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## SEC Charges Adviser with Section 204A Violation for Failing to Maintain MNPI Procedures: Paul Hastings

Recently, the SEC settled an enforcement action against a registered investment adviser (the "Adviser") for allegedly failing to implement policies and procedures reasonably designed to prevent the misuse of material non-public information ("MNPI") in violation of Section 204A of the Investment Advisers Act of 1940 ("Section 204A"). The terms of the settlement required the Adviser to pay an $18 million penalty. Although the SEC's pursuit of violations of Section 204A is nothing new, this action is significant for a couple of reasons.

First, the SEC's allegations focused on policies and procedures governing advisory personnel who were considered "above-the-wall" in relation to the Adviser's MNPI informational barriers. Specifically, although the Adviser had instituted walls that prohibited certain personnel from obtaining MNPI from the Adviser's affiliates, the Adviser allegedly had no procedures or "walls" that governed senior personnel who sat on the Adviser's Investments Committee (i.e., in a position above the informational walls) and ratified investment decisions for the Adviser. Those senior individuals also allegedly "had access to" MNPI about many of the issuers in which the Adviser invested through their work as consultants acting on behalf of the Adviser's affiliates.

Second, the SEC's allegations suggest that the agency is willing to take an aggressive view when determining what type of information might constitute MNPI for the purpose of Section 204A. Here, the SEC classified information relating to the Adviser's internal investment strategies and allocations as "MNPI" for the purposes of Section 204A. In other words, the SEC considered the procedures the Adviser had in place to prevent the misuse of information relating to the Adviser's own investment holdings and allocations in determining whether the Adviser's policies were adequate under Section 204A. Traditionally, the SEC has not designated this type of information as MNPI for the purposes of Section 204A. Further, some of the information at issue related to municipal debt securities, which are rarely, if ever, the subject of SEC insider trading claims.

**Background: Senior Advisory Personnel Wore Many Hats and Sat Above the "Wall"**

According to the SEC, the Adviser invested the vast majority of its funds indirectly through third-party investment managers who maintained discretion over the funds. Some of these indirect investments were held in separately managed accounts ("SMAs"). The SEC alleged that the Adviser was aware of the SMAs' holdings and activity because the Adviser maintained books and records of all trades executed by the third-party managers in the SMAs. The SEC also alleged that the Adviser had insight into certain details regarding the holdings in the remaining portion of the indirect investments because the Adviser had access to, among other things, client updates that it received from the third-party managers.

The SEC alleged that the Adviser managed the money of the partners and personnel of the Adviser's parent company ("Parent"), a large consulting company. To help manage the money, the Adviser apparently formed an Investments Committee that was responsible for overseeing and monitoring all investments. The Investments Committee was allegedly responsible for ratifying or approving

investment decisions, including planned allocations to third-party managers. The SEC alleged that members of the Adviser's Investments Committee also separately provided consulting services to public companies and entities emerging from bankruptcy on behalf of the Parent.

Among other things, the SEC alleged that the Adviser invested hundreds of millions of dollars in the securities of issuers about which members of the Investments Committee had access to substantial MNPI as a result of the consulting services that those individuals performed on behalf of the Parent. For example, the SEC alleged that the Adviser's Investments Committee allocated millions of dollars in investments to a third-party manager that substantially invested in a public company ("Company A"). The SEC alleged that, at the same time, a member of the Investments Committee was responsible for overseeing the strategic and corporate advice that the Parent was then providing to Company A. The SEC indicated that, given this type of conduct, the "risk of misuse of MNPI was real and significant."

The SEC alleged that the Adviser did not have policies and procedures to address this risk and prevent the misuse of MNPI to which members of the Investments Committee had access.

**SEC Classifies the Adviser's Internal Investment Decisions as "MNPI"**

The SEC also alleged that the Adviser lacked policies and procedures to prevent the misuse of MNPI relating to the Adviser's own internal investment decisions. Specifically, the SEC alleged that members of the Investments Committee were "aware of MNPI regarding [the Adviser's] investment strategies, concentration limits, risk limits, and third-party managers allocations, and had access to [the Adviser's] holdings," including holdings of securities that are very infrequently the subject of SEC insider trading claims, such as municipal bonds and private senior secured debt for an issuer in bankruptcy proceedings.

The SEC claimed that, armed with this MNPI regarding the Adviser's investment positions, members of the Investments Committee might be tempted to engage in conduct designed to influence those investments. For example, the SEC suggested that members of the Investments Committee might influence their consulting advice in a way that favored the Adviser's investments, given the overlap between the issuers for which the members of the Investments Committee provided consulting services and the issuers in which the third-party managers made investments. Notably, the SEC did not allege that any of the members of the Investments Committee actually tried to influence the investment decisions in an improper way. Nonetheless, the SEC alleged that the Adviser did not have policies and procedures in place to prevent the misuse of this "MNPI."

**The Takeaways**

This action presents many takeaways and reminders for registered broker-dealers and investment advisers:

- A violation of Section 204A does not require an allegation of insider trading
- According to the SEC, a "risk" of misuse of MNPI is sufficient to substantiate a finding that policies and procedures are not reasonably designed
- From the SEC's perspective, a potential violation of Section 204A may be predicated on an individual merely having "access to" MNPI
- The SEC might allege that MNPI includes internal advisory decisions regarding a potential investment, which might significantly complicate an adviser's/broker-dealer's efforts to design procedures to prevent the misuse of MNPI under the federal securities laws
- "Above-the-wall" procedures must be considered when implementing informational barriers to prevent the misuse of MNPI

- Wearing many hats can lead to complex issues regarding MNPI policies and procedures under Section 204A

**Paul Hastings LLP** – Thomas A. Zaccaro , Nick Morgan, John P. Nowak and Jessica Baker

December 2 2021

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