CLO as follows: Each CLO issues a series of bonds, the most junior tranche of which is typically referred to as the "equity" tranche, because it takes the first loss. These tranches differ in terms of subordination and priority. Cash flows from the underlying loans of a CLO are used to pay interest and principal on the debt tranches and are distributed based on a "waterfall" whereby cash flows are paid sequentially starting with the senior-most tranche until each tranche has been paid its full distribution. After expenses and liabilities are paid off, the equity tranche receives the residual distribution. As the equity tranche is subordinate to the debt tranches, it is the first to absorb losses if any of the underlying loans materially decrease in value or default. Therefore, a CLO equity tranche is generally considered to be the riskiest part of the CLO capital structure.

Sound Point managed approximately 55 U.S. CLOs and 16 European CLOs and traded its own CLOs as well as CLOs managed by third parties. Sound Point also ran a credit business through which it often participated in ad hoc lender groups or creditors' committees, which joined other large creditors with similar interests together in order to explore potential favorable debt restructuring opportunities with the issuer of an underlying loan prior to the issuer filing for bankruptcy, reorganizing the company, or otherwise initiating formal restructuring proceedings.

Sound Point was one of the largest holdings in term loans issued to a specific company and therefore became a member of an ad hoc lender group to the company. In this capacity, multiple Sound Point personnel because aware of the likely failure of an expected major asset sale by the company and company's need for rescue financing. This information constituted MNPI about the company, whose loans were included in certain Sound Point CLOs. A Sound Point portfolio requested approval from the firm's compliance department to sell portions of two equity tranches of Sound Point CLOs that contained loans by the company. Although the compliance department was aware of Sound Point personnel's participation in the company's ad hoc lender group, they apparently did not understand or consider that the personnel had access to MNPI by virtue of such role and approved the requested sales.

When MNPI regarding the company's need for rescue financing became public the next day, the loans that had been sold immediately dropped by more than 50% of their value. One of the counterparties to which the loans were sold requested a rescission of the sale or reduction in sales price, which amount Sound Point paid.

Following these events, Sound Point began to conduct compliance reviews taking into consideration the loan exposure of CLO tranches and potential possession of MNPI prior to trades. However, the firm did not conduct such reviews with respect to third-party CLOs nor establish adequate written policies and procedures with respect to is possession of MNPI about underlying loans held by third party CLOs. The SEC faulted the firm for failures, as well as failure to maintain information barriers between personnel responsible for the firm's credit investment decisions and those responsible for CLO trading. Ultimately, the firm did adopt and implement written policies and procedures to prevent the misuse of MNPI with respect to such practices following the SEC investigation, but the action was too little and too late to avoid enforcement action.

This action demonstrates that it is not sufficient to establish a Code of Ethics and personal securities reporting and trade pre-approvals without fully considering and addressing all the ways in which an investment adviser may have access to MNPI and effectively establishing controls to prevent the misuse of such information. To settle the SEC's charges, Sound Point agreed to pay a $1.8 million civil penalty.

See Summary - https://www.sec.gov/newsroom/press-releases/2024-106