INTERNATIONAL MONETARY FUND

Collective Action Clauses: Recent Developments and Issues

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Contents Page

I. INTRODUCTION

1. **In June 2002, the Executive Board discussed the design and effectiveness of collective action clauses (CACs) and ways to encourage their greater use.**[1] In its Communiqué of September 28, 2002, the International Financial and Monetary Committee (IMFC) welcomed the ongoing dialogue in the G-10 and other fora with private creditors and emerging market sovereign issuers. It also encouraged the official community, the private sector, and sovereign debt issuers to continue working together to develop CACs, and to promote their early inclusion in international sovereign bond issues.[2]

2. **Following up on the September 2002 IMFC Communiqué, this paper reports on developments in promoting the use of CACs** along two fronts: (i) efforts within both the official sector and the private sector to design CACs that would be appropriate for issuance in key jurisdictions and (ii) recent cases where CACs were actually included in international sovereign bonds.

3. The paper is organized as follows. Section II discusses the recommendations made by the G-10 Working Group on Contractual Clauses (the "G-10 Working Group"). Section III discusses the work undertaken by relevant industry associations in developing concrete model clauses for bonds governed by English and New York law. Section IV discusses the recent developments in including CACs in new international sovereign bond contracts. Section V provides a summary and draws some preliminary conclusions. Section VI sets forth some issues for discussion.

II. WORK DONE BY THE GROUP OF 10 IN DESIGNING COLLECTIVE ACTION CLAUSES

4. **At their April 22, 2002 meeting, the G-10 Ministers and Governors encouraged the Deputies to initiate in-depth work on the development of provisions for sovereign debt contracts to enhance sovereign debt resolution and foster the orderly expansion of the market for emerging market debt.** In that context, the G-10 Working Group was formed in June 2002 to consider how sovereign debt contracts could be modified so as to make the resolution of debt crises more orderly.[3]

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[1] The Design and Effectiveness of Collective Action Clauses (SM/02/173, 6/7/02) and Collective Actions Clauses in Sovereign Bond Contracts—Encouraging Greater Use (SM/02/175, 6/7/02).

[2] In this paper, as in SM/02/173 and SM/02/175, the term collective action clauses (CACs) is used to refer to clauses that include both majority restructuring and majority enforcement provisions. The term "international sovereign bond" means a bond that is governed by a foreign law or subject to the jurisdiction of a foreign court.

[3] A Fund staff member participated as an observer.

5. **In September 2002, the G-10 Working Group issued a report (the "G-10 Working Group Report") that contained recommendations on the design of clauses that aim to achieve three objectives:** (i) to foster early dialogue, co-ordination and communication among creditors and a sovereign experiencing debt problems; (ii) to ensure that there are effective means for creditors and debtors to agree to restructuring, without a minority of debt-holders obstructing the process; and (iii) to ensure that disruptive legal action by individual creditors does not hamper a workout that is under way. These recommendations were broadly endorsed by the G-10 Deputies.[4] The G-10 Working Group has also recently completed work, with input from market participants, on a set of model clauses that are designed to illustrate how these recommendation could be implemented.[5]

A. General Approach

6. **The general thrust of the G-10 Working Group Report with respect to the design of CACs is consistent with the approach endorsed by the Fund's Executive Board in June 2002.** Specifically, the G-10 Working Group Report recognized that the terms of many international sovereign bonds that have been successfully placed in the market already contain provisions that can help facilitate an orderly process. For this reason, it recommended the incorporation of these provisions (with appropriate modifications where necessary) into bonds issued in jurisdictions where such provisions are not market norms, including bonds governed by New York law.

7. **Before discussing the G-10 Working Group's specific recommendations, some general observations can be made with respect to their conclusions.**

- First, to provide meaningful guidance on the design of the clauses, the G-10 Working Group Report made recommendations as to what range of voting thresholds would be desirable, drawing on the thresholds that had already been accepted in the market.

- Second, the Working Group did not propose standardization of terms across jurisdictions. For example, it noted that the majority restructuring provisions recommended for bonds governed by New York law would probably need to contain specific voting calculation methods so as to accommodate the concerns of U.S. institutional investors. However, it did not go as far as to propose that existing majority restructuring provisions would need to be modified in bonds issued in those jurisdictions that can accommodate different voting calculation procedures. It also

[4] The G-10 Working Group has focused on documentation for sovereign bonds with the expectation that practices developed with respect to sovereign bonds could be implemented with appropriate modifications in other types of debt over time.

[5] Can be found at: http://www.bis.org/publ/gten08.htm#pgtop.

recognized that, given the constraints of certain legal systems, certain provisions could only be used if a number of modifications were made.

- Third, while most of the provisions recommended already exist in some international sovereign bonds, a few of the recommended features are novel. Of particular importance is the inclusion of an engagement provision, which would be designed to empower a bondholder representative to engage, on behalf of all bondholders, in restructuring negotiations with the debtor and other creditors without delay.

B. Specific Recommendations

8. ***Majority Restructuring Provisions –*** In their discussion of the design of CACs in June 2002, Directors recognized that one of the most useful collective action clauses was the provision which enables a qualified majority of bondholders to bind all bondholders within the same issue to the financial terms of a restructuring, both before and after a default ("majority restructuring provisions")**.** Although majority restructuring provisions are generally found in bonds governed by the laws of England or Japan, they are not included in bonds governed by the laws of New York or Germany. Although Directors did not endorse a specific voting threshold, they noted that the 95 percent voting threshold proposed by one industry association would defeat the purpose of these clauses.

9. **Consistent with the approach adopted by the Board, the G-10 Working Group took the view that these provisions were an essential feature of collective action clauses.**[6] In terms of their design, while the G-10 Working Group Report endorsed the 75 percent voting threshold that generally follows the terms of existing bonds governed by English law, it recognized that there may be some resistance to including these provisions in bonds governed by New York law unless the means by which the voting thresholds are calculated were modified.

10. **Specifically, for bonds governed by English law, the vote is typically calculated on the basis of the claims of bondholders present at a duly convened meeting.** A duly convened meeting typically requires a quorum of bondholders representing 75 percent of the outstanding principal amount. If the quorum requirement is not met, a reconvened meeting allows for a lower quorum, typically 25 percent.[7] As noted in the G-10 Working Group Report , the advantage of this approach is that it avoids a situation where a restructuring agreement is frustrated solely because a critical mass of bondholders fails to cast a vote,

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[6] These provisions are referred to in the G-10 Working Group Report as "majority amendment provisions".

[7] Modification of key terms could be achieved at an adjourned meeting with the support of bondholders holding 19 percent of the outstanding principal, i.e., 75 percent of the value of the bond issue represented at the meeting.

which can be particularly problematic in circumstances where the bonds are held in the retail sector.

11. **However, based on its outreach efforts, the G-10 Working Group concluded that such a calculation method could be resisted by U.S. institutional investors who mainly purchase bonds governed by New York law.**[8] The concerns expressed by these investors were that the quorum approach created a risk that a minority of bondholders could conclude a restructuring in the event that a small percentage attended the meeting. To address this concern, the G-10 Working Group proposed that it would be acceptable for the voting threshold to be based on either the quorum requirement discussed above or on the basis of the outstanding principal amount. However, in circumstances where the outstanding principal approach is used, it stressed that going above a 75 percent threshold "could jeopardize the ability to achieve workouts and increase the risk that an organized minority, such as a vulture fund, could hold up a process that a reasonable majority supported." Moreover, it noted that achieving the necessary support through a higher threshold could be more difficult where the issuance is largely held by retail investors. Finally, the G-10 Working Group Report emphasized that it was not proposing that the quorum approach be abandoned in jurisdictions where it has been accepted.[9]

12. ***Majority Enforcement Provisions*** – Many international sovereign bonds governed by both New York and English law contain provisions that prevent a minority of creditors from pursuing disruptive legal action after a default and prior to the reaching of a restructuring agreement ("majority enforcement provisions"). In its June 2002 discussion, the Board endorsed the use of these provisions where: (i) an affirmative vote of a minimum percentage of bondholders is required to accelerate their claims following a default and (ii) a simple or qualified majority of bondholders can reverse an acceleration that has already occurred. The staff had also recommended the incorporation of provisions found in trust deeds governed by English law where, in addition, the right to initiate legal proceedings on behalf of bondholders is conferred upon the trustee, who is only required to act if requested to do so by the requisite percentage of bondholders. Moreover, the terms of the trust deed ensure that the proceeds of any litigation are distributed ratably by the trustee among all bondholders. Although some Directors observed that such trust deeds could serve as a useful model for future issues, others expressed concern that the increased cost of using trust deeds may outweigh the benefits.

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[8] Although, to the extent that U.S. institutional investors use the EMBI Global as a benchmark, they would likely be holding bonds issued by Pakistan, Russia, and Ukraine, all of which are governed by English law, which includes majority restructuring provisions using the quorum approach.

[9] As an alternative to an amendment of existing bond provisions, the G-10 recommendations also include a new feature allowing the bondholders of 75 percent of outstanding principal to accept an exchange of bonds for new instruments, the most common method of completing sovereign bond restructurings.

13. **The G-10 Working Group Report also recommended the inclusion of majority enforcement provisions and identified voting thresholds that are consistent with prevailing market practice.** Specifically, it recommended: (i) a vote by 25 percent of the outstanding principal amount to accelerate a bond following a default and (ii) a vote by more than 50 percent or, at a maximum, 66⅔ percent, to reverse an acceleration. The G-10 Working Group Report also recommended the inclusion of provisions found in trust deeds that concentrate the power to initiate litigation within a bondholder representative and ensure the *pro rata* distribution of proceeds recovered in litigation. However, in recognition that trust deeds may not be compatible with all legal systems, it noted that alternative structures may need to be relied upon by some countries to achieve a similar result.

14. ***Disenfranchisement Provision*** – The G-10 Working Group Report recommended that a provision be included that would exclude bonds that are owned or controlled, directly or indirectly, by the issuer and its public sector instrumentalities for quorum and voting purposes. The inclusion of public sector instrumentalities goes beyond disenfranchisement provisions that exist in outstanding bonds in trying to address creditor concerns about manipulation of votes by a sovereign. It was recognized that such a provision may make the introduction of a majority restructuring provision into bonds governed by New York law more acceptable to investors.

15. ***Engagement Provision*** – The G-10 Working Group Report recommended the inclusion of provisions that would promote dialogue between the sovereign and the bondholders in two respects. First, it proposed that a bondholder representative be appointed for the life of the bond in order to act as an interlocutor with the sovereign. This role might be performed within a trust structure in some jurisdictions or similar structures in other jurisdictions. Second, the G-10 Working Group Report also considered the need to promote a collaborative sovereign restructuring process by allowing a qualified majority of bondholders of not more than 66⅔ percent of the outstanding principal amount to elect a special bondholder representative to engage, on behalf of all bondholders, in restructuring discussions with the debtor without undue delay.

16. **This proposed feature is similar to the representation clause discussed at the Board meeting of June 2002.** As recognized by several Directors at that time, the bondholder representation clause could potentially contribute to an orderly and speedy restructuring process by establishing a channel of communication between the debtor and bondholders early in the restructuring process.

17. ***Transparency Provisions –*** The G-10 Working Group Report recommended the inclusion of a covenant requiring the provision of financial information by the sovereign. Such a provision does not exist in outstanding international sovereign bonds and was not discussed by the Board in its June 2002 meeting. This new covenant would require the sovereign to provide certain types of key financial information to bondholders over the life of the bond and additional information following an event of default. The G-10 Working Group Report was not specific as to the type of information that was to be provided and recognized that a number of issues would need to be resolved before such clauses are actually included

in international sovereign bonds. For example, the G-10 Working Group Report indicated that further consideration would be given as to the type of nonpublic information that could be provided that would not require confidentiality agreements.

18. ***Consistency with Domestic Laws*** – The G-10 Working Group Report noted that its recommendations could be incorporated into sovereign bonds governed by English, French and New York law immediately and in bonds governed by Japanese law with some modifications. In the case of Germany, the G-10 Working Group noted that market participants are willing to implement a structure reflecting the above provisions under certain conditions. Some market participants are of the view that legislative clarification would be necessary to support the validity of these clauses. While the German government has confirmed in public the validity of these clauses under German law, it is nevertheless preparing legislation designed to dispel any remaining doubts on this question in order to promote the broader use of CACs.

III. Work Done By The Private Sector In Developing Model Clauses

19. **With a view to strengthening the crisis resolution frameworks for emerging markets, the Institute of International Finance and six other financial industry trade associations recently put forward for discussion a draft set of model collective action clauses developed for bonds governed by New York law and English law (the "Industry Associations Draft").**[10] This initiative is a welcome step by these associations to engage in an effort to improve the crisis resolution framework. However, and as will be discussed below, the Industry Associations Draft falls short of recommending adopting the type of collective action clauses that are already included in many international sovereign bonds. Moreover, the rationale for some of the proposed changes to existing market practice under English law is unclear.

20. **Relative to the recommendations contained in the G-10 Working Group Report, the Industry Associations Draft seeks greater standardization of clauses, while recognizing that there may continue to be differences between bonds governed by New York law and those governed by English law.** Moreover, the Industry Associations Draft includes far more detailed covenants regarding the provision of financial information. Set forth below is an analysis of the proposed design of these clauses, including a comparison with: (i) those collective action clauses that already exist in international sovereign bonds, and (ii) those provisions recommended in the G-10 Working Group Report. Box 1 contains a summary of this comparative analysis.

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[10] The six financial industry associations are the Emerging Market Traders Association (EMTA), the International Primary Market Association (IPMA), the Bond Market Association (BMA), the Securities Industry Association (SIA), the International Securities Market Association (ISMA), and the Emerging Markets Creditors Association (EMCA).

Box 1. Existing and Proposed Collective Action Clauses

PROVISIONS	ENGLISH LAW GOVERNED BONDS	NEW YORK LAW GOVERNED BONDS	G-10 RECOMMENDATIONS	INDUSTRY ASSOCIATIONS DRAFT	MEXICAN BONDS GOVERNED BY NEW YORK LAW
Amendment of key terms, including payment terms	• *Voting thresholds* 75% based on votes cast at duly convened meeting. Quorum requirement for meeting: 75% for first meeting; 25% for adjourned meeting.	• *Voting thresholds:* unanimous consent	• *Voting thresholds*: 75% based on either outstanding principal or duly convened meeting	• *Voting thresholds*: based on outstanding principal, 85% for key terms unless more than 10% object; unanimous consent for governing law, submission to jurisdiction, waiver of sovereign immunity and service of process; and 75% for other terms	• *Voting thresholds*: based on outstanding principal; 75% for key terms (including governing law and submission to jurisdiction)
Disenfranchisement	• *Excluded bonds:* bonds held by or on behalf of the issuer	• *Excluded bonds:* bonds owned directly or indirectly by the issuer	• *Excluded bonds:* bonds owned or controlled directly or indirectly, by the issuer or any of its public sector instrumentalities	• *Excluded bonds:* bonds owned or controlled, directly or indirectly, by or on behalf of the issuer or any of its agencies or instrumentalities	• *Excluded bonds:* bonds owned directly or indirectly by Mexico or any of its public sector instrumentalities
Events of Default and Acceleration	• *Acceleration:* trustee has discretion, but is required at the request of typically 25%, to accelerate • *De-acceleration*: none, but achieved through majority restructuring clauses	• *Acceleration:* typically 25% • *De*-acceleration: typically more than 50%, but in some cases 75%	• *Acceleration:* trustee has discretion, but is required at the request of 25%, to accelerate • *De-acceleration*: 50-66⅔%	• *Acceleration:* 25% • *De*-acceleration: 75%	• *Acceleration:* 25% • *De-acceleration*: more than 50%

PROVISIONS	ENGLISH LAW GOVERNED BONDS	NEW YORK LAW GOVERNED BONDS	G-10 RECOMMENDATIONS	INDUSTRY ASSOCIATIONS DRAFT	MEXICAN BONDS GOVERNED BY NEW YORK LAW
Initiation of Proceedings	• *Fiscal agency structure:* any bondholder • *Trust structure:* trustee has discretion, but can be instructed by 25 percent, to initiate lawsuits • Pro rata distribution of recovery proceeds under trust structure.	• Any bondholder	• Recommend trust deed or similar legal structure • 75% to instruct the trustee to settle lawsuits	• Any bondholder for bonds governed by NY law; trust deed optional for English law bonds.	• Any bondholder
Engagement	• None	• None	• A bondholder representative be appointed for the life of the bond • 66⅔% to appoint *at any time* any person to represent all holders in negotiation with the issuer or other creditors	• Upon approval of more than 50%, a bondholder committee will be formed only after an event of default or announcement of the issuer's intention to restructure • A majority to appoint any creditor committee representative unless more than 25% object • The issuer will pay any fees and expenses of the committee and its legal and financial advisors	• None
Information Provision	None	• None	• A covenant requiring the issuer to provide certain specified information over the life of the bond and following an event of default	• Requiring the issuer to subscribe to the SDDS, publish rolling 12-month forecasts, and provide other information over the life of the bond • Requiring the issuer to provide information reasonably requested by bondholders of 5%	• None

A. Bonds Governed by New York Law

21. ***Majority Restructuring Provisions –*** The majority restructuring provision proposed by the Industry Associations Draft would allow an amendment of payment terms by a vote of 85 percent of the outstanding principal amount, provided that no amendment would become effective over the objection of the holders of more than 10 percent of the outstanding principal amount.[11] With respect to bonds governed by New York law, such a threshold would represent an improvement over the unanimity requirement which is current market practice for bonds governed by New York law. However, it would not follow the terms of existing bonds governed by English law in two respects. First, it would establish a considerably higher voting threshold compared to 75 percent under the bonds governed by English law. Second, it would calculate the voting threshold on the basis of the outstanding principal amount rather than on the basis of the claims of bondholders present at a duly convened meeting.

22. **The latter deviation from the prevailing English law practice is consistent with the approach recommended by the G-10 Working Group Report.** As discussed above, the G-10 Working Group Report took the view that relying on the outstanding principal amount as the basis for calculating the voting threshold may be necessary in order to make a majority restructuring provision acceptable to U.S. investors. However, the first deviation (using a significantly higher threshold than the 75 percent threshold that prevails in bonds governed by English law) is not consistent with the approach taken by the G-10 Working Group. Indeed, and as is discussed above, the G-10 Working Group emphasized that a threshold above 75 percent would be particularly problematic if the vote was calculated on the basis of the outstanding principal amount rather than on the basis of the claims of bondholders present at a duly convened meeting. Such a high voting threshold could continue to make it difficult to coordinate a larger majority of bondholders, particularly in cases in which bonds are largely held by retail investors.

23. **The ability of a bondholder holding 10 percent of outstanding principal to block a restructuring supported by bondholders holding 85 percent is likely to give vulture creditors an incentive to acquire such a blocking position.** This could be of particular importance in the case of "orphan" bond issues with small outstanding amounts of principal, for which it would be relatively inexpensive for a creditor to acquire a blocking position.

24. ***Majority Enforcement Provisions*** –In one respect, the majority enforcement provisions proposed in the Industry Associations Draft would adopt the useful provisions that are often found in international sovereign bonds. Specifically, the Industry Associations

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[11] This high proposed threshold may be influenced by the private sector's concern over a sovereign debtor's control of a significant stock of outstanding principal in a particular issue, as may be the current case in Argentina. This issue is more directly dealt by the disenfranchisement provision.

Draft proposes that an acceleration of the bonds following a default would require an affirmative vote of bondholders holding 25 percent of outstanding principal. In two other respects, however, the Industry Associations Draft falls short of the majority enforcement provisions that can be found in international sovereign bonds.

25. **First, the Industry Associations Draft provides for the reversal of an acceleration by a vote of 75 percent, which is higher than the threshold that is typically found in existing New York law bonds (i.e., more than 50 percent).** As discussed above, the G-10 Working Group Report recommended a range from more than 50 percent to a maximum of 66⅔ percent.

26. **Second, the Industry Associations Draft does not propose the use of a trust structure for sovereign bonds governed by New York law**. As noted above, such a structure can be found in bonds governed by English law and can act as an important deterrent to disruptive litigation after a default but prior to a restructuring agreement. It was for this reason that it was also endorsed by Fund staff and by the G-10 Working Group. As discussed earlier, however, views of Executive Directors were mixed as to whether the costs of such a structure justified their inclusion. The unwillingness of the Industry Associations Draft to include such a provision was due to the concern of certain U.S. trade associations that it "unduly restricts the right of individual bondholder action." However, according to informal indications from some industry association representatives, as the New York market develops the required expertise to provide the appropriate trustee services, there will likely be more flexibility on this issue going forward.

B. Bonds Governed by English Law

27. ***Majority Restructuring Provisions*** – With respect to the essential terms of this provision, the Industry Associations Draft proposes that the majority restructuring provision be the same as the one it proposes for bonds governed by New York law; namely, an amendment of payment terms could be made by a vote of 85 percent of the outstanding principal amount, provided that no amendment would become effective over the objection of the holders of more than 10 percent of the outstanding principal amount. As discussed above, the adoption of such a provision in bonds governed by English law would result in a significant restriction of the clauses that currently exist in such bonds, since it would not only increase the existing voting threshold (typically 75 percent), but would also rely on the outstanding principal rather than the claims of bondholders present at a duly convened meeting as the basis for calculating whether this threshold had been met. The Industry Associations Draft acknowledges that "in compelling circumstances in the context of a predominantly retail distribution, it may be appropriate to reduce the applicable percentage, but not below 75 percent."[12] However, even in these circumstances, the provision would still

[12] Such a qualification does not apply to the Industry Associations Draft's proposal for bonds governed by New York law, presumably because retail placements are more familiar in the London market.

give bondholders holding 10 percent of outstanding principal the right to block a restructuring.

28. ***Majority Enforcement Provisions*** – With respect to majority enforcement provisions, the Industry Associations Draft proposes 25 percent for acceleration and 75 percent for de-acceleration. With respect to de-acceleration, this would constitute some further restriction from existing English practice, where de-acceleration is typically achieved through the majority restructuring provision, which allows for the 75 percent threshold to be calculated on the basis of the claims of bondholders present at a duly convened meeting (a feature that can be particularly relevant for issues placed in the retail market).

29. **In one important respect, however, the Industry Associations Draft maintains existing practice for English law bonds: it recognizes that English law bonds may utilize trust deeds, although it does not necessarily recommend them as being preferable.** In this respect, the Industry Associations Draft deviates from the G-10 Working Group Report, which recommends the use of trust deeds or equivalent structures. The relevant industry associations point out, however, that there have been no issues under English law recently that contain a trustee structure.

C. Other Provisions

30. ***Amendment of Nonpayment Terms*** – The Industry Associations Draft would raise the threshold for the amendment of a number of nonpayment terms as a means of restricting the use of the type of "exit consents" that were successfully relied upon in the restructuring of Ecuador's debt. In the case of Ecuador, although the bonds in question required unanimity for the amendment of payment terms (as is the case for existing New York bonds), they allowed for the amendment of nonpayment terms by a simple majority. As a means of providing an inducement for bondholders to participate in the bond exchange, the terms of the exchange provided for the amendment of the nonpayment terms of the old bonds in a manner that made these bonds less attractive (e.g., eliminating the requirement to cure a default prior to reversal of acceleration and the elimination of certain financial covenants).

31. **The exit consent technique has raised considerable controversy within the creditor community and the Industry Associations Draft would seek to restrict their use in two respects.** First, it expands the definition of terms that would require approval by a qualified majority to include, for example, the waiver of certain covenants, including the negative pledge clause and the *pari passu* provision. Second, it clarifies that amendments that would deprive the creditors of important enforcement rights (e.g. waiver of sovereign immunity and change in governing law) would require unanimous approval.

32. **As a general matter, the exit consent technique, when appropriately designed, may play a useful role in facilitating a debt restructuring in circumstances where the**

bonds do not contain majority restructuring provisions.[13] However, where a bond already contains a provision that establishes a reasonable threshold for the amendment of payment terms, it is understandable why investors would wish to include provisions that make it more difficult for a debtor to use lower majorities to achieve the same result. Accordingly, the issue raised by the Industry Associations Draft proposal is not whether the restriction it places on the amendment of nonpayment terms is reasonable but, rather, whether the very high threshold needed for the amendment of payment terms is so restrictive that it undermines the effectiveness of these clauses.

33. ***Disenfranchisement Provision –*** The Industry Associations Draft proposes to exclude bonds that are owned or controlled, directly or indirectly, by or on behalf of the issuer or any of its agencies or instrumentalities for voting purposes. This disenfranchisement provision is consistent with the approach taken by the G-10 Working Group.

34. ***Bondholder Committee –*** It is generally recognized that a representative bondholder committee could play an important role in facilitating early dialogue and coordination between creditors and the sovereign during a crisis so as to address both debtor-creditor and inter-creditor issues. The Industry Associations Draft provides that a bondholder committee may be formed with the consent of bondholders with more than 50 percent of the outstanding principal, but that any appointment to the committee cannot become effective over the objection of bondholders with 25 percent of the outstanding principal.

35. **This provision differs from the engagement provision recommended in the G-10 Working Group Report, which proposed that a special bondholder representative be elected for each bond issue to engage in restructuring discussions with the sovereign and other creditors, most probably as part of a single committee for all bond issues.** In contrast, the Industry Associations Draft appears to contemplate the possibility of the formation of a bondholder committee for each outstanding bond issue. Although these committees may eventually consolidate into a single committee during the restructuring process, the potential for a multiplicity of committees may create some inefficiencies. In addition, the Industry Associations Draft requires the sovereign to pay all fees and expenses of the committees and their legal and financial advisors. While the payment of fees by debtors is consistent with standard market practice, its combination with the possibility of a multiplicity of committees could make the costs that must be borne by a debtor excessive.

36. ***Information Covenants*** – The Industry Associations Draft also contains, as financial covenants, new transparency requirements for sovereign issuers that are far more detailed than those proposed by the G-10 Working Group. All such information would be published by the relevant industry associations on their websites. Some of the required information includes data that an emerging market country would normally be providing anyway. Most

[13] For a detailed discussion of exit consents, see The Design and Effectiveness of Collective Action Clauses, SM/02/173 (6/7/02).

importantly in this regard, the Industry Association Draft would require an issuer to subscribe to the SDDS as long as the bond remains outstanding.[14]

37. **Other specified information, however, would normally not be made available and would raise issues for both the member and the official sector.** First, some of information required (e.g., the text of stand-by arrangements) are decisions of the Fund–not documents owned by the member. Moreover, such documents are not published under the Fund's existing policy. Second, some of the specified information includes confidential agreements between the sovereign and another party and, presumably, consent by the counterparty would be required before the terms of the agreements could be released. For example, the Industry Associations Draft would require the provision of the terms of any agreed minute or bilateral agreement completed under the Paris Club process.

38. **In addition to specified information, the Industry Associations Draft would also require the sovereign to provide such other information that can "reasonably" be requested from time to time by bondholders holding 5 percent of outstanding principal**. This provision could require the disclosure of confidential information (unless the sovereign is able to convince a court that such information is not the type that can be "reasonably" requested). Giving 5 percent of bondholders the power to activate this provision is particularly significant given the fact that noncompliance with a financial covenant would typically give rise to an event of default.

39. **Finally, the Industry Associations Draft requires quarterly reporting for as long as the bonds are outstanding, of twelve-month projections on government budget and inflation figures.** Based on informal consultations with legal experts in this area, this requirement may raise U.S. securities law concerns in cases where, after the issuance of the bonds in question, the issuer plans to conduct a public offering of additional instruments in the United States during the reporting period. In the case of a public offering, the U.S. Securities Act of 1933, as amended (the "Securities Act"), prohibits any sale of or offer to sell securities in the United States before a registration statement has been filed with the Securities and Exchange Commission (the "SEC"). If an issuer publishes information and statements or initiates publicity relating to the offering during this pre-filing period, it may be held liable under the Securities Act for "conditioning the market" for the offering as part of the selling effort. In the sovereign context, the SEC has not provided specific guidance as to what type of publicity would constitute conditioning the market. Accordingly, legal experts have advised that whether these covenants would, in fact, give rise to problems under the U.S. securities laws would depend on the facts and circumstances of a particular case.

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[14] Under existing international bonds, a breach of a covenant would normally give rise to an event of default. Informal consultation with the preparers of the Industry Associations Draft suggest that such consequences may not be intended.

IV. Recent Developments in Including CACs

A. Overall Developments in Market Practice

40. **Since 1994 there is growing issuance of international sovereign bonds without CACs.** [15] Increasingly bonds are issued under New York law, which do not typically contain CACs, both in terms of number and volume of issues (Table 1 and Figure 1 and 2).[16] Issuances governed by English law, which contain CACs, declined to around 20 percent of the total at end-2002 from a level of 40 percent in 1998. As of February 2003, the outstanding stock of international sovereign bonds issued with CACs amounted to about 33 percent of the total. [17]

41. **Existing evidence does not suggest that the use of CACs raises borrowing costs.** Most studies have not found evidence that issuers who issue bonds governed by English law systematically pay a premium relative to issuers who issue bonds governed by New York law; and some have found a small discount for the use of English law.[18] One study suggests that with respect to use of English style documentation, higher credit quality issuers paid lower spreads, while lower quality issuers paid a premium.[19]

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[15] Since there is a strong correlation between governing law and the use of majority restructuring provisions in international sovereign bonds, data on governing laws can be used as a proxy for the use of CACs in bonds (see SM/02/175, 6/7/02 for an elaboration).

[16] Bonds issued under New York law typically include majority enforcement provisions.

[17] Non-U.S. dollar denominated bonds were converted into U.S. dollars at the current exchange rate. Brady bonds were not included.

[18] See Petas and Rahman, "Sovereign Bonds—Legal Aspects that Affect Default and Recovery", *Global Emerging Markets—Debt Strategy*, Deutsche Bank (May 1999); Tsatsanoris K., "The Effect of Collective Action Clauses on Sovereign Bond Yields", in Bank for International Settlements, *International Banking and Financial Market Developments*, Third Quarter, pp. 22-23 (1999); Dixon and Wall, "Collective Action Problems and Collective Action Clauses, Bank of England Financial Stability Review (June 2000); Becker, Richards, and Thaicharoen, "Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly?", IMF Working Paper WP/01/92 (July 2001); Gugiatti and Richards, "Do Collective Action Clauses Influence Bond Yields? New Evidence from Emerging Markets", Research Discussion Paper, Reserve Bank of Australia (March 2003); and SM/02/175, 6/7/02.

[19] Eichengreen and Mody, "Bail-ins and Borrowing Costs," IMF Staff Papers, Volume 47, pp. 155–188 (2201). See also Eichengreen and Mody, "Would Collective Action Clauses Raise Borrowing Costs: An Update and Additional Results," Policy Research Working Paper No. 2363, World Bank, May 2000.

Table 1. Emerging Markets Sovereign Bond Issuance by Jurisdiction [1]

	2001				2002				2003 [4]
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
With CACs [2]									
Number of issuance	14	10	2	10	6	5	2	4	6
Volume of issuance	5.6	4.8	1.8	2.2	2.6	1.9	0.9	1.4	4.2
Without CACs [3]									
Number of issuance	16	17	6	18	17	12	5	10	10
Volume of issuance	6.7	8.5	3.8	6.1	11.6	6.4	3.3	4.4	6.8

Source: Capital Data.

[1] Number of issuance is in number. Volume of issuance is in billions of U.S. dollars.

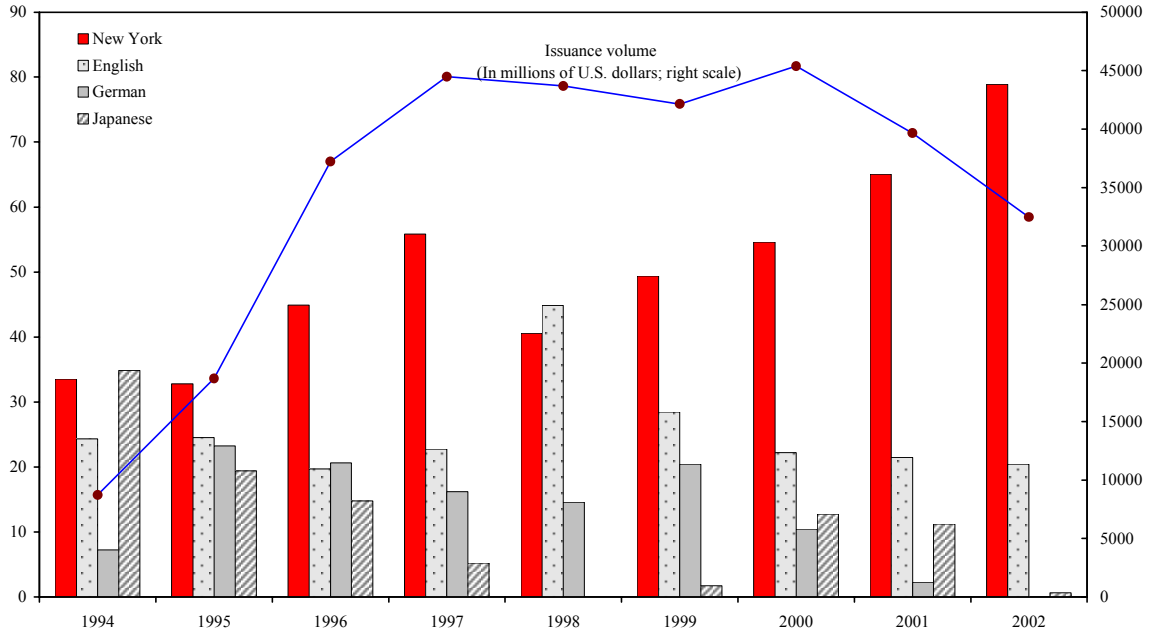
[2] English and Japan laws.

[3] German and New York laws. However, the Egyptian issuance of US$1500 million out of New York in June 2001 CACs and thus reclassified.

[4] Data for 2003-Q1 are as of February 20, 2003.

Figure 1. Emerging Market Sovereign Bond Issuance by Governing Law [1]

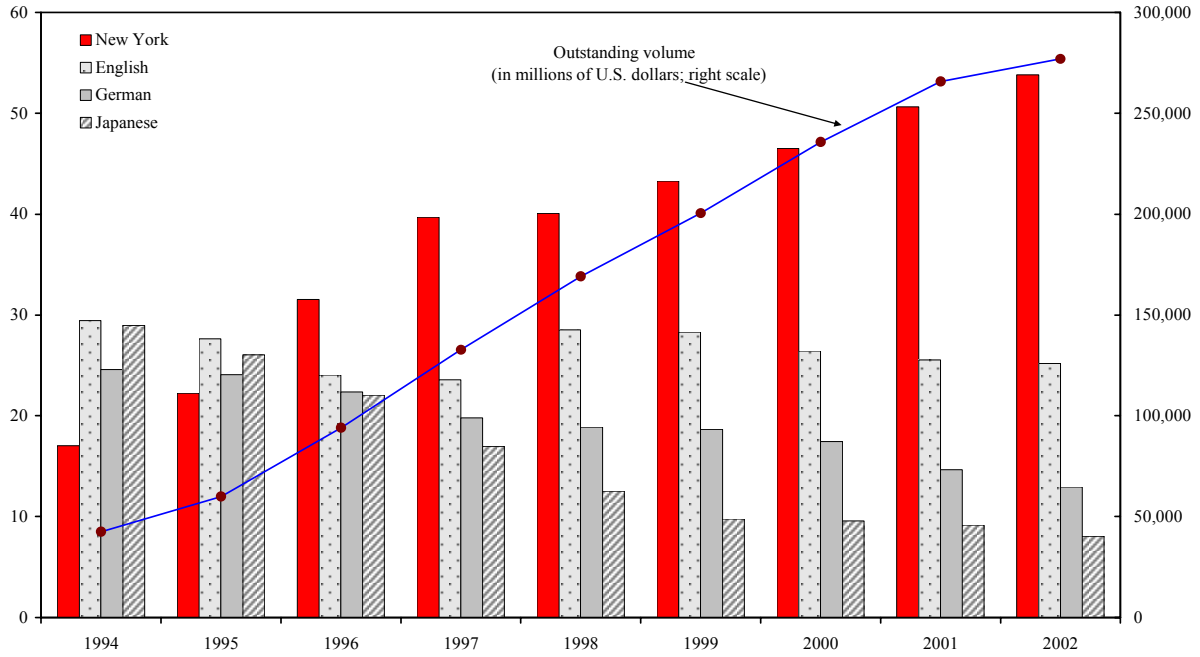
(In percent of total volume)



Sources: Capital Data Ltd; and IMF staff estimates.

[1] The total is the sum of bond issuance governed by New York, English, German, and Japanese laws.

Figure 2. Emerging Market Sovereign Bond Outstanding by Governing Law
(In percent of total volume)



Sources: Capital Data Ltd; and IMF staff estimates.

[1] The total is the sum of bond issuance governed by New York, English, German, and Japanese laws.

42. **There is also no evidence that investors eschew bonds issued with CACs.** Rather, the observed pattern of the use of CACs, proxied by the jurisdiction of issuance, is typically determined by a variety of factors, including changes in the issuer and investor base, the desired currency denomination of the issue, and debt management considerations. Changes in the investor base and issuers pool have tended to favor New York as an issuing jurisdiction. On the demand side, institutional investors gained more importance, especially the U.S. institutional and cross-over investors. At the same time, the retail investor base in Europe and Japan has declined. These changes have led to greater focus on the U.S. market and more issuance out of New York. On the supply side, the pool of issuers has changed as well with Latin American issuers becoming more prominent and emerging European issuers declining in importance, most noticeably Russia. Typically, issuers targeting a global investor base increasingly tend to issue out of New York. The decline in new bonds governed by English law is partially explained also by the fact that Russia, which has issued only Eurobonds out of London, has not accessed the market recently, except for an exchange in 2000 (Table 2).

Table 2. EMSB Outstanding Issuance by Governing Law and Issuer
(Number of bond outstanding)

	New York	English	German	Japan
Emerging Markets	**270**	**158**	**72**	**55**
Asia	30	18	1	13
Europe	34	77	27	18
Latin America	169	47	43	15
Middle East/Africa	37	16	1	9

Source: Capital Data

43. **The use of governing laws is highly correlated with the currency of a bond issue, with the exception of English law.** Bonds issued under New York law are largely denominated in U.S. dollars. The increasing use of New York law reflects a stronger preference for U.S. dollar denominated bonds over other currencies, with the termination of the German mark and the decline of Japanese yen issuance worldwide (Table 3).

Table 3. EMSB Outstanding Issuance by Governing Law and Currency 1/

	New York	English	German	Japan	Total
		(In percent)			
U.S. dollar	91	34	0	0	
Euro	8	54	53	0	
Deutsche Mark	0	0	46	0	
Japanese yen	0	3	0	100	
other	1	8	1	0	
		(In billions of U.S. dollars)			
Total	151	72	29	17	270
		(In number of issuance)			
Total	270	158	72	55	555

Source: Capital Data; and IMF staff estimates.
1/ Brady bonds are excluded.

B. Issuing Country Developments

Mature Market Issuers

44. **In response to the official community's call for encouraging greater use of CACs, a number of mature market countries have taken steps to introduce such clauses in their international sovereign bonds.** In January 2000, the United Kingdom included a majority amendment clause in its euro-denominated treasury note program, which had no

discernible impact on price or liquidity. In April 2000, Canada announced that it would include CACs in its future foreign jurisdiction bond and note issues.

45. **In September 2002, EU Finance Ministers stated that EU countries' sovereign bonds issued under foreign jurisdictions (i.e., bonds governed by a foreign law or subject to the jurisdiction of a foreign court) would henceforth include CACs.** Although such bonds are a small part of overall bond issuance by EU countries, there are a number of countries that have issued in foreign jurisdictions in the past few years, such as Austria, Finland, Italy, Portugal, and Spain.[20] The intent of this step is to "lead by example", thereby facilitating the incorporation of such clauses in bonds issued by emerging market countries.

Emerging Market Issuers

46. ***Egypt, Lebanon, and Qatar*** – There have also been important developments with respect to emerging market issuers. Although the most publicized case is the recent issuance by Mexico, which is discussed in considerable detail below, three other emerging market countries have also successfully included majority restructuring provisions in bonds governed by New York law. Specifically, Egypt, Lebanon and Qatar issued bonds under New York law, which in the U.S. were offered to institutional investors under Rule 144A of the U.S. Securities Act of 1933.[21] Lebanon's Global Medium Term Note Program launched in June 2000, Qatar's bonds issued in June 2000, and Egypt's bonds issued in June 2001, all contain majority restructuring provisions. While, in the case of Lebanon and Qatar, the provisions include a 75 percent voting threshold based on the claims of bondholders present at a duly convened meeting, the Egyptian bond provides for an 85 percent threshold calculated on the basis of the outstanding principal amount. Although the bonds issued by Egypt and Qatar also include a very limited form of majority enforcement provisions, the

[20] Overall issuance by EU countries of international sovereign bonds is estimated to amount to roughly 3½ percent of the outstanding stock of bonds (this includes issuance by an EU country in another EU country). However, while the share of international bonds issued by EU members is relatively small, the EU represents a sizeable portion of the global market. It is estimated that, since 1996, over € 37 billion in bonds was issued by EU countries through New York, and roughly € 6 billion through the German market – a possible indication of the impact future use of CACs could have on changing market practice in these jurisdictions.

[21] Rule 144A provides a "safe harbor" from the registration statements of the U.S. Securities Act of 1933 and is often used for the secondary sales of unregistered securities to "qualified institutional buyers."

Lebanese bonds do not contain such provisions.[22] None of the bonds were issued under a trust deed.

47. **At the time of issuance of these bonds, there was no discussion among market participants concerning their inclusion of majority restructuring provisions.** In recent months, however, as the general discussion of CACs made investors aware that the Egyptian bonds included these provisions, there was no indication that the market penalized these bonds for their inclusion of CACs.[23]

Mexico

48. **In March 2003, Mexico issued bonds governed by New York law that included both majority restructuring provisions and majority enforcement provisions.** This issuance has garnered considerable attention because there had been extensive discussion of CACs prior to the issuance. More specifically, the issuance follows the completion of both the G-10 Working Group Report and the Industry Associations Draft. Accordingly, there has been considerable interest as to the manner in which the provisions proposed by the G-10 Working Group and the Industry Associations Draft were applied by Mexico. Moreover, a detailed discussion of the CACs took place with investors when the bonds were marketed.

49. **A close look at the provisions reveal that they are generally—but not entirely—consistent with the types of clauses recommended by the G-10 Working Group and attempt to achieve a careful balance between the objectives of resolving collective action problems and protecting creditor rights.** While these provisions also include some of the features proposed in the Industry Associations Draft, they depart from the Industry Associations Draft in a number of important respects.

50. ***Majority Restructuring Provisions*** – The Mexican bonds provide that the payment terms may be amended by 75 percent of the outstanding principal amount.[24] The 75 percent threshold is consistent with the prevailing practice for bonds governed by English law. However, the reliance on the outstanding principal amount as the basis for calculating whether the threshold has been met deviates from English practice but, when taken together with the 75 percent voting threshold, follows the recommendations of the G-10 Working Group Report. As noted earlier, reliance on the outstanding principal as a means of

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[22] Although the majority enforcement provisions contained in the Egypt and Qatar bonds would require the support of at least 25 percent of outstanding principal to accelerate the entire issue, individual bondholders would still have the right to accelerate their own claims.

[23] In recent months there was a rally in the price of Egyptian bonds that was independent of the inclusion of CACs and was likely associated with the floating of the Egyptian pound, which was interpreted by the market as a positive credit event.

[24] Among the terms subject to the 75 percent threshold are the provision on governing law and the submission to foreign jurisdiction.

calculating whether the voting threshold has been met was viewed by the G-10 Working Group as a possible way addressing the specific concerns of U.S. investors. While the Industry Associations Draft also utilizes the outstanding principal approach, its proposed voting threshold is higher than 75 percent.

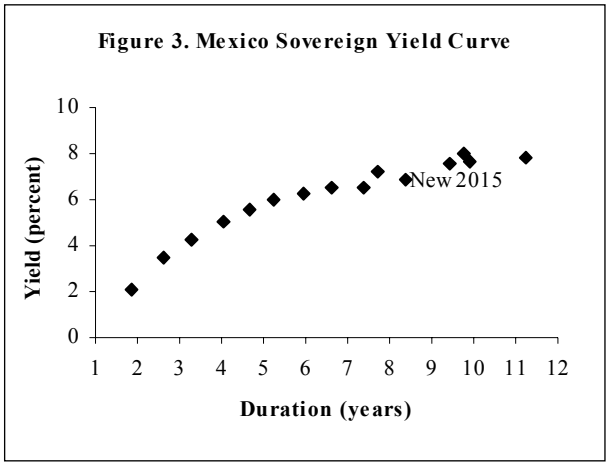
51. ***Majority Enforcement Provisions*** – The applicable voting thresholds for the acceleration and de-acceleration of the bonds are 25 percent and more than 50 percent, respectively. These thresholds are consistent with the prevailing practice for bonds governed by New York law and are consistent with the ranges proposed by the G-10 Working Group. While the acceleration provision is consistent with the Industry Associations Draft, the voting threshold for de-acceleration is lower than that proposed by the Industry Associations Drafts, which is 75 percent.

52. **The Mexican bonds were not issued under a trust deed as proposed by the recommendations set forth in the G-10 Working Group Report.** However, the authorities have indicated that this is attributable to the fact that the issue was part of Mexico's ongoing Medium-Term Notes program, under which Mexico regularly issues bonds. Rather than issuing the bonds under a new trust deed, Mexico revised the fiscal agency agreement in the medium-term program to reflect the inclusion of the CACs.

53. ***Disenfranchisement Provision*** – The documentation expands the scope of bonds excluded for voting and quorum purposes from bonds owned by Mexico to those owned directly or indirectly by the government or any public sector instrumentality. This expansion, which is consistent with the recommendations of the G-10 Working Group and the Industry Associations Draft, is designed, in large part, to provide investors with a greater assurance that the issuer will not be able to manipulate the voting process through its effective control of certain bondholders.

54. ***Engagement Provisions*** – The Mexican bonds did not contain the type of engagement provisions proposed in the G-10 Working Group Report, nor did they provide for the establishment of a bondholders committee, as proposed by the Industry Associations Draft. Mexico has expressed the view that it would be inappropriate to determine *ex ante* the type of restructuring process that may occur many years in the future, by which time best practices may have evolved.

55. ***Transparency*** – As discussed earlier, the G-10 Working Group Report proposed the inclusion of some general transparency covenants, recognizing that the type of information to be provided would need to be resolved. The Industry Associations Draft proposed a very ambitious list of information that would need to be disclosed pursuant to a covenant under the terms of the bond. The terms of the Mexican bonds do not include any covenants that require the provision of such information. Mexico did not believe it was necessary to include such covenants since it believes its continued access to capital markets would be conditioned on transparency. For example, the relevant prospectus provided that Mexico subscribed to the SDDS, one of the requirements under the covenants of the Industry Associations Draft.



56. **Mexico's March issuance with CACs was a success.** Based on analysis of the Mexican sovereign yield curve, there is no evidence that the issue price of the US$1 billion placement reflected a yield premium for including CACs (Figure 3).[25] A number of private market buyers of the bond also expressed the view at the time of issuance that there had been no premium due to CACs. To date, the bond has traded without a yield premium in the secondary market.

57. **Mexico's bond placement with CACs is a test of the market's acceptance of meaningful clauses**. Its continued successful performance in the secondary market may determine the extent to which this issuance will be a significant step in eliminating the first mover problem for including majority restructuring provisions in New York law governed bonds. Indications from private market participants are that two conclusions may be drawn from this experience. First, even if Mexico's move shows that the market will readily accept CACs from investment grade emerging market issuers with an established reputation for sound debt management practices without extracting a yield premium, investors may be more resistant to CACs from other issuers that are below investment grade, and this may lead in some cases to pressures to modify the contractual provisions and/or to accept some premium due to CACs. Second, whether or not successful, this was an educational process for private investors, in particular cross-over investors. As investors that are active with instruments governed by New York law become familiar with CACs, they may gradually become less resistant to such contractual provisions.

58. **Reportedly, several other investment grade emerging market issuers are also considering to include CACs in their future government bond contracts, although no formal announcements have been made yet.** In addition, Argentina has suggested that it may be considering including CACs in debt instruments to be issued in its forthcoming restructuring, in the terms of reference for the recently appointed external debt restructuring advisors.[26]

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[25] Calculations on Mexico's issue have varied depending on the methodology used, in particular in light of the complex nature of the Mexican sovereign yield curve. Some calculations showed a small yield premium of up to 10 basis points.

[26] At the subnational level, the City of Buenos Aires recently completed a restructuring of its external debt, using the CACs incorporated in all of the City's external debt instruments governed by English law.

V. SUMMARY AND CONCLUSIONS

59. **As has been described in this paper, there have been important developments over the past year with respect to both the design of CACs and their incorporation into bonds governed by New York law.** These developments are welcome and, consistent with the guidance provided by the Board during the June 2002 discussions, the Fund will continue to encourage the inclusion of CACs through its multilateral and bilateral surveillance. Of course, the staff is mindful that, given the outstanding stock of bonds that do not include CACs, it will take considerable time before CACs are included in most international sovereign bonds, even if there are instances in which CACs are added to the existing debt stock through market-based debt exchanges and swaps.

60. **If the Fund is to promote the inclusion of CACs in its bilateral and multilateral surveillance, the issue arises as to the types of CACs the Fund should be recommending.** When addressing this issue, it is necessary to bear in mind that, since CACs are contractual in nature, any decision as to their use and features will ultimately be one made by the debtor and its creditors. Neither the official sector nor the relevant industry associations will be able to mandate their incorporation nor determine their design.

61. **Having recognized that the CACs will only be adopted if they are acceptable to the market, the Fund has taken the position—as evidenced in its June 2002 discussion—that the most effective strategy is to promote the more widespread use of those types of provisions that already exist in many international sovereign bonds (these provisions have been described in considerable detail in earlier Board papers).** Among the issues raised by the developments over the past year is the question of whether these provisions can be introduced—without any modification—into bonds issued in jurisdictions where such provisions have typically not appeared. In particular, when purchasing bonds governed by New York law, will U.S. institutional investors be willing to accept the type of provisions that exist in bonds governed by English law? More generally, the question arises as to the degree of standardization that should be sought, in terms of desired uniformity across different jurisdictions.

62. **Since emerging market issuers are only just beginning to explore the more widespread use of CACs in their international bond issues, it is too early to reach a definitive view on these questions**. For this reason, it would not be advisable at this time for the Fund to endorse a set of model clauses. Nevertheless, based on recent developments—both in terms of the design of CACs and their incorporation into new international issues—a number of preliminary observations could be made regarding those features of CACs that would both facilitate a rapid and orderly restructuring process and have a reasonable probability of being acceptable to the market. These observations, relating to specific design features of CACs, are discussed below.

63. ***Majority Restructuring Provisions*** – Perhaps the most important feature of any CAC is the provision that enables a qualified majority to bind all bondholders within the same issue to the financial terms of a restructuring. These clauses are found in bonds governed by

English law, where the required majority is normally set at 75 percent. Recent developments and, in particular, Mexico's successful bond issue, provides some evidence that investors are willing to purchase bonds—at least of investment grade—governed by New York law that include majority restructuring provisions which rely on the same majority.

64. **However, a close look at the terms of the CACs utilized by Mexico demonstrates that at least two important modifications were made to the English-style provisions so as to make them more acceptable to the U.S. market.** First, the method used to calculate whether the 75 percent voting threshold has been met is based on the outstanding principal amount rather than the claims of bondholders present at a duly convened meeting. U.S. investors have expressed concern that the latter approach, when coupled with the quorum rules that determine when a meeting is convened, could result in a minority of bondholders agreeing upon a restructuring where only a small percentage attend the meeting. Second, as described in the paper, the bonds also include an expanded disenfranchisement provision that precludes bonds being voted where they are directly or indirectly owned or controlled by the sovereign issuer and its public sector instrumentalities.

65. **These provisions, taken together, appear to strike an appropriate balance between the objective of resolving collective action problems and protecting creditor rights.** It is notable that they are consistent with the recommendations made by the G-10 Working Group Report. Although they are also consistent with certain features of the Industry Associations Draft (e.g., an expanded disenfranchisement clause and reliance on outstanding principal for voting purposes), the 75 percent voting threshold used by Mexico is considerably lower than that proposed in the Industry Associations Draft.

66. ***Majority Enforcement Provisions*** – These provisions are designed to limit the ability of a minority of bondholders to disrupt the restructuring process by enforcing their claims after a default and prior to a restructuring agreement. Two of these provisions can already be found in bonds governed by English law and New York law: (i) an affirmative vote of a minimum percentage of bondholders is required to accelerate their claims after a default and (ii) a simple or qualified majority can reverse such an acceleration. The bonds issued by Mexico include such provisions and rely on thresholds that have already been generally accepted in bonds governed by New York law and which, on balance, appear to be reasonable: a vote by 25 percent of outstanding principal is needed to accelerate the claims and a vote of more than 50 percent is needed to de-accelerate these claims.

67. **A more difficult question relates to the use of provisions that confer the right to initiate litigation on behalf of all bondholders upon a bondholder representative who is only required to act if requested by the requisite percentage of bondholders.** Moreover, these provisions ensure that the proceeds of any litigation are distributed by the representative on a *pro rata* basis among all bondholders. These provisions can be implemented through the type of trust deeds that are occasionally used for bonds that are governed by English law. However, they are not generally found in bonds governed by New York law and were not relied upon by Mexico.

68. **Consistent with the recommendations contained in earlier papers, the staff continues to be of the view that the use of these types of trust deeds—or an equivalent legal structure—can play a very important role in the restructuring process and that the potential benefits justify the limited financial cost of using them.** Although this view is also shared by the G-10 Working Group, the Industry Associations Draft does not propose their use in bonds governed by New York law.[27]

69. ***Engagement Provisions*** – In an earlier paper, the staff expressed the view that a representation or "engagement" provision that could play a useful—but perhaps not a critical —role in the restructuring process by giving a bondholder representative the authority to act as channel of communication between bondholders and the sovereign debtor in the context of a crisis. Although such clauses would be novel, both the G-10 Working Group Report and the Industry Associations Draft have proposed different variations of such a provision. Although it is too early to form a judgment as to its specific design features, staff are of the view that the provision should clearly avoid the establishment of a multiplicity of bondholder committees where a number of bond issues are being restructured.

70. **Abstracting from an analysis of the specific design features of CACs, a more general question arises as to whether their complete standardization is feasible and desirable, in terms of uniformity across jurisdictions.** While it might be desirable for all CACs to possess all of the features described above, differences in legal systems may necessitate some degree of variation. For example, not all jurisdictions will be able to limit disruptive litigation through reliance on trust deeds and may need to implement other structures to achieve the same results. Indeed even within the London market, bonds differ in the form of trustees or in the percentages applied to decisions.

71. **One could also envisage variations across jurisdictions that are attributable to differing features of the market that is being accessed by the sovereign.** For example, and as discussed in this paper, reliance on the outstanding principal amount for purposes of calculating whether the voting threshold has been met may be appropriate in the New York market, which is dominated by institutional investors. However continued reliance on the "quorum" approach (where the calculation is based on the vote of bondholders attending a meeting) may be a more practical method for the London market, where the bonds are more widely held in the retail sector. At the same time, however, there is growing evidence (as demonstrated by the Industry Associations Draft) of a desire by the relevant trade associations to shift to a reliance on the outstanding principal amount approach.

72. **There are few *a priori* grounds for believing that bonds containing CACs should trade at a discount compared with those that do not.** There has been no systematic historical difference in pricing between bonds issued in London (typically containing CACs)

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[27] Moreover, while it accepts their use in bonds governed by English law, it does not take a position as to whether they are preferable to fiscal agency agreements.

and those issued in New York (without them). Indeed, Mexico was able to issue a bond in New York containing clauses without paying a noticeable premium. Nevertheless, in the period during which CACs are not yet standard practice, less creditworthy borrowers may be called upon to pay a premium for incorporating CACs on their bonds. In such circumstances, the issuer will have to decide whether the premium for the CACs is worth paying.

73. **While the increasing standardization of CACs may evolve over time, it is not something that is likely to occur immediately.** For example, while the terms of the CACs recently adopted by Mexico appear to be broadly appropriate, some acceptable variations may develop in light of market experience.

74. **A final issue relates to the desirability of including contractual covenants relating to the provision of information. Although these provisions are not directly related to the resolution of collective action problems, detailed covenants in this area are presented as part of the CAC "package" in the Industry Associations Draft.** While the increased transparency is to be welcomed, it is unclear as to what type of nonpublic information can and should be made available under the terms of a contract. For example, some of the information identified by the Industry Associations Draft would either be confidential or would be owned or controlled by parties other than the sovereign (e.g. decisions of the Fund).

Next Steps for Encouraging the Use of Collective Action Clauses

75. **There is broad agreement that the Fund can and should play a role in encouraging the use of CACs through its multilateral and bilateral surveillance**.[28] Following the June 2002 discussion, the International Capital Markets Department now routinely devotes attention in the Global Financial Stability Report to the use of CACs in both new international bond issuance and to trends in the outstanding debt stock. Efforts are also being made to pay more attention to encouraging the use of CACs through bilateral surveillance, although until recently these efforts have been constrained by the lack of consensus on the appropriate design for such clauses.

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[28] The 2002 Board paper also examined a range of other options for the Fund to promote the use of CACs, but most options were rejected as impractical or disproportionate. In particular, most Directors were opposed to the idea of conditioning access to Fund resources, in part because it was deemed unlikely that the Fund would consider withholding resources from a member that was otherwise willing to implement a strong adjustment program, in part because the link between the use of clauses and the macroeconomic objectives was weak, and in part because countries seeking access to Fund resources would often be ill-placed to change market practice, possibly stigmatizing the use of clauses (BUFF/02/99).

76. **In recent months, efforts have focused on defining a set of desirable features for CACs that would be both effective in facilitating the orderly resolution of crises and be broadly acceptable to debtors and their creditors.** As the consensus on a desirable set of features for CACs develops, the promotion of majority restructuring and majority enforcement provisions that can contribute to an orderly restructuring process can now take on a more prominent role in bilateral surveillance activities. It would seem realistic for the Fund to continue to encourage the use of those clauses that, as described above, contain features which have already been accepted in the market and are generally considered to facilitate an orderly and rapid restructuring process. To the extent that the terms of these provisions evolve over time, the Fund will need to take these developments into account when making recommendations in this area. Staff have already initiated a more systematic information and education effort with Area Departments on the meaning and content of CACs.

77. **In addition, staff proposes to continue several forms of outreach to encourage the use of CACs.** First, a more active dialogue could take place especially with investment grade emerging market issuers, with a view to encouraging a group of "second-movers" to issue CACs in the New York market that are broadly in line with those issued by Mexico. Progress by mature market economies in the use of CACs in international bond issuance would further strengthen these efforts. Second, as part of a more concerted effort to encourage the use of CACs, an international seminar with key issuers, major issuing houses, institutional investors and legal practitioners could be organized later this year to discuss ways to promote CACs.

VI. Issues For Discussion

78. **As has been described in this paper, there have been important—and welcome—developments over the past year with respect to both the design of CACs and their incorporation into bonds governed by New York law.** These developments raise a number of issues with respect to both the design and implementation of CACs and the Fund's role in promoting them. Directors are particularly encouraged to express their views on the following issues:

- In recognition that market acceptability is a necessary feature of any CAC, do Directors agree that, as a general matter, the most effective strategy is for the Fund to promote the more widespread use of those types of CACs that: (i) already exist in many international sovereign bonds and (ii) promote an orderly and rapid restructuring process, as described in paragraphs 63–69?

- In terms of existing CACs, perhaps the most important provision is the one that enables a qualified majority to bind all bondholders within the same issue to the financial terms of a restructuring (majority restructuring provision). Directors may wish to comment on the design of majority restructuring provision recently relied upon by Mexico, the features of which are consistent with the recommendations of the G-10 Working Group. Do Directors agree that, taken together, this provision

strikes an appropriate balance between the objective of resolving collective action problems, on the one hand, and protecting creditor rights, on the other hand?

- Many bonds governed by New York law and English law also include provisions that are designed to limit the ability of a minority of bondholders to disrupt the restructuring process by enforcing their claims after a default and prior to a restructuring agreement (majority enforcement provisions). Do Directors support the more widespread use of these clauses, including the use of the range of voting thresholds for acceleration and de-acceleration that are most typically found in the market?

- While some bonds governed by English law are issued under trust deeds, those issued under New York law are not. Do Directors support the more widespread promotion of trust deed (or equivalent) structures?

- The G-10 Working Group Report and the Associations Draft propose different types of "engagement" provisions, which are designed to assist in establishing a channel of communication between bondholders and the sovereign following a default. Directors may wish to comment on these proposals.

- The staff proposes to continue its outreach effort as described in paragraph 77. Directors' views on the appropriateness of this program would be appreciated.

- Both the G-10 Working Group Report and the Associations Draft provide for the inclusion of covenants that would require the provision of information, although the latter provisions are far more detailed than the former. Directors may wish to comment on these proposals. If covenants are to be included, what type of information should they cover?

- The use of CACs is at bottom a market-driven process, both in terms of the precise CACs and the pricing of bonds containing CACs. If it is apparent that there is a clear premium for using CACs as described above, how do Directors view the member's decision?