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Private and Inside Information in the Loan Market

Background

Following the paper on 'Dealing with confidential and price sensitive information' issued by the LMA in April 2006, the LMA Board decided to continue work in this area by producing a paper which gives examples of situations where information deriving from activities in the loan market is likely to be private or in some way privileged, including where such information may constitute inside information, and consequently where participants in the loan market may need to deploy measures to deal with such information, potentially including measures such as information walls to isolate parts, or potentially all, of their business from such information.

This paper therefore sets out circumstances where such information may arise. It also sets out some of the main practical implications arising in the context of possession of private or privileged information for participants in the loan market.

This paper does not attempt to prescribe mechanisms that members of the loan market may choose to deploy to isolate themselves from the risk of mishandling private or privileged information. This is because the LMA does not wish to be prescriptive in relation to such measures as this may imply that other equally valid measures are inappropriate or less appropriate. Rather, the LMA wishes to ensure that its members retain the maximum possible flexibility to deal with such information as appropriate in the context of their various different business models. However, in some of the sets of circumstances described below, non-exhaustive examples are given of some of the methods that members may deem appropriate to deal with these sets of circumstances.

Private and privileged information

Participants in the Loan Market are regularly given access to private and otherwise privileged information relating to borrowers. This typically arises either because borrowers give to their lenders access to financial and other sensitive information due to their status as lenders (e.g. it may be a condition of major lendings that the borrower gives access to financial and other management data on an ongoing basis) or because the existence or status of a loan is in itself a piece of privileged information (e.g. a default or potential default or restructuring under the terms of a loan is likely to be a sensitive piece of information).

Information may need to be subject to controls and restrictions because some form of contractual duty of confidentiality is imposed on the information, or such duty is implied at law. Typically, participants in syndicated loans are subject to duties of confidentiality, both in the primary and secondary market. Information may also need to be subject to controls and restrictions due to the existence of legislative or other regulatory restrictions. These restrictions normally derive from insider dealing and market abuse/ market conduct restrictions designed to ensure that those who have access to information on a privileged basis do not use that information to make a profit/avoid a loss in market trading where other members of that market do not have access to that same information.

Where information is made publicly available this will mean that it is no longer privileged. However, it should be noted that making information accessible to all members of a syndicate of lenders does not equate to making that information publicly available. It is likely that, where such information is subject to contractual provisions of confidentiality, those restrictions will extend to cover all members of a syndicate and are likely to be further extended to those who obtain relevant information in the secondary loan market or through taking a sub-participation or other economic interest in the loan.

Insider dealing/market abuse

In relation to making public information that may be subject to the insider dealing or market abuse regime, information can only be considered to be public where it is generally accessible to users of the market(s) on which securities issued by the relevant borrower are traded. Again, therefore, where information has only been made available to members of a syndicate of lenders, this will not qualify as information being publicly available for this purpose.

Information is subject to the insider dealing/market abuse regime in the UK where it is information that relates to securities, or the issuer of securities, where those securities are admitted to trading on a wide range of markets and where that information has not been made public - but if it were, that information would be likely to have a material impact on the price at which those securities trade. Where someone who is a participant in a loan has access to such inside information it is an offence to trade in securities issued by the borrower to which the information relates. It is also an offence to pass that information on to anyone else unless doing so is in pursuance of the proper course of the exercise of the participant's / relevant employee's employment, profession or duties. Consequently, passing on inside information to a participant in a syndicate or to the purchaser of an interest in a loan, in each case as envisaged through the terms of the loan arrangements, is acceptable. Also, of course, such disclosure is likely to be made subject to confidentiality restrictions. However, if that participant then passes on the inside information on a selective or casual basis to those who trade in securities issued by that borrower this will not be acceptable and is likely to constitute an offence under the insider dealing and/or market abuse regimes.

Types of information that may trigger insider dealing/market abuse restrictions where a borrower has securities admitted to trading on a regulated market include information that a borrower is about to reschedule its lendings, that a borrower is intending to make a significant draw-down under a major loan, amendments or waivers to the terms of a loan contract (e.g. covenant waivers) or that an interest rate ratchet has been triggered. However, these events

will only constitute inside information where the relevant event is significant enough to affect the price of securities issued by the relevant borrower and will therefore always depend on the factual circumstances.

Consequently, if a borrower enters into a loan which, in the context of its overall business, is minor in scale, information about such a loan, even though not publicly known, is unlikely to constitute inside information. This is because, even were the information to become publicly known it would be highly unlikely to have any material impact on the price of any securities issued by the borrower.

However, information that a loan of significant scale compared to the overall size of the business of the borrower is about to be fully drawn down could have an impact on the price of securities issued by that borrower and consequently may well be inside information. This could be because, for example, the market had expected that the draw down of the loan would be staged over a period and a full draw down being made earlier than expected may imply financial difficulties for the borrower or it may cause concerns at the relative level of indebtedness that this would lead to for the borrower relative to the size of its overall balance sheet. Similarly, a waiver to a term of the loan contract may not constitute inside information if it is a minor or inconsequential term. However, a waiver to, say, a significant covenant within the terms of a major syndicated loan facility is likely to constitute inside information.

Additionally, triggering of an interest ratchet provision may be inside information if it relates to a loan that is of significant size compared to the overall business of the borrower, but is unlikely to be if it only relates to relatively minor borrowings. By contrast, information that a borrower is about to reschedule its lendings or to trigger a default event under a loan is always likely to constitute inside information as this will generally signal that a borrower is in financial difficulties and this information or implication, were it to be made public, would have a significant impact on the price of securities issued by the borrower. Equally, where a borrower's debts are being restructured, it can be assumed that significant elements of the information that is available to members of a creditors' committee will constitute inside information as this information relating to the future plans for the business and balance sheet structure of the borrower would impact upon the price of securities issued by the borrower were it to be made public.

Any information that has yet to be made public relating to a major restructuring or proposed merger or acquisition impacting on a borrower will also constitute inside information.

It should also be noted that other financial and management information relating to borrowers that is given on a privileged basis to lenders also needs to be assessed to determine whether it is sufficiently significant that it may have an impact on the price of relevant securities, in which case it would potentially constitute inside information. However, it will generally be the case that any information that signals a shift in financial prospects of a borrower compared to the current information available to the market will constitute inside information.

Other restrictions

As mentioned above, the insider dealing and market abuse restrictions relating to the use of inside information only apply where the information relates to an issue or issuer of securities that are admitted to trading on a regulated market. Consequently, where a borrower has no securities that are admitted to trading, these regimes will not apply. However, restrictions may be appropriate in the context of information relating to such borrowers. For example, some loan agreements do not require to be repaid if the borrower is subject to an IPO or otherwise issues securities that are traded on a relevant market. If that is the case, then information relating to such a borrower will become subject to the insider dealing and market abuse regimes. It cannot therefore be assumed that because information relating to a borrower is not inside information, because that borrower has no securities admitted to trading, that that will always continue to be the case.

In any event, care should be taken in handling and trading on the basis of information relating to a borrower that, throughout the life of the relevant loan, does not have any securities admitted to trading on a regulated market. In such cases, members of the loan market should still take care to act in a manner that is consistent with general standards of professional integrity and fair dealing and to ensure that they are not breaching any confidentiality requirements or obligations. (See also, in relation to trading when in possession of material confidential information, the LMA's Code of Practice for Par Trade Transactions, dated April 1998, as updated in January 2003 - and particularly Annex B of that document.)

In considering information that is received from borrowers, those in the loan market should consider that the capacity in which they receive that information may differ and that may give rise to differing concerns over the level of sensitivity of that information and may, in turn, instruct how such information should be treated.

So, for example, where a borrower's debts are being rescheduled/in a work out situation, if a lender joins a steering committee that has been established to advise on and help to control this process, it is likely that the information given to members of that committee will be particularly sensitive. Consequently, such information may well not be available to members of syndicates generally and therefore it should be treated with particular care.

Similarly, banks who enjoy a relationship banker role with a particular borrower may obtain access to particularly privileged and sensitive information on that company. Again, such information may not be generally available to relevant lending syndicates and will need to be treated with particular care.

In both these cases - information received in the capacity of a member of a steering committee and information provided to relationship bankers - recipient organisations may wish to consider holding such information behind an information wall or otherwise taking additional steps to ensure that any trading based on such information is not in breach of the insider dealing or market abuse regimes and is not inconsistent with general standards of professional integrity and fair dealing and does not breach any confidentiality requirements or obligations.

Credit derivatives and other structures

Controls may also need to be put in place in relation to information received in the context of various credit derivative structures such as Credit Default Swaps, and also structures such as Collateralised Debt Obligations (CDO's) and Collateralised Loan Obligations (CLO's). Such considerations also potentially extend to Loan only Credit Default Swaps (LCDS).

Participants in the market should be aware of several potential issues relating to information that may arise in the context of those types of transactions.

First, where credit derivatives could potentially involve delivery of a security, unpublished price sensitive information relating to relevant securities or the issuers of those securities will need to be segregated away from those structuring the credit derivative to avoid concerns over insider dealing issues arising.

Second, even where operations relating to credit derivatives do not involve trading in securities that are admitted to trading on a regulated market, care needs to be taken in handling and using inside or otherwise privileged information for the reasons set out above. This would, for example, apply to LCDS where the entity structuring the LCDS has privileged access to information that is not available generally to the market. Particular concerns may arise, for example, due to access by those involved in the LCDS to information relating to a credit event concerning the reference entity under the LCDS. These concerns would, however, be dealt with to the extent that information relating to such credit events had become generally known to all those dealing in either the LCDS or loans of the relevant reference entity.

Third, it should be noted that CDO's and CLO's are themselves often listed. Consequently, information relating to a listed CDO/CLO - including information relating to a very significant element of the portfolio of such a CDO/CLO - i.e. a loan making up a significant proportion of the portfolio may constitute inside information and need to be dealt with accordingly.

Practical implications

Taking into account these general points regarding the circumstances in which private / privileged and in particular inside information may arise, the following practical implications are likely to result.

For a participant in the loan market to be free to trade securities relating to borrowers without regard to the existence of private or privileged information, it is necessary for that participant to avoid the receipt of any such information from the borrower or, where in the context of a syndicated deal it has contact through the agent of the syndicate, from the agent or to ensure that it only has access to that information which is not subject to confidentiality or insider dealing / market abuse restrictions.

In larger organisations, some individuals may be able to remain free to trade securities without being tainted by private or privileged information that is held elsewhere within the organisation due to the existence of effective information barriers. However, for smaller organisations or organisations where there is no desire to have segregation of function such information barriers may not be appropriate. In those circumstances, care must be taken to

ensure that private / privileged information is not available to the organisation at all, or only after sanitisation of that information which is confidential or subject to insider dealing / market abuse restrictions. This may mean sanitising the information received by an organisation in its capacity of lender by stripping out those elements that are subject to restrictions. Alternatively, it may mean avoiding receiving any information on the borrower other than through publicly available sources.

These practical implications also need to be read in the light of concerns relating to the capacity in which information is received, specifically where particularly sensitive information is received relating to a borrower that does not have securities admitted to trading, as these concerns are outlined above.

Where members of the loan market wish to receive sanitised information from a borrower, this will need to be approached with care. Typically, the borrower will be best placed to judge whether information is or is not inside information. An agent will not be well placed to make this judgement and will probably be reluctant to take on the responsibility of doing so. In some circumstances, participants in the loan market may decide to appoint a third party to take the role of stripping out from information those elements that are subject to confidentiality or insider dealing / market abuse restrictions. However, it should always be noted that the liability for insider dealing / market abuse and for breach of confidentiality requirements where they apply would potentially rest with the participant of the loan market who may then be using that information for market trading. Consequently, many members of the loan market may only feel fully secure in relying on the fact that they do not have any inside information if they are only receiving information relating to a borrower from publicly available sources.