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

1. Introduction

On 26 July 2011, the EFC Sub-Committee on EU Sovereign Debt Markets (the "Committee") distributed for comment by market participants and other interested stakeholders a draft of the model collective action clause ("CAC") to be included in all euro area government securities. The draft CAC was accompanied by an Explanatory Note dated 26 July 2011 that, among other things, summarized the key provisions of the model CAC.

A total of fifteen responses were received from institutional investors, securities and insurance trade associations, the European Central Bank, the IMF, the London Stock Exchange and Euroclear. Following a careful review of the comments received and further informal consultations with market participants and other interested stakeholders, the Committee has approved the enclosed final version of the model CAC.

This Supplemental Explanatory Note discusses the principal changes made in the model CAC in response to market comments, and should be read together with the Committee's earlier Explanatory Note. It also describes the process that will be followed by euro area Member States in implementing the model CAC.

2. Mandatory Introduction Date

On 2 February 2012, a modified version of the Treaty Establishing the European Stability Mechanism was signed by all 17 euro area Member States. Paragraph 3 of Article 12 of the Treaty states:

> "*Collective action clauses shall be included, as of 1 January 2013, in all new euro area government securities, with maturity above one year, in a way which ensures that their legal impact is identical.*"

As a result, the model CAC will become mandatory in all new euro area government securities issued on or after 1 January 2013, and not 1 July 2013, as previously contemplated.

The introduction of the model CAC will not affect any euro area government securities issued prior to 1 January 2013 unless those securities include a collective action clause that allows for their modification on a cross-series basis on the terms contemplated in the model CAC. There are no such bonds now outstanding, apart from the English-law governed bonds recently issued by the Hellenic Republic as part of its Private Sector Initiative, which include a forward-looking collective action clause based on the model CAC. The Committee does not expect that any other euro area government securities issued prior to 1 January 2013 will contain a collective action clause based on the model CAC. As a result and except as just noted, euro area government securities issued prior to 1 January 2013 will not be subject to modification as part of a cross-series modification pursuant to the model CAC.

3. Changes Made to the Model CAC

Set out below is a summary of the most important changes made to the model CAC in response to comments received as part of the public consultation process.

A. Bondholder-Meeting Approval Thresholds and Quorums

The modification of a reserved matter, if proposed at a duly called meeting of bondholders, now requires the affirmative vote of not less than 75% – up from 66 2/3% in the prior draft – of the aggregate principal amount of the outstanding bonds represented at that meeting.

The quorum for any adjourned meeting of bondholders at which a reserved-matter modification will be considered has now been fixed at the same level – 66 2/3% of the outstanding principal amount of the affected bonds – as the quorum required at the initial meeting of bondholders called to consider that matter. No change has been made in the initial- or adjourned-meeting quorums for a non-reserved matter, which remain at 50% (initial meeting) and 25% (adjourned meeting) of the outstanding principal amount of the affected bonds.

The Committee believes that it should not be easier, or more difficult, for a proposed modification to be approved at a meeting of bondholders than by an action in writing. The Committee also continues to be of the view that investors opposed to a proposed modification are more likely in practice to be represented at a meeting called to consider the modification, and that the bondholder-meeting and action-in-writing approval thresholds should accordingly be fixed at the same level, though with the former measured against the outstanding principal amount of affected bonds represented at a quorate meeting and the latter against the outstanding principal amount of all affected bonds.

The Committee has nonetheless increased both the bondholder-meeting approval threshold and the adjourned-meeting quorum for reserved-matter modifications in light of the concern expressed by some market participants that the prior draft unfairly advantaged the approval of a reserved matter at a bondholder meeting. By contrast, the action-in-writing approval threshold, which had already been informally sanctioned by a number of market participants, attracted relatively little comment, and remains unchanged at not less than 66 2/3% of the aggregate principal amount of the bonds then outstanding.

One consequence of the two changes, taken together, is that a single-series modification of a reserved matter will in all events require the approval of at least a majority in principal amount of the affected bonds (>75% x 66 2/3% > 50%). While the Committee continues to believe it extremely unlikely that an important single-series reserved-matter modification would ever have been approved under the prior version of the CAC without the consent of a majority of the principal amount of the affected bonds, the Committee thought it appropriate under current market conditions to rule out this possibility even as a theoretical matter.

The Committee also considered two related suggestions made by some commentators – first, that the model CAC require that a reserved-matter modification be approved only by an action writing, and second, that the bondholder-meeting reserved-matter approval threshold, if retained, be fixed at 66 2/3% of the outstanding principal amount of all affected bonds. The

Committee ultimately rejected both suggestions. While it is true that most recent emerging market sovereign debt restructurings have been implemented by actions in writing, bondholder meetings are the norm in the euro area for corporate restructurings, and it is expected that local corporate rules will in many cases serve as the starting point for the procedural rules to be adopted by euro area governments for modifying their own debt securities.

If the approval threshold for a reserved-matter modification was in all cases measured against the outstanding principal amount of the affected bonds, every bond not represented at a meeting of bondholders would automatically be treated as a vote in opposition to the proposed modification. This struck the Committee as unreasonable, and would in practice make it increasingly difficult, and ultimately impossible, for a proposed modification to be approved with declining levels of bondholder-meeting participation. As a result, the Committee concluded that this approach, while it would preserve formal equality of treatment, would in practice produce very different results depending on the level of bondholder representation.

The Committee also notes that the model CAC, in fixing the reserved-matter quorum for all meetings at 66 2/3% of the outstanding principal amount of the affected bonds, achieves, by a different route, a comparable balancing of the interests of investors and issuers to that which would have been provided by the proposed alternative approach.

In sum, the Committee believes that the model CAC as now drafted avoids the unfair consequences of the unrealistic assumption that all non-participating bondholders will vote against a proposed modification, while affording bondholders appropriate protection against a reserved-matter modification being approved over the voiced opposition of a substantial minority of investors.

B. <u>Cross-Series Modification</u>

Two changes have been made to provisions of the model CAC dealing with cross-series modification. First, the bondholder-meeting approval thresholds have been increased to 75% of the outstanding principal amount of all affected bonds in the aggregate and to 66 2/3% of the outstanding principal amount of each individual series of affected bonds. In addition, every modification proposed in relation to any series of bonds covered by a cross-series modification must now be available to be accepted by every holder of an affected bond.

By way of background, the Committee notes that it will be for the issuer to decide whether to pursue – or not to pursue – a cross-series modification. An issuer that elects to pursue a cross-series modification may include some – but not all – of its outstanding bonds in a single cross-series modification, and may also treat its remaining bonds in one or more additional cross-series modifications, in several separate single-series modifications or in a combination of the two. The flexibility afforded to the issuer in grouping bonds of different series in different modification baskets is intended to minimize the likelihood of a hold-out series, an interest shared by both the issuer and those investors – the vast majority – that approve a cross-series modification on both an aggregate and individual basis.

A cross-series modification can be understood as, in effect, a collective action clause that works at the series level, in that it binds all of the holders of all of the affected series so long as the proposed modification is overwhelmingly approved in the aggregate by the affected group of bondholders, with the important further protection that holders of any individual series of affected bonds will not be bound by the decision of the group as a whole unless they also vote in favour of the proposed modification, though not necessarily at the level that would be required on a stand-alone basis.

The rationale underlying a cross-series modification requires that all bondholders affected by a cross-series modification should have the right to vote on the same proposed modification or, if a menu of different options is proposed, on each of the proposed options. New Section 2.3 of the model CAC makes this point expressly by providing that a cross-series modification may include one or more proposed alternative modifications, but only if all of the proposed alternatives are addressed to and may be accepted by any holder of any bond that would be affected if the cross-series modification were to be approved.

The issuer is thus given the right to propose a menu of alternative options, and investors the right to pick the option they prefer, ensuring that all investors have the right to accept from a common menu of options the option that best suits their interests. This arrangement, together with the veto right effectively granted to each individual series of affected bonds, should ensure that no series of bonds is singled out for invidious treatment. Together with the issuer's self-interest in having a cross-series modification approved by all of the affected series (no hold-outs), this provision should also lead to different series of bonds being grouped in a commercially sensible way in a cross-series modification.

The Committee confirms that, under the model CAC, a separate meeting will be held for each series of bonds covered by a cross-series modification, though these meetings are likely to take place on the same day and, perhaps, even in the same place.

C. Partial Cross-Series Modification

An issuer is now required to notify investors in advance of the conditions under which a partial cross-series modification will come into effect. Investors will, as a result, be able to make an informed investment decision as to whether they are in favor of a proposed cross-series modification even if it is only partially successful. This approach should be familiar to the market, as it is already standard practice for an issuer proposing to modify a series of bonds that does not include a collective action clause to specify the "critical mass" of bonds that must approve the proposed changes before they will become legally effective.

D. Zero-coupon and Index-Linked Obligations

The provisions of the model CAC dealing with zero-coupon obligations have been substantially revised and new provisions added to deal with index-linked obligations and stripped index-linked obligations. The model CAC now includes comprehensive rules for calculating the principal amount of a zero-coupon and index-linked obligation. These amounts will in turn be used to determine whether a proposed modification has attracted the support of the requisite principal amount of the affected bonds.

(1) Index-linked obligations

The model CAC now provides special treatment for the adjustable principal and interest components of an index-linked obligation. The principal issue addressed by the Committee was whether, in allocating votes to the adjustable portion of an index-linked obligation, the value of that adjustable portion should be 'crystallized' on the record date for a proposed modification even if, in accordance with its terms, its value would not then be adjusted and could in theory be reversed over time. The Committee ultimately concluded that interim 'crystallized' values should be used, principally because the adjustable portion of an index-linked obligation is keyed to changes in a published price index, and in the euro area these changes have over many years been almost entirely a one-way street of increasing prices.

The component parts of most index-linked obligations may be 'stripped' by the holder. The resulting zero-coupon obligations are afforded the same 'crystallized' treatment under the model CAC, though the votes allocated to a zero-coupon index linked obligation are subject to further adjustment in accordance with the rules applicable to zero-coupon obligations more generally, discussed below.

(2) Zero-Coupon Obligations

Under the prior draft of the model CAC, the principal amount of a zero-coupon obligation was equal to its present value on the record date for a proposed modification. This remains the case in the final version of the CAC, though it is now expressly stated that the principal amount of a zero-coupon obligation will be equal to its nominal amount if the stated maturity date of the zero-coupon obligation has already occurred.

The present value of a zero-coupon obligation is now calculated using one of three different discount rates:

- if the bond was originally issued as a zero-coupon obligation, the applicable discount rate is the zero-coupon obligation's yield to maturity at issuance;

- if the zero-coupon obligation was 'stripped' from a couponed debt security, the applicable discount rate is the coupon on the underlying debt security; and

- if the zero-coupon obligation was 'stripped' from a couponed debt security that cannot be identified due to the fungibility of all of the issuer's zero-coupon obligations maturing on the same date, the applicable default discount rate is the weighted average of the coupons on the issuer's debt securities that have the same stated maturity date as the zero-coupon obligation or, if there are no such securities, the coupon interpolated on a linear basis using the weighted average of the coupons on the issuer's debt securities having the two closest maturity dates to that of the zero-coupon obligation.

The methods to be used in calculating the applicable discount rate, described above, are subject to further detailed rules set out in the model CAC.

The Committee's principal aim was to assign the same number of total votes to the zero-coupon component parts of a 'stripped' security as were allocated to that same security before it was 'stripped'. Using the coupon on the underlying 'stripped' security as the discount rate achieves this goal with mathematical precision. Using the yield to maturity at issuance of a bond initially issued as a zero-coupon obligation produces the same result (assuming the 'stripped' couponed security was issued at par). By contrast, use of the default discount rate could in practice result in more or fewer votes being allocated to the former component parts of a 'stripped' security. To address this concern, the Committee tested the default methodology using actual debt securities now in the market, and concluded that that variance in the votes allocated fell within acceptable limits.

Several related drafting changes have also been introduced. A 'zero-coupon obligation' and an 'index-linked obligation' are now defined in the model CAC, and these terms are used extensively in Section 2.6, which deals in a comprehensive way with the calculation of their principal amounts. The definition of 'debt securities' also now expressly confirms that all of the stripped component parts of a debt security are themselves debt securities irrespective of their stated maturity date. As result, even short-dated 'stripped' coupons will be treated as debt securities so long as the underlying couponed security was itself a debt security.

E. <u>Disenfranchisement</u>

Several commentators suggested that consideration should be given to disenfranchising investors who have the same interests as an issuer, who are predictably likely to vote in favour of a proposed modification or who are likely to be motivated by circumstances other than the direct effect of a proposed modification on the value of their holdings. The Committee strongly disagrees.

In the Committee's view, disenfranchising an investor is a serious step with important legal consequences, and should be taken only for good cause. The Committee believes that neither an investor's interests or motives, nor the predictability of an investor's vote for or against a proposed modification, constitutes adequate grounds for disenfranchising an investor. For the Committee, the litmus test remains: is a bondholder acting in its own interest? If so, the bondholder should be enfranchised irrespective of whether the investor may also be directly or indirectly owned or controlled by the issuer for purposes of the model CAC.

The legal status of euro area national central banks illustrates the Committee's thinking on this issue. Article 130 of the Treaty on the Functioning of the European Union and Article 7 of the Statute of the European System of Central Banks and of the European Central Bank expressly prohibit euro area national central banks and members of their decision-making bodies from seeking or taking instruction from European Union institutions or bodies, from any government of a Member State of the European Union or from any other body.

As a result, a euro area national central bank's decision to vote for or against the proposed modification of securities acquired in connection with, for instance, its Eurosystem operations must, as a matter of law, be made by the bank acting in its own interest, even though the bank may well be owned or, for other purposes, controlled by its government (for example, the government may have the right to appoint the bank's governor or a majority of its directors). In the Committee's view, euro area national central banks accordingly have autonomy of decision in deciding how to vote on the proposed modification of any euro area government securities so acquired, and their holdings of these securities will be enfranchised under the model CAC.

F. Bondholder Meetings

The Committee would like to emphasize that the model CAC does not prescribe the complete set of rules applicable to bondholder meetings. All euro area jurisdictions already have their own bondholder-meetings rules and practices, and the model CAC expressly contemplates that its bondholder-meeting rules may be supplemented by additional rules adopted and published by the issuer in advance of any meeting called to consider a proposed modification.

G. Transparency

The transparency provisions of the model CAC have been strengthened in response to market comment. An issuer is now required to publish, promptly following the announcement of a proposed modification, but in no event less than 10 days prior to the record date for a proposed modification, a list (prepared on the basis of enquiries made by the issuer) of the disenfranchised companies and entities then holding affected bonds. The issuer must now also publish a list of the record-date holders of disenfranchised bonds and the total amount of their holdings (but not the amount of any individual investor's holdings).

In discussing this matter informally with market participants, many investors were more interested in having a list of the companies whose bondholdings will be disenfranchised, rather than (as was contemplated in the prior draft) a non-exhaustive list of the companies having autonomy of decision. The list now required by the model CAC will presumably enable investors to assess whether there are additional bondholdings that they believe should also be disenfranchised.

H. Calculation Agent

A number of commentators suggested that the model CAC should require the appointment of a calculation agent at the time of issuance. The Committee expects, in the case of a euro area government's international debt securities, that the calculation agent will in fact be appointed at the time of issuance and will most likely be an affiliate of the fiscal agent or trustee also appointed by the issuer. By contrast, the Committee believes that appointment of a calculation agent at the time of issuance of a euro area government's domestic debt obligations would be inconsistent with current market practice and unduly burdensome. The Committee does not anticipate any problem in the appointment of a calculation agent closer to the time of a proposed modification, as the calculation agent's responsibilities are limited and strictly administrative in nature.

I. Other Provisions

The model CAC does not include a technical amendments clause, does not limit the right of a bondholder to accelerate its bonds or to bring legal proceedings against an issuer, and does not grant bondholders the right to rescind a prior acceleration notice. While these provisions are found in many (but not all) collective action clauses now trading in the international debt market, they were omitted from the model CAC because the CAC will be included in both an issuer's international and domestic obligations, and the above-mentioned provisions are either inconsistent with current domestic government debt issuance practice or would raise serious legal concerns in some euro area jurisdictions.

The Committee nonetheless believes that these provisions serve the same purpose as are intended to be served by the model CAC, and the Committee accordingly recommends that they be included in all euro area government debt securities beginning in 2013 to the extent they are consistent with an issuer's existing practice and applicable law. The text of the recommended provisions is enclosed.

The model CAC also does not provide for the mandatory appointment of a fiscal agent or trustee. While found in most international debt securities, fiscal agents and trustees are not at all common in domestic government debt issuances, and were for that reason not included in the model CAC. The Committee does not expect that the introduction of the model CAC will affect a euro area government issuer's existing practice of appointing fiscal agents and trustees for international debt issuances. If a fiscal agent or trustee is appointed by a euro area government, the Committee anticipates that they will have their customary responsibilities, including, among other things, liaising with the issuer and assisting in the convening and holding of bondholder meetings.

J. <u>Retail Savings Bonds</u>

A number of euro area governments sell through retail channels, without any fees, charges or commissions, so-called savings bonds or certificates that may not be transferred by their holder. These savings products are manifestly not capital market instruments – indeed, they are almost certainly not securities at all – and the Committee accordingly concluded that they should not be treated as 'debt securities' for purposes of the model CAC, even if in some cases they are styled as 'savings bonds'. Euro area governments are, as result, neither required nor expected to include the model CAC in retail savings instruments that have the above-mentioned features.

K. <u>Miscellaneous Drafting Matters</u>

A number of more technical drafting changes have been made to the revised model CAC:

- The definition of a 'series' now provides that all of the bonds comprising a 'series' of bonds must be identical in all respects except for their date of issuance *or first payment date.*

- If a bond provides for acceleration upon the occurrence of an event of default, the list of reserved matters now includes a payment-related change in the circumstances under which that bond may be accelerated prior to its stated maturity.

- Except as permitted by any related security agreement, the release of any collateral that is pledged *or charged* as security for the payment of a bond now constitutes a reserved matter.

- If a bondholder wishes to legally challenge the calculation agent's reliance on information provided by the issuer in connection with a proposed modification, the investor must now do so within 15 days of the publication of the result of the vote on the proposed modification (rather than within 15 days of the vote itself, as provided for in the prior draft).

- The record date for a bondholder meeting may now be set at not more than five *business* days before the date of the meeting.

- If an issuer's debt securities are cleared through a central depositary system, notices required under the model CAC must now also be published through that clearing system.

- The ordering of several sections of the model CAC has changed, in part as a result of the introduction of new Section 2.3, dealing with the availability of the complete menu of options in a cross-series modification.

3. <u>Tapping</u>

At its summit held on 24-25 March 2011, the European Council concluded that euro area Member States should be allowed under agreed conditions to reopen ("tap") debt issuances outstanding on the date of the CAC's mandatory introduction, in order to preserve market liquidity. Neither the tapped issuance nor (to preserve fungibility) the debt securities issued as part of the reopening of that issuance will contain the model CAC.

All of the euro area Member States have agreed that the aggregate face amount of euro area central government debt securities that may be issued by any Member State in any year as part of the reopening of an issuance outstanding on 31 December 2012 will limited to a stated percentage of the total face amount of all central government debt securities issued by that Member State in that year. The table below lists for each year the total face amount of a Member State's central government debt securities that may be issued without the model CAC in connection with the reopening of a debt issuance which was outstanding on 31 December 2012, expressed as a percentage of the total face amount of all of that Member State's central government debt issuance for that year.

Year	Percentage
2013	45
2014	40
2015	35
2016	30
2017	30

2018	25
2019	25
2020	25
2021	25
2022	10
2023 onwards	5

In light of the uncertain liquidity of existing euro area government debt issuances, the Committee has agreed that the limits on tapping set out above will be revisited in 2015 and that Member States may in urgent cases request permission from the Committee to exceed the agreed limits. In the interim, the Committee will monitor Member States' tapping of pre-model CAC issuances, based on information periodically supplied by each Member State.

4. Approval and Implementation

The model CAC was approved by the Economic and Finance Committee (EFC) on 18 November 2011. The text of the model CAC, together with this Supplemental Explanatory Note and the Committee's prior Explanatory Note of 26 July 2011, are now posted on the Committee's website (http://europa.eu/efc/sub_committee/) and will shortly be posted on the website maintained by each Member State's debt management office.

The Committee has agreed a schedule for monitoring each euro area Member State's progress in implementing the model CAC, with a view to its timely introduction in all euro area government securities issued after 31 December 2012. As part of this process and consistent with the "identical legal impact" mandate contained in the Treaty Establishing the European Stability Mechanism, each Member State will be required to deliver a legal opinion to the Committee from the highest State authority competent for such matters, confirming that the model CAC will be legal, valid, binding and enforceable in accordance with its terms under the laws of that Member State.

The Committee expects to publish a report on the implementation of the model CAC prior to January 2013, when the CAC will become mandatory in all new bonds, notes and other debt securities with an original stated maturity of more than one year issued by euro area national governments.

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