



International Practices of Bond Trustee Arrangements

债券受托管理人制度国际实践

ICMA-NAFMII Working Group
9th UK-China Economic and Financial Dialogue

Editorial Committee

Editors in Chief:

XIE Duo, Martin Scheck

Associate Editors in Chief:

YANG Nong

Committee Members (in alphabetical order):

LI Xia, REN Qing, SHI Di, WAN Tailei, XU Mengyun, Ricco Zhang

ICMA Special Acknowledgements:

Allen & Overy, BNY Mellon, Deutsche Bank, Linklaters,
Mayer Brown

Contents

| | |
|--|-----|
| Chapter 1 Introduction | /1 |
| Chapter 2 Bond trustee arrangements and its application worldwide | /3 |
| 2.1 The definition of bond trustee | /3 |
| 2.2 The role and function of a bond trustee | /4 |
| 2.3 The development process of bond trustee arrangements | /7 |
| 2.4 The application of bond trustee arrangements around the globe | /9 |
| Chapter 3 Global practices of bond trustee services | /24 |
| 3.1 Legal and institutional basis | /24 |
| 3.2 Applicability of bond trustee mechanism | /27 |
| 3.3 Qualifications of Trustee | /28 |
| 3.4 Obligations, duties and rights | /31 |
| 3.5 Conflict of interests | /34 |
| 3.6 Indemnification of Bond trustees | /38 |
| Chapter 4 Conclusion | /42 |

01 Chapter 1 Introduction

After years of development, China's bond market is welcoming market-oriented mechanisms, improving supporting infrastructures, and offering more diversified products. The bond market is playing an increasingly pivotal role in supporting the real economy and meeting the varied investment, financing, and risk management needs of market participants. With the introduction of more measures aimed at trimming excess capacity, inventory and leverage, reducing businesses' operating costs, and strengthening underdeveloped sectors, the capital market has seen an increase in overall risk and a growing number of bond defaults. It should be noted that defaults are a natural and normal result of corporate credit risk in a market economy. A healthy amount of defaults will rein in issuers and investors, which is conducive to the sustainable and sound development of China's bond market.

Although Chinese policymakers regard the overall risk in the market as still manageable, rising risk of default also sets higher bars for creating safeguards for bond investors. Experience with recent bond defaults in China has exposed a number of issues that need to be addressed urgently, such as the convoluted process to defend

lawful rights and the lack of a "driver" in resolution efforts.

Internationally, developed overseas bond markets have a complete set of market-driven mechanisms, one of which is the bond trustee. In European and the United States (US) markets, the trustee structure has been used for many years. After executing a trust document, the bond trustee will be authorized to exercise its discretionary power to handle relevant affairs on behalf of investors following the issuance of the bond. Acting as a "counterparty" to the issuer, the bond trustee is better positioned to represent the interest of the numerous bondholders, and lends greater flexibility to bond management.

This report presents a detailed look at the trustee system in developed overseas bond markets, covering its origin, history, institutional value, and state of global adoption. This report also provides a systematic overview on aspects such as legal basis, applicability, qualification requirements, duties and rights, and conflict of interest and solution, with a summary of its practical significance.

This report adopts a "theory plus practice" approach in its analysis. At the theoretical level, this report examines overseas legal texts, the model trust indenture published by the American Bar Association, and a large volume of foreign literature to describe in detail the legal rules for the trustee system. More importantly, on a more practical level, the research team invited several foreign trustees who have first-hand experience in developed overseas bond markets to illustrate foreign market practices, summarize the role of the bond trustee both before and after a default, and clarify the duties of each interested party after an event of default.

02 Chapter 2

Trustee appointments⁴ under English and New York Law

2.1 The definition of a bond trustee

In many bond issues, the issuer appoints a trustee to represent the bondholders. The trustee is usually a professional specialist entity or a specialist trustee subsidiary of a financial institution. If a trustee is appointed by the issuer, the undertaking of the issuer to pay interest and to repay principal will be vested in the trustee. Although the entity chosen to act as trustee is chosen and appointed by the issuer, the trustee's role is to act as a fiduciary on behalf of bondholders in accordance with the terms of a "trust deed". The trust deed is a bilateral deed between the issuer and the trustee (and other obligor entities such as the guarantors or keep-well providers). The trustee is not an agent of the issuer, but an independent institution which is appointed by the issuer and acts on behalf of the bondholders. Under common law principles and certain jurisdictions' statutory provisions, the trustee owes the bondholders a duty of care. See section 2.4.2 "The differences between English and New York law" which are the two key international legal systems for bond trustees and section titled "Standard of duty of care" below.

⁴The discussion in this Chapter 2 assumes an English law governed bond trustee arrangements (other than as specifically set out in Chapters 2.3 and 2.4 relating to bond trustee arrangements under New York law governed indentures).

2.2 The role and function of a bond trustee

2.2.1 Issuer's perspective

From a bond management perspective, using a trustee structure is often less cumbersome for all parties involved in the process.

Firstly, if a trustee is not appointed to represent the bondholders, then the alternative "fiscal agency" or direct issuance structure would put bondholders into a direct contractual relationship with the issuer. Whoever holds the bond has the direct right to receive payment on it, and to sue the issuer, if the terms of the bond are not performed. As the bondholders are not represented by a professional body, they must police the issuer's compliance with the terms of the bonds and associated contractual documentation themselves. In a fiscal agency structure, each bondholder would have to take individual action against a defaulting issuer. The experience of bondholders following these defaults was one of the main factors that caused the increase in the use of a trustee structure in recent years.

Secondly, the vast majority of English law governed bond issues (whether or not a trustee is appointed) will contain provisions enabling the bondholders to meet and discuss issues that arise and agree upon a joint course of action (i.e., the calling of a bondholders' meeting). The bonds will provide that a decision will be binding on all bondholders if it is passed by a specified majority of a specified quorum, an important method of combining some flexibility with uniformity of treatment.

Thirdly, a trustee structure allows additional flexibility as the trustee may agree to waive technical and other breaches by the issuer which would otherwise require the sanction of bondholders. In addition, the trustee ensures that when action is required – such as declaring an event of default or taking enforcement proceedings – it is done on behalf of all bondholders. In practice, the trustee will require an indemnity, pre-funding and/or the provision of security to its satisfaction before agreeing to take action.

For further information on the flexibility of a trustee structure and how this differs as between English law and New York law governed transactions, see section 2.4.2 “The differences between English and New York law” which are the two key international legal systems for bond trustees and section titled “Standard of duty of care” below.

2.2.2 Bondholders’ perspective

The trustee is usually given certain rights to obtain information (in the form of information covenants) from the issuer and is therefore in a better position than the bondholders to monitor the issuer’s compliance with these covenants, to identify a breach, and to notify other stakeholders in order to take appropriate action.

As the trustee is generally able to enforce its rights on behalf of all bondholders as a class, enforcement proceedings are taken in one unified action on behalf of all the bondholders. The legal and financial advice which the trustee obtains is typically for the benefit of this class of bondholders. Many trust deeds contain wording to prohibit individual bondholders from taking enforcement action against the issuer, unless the trustee having been bound to act, fails to do so. This prevents individual bondholders from acting against the wishes of the majority. The trustee performs the role of a fiduciary between the issuer and the bondholders and between the bondholders themselves. The point in time at which this fiduciary obligation commences differs between governing laws.

Without a trustee structure, individual bondholders would have to take action themselves, which would be impracticable due to the expense, the general disparity of the bondholders, the difficulties in organising them and, in some cases, the wish of many noteholders to remain anonymous.

In a restructuring scenario, the trustee will often be involved in settling the form in which proposals are put to the bondholders. For instance, the circular would include wording to the effect that, whilst the trustee had no involvement in the negotiation

of the commercial terms, it has no objections to such proposals being put to the bondholders for their consideration. Trustees would satisfy themselves that the proposals are put correctly and with a clear explanation and are in a suitable state for bondholders to consider and vote on them.

Any moneys recovered by the trustee are distributed to all the bondholders in accordance with a pre-defined waterfall, thereby avoiding the risk that some bondholders recover, and others do not.

Prior to an event of default, any monies received or collected by the trustee will be distributed to all holders in accordance with the terms of the trust deed or the indenture (as applicable), thereby ensuring that all holders are paid on a pro rata and pari passu basis in accordance with the terms of the applicable trust deed or indenture. Following any court sanctioned restructuring, the court will generally take into account the payment waterfall included in the documents governing the restructured debt. However, following liquidation of the issuer, distribution of monies will be made at the order/discretion of the liquidator and the payment waterfall may or may not be applied in accordance with the terms of the documents.

2.2.3 New York law perspective

A New York law governed indenture will typically contain information covenants pursuant to which the issuer of securities is required to file certain information with the trustee (by way of an officers’ certificate and/or an opinion of counsel) either on an annual basis or to confirm and notify compliance with the financial covenants of the issuer. The trustee is able to conclusively rely on these certificates and opinions, without independent investigation into the underlying matters contained in the documents, so long as they conform to the requirements of the indenture. Unless it is expressly provided for in the indenture, the trustee has no obligation to forward such information to holders.

Under New York law, prior to an event of default, corporate trustees are not deemed to owe fiduciary duties to the bondholders. Other than the express contractual provisions, corporate trustees owe an obligation to avoid conflicts of interest and an obligation to perform basic, non-discretionary, ministerial tasks with due care. It is fairly standard for corporate trustees to disclaim monitoring duties with respect to financial performance of the issuer or as to compliance by the issuer of its covenants. A New York law indenture will typically provide that prior to an event of default, the obligations of the trustee are only as expressly stated and that no duties will be implied.

New York law indentures typically provide for holders of 25% of the aggregate principal amount of securities outstanding to declare the principal and interest to be due and payable immediately. A holder is only able to pursue a remedy if the requisite number of holders have notified the trustee of an event of default, instructed the trustee to pursue a remedy, the trustee does not comply with such request within a reasonable period of time and if holders of a majority aggregate principal amount outstanding have not provided any contrary instructions. In addition, instructing holders will also need to provide indemnity, security and/or prefunding to the trustee to its satisfaction, without which the trustee has no obligation to take any action.

2.3 The development process of bond trustee arrangements (brief history, background and status)

The trustee structure has its origins in English law dating back to the 11th and 12th centuries, initially arising from decisions of the Chancellor, and after the 15th century, the Chancery Court.

The principle of a trust is the splitting of the concept of ownership into two parts, the legal title and the beneficial title (the right to receive the benefit of the property). In a trustee structure, the trustee holds the legal title for the beneficiaries (who have the

beneficial title) pursuant to the terms of the trust. As the law developed, the trustee was bestowed with both statutory and non-statutory (fiduciary) duties of care.

In financial markets, the trustee structure was increasingly used during the 20th century. The fiscal agency structure had limitations where the bonds were not closely held. The defaults following the Great Depression highlighted the benefits of having a trustee to represent the bondholders.

Following the US “Wall Street Crash” of 1929, President Roosevelt introduced reforms to the banking system including enacting the US Banking Act 1933. Also, in an attempt to regulate the issuance of widely held public debt in the United States, the Trust Indenture Act of 1939 (the “TIA”) was passed as a supplement to the US Securities Act of 1933 (the “1933 Act”) and is administered by the US Securities and Exchange Commission (the “SEC”). The TIA requires all debt issuances over US\$5,000,000 to include a written agreement which includes the terms of the securities being offered. The TIA imposes obligations on trustees thereby making them more proactive as compared to prior to the TIA. The TIA sets the standard for debt issuances and provides for trustee’s functions and regulates the duties of the trustee. The TIA provides the general framework and limitations of the trustee function and also addresses the compensation and indemnity requirements of the trustee.

During the 1960’s, 1970’s and 1980’s the issuance of eurobonds greatly increased the importance of the European market. As the eurobond market developed, so did the use of bond trustees (in part due to the benefits of having a trustee to represent the bondholders highlighted during the defaults following the Great Depression as mentioned above). The bond trustee for a eurobond did not develop in the same way as the US indenture trustee. The bond trustee developed through common law, the contractual trends in the market and the enactment of the UK Trustee Act 1925 and later the UK Trustee Act 2000.

An obstacle to the widespread use of the trustee structure was that the principles of trust law varied from country to country and some countries did not have trust law as part of their legal framework (i.e. civil law jurisdictions). The Hague Trust Convention is a multilateral treaty developed by the Hague Conference on Private International Law on the Law Applicable to Trusts. It concluded on 1 July 1985, entered into force on 1 January 1992 and has been ratified by 14 countries. The Hague Trust Convention created a harmonised definition of a trust and sets out principles for resolving conflicts in the choice of the applicable law. The ratifying countries so far are: Australia, Cyprus, Canada (8 provinces only), Hong Kong, Italy, Luxembourg, Liechtenstein, Malta, Monaco, the Netherlands (European territory only), Panama, San Marino, Switzerland and United Kingdom. The Hague Trust Convention has the potential to allow even greater use of the trustee structure in issuances should more countries ratify the treaty.

The principles of trust law have developed over many centuries. The role of the trustee in a capital markets transaction has been, and is continually being, refined by statute, by the contracts that appoint it, by the decisions of the courts in disputes involving it and also by any defaults by bond issuers.

2.4 The application of bond trustee arrangements around the globe

2.4.1 Application of bond trustee arrangements in bond markets around the world

Trustee structures in the UK and Europe: It is important to note that the perceived disadvantages to the issuer of a bond trustee structure have become less significant in recent years. It was previously felt that using a bond trustee was an unwelcome additional cost to issuers. However, it is widely acknowledged that, in practice, bond trustees' fees are minimal in the context of the overall expenses of a securities

offering. In addition, a perceived “diminution of status” caused by the use of a bond trustee, is similarly becoming less of a concern to issuers. Whilst UK corporate issuers have almost always appointed a bond trustee in relation to their debt security, issuers with a high credit standing, such as governments and governmental bodies, would not generally expect the risk of default to be of a concern to bondholders and would not expect to undertake detailed covenants that may require waivers or modifications in the years to come. Thus, as a broad generalisation, other than a UK corporate issuer, the higher the credit standing of the issuer, the less likely it was to appoint a bond trustee. However, this approach is changing. For example, in 2003, the UK government used a bond trustee for one of its international bond issues for the first time, in order to encourage the use of a “collective action” approach by other sovereign issuers in line with recommendations by the G10 Working Group on Contractual Clauses⁵. Trustee structures have also been used by several European and emerging market sovereign issuers and even by Iraq in its restructuring after the second Gulf War.

In light of the above, it is not surprising therefore that a search on Filings Expert (a subscription-based database of publicly listed bonds) shows that, in each of 2016 and 2017, approximately 88% and 90%, respectively, of bonds issued by UK issuers use a trustee structure. However, as the choice as to whether to use a bond trustee is driven by multiple factors such as product type as well as the nature of the issuer and the investor base, the frequency of bond trustees may vary year on year depending on what sort of issuers, products and investors are particularly active in the market at that time. Therefore, although the use of a bond trustee may be appropriate and beneficial for the reasons highlighted above in section “The role and function of a bond trustee”, the findings highlighted in this paragraph may not be reflective of any market trend going forward and will depend on variables such as those highlighted in this paragraph.

⁵Bank of England press release, 23 June 2003

Trustee structures in the US: In respect of securities offerings that are not exempt from the 1933 Act (for example: offerings of bonds which are registered with the SEC and in some cases offerings made pursuant to Rule 144A), the TIA requires that the securities be governed by an indenture and prescribes certain eligibility criteria for a trustee. The role of the trustee under a New York law governed indenture is largely ministerial and prior to an event of default, limited to express contractual provisions. A New York trustee would generally not be required to exercise any discretion prior to an event of default except in the context of amendments, modification or waivers that can be made without consent of holders.

Again, it is not surprising that a search on Filings Expert shows that, in each of 2016 and 2017, approximately 95% and 96%, respectively, of bonds issued by US issuers use a trustee structure. We note that the higher percentage for US issuers (when compared to UK issuers) is probably due to the requirement that all SEC registered bonds require a bond trustee (although our search includes both SEC registered and non-SEC registered bond issues). In addition, the same reasons highlighted above for UK issuers apply equally to US issuers when considering the appropriateness and benefits of a bond trustee.

Trustees in secured debt offerings: Aside from the perceived advantages of the bond trustee structure, the circumstances of the issue can necessitate the use of a bond trustee. In the case of a secured bond issue, it is not practicable to grant a security interest to each bondholder and therefore a bond trustee is appointed, with only one security interest over the whole pool of assets being granted to the bond trustee. This ensures that the security can be enforced efficiently, and the proceeds are distributed by the trustee equitably amongst the bondholders in accordance with the transaction documents. It also preserves the ability of bondholders to transfer their bonds without the necessity to re-execute the security for the benefit of new transferee holders.

The same logistical and administrative advantages also apply to other credit

enhancement features such as keep-well agreements and equity interest put undertakings which allow the trustee to take action against the keep-well provider on behalf of all holders pursuant to the terms of the documents.

Trustee structures in cross-border issuances: Most Eurobonds generally contain a cross-border element and it is common for example, for a UK or US issuer to issue Eurobonds to offshore investors. Typically, the trust deed or indenture will be governed by English law or New York law, respectively and will generally follow the same governing law of the bonds (which will also typically be either English law or New York law). The choice of English or New York law will depend on a variety of factors such as the issuance size, jurisdiction of incorporation of the issuer, reciprocity of foreign law judgements in the jurisdiction of the obligor group, the governing law of bonds previously issued by the issuer (if any) and the investor base to which the securities will be offered for sale and the governing law of similar bonds currently existing in the market etc.

2.4.2 The role of trustee under English and New York law

Bond trust documentation and relationship between the parties: The Trustee Act 1925 and Trustee Act 2000 are the primary UK laws which govern English law trust arrangements. The issuer and the trustee will enter into a trust deed which constitutes the bonds, appoints the trustee as a fiduciary of the bondholders and sets out the trustee's rights, obligations, powers, discretions and protections with respect to the bonds and its role as trustee. The issuer gives covenants directly to the trustee relating to the bonds (e.g. the covenant to repay principal and pay interest on the bonds), and in turn, the trustee holds these covenants on trust for the benefit of the bondholders.

In respect of a bond issuance that is to be registered with the SEC under the 1933 Act, the TIA requires that the bonds are governed by an indenture with a trustee that satisfies certain eligibility criteria. The issuer's covenants are included in the indenture and are made for the benefit of the bondholders. The trustee's appointment

as the representative of bondholders including its duties, rights, powers and discretions are also included in the indenture.

A trustee appointed pursuant to an indenture or a trust deed will take action on behalf of the bondholders subject to receiving indemnity, security and/or prefunding to its satisfaction. Indentures and trust deeds will typically restrict individual bondholders' rights of recourse against the issuer. Under both systems of law, bondholders can take action against a defaulting issuer only if the trustee fails to act on their behalf.

A key area of difference between English and New York law is that prior to an event of default, trustees under a New York law governed indenture are not deemed to owe fiduciary obligations and are only required to perform express contractual obligations. In addition, trustees have an obligation to avoid conflicts of interest and an obligation to perform basic, non-discretionary and ministerial tasks with due care. Following an event of default, the trustee's obligations under a New York law governed indenture would become more "fiduciary like" and would typically be held to a "prudent person standard" which would require the trustee to use "the same degree of care and skills in its exercise as a prudent person would exercise or use under the circumstances in the conduct of such person's own affairs". The key issue to consider in this context is that there may be disagreement between a trustee and holders as to what facts are sufficient to trigger an event of default. Trustees under New York law hold that only actual knowledge (and this is often limited to express written notice in the indenture) of specific facts which indicate that a defined default has occurred would trigger an event of default and this is generally expressly provided for in indentures. On the other hand, other parties may claim that more general, publicly available information of a transaction's poor performance or other issues relating to the transaction parties are sufficient to trigger an event of default. This determination would be largely dependent on the specific facts and circumstances of each case.

Powers of the trustee: A trustee which is party to an English law governed trust deed

has a wide range of discretionary powers. For example, a trustee typically has the power to agree to certain amendments to the bond documentation, or waive breaches of the conditions of the bonds, in each case without consent of the bondholders at a bondholders' meeting, provided that such amendments/waivers are not (in the opinion of the trustee) materially prejudicial to the interests of the bondholders. In addition, a trustee will usually have the power to correct a "manifest" or "proven" error or make formal, minor or technical changes to the bond documentation without the need to make a material prejudice assessment.

A trustee under a New York law governed indenture would similarly exercise its discretion and make modifications or amendments to the transaction documents to cure ambiguity, defect or inconsistency and to make any changes that do not adversely affect the rights of any holder. This is in addition to certain other changes that are specified in the indenture which can be made by the issuer and the trustee without seeking holder consent.

Indentures governed by New York law typically classify amendments, modification and waivers into three categories – those that can be made by the issuer and the trustee without seeking holder consent, those that require consent from a majority of bondholders of the aggregate principal amount of securities outstanding and those that require consent of every holder. For example, amendments relating to the right to repayment of principal or payment of interest (subject to certain exceptions relating to postponement of interest payments under the TIA) must be approved unanimously by all bondholders. By contrast, English law trust deeds often only require a two-thirds or three-quarters majority of bondholders to approve a similar amendment, acting by way of an extraordinary resolution passed at a meeting of bondholders. Unlike trust deeds, however, indentures rarely provide for meetings of bondholders. Amendments or waivers are instead typically made by written consent or, if the securities are held in global form and through the clearing systems, electronically through a consent solicitation process. Amendments and modifications are made effective upon the

execution of a supplemental indenture whereas a waiver letter would generally be issued by the trustee in respect of a one-time waiver.

Under English and New York law, trustees have the discretionary power to declare an event of default and upon such declaration the securities would be immediately due and payable. The terms of the securities generally require a specified percentage of bondholders to declare or instruct the trustee to declare an event of default. Examples of potential events of default are non-payment of principal, premium or interest, breach of issuer's other contractual obligations under the bonds, cross-default of issuer's other debt obligations, certain enforcement proceedings initiated against the issuer such as insolvency or winding-up.

The trustee's discretionary power to declare an event of default, allows the trustee to take timely action, without seeking holder instruction. Under an English law trust deed, in certain instances the trustee has discretion to decide whether or not an event of default has occurred. For example, the disposal of part of the issuer's business may only be considered an event of default if the trustee considers it to be material. A trustee would not typically have such discretion under a New York law governed indenture.

Standard of duty of care: The UK Trustee Act 2000 introduced a statutory duty of care for trustees, pursuant to which a trustee is required to exercise such "skill and care as is reasonable in the circumstances". As the precise scope of this duty is uncertain, an English law governed trust deed will typically disapply the relevant provisions of that Act such that the established common law duty of care will apply, subject to certain liability exculpations (see further below).

In contrast, if the indenture is TIA qualified, a trustee is subject to different liability standards and duties prior to and following an event of default. Prior to an event of default, the trustee is required to perform only those duties as are expressly set

out in the indenture, and it may conclusively rely on certificates or opinions with regard to the truthfulness and correctness of the statements contained therein, unless the trustee's reliance on such certificates or opinions was in bad faith. Upon the occurrence of an event of default, however, the trustee is required to play a more proactive role and exercise the skill and care in performing its duties as a prudent person would do in conducting its own affairs under similar circumstances but to the extent the same is provided for in the contractual documents. Technically, even after the occurrence of an event of default that is known or notified to the trustee, it is not required to take any action not specifically provided for in the indenture and the applicable standard would still be fiduciary-like, not that of an actual fiduciary.

Liability of trustees: Trust deeds are typically drafted to exclude any liability for the trustee arising from a breach by it of its fiduciary duties or of the terms of the relevant trust deed, unless such breaches were committed fraudulently, in bad faith or with wilful default. New York law governed indentures that are not TIA-qualified typically exclude all liability of the trustee except to the extent caused due to the negligence, wilful misconduct or fraud of the trustee. In a non TIA-qualified indenture, the liability standard of the trustee would generally be set at gross negligence instead of negligence.

2.4.3 The differences between the responsibilities of bond trustees, principal paying agents, registrars, transfer agents, common depositaries and fiscal agents

Roles and responsibilities of a bond trustee:

The key elements of the trustee's role include: exercising discretion to agree to modifications without seeking consent from bondholders, waiver of defaults and to provide certain other consents; and taking enforcement action where permissible.

The fiduciary role of the bond trustee under an English law governed trust deed typically includes the below:

- Holds the benefit of the payment obligation and other covenants on behalf of the noteholders in parallel with the issuer’s payment obligation to the noteholders
- Holds the benefit of a security interest for noteholders
- Responsible for passive monitoring of compliance with issuer’s obligations
- Has discretion to exercise powers on behalf of noteholders, including the declaration of an event of default, acceleration of notes/bonds, enforcement of noteholder’s rights of recovery, agreeing waivers and amendments that are not materially prejudicial to noteholders, convening meetings of noteholders and the substitution of obligors⁷
- Acts in accordance with instructions of defined percentage of noteholders
- Entitled to enforce a security interest following default and distribute any proceeds to noteholders in accordance with waterfall
- Noteholders may only enforce individually after the trustee fails to do so having become bound to act.

The role of the bond trustee under a New York law governed indenture typically includes the following:

- Receives information from the issuer in respect of compliance with its various covenants under the issuer. This would include annual financial statements, officers’ certificates confirming financial ratios, annual compliance certificates confirming compliance with all obligations under the indenture, and fairness opinions
- Exercises discretion in respect of effecting any amendments, modifications and providing waivers in accordance with the terms of the indenture without seeking consent of holders

⁷The term obligor in this context refers to guarantors, chargors, or pledgors.

- Declares the notes due and payable following an event of default and take action in accordance with instructions from bondholders
- Distributes funds in accordance with the payment waterfall following an enforcement

Roles and responsibilities of a fiscal agent:

The term fiscal agent is used to describe a paying agent, transfer agent and registrar for a bond issue for which no trustee has been appointed. A Fiscal Agent typically performs administrative functions, especially relating to receipt of interest and principal payments from the issuer for distribution to the noteholders (either directly if the bonds are in definitive form or through the clearing systems if the bonds are in global form), and also relays information from the issuer to the noteholders.

The fiscal agent solely serves the issuer and bears no duty or obligation towards the noteholders. Under a fiscal agency agreement, each noteholder retains the right to contractual remedies in the event of a default.

The difference between a Fiscal Agent and a Bond Trustee:

| | Fiscal Agent | Bond Trustee |
|----------------------|--------------|--|
| Overriding Duty | To issuer | To bondholders |
| Discretionary powers | Minimal | Yes |
| Monitoring duties | No | Passive under English Law and none prior to an event of default under New York Law |

Principal paying agents: A principal paying agent has similar functions to a fiscal agent and is appointed in a bond issue where there is a trustee.

Registrars and Transfer agents: a registrar is appointed by the issuer and assists with maintaining a register of bonds which, for bonds held in definitive form, includes address and bank account details of bondholders and the principal amount of bonds held by each bondholder and in respect of bonds held in global form, includes maintaining a record of the registered holder of the bonds, any increases or decreases in the aggregate principal amount of bonds outstanding following early redemption or buyback. A transfer agent is appointed by the issuer and assists with transfer of bonds and exchange of bonds from global to definitive upon occurrence of certain events such as an event of default or if the clearing systems cease to operate.

Like the fiscal or principal paying agent, the registrar and fiscal agent are agents of the issuer and owe no duty or obligation to holders. They have a principal-agent relationship with the issuer and no contractual relationship with the bondholders.

Common depositaries: a common depositary is necessary where the bonds are issued in global form (and most bonds are now issued in this way). In a delivery versus payment settlement a depositary that is common to Clearstream and Euroclear takes delivery of a global bond on behalf of the clearing systems for the account of their participants and assists with the transfer of net proceeds to the issuer. Subscribers or clearing system participants deposit subscription funds to the clearing systems and are in return credited with entitlements (in the form of electronic, book-entry interests in the global bond) through the clearing systems. These clearing system participants may be beneficial owners of the bonds or they may be brokers, custodians, or nominees acting on behalf of beneficial owners. While the bonds are held in global form, the common depositary is the registered holder of the bonds, and payment of interest and principal is made to the common depositary as the registered holder. The common depositary would then forward the interest and principal payments to the clearing systems which would in turn distribute them to their participants. The clearing system participants would in turn either retain such monies (if they are the beneficial owner of the bonds) or forward them onwards to the ultimate beneficial

owner of the bonds (through a chain of custodians/brokers/nominees). However, in a consent solicitation exercise or following an event of default where a commercial decision in respect of the bonds needs to be made, the common depositary would seek instructions from the ultimate beneficial owner of the bonds.

Roles and responsibilities of a Principal Paying Agent (PPA) and an Issuing and Paying Agent (IPA):

Debt securities issued through the clearing systems typically require an authorised institution to act as a Fiscal Agent or Principal Paying Agent, or for issuances under an established programme, an Issuing and Paying Agent. The paying agent is an agent of the issuer and, whether as a PPA or IPA, provides administrative support to the issuer. The key difference between PPA and IPA is the underlying debt. In a standalone bond, issuance only occurs once, thus a PPA is used. On the other hand, under a programme, multiple issuances of debt occur and there is a requirement for an IPA.

Their duties may include:

- Issuing securities upon demand in the case of a debt programme, including obtaining the ISIN / common code for each programme drawdown (this is the one-off responsibility of the lead arranger in a standalone bond)
- Collecting funds from the issuer and remitting them as coupon and redemption payments
- For global notes, acting on behalf of the issuer to supervise interest and principal payments to investors via the ICSDs (International Central Securities Depository). In the case of definitive notes, paying out interest on presentation by the investor of the coupon or bond
- Transferring funds to sub-paying agents, where applicable (e.g., Luxembourg listing requirements require that a local sub-paying agent be appointed)

- Maintaining an account of the cash flows
- Cancellation and payment of coupons, matured bonds and global notes
- Obtaining ISIN codes for programme issuances.

A paying agent acts on behalf of the issuer, whereas a trustee has an obligation to look after the interests of investors. It should be noted that in an event of default the Trustee usually has the power to direct the Agent to act as an agent of the trustee, rather than the issuer.

For large bond issuances, multiple sub-paying agents help ensure noteholders in different locations receive their payments without delay, with the Principal Paying Agent acting as coordinator.

Roles and responsibilities of a Common Depository:

A Common Depository is specific to ICSDs responsible for the safekeeping of securities. Issues are made in dematerialized form and are represented by a global note. Trading and settlement is in computerized book-entry form via the ICSDs. The ICSDs have appointed a group of banks to act on their behalf as depositories for book-entry securities, known as Common Depositories and to hold the physical Global note on their behalf.

The appointment of a Common Depository for a new issue of securities is at the discretion of Euroclear and Clearstream.

Responsibilities of a Common Depository include:

- Representing the ICSDs and facilitating issuances. Settlement is either free of payment or against payment. Where the settlement is against payment, the ICSDs pay the subscription proceeds to the Common Depository for onward remittance to the issuer. The Common Depository may have established credit lines for both

clearing systems to enable it to pay funds to the issuer without the need to wait for the funds to be received.

- Taking possession of the temporary global note, which allows securities to be released to investors
- Holding the temporary global note in safe custody, until it is exchanged for definitive notes or a permanent global note
- Making adjustments to the nominal value of the global note that occur after the exercise of any options or after conversions and reconciling these with the ICSDs
- Surrendering the cancelled temporary global note after the exchange into definitive certificates or a permanent global note, or on maturity of the permanent global note.

Roles and responsibilities of a DTC custodian:

Bonds can also be issued through the Depository Trust Company (“DTC”) which is a clearing house based in New York. Settlements through DTC are free of payment and net proceeds are settled with the issuer directly outside of the clearing system. Typically, offerings made pursuant to Rule 144A are settled through DTC due to investor preference. DTC provides the same services as Euroclear and Clearstream, however, there are some key differences in certain functions such as bondholder identification (DTC will provide a holder list upon payment of a fee whereas a disclosure event needs to be set up in Euroclear and Clearstream and holders have the ability to not disclose their holdings), and partial redemptions (by random lottery for bonds held through DTC and on a pro rata basis in Euroclear and Clearstream). Euroclear and Clearstream will generally be participants of DTC and liaise with investors that hold accounts through Euroclear and Clearstream in respect of bonds which are primarily cleared through DTC.

Roles and responsibilities of a registrar:

A registrar's responsibilities are administrative in nature. Responsibilities of a Registrar include:

- Maintaining a noteholder register and recording ownership transfers
- Coordinating registration, transfer or exchange of bonds
- Issuing and authenticating new bonds in the event of transfers or exchanges
- Maintaining a record of the bond's outstanding principal
- Assisting with the authentication of definitive notes

03 Chapter 3 Global practices of bond trustee services

3.1 Legal and institutional basis

3.1.1. Trustee relationship vs. principal-agent relationship

The bond trustee

In the international debt capital markets, a bond trustee is typically appointed under an English law trust deed or a New York law indenture, both of which are contracts through which the issuer appoints the bond trustee for the benefit of the bondholders. The trust documentation sets out the terms of the trust, including the obligations, rights, powers and protections of the bond trustee and provisions as to its remuneration and indemnification. By acquiring an interest in the bonds, a bondholder becomes bound by the terms of the trust documentation. In a trust structure, there are several ancillary documents to the bond trust deed or indenture and these would typically include:

- (1) subscription/placement/underwriting agreements between the issuer and the arranging/underwriting banks for the offer and sale of the bonds;

- (2) terms and conditions of the bonds which would be set out as a schedule to the bond trust deed (the description of notes is a summary of the indenture but is not included in the indenture as a schedule);
- (3) agency agreement between the issuer and the relevant agents in respect of the payment and operational aspects of the bond issuance and servicing;
- (4) legal opinions and closing certificates provided at the time of issuance of the bonds; and
- (5) offering circular or information memorandum, if the transaction is a not a private placement. (This is a disclosure document for marketing and distribution purposes only and not contractually binding. The trust deed or indenture which incorporate the terms and conditions of the bonds or description of notes will prevail in the event of any inconsistencies and are contractually binding on the relevant parties.)

What is the alternative?

A fiscal agent is an agent of the issuer who is appointed to carry out paying agency and other administrative duties in relation to the bonds on the issuer's behalf. It does not assume any relationship of agency or trust with the bondholders and it takes no action on their behalf. The principal responsibilities of the fiscal agent are to process payments to the bondholders, publish notices for the issuer and other corporate actions.

In a structure with no bond trustee, all bondholders have to individually enforce their own rights against the issuer. The fiscal agent has no role in that process.

Why appoint a bond trustee?

There are a variety of factors that need to be considered when deciding whether to use a trustee or fiscal agency structure:

- the issuer will pay the annual fees and expenses (including indemnity payments) of the bond trustee

- bondholders in some markets will expect to see a bond trustee appointed – benefits for them include enforcement action being taken on their behalf and having a single representative being able to negotiate with the issuer on behalf of the whole issuance of the bonds
- typically, lower credit issuers will more often appoint a bond trustee than higher credit issuers (such as sovereigns)
- issuers may want the additional flexibility afforded by a bond trustee that is able to exercise discretion on behalf of the bondholders – this may reduce the circumstances in which issuers need to seek bondholder consent to modifications, waivers or substitutions
- issuers may not wish to negotiate with individual holders – a trustee would be able to take action on behalf of all holders in an enforcement and provides a single point of contact to the issuer and holders;
- in limited circumstances, a bond trustee may be necessary in practice if not in law (as discussed further below).

3.1.2 Institutional basis: Legal code

English law generally provides flexibility for parties to contract however they see fit. The law derives from statutes (law written by the English Parliament) and case law (past decisions of the English courts). Whilst there are some statutes that are applicable to trustees and agents (particularly trustees), much of the relevant law in this area has built up over several hundred years by case law.

Neither bond trustee nor fiscal agent roles are specifically regulated in England and Wales and accordingly there is broad flexibility (subject to operational constraints and requirements depending on the type of bond involved) on the types of entities that can operate in this space.

In a TIA-qualified indenture, a trustee's appointment would be governed by the TIA. The TIA also includes limited guidance relating to the roles of agents. Non-TIA-qualified indentures typically incorporate several TIA provisions.

3.2 Applicability of bond trustee mechanism

3.2.1 Is the bond trustee mechanism mandatory?

In most situations it is not necessary for a trustee to be appointed. In particular, trustees are not required as a matter of English or New York law. However, there are three situations in particular where a trustee would ideally need to be appointed:

- (i) Security – if the bonds benefit from security/collateral, a security trustee or collateral agent will be required to hold the security on behalf of the bondholders (as the bondholders are likely to change from time to time and it would be impractical and costly for the issuer to discharge and create new security interest each time the bonds are traded).
- (ii) Subordination – some forms of regulatory capital and other subordinated bond issuance may be structured in a way that requires a bond trustee to be appointed to allow for the subordination to work effectively in practice.
- (iii) Listing requirement – some stock exchanges may require the appointment of a bond trustee for the bonds to be eligible for listing on those exchanges. This is increasingly rare, however.
- (iv) Rating requirements – sometimes rating agencies may require that a trustee with specific ratings is appointed for a transaction as opposed to a fiscal agent.

3.2.2 Applicable issuing places, size of issuance, ways of issuance

Subject to compliance with relevant securities laws and selling restrictions, securities may be offered to sophisticated investors outside and within the United States. If

securities are issued in global form then DTC, Euroclear and Clearstream, Hong Kong's Central Moneymarkets Unit ("CMU") or Singapore's Central Depository Pte Ltd. ("CDP") are generally used as the clearing systems through which the notes are held. Securities offered pursuant to Rule 144A are generally cleared through DTC and securities offered pursuant to Regulation S are generally cleared through Euroclear and Clearstream although Regulation S securities can also be cleared through DTC. DTC processes payments only in US dollars whereas Euroclear and Clearstream provide for clearance of securities denominated in most major currencies. If the securities are issued in definitive or certificated form each holder will receive one certificate for its entire holding and the issuer will need to maintain a register of holders which will include details of each holder such as its mailing address and account details. Definitive securities may be printed on security paper, if required.

English law bonds are issued around the world in a wide variety of circumstances and forms. As discussed above, parties have broad freedom to contract on the terms they choose and that allows English law bonds to be used in many different ways.

Securities issuances may vary in size from a few million dollars up to several billion dollars. They may be privately placed or, subject to applicable securities laws, be publicly offered to sophisticated investors. The securities may be listed or unlisted – if listed, an offering document or a listing document will generally be prepared which will include information regarding the issuer, its business and the notes. Securities may have the benefit of collateral which may be note specific or intended for pari passu sharing with other debt of the issuer. A collateral package may consist of pledges over capital stock, cash accounts, land, receivables, or other forms of assets.

3.3 Qualifications of the trustee

3.3.1 Requirements on the qualifications of the trustee

Trustee eligibility requirements vary by jurisdiction. For example, in the US, only

institutional trustees may act as trustees for issuances of debt securities qualified under the TIA. A trustee must be a corporation organized and doing business under the laws of the US or a corporation or other person permitted to act as trustee by the SEC. The TIA also specifies capitalization and other requirements which must be taken into account regarding eligibility of a trustee. The TIA allows a foreign corporation (subject to SEC approval) to act as a trustee pursuant to a TIA-qualified indenture where such corporation is authorized under the laws of its home country to exercise “corporate trust” powers and is subject to the supervisory oversight of the competent authority authorized by the government of its jurisdiction of incorporation in a manner similar to that applicable to US institutional trustees.

In the United Kingdom, there are no statutory requirements for an organization to act as trustee for bond issuances. However, it is standard in the English law bond market for a trustee to be a “trust corporation” authorized to provide corporate trust services.

In Hong Kong, a new licensing regime for trust or company service providers (“TCSPs”) commenced on 1 March 2018. Under the new licensing regime, TCSPs are required to apply for a license from the Hong Kong Registrar of Companies and satisfy a “fit-and-proper” test before they can provide trust or company services as a business in Hong Kong. TCSP licensees are also required to comply with the statutory customer due diligence and record-keeping requirements. However, it should be noted that certain kinds of financial institutions that are separately licensed by the Hong Kong Monetary Authority may be exempt from obtaining a separate license under the TCSP regime (example, an authorized institution within the meaning of section 2(1) of the Banking Ordinance (Cap. 155)). Each financial institution would need to undertake its own assessment of licensing requirements in the relevant jurisdictions where services are offered.

In Singapore, trust companies (that are not exempt from licensing) are required to obtain a license under the Trust Companies Act (Cap. 336 of Singapore (the “TCA”). The TCA together with the Trustees Act (Cap. 337) of Singapore are the key

legislations for trust law framework in Singapore as supplemented by the Banking Act (Cap. 19) of Singapore. The MAS has published FAQs regarding the TCA framework⁸.

3.3.2 After appointing a trustee, the procedures to be followed for the issuer and trustee to enter a trusteeship

The relationship between an issuer and a trustee is governed by the document which constitutes the trust: indenture or trust deed. The trust document embodies the covenant to repay the debt raised by the issuer through the bond issuance. While the issuer appoints the trustee, this is solely for the benefit of constituting the trust in favour of the bondholders and the trustee owes no fiduciary duties or obligations towards the issuer. The trustee owes all its fiduciary duties or obligations to the bondholders. In addition to the covenant to repay, the trust document will also contain several other standard covenants and terms relating to the issuer’s obligations for the term of the bonds (including indemnities issued to the trustee). Depending on the type of bond issuance, these provisions are fairly standard.

There is no universally standard documentation in the English law bond market. However, English law international bonds have been issued for more than 50 years and accordingly there are certain commonly accepted terms and normal provisions which are usually seen in most bonds. None of these terms and provisions are mandatory, however, so the bond terms and provisions are always a matter for negotiation among the parties and subject to the practical requirements of each bond issue. The documentation also evolves over time as relevant regulation, law, risk appetites and operational mechanics change.

The American Bar Association published a model simplified indenture in 1983 which has since been revised and the 1999 version included updated subordination and trustee provisions following significant changes these areas. Most of the indentures

⁸http://www.mas.gov.sg/~media/resource/legislation_guidelines/trust_companies/faqs/FAQs_TCA_revised%203%20May%202013

governed by New York law generally follow the ABA model indenture and include several of the TIA provisions (even in non-TIA qualified indentures).

3.4 Obligations, duties and rights

3.4.1 Duties and obligations

A trustee is required to treat all holders of a particular series of securities as one class and will not be required to have regard to the consequences of such treatment in respect of individual holders resulting from their being for any purpose domiciled or resident in, or otherwise connected with, or subject to the jurisdiction of, any particular territory or otherwise to the tax consequences thereof. Under a New York law governed indenture, prior to an event of default the trustee is not responsible for monitoring the issuer's performance (financial or otherwise) and compliance with its covenants and obligations under the indenture and in respect of the securities and has the ability to conclusively rely on opinions and certifications provided to it by the Issuer. Unless a responsible officer of the trustee receives express written notice of the occurrence of an Event of Default ("EOD") or a Potential Event of Default ("PEOD") (or in certain circumstances has actual knowledge), it is entitled to assume that no EOD or PEOD has occurred. If an EOD and PEOD has occurred and is continuing, a trustee is only obliged to act if it has received written instructions from holders holding a certain aggregate principal amount of bonds then outstanding and indemnification having been provided by the instructing holders with respect to any costs or liabilities which the trustee may incur or be exposed to as a result of the taking of such actions. That said, very often where the EOD is clear – such as a payment default – a trustee would usually issue a notice to the holders of such default and also to the issuer. Any further action such as acceleration or enforcement/recovery would be subject to indemnification and instruction requirements of the trustee. The nature of action that a trustee may take will often vary on the enforcement and recovery strategy of the holders and this could range from:

- (1) seeking a default/summary judgment in an English court;
- (2) initiating insolvency proceedings in the relevant jurisdiction;
- (3) appointment of insolvency officials such as receivers, liquidators, administrators or judicial managers; and
- (4) enforcement of security.

If the trustee is required to perform any additional duties it may be entitled to additional compensation not covered by its annual compensation which is generally calculated on the basis of actual time spent and based on hourly rates. The trustee typically enjoys a senior claim in respect of its unpaid compensation and expenses in priority of holders except in respect of funds held in trust by it. The trustee's compensation and expenses are generally paid free of taxes and if any withholding or deduction is required then such payment is expected to be grossed up.

3.4.2 Rights

The rights of the trustee under an English law trust deed and a New York law governed indenture vary significantly given the differences in the duties owed by the trustee as a matter of English and New York law, respectively.

A New York law governed indenture will, among other things, generally provide for the ability of the trustee to be compensated and indemnified by the issuer, request for certificates and opinions prior to taking any action, appoint legal counsel at the cost of the issuer, appoint and act through delegates, agents and attorney at the cost of the issuer, specify the liability standard of the trustee, clarify the trustee's standard of care prior to and after the occurrence of an event of default, include the ability of the trustee to assume due performance by the issuer of its obligation in the absence of express written notice, clarify that the trustee is not obliged to take any action on behalf of holders unless the requisite number of holders have instructed it in writing and provided indemnity, security and/or prefunding to its

satisfaction, include disclaimers relating to monitoring duties and consequential loss and no responsibility of the trustee to ensure effectiveness of documentation and, if applicable, collateral. The indenture will also clarify the ability of the trustee to have other business relationships with the issuer including becoming a holder of the notes (subject to applicable conflict of interest rules) and make provision for the removal of and resignation by the trustee in the event a conflict of interest arises and cannot be eliminated. Financial institutions that provide or could potentially provide multiple services to the issuer will generally clarify that it will perform various functions through separate divisions – for example, a separate legal entity will act as an underwriter or lender versus the trustee to ensure independence of functions. In summary, the rights of a trustee include (but are not limited to) the following:

- (a) the bond trustee has the right to be indemnified by the issuer;
- (b) no responsibility to monitor compliance by the issuer or other parties and can assume compliance unless notified to the contrary in writing;
- (c) for secured deals, the bond trustee will have no responsibility for the adequacy, sufficiency or validity of security interests and no liability to any person for any loss arising therefrom;
- (d) the issuer is obliged to immediately notify the trustee of the occurrence of an EOD or PEOD;
- (e) the issuer is obliged to provide a compliance certificate at least annually, and upon request of the trustee within 14 days or less;
- (f) the bond trustee is entitled to seek indemnification, security and/or prefunding prior to taking any action – in addition standard tax and currency indemnities will be included in the documentation;
- (g) the bond trustee is not required to expend or risk its own funds under any

circumstances nor does it assume any of the issuer obligations or guarantee repayment by the issuer or endorse the issuer in any manner;

- (h) the bond trustee is entitled to rely on and act in accordance with advice of counsel and is entitled to appoint counsel at the cost of the Issuer;
- (i) the bond trustee can call for additional documents and certificates from the issuer and is entitled to rely conclusively on these; and
- (j) the bond trustee has the ability to appoint agents and delegates.

3.5 Conflict of interests

3.5.1 Types of conflict of interests (between issuer and trustee, between trustee and bondholders, etc.)

As a matter of English law, it is a core fiduciary duty of trustees that they do not place themselves in a position where their duty and interest may conflict. In practice, this means that bond trustees must not take on roles or act in such a way that means they cannot act independently in the best interests of the bondholders.

Bond trustees do not undertake material obligations to issuers, so it is not likely that conflicts will arise between bond trustees and issuers.

However, it is quite possible that conflicts of interest may arise between bond trustees and bondholders. For example:

- If the bond trustee acts for the holders of different series of bonds issued by an issuer (or for other creditors of the issuer). Following a default, the interests of the different creditor groups may diverge and/or the bond trustee may find itself in possession of confidential information relating to one group that may be relevant to others.

- The bond trustee may be part of an institution that has other commercial relationships with the issuer, for example as a lender or a bondholder in its own right. Those other roles may result in the bond trustee having (or being directed) to take action following a default that is not in its interests as an institution.

3.5.2 How to deal with conflicts of interest

For most bond issuances, there are no regulatory restrictions with respect to resignation/removal or termination of appointment of trustees. These terms are contractually agreed in the governing trust document: indenture or trust deed. Notice periods range from 60 – 90 days and the trust document will stipulate that resignation/removal of the outgoing trustee would not be effective until a successor is appointed. A trustee is not required to provide reasons for its intention to resign. Additional criteria may apply for transactions which are rated or specifically regulated.

Conflicts – or at least the potential for conflicts (or apparent conflicts) – are a real issue for bond trustees which are part of large banking groups.

This issue is often addressed, at least in part, by the bond trustee role being performed through a dedicated team that does not operate under common day-to-day control with groups engaging in other commercial activities. This dedicated trustee team is often split out as a different business line within large and diversified bank groups, often grouped within the transaction banking arm of such banking groups, being separate to their capital markets structuring, trading and originations business with appropriate controls in place to restrict flow of non-public information across product lines (e.g., physical segregation between public/private side teams in office set-up, wall-crossing and/or ethical or insulation walls). The use of a segregated and independent trust entity, in markets where this is applicable, also works to draw a line between the responsibilities of the bond trustee team and those undertaken by other parts of the bank. This allows for a greater independence to the actions of the bond trustee.

In any event, it is acceptable for bond trustees to take trusteeships where as an institution it has other relevant roles, because the risk of an actual conflict arising is remote at the outset of a transaction. As outlined above, it is only following a default by the issuer, when the bond trustee's role becomes more active, when there is a realistic possibility for an actual conflict to arise. As relatively few deals go into default, it is reasonable for bond trustees to assume at the outset that a conflict is not very likely to arise.

A properly drafted trust deed will have standard language that expressly allows the bond trustee to have other related business interests. This goes some way to avoid actual conflicts.

However, should an actual conflict of interest appear the bond trustee could deal with it in one of four ways:

- (i) Resign – all trust deeds should allow the bond trustee to resign at any time and without specifying any reason. This would be a complete answer to a conflict situation but has the drawback of being potentially time consuming and not possible to complete without a successor being identified and appointed.
- (ii) Get bondholder consent – whilst the standard conflicts wording included in trust deeds is helpful, any significant conflict would require express bondholder consent (following full disclosure of the issue) to permit the bond trustee to remain in the role.
- (iii) Appoint an additional trustee – the bond trustee may be able to use its power under the trust deed to appoint a co-trustee or an additional trustee to perform the part of the role which is giving rise to the conflict.
- (iv) Delegate all or part of its role – as with the appointment of an additional trustee, it may be that the bond trustee could delegate all or part of its role to another party to escape the conflict situation.

The fundamental principle is that the bond trustee must always act in good faith and in the interests of the bondholders as a class in considering how it should resolve any conflict situation.

From New York Law perspective, the trustee (and its affiliates) under a New York law governed indenture in its individual or any other capacity is allowed to become an owner or pledge of securities and have other business and financial relationships with the issuer. However, the trustee is subject to the basic duties of a fiduciary which includes the duty of loyalty which “bars” the fiduciary from “blatant self-dealing” and requires the fiduciary to avoid situations “in which the fiduciary’s personal interest possibly conflicts with the interest of those owed a fiduciary duty.

Financial institutions will typically also have their internal conflict of interest policy, however, it is not uncommon for the same corporate group to take up a variety of roles in a debt securities offering transaction such as that of an underwriter, trustee, agents and security trustee/collateral agent. This is generally done by separate divisions taking up the various roles. The indenture will also include the right of the trustee to resign by providing notice but without assigning any reason or being responsible for the costs of its resignation. This provides the flexibility to the trustee to resign in the event it identifies a conflict of interest during the course of its duties. The indenture will also typically include a provision which requires the trustee to either resolve a conflict of interest within a certain specified period of time failing which it must resign.

3.5.3 Conflicts case studies

Examples of real-life conflict situations for bond trustees have included:

(a) Acting as a bond trustee in circumstances where the same financial institution was also a lender to the bond issuer under an unrelated loan facility. Upon default by the issuer/borrower, the lender team was in possession of information which could not

be shared with the bondholders. In those circumstances, whilst the two teams were separated by information barriers, the bond trustee elected to delegate its role to a third party trustee, to avoid any suggestion that it was not acting in the interests of the bondholders; and

(b) acting as a bond trustee in circumstances where the same financial institution had significant other commercial relationships with the bond issuer. Upon default by the issuer, the trustee could not freely take appropriate enforcement action against the issuer and accordingly resigned to allow a replacement trustee to pursue the necessary action.

3.6 Indemnification of bond trustees

Prior to a default, it is the issuer that is solely responsible for the payment of all amounts due to the bond trustee in connection with its role. These amounts fall into three categories:

1. Fees - the bond trustee will usually charge an annual fee during the life of the deal and sometimes also an upfront acceptance fee. The trust deed will detail when these fees should be paid (usually annually in advance) but the amount of the fees will typically be set out in a separate fee letter rather than in the trust deed itself. The trust document and/or the fee letter will also generally include provisions for additional remuneration for duties of an exceptional nature. Examples include fees and costs relating to an amendment, tender or exchange offer.
2. Expenses - the trust documents will provide that the issuer must reimburse the bond trustee for all expenses incurred by it in connection with its role. These would include (among other things) fees and expenses of any counsel or expert appointed by the trustee, costs associated with any agent /delegate/attorney appointed by the bond trustee in the course of performance of its duties and internal management time spent with regard to any issues relating to the bonds.

3. Indemnity amounts – the trust documents will also provide that the issuer must indemnify the bond trustee against all other liabilities incurred by it in the course of performance of its duties except in the case of gross negligence, wilful misconduct or fraud of the trustee. This is the primary financial protection for the bond trustee against, for example, claims that may be made against or legal proceedings it may be brought into by reason of its role.

If there are other obligor entities such as parent or subsidiaries of the issuer that guarantee the bonds, the issuer and such other obligors will be jointly and severally responsible for all payments to be made to the trustee.

In the ordinary course of a deal, the issuer will pay the bond trustee's fees on an ongoing basis in accordance with the trust deed and the bond trustee's fee letter and also reimburse periodically any out-of-pocket expenses of the bond trustee (of which there may be none). In these normal circumstances, there would not typically be any claims made by the bond trustee under its indemnity.

It is however only following the occurrence of a default by the issuer that there would often be a significant change in how the bond trustee is paid. Usually following a default a bond trustee will seek instructions from the bondholders as to the enforcement (or other) action that they wish it to take. In these circumstances the bond trustee will usually also request an indemnity, security and/or prefunding from the instructing bondholders (often also accompanied by some upfront cash funding), to reflect the fact that the issuer's indemnity may no longer be sufficient to guarantee payment to the bond trustee of its fees, expenses and liabilities without which the trustee is not obliged to take any action.

The issuer will always remain liable under the trust documents for all amounts which are payable to the bond trustee but post-default, where there is an indemnity from the bondholders, the bond trustee may have to recover the sums due to that first from the bondholders (because the issuer is unable or unwilling to pay). If that

happens, the expectation would usually be that the trustee would reimburse those funds to the indemnifying bondholders from any recoveries it makes from the issuer, before then distributing the balance to all bondholders equally. Of course, if there are no recoveries from the issuer following an EOD, or if the amounts recovered are insufficient to cover the amounts already prefunded to the bond trustee, the indemnifying bondholders will remain liable for the trustee's indemnity payment.

The scope of an indemnity from the bondholders would be expected to be broadly the same as the original indemnity from the issuer, so it would indemnify the bond trustee against all losses and liabilities incurred by it (although often in the case of a bondholder indemnity, only in connection with the specific instructions being given by the bondholders). Bond trustees usually require indemnities (whether being given by bondholders or the issuer) to be on a joint and several basis and (as with issuer indemnities) will not permit them to be capped at a particular amount (because the potential financial risks for the bond trustee are usually not quantifiable) and cannot be readily estimated.

From New York law perspective, a New York law governed indenture will typically include an indemnity provision which will include a joint and several indemnity from the issuer and each of the guarantors in favour of the trustee (including its officers, employees, directors, agents, attorneys and delegates). The indemnity of the issuer covers all actions of the trustee taken in course of performance of its duties and is limited only by the trustee's gross negligence (negligence for a TIA-qualified indenture), wilful misconduct or fraud. In certain circumstances, the issuer may request the trustee to notify it or seek consent from it before settling any indemnity claims, however, there is no legal obligation on the trustee to provide prior notification or seek consent, however, some trustees may agree to this on a commercial basis although this is not market standard for Asian high yield debt issuances.

In practice, if there is no event of default, the trustee would not generally exercise its right to claim indemnity but rely on the provisions relating to compensation (including, additional compensation) and expenses. To clarify, the trustee will typically charge additional fees for consent exercises and other compliance work that falls outside the scope of its duties. The indenture will also include provisions for holders to indemnify the trustee. Unlike the issuer's indemnity, the indemnity of the holders is not provided at the time of issuance but is provided "on demand". Under a New York law governed indenture, the trustee has no obligation to perform any of its duties, powers or discretions unless it has been instructed by the requisite number of holders in writing and such instructing holders have offered indemnity, security and prefunding to the trustee's satisfaction. The amount of indemnity that may be demanded by the trustee depends largely upon the particular facts and circumstances of the situation and will differ depending on the action that the trustee is being instructed to take. In practice, if there is no event of default, no indemnity would be demanded by the trustee of the holders. To clarify, routine requests for information or questions from holders would not result in the trustee demanding an indemnity. All indemnity payments to the trustee, whether payable by the issuer or the holders, would generally be paid in priority to any amounts due to holders of securities following an enforcement.

04 Chapter 4 Conclusion

From this paper's description of the basic characteristics of the bond trustee structure in international markets, a few conclusions may be drawn.

First, the bond trustee structure is one of the fundamental arrangements in international bond markets. A bond trustee enables better representation of the numerous and scattered bondholders, more efficient collective action, and more flexibility in bond management. However, the proper handling of defaulted bonds requires a sophisticated, multi-faceted investor protection framework, wherein information disclosure, bondholder meetings and resolutions, distressed bond trading and other systems work in tandem with the trustee arrangements.

Second, the legal relationship of a trust is the cornerstone of bond trustee arrangements. Bond trustees in international bond markets owe fiduciary duty to bondholders to protect their interest through efficient, expedient means. Third, it is clear from international experience that the boundary of a trustee's discretionary power should be appropriately defined. For historical reasons, bond trustees abroad are endowed with a certain extent of discretionary power which has its basis in

applicable law. Such discretionary powers give them considerable flexibility in handling technical defaults and modifying certain bond terms without seeking bondholder consent. However, the appropriate scope of discretionary power may vary between different bond market environments; and a right balance needs to be struck in consideration of the efficiency of default handling process and the needs of bondholders.

Fourth, conflicts of interest need to be properly addressed. Overseas markets have certain threshold for eligible trustees, complemented by a complete set of rules and past experiences in resolving conflicts of interest. Overseas practices do not forbid conflict of interests entirely; rather, they aim to require trustees to duly and fully disclose potential conflicts.

Fifth, the trustee service fee should be determined by market participants, but the trustee's priority in remuneration, costs and expenses should be in priority to payments to the holders.

Overall, a bond trustee structure modeled after international practice but adapted to the needs of the Chinese market may have a role to play in creating safeguards for bond investors and reducing overall capital market and systemic risk.

About

International Capital Market Association (ICMA)

ICMA is the trade association for the international capital market with almost 550 member firms from 62 countries, including banks, issuers, asset managers, infrastructure providers and law firms. It performs a crucial central role in the market by providing industry-driven standards and recommendations for issuance, trading and settlement in international fixed income and related instruments. ICMA liaises closely with regulatory and governmental authorities, both at the national and supranational level, to ensure that financial regulation promotes the efficiency and cost effectiveness of the capital market.

www.icmagroup.org

National Association of Financial Market Institutional Investors (NAFMII)

NAFMII was founded on September 3, 2007, under the approval of the State Council of China. NAFMII aims to propel the development of China OTC financial market, which is composed of interbank bond market, inter-bank lending market, foreign exchange market, commercial paper market and gold market.

As a self-regulation organization (SRO) in China, the membership of NAFMII includes policy banks, commercial banks, credit cooperative banks, insurance companies, securities houses, fund management companies, trust and investment companies, finance companies affiliated with corporations, credit rating agencies, accounting firms and companies in non-financial sectors.

www.nafmii.org.cn