

Client Alert.

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LMA Releases Guidelines for Use of Nonpublic/Confidential Information in Secondary Loan Trading

By Michael Fransella

On June 6, 2011, the Loan Market Association (the “LMA”) issued guidelines (the “LMA Guidelines”) for the use of nonpublic information in the context of secondary loan trading in the European market (or other markets where LMA documents are used or LMA protocols followed).¹ In general, the LMA Guidelines are consistent with the guidelines (the “LSTA Guidelines”) for trading in the U.S. market set forth in the Confidential Information Supplement, published as of October 20, 2008, to the Code of Conduct of the Loan Syndications and Trading Association (the “LSTA”).² Both sets of guidelines are voluntary, and are independent of both the trading documentation published by the LMA and LSTA and applicable legal requirements.³ Both divide material nonpublic information (“MNPI”) between “syndicate” confidential information, which is available to all members of a lending syndicate that choose to receive it, and “borrower” confidential information, which is not available to all members of the syndicate and is obtained through some other role played by, or connection to the borrower of, the loan market participant in possession of it (e.g., membership on a steering or creditors’ committee or affiliation with the borrower).⁴ Both (i) also state that trading on the basis of syndicate confidential information is generally permissible, even when one’s counterparty has chosen not to receive, or otherwise lacks, such information, while trading on the basis of borrower confidential information is generally not, and (ii) recognize the validity of informational walls that separate decision-makers with respect to trades from information in the possession of other personnel of the same institution. However, the LMA Guidelines go beyond the LSTA Guidelines in several respects that could impair the ability of market participants in possession of borrower confidential information to engage in any trading transactions.

THE LSTA APPROACH

In addition to providing recommendations for specific situations, the LSTA Guidelines call upon parties to act in accordance with “general standards of professional integrity and fair dealing.” As noted above, the LSTA Guidelines state

¹ The LMA Guidelines are available to LMA members at www.loan-market-assoc.com. The LMA is the principal association of loan market participants in the European market.

² The LSTA Guidelines and Code of Conduct are available to LSTA members at www.lsta.org, and may be acquired by non-members through the LSTA. The LSTA is the principal association of loan market participants in the U.S. market.

³ Loans are not considered securities under U.S. Federal law, and are therefore not subject to securities-law restrictions on trading, while in possession of material nonpublic information, with a counterparty lacking such information. The risk of state-law fraud claims arising from an informational disparity is addressed by the standard “big-boy” representations, acknowledgments, and waivers contained in the LSTA standard documents. Similarly, the provisions of the EU Market Abuse Directive relating to trading on the basis of price-sensitive inside information, and the analogous laws of individual EU member states, generally apply only to securities, and not to loans.

⁴ The guidelines recognize that not all confidential information is necessarily material; however, for discussion purposes, this Bulletin assumes that “syndicate confidential information” and “borrower confidential information” contain MNPI.

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that parties may trade on syndicate confidential information; they then go on to provide detailed recommendations for disclosing, or offering to disclose, syndicate confidential information to a trading counterparty at different stages of the trading process. With respect to borrower confidential information, the LSTA Guidelines state that a party should never trade on the basis of such information unless (i) the party received the information without breaching any duty to the borrower and (ii) the party reasonably believes that its counterparty possesses the same borrower confidential information. An obvious corollary to this rule is that a party possessing borrower confidential information may trade with a party lacking such information if the borrower confidential information is disclosed to the second party prior to the trade (without breaching any applicable confidentiality obligation or duty). The LSTA Guidelines go on to state that other exceptions may be made to the general restriction on trading on borrower confidential information if the exceptions are “consistent with the general philosophy of the Code of Conduct.”

This last statement is interpreted by many loan market participants to permit, in conformity with the LSTA Guidelines, trading between parties with and parties without borrower confidential information, provided that the party possessing such information discloses the fact of its possession to the other party prior to or at the time of the trade, and the other party determines that it wishes to proceed with the trade notwithstanding the information disparity. These parties frequently insert into their LSTA trade confirmations clauses in which one party states that it possesses borrower confidential information and the other party acknowledges the first party’s possession and waives any claims against the first party based on non-disclosure or on the information disparity.⁵ This type of trade is widely thought to be consistent with the philosophy of the Code of Conduct (and of the secondary loan market generally), since all LSTA terms are generally viewed as default provisions only, freely waivable and modifiable by sophisticated parties as long as neither party is acting fraudulently.

THE LMA APPROACH

Like the LSTA Guidelines, the LMA Guidelines state that market participants may trade loans based on syndicate confidential information, but should generally not trade based on borrower confidential information. However, whereas the LSTA Guidelines explicitly contemplate trading between parties that both hold the same borrower confidential information, the LMA Guidelines state specifically that the general rule against trading on borrower confidential information applies even if the counterparty has the same level of information. The LMA Guidelines go on to craft a narrow exception for specific purposes (“to facilitate restructurings and encourage the involvement of key major lenders”) and in specific circumstances (where (i) the party possessing borrower confidential information determines reasonably that the trade is “consistent with appropriate standards of professional integrity and fair dealings,” (ii) the counterparty has, or has the ability to receive, the same borrower confidential information, and (iii) the transaction “will not adversely affect other members of the syndicate / market”). Whether this is the only permissible exception, or whether the word “generally” implies that other exceptions might exist that are not inconsistent with the LMA Guidelines, is not stated.

Neither the LMA Guidelines nor the accompanying press release discusses the rationale for this departure from LSTA practice, with which the LMA has in recent years generally tried to move toward harmonizing. The reference to whether a transaction “adversely affect[s] other members of the syndicate / market,” however, suggests that the LMA may view trading that takes place solely among “insiders” to be antithetical to the health of the loan market, and may be trying to

⁵ These clauses are not necessary as a matter of law or contract: the LSTA standard terms for both par/near par and distressed trades already contain reciprocal waivers of any liability arising from either party’s possession of information not possessed by the other party, which waivers do not distinguish between syndicate confidential and borrower confidential information. The added clauses do, however, document observance of the LSTA Code of Conduct, and therefore may be valuable for reputational purposes.

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promote an ethos in which trading opportunities must be or ought to be shared with the market at large. The LMA Guidelines should also be considered in the context of the market trend toward purchases of loans by borrowers, sponsors, or their respective affiliates or controlled funds, which trend largely occurred after issuance of the LSTA Guidelines and could be seen as increasing the opportunities for insider dealing in syndicated loans to the exclusion of other market participants.

The question of whether a trade could be permissible between a party in possession of borrower confidential information, on the one hand, and a party to which the informational disparity was disclosed prior to the trade and which determined to move forward with the trade anyway, on the other hand, is not addressed in the LMA Guidelines. Although such a trade would not fit within the only explicit exception to the general rule against trading on borrower confidential information, it would help permit insiders to sell (or buy) loans without limiting their universe of potential counterparties to other insiders, and therefore could be seen as consistent with the putative purposes of the LMA Guidelines.

POST-GUIDELINES LMA TRADING FOR PARTIES POSSESSING BORROWER CONFIDENTIAL INFORMATION

Putting aside reputational concerns, because the LMA Guidelines are voluntary rather than legally or contractually required, parties in possession of borrower confidential information need not necessarily change their practices as a result of the guidelines: parties possessing borrower confidential information can continue to trade on LMA standard documentation with other parties in possession of the same information or with parties informed of, and willing to disregard, the informational disparity. Indeed, the LMA standard terms and conditions continue to contain reciprocal waivers of claims in respect of any and all informational disparities. The guidelines may, however, shape market expectations as to what constitutes fair dealing, in which case parties that treat them with flagrant disregard may pay a reputational price.

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