Linklaters

Hard Rules for Soft Soundings?

Given the current slowing global economy and restricted capital markets, the practice of "soft sounding" investors in advance of any capital raising or refinancing is more prevalent than usual. "Soft sounding" is the term given to discussions with investors (which take place prior to announcement of an actual transaction) to gauge their interest in a potential structure or transaction and its potential pricing. Given the timing of such discussions, one attendant risk is that non-public, price-sensitive or inside information may be disclosed to the investor.

The recent investigation and penalty imposed by the FSA on an investment manager for market abuse serves as a timely reminder of the need for internal procedures to avoid misuse of information in the credit markets. In particular, there needs to be clarity as to whether or not an investor is being made an insider or is being "wall-crossed". This case is discussed in further detail below.

This note summarises some of the legal concerns involved in the practice of "soft sounding" investors and provides some practical guidelines for consideration.

Legal Context

Market abuse is defined in Section 118 of FSMA as inappropriate behaviour relating to qualifying investments on a prescribed market[1]. One category of inappropriate behaviour is where an insider discloses inside information to another person otherwise than in the proper course of the exercise of his employment, profession or duties (Improper disclosure - Section 118(3)). Another such category is dealing by an insider in qualifying investments, on the basis of inside information possessed by him relating to those investments (Insider dealing - Section 118(2))[2].

Therefore it is essential to ascertain whether or not the information being divulged constitutes inside information.

"Inside information" is information which is:

- of a **precise** kind
- **not generally available**
- **relates, directly or indirectly**, to a company with securities trading on a "prescribed market"; and
- would, if generally available, have a "**significant effect**" on the price of securities.

Obvious examples of inside information include information that there is about to be a change in the issuer's credit rating or as to the content of an imminent results announcement or trading update, or information about potential M&A transactions by the issuer. However, more subtle examples of inside information may include the fact that an issuer is contemplating issuing new securities or buying back a significant amount of existing securities.

Financial advisers risk breaching market abuse rules if they disclose information without a legitimate reason for doing so. However, exploring a potential new transaction or refinancing

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1 We assume for the purposes of this note that the securities being referenced constitute qualifying investments on a prescribed market.

2 It should be noted that similar offences of insider dealing and improper disclosure exist under the Criminal Justice Act 1993. This note, however, concentrates on the civil offences set out in FSMA.

would constitute a legitimate reason for disclosure of inside information in the proper course of employment/profession.

MAR 1.4.5 lists the factors which the FSA will take into account for this determination and requires that the disclosure is accompanied by the imposition of confidentiality requirements upon the person to whom the disclosure is made. Therefore, it is clear that (i) the recipient must be made aware that they may be given potentially inside information and (ii) reasonable steps must be taken to protect the on-going confidentiality of the information.

FSA issues penalty

In September of this year the FSA issued a financial penalty and a 12 month suspension from carrying out regulated activities on Steven Harrison, a portfolio manager. Mr Harrison received inside information in respect of a proposed refinancing of bonds issued by Rhodia SA (Rhodia) from a bank, who contacted Mr Harrison to try to gauge appropriate pricing in respect of the refinancing. Mr Harrison placed a buy order in respect of those bonds, with knowledge of the fact that Rhodia would be tendering for them at a premium to the market price. He subsequently sold the bonds into the tender offer at a profit.

The FSA found that Mr Harrison was provided with precise information, which was not generally available, concerning the proposed refinancing, including the proposed size, timing and price of the tender. The FSA also took the view that if the information had been generally available it would have been likely to have a significant effect on the price of the bonds being refinanced. Therefore the information constituted inside information, and that this information was at least a material influence on the decision to deal.

Click here to view the final notice issued by the FSA.

Lessons to be learned

No criticism was made of the bank involved who, prior to giving the information, asked Mr Harrison whether he wished to receive restricted information in connection with an upcoming financing. However, the phone lines in this case had not been taped, which made the determinations of fact more difficult. Further, no criticism was made of the firm for whom Mr Harrison was a portfolio manager at the time. This case is a reminder of the importance of controlling inside information and of having clear cut wall-crossing policies in place on both the buy and the sell side.

Under section 123(2) of FSMA, the FSA may not impose a penalty on a person if there are reasonable grounds for it to be satisfied that:

(i) the person believed, on reasonable grounds, that his behaviour did not fall within the market abuse regime or

(ii) the person took all reasonable precautions and exercised all due diligence to avoid behaving in a way which breached the market abuse regime.

Both defences suggest that a careful paper trail, evidencing discussion, consideration and advice from legal and compliance advisers, may be beneficial in establishing a defence if it subsequently becomes necessary to resort to one.

Certain guidelines

Avoiding disclosure of inside information

Speaking to an investor on a "no-names" basis, but by reference to an industry sector or other group, may be sufficient to avoid disclosing inside information. This will be the case if the investor could not, from the information it received, distinguish the issuer from other companies within the same industry sector or group. The group should be as broad as possible and the information should be sufficiently imprecise and general (see definition of "inside information" above.) It should be noted however, that difficult market conditions may make this practice a hazardous one where it might be obvious to investors who the issuer from within a certain group is.

Disclosing inside information and wall-crossing

If the discussion does require identification of the particular issuer and disclosure of potentially inside information, then financial advisers will be best protected by having a specific wall-crossing policy in place which takes account of the following principles.

- The investor must be told, prior to the issuer's identity being revealed, that (i) the information he is to receive may be inside information, (ii) he will be restricted from trading or acting on that information and (iii) by agreeing to receive the information he is also agreeing to, and must, keep the information confidential. Many compliance departments will have a particular script to follow to impart these conditions. If the investor does not agree to these conditions (including the requirement to keep the information confidential), the conversation should be terminated.
- It is advisable to send a confidential email following the conversation setting out that the investor received inside information and agreed to become an insider, keep the information confidential and be restricted from trading on the basis of the information. Some financial institutions may also require a written non-disclosure agreement (NDA), especially if the transaction will have a long gestation period. Where possible it is good practice to obtain these.
- Internal records should be kept of when and what has been disclosed, by and to whom, and the reason why disclosure was necessary. Insider lists should be updated as necessary.
- Discussions should be conducted on a recorded telephone line (if possible), for evidential purposes.

Following the above guidelines will not only help to keep financial advisers within the market abuse rules, but will also ensure that investors are clear as to their obligations and dealings when doing business with that particular firm (which will be good from a reputational perspective).

It is worth noting that, depending on the type of inside information being transmitted (e.g. if it relates to the industry more generally as well as to a particular issuer), the investor may be subject to broader restrictions than simply in respect of the particular issuer contemplating the transaction. This may have further limitations on the investor's business and should be given careful consideration.

When are you no longer an insider?

Once the transaction is launched or another public announcement has been made in respect of it, that information will be generally available and will no longer constitute inside information[3]. At that point the conditions and restrictions attached to the information will fall away. (If a NDA is in place, the terms of this should specify that it terminates automatically in these circumstances.)

The position is more difficult where the transaction does not proceed and no public announcement "cleansing" the market is made. If the transaction is postponed and is likely to be resurrected in the near future, then in the absence of an issuer announcement, the confidentiality obligations and dealing restrictions are likely to continue to apply. If the transaction is cancelled and there is no intention to resurrect it in the future, then in the absence of an issuer announcement the position is less clear - if there is a NDA is in place, the terms of it should be carefully considered. Financial advisers should carefully consider whether, when telling investors that a transaction will not proceed, they also give a reason for this, which may itself amount to further inside information. In such a case, the principles set out above should be followed. In the case of any doubt, the bank's compliance department must be consulted.

Conclusion

The Harrison case is a timely reminder of the importance of conducting soft soundings in compliance with market abuse rules regulating the control of inside information. It is also interesting that this is a case from the debt markets, as previous cases have almost exclusively been in the equity markets. In the current climate, the risk of information leakage should also be borne in mind given (i) the FSA's focus on this in its recent market watch pronouncements and (ii) the fact that rumours of a need to raise capital can have dramatic effects on securities' prices due to current investor nervousness. We recommend that all firms review their wall-crossing approach and in particular consider whether it is appropriate to wall-cross investors in particular cases or whether discussions can legitimately be had on a generic basis. This is particularly so where a large number of investors might be approached (for example on a joint-lead transaction) and/or the lead-time to a transaction might be long, such that the bank's confidence that it can maintain confidentiality might be lower. A consistent approach by the banks on joint-lead transactions will also help to reduce such risks.

Finally, while the cases in this area have so far focused on the recipients of information, there could also be liability for the disclosers if either proper procedures are unclear or not followed, or if in the circumstances it was not reasonable to believe that confidentiality could be maintained.

[3] Note that if the inside information originally passed to the investor goes beyond the fact of the proposed transaction, a comparison will need to be made of the inside information transmitted and the information that has been made public, in order to ascertain whether the investor is fully "cleansed" or not.