



# THE HANDLING OF MATERIAL NONPUBLIC INFORMATION IN THE U.S. AND U.K. LOAN MARKETS

Institutions that maintain loan portfolios through origination or acquisition or engage in other activities that generate credit exposures (“loan market participants” or “LMPs”) very often have access to (or are deemed to have access to) confidential information that may include material nonpublic information<sup>1</sup> (“MNPI”). MNPI is information not generally disseminated to the public that a reasonable investor would likely consider important in making an investment decision (*i.e.*, to buy, sell, or hold securities). Anti-fraud and related provisions of the United States securities laws and equivalent provisions in the U.K. restrict the use of MNPI in connection with securities transactions (or security-based swaps).<sup>2</sup>

- 1 Often referred to as “nonpublic price-sensitive information” in the U.K.
- 2 Rule 10b-5 under the Securities and Exchange Act of 1934 prohibits illegal insider trading, which is generally defined as the participation in securities transactions, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of MNPI regarding the security. In the U.K., the Financial Services and Markets Act 2000 prohibits insider trading, which is similar in nature

Bank loans are not currently characterized as “securities” under the U.S. federal securities laws or their U.K. equivalents. However, as many LMPs also participate in securities transactions, such LMPs must have compliance procedures to ensure that personnel engaged in securities or securities-related transactions do not have access to MNPI regarding borrowers whose securities the LMP may trade.

## MNPI—WHAT LENDERS AND BORROWERS SHOULD KNOW

Information is public if it has been generally disseminated to the public. LMPs, in their role as lenders (or prospective lenders), typically receive nonpublic information, which may or may not contain MNPI, either directly from the borrower or via syndicate information obtained from or on behalf of

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to the U.S. prohibition but which does not require a breach of trust or confidence; trading on the basis of MNPI is sufficient. In addition, in the U.K., there is a criminal offense of insider dealing.

the borrower by the administrative agent and distributed to the lender group.<sup>3</sup> Regardless of whether the nonpublic information contains MNPI, LMPs will typically be bound by confidentiality provisions. This is particularly true in the U.K., where there is an implied duty of confidentiality between a bank and its customer. Examples of nonpublic information that are not MNPI are the Social Security numbers of the directors of a borrowing company or commercially sensitive information that may be of use to a competitor of that company. An example of nonpublic information that could constitute MNPI is the fact that the borrower has approached its lender(s) for a waiver in connection with a pending default for failure to meet certain financial covenants. In a syndicated loan transaction, a lender can usually choose to become a public-side lender or a private-side lender. A private-side lender will have access to MNPI, whereas a public-side lender will generally not have access to MNPI, and consequently, a public-side lender will generally be able to trade the borrower's securities with less risk of running afoul of U.S. federal securities laws or other laws prohibiting "insider trading."

As many LMPs are also active players in the securities market, in an effort to comply with U.S. federal securities laws (and/or their U.K. equivalent), large firms have employed "information walls" to separate parts of a firm engaged in securities sales and trading activities (so-called "public-side" activities) from other parts of the firm such as banking (so-called "private-side" activities) that routinely have access to MNPI. However, for smaller firms with fewer employees who desire to handle both loans and securities, setting up information walls is likely neither feasible nor practical. Therefore, a lender such as a small hedge fund should choose to be a public-side lender if it wants to potentially have the option to trade a borrower's securities while also being a lender to such borrower.

Likewise, borrowers must be sensitive to any information provided to the agent and/or its lenders that could potentially be considered MNPI. Very often a borrower may elect and/or be requested to designate information provided to the agent and/or lenders as public or private (*i.e.*, maintain

both public-side and private-side "books" for each of the public-side and private-side lenders). For example, a private borrower may want to consider having public-side and private-side books in the event that the borrower subsequently wants to pursue an initial public offering ("IPO"). If such a private borrower has not previously segregated information in public-side and private-side books, and the subsequent offering materials do not publicly disclose all the information provided to the lenders, then the lenders that received the MNPI would be tainted with the MNPI and unable to participate in the IPO without the risk of insider-trading liability. Similarly, a publicly listed borrower benefits from maintaining both public- and private-side books because the option of being a public-side lender widens the scope of potential lenders (as such lenders can still act as lenders and trade in the borrower's securities, provided that they maintain certain procedures and information walls to remain compliant with U.S. federal securities laws and their U.K. equivalents as discussed above).

## BIG BOY/SOPHISTICATED INVESTOR LETTERS

In addition to securities laws/insider trading considerations, LMPs must also consider common law fraud and breach of contract and/or confidentiality claims in connection with the possession and use of MNPI with regard to loan sale transactions. In particular, LMPs should be mindful of disparities between information held and information disclosed or represented to counterparties, especially to the extent MNPI is involved. In general, a common law fraud plaintiff will need to prove that (1) the defendant made a material false representation, (2) the defendant intended to defraud the plaintiff thereby (*scienter*), (3) the plaintiff reasonably relied on the representation, and (4) the plaintiff suffered damages as a result of such reliance. A common precaution against common law fraud claims is the use of big boy letters, sometimes called "sophisticated investor" letters in the U.K.

Big boy letters are agreements entered into prior to or at the time of a loan sale transaction in which the buyer and seller acknowledge that each is a sophisticated investor, acknowledge that one party may possess MNPI regarding the borrower, disclaim reliance on each other's disclosures or

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<sup>3</sup> An LMP may also receive MNPI through participation in a creditors' committee.

omissions, and essentially state that each is a “big boy” and is entering into the transaction notwithstanding any information disparity or its potential effect on the value of the transaction. Big boy letters provide some defense against common law fraud as the disclaimers contained therein work to negate reasonable reliance, a typical element of common law fraud. They do not, however, necessarily offer protection against infringements of U.S. federal securities laws.

Likewise, by carefully detailing the extent of the representations and warranties provided in the transaction documents as well as by providing enough detail regarding what information has been or may be excluded (due to its confidential nature or otherwise) such that the other party is “on notice” as to what may not be reasonably relied on (without actually disclosing such information), a participant in the loan market likely provides further protection to itself in regards to potential breach of contract and/or fraud claims. Clearly, the best way to avoid a claim for breach of confidentiality is to not pass on the MNPI, unless (as is common in documentation) the borrower consents to its disclosure on the basis that the recipient enters into an appropriate confidentiality undertaking. Note, however, that in the U.K. context, passing on MNPI, even to an LMP who has signed a confidentiality agreement, may still fall foul of the insider trading prohibitions.<sup>4</sup>

## ABOUT THE LSTA AND THE LMA

The Loan Syndication and Trading Association (the “LSTA”) and the Loan Market Association (the “LMA”), both not-for-profit trade associations representing members involved in the commercial loan markets, have engaged in a wide variety of activities to foster the development of policies and market practices designed to promote equitable market-place principles and to better facilitate transactions in loans and related claims. For example, both the LSTA and the LMA have developed guidelines and several standard documents for use in documenting loan transactions in an effort

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<sup>4</sup> In these circumstances, any MNPI needs to be passed on, not only marked as confidential, but also with a warning that the recipient should not trade in any relevant securities and that the LMP passing on the information should make sure that it is doing so “in the proper course of the exercise of his employment, profession or duties.”

to increase efficiency and uniformity in the loan market. Additionally, both the LSTA and LMA standard documentation contain provisions similar to big boy letters, such as the nonreliance provisions, that afford some protection to LMPs against breach of contract and common law fraud claims and, in the case of the LMA documentation, breach of confidentiality claims.

## CONCLUSION

Although bank loans are not currently characterized as “securities” under the U.S. federal securities laws or their U.K. equivalents, LMPs must consider these issues and maintain adequate internal procedures when MNPI is obtained through participation in the loan market (either directly or indirectly) and securities transactions are involved in other parts of the business. The LSTA and the LMA both encourage LMPs to establish policies and procedures to ensure that people who are engaged in securities sales and trading activities do not have access or exposure to MNPI that may be contained in information communicated to the LMP as a result of its loan positions. Confidentiality and the handling of MNPI with respect to U.S. securities laws and their U.K. equivalents are important considerations for both borrowers and LMPs.

## LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our “Contact Us” form, which can be found at [www.jonesday.com](http://www.jonesday.com).

### **Vanessa G. Spiro**

New York  
+1.212.326.7864  
[vspiro@jonesday.com](mailto:vspiro@jonesday.com)

### **Liz Saxton**

London  
+44.20.7039.5162  
[esaxton@jonesday.com](mailto:esaxton@jonesday.com)

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