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Briefing note

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ICMA consults further on sovereign bonds

The International Capital Market Association has followed up its consultation paper of December 2013 about collective action and pari passu clauses in sovereign bonds with supplementary questions about how collective action clauses should be structured in order to enable sovereign debt restructuring to take place in an efficient and fair manner. The questions relate mainly to how voting should be managed across multiple series of bonds. For example, is a single vote across all series of bonds being aggregated sufficient, or should there also be individual votes within each series? What series of bonds should be capable of aggregation? How and when should information be given to bondholders? The questions raise important policy issues that are vital to ensure that appropriate forms of sovereign collective action are used in the future and are being discussed at a time when the International Monetary Fund is working on its lending framework and sovereign debt vulnerabilities.

The continuing travails of Argentina (see our briefing Sovereign pari passu clauses - NML Capital 2, Argentina 0, June 2014) illustrate well why many, including the International Monetary Fund, the Institute of International Finance and sovereign issuers as well as investors in the sovereign asset class, remain concerned to put in place arrangements that will allow sovereigns in distress to restructure their debts through a means that both works effectively and is fair to creditors.

There is no insolvency procedure for sovereigns, nor any sign that one will be agreed in the foreseeable future. This leaves the primary focus for improving sovereign debt restructuring techniques on enhancing the contractual provisions in bonds that are applicable to a restructuring, should one prove necessary. The International Capital Market Association (ICMA) plays a key role in establishing terms for bonds that are acceptable to the market.

The main contractual enhancement under discussion is the form of collective action clauses (CACs) to be used in sovereign bonds. CACs allow a majority of bondholders to bind all the holders to a restructuring deal, reducing the ability of a minority of "holdout" creditors to impede a deal that the majority accepts. CACs have been regarded as a cornerstone of sovereign debt restructuring architecture for some time and the focus now is to develop the next generation of contractual provisions for the future, though it will take some years for all, or even sufficient, bonds to include the improved CACs before the enhanced mechanisms can provide their full potential.

Key issues

- Should sovereigns be able to choose the manner of aggregation on a restructuring?
- Should a vote across a number of series of bonds be able to bind all series?
- What is required to ensure that bondholders are treated fairly?

CACs raise difficult issues as to how they should be structured in order to achieve their aim of facilitating debt restructuring but at the same time not allowing sovereigns to railroad bondholders into an unfair deal.

The structure of the provisions proposed by ICMA include three collective action alternatives.

- **Aggregation across multiple series of bonds with a single limb voting mechanism.**
  In order to use these powers, the sovereign debtor would need to comply with the safeguards included in the relevant provisions, which are described below. If these conditions could not be met, the two limb voting aggregation would remain available to the sovereign debtor.

- **Aggregation across multiple series of bonds with a two limb voting mechanism.**
  This mechanism is broadly modelled on the euro area model CAC and contemplates an aggregate vote across multiple series of bonds as well as at the individual bond level, with the sovereign issuer and approving bondholders benefitting from voting thresholds set at a level to facilitate the approval process within supermajority principles.

- **Collective action within a single series only.**
  This mechanism (the historic collective action provision) has been retained for circumstances where the sovereign debtor only needs to restructure a single or a very small number of bonds. It may choose to do so on a series by series basis with no aggregation.

The ICMA proposal envisages that the sovereign debtor would decide which collective action alternative (or, indeed, combination thereof) to pursue at the relevant time.

ICMA consulted its members in December 2013 on the form of sovereign CACs (see our briefing ICMA consults on sovereign bonds, January 2014), but has now come back with supplementary questions. These questions include those discussed below.

One vote or many

CACs are not in themselves new. They have, however, generally applied to single bond issuances, allowing the holders of one series of the bonds to vote amongst themselves on whether or not to accept changes to the terms of their bonds. The innovation proposed is aggregation, i.e. allowing the holders of a number of series of bonds (provided that they all contain the requisite CACs) to vote as a single group in a manner that binds each series involved.

A key question raised by ICMA is whether it is enough for the restructuring to be approved by a majority of all bondholders voting together (single limb voting) or whether the restructuring must also be supported by a majority within each series that will be bound (two limb voting). A majority within each series is required by the euro area model CAC (see our briefing Euro area member states take collective action to facilitate sovereign debt restructuring, December 2012).

If a restructuring requires a majority within each series to be bound, aspiring holdouts can, for example, try to acquire a blocking minority in certain bonds in order to keep those bonds out of the restructuring. This happened to certain issuances on Greece's restructuring, leading Greece to pay in full the holders of those bonds rather than go into default. Single limb voting will make this tactic more difficult. But could it also mean that holders in a particular series could be treated unfairly in a restructuring or in a manner that might lead to legal challenge? This leads on to the protections given to bondholders.

Must holders be treated the same?

In order to prevent any attempt by the sovereign at divide and rule, or the interests of the holders of one series of bonds being overridden by a majority of the bondholders as a whole, the CACs on which ICMA is consulting require any proposal to restructure a number of series of bonds to be "Uniformly Applicable". This means that if an exchange offer is made, all bondholders must be offered the same exchange bonds or a choice from the same menu of options. Further, if the proposal is to change the terms of the bonds, changes must be made across all affected series so that they become identical, thereby achieving the same outcome as if there had been an exchange offer (this option is only likely to be feasible for a sovereign with a relatively small number of already similar issuances). In this way, one group of bondholders cannot suffer discrimination at the hands of the majority.

The claims of bondholders will be treated broadly in the same way that they would be treated in a corporate insolvency. So, for example, the holder of a bond with a par value of €100 that matures in one year's time will be treated for voting and other purposes in the same way as the holder of a bond with a par value of €100 that matures in 30 years' time. No attempt would be made to calculate a net present value of bonds or to take account of varying interest rates or other differences between the bonds (e.g. that one has already been accelerated and another has not). This is primarily a matter of pragmatism. The complexities of trying to establish in advance a formula that would cover all eventualities probably outweigh any gain from doing so.

What is aggregated?

Assuming that a number of series of bonds contain CACs allowing aggregation, ICMA's proposal gives the sovereign a choice of whether to use the aggregation provisions, and, if so, which bonds to aggregate for restructuring purposes, subject to those bonds meeting the "Contiguous Maturities" condition discussed below. Is it right to leave the choice entirely to the sovereign?

If a sovereign wishes to aggregate different series of bonds, the series must meet the "Contiguous Maturities" condition. This means that if a sovereign proposes, say, to restructure bonds maturing in 2016 and 2024, it must also include in the restructuring all bonds it has issued that have maturities between those dates (for example, the sovereign must include a bond that matures in 2020 but need not include bonds maturing in 2015 or 2025). This is seen by some as a means to restrain the ability of a sovereign to manipulate the aggregation process in order to secure a particular outcome or disadvantage certain bondholders. This could lead to complications. For example, what about bonds including an optional early repayment, perhaps with an interest rate increase designed to ensure that the early repayment takes place?

Then there is a question of governing laws. Bonds issued under the sovereign's domestic law will not generally be included in aggregation. A sovereign can pass legislation, as Greece did, to amend the terms of these bonds (though a threat, perhaps even the ability, to do so could open up a price differential between domestic and foreign law bonds). Aggregation will therefore generally apply only to foreign law bonds, but should aggregation be limited to bonds subject to the same foreign law, to particular foreign laws (e.g. English and New York) or to all foreign laws?

The potential problem with aggregating bonds governed by various foreign laws is that these laws may offer different protections against unfair treatment to bondholders, which could lead to an increased risk of court challenges and inconsistent treatment, thereby undermining the restructuring. For example, the introduction of the euro area model CAC required changes in the domestic laws of some euro area states in order to allow a majority vote among bondholders to bind all bondholders.

Information for bondholders

ICMA's proposed single limb aggregation mechanism in the CACs requires the sovereign to publish information to enable bondholders to take an informed decision as to how they should vote. This includes any debt sustainability analysis undertaken, together with reasonable details of the sovereign's economic and financial circumstances, a description of the sovereign's proposed treatment of other creditors, and details of assistance from the IMF and other multilateral or official lenders. This is a significant innovation.

Who can vote?

As an additional protection for bondholders, ICMA's proposal includes more stringent (though commonly used) disenfranchisement provisions than are contained in the euro area model CAC. If bonds are held by an entity that is owned or controlled by the sovereign, those bonds will not be counted in any vote. Control for these purposes includes the ability to appoint a majority of the directors or similar officeholders. So, for example, bonds held by a sovereign's central bank would generally be disenfranchised; in contrast, a central bank with autonomy of decision could vote under the euro area model CAC.

In order for a single limb vote to be passed, it must receive the votes of 75% of the principal amount outstanding on all bonds that have been aggregated. There is no quorum requirement across the aggregated bonds because the required majority is measured by reference to outstanding bonds rather than bonds that are voted. Similarly, in this context, there is no quorum requirement for the individual issuances that are aggregated. If there were a quorum requirement for each issuance, it would enhance the ability of holdouts to prevent a particular series being bound by the vote in the same way that a majority requirement for each series would do so.

Noteholders' committees

The existing ICMA sovereign CAC includes a provision dealing with Noteholders' Committees. This is designed for use in connection with a single series of bonds. A question is raised as to how this feature should most appropriately apply in circumstances where multiple series of bonds are aggregated for the purposes of a single vote.

Conclusion

Clauses proposed by ICMA inevitably carry significant weight in the bond market, a market driven heavily by precedent and practice. Anyone involved in the sovereign bond market should respond to ICMA to ensure that their views on CACs in sovereign bonds are taken into account.

ICMA's consultation paper is at http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Sovereign-Debt-Information/ICMA---Sovereign-Bond-Consultation-Paper---June-Supplement-27.06.14.pdf

The IMF's papers regarding the implications of recent developments on its legal and policy framework and its lending framework can be found at https://www.imf.org/external/np/pp/eng/2013/042613.pdf and at http://www.imf.org/external/np/pp/eng/2014/052214.pdf

Clifford Chance LLP advised ICMA in relation to the legal issues raised by its consultation paper.

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