



EUROPEAN CENTRAL BANK

## European Market Financial Lawyers' Group

### ESTABLISHING A SET OF STANDARDS TO HARMONISE TRADED DEBT SECURITIES

This letter introduces an interim analysis of those responses received so far to the questionnaire intended to commence the work that the EFMLG will do related to “different legal concepts of debt instrument and asset-backed securities”.

#### I BACKGROUND

When the EFMLG discussed the implications of national legal differences in the concept and definition of securities, namely of debt instruments and asset-backed securities, it 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. It therefore decided that the grouping should analyse whether some EU-wide standards for national securities could be established.

Of course, 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, were now ripe for review.

The EFMLG agreed a questionnaire to implement a survey of national legal features of debt. This paper commences an analysis of the answers given to that questionnaire.

#### II RECOLLECTION OF SCOPE OF SURVEY

The exercise focuses on the *internal characteristics* of debt securities. That is to say, the content of the terms and conditions of debt.

Thus, currently excluded topics include: 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’).

The debt securities covered by the exercise were agreed to be: government debt securities; central bank debt securities; private sector debt securities; secured debt securities (meaning asset-backed bonds, mortgage bonds and the like).

### **III ANALYSIS**

The following sets out a preliminary analysis of the responses received in respect of 7 countries: Germany, Spain, Italy, Austria, Finland, Sweden and England.

Responses are awaited in respect of 8 countries: Belgium, Denmark, Greece, France, Ireland, Luxemburg, Netherlands and Portugal.

For further detail, reference should be made to the responses made by EFMLG members.

#### **1. Concepts of debt**

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

Security is defined in statute in Germany. Debt security and debt instrument are not defined in Germany.

There are separate definitions in statute in Italy for financial instruments, debt instruments and debt securities.

The concept is not defined in statute in Spain.

There are separate definitions in statute in Austria.

There are separate definitions in Finland for securities and debt certificates.

Financial instrument is defined in statute in Sweden.

There is no general definition in England.

Is there a definition used by organised exchanges in the relevant rules/regulations applicable to those exchanges?

The statute for the stock exchange adopts the statutory definition of security in Germany.

The statute for the stock exchange includes a definition in Austria.

The rules for the stock exchange includes a definition in England.

Is there a definition used for the purposes of taxation regimes?

There is no definition in Germany, Austria.

Statutory definitions are used in Italy, England.

Is there a clear distinction in law between debt and equity and, if so, how is the distinction recognised?

In Germany, debt is characterised by an obligation to repay principal. Equity is repayable only in a capital reduction or liquidation; income is contingent on profits.

In Italy, there is a clear distinction: the holder of equity owns part of the capital; the holder of debt is a creditor.

In Sweden, there is a clear distinction in statute.

In England, there is no clear distinction.

## 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?

Note: there may be restrictions specific to certain issuers in their relevant constitutions and/or legal status.

There is full freedom of contract in Germany, Austria, Finland, Sweden, England.

In Italy, companies may only issue standardized securities, so that there are limitations on term, early redemption, issue amount (it may not exceed their paid up capital). Special rules apply to subordinated notes.

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?

There are no legal restrictions in Germany, except in relation to compound interest.

There are no legal restrictions in Italy, Austria, Finland, Sweden, England.

Note: the position may be different for default/penalty interest

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?

There are no legal restrictions in Germany, Italy, Austria, Finland, Sweden, England.

## 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)?

All forms may be issued in Spain, Austria, Sweden, England.

All forms may be issued in Germany, except that fully dematerialised issues are restricted to state issuers.

All forms may be issued in Italy, except that public securities are now mandatorily dematerialised

and only a limited portion of private securities may be in physical form.

Debt may be in bearer form with individual note or in dematerialized form in Finland

Does this answer vary depending on whether the securities are domestic or international?

The answer does not vary in Germany, Austria, England.

#### **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?

They are negotiable (as long as acquired in good faith) in Germany, Italy, Austria, Finland, Sweden.

Bearer instruments are negotiable in England. Registered securities are transferred by effecting entries on the register. Securities in clearing systems are (in nearly every case) transferred in accordance with the rules of the system.

#### **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)?

For non-public domestic debt there can be a common representative with fiduciary functions in Germany.

For domestic debt there can be a common representative, and for international issues a trustee, in Italy.

Regularly, it is stipulated that the arranging bank will pursue claims collectively in Sweden. A trustee or a fiscal agent are regularly used in England.

Are such claims pursued individually or collectively and, if collectively, how?

Claims may generally be pursued individually in Germany, Italy, Austria, Finland.

Claims may be pursued collectively in Austria.

## **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)?

Typically the consent of each creditor is required in Germany, except where there is a common representative, who operates by majority decision, subject to certain restrictions designed to protect minority holders.

A majority of holders is required (more if changing payment dates in MTN programmes) in Italy. Unanimity of all holders is required in Austria.

A majority of holders is required (sometimes by two-thirds) in Finland.

Approval from the holders is required in Sweden.

A contractually specified percentage of holders is required in England.

## **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?

The provisions used are established by the common representative statute in Germany, Italy. Such provisions are not used in Austria, Finland, Sweden

The provisions used are established by contract in England (using the trustee or fiscal agent structures)..

## **8. Covenants and negative pledges**

What contractual promises/covenants do issuers usually give, other than those directly related to payment?

There is complete freedom of contract and no typical usage in Germany.

Provisions relating the maintaining and providing of financial information are normal in Italy.

Cross-default and force majeure provisions are normal in Austria.

Provisions of this type are not normal in Finland.  
 Provisions of this type are normal in Sweden, England.

What negative pledges do issuers usually give?

Agreement not to create secured interests that undermine economic value of the debt are normal in Italy, England.

Negative pledges may be included in Finland, Sweden.  
 Provisions of this type are normal in England.

## **9. Events of default**

What provisions are usually included to stipulate events of default?

There is complete freedom of contract and no typical usage in Germany. For state and bank issuers, it is normal to have none. Where the debt relationship is unreasonable due to material adverse change, the law may oblige repayment in Germany.

Late payment, breach of a contractual term, insolvency-type events and others linked to the issuer's behaviour are normal in Italy. So also are force majeure-type events.

Late payment, breach of a contractual term, insolvency-type and cross-default events are normal in Austria, Finland, Sweden.

Late payment, breach of a contractual term, insolvency-type, cross-default failure to act, intervening unlawfulness, sale of underlying business, are normal in England.

## **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?

Such provisions are not generally used in Germany, Sweden.

Priority rights are provided by law, pari passu status is provided by contract in Italy.

Such provisions are provided by contract in Austria, England.

Such provisions are provided by law, but also included contractually, in Finland.

## **11. Information**

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

Note: these requirements are in any event imposed by listing authorities.

Such provisions are not normal in Germany, Austria, Finland.

Provisions requiring periodical information and specific to certain events are normal in Spain, Italy, Sweden, England.

## **12. Prescription**

What period is usually specified after which it is too late to claim payment?

Principal 10 years ; interest 4 years, in Germany.

No period is usually specified in Spain.

5 years in Finland.

Principal 10 years; interest 5 years in England.

What is the length of time provided for by law?

Principal 30 years; interest 4 years, in Germany.

Principal 10 years; interest 5 years in Italy.

Principal 30 years; interest 3 years in Austria.

5 years in Finland.

Principal 10 years; interest 3 years in Sweden.

6 years or 12 years, depending on the underlying structure, in England.

Is it possible to shorten or lengthen this period by contract?

Yes in Germany

Is the answer the same for interest payments as for redemption at maturity?

Yes in Germany

### **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?

The provisions are established by statute in Germany, Spain, Italy, Finland .  
Usually by application to the relevant appointed agent in Italy, Austria, England.  
The provisions are established by contract in Sweden.

### **14. Notices**

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

Bearer securities, by publication in appointed newspapers; registered securities, by notice to the registered holders, in Germany, Finland.  
A public procedure is normal to avoid individual communications, in Spain.  
By publication in appointed newspapers in Italy, Austria.  
By notice to the holders in Sweden.  
By publication in appointed newspaper or in accordance with the rules of the relevant clearing system in England.

### **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?

No in Germany, Austria, Finland, Sweden, England.  
Issuers are obliged to choose domestic law in Italy.

### **16. Secured debt securities**



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

Pfandbriefe and asset-backed securities of different types are normal in Germany.

They are issued normally where the limits imposed on corporate issuers would otherwise be exceeded in Italy.

Debt backed by housing loans, tax income, or other securities, are normal in Austria.

Asset-backed securities are issued in Finland, England.

Secured debt securities are not issued in Sweden.

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

Pfandbriefe in Germany.