Bank-Debt Trading: Custody Of Nonpublic Information Is Vexing

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The year to come will undoubtedly be one of severe economic challenges. But for the survivors of 2008's financial hurricane, 2009 could also be a year of unprecedented opportunity.

Bank debt and bonds of good-quality companies are trading at historic lows and are becoming part of the staple trading diet of those institutions who remain, either to participate in the enhanced returns available in otherwise flat to down markets, or to establish positions that will one day convert into the equity of the underlying assets. The rules and customs of the distressed debt market are somewhat different from those that govern equity and other securities trading, and it is important to be careful with information to avoid a problem. Increased activity in the market will no doubt be accompanied by increased regulatory focus and litigation.

Insider Trading

• ***When do federal securities rules apply to debt trading?***

In order for the prohibition against insider trading under the federal securities laws to apply, the instruments being traded must be "securities." Bonds are generally considered "securities" covered by the antifraud provisions of the U.S. securities laws. Interests in bank debt, however, typically have been considered not to constitute "securities" for purposes of the securities laws.[1] Because of this, the consensus has been that Rule 10b-5 (restricting insider trading) does not apply to trading in such interests.

However, the assumption that bank debt programs do not qualify as "securities" is not universally held. There are some, including former Securities and Exchange Commission (SEC) Chairman Harvey Pitt, who believe that as more nonbanks trade in the bank debt market, bank debt could be considered a security.[2]

There has been a lack of recent case law directly discussing these issues, and, in the last 10 years, the documentation and process governing the trading of bank debt has tended to converge with that for bonds that are traditional securities.

Therefore, some take the most-conservative approach, assuming that the law may change at any time, and treat trading in bank debt as they would treat trading in securities.

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Even if bank debt is itself not a "security" and the most-conservative approach is not taken, the use of information available as a result of holding bank debt may give rise to insider trading concerns with respect to other securities (such as common stock and bonds). For instance, unlawful insider trading may occur if an investor obtains nonpublic information as a result of being a bank lender or holder of bond or trade claims, and then trades in debt or equity "securities" (either alone or alongside bank debt).

The key issue in such trading is not the purpose of the trade but rather the possession of material nonpublic information which could result in a Rule 10b-5 violation. As such, even if bank debt is not itself considered a "security," it is important to monitor whether nonpublic information is obtained as a holder of bank debt and to understand how any such information impacts trading activities.

In addition, even if bank debt is not a "security," common law theories of wrongdoing nonetheless remain. Trading with a sophisticated counterparty through the use of a so-called "big boy" letter may help to shield the insider from common law fraud liability. However, "big boy" letters may present problems of their own.

MNPI

• ***With what information do investors have to be most careful?***

Insider trading liability arises from purchasing or selling a security based on material nonpublic information (MNPI) about a company.

Under the U.S. securities laws, information is treated as material if there is a substantial likelihood that, considering all of the surrounding facts and circumstances, a reasonable person would consider that information important to an investment decision. Information need not be market moving in order to be material. Insider information can include, but is not limited to, information regarding negotiations leading to financial restructuring, potential mergers and acquisitions or other significant transactions, the making of arrangements preparatory to an exchange or tender offer, projections or other information about business performance that has not yet been publicly released, and extraordinary borrowings or liquidity problems, to cite just a few examples.

Although the law of insider trading is not static, it is generally understood that the law prohibits:

(1) trading by a company's insider (or a temporary insider, such as an investment banker or lawyer) on the basis of MNPI about the company

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as such insider would be breaching a duty to disclose or abstain;

(2) trading by an "outsider" on the basis of MNPI in violation of a duty to keep it confidential or when the information was otherwise misappropriated from any source;

(3) disclosing such MNPI to others in breach of a duty (tipping); or

(4) trading on the basis of MNPI that one knows, or should have known, was acquired (directly or indirectly) through a breach of an insider's duty, a breach of a confidence, or some other breach of duty or misappropriation.

The rules governing insider trading are complex and subtle. Any employees or consultants of the investor should notify the investor's legal department if they think there is even a potential issue of MNPI or any kind of breach of duty. Both compliance and reputational risk may be at stake.

The issue in bank-debt trading is not the purpose of the trade but the possession of material nonpublic information which could result in a Rule 10b-5 violation. As such, even if bank debt is not itself considered a "security," it is important to monitor whether nonpublic information is obtained as a holder of bank debt.

Potential Safeguards

• ***How can investors better protect themselves?***

Information Restrictions. One way that an investor can manage information risk is to either restrict the way it moves across the organization or, alternatively, decide not to receive it in the first place. For instance, to avoid potential consequences of trading debt with nonpublic information, one strategy is to avoid any access to material nonpublic information until the investor has accumulated all of the claims or interests it needs to execute its strategy.

"Public Side" and "Private Side." In addition, generally with respect to bank debt where nonpublic information is frequently made available to syndicate members ("syndicate" level information), the syndicate is managed so that an investor may opt to receive "public side" or "private side" information, generally choosing between the "public side" ability to trade or the "private side" access to information. Both "public side" and "private side" information is generally provided subject to express confidentiality requirements, and the biggest difference between "public side" and "private side" information is the quality of the information received.

Thus, information on the "private side" is usually recognized by the issuer as containing or potentially containing material nonpublic information. (*Note:* This does not mean that "public side" information is always free from material nonpublic information.)

To avoid issues with respect to the informational advantage of being on the "private side," the investor may opt not to take any "private side" information and therefore avoid the restrictions on trading that would thereby arise. Alternatively, if the investor chooses the "private side," the investor should trade only with counterparties with the same type of access to information (even if the counterparty elects not to receive the information itself), should be prepared to accept restrictions against trading in securities of the same issuer, and should consider (depending on the sensitivity of the information that the "private side" lender possesses) requiring counterparties to enter into "big boy" letters. Additionally, if "private side" investors are part of a "steering committee" of bank lenders who receive more sensitive information than, or who are actively involved in negotiating a restructuring that has not yet been disclosed to, the broader "private side" group, such investors should consider even more stringent limits on trading in the bank debt, such as only trading with other "steering committee" members, or not trading at all, while the information disparity exists.

Some investors who recognize that they will be trading in bonds or other securities may opt not to receive even "public side" information, in order to avoid any conceivable issues that may arise from the receipt of such information. For example, it is at least theoretically possible that an issuer might inadvertently place material nonpublic information on the "public side" of a dataroom site instead of the "private side," or that the issuer might propose a loan modification or waiver that is not generally known to the investing public, has not been filed with the SEC, and could be material in the particular circumstances, and that the investor might thereby risk becoming, in this perhaps rare circumstance, "inadvertently" restricted by virtue of signing up for even "public side" information.

In dealing with the public side/private side choice, it is obviously important to limit clearly the authority to accept confidentiality restrictions and sign confidentiality agreements, lest employees and officers informally agree (or be accused of agreeing) to confidentiality arrangements. By limiting authority in this way, the investor will be better prepared to make these choices and will be in a better position to adopt effective compliance measures to control and monitor access to and avoid misuse of material nonpublic information.

Portfolio Companies. Information access is also important in the context of debt of a portfolio company where the investor may be an affiliate and/or may have representatives on the portfolio company's board or access to special information—for example, under a "venture capital operating company" (VCOC) management rights letter.

To help avoid allegations about the use of information, the investor should consider purchasing debt securities of a portfolio company only during a customary window period, such as for a short period after the announcement of quarterly results, and should avoid purchases during sensitive periods (such as near the quarter-end until earnings are announced, or when the portfolio company is seriously pursuing a significant transaction).

Window periods are not a panacea, however, and it will still be necessary before each trade to confirm that the investor is not otherwise in possession of material nonpublic information. Invest-

ing in the distressed debt of one's portfolio company potentially raises other noninformational risks, and so should be undertaken only after careful study.

Trading Walls

Another way to avoid the misuse of information is to employ some form of trading wall around the information within the investor's firm. "Trading walls" (or "ethical walls") have been approved in a number of bankruptcy cases. While trading walls may work for some institutions, for small institutions, a trading wall may not provide a robust defense because (1) trading walls are difficult to implement in small organizations that are more dependent on individuals to serve a variety of functions, and (2) there could be skepticism about whether the trading wall was respected in a small organization.

Both within and outside of the bankruptcy context, it is generally expected that adequate trading walls will consist of certain minimum elements, including: (1) review of employee and proprietary trading; (2) memorialization and documentation of firm procedures; (3) substantive supervision of interdepartmental communication by the firm's compliance department; and (4) procedures concerning proprietary trading when the firm is in possession of material nonpublic information.

Trading walls should also include policies and procedures designed to limit the flow of material nonpublic information to those employees with a need to know, including by way of actual physical separation of personnel working on opposite sides of the wall and restrictions on access to sensitive records or documents. Employees should also receive regular training on the relevant laws and regulations governing use of material nonpublic information and the firm's own policies and procedures in this regard. Of course no single trading wall policy is right for every firm, and firms should tailor policies and procedures to fit their particular businesses and needs.

'Big Boy' Letters

In a big boy letter, the counterparty acknowledges that it is a sophisticated market actor; that the insider may possess material nonpublic information; that it will not sue the insider in connection with the transaction; and that it is relying only on its own research and analysis in entering the transaction. There is sparse case law addressing the efficacy of this type of agreement between private parties. Particularly in view of the general law disfavoring any advance waiver of fraud claims, the effectiveness of big boy letters in shielding insiders from liability cannot be assured. However, many standard form bank debt trading documents contain big boy language.

Much has been written about the use of big boy letters. Investors should seek expert advice before entering into big boy letters, and should weigh carefully whether the situation is an appropriate one. At least in the context of "securities" (but not in the context of standard-form bank debt trading documentation), transactions involving big boy letters have been the subject of significant investigation by the SEC in recent years.

Depending on the circumstances, use of a big boy letter may magnify the SEC's concerns with respect to particular transactions involving insiders. Particularly in the context of debt that may be "securities," consideration should be given when a big boy letter is employed as to whether the letter itself evidences that the parties consider there to be some potential information abuse in the trade.

If a prospective trade is likely to raise questions if scrutinized by the SEC, there may be additional steps that could be taken in advance to enhance the likelihood that the trade will pass muster. This is a case-by-case question that turns on the particular facts with respect to such matters as the nature of the trade, the type of nonpublic information that is involved, the source of the information and the conditions under which it was obtained, and the relative positions of the trading partners. SEC officials have made clear in public comments that they do not view big boy letters as problematic in all contexts; if handled properly, these letters continue to serve a useful purpose in some transactions.

There is an argument that big boy letters should help shield insider purchasers and sellers from liability to their counterparties for common law fraud. Judicial analysis of "big boy" nonreliance agreements may be context-dependent, however, with courts more likely to approve of those agreements indicating a greater level of specificity and pre-agreement exchange of information.[3] In addition, courts have indicated that big boy letters and other waivers of reliance may not be sufficient to defeat common law fraud liability in all circumstances, including, for example, when the waiver or disclaimer involves "facts...peculiarly within the knowledge of the party invoking it."[4]

With respect to federal securities fraud, to the extent that big boy letters are viewed as purporting to waive Rule 10b-5's antifraud requirements, they may run afoul of §29(a). Even if a big boy letter insulates a seller from a common law or federal securities fraud claim by a counterparty who signs the big boy letter, future purchasers of the debt instrument, who were not parties to the initial big boy letter, may attempt to make fraud claims against the original seller or against the original counterparty to the big boy letters.

1. See *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51, 55-56 (2d Cir. 1992) (note in particular that the majority cautioned that "the manner in which participations in [the debt] instrument are used, pooled, or marketed might establish that such participations are securities"). See also *SEC v. Texas Int'l Co.*, 498 F.Supp. 1231 (N.D. Ill. 1980) (unsecured claims, including bank debt, entitled to receive stock pursuant to a confirmed bankruptcy plan of reorganization of insolvent debtor held to constitute "securities"). An eventual holding that bank debt programs are "securities" could lead to other sources of liability under the federal securities laws, including, for example, for failure to file a registration statement under the Securities Act.

2. Christopher O'Leary, "The Loan Market's Biggest Bugaboo," Dec. 5, 2004, IDDmagazine.com.

3. See, e.g., *Lazard Frères & Co. v. Protective Life Ins. Co.*, 108 F.3d 1531, 1542-43 (2d Cir. 1997).

4. *Banque Arabe*, 57 F.3d at 155 (quoting *Stambovsky v. Ackley*, 572 NYS2d 672, 677 (1991)).