The use of non-public confidential information and secondary debt trading.

Overview

Concerns around the asymmetry of information in the secondary trading of debt in the European loan market will become particularly heightened during the course of a restructuring where parties sitting on a coordinating committee of lenders will likely have access to material confidential information (which may also be price sensitive) not available to the market at large or even the wider lender syndicate.

Parties will need to consider, for example, whether to trade the debt and, if so, on what terms and/or whether to ensure equality of information through the operation of some form of disclosure or “cleansing” arrangement.

There are a number of possible relevant considerations:

- the market abuse and insider dealing regime in the UK applying to listed securities;
- recent industry guidelines as to market conduct (notably, of the LMA and AIMA);
- industry wide secondary debt trading terms (LMA); and
- the general FCA Principles of Business.

In light of the changing capital structures of many European debtors over recent years and the number of new entrants into the restructuring market, who may be used to the trading of debt in the US loan market where market practice is more settled, these issues are becoming increasingly more common.

Is the trade caught by the market abuse and insider dealing regime?

An issuer’s public disclosure of inside information which could have a “significant effect” on the price of “listed securities” is vital to ensure no market abuse or insider dealing offences are committed under the Financial Services and Markets Act 2000 (which can carry civil and, for individuals, criminal sanctions).

In the case of the trading of credit claims/bank debt only, then public disclosure concerns should not arise. This is because such trades do not involve “listed securities” which instead include shares, debt securities (i.e. notes), warrants, options and various other derivative contracts traded on a regulated market.

Where a lender has mixed holdings across the capital structure (e.g. both listed securities, such as notes, and private bank debt), they must have a trading strategy to ensure that there is no breach by them of the market abuse or insider dealing regime. Until the issuer has publicly disclosed the inside information, a lender in receipt of that same information cannot trade the listed securities and they are unable to disclose the information publicly themselves. In these circumstances, thought will also need to be given as to
whether to continue to trade the bank debt bearing in mind some of the practical strategies referred to below.

**Best practice when trading secondary debt**

Whether or not there are also listed securities, co-com members should consider carefully whether they should trade their debt so as to avoid destabilising attempts to restructure or undermining confidence in the co-com, in particular any perception that its members are only there to take a fee and get an inside track on the correct debt price.

Nevertheless, co-com members are invariably free to trade their debt. Indeed, the LMA co-com appointment documents make clear that co-com members are “at all times free to transfer or otherwise deal” with their commitments, as permitted by the relevant facility agreement. We are not aware of any examples of documentary restrictions in co-com appointment documents preventing trading. Any attempt to do so would be strongly resisted.

**Do industry guidelines provide assistance as to secondary debt trades?**

Unfortunately, where a lender is in receipt of material non-public information, recent industry guidance published by the LMA and AIMA on debt trading during a restructuring has created uncertainty due to differences in approach. Broadly, the LMA Transparency Guidelines (published in 2011 and updated in 2012) are seen as adopting a restrictive approach to trading, whereas the AIMA Secondary Loan Market Guidelines (published in March 2013) are seen as more permissive.

The LMA Transparency Guidelines are broadly consistent with the LSTA guidelines for the trading of secondary debt in the US loan market. They seek to address the imbalance in information between co-com members and the wider syndicate/other market participants. While not binding, the guidelines inform best practice and market conduct in the trading of loans. Both the LMA and LSTA guidelines divide confidential information into two categories:

- **Syndicate** confidential information – information available to the whole lending syndicate. Trading on the basis of this type of information is generally permissible, even where the counterparty has elected not to receive such information; and

- **Borrower** confidential information – material information not made available to the whole syndicate, obtained through some other role such as membership of a co-com. Trading on the basis of this type of information is generally restricted.

**Divergence in US and European practice on debt trades**

While both the LSTA and LMA guidelines generally restrict trading on the basis of borrower confidential information, the LSTA guidelines make an exception for where the counterparty is also in possession of the same borrower confidential information. The LMA guidelines, however, do not and expressly state that the restriction applies “even where the counterparty to that trade has access to the same level of Borrower Confidential Information”. The LMA guidelines recommend that borrower confidential information should be shared to the broader syndicate “as quickly as possible”. The increasing use of “cleansing” provisions in private debt situations is, in part, driven by parties looking to comply with the LMA approach of ensuring borrower confidential information is turned into syndicate confidential information.

Of course, the LMA guidelines are simply focussed on market conduct, rather than market abuse, and (as they make clear) must be considered alongside the FSMA regime for market abuse and insider dealing in the trading of publicly listed securities issued by the borrower, where cleansing could further require the issuer to make syndicate confidential information known to the market in general.
**LMA safe-harbour**

The LMA guidelines do contain a narrow safe-harbour enabling trades on the basis of borrower confidential information if carried out “in order to facilitate restructurings and encourage the involvement of key major lenders”. This might, for example, cover the purchase of a small debt holding from a hold-out creditor. Provided the trade is for this purpose, a co-com member or lender possessing borrower confidential information “may reasonably make a judgement (subject to applicable law) that it is consistent with appropriate standards of professional integrity and fair dealings to trade” with another person regardless of whether that other person has or can ask for the relevant confidential information. In particular, the LMA guidelines suggest that the ‘reasonable judgement to trade’ can be made provided that the lender has reasonably made a judgment that the transaction will not adversely affect the syndicate/market.

**Criticism of the LMA approach**

The divergence in approach between recommended best practice in US and European debt trading has created uncertainty and, in particular, the LMA approach has been criticised for being too cautious and impractical by AIMA (the Alternative Investment Management Association which represents the global hedge fund industry). AIMA published its own guidelines to the trading of debt in the loan markets under which it recommends parties to a trade:

- rely on “big boy” representations to address asymmetry of information between seller and buyer;
- continue to trade with fellow co-com members where both seller and buyer have the same level of borrower confidential information; and
- continue to trade where the buyer has elected not to receive any borrower confidential information from the seller.

The AIMA guidelines also point to the difficulties in interpreting the LMA guidelines as to forming a ‘reasonable judgment to trade’, since it will not always be possible to exclude entirely the possibility that a transaction will not adversely affect the syndicate/market.

**FCA Principles of Business**

Despite the criticism of the LMA guidelines and the fact that they are non-binding, parties to a trade (particularly, but not exclusively, where a co-com is made up of traditional bank lenders or members of the LMA), may be concerned to ensure they follow the market conduct best practice set out by the LMA guidelines.

In this regard, it is also worth noting that where parties are regulated by the FCA then they will be subject to its general Principles of Business. Principle 5 provides that “A firm must observe proper standards of market conduct.”

Even though the loan market may be unregulated, it is likely that the FCA would apply that standard and, in determining proper standards, could have regard to the LMA and/or AIMA guidelines (in the same way that it seeks to use industry guidance in other areas, such as the IBA’s LIBOR code of conduct, in an enforcement context). As such, in a case of egregious behaviour there is a risk that the FCA would point to provisions in the LMA guidelines in support of any action they may wish to take and that this may lead firms to think about taking a more cautious approach, although depending on risk appetite some comfort can be taken from the support leant by the AIMA approach to adopting a more permissive stance.
**Practical strategies**

In order to facilitate the trading of debt, even where in receipt of borrower confidential information, there are a number of practical steps which a lender might take:

- establish an **information barrier** (i.e. between those on the co-com/part of the lender syndicate and those making the decision to trade). The LMA guidelines expressly recognise the validity of this approach and describe it as "**perfectly acceptable**". Of course, this may not always be desired or practical (e.g. for reasons of size);

- ensure trades are on "**big boy"/"sophisticated investor**" terms. These would provide that the parties understand that the seller may have more information about the company which is not being disclosed and which could be material inside information. Significantly, under clause 21.5 (**Material Information**) of the (post March 2014) LMA Standard Terms and Conditions for Par and Distressed Trade Transactions (Bank Debt/Claims), the buyer and seller each acknowledge that the other may possess material information not known to it and that no claims may be brought on the basis of non-disclosure (other than in respect of a breach of an express representation). There is no distinction made between syndicate and borrower confidential information nor, more generally, is any reference made to the LMA guidelines in any of the debt trade documents;

- impose **disclosure or cleansing provisions** in the co-com appointment documents. However, in the case of listed securities, since disclosure obligations on the issuer will already be high, any additional disclosure requirement may be unnecessary, potentially disruptive and could delay the restructuring while its terms are negotiated. Currently, there is no market standard approach to the drafting of these provisions in a restructuring scenario. Issues to consider include:
  - what information should be cleansed – there would usually be a definition of “confidential information” in the co-com appointment documents, but should other (more sensitive) information also be disclosed?
  - how often and by whom should information be disclosed?
  - should the practice in the bond market - where confidential information/price sensitive information is provided to advisers, so as not to restrict the ability of the bond holders to trade in the listed securities - also be adopted in a restructuring scenario only involving unlisted bank debt? AIMA highlight this as a possible undesired consequence of the LMA approach. While not a wide-spread practice, we note that in a recent restructuring in which we were involved, we (together with the financial advisors) acted as the first point of contact for potentially sensitive information and filtered it for the co-com;
  - should there be a “**blackout**” period during which no confidential information can be cleansed, so as not to disrupt restructuring negotiations? If so, how long should that period be? For example, there may be key periods, such as shortly before a syndicate meeting, where in order to ensure maximum engagement and efficiency, the co-com will accept being restricted for a short period of time. The co-com would then be “cleansed” when the information is subsequently disclosed at the lender meeting;
  - should the co-com itself, or individual members of it, have a backstop ability to **self-cleanse** if the company refuses to do so (for whatever reason)? While this may be potentially useful, lenders are likely to be wary of self-cleansing and it is not something we have seen happen in practice;
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- as a seller, make an election not to receive inside information in the first place. This would also enable a lender to trade listed securities where relevant. To do so while remaining on a co-com, however, may be problematic and would not be conducive to restructuring negotiations; or
- decide to “remain public” and not sit on the coordinating committee. It is worth noting, however, that information available to the lender syndicate itself might also amount to inside information.

The decision whether to trade is ultimately a matter of judgment, made difficult because of the divergence of approach between the LMA and AIMA guidelines and the lack of clear law in this area. Investors will differ as to how conservative an approach they may wish to adopt. What is clear is that given the uncertainty highlighted above, potential co-com members and their advisors need to carefully consider any cleansing provisions of their appointment documents. There needs to be a pragmatic and proactive management of the information flows and process through the restructuring to ensure that the industry guidelines are respected, without restricting co-com members inadvertently or for an unnecessary length of time.