



EUROPEAN CENTRAL BANK

To the Members of the
European Financial Market Lawyers Group

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Different legal concepts of debt

This paper introduces a draft questionnaire which is intended to commence the work that the European Financial Market Lawyers Group (EFMLG) will do related to “different legal concepts of debt instruments and asset-backed securities”.

I BACKGROUND

At the first meeting, the group discussed the implications of national legal differences in the concept and definition of securities, namely of debt instruments and asset-backed securities.

The group felt that a smooth functioning of the euro-wide capital markets would require that an attempt is made to narrow down the existing legal differences as far as possible. Therefore, it was decided that the grouping could analyse whether some EU-wide standards for national securities could be established.

In the debate, it was accepted that the differences between national capital markets ran deep and would be difficult to reconcile. However, it was felt that, since traders tend to buy and sell debt without considering

the true nature of the subject matter of their dealings, there may be hidden dangers in the process of European integration continuing as if all EU debt were homogeneous when it is not. Thus, matters not normally subjected to detailed comparative analysis, including those which are not normally commercially significant, such as prescription periods and procedures for lost certificates, may now be ripe for review.

It is therefore proposed to ask the group to endorse a questionnaire, a suggested draft of which is presented below. Once it has been established that this questionnaire poses the right questions, answers for the capital market of each country can be obtained, and then further discussion can establish which features could be harmonised. At a later stage, discussion may have to turn to how this harmonisation would be achieved (e.g. by market convention, by legislation).

2 GENERAL REMARKS

2.1 The scope of the examination

It is proposed in the examination to consider the *internal characteristics* of debt securities. That is to say, the content of the terms and conditions of debt. This focus on internal characteristics excludes a number of wide-ranging topics that either fall completely outside this exercise, or at least should be postponed. These currently excluded topics are

- listing debt securities in exchanges;
- the tax treatment of debt securities;
- mechanisms for settling and clearing trades in debt securities;
- rules about marketing and distribution of debt securities, including rules about prospectuses and rules imposing selling restrictions;
- rules about currency (including any residual traces of pre-euro attempts to assert a 'Verankerungsprinzip')

A quick review of this list is sufficient to justify its own exclusion: without an initial limitation to internal characteristics, the project is too vast for there to be a sensible way to tackle it. And the topics in this list reveal also that we are looking much more at substantive law than at regulations and regulated activities (perhaps with the exception of asset-backed debt, where regulation plays a particularly large part).

2.2 The subject of the examination.

It is suggested that the first question should initiate an exploration of national concepts of debt. That is in line with the group's first discussion on this point. But it may not be a fruitful avenue, if - as is suspected - there are few definitions of what a debt security is. Certainly in some EU jurisdictions, 'security' is no

more than a term of art, with the result that the question, ‘What is a security?’ does not raise itself above the level of terminology. And that itself can cause confusion. In much of the current debate relating to methods of collateralising international securities, one encounters the problem that it is very common to talk about “securities” as if they were an homogeneous group of things which have the same broad characteristics. It is expected that this project will confirm that they do not.

One point is likely to be agreed by all, which is that this project is not looking at equities. In legal terms, debt securities and equities are different in a fundamental respect: equities constitute a bundle of legal rights which are determined according to statute. A company’s governing documents may, of course, change the rights of parties within narrow parameters. But, broadly speaking, a share is the same in legal terms throughout the EU. In the case of debt securities, on the other hand, the legal rights arise purely as a matter of contract. It is up to the parties to shape their own relationship. The way they choose to do this, of course, determines the position of third parties who deal in or with the rights which have been created.

Within debt securities, then, we may include:

- government debt securities;
- central bank debt securities;
- private sector debt securities;
- secured debt securities (meaning asset-backed bonds, mortgage bonds and the like).

The examination may include shorter term securities such as commercial paper and medium-term note programmes. The scope of the examination would not include equities nor, for the time being, debt convertible into equity, nor bonds with share warrants attached. At least for the time being, it is also proposed to exclude from the scope of the examination warrants to purchase bonds, and structures involving bearer depositary receipts.

2.3 National/international

The ‘international’ bond market is an expression that normally refers to debt instruments issued by corporates or governments for sale and trading outside their own jurisdictions (often synonymous with the ‘eurobond’ market). In the context of this project’s ‘bottom-up’ approach, where we start with a comparative analysis of features internal to debt instruments across the EU, motivated by the idea that all such instruments are taking or will take on a cross-border role, it seems better to ignore the international/national distinction.

2.4 Rescheduling

The topic of rescheduling of debt and novation of debt instruments, and the (many) legal constraints making that objective often complex and difficult, was touched on in the first debate on this area. Historically, rescheduling has been an issue more for the loan than the bond markets. More recently, there is a trend, especially in emerging markets, in favour of financing through the bond markets, together with

a more general dynamic that in any restructuring process all types of financial market instrument may come into play. Accordingly, the proposed questionnaire attempts to draw out relevant information by splitting what might have been one question ('How can the issuer negotiate with the debt holders?') into several.

2.5 Dematerialisation

This topic is being treated as a separate project, since it is of such great importance and so technical in nature. It is touched upon under the proposed question dealing with Form, but not otherwise looked at.

2.6 Secured debt securities

The internal characteristics of secured debt securities (asset-backed bonds etc) are likely to be usefully susceptible to the same set of questions as other debt securities. But they do, of course, have special features. In the international bond market, issues are generally unsecured, for reasons that are not likely to disappear merely because the debt is all issued in the same currency. These reasons include a preference for issuers who are well-known and can therefore borrow unsecured, and a reluctance to make cross-border credit assessments of issuers and of foreign security-giving regimes. Secured issues are not, however, unknown in the international market and are common, even dominant, in some domestic markets.

One starting point for analysis that suggests itself is the definition used in the UCITS directive (and adopted by the ECB for its eligible collateral rules). Some general fact-finding questions concerning secured debt securities have been included accordingly in the proposed questionnaire.

III PROPOSED QUESTIONNAIRE

Many of the questions are phrased in a way that may seem to presuppose for each market a standard model. And in the eurobond market there are indeed a number of common forms of structure which use documentation which is strikingly similar. However, parties can - and often do - change dramatically the legal relationships created by the "standard" model which they are using. Thus, in many cases the question is phrased to discover what is usual, that being the most sensible way to achieve the right focus for the investigation, what is said here serving as a caveat that 'usual' may not always be an easily applicable concept.

The questions, then, which it is proposed to ask in order to establish the necessary information are set out below. For each question, it is proposed that the answer will be in two parts: first, a factual description of current practice; secondly, a statement of the law underlying that practice. It is hoped (although it is admitted that the hope may be unjustified) that the answers will not vary much depending on whether the question is applied to government debt, central bank debt, private sector debt, secured debt (meaning asset-backed bonds, mortgage bonds and the like), and shorter term securities such as commercial paper

and medium-term note programmes. If the answers do so vary, it would be helpful for all variants to be stated.

One reminder: the focus of this project is debt denominated in euro. For 4 of the 15 countries that is a foreign currency. Where the answers for those country differs depending on whether the debt is in domestic currency or euro, both answers should be given.

Finally, it may be added that, in addition to the answers to the questions posed, any other material (informative, academic, precedent, examples) is more than welcome.

1. Concepts of debt

Is there a definition in law of a security, debt security, debt instrument?

2. Basic terms of the debt

Is the issuer able to set the terms of debt securities as to amount, interest rate, periodicity of interest payment, redemption/repayment and maturity with full freedom of contract, or is that freedom limited and, if so, in what way?

In relation to interest, are there any legal restrictions against the issuer's ability to choose from a fixed rate, a floating rate, a deep discount?

In relation to redemption/repayment, are there any legal restrictions against the issuer's ability to choose from redemption by instalments, creation of a purchase fund, early voluntary redemption, early redemption by reason of a change in applicable tax law, purchase by the issuer?

3. Form

In what form may debt securities be issued (e.g. bearer form but with a global note, bearer form with individual notes, registered, dematerialised)?

[see also EFMLG working paper for a preliminary overview of the extent to which each EU legal system includes provisions allowing for debt to be issued in dematerialised form.]

4. Dealings

Are debt securities negotiable, in the sense that any buyer (or enforcer of a pledge) acquires the security free from any defects of title that the seller or any other prior holder or previous owner may have and free from the consequences of any claims the issuer may have against the seller?

5. Enforcement of the debt

What mechanism is usually used to allow holders of the security to pursue claims against the issuer (for example, appointment of a trustee or a fiscal agency structure including the giving by the issuer

of covenants in favour of holders)? Are such claims pursued individually or collectively and, if collectively, how?

6. Modification of terms

What mechanism is usually used to allow the issuer to modify the terms of the security, in particular the payment terms (usually through majority action)?

7. Collective representation

Are provisions usually used which are designed to speed up a process through which a representative forum is established within which issuer and bondholder views may be heard?

8. Covenants and negative pledges

What contractual promises/covenants do issuers usually give, other than those directly related to payment (example: a promise not to change the nature of the issuer's business)? What negative pledges do issuers usually give (example: not to create secured interests that undermine economic value of the debt)?

9. Events of default

What provisions are usually included to stipulate events of default?

10. Status of the debt/pari passu

What provisions are usually included to ensure that the units of the security rank equally with each other and (except for secured debt) overall equally with all other unsecured obligations of the issuer?

11. Information

What provisions are usually included to oblige the issuer to provide periodical information about itself (e.g. annual accounts)?

12. Prescription

What period is usually specified after which it is too late to claim payment? What is the length of time provided for by law? Is it possible to shorten or lengthen this period by contract? Is the answer the same for interest payments as for redemption at maturity?

13. Replacement of notes and coupons

What provisions are usually included to deal with the holders' right to receive replacement for lost/destroyed notes/coupons?

14. Notices

What provisions are usually included for the giving of notices by the issuer?

15. Governing law and forum

Is it obligatory to choose domestic law? Is it obligatory to choose a domestic forum for the litigation of disputes?

16. Secured debt securities

Are secured debt securities issued and traded and, if so, of what type?

Which of these fall within the definition set out in Article 22(4) of the UCITS directive and which do not?

In what way do any such securities not fall within the answers given to previous questions?