

EFC SUB-COMMITTEE ON EU SOVEREIGN DEBT MARKETS
COLLECTIVE ACTION CLAUSE
EXPLANATORY NOTE

1. Introduction

On 28 November 2010, euro area finance ministers announced a number of policy measures intended to safeguard financial stability in the euro area, among them the mandatory inclusion of standardised collective action clauses (“CACs”) in all new euro area government securities beginning in July 2013. This commitment was later confirmed by the Heads of Government and States of euro area Member States at their meeting on 11 March 2011 and by the European Council at the summit held on 24-25 March 2011. All of the euro area Member States have also agreed to take all action necessary to implement the standardised CAC.

The decisions taken by the euro area authorities contemplate that the standardised CAC to be introduced in July 2013 will:

- be based on those commonly used in the UK and US after the G10 report on CACs of 26 September 2002;
- be included in all new euro area government securities with a maturity of more than one year;
- have uniformity of application and provide a level playing field for all euro area Member States;
- allow a proposed modification of a euro area government’s securities to be made binding on all holders of the affected securities if approved by holders of the requisite principal amount of the affected securities;
- facilitate the agreement of private-sector creditors to the possible modification of euro area government debt securities that contain a standardised CAC; and
- not increase the probability of a euro area issuer defaulting on or modifying its debt securities containing a standardised CAC.

The EFC Sub-Committee on EU Sovereign Debt Markets (the “Committee”) was tasked with producing the standardised CAC called for by the euro area authorities. Following an extensive review process, the Committee has approved the enclosed draft CAC.

The draft CAC will be the subject of the public consultation process described in the accompanying note from the Chair of the Committee. Subject to the outcome of that process, the Committee contemplates that the standardised CAC will form a part of the definitive documentation for all covered euro area government debt securities beginning in July 2013, including all domestic and international bonds, irrespective of their governing law, issued by euro area governments. While euro area governments will be allowed to reopen (‘tap’) existing

securities issuances after July 2013 to the extent necessary to ensure adequate liquidity, the Committee envisions that issuers will avail themselves of this opportunity only in limited cases.

2. Scope of Application

The standardised CAC will be mandatory for all new bonds, notes and other debt securities with an original stated maturity of more than one year issued by national euro area governments from July 2013, regardless of whether the debt security is listed on a securities exchange, is actively traded or was privately placed.

The Committee considered making the standardised CAC also mandatory for debt securities issued by regional and local euro area governments, for actively traded syndicated loans contracted by covered borrowers and for debt securities guaranteed by covered guarantors. The Committee ultimately concluded not to make the standardised CAC mandatory for any of these governmental obligations because, among other things, they at present represent only a very small portion of total euro area governmental indebtedness. The Committee's decision does not, however, preclude the voluntary introduction of a CAC in any euro area governmental obligation.

For ease of reading, any euro area government debt security that must contain a standardised CAC is generally referred to as a bond in this Explanatory Note.

3. Summary of Key Provisions

The draft CAC distinguishes between three types of modification:

- a reserved matter modification, involving the modification of a bond's most important terms and conditions and requiring the highest level of bondholder consent; and
- a non-reserved matter modification, involving the modification of a bond's less important terms and conditions and requiring a lower level of bondholder consent.

Under the draft CAC, a modification may be proposed in relation to either a single series of bonds or more than one series of bonds – a so-called cross-series modification. Different approval thresholds apply to single-series and cross-series modifications. In all events, a proposed modification will require the issuer's own consent, and may also require the consent of other interested parties (for example, a fiscal or paying agent) under other provisions of an issuer's definitive documentation. Interested-party approvals are not addressed in the standardised CAC.

A. Single-Series Approval Thresholds

The affirmative vote of holders of not less than 66 2/3% of the outstanding principal amount of the bonds represented at a meeting of bondholders at which a quorum is present is required to modify a reserved matter in relation to a single series of bonds. A reserved-matter modification may also be approved by a written resolution signed by holders of 66 2/3% of the principal amount of all outstanding bonds.

The required approval threshold in the case of a non-reserved matter modification is a simple majority of the outstanding principal amount of the affected series of bonds represented at a duly called meeting of bondholders or a simple majority of the principal amount of all outstanding bonds if the modification is approved by a written resolution.

A leading international securities trade association has previously expressed its support for a model CAC that allowed a reserved-matter modification to be approved by 66 2/3% of the outstanding principal amount of all affected bonds, and a non-reserved-matter modification to be approved by more than 50% of the outstanding principal amount of bonds represented at a quorate meeting. The Committee believes it appropriate that a reserved-matter modification may also be approved by at least 66 2/3% of the outstanding principal amount of bonds represented at a duly called meeting of bondholders. Even though bondholder meetings are rarely, if ever, attended by all holders, the likely disproportionate representation at a meeting of investors opposed to a proposed modification will in practice, in the Committee's view, often make it as difficult to obtain the same nominal level of approval at a meeting of bondholders as of all outstanding bonds.

B. Cross-Series Approval Thresholds

The draft CAC provides that more than one series of bonds may be modified in relation to a reserved matter with the affirmative vote of holders of at least:

- 66 2/3% of the outstanding principal amount of all the affected series of bonds (taken in the aggregate) represented at duly called meetings of the affected bondholders; and
- 50% of the outstanding principal amount of each affected series of bonds (taken individually) represented at a duly called meeting of the bondholders of each such series.

The same approval thresholds are also required in the case of a cross-series modification approved by a written resolution, though, as with the modification of a single series of bonds, the approval thresholds are in that event expressed in terms of all affected bonds then outstanding.

The Committee gave careful consideration to allowing a cross-series modification to be approved on an aggregate all-series basis only. The Committee ultimately rejected this approach notwithstanding its evident administrative advantages (and its use in many statutory insolvency regimes) because of the perceived unfairness of allowing a series of bonds to be modified over the objection of a majority of the affected holders in the absence of any supervising judicial authority, as well as related legal concerns that a single aggregate approval threshold might not be enforceable throughout the euro area.

In the event a proposed cross-series modification is approved as to some but not all of the affected series of bonds, an issuer may implement the proposed modification in relation to those series of bonds whose modification would have been approved if the cross-series modification had initially been proposed only in respect of the bonds of those series. The draft CAC does not distinguish between a cross-series modification involving bonds governed by the same law and one involving bonds governed by different laws. The Committee is not aware of any legal obstacle to allowing a cross-law modification so long as the modification of each affected series of bonds is approved at a separate meeting of bondholders or a separate written resolution. In providing for a separate approval process for each affected series, the draft CAC avoids a possible conflict between the laws governing the bonds of different affected series.

Cross-series modifications and their partial and cross-law variants are intended to facilitate the broadest possible modification of an issuer's bonds, with a view to affording the greatest possible equality of treatment to the holders of an issuer's bonds.

C. Quorums

A proposed modification may not be approved at a meeting of bondholders unless a quorum is present. The quorum of any initial meeting called to consider a proposed modification is 66 2/3% of all then outstanding bonds in the case of a reserved matter modification and 50% of all then outstanding bonds in the case of the proposed modification of a non-reserved matter. The quorum for all adjourned meetings is 25% of the outstanding bonds irrespective of the type of modification to be voted on.

The Committee is aware of the concerns expressed by some market participants that even the high quorums included in the draft CAC could theoretically result in a reserved matter being approved by a relatively small percentage of the total affected bonds then outstanding, especially in the case of a vote held at an adjourned meeting. The Committee believes these concerns are misplaced. Experience suggests that a significant percentage of the principal amount of outstanding bonds will in fact be represented at a meeting called to vote on the proposed modification of a euro area government's debt securities. In the unlikely event a quorum is not present at the initial meeting called to vote on a reserved-matter modification, the Committee is of the view that the apparent indifference of the absent bondholders can fairly be understood as constituting their silent acquiescence to the proposed modification.

D. Disenfranchisement

Consistent with market practice, the draft CAC disenfranchises government bonds held by the issuer or by any of its ministries, departments or agencies. An issuer's holdings of its own bonds, and the bonds held by other governmental bodies, are therefore treated by the draft CAC as not outstanding for purposes of determining whether a proposed modification has been approved, and may not be voted for or against a proposed modification or counted towards the quorum required for a duly called meeting of bondholders.

The Committee believes that disenfranchising an issuer's holdings of its own bonds is appropriate because the losses suffered by the issuer from the modification of the bonds it holds, unlike the losses suffered by an ordinary market participant, are more than offset by the gains

realised by the issuer from the resulting reduction in its debt service or debt stock or both. The Committee also agrees that an issuer should not be allowed to accomplish through indirection – by instructing government-controlled companies to vote in favour of a proposed modification – that which is denied the issuer directly.

Where, however, a government-controlled legal entity (referred to below as a government-controlled ‘company’ regardless of its legal form) has autonomy of decision and is required by applicable law, rule or regulation to act independently of any instruction given by an issuer, the Committee is strongly of the view that it would be inconsistent with the issuer’s own laws to disenfranchise a company’s holdings of government securities on the basis of its assumed disregard of binding legal obligations. To do otherwise would not only undermine the presumption of lawful action enjoyed by all euro area companies, but would also call into question the issuer’s commitment to its own laws intended to ensure a company’s autonomy of decision.

The draft CAC accordingly casts the net wide in treating a company as directly or indirectly controlled by an issuer even if the issuer has never sought to instruct the company on the day-to-day management of its affairs or investments, but does not disenfranchise a government-controlled company that has autonomy of decision under applicable law. In furtherance of this arrangement, the draft CAC includes three safe-harbours that expressly exempt companies having autonomy of decision from the otherwise applicable disenfranchisement of their holdings of government securities.

The first safe-harbour is available to government-controlled companies that under applicable law may not take instruction from a euro area government issuer. The second safe-harbour is available to a government-controlled company that is required under applicable law to act in accordance with an objective prudential standard, in the interest of all of its stakeholders (and not just its shareholders) or in its own self interest. The final safe-harbour is available to an issuer-controlled company that owes a fiduciary (or similar) duty to one or more third parties independently of any obligation it may owe to its controlling parent.

The Committee believes that all of the safe harbours are consistent with the underlying rationale of the disenfranchisement clause – to prevent an issuer from voting in favour of the modification of its own securities either directly or by instructing companies it controls to so vote their holdings of the issuer’s debt securities.

The Committee also considered but rejected two other related grounds sometimes offered as a reason for disenfranchising issuer-controlled companies – their supposed predictability of action and their assumed motivation. The Committee does not believe that predictability of action constitutes a sound basis for disenfranchisement. The Committee is mindful in this regard that the actions of many private creditors are at least as predictable as those of government-controlled companies – for example, the holder of a credit default swap is almost certain to vote in favour of a proposed modification that will result in a ‘credit event’ – and yet it has never been suggested that private investors should be disenfranchised because their actions are often predictable in practice.

In the Committee's view, a creditor's motivation provides an even less appropriate basis for disenfranchisement. Experience suggests that it is often difficult, if not impossible, to discern a creditor's real motivation, or to distinguish among the arguably acceptable and arguably unacceptable motivations that may together inform an investor's decision. In any event, it is not clear to the Committee what motives would even arguably constitute grounds for an investor's disenfranchisement. It will be recalled that issuers often pay early-participation fees to private creditors to encourage their public support for a proposed modification of the issuer's bonds, without calling into question the creditors' right to have their votes counted.

To enhance the transparency of the voting process, an issuer is required under the standardised CAC to publish, promptly following the formal announcement of a proposed modification (but in any event not less than five days before the record date for that modification), a non-exhaustive list of issuer-controlled companies that have autonomy of decision.

E. Reserved Matters

The list of reserved matters included in the standardised CAC is broadly consistent with the list of reserved matters found in other CACs currently in the market. In light of the wide range of debt securities covered by the draft CAC – bearer, registered and dematerialised bonds, zero-coupon and interest bearing bonds, redeemable and non-redeemable bonds and domestic and international bonds, among others – the list of reserved matters is necessarily expressed in more general terms than might otherwise have been the case, and often combines items that sometimes receive separate treatment in other CACs. For example, the draft CAC treats as a reserved matter a reduction in 'any amount' payable on a bond. This formulation covers, among other things, any reduction in the principal, interest or 'additional amounts' that may be payable on that bond.

The standardised CAC also treats as a reserved matter a modification that would impose a condition on or otherwise modify an issuer's obligation to make payments on a bond. This formulation covers, among other things, a change in the nature of the issuer's obligation – for example, a modification of the issuer's unconditional obligation to make bond payments – or the substitution of a new obligor in place of the original issuer through an exchange of existing bonds for a new series of bonds.

Still other reserved matters listed in the standardised CAC are relevant for some, but not all, government securities. The draft CAC accordingly treats these items as reserved matters only where they are relevant to an investor. For example, the standardised CAC treats a change in the law governing a bond as a reserved matter only if a bond is governed by a law other than the law of the issuer. The Committee believes there is no need to treat a change from the issuer's own domestic law as a reserved matter because the issuer already has the power, at least in theory, to adopt any desired modification by means of domestic legislation without changing the law governing its bonds. In so treating a change in governing law, the Committee does not mean to suggest that euro area government issuers will in fact exercise their sovereignty in relation to any series of bonds, or that modifying the terms of a bond by means of domestic legislation does not itself raise difficult legal issues.

Other items on the list of reserved matters are manifestly not relevant to some euro area government securities. For example, a change in the terms on which collateral is pledged to secure payment of a series of bonds is relevant only in the case of bonds that are collateralised in the first place. These items are footnoted in the standardised CAC to indicate when they are to be included in the terms and conditions of a bond.

F. Technical Amendments

The standardised CAC does not include a technical amendments clause because, in the Committee's view, it is not an essential element of a CAC. Under the technical amendments clause found in many international debt obligations, an issuer may amend the terms and conditions of a bond, or an agreement governing the issuance or administration of a series of bonds, without the consent of bondholders (a) to correct a manifest error or cure an ambiguity, (b) if the modification is of a formal, minor or technical nature, or (c) if the modification does not materially prejudice the interests of bondholders. All euro area Member States will be free to include an international-style technical amendments clause in the definitive documentation for their debt securities or a technical amendments clause of the type customary in the issuer's own market.

G. Calculation Agent

All euro area issuers will be required to appoint a calculation agent to determine whether a proposed modification has been approved by the requisite principal amount of outstanding bonds. For ease of administration, the same person will be appointed as the calculation agent for each series of affected bonds in the case of a cross-series modification. The Committee anticipates that the calculation agent for any bonds will often be the same person as the fiscal or paying agent appointed by the issuer for those bonds.

The calculation agent may rely on a certificate prepared by the issuer, listing the principal amount of outstanding bonds and specifying the principal amount of bonds then deemed to be not outstanding because they are held by the issuer or by a company controlled by the issuer that does not have autonomy of decision. Any information relied on by the issuer will be conclusive and binding on the issuer and bondholders, unless an affected bondholder timely delivers a substantiated written objection that, if sustained, would affect the outcome of the vote taken on a proposed modification. The issuer and affected bondholders will also be bound by any information relied on by the calculation agent if the objection is later withdrawn or a court subsequently rules that the objection is either not substantiated or would not have affected the outcome of the vote taken.

H. Bondholder Meetings

The standardised CAC includes mandatory rules for holding bondholder meetings, intended to ensure that the CAC operates in the same manner and with the same legal effect in all euro area Member States. In light of the wide diversity of bondholder meeting rules and practices in the euro area, issuers may adopt supplementary rules for the holding of bondholder meetings that are consistent with the mandatory rules included in the standardised CAC. For example, the documentary evidence required to be presented by a bondholder in order to vote on

a proposed modification will vary depending on the nature – registered, bearer or dematerialised – of the debt securities in question. The standardised CAC accordingly contemplates that the issuer will specify the required evidence in the notice convening a bondholder meeting.

I. Zero-Coupon and Index-Linked Obligations

The draft CAC provides special treatment for zero-coupon obligations, by which is meant both bonds originally issued without express provision for the accrual of interest, as well as so-called stripped bonds consisting of the component parts of a bond that originally expressly provided for the accrual of interest. In the absence of special treatment, the holder of a zero-coupon obligation would enjoy preferential voting rights as compared to the holder of an interest-bearing bond. An example may be helpful in illustrating the problem. If an interest-bearing bond were to be stripped into its component parts, and the holders of the stripped components were to be afforded voting rights based on the face amount of their holdings, the total voting rights enjoyed by the holders of all the stripped components would exceed the total votes that would otherwise have been cast by the holder of the original interest-bearing bond.

In order to remedy this situation, the draft CAC adjusts the face amount of each stripped component so that the holders of the stripped components have, in the aggregate, the same voting rights as the original investor would individually have had in relation to the underlying interest-bearing bond. The draft CAC includes a similar mechanism for obligations issued without any express provision for the accrual of interest. Consistent with the approach adopted more generally for interest-bearing obligations, the draft CAC assumes, in the case of a stripped bond, that the original interest-bearing bond was issued at par.

The draft CAC does not include a special rule for amortising bonds, index-linked obligations or other obligations whose principal amount may change over time, as any increase or reduction in their principal amount is already provided for in their terms and conditions. In determining whether a proposed modification has received the requisite approval, the principal amount of an obligation whose principal amount may change over time will be its outstanding principal amount on the record date for the proposed modification.

The treatment of zero-coupon obligations inevitably raises complicated technical issues (for example, the treatment of stripped index-linked bonds), and the provisions of the draft CAC dealing with zero-coupon obligations are subject to ongoing technical review.

J. Governing Law and Enforcement

The Committee gave careful consideration to having the standardised CAC governed by the law of one euro area Member State, to including the standardised CAC in a treaty binding on all euro area Member States, and to having all disputes arising out of or relating to the standardised CAC be heard and resolved in an agreed international forum or before the courts of one euro area Member State. The Committee ultimately concluded that the proposed arrangements either would not significantly enhance the uniformity of application of the CAC throughout the euro area, or that the desired uniformity could be achieved through other means more consistent with well-established market practice. The CAC included in any bond issued by a euro area Member State will instead be governed by the law that governs that bond more

generally, and any dispute arising out of or relating to the CAC included in a bond issued by a euro area Member State will be resolved on the same basis and before the same courts as are all other disputes arising out of or in connection with any other provision of that bond.

4. Drafting Notes

For ease of reading, the draft CAC refers to the covered debt securities as Bonds. The actual CAC included in each issuer's definitive documentation will of course identify the offered securities by their proper name. The standardised CAC also refers to bonds or other debt securities that will be 'affected' by a proposed modification. These references are in all cases to be understood as references to the bonds and other debt securities whose terms and conditions are the subject of the proposed modification, and not to any other bonds or debt securities that may be economically affected by the proposed modification.

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