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Public, Private or 'Private Private'

Do you have the right information barriers?

PUBLIC, PRIVATE OR 'PRIVATE PRIVATE': DO YOU HAVE THE RIGHT INFORMATION BARRIERS?

As the months stretch out ahead, and the 'new normal' working environments evolve, the financial industry continues to navigate the COVID-19 blighted landscape.

Throughout the lockdown, the Financial Conduct Authority (FCA) and the Securities and Exchange Commission (SEC) have reiterated both their expectation that private information be handled appropriately and their requirement for firms to maintain adequate and appropriate information barriers. Handling of Material Non-Public Information (MNPI) has been a topic that the FCA has returned to repeatedly over the years with **Market Abuse** a staple of the annual business plan. Most recently, the FCA (re)raised this topic in their **Market Watch 63** and the SEC as part of an OCIE **Private Fund Risk Alert** and the **SEC's Division of Enforcement Co-Director's statement** regarding market integrity and increased risk during COVID-19.

As we move into and through the second half of 2020, it is anticipated that deal flow in the private markets space will pick up. With the various state-aid programs coming to an end, or at a minimum winding down, firms may look to fill that potential funding gap with new loan facilities via the direct lending option. Even during the early part of the lockdown, there were signs of bargain hunting in the corporate space, with certain sovereign wealth funds seeing value in companies being affected by COVID-19 and taking substantial stakes.

Consensus at the Alternative Investment Association's (AIMA) Alternative Credit Coucil Global Virtual Summit in June was that economic recovery is expected to be most likely either a "Nike Swoosh" or a "W" in shape. Both these recoveries indicate potential for Private Equity/M&A deals to come to market late in 2020 and early 2021. Of course, these predictions were all based upon a lack of a second wave of COVID-19 and (re)lockdown of states/cities. We also see in the market firms re-positioning existing funds, and in some cases targeted fund raising, to take advantage of market dislocations and to invest in different parts of the capital structure.

Be it new facilities, refinancings or brand-new deals, each of these have the potential, if not the certainty, of introducing "private" information into the work environment. Ahead of what could be a busy second half of 2020 for the credit space, there is possibly no time better to revisit what should be considered as "private" information and how that can get a little grey and nuanced in the private markets sector.

THE REGULATORY BIT: EU MARKET ABUSE REGULATIONS – "INSIDE INFORMATION"

The European Market Abuse Regulation (MAR) defines "inside information" as follows:

> *"information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments" (Article 7.1(a) of Regulation (EU) no 596/2014))*

As with all European regulations some of the language is tied into definitions from other regulations and "financial instruments" is defined within the original Markets in Financial Instruments Directive (MiFID).

Encompassing all publicly traded instruments (shares, bonds, derivatives, etc.), the concept of trading on "inside information" is clear; If you trade in the public financial instruments of a company and you are in possession of information about that company that the rest of the market does not have, you are committing market abuse.

The nuances and complications of inside information start to appear when moving away from publicly traded financial instruments and into the private markets. Although MAR is somewhat irrelevant – though dealing in price sensitive or confidential information can obviously lead to regulatory and civil sanctions – the Senior Managers and Certification Regime (**SM&CR**) does, in a somewhat abstract manner, have a part to play. Indeed, all firms should be cognisant of the FCA's **Conduct rules**. Conduct rule 1 states that all employees of FCA regulated entities must "act with integrity" and rule 5 states "You must observe proper standards of market conduct." It could be argued that acting on material information not widely known to that market segment, would be reason to question an individual's integrity.

THE PUBLIC VS PRIVATE DEBATE: INSIDE INFORMATION VS CONFIDENTIAL INFORMATION VS PRICE SENSITIVE INFORMATION

For the avoidance of doubt, publicly traded financial instruments are not public because they are issued by publicly listed companies. Rather they are considered public as they have been admitted to trade on a European Union (EU) or other trading venue. Much of the High Yield Debt Market is issued by private companies looking to diversify their capital structure and, though over-the-counder trades, the bonds are listed on an exchange somewhere in the world. So, when in possession of what is genuinely considered inside information, confirmation should be sought regarding the existence of any publicly traded financial instruments issued by that company and those securities should be placed immediately on a restricted list.

When evaluating a broadly syndicated loan, a potential lender may be given the choice to designate themselves "private" or "public"

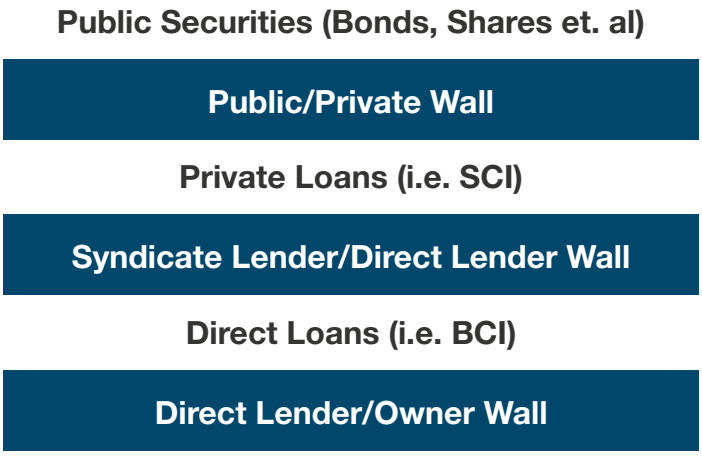
- **Private:** Where the lender acknowledges they are prohibited from participating in any public issuance as they are in receipt, and will be in receipt, of private information
- **Public:** Means the lender acknowledges they do not have the same level of information as the "private" lenders, but are allowed to participate in any public issuance.

All of which is a way to indicate that there is an expectation of certain market conduct in the private loan market.

The Loan Market Association (LMA), Europe's leading industry body for the private loan market, has set out designations for the differing information that is made available to lenders when participating in a syndicated loan. "Syndicate Confidential Information" (SCI) is information provided to lenders in accordance with the stipulations and covenants of the facilities agreement. This ensures that all members of the syndication are on an equal information footing and covers the information provided under the "private" designation described previously.

Beyond the syndicated loan market, adding another level of private information, is the direct lending market. Direct lenders, generally speaking, maintain closer links to borrowers and obtain greater levels of information than that provided to the typical syndicated market. The LMA designates this information as "Borrower Confidential Information" (BCI) which should be considered as being more private than the private information received in a syndication. Therefore, if engaging in a Direct Lending loan, for instance refinancing an existing term loan or syndicated loan, the prospective lender should be considered to be in a privileged position relative to other market participants. In addition to having any public securities on a restricted list, other outstanding loan positions should also be added to a restricted list to avoid potential market conduct issues.

Information level simplified diagram



OPERATING WITH DIFFERING LEVELS OF PRIVATE INFORMATION

The previous examples are based on a firm maintaining no information barriers and deciding to participate in only one part of the information barrier structure. Firms can of course erect information walls between various investment teams and divisions to allow for different investment strategies. If a wall is built, then that wall must be "manned." Understanding the sharing of information between various teams, and sometimes more importantly the direction of travel of that information can be key.

For larger organisations with both Private Equity and Private Credit businesses, this balance of information can be troublesome. Ensuring that the lending business does not receive more information than a wider syndication, even if inadvertently, can require substantial compliance oversight and monitoring of conversations and interactions. This can be further stretched when the sharing of ideas and general information on specific sectors is encouraged between the various teams.

Some firms have utilised the concept of a "trading window" to allow trading in certain securities. Based upon the idea that directors and board members of a firm will not be in receipt of any material information at certain points in time, these periods of information parity can provide employees a window of time to invest in their own companies. Where investment firms hold either board seats or directorships in portfolio companies, this can be a way to allow further investments (and divestments) in the various securities and loans of that company. Recent enforcement action in the U.S. by the SEC however has seen this trading window concept come under scrutiny.

HOW ELSE COULD FIRMS COME INTO CONTACT WITH "CONFIDENTIAL" OR "PRICE-SENSITIVE" INFORMATION?

Market soundings are a well-established process under MAR, and the private markets have their own version of this which is commonly, though not exclusively, referred to as a wall crossing. Where Market soundings refer to enquiries regarding the (potential) issuance of publicly traded financial instruments, a "wall crossing" is a discussion regarding a potential refinancing or offering in the private loan space, thus providing BCI to entities possibly only holding SCI. Should the firm wish to be "Wall Crossed" then the loans that would potentially be refinanced, or affected in one form or another, should be placed on a restricted list or an appropriate information wall erected.

Another possibility is when a public company is looking to dispose of a business unit. If the public market is not aware of this potential disposal, knowledge that something could potentially occur would be considered "non-public" information. Importantly however, thought must be given about the materiality of that knowledge and if wider knowledge of the potential disposal would cause a move in the price of publicly traded financial instruments issued by that public company. Only if a price move would be anticipated is the information, while non-public, truly MNPI and the name then be placed on a restricted list. Certainly, the conservative approach in such a scenario is to place the name on a restricted list until an assessment of materiality can be gauged.

ACA RECOMMENDATIONS

With the "work from home" orders in place, the physical protections that firms have put in place in the office environment and refined over the years (separate printers, locked doors, etc.) are no longer applicable. Likewise, working from the (relative) comfort of home can lead to a relaxing of awareness around what should be considered private or price sensitive information as the focus is on assessing the creditworthiness of economic soundness of a firm. Communication in the remote environment has also become more important than ever, perhaps at the cost of being cognisant of the exact details of what is being discussed.

So, as the world works towards pulling itself out of the **COVID-19** economic malaise, now is an important time for compliance officers to review their information barriers and identify the various levels of information that may exist across the firm and the teams accessing that information at any given point in time. The Private Fund Risk Alert cited advisers not addressing risks posed by their employees who periodically had access to MNPI about issuers of public securities as a common deficiency. Circulating a restricted list to all employees may be something to revisit, though this places more emphasis on the compliance team performing adequate monitoring of not only trades within the firm but also personal account dealing. The Private Fund Risk Alert also listed as a common deficiency that advisers did not enforce trading restrictions for securities on the adviser's restricted list in personal accounts.

We would certainly recommend a review of all levels of information within your organisation and confirmation of the adequacy and soundness of information walls that have been put in place. It may also be necessary to start building additional safeguards. If your firm is planning for a longer work from home mandate, consider safeguards to address risks around information transmitted over personal Wi-Fi and information that may be inadvertently seen or overheard by other adults that may be in an employee's household.

HOW WE HELP

ACA works with hundreds of credit and private market clients globally. We can help you assess your information flow and risks and design your information barrier framework and controls around provision of such information, creating a structure that works for your business model.

We also provide policies and procedures for employee compliance as well as **personal account dealing surveillance technology** for identifying potential conflicts of interest, insider trading, market abuse, and other misconduct. We also conduct mock regulatory examinations, policy and procedure reviews, and various surveillance reviews and analysis to help our clients identify potential issues and areas for improvement.

In addition, we provide a range of **market abuse compliance solutions** to help you meet your regulatory responsibilities.

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ABOUT ACA COMPLIANCE GROUP

ACA Compliance Group (ACA) is a leading global provider of governance, risk, and compliance advisory services and technology solutions. We partner with our clients to help them mitigate the regulatory, operational, and reputational risks associated with their business functions.

We support our clients to enhance and improve their compliance and risk management programs through the use of consulting, managed services, technology, and education.

Our clients include leading investment advisers, private fund managers, commodity trading advisors, investment companies, broker-dealers, and domestic and international banks. ACA is based in New York City and the Washington, D.C. area, and has offices in London and other U.S. cities.

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