

European Working Group

Joint Market Practices Forum

**Statement of Principles and Recommendations Regarding the
Handling of Material Nonpublic Information by Credit Market
Participants**

Exposure Draft of European Supplement dated 12 January 2005



ISDA

LIBA



Comments from any source are invited. Interested parties should send their comments via e-mail to eujmpf@isda.org no later than Friday, 11 February 2005.

Statement of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participants: European Supplement

Table of Contents

Executive Summary	1
Preliminary Comments	2
Background to the October 2003 Statement of Principles and this Supplement.....	2
Objectives of this Supplement	3
Definitions.....	4
Scope of this Supplement.....	4
October 2003 Statement of Principles: Summary of Recommendations	6
Supplement to the October 2003 Statement of Principles	8
I. EU Market Abuse Directive Requires Member States to Impose Prohibitions on "Insider Dealing" With Which All Credit Market Participants Must Comply	9
A. Market Abuse Directive.....	9
1. Definition of Nonpublic Price-Sensitive Information.....	9
2. Obligation to Disclose or Abstain.....	11
3. Publicly-Traded Securities.....	12
4. Application to Derivative Transactions.....	12
5. Exercise of Options.....	13
6. Whose Rules Apply?.....	14
B. Other Potential Restrictions on the Use of Information.....	15
II. Information Controls and Related Policies and Procedures for Handling Nonpublic Price-Sensitive Information May Prevent Credit Market Participants from Entering into any Security-Based Transactions on the Basis of such Information	16

III. A Firm's Information Controls and Related Policies and Procedures Should be Tailored to the Nature and Scope of its Business Activities and Operations.....	17
IV. Credit Market Participants Should Consider Including Certain Key Elements in Their Information Controls and Related Policies and Procedures.....	17
V. Credit Market Participants Should Consider Addressing the Following Special Issues that May be Posed for Their Credit Portfolio Management Activities Depending on Whether Those Activities are Conducted on the "Private Side" or the "Public Side" of an Information Wall.....	17
 Annexes	
I. Differing National Implementation of the EU Market Abuse Directive.....	19
II. Differences Between US and EU Regulation of Insider Dealing.....	21
The European Working Group.....	23

Acknowledgements and Process

The European Supplement to the October 2003 'Statement of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participants' of the Joint Market Practices Forum (the "October 2003 Statement of Principles") was developed and refined by members of the European Working Group in meetings and discussions in October to December 2004. Participants in those meetings and discussions included senior business and legal professionals from a broad range of the participating Associations' member firms based in Europe, including credit portfolio risk management personnel. As a consequence of these meetings, the European Working Group gained valuable input and perspectives on the issues that are addressed in the European Supplement.

In addition to the time, effort and professional expertise supplied by the members and staffs of the participating Associations who were directly involved in this project, the European Working Group wishes to acknowledge the invaluable contribution made by Clifford Chance LLP, special outside counsel for this project. The European Working Group also wishes to acknowledge the contribution of the Loan Syndications and Trading Association to the October 2003 Statement of Principles and its kind permission to make use of the material in that Statement.

The October 2003 Statement of Principles is available on the websites of each of the members of the Joint Forum and the European Working Group or by following this link: [October 2003 Statement of Principles](#).

This Supplement and its discussion of applicable legal requirements do not constitute and are not intended to provide legal or other professional advice. Credit market participants should consult with their own legal counsel regarding the application of insider dealing and other laws, regulations and rules to their own credit portfolio management activities, policies and procedures. In particular, those laws, regulations and rules may impose on credit market participants requirements not reflected in the recommendations set out in the October 2003 Statement of Principles or this Supplement.

Statement of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participants: European Supplement

Executive Summary

This paper supplements the October 2003 'Statement of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participants' of the Joint Market Practices Forum, which sets out principles and recommendations regarding the handling and use of material nonpublic information by financial institutions that use securities and securities-based swaps to manage and hedge their credit portfolios.

The October 2003 Statement of Principles does not address non-US activities conducted in accordance with rules applicable in other jurisdictions. Accordingly, the European Working Group has produced this Supplement to articulate how members of the participating Associations can apply the recommendations set out in the October 2003 Statement of Principles where their credit portfolio management activities are subject to the laws of EU Member States, in particular, having regard to the requirements of the Market Abuse Directive which is currently in the process of being implemented across the EU.

This Supplement concludes that those recommendations should generally also be appropriate, *mutatis mutandis*, for credit market participants subject to the laws of EU Member States with respect to the dissemination and use of nonpublic price-sensitive information as defined in the Directive.

The recommendations should assist those credit market participants to ensure that nonpublic price-sensitive information obtained by them in the ordinary course of their lending or other relationships with a company is not inappropriately shared with or used by other business units or personnel within the same institution that transact in the securities and credit derivative markets. Credit market participants should consider including certain key elements in their information controls, tailoring these approaches to a firm's particular business activities, and should take into account the special considerations and related guidance set out in the October 2003 Statement of Principles based on whether a firm has chosen to organise its credit portfolio management activities on the "private side" or the "public side" of an information wall. Individuals on the private side are typically involved in loan origination or advisory activities and, through the normal course of business, may have access to nonpublic price-sensitive information. Those on the public side are typically involved in securities sales and trading activities and should not have access to nonpublic price-sensitive information.

However, credit market participants must take into account the fact that this area of law is in a process of evolution across the EU. Member States are currently in the process of implementing the Market Abuse Directive and, even after the full implementation of the Directive, there will continue to be differences between the national laws of EU Member States. Credit market participants will need to take these and other differences into account in designing their policies and procedures.

Preliminary Comments

Background to the October 2003 Statement of Principles and this Supplement. In recent years, firms that originate or acquire loans or otherwise have credit exposures to particular companies have turned increasingly to the securities and credit derivatives markets to help manage risk. This development has generated efficiencies for both lenders and borrowers and has created new investment opportunities for other parties seeking to take credit risk positions. At the same time, the fact that credit market participants – in the ordinary course of their business and as a natural consequence of their lending or other relationships with a company – may receive material nonpublic information with respect to the company raised concerns regarding the potential use of such information in the securities and credit derivatives markets.

This paper builds on and supplements work carried out in 2003 by the Joint Market Practices Forum (the "Joint Forum"), a collaborative effort of The Bond Market Association, the International Association of Credit Portfolio Managers, the International Swaps and Derivatives Association and the Loan Syndications and Trading Association. The Joint Forum was formed to address issues of common concern to member firms of its constituent associations who transact in the credit derivatives and corporate debt securities markets in the United States.

The first initiative of the Joint Forum was to articulate certain principles and recommendations regarding the handling and use of material nonpublic information by credit market participants that maintain loan portfolios (or engage in other activities that generate credit exposures) and, in that connection, enter into transactions in securities and security-based swaps (including certain credit derivatives). The Joint Forum published the resulting 'Statement of Principles and Recommendations Regarding the Handling of Material Nonpublic Information by Credit Market Participants' in October 2003.

The October 2003 Statement of Principles is limited in its scope and, among other things, does not address non-US activities conducted in accordance with rules applicable in other jurisdictions. Accordingly, The Bond Market Association, the International Association of Credit Portfolio Managers, the International Swaps and Derivatives Association, the Loan Market Association and the London Investment Banking Association (the "participating Associations") formed the European Working Group (the "European Working Group") to build on and supplement the work of the Joint Forum. The objective of the European Working Group was to articulate how the principles and recommendations set out in the October 2003 Statement of Principles can be applied by members of the participating Associations who transact in the credit derivatives and corporate debt securities markets in the European Union (the "EU"), taking into account the legal and regulatory frameworks and market structures that exist there and, in particular, the requirements of the Market

Abuse Directive (the "Directive")¹ which is in the process of being implemented across the EU.

Objectives of this Supplement. The Market Abuse Directive requires all EU Member States to maintain insider dealing laws that restrict the use of nonpublic price-sensitive information when entering into transactions in publicly-traded securities and security-related derivatives, in a similar way to the corresponding anti-fraud provisions of the US federal securities laws. Moreover, economic and reputational damage can result from the mere appearance of inappropriate or unethical conduct by market participants. Rumours of such misconduct have the potential to erode confidence in the integrity – and thus the liquidity and efficiency – of the securities and credit derivatives markets on which the participating Associations' members rely in conducting their business.

In the light of those considerations, this Supplement, like the October 2003 Statement of Principles, has a number of important objectives, including to:

- identify important business and legal issues that can arise in connection with the handling and use of nonpublic price-sensitive information in the context of credit market participants' credit portfolio management activities;
- articulate recommendations designed to (i) assist credit market participants in evaluating (and, if necessary, supplementing) their policies and procedures for handling nonpublic price-sensitive information in the context of their credit portfolio management activities and (ii) facilitate compliance with applicable laws and sound business practices;
- reassure market participants that the innovative risk management techniques and instruments that have emerged within the securities and credit derivatives markets are used responsibly and will continue to contribute to the stability and efficiency of the financial markets; and
- promote fair and competitive markets in which inappropriate use of nonpublic price-sensitive information is not tolerated, and in which lenders may engage in effective credit portfolio management activities that facilitate borrower access to more liquid and efficient sources of credit.

Many credit market participants in the EU already have in place sophisticated and extensive policies and procedures for handling nonpublic price-sensitive information generally and in connection with their credit portfolio management activities in particular, in many cases based on the principles and recommendations set out in the October 2003 Statement of Principles. The analysis and recommendations articulated below, however, will be useful to European and other credit market participants designing and implementing policies and

¹ Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse). The Directive replaces Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing.

procedures in the context of an extension of their credit portfolio management activities or reviewing their policies and procedures on an on-going basis.

Definitions. For the purposes of this Supplement, the following terms have the following meanings:

- "*Credit market participants*" are - as in the October 2003 Statement of Principles - institutions that (i) maintain loan portfolios (through origination, acquisition or both) or engage in other activities that generate credit exposures, (ii) may receive nonpublic price-sensitive information in connection with these credit exposures or other activities and (iii) engage in credit portfolio management activities.
- "*Credit portfolio management activities*" are - as in the October 2003 Statement of Principles - the credit risk and other portfolio management activities undertaken by credit market participants to address the credit, liquidity and related risks associated with their loan portfolios or other credit exposures. These activities may be designed to achieve a reduction in credit exposure to a particular counterparty or, under appropriate circumstances, an increase in credit exposure to that counterparty.
- "*Publicly-traded security*" means a financial instrument admitted to trading on a regulated market in a Member State, or for which a request for such admission has been made, within the meaning of the Directive.
- "*Security-related derivative*" means a financial instrument whose value depends on a publicly-traded security within the meaning of the Directive.
- "*Security-based transactions*" means purchases or sales of publicly-traded securities or security-related derivatives that are effected in furtherance of a firm's credit portfolio management activities. The term "security-based transactions" does not include transactions in instruments that are not publicly-traded securities or security-related derivatives, including in general loan originations, acquisitions and dispositions (although such transactions may also be effected in furtherance of a firm's credit portfolio management activities).²

Scope of this Supplement. This Supplement is limited in its scope and addresses only the security-based transactions of credit market participants. It is not intended to address other securities dealing activities of credit market participants unrelated to their credit portfolio management activities.

² Because this Supplement, like the October 2003 Statement of Principles, focuses on credit portfolio management activities, the definition of "security-based transaction" is limited to transactions in securities or security-related derivatives that are effected as part of such activities. As noted herein, however, the European Working Group recognises that the restrictions on insider dealing discussed in this Supplement are potentially applicable to other purchases or sales of securities or security-related derivatives.

In preparing this Supplement, moreover, the European Working Group has focused on those activities that are governed by the securities laws and regulations of EU Member States. Accordingly, this Supplement does not address activities conducted in accordance with rules applicable in other jurisdictions or transactions involving instruments or obligations that are not subject to those laws (such as loan sales).

In addition, while this Supplement discusses the applicable requirements of the Directive and gives illustrative examples of relevant laws and regulations in selected Member States, it is not intended to be a comprehensive description of national law in every Member State. In particular, many Member States have not yet fully implemented the Directive (even though the deadline for national implementation was 12 October 2004). In any event, the Directive does not fully harmonise the insider dealing laws of Member States, so that even after the full implementation of the Directive, there will continue to be differences between national laws in the EU.

The European Working Group shares the belief of the Joint Forum that the fundamental objectives underlying this initiative, including the promotion of fair and efficient markets, are of potentially broader application than the intended scope of the October 2003 Statement of Principles and this Supplement. Credit market participants are therefore encouraged to consider the extent to which the principles and recommendations discussed herein may be relevant to securities activities beyond their scope.

* * *

October 2003 Statement of Principles: Summary of Recommendations

I. Information Controls and Related Policies and Procedures for Handling Nonpublic Price-Sensitive Information May Prevent Credit Market Participants from Entering into any Security-Based Transactions on the Basis of such Information

Credit market participants should establish information controls and related policies and procedures appropriate to their own business activities and organizational structures to control, limit and monitor the inappropriate dissemination and use of information. Such information controls may include (i) establishing a "wall" to prevent access to material nonpublic information by persons having responsibility for the execution of, or the decision to execute, security-based transactions, (ii) "need-to-know" policies to limit the dissemination of information within the firm and (iii) restricted lists, watch lists and dealing reviews.

II. A Firm's Information Controls and Related Policies and Procedures Should be Tailored to the Nature and Scope of its Business Activities and Operations

Each firm's policies and procedures for handling material nonpublic information should be tailored to the unique structure and circumstances of its credit portfolio management activities.

III. Credit Market Participants Should Consider Including Certain Key Elements in Their Information Controls and Related Policies and Procedures

Credit market participants should consider incorporating the following elements in their information controls:

- written and formalised policies and procedures;
- an independent compliance function;
- functional and physical separation of departments;
- procedures for monitoring and handling communications across information walls;
- recordkeeping arrangements, including records of certain communications across information walls;
- restricted lists, watch lists and dealing reviews;
- education and training requirements;
- review and approval of policies and procedures by senior management;
- coordination with the firm's other procedures.

IV. Credit Market Participants Should Consider Addressing the Following Special Issues that May be Posed for Their Credit Portfolio Management Activities Depending on Whether Those Activities are Conducted on the "Private Side" or the "Public Side" of an Information Wall

Where credit market participants maintain information walls, they should determine whether their credit portfolio management activities will be located on the "private side" of the wall, where individuals may have access to material nonpublic information, or the "public side" of the wall, where individuals do not.

Where credit portfolio management activities are conducted on the private side of an information wall, the firm's procedures should be designed to prevent portfolio management personnel with potential access to such material nonpublic information from making investment decisions relating to security-based transactions based on that information. These procedures may include establishing a "wall within a wall" and procedures for communications between the private and the public sides in relation to security-based transactions.

Where credit portfolio management activities are conducted on the public side of an information wall, the firm should define the scope of the activities to be conducted there having regard to the fact that information transferred from the private side to the public side (such as information regarding changes to internal ratings or exposure limits or the existence or amount of exposures) may sometimes convey or signal material nonpublic information and have procedures for determining whether information to be communicated to the public side is material or nonpublic and for handling such communications.

The above is only a summary of the recommendations set out in the October 2003 Statement of Principles. For the full details of those recommendations, refer to the text of the October 2003 Statement of Principles.

* * *

Supplement to the October 2003 Statement of Principles

I. EU Market Abuse Directive Requires Member States to Impose Prohibitions on "Insider Dealing" With Which All Credit Market Participants Must Comply

The Directive requires all Member States to impose prohibitions on "insider dealing", i.e. certain types of securities dealing on the basis of nonpublic price-sensitive information.

The Directive also makes a number of significant changes to the EU requirements of Member States regarding the regulation of insider dealing. In particular, it requires Member States to extend the scope of insider dealing legislation to cover over-the-counter dealings in publicly-traded securities and security-related derivatives,³ extends the definition of nonpublic price-sensitive information and reduces the extent to which enforcement authorities will have to prove an alleged offender's subjective knowledge of the nature or source of the information that is known to him. In addition, it requires Member States to give a single national administrative authority broad powers to investigate and take action against insider dealing and to facilitate enforcement by ensuring that administrative sanctions (not just criminal penalties) can be imposed on those engaging in insider dealing.

This section provides an overview of the requirements of the Directive, as well as commenting on illustrative examples of other related national laws that are potentially applicable to the credit portfolio management activities of credit market participants.

However, the European Working Group recognises that it is the national laws implementing the Directive and other national requirements that will principally form the foundation for the policies and procedures of credit market participants regarding the handling of nonpublic price-sensitive information and that this area of law is in a process of evolution across the EU. As already noted, Member States are currently in the process of implementing the Directive and, even after the full implementation of the Directive, there will continue to be differences between national laws in the EU (see Annex I).

Credit market participants will need to take account of these differences in national law when considering the recommendations set out in this Supplement and may need to adapt their policies and procedures to reflect these. Accordingly, credit market participants should consult with their own legal counsel regarding the application of insider dealing and other laws, regulations and rules to their own credit portfolio management activities, policies and procedures. In particular, those laws, regulations and rules may impose on credit market participants requirements not reflected in the recommendations set out in the October 2003 Statement of Principles or this Supplement. This Supplement and its discussion of applicable

³ The Directive will result in a significant extension of the insider dealing laws of some Member States, such as Germany and Luxembourg, whose laws previously did not address dealings in over-the-counter derivatives, even if the derivatives were based on underlying securities which were admitted to trading on a regulated market.

legal requirements do not constitute and are not intended to provide legal or other professional advice.

A. Market Abuse Directive. The Directive requires Member States to prohibit a person who possesses nonpublic price-sensitive information from using that information by acquiring or disposing of, or attempting to acquire or dispose of, for his own account or for the account of a third party, either directly or indirectly, publicly-traded securities or security-related derivatives to which that information relates.⁴

1. Definition of Nonpublic Price-Sensitive Information. In order for the restrictions in the Directive to apply, information must be non-public price-sensitive information.⁵ This is information relating (directly or indirectly) to one or more issuers of publicly-traded securities or to one or more publicly-traded securities where the information is of a "precise" nature, as well as being "price-sensitive" and "nonpublic".

- *"Precise"*. Information will be deemed to be of a precise nature if it indicates a set of circumstances which exists or may reasonably be expected to come into existence (or an event which has occurred or may reasonably be expected to occur) and if it is specific enough to enable a conclusion to be drawn as to its possible effect on prices of publicly-traded securities or security-related derivatives.⁶ For example, information about a possible forthcoming corporate transaction may be "precise" if the transaction can reasonably be expected to occur and if a conclusion can be drawn as to its possible effect on prices.
- *"Price-Sensitive"*. Information will meet this criterion under the Directive if it would be likely, were it to be made public, to have a significant effect on the prices of publicly-traded securities or security-related derivatives. However, information will be treated as price-sensitive for these purposes if it is "information a reasonable investor would be likely to use as part of the basis for his investment decisions".⁷ Whether this is the case must be assessed by reference to the information available at the time, taking into account the anticipated impact of the information in light of the totality of the relevant

⁴ Article 2 of the Directive.

⁵ Article 1(1) of the Directive uses the term "inside information", which also covers certain nonpublic information related to derivatives on commodities. The European Commission has adopted two implementing measures under the Directive which elaborate on the definition of inside information contained in the Directive: (i) Commission Directive 2003/124/EC of 22 December 2003 implementing the Directive as regards the definition and public disclosure of inside information and the definition of market manipulation; and (ii) Commission Directive 2004/72/EC of 29 April 2004 implementing the Directive as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions.

⁶ Article 1(1) of Commission Directive 2003/124/EC (see supra note 5).

⁷ Article 1(2) of Commission Directive 2003/124/EC (see supra note 5).

issuer's activities, the reliability of the source of information and any other market variables.⁸ This suggests that it is not necessary for the enforcement authority to show that the public announcement of the information would actually be likely to cause a significant price movement. However, in evaluating whether any particular item of nonpublic information is nonpublic price-sensitive information, it will be necessary to evaluate the relevance of that particular item of information to the hypothetical reasonable investor against the background of the total mix of information already in the public domain.

- "*Nonpublic*". The Directive does not elaborate on when Member States should treat information as "public" for these purposes, except to indicate that research and estimates developed from publicly available data should not be regarded as nonpublic price-sensitive information.⁹

The use of certain types of information relevant to conducting credit portfolio management activities may not be subject to the restrictions imposed under the Directive because the information is not precise, price-sensitive or nonpublic - e.g., information that is generated by the credit market participant from publicly available sources or which is already in the public domain. However, information about the amount of a borrower's utilisation of loan facility or the terms, purpose or sometimes even the existence of a loan may constitute nonpublic price-sensitive information where the information has not been publicly disclosed by the borrower or is not otherwise available from public sources, such as public websites or specialist periodicals.

The Directive does require Member States to impose a continuing obligation on an issuer of publicly-traded securities to disclose to the public all otherwise nonpublic price-sensitive information that directly concerns the issuer.¹⁰ However, it also allows the issuer to delay the public disclosure of that information where there are legitimate reasons for doing so.¹¹ Thus, a credit market participant cannot necessarily conclude from the absence of disclosure by the issuer that information is not specific or price-sensitive information.

⁸ Recital 1 to Commission Directive 2003/124/EC (see supra note 5).

⁹ Recital 31 to the Directive. For example, under proposed UK implementation of the Directive, information would be regarded as public if it has been disclosed under exchange or market rules, is a matter of public record, is generally available through the Internet, some other publication or otherwise or can be obtained by legitimate observation. In addition, information will still be regarded as public even if it is only available to someone with above average financial resources, expertise or competence, is only publicly available outside the UK or is only available on the payment of a fee. See "UK Implementation of the EU Market Abuse Directive (Directive 2003/6/EC) - A Consultation Document" published by HM Treasury and the Financial Services Authority (June 2004).

¹⁰ Article 6(1) of the Directive.

¹¹ Article 6(2) of the Directive.

2. Obligation to Disclose or Abstain. The Directive essentially requires Member States to prohibit certain persons who are aware of nonpublic price-sensitive information relating to a company or its publicly-traded securities from using that information to deal in those securities or their related derivatives unless the information has been disclosed to the public. In effect, if such persons are not able to make the disclosure or are unwilling to do so (e.g., because of duties of confidentiality owed to the company), they must abstain from dealing – the obligation that is described as the duty to "disclose or abstain".

- *Insiders.* Under the Directive, the obligation not to deal applies to traditional insiders i.e. those who possess nonpublic price-sensitive information by virtue of their membership of the administrative, management or supervisory bodies of an issuer or by virtue of their holding of capital of the issuer.¹² However, it also applies to anyone who possesses such information by virtue of having access to such information through the exercise of his employment, profession or duties (as well as anyone else who possesses such information and who knows or ought to know that it is nonpublic price-sensitive information), in each case regardless of the person's relationship with the issuer, the source of the information and whether or not they owe duties of trust or confidence with respect to the information.¹³

Under the Directive, it is not necessary to show that traditional insiders and those who possess information by virtue of having access to such information through the exercise of their employment, profession or duties actually knew or ought to have known that the information they possess is nonpublic price-sensitive information. In designing their policies and procedures, credit market participants will need to take into account that it will not normally be a defence to assert that they did not know and could not have known that the information on which they acted in entering into a security-based transaction was nonpublic price-sensitive information.

- *Tipping.* The Directive also requires Member States to prohibit a person who is subject to the duty to disclose or abstain from (i) disclosing nonpublic price-sensitive information to any other person unless such disclosure is made in the normal course of the exercise of his employment, profession or duties (regardless of whether it is likely that the recipient will deal on the basis of the information) or (ii) recommending or inducing another person, on the basis of nonpublic price-sensitive information, to acquire or dispose of publicly-traded

¹² Article 2(1)(a) and (b) of the Directive.

¹³ Articles 2(1)(d) and 4 of the Directive.

securities or security-related derivatives to which the information relates (regardless of whether he discloses the information to the "tippee").¹⁴

3. Publicly-Traded Securities. The prohibitions on insider dealing in the Directive apply with respect to dealings in publicly-traded securities, i.e. financial instruments admitted to dealing on a regulated market in a Member State or for which a request for such admission has been made.¹⁵

4. Application to Derivative Transactions. The prohibitions on insider dealing in the Directive also apply with respect to dealings in any security-related derivative i.e. a "financial instrument whose value depends on" a publicly-traded security.¹⁶ These prohibitions apply regardless of whether the security-related derivative is itself listed or traded on a regulated market and therefore cover transactions in over-the-counter derivatives.

The Directive's definition of "financial instrument" covers a range of different instruments which includes options to acquire or dispose of transferable securities, and equivalent cash-settled instruments.¹⁷ The Directive does not further elaborate on when the value of a financial instrument "depends on" a publicly-traded security. However, although each transaction must be analysed individually in the light of these definitions, as a general matter, it seems that credit default swaps may qualify as security-related derivatives for these purposes, at least where the deliverable obligation(s) under the swap are or may include publicly-traded securities or where the swap is cash-settled by reference to the price of one or more reference obligation(s) which are publicly-traded securities (as would be the case for many credit default swaps traded in the market).¹⁸

5. Exercise of Options. The Directive requires Member States to prohibit a person "acquiring" or "disposing" of a publicly-traded security or a security-related derivative on the basis of nonpublic price-sensitive information. In relation to a security-related derivative, this is likely to cover the execution, termination (prior to

¹⁴ Article 3 of the Directive.

¹⁵ Article 9 of the Directive. The Directive defines "regulated market" by reference to the definition of that term in Article 1(1) of Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (the "ISD"). This will be replaced by the corresponding definition in Article 4(1)(14) of Directive 2004/39/EC of the European Parliament and the Council of 21 April 2004 on markets in financial instruments (the "MFID"). A list of the regulated markets under the ISD is available from the European Commission's website at http://europa.eu.int/comm/internal_market/securities/isd/index_en.htm.

¹⁶ Article 9 of the Directive.

¹⁷ Article 1(3) of the Directive.

¹⁸ In this respect, it seems that the Directive is broader in scope than some pre-existing regimes under national law. For example, the UK Financial Services Authority had indicated that the majority of credit derivatives used to buy credit protection would be likely to fall outside the scope of the UK's pre-existing market abuse regime regulating the misuse of information. See the Financial Services Authority's Market Watch Issue No. 10 - July 2004.

its scheduled maturity date), assignment, exchange or similar transfer or conveyance of, or extinguishing of rights or obligations under, the security-related derivative.¹⁹

The prohibitions are also likely to cover certain subsequent actions taken by a credit market participant with respect to a credit default swap. For example, the prohibition may cover a firm's discretionary exercise of the right to serve a credit event notice upon the occurrence of a credit event where this will lead to the acquisition or disposal of a publicly-traded security. Accordingly, the firm's procedures should permit it to conclude that those subsequent actions are not taken on the basis of nonpublic price-sensitive information.

6. Whose Rules Apply? The Directive provides that every Member State shall apply its national rules implementing the insider dealing provisions of the Directive to actions carried out on its territory concerning publicly-traded securities admitted to trading in any Member State (or the subject of a request for such admission).²⁰ For example, a credit market participant in Germany would still need to comply with the German law implementing the Directive when entering into a credit default swap even though the deliverable obligations under the swap are securities admitted to trading in other Member States.

However, the Directive also provides that a Member State shall apply its national rules, on an extraterritorial basis, to actions carried out in other Member States or in countries outside the EU where those actions concern publicly-traded securities admitted to a regulated market situated or operating within its own territory.²¹ Accordingly, in the example given above, the German credit market participant would, when entering into the credit default swap, also need to comply with the laws implementing the Directive in the Member States where the deliverable obligations are admitted to trading, even if the transaction has no other connection with those Member States.

Given that the insider dealing laws of a number of Member States go beyond the minimum requirements of the Directive, credit market participants need to take into account the possibility that a number of differing and possibly conflicting rules will apply to their credit portfolio management activities, especially where their security-based transactions relate to publicly-traded securities admitted to trading on a number of regulated markets in different Member States.

¹⁹ For example, proposed amendments to the existing UK market abuse regime would make clear that the prohibitions also apply to agreements to acquire or dispose of the relevant instrument and entering into and bringing to an end the contract creating it. See UK consultation paper, supra note 9.

²⁰ Article 10(b) of the Directive.

²¹ Article 10(a) of the Directive.

B. Other Potential Restrictions on the Use of Information. Credit market participants should consider other restrictions potentially applicable to their use of nonpublic information, including those discussed below.

- **Other Securities Regulations.** Other provisions of national securities laws may impose restrictions on the use of nonpublic price-sensitive information, for example during takeovers.²²
- **Conduct of Business Rules.** Conduct of business rules applicable to credit market participants regulated as banks or investment firms under the laws of a Member State may restrict the extent to which the firm may use nonpublic information to enter into transactions in securities or derivatives even in circumstances where the use of the information does not amount to insider dealing because the securities or derivatives in question are not publicly-traded securities or security-related derivatives within the scope of relevant insider dealing laws.²³ In addition, as discussed below, those rules may require a regulated firm to create information walls to prevent the misuse of nonpublic price-sensitive information and to manage conflicts of interest.
- **Duties of Confidentiality.** Credit market participants may be subject to duties of confidentiality which restrict the extent to which they can disclose or use nonpublic information. These duties may arise in a number of ways. In some countries there are general statutory provisions which impose secrecy or equivalent obligations on banks or other regulated firms (in some cases, backed by criminal penalties).²⁴ In others, duties of confidentiality usually arise as a contractual matter under general terms of business or by virtue of implied terms in contracts.²⁵ In any event, duties of confidentiality may arise by virtue of confidentiality legends or notices on information memoranda and other documents as well as by express provisions in transactional and other documents. In addition, under the Directive itself, issuers must not disclose nonpublic price-sensitive information to third parties, without making an immediate public

²² For example, in the UK, the City Code on Takeovers and Mergers restricts pre-announcement dealings in the target company's securities (and derivatives on those securities) by anyone other than the bidder if they have confidential price-sensitive information concerning a contemplated bid.

²³ For example, in the UK, the Financial Services Authority's Principles for Business require regulated firms to "observe proper standards of market conduct". Similarly, in the Netherlands, the Further Regulation on the Market Conduct Supervision of the Securities Trade 2002 requires regulated firms to act in the best interests of their clients (even their professional clients) and to refrain from acts that "could damage the efficient, fair and orderly operation of the securities markets or investors' confidence in the efficient, fair and orderly operation of the securities markets".

²⁴ For example, France and Luxembourg impose criminal penalties for breach of banking secrecy obligations and, in Italy, the bankers' duty of confidentiality arises under data protection laws which also protect corporate information.

²⁵ For example, English law generally implies a duty of confidentiality as a term of the banker-customer relationship. In the Netherlands, duties of confidentiality arise under general terms of business.

announcement, unless the person receiving the information owes a duty of confidentiality with respect to the information.²⁶

These duties may apply to information which is not nonpublic price-sensitive information for the purposes of insider dealing laws. For example, a credit market participant may breach these duties by entering into a transaction the terms of which disclose the existence or terms of a loan, or information as to the amount of a borrower's utilisation of a loan facility, where that information is not in the public domain, even if that information is not price-sensitive information. Also, a credit market participant may breach these duties by disclosing details of a borrower's default under a loan - as a credit event - to a counterparty under a credit default swap where that information is also not in the public domain.

In some cases, the terms of the loan or other underlying transaction may permit disclosure of information of this kind to persons who are party to a credit derivative transaction referencing the particular transaction.²⁷ However, where this is not the case, the credit market participant may need to consider the extent to which it can enter into transactions which specifically reference that underlying transaction or which might, in practice, require it to disclose defaults or other confidential information as credit events.

Duties of confidentiality may also prevent a credit market participant using information for dealing purposes, even if that use does not entail disclosure of the information. For example, in some cases, the express terms of contracts may restrict a credit market participant using information otherwise than for the purposes of evaluating a particular transaction.

- **Lists of Insiders.** The Directive requires Member States to impose duties on issuers, or persons acting on their behalf or for their account, to maintain records of those persons working for them who have access to inside information concerning the issuer.²⁸ Although there is some continued uncertainty about how Member States should implement this requirement of the Directive, these duties are likely to extend to banks which assume an advisory role for a borrower which is an issuer of publicly-traded securities. However, these duties should not apply to a credit market participant merely because it lends money to an issuer (whether as a participant in a syndicate or otherwise).

²⁶ Article 6(3) of the Directive.

²⁷ For example, the Loan Market Association's standard form primary market documentation permits disclosure of information to anyone with whom the lender of record enters (or may potentially enter) into another transaction under which payments are to be made by reference to the loan agreement or any obligor under it.

²⁸ Article 6(3) of the Directive and Article 5 of Commission Directive 2004/72/EC (see supra note 5).

II. Information Controls and Related Policies and Procedures for Handling Nonpublic Price-Sensitive Information May Prevent Credit Market Participants from Entering into any Security-Based Transactions on the Basis of such Information

The October 2003 Statement of Principles recommends that credit market participants should establish information controls and related policies and procedures appropriate to their own business activities and organizational structures to control, limit and monitor the inappropriate dissemination and use of information (see the summary of the recommendations set out above). These recommendations should also be appropriate, *mutatis mutandis*, for credit market participants subject to the laws of EU Member States with respect to the dissemination and use of nonpublic price-sensitive information.

The European Working Group notes that information controls and related policies and procedures have been recognised by a number of EU regulators as appropriate mechanisms for handling the receipt of nonpublic price-sensitive information in accordance with applicable legal restrictions.

- The Directive itself envisages that firms can contribute to market integrity through the use of preventative measures such as information walls ("Chinese walls"), provided that they are subject to adequate enforcement control, such as by the designation of compliance officers and periodic checks by independent auditors.²⁹ In any event, the Directive requires Member States to prohibit the "use" of nonpublic price-sensitive information to enter into security-based transactions.³⁰ This indicates that the Directive is not intended to prevent a legal entity engaging in security-based transactions solely because some members of its staff possess nonpublic price-sensitive information, so long as appropriate information walls separate those staff members who possess that information from those who make or participate in decisions relating to security-based transactions.
- In some cases, existing national rules already specifically require regulated firms to establish information walls to prevent the dissemination of nonpublic price-sensitive information or to manage conflicts of interest.³¹ The Directive on Markets in Financial

²⁹ Recital 24 to the Directive.

³⁰ Article 2(1) of the Directive.

³¹ For example, in the Netherlands, the Further Regulation on the Market Conduct Supervision of the Securities Trade 2002 requires regulated securities firms which combine activities that give rise to conflicts of interest or could damage confidence in the efficient operation of the securities markets (because price-sensitive or other confidential market information may become known in other parts of the business of the securities firm) to take all measures necessary to ensure that they are able to operate independently with regard to the combined activities and to prevent the dissemination of price-sensitive or confidential market information.

Instruments will also impose similar requirements.³² In some cases, existing national rules also create specific safe harbours under insider dealing rules where, as a result of the implementation of information walls, the individuals within a firm responsible for making the decision to engage the security-based transaction were not aware of the nonpublic price-sensitive information held by other individuals within the firm.

III. A Firm's Information Controls and Related Policies and Procedures Should be Tailored to the Nature and Scope of its Business Activities and Operations

The October 2003 Statement of Principles recommends that each firm's information-handling policies and procedures should be tailored to the unique structure and circumstances of its credit portfolio management activities. These recommendations should also be appropriate, *mutatis mutandis*, for credit market participants subject to the laws of EU Member States with respect to the dissemination and use of nonpublic price-sensitive information.

IV. Credit Market Participants Should Consider Including Certain Key Elements in Their Information Controls and Related Policies and Procedures

The October 2003 Statement of Principles recommends that, in designing or reviewing their information controls with respect to the handling of material nonpublic information, credit market participants should consider including a number of specific elements set out in the October 2003 Statement of Principles. These recommendations should also be appropriate, *mutatis mutandis*, for credit market participants subject to the laws of EU Member States in relation to the design or review of information controls with respect to the handling of nonpublic price-sensitive information.

V. Credit Market Participants Should Consider Addressing the Following Special Issues that May be Posed for Their Credit Portfolio Management Activities Depending on Whether Those Activities are Conducted on the "Private Side" or the "Public Side" of an Information Wall

Finally, the October 2003 Statement of Principles makes a number of recommendations with respect to credit market participants which establish information walls, depending on whether the personnel responsible in whole or in part for credit portfolio management activities are located on the "private" side or the "public" side of an information wall. These recommendations should also be appropriate, *mutatis mutandis*, for credit market participants subject to the laws of EU Member States with respect to the handling of nonpublic price-sensitive information.

However, a credit market participant conducting credit portfolio management activities from the private side of an information wall would need to give specific consideration to the discussion in the October 2003 Statement of Principles regarding the use of the "written

³² Articles 13(3) and 18 of the MFID (see supra note 15). The deadline for national implementation of the MFID is 30 April 2006.

trading plan" safe harbour available under US law. The Directive does not contain any equivalent safe harbour, although - where there is such a plan - it may be possible to establish that the credit market participant did not "use" the nonpublic price-sensitive information in question when entering into subsequent transactions in accordance with the plan.

* * *

Annex I: Differing National Implementation of the EU Market Abuse Directive

The Market Abuse Directive will bring about greater harmonisation of the law on insider dealing in Member States. However, the following discussion illustrates some areas where, even after the full implementation of the Directive, there are likely to continue to be differences between national laws, as Member States take differing approaches to its implementation. Credit market participants will need to take these and other differences into account in designing their policies and procedures.

Multiple Regimes. In order to overcome some of the problems that there had been in taking criminal proceedings against those suspected of insider dealing, the Directive requires Member States to impose administrative sanctions against the persons responsible for a contravention of its prohibitions on insider dealing. However, some Member States, such as France, Spain and the UK, are likely to retain separate, differently defined criminal offences as well (and the UK is also likely to retain a separate, differently defined regime providing for the imposition of administrative sanctions on those who misuse nonpublic relevant information concerning issuers of securities). In contrast, some Member States, such as Germany, Italy and the Netherlands, have (or, in the case of Italy will have, following its proposed implementation) a single definition of insider dealing, punishable by either administrative or criminal penalties depending on the circumstances.

Scope of Insider Dealing Laws. Member States may also choose to extend their insider dealing laws so that they apply to dealings relating to securities which are not publicly-traded securities within the scope of the Directive. For example, the insider dealing laws of Germany and the UK apply to dealings in securities admitted to trading on domestic organised markets that are not regulated markets within the meaning of the Directive, such as, in Germany, the regulated unofficial market (*freiverkehr*) and, in the UK, the London Stock Exchange's proposed new exchange regulated market for eurobonds. The French authorities are considering the extension of their new administrative regime to Euronext's proposed Alternext market, even though this may not be a regulated market within the meaning of the Directive. Both the Belgian and Spanish laws are capable of applying to dealings in securities admitted to multilateral trading facilities. In the UK, the criminal law applies to dealings in securities listed on specific non-EU markets (NASDAQ and SWX Swiss Exchange), while the Dutch law and the French criminal law can apply to dealings in securities listed on any EU or non-EU stock exchange.

Some Member States may also extend their insider dealing laws to cover dealings in a broader range of financial instruments than required by the Directive. For example, the proposed implementations of the Directive in France and the UK are likely to cover a somewhat broader range of over-the-counter derivatives than required by the Directive.

On the other hand, Italy's current plans are to bring its insider dealing laws more closely into line with the Directive by restricting them to dealings in publicly traded securities and related derivatives; the existing Italian criminal law is significantly broader as it applies to

dealings in any security or derivative, whether or not listed or admitted to trading (or related to a security listed or admitted to trading) on a regulated or organised market.

Restrictions on the Use of Information. In some Member States, the prohibition on insider dealing is expressed so as to apply to someone who deals while in possession of nonpublic price-sensitive information. For example, this is the case under the Spanish rules and the Belgian administrative provisions on insider dealing. In contrast, other Member States' laws more closely reflect the provisions of the Directive, which only requires Member States to prohibit a person from making "use" of nonpublic price-sensitive information in deciding to enter into a relevant transaction. For example, this is the case in France, Germany and the UK and the proposals in Italy and the Netherlands are to bring their insider dealing rules more into line with these provisions of the Directive.

Regulators do generally recognise that a firm will not be liable for insider dealing where appropriate information walls ensure that those responsible for entering into security-based transactions do not have access to relevant non-public price-sensitive information. In some cases, such as in the Netherlands and the UK, the existing rules include explicit defences or safe harbours to that effect. In addition, although the Directive does not contain any specific safe harbour equivalent to that available under US law for market participants following a written trading plan, where a market participant has such a plan it may be possible to establish that the credit market participant did not "use" any nonpublic price-sensitive information in question when entering into subsequent transactions in accordance with the plan, at least in those Member States which have followed the Directive provisions in this respect.

Application of the Directive. More generally, there are likely to be continued differences in the way in which Member States apply the Directive. For example, a recital to the Directive indicates that, where a market maker or other entity authorised to act as counterparty has inside information and confines itself to pursuing its legitimate business of buying and selling financial instruments, this should not in itself be deemed to constitute the use of nonpublic price-sensitive information. Some Member States, like the UK, may apply this in cases where a market participant has information arising out of its trading activities, but it is possible that others could apply it in other ways. The Committee of European Securities Regulators will have a role in coordinating the way in which Member States implement the Directive with a view to achieving a common approach.

* * *

Annex II: Differences Between US and EU Regulation of Insider Dealing

The work carried out by the European Working Group has highlighted a number of areas where there may be differences between the way in which the US and the EU regulate insider dealing. Credit market participants subject to both US law and the laws of EU Member States should take these and other differences into account in designing their policies and procedures.

US Law Not Limited to Publicly-Traded Securities. The US law on insider dealing applies to dealings in any securities, whether or not listed or traded on any organised market. In contrast, the prohibitions in the Directive are restricted to dealings in publicly-traded securities (and related security-based derivatives). However, many fixed income securities that would, in the United States, be sold in private placements without a listing on a stock exchange (for example, under Rule 144A under the U.S. Securities Act of 1933) would, in Europe, be listed on a stock exchange to meet investors' legal investment restrictions even if the distribution takes the form of a private placement. Therefore, in practice, the prohibitions envisaged by the Directive are likely to cover dealings in many of the securities issued by regular issuers in the euromarkets which may be used in credit portfolio management activities or which may be deliverable obligations under credit derivative transactions. In addition, some Member States may maintain insider dealing laws with a broader scope than required by the Directive.

US Has Different Definition of Material Nonpublic Information. The October 2003 Statement of Principles indicates that information would be "material" for the purposes of US securities laws in circumstances where: (i) there is a "substantial likelihood" that a "reasonable investor" would consider the information important in making an investment decision; (ii) the disclosure of the information would be "viewed by the reasonable investor as having significantly altered the 'total mix' of information made available"; or (iii) the disclosure of the information is "reasonably certain to have a substantial effect on the market price of the security". The definition in the Directive of "price-sensitive information" is similar to the last limb of this definition, although it only requires that it be "likely" that the public disclosure of the information would have a significant effect on prices. Moreover, the implementing measures under the Directive import a test which is similar to that in the first limb of the US definition and which may, in practice, subsume the second limb of the US definition as well. In addition, under the Directive, in most cases, there will be no need for the enforcement agency to show that a credit market participant knew that the information used by it was nonpublic price-sensitive information if in fact it was.

US Law Applies Where Duty of Trust and Confidence. The October 2003 Statement of Principles indicates that a credit market participant that possesses material nonpublic information may not be subject to the restrictions of the US law on insider dealing where it does not owe a duty of trust or confidence with respect to the information in question. In contrast, the Directive's prohibitions would apply to a credit market participant that has nonpublic price-sensitive information, regardless of whether it is subject to any such duty.

Extent of Public Disclosures. The practical impact of the prohibitions of the use of nonpublic price-sensitive information will depend in part on the extent of public disclosures made by issuers. Issuers subject only to EU standards of disclosure may, in practice, disclose less information concerning their affairs than corresponding US issuers registered under the Securities Exchange Act of 1934 (for example, because of the quarterly reporting obligations that apply under US law). In particular, US registered issuers routinely disclose more information about their financing arrangements - e.g., they commonly publicly disclose copies of credit agreements as part of their filings under US securities laws.

Therefore, information which ordinarily might be considered to be in the public domain in the US (and thus not material nonpublic information) in relation to US issuers may not be in the public domain in relation to EU issuers; it may thus still constitute nonpublic price-sensitive information the use of which is subject to restrictions under EU insider dealing laws. In addition, where a company makes less extensive public disclosures about its affairs, there is an increased risk that an individual item of nonpublic information will be considered to be price-sensitive information. This is particularly relevant to those credit market participants whose personnel responsible for credit portfolio management activities are located on the public side of an information wall. It may increase the practical difficulty for the firm of ensuring that it can provide those personnel with sufficient information to enable them to perform their job effectively, without inappropriately communicating nonpublic price-sensitive information to them.

US Law Specifically Recognises Written Trading Plans. The October 2003 Statement of Principles indicates that there is a safe harbour under US law pursuant to which a person will be deemed not to have entered into a transaction on the basis of material nonpublic information, even if the person is in possession of material nonpublic information at the time of the transaction, as long as prior to becoming aware of the information the person adopted a plan for the transaction effectively eliminating discretion as to whether to execute the transaction. As noted elsewhere in this Supplement, there is no equivalent specific safe harbour in the Directive. This is particularly relevant to those credit market participants whose personnel responsible for credit portfolio management activities are located on the private side of an information wall. However, as noted in the October 2003 Statement of Principles, credit market participants may elect not to follow the "written trading plan" approach for a variety of reasons, including their desire to retain maximum flexibility to determine when and whether to exercise their credit protection rights.

* * *

European Working Group

The Bond Market Association is an international trade association with offices in London, New York and Washington representing approximately 200 securities firms and banks that underwrite, distribute and trade in fixed income securities. More information about the Association is available on its website, www.bondmarkets.com.

The International Association of Credit Portfolio Managers, Inc. ("IACPM") is a not-for-profit corporation created in November 2001. The mission of the IACPM is: (1) to further the understanding and management of credit exposures by providing a forum for member institutions to exchange ideas on topics of practical interest; (2) to cooperate with other organizations on issues of mutual concern in order to promote common interests; (3) to inform members of legislative and administrative developments affecting participants in credit portfolio management and to represent its members before legislative and administrative bodies and international and quasi-public institutions, boards, and other bodies; and (4) to foster research on credit portfolio management. There are currently 42 member institutions in the IACPM. These institutions are based in ten countries and include the world's largest wholesale commercial banks and investment banks. Information about the IACPM can be found at www.iacpm.org.

The International Swaps and Derivatives Association ("ISDA") is the global trade association representing leading participants in the privately negotiated derivatives industry, a business which includes interest rate, currency, commodity, credit and equity swaps, as well as related products such as caps, collars, floors and swaptions. ISDA was chartered in 1985, and today numbers over 600 member institutions from 46 countries on six continents. These members include most of the world's major institutions who deal in and leading end-users of privately negotiated derivatives, as well as associated service providers and consultants. For more information, please visit www.isda.org.

The Loan Market Association (the "LMA") was founded in December 1996 with the aim of encouraging liquidity and efficiency in both the primary and secondary loan markets by promoting market depth and transparency, as well as by developing standard forms of documentation and codes of market practice. Banks, law firms and other market practitioners were invited to join, and the membership currently stands at over 200, representing 23 countries. Since inception, the LMA has expanded its activities to include all aspects of the primary and secondary syndicated loan markets, and is generally perceived as the authoritative voice of the syndicated loan market in Europe vis à vis banks, borrowers, regulators and other affected parties. For more information, please visit www.lma.eu.com.

The London Investment Banking Association is the principal trade association in the United Kingdom for firms active in the investment banking and securities industry. The Association represents the interests of its Members on all aspects of their business and promotes their views to the authorities in the United Kingdom, the European Union and elsewhere. For more information, please visit www.liba.org.uk.

