

Clients & Friends Memo

Introduction of the 'New Global Note' Format for International Bonds

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Introduction

On 1 July 2006 a New Global Note ("NGN") structure will be introduced for international debt securities to be launched by an issuer (the "Issuer") in global bearer form and deposited with Euroclear or Clearstream (the "ICSDs").

The sponsors of the new structure are the ICSDs, the International Capital Markets Association (ICMA), the International Capital Markets Services Association (ICMSA) and several leading issuers and lead managers from the international capital markets. In addition the European Central Bank ("ECB") has been a prime mover in providing the rationale for the new structure.

After its inception the NGN structure will run alongside the existing structure for bearer notes (the so-called Classical Global Note ("CGN") structure) pursuant to which non-bearer (i.e. registered or de-materialised) securities will continue to be issued.

While it will not be mandatory to use the new structure to launch global bearer securities, an Issuer seeking to ensure that its securities may be eligible collateral for ECB monetary operations ("Eligible Collateral") will, from 1 July 2006, have to issue using the new format.

The CGN Structure

The CGN structure is based on the deposit of a global note (the "Global Note") representing the underlying securities with a common depository (the "Common Depository") on behalf of the ICSDs. Common Depositories provide both safekeeping and asset servicing for such securities while recording the notional outstanding amount of the issue by physically annotating the Global Note with this information. Importantly, where a CGN Global Note is in bearer form, Common Depositories or their nominee companies will be the legal owner of the Global Notes.

The NGN Structure

The NGN structure replicates that of the CGN except that:

- (i) it applies only to global securities in bearer form;
- (ii) the outstanding amount of the issue will be determined and maintained electronically by the ICSDs using their own records;

- (iii) legal ownership of NGN bearer securities will not reside with the Common Depositories and they will have no role in safekeeping them, that role being replaced by a Common Safekeeper ("CSK") (to be either Euroclear or Clearstream);
- (iv) while a Common Depository may have a role in providing asset servicing to an NGN security as a new Common Service Provider ("CSP") it will have to be appointed by a CSK in order to do so; and
- (v) it introduces the concept of 'effectuation' (for the purpose of ensuring that any NGN which is intended to constitute Eligible Collateral bears at least one original signature) and of direct agreement between the Issuer and the ICSDs (the "Issuer-ICSD Agreement") which requires the new securities to be made available for settlement with the ICSDs.

Rationale for the Changes

The ECB has highlighted a number of problems with the old system which arise out of its concerns as to the custody arrangements for securities which can be used in Europe as Eligible Collateral.

The key problem identified with the CGN structure stems from the role played by the Common Depositories, which are typically commercial banks, and sit between the issuer of the securities on one hand and the ICSDs on the other. The ECB consider the presence of commercial banks in this chain to represent an unwarranted risk to the efficacy of its monetary operations. In particular it forces the ECB to accept the unwanted credit and settlement risk of the commercial bank itself.

The NGN structure, by removing this intermediate stage, creates a direct, contractual link between issuer and ICSD which is more acceptable to the ECB due to the perceived relative credit of the ICSDs compared with that of the commercial banks.

Eligible Collateral and the Eurosystem

From 1 July 2006 newly issued bearer securities will only be available for recognition as Eligible Collateral under ECB guidelines if they are both issued in NGN format and fall into the list of eligible assets set out below. If a security constitutes Eligible Collateral then it is available for lodging with the ECB and/or the holder's national central bank as collateral for Eurosystem monetary policy and intra-day credit operations.

The list of eligible assets for Eurosystem monetary policy operations, for which only assets denominated in euros may qualify, is itself divided into two tiers. Tier one is made up of eligible 'marketable debt' issued by issuers based in the EEA and non-EEA G-10 countries and which the ECB consider to be of sufficiently high credit quality. Tier two consists of eligible marketable and non-marketable debt instruments of Eurozone issuers which individual Eurozone central banks consider to be of sufficiently high credit quality. While most such issues constitute what may be thought of as the prime end of the market (including as they do both government and supranational debt) both tiers also admit sufficiently credit-worthy private sector debt which, in practice, includes certain well-rated ABS structures issued by SPVs based in familiar Eurozone jurisdictions such as Ireland, Luxembourg, and the Netherlands.

A holder of Eligible Collateral may use that collateral (via either outright sale or pledge) to obtain credit by way of borrowings from its home central bank via the Eurosystem. This is available to the holder whether or not the assets are held in the country in which the central bank is based through the Eurozone 'correspondent central banking' system.

Effectuation

NGNs which are intended to be Eligible Collateral will still have to be authenticated by the agent before going 'live' in the usual way. The new step is the further requirement that the NGN is effectuated by the CSK subsequent to delivery to it. A suggested form of effectuation authorization for both stand-alone and programme NGNs is provided in the 'legal pack' referred to below. Failure to effectuate means that the ICSDs will be unable to hold the NGN in a manner which would allow it to be Eligible Collateral.

Practical Implications

Issuers

An issuer of Euro-denominated bearer securities which is indifferent to ECB eligibility may of course simply continue to issue securities under the old CGN system. Self-standing issues launched under the CGN structure may still be Eligible Collateral after the introduction of the NGN if they were issued prior to 1 July 2006 and meet (or continue to meet) the ECB collateral eligibility criteria. However a new issue launched on or after 1 July 2006 using existing CGN-style programme documentation will not qualify unless the issue is fungible with securities launched under the same ISIN code launched before 1 July 2006.

Issuers using the new structure will be required to follow a model format which has been developed for the purpose. A 'legal pack' containing these and other relevant documentary changes was issued on behalf of the sponsors on 10 February 2006. This sets out ten annexes, the most important of which highlight suggested model forms of stand-alone and programme NGNs; amendments to agency agreements, trust deeds, ICMA standard 'Final Terms', subscription agreements and deeds of covenant; and the required forms of effectuation and Issuer-ICSDs Agreement.

Existing programme documentation will have to be made compliant with the NGN structure if an Issuer wishes its new issue under that programme to qualify as Eligible Collateral post 1 July 2006.

Common Depositaries and ICSDs

Although the Common Depositaries will effectively have been removed from their roles as safekeepers of global bearer securities by the new structure they will continue to safekeep CGN securities and, indeed, may safekeep any NGN securities which an issuer may not wish to qualify as Eligible Collateral.

Similarly the Common Depositaries will continue in their former role as asset servicers, though their role in servicing NGN securities will be limited to asset servicing as a CSP. This will principally involve acting as issuing and paying agent, principal paying agent or fiscal agent. The role of CSK, as noted above, is to be available only to Euroclear and Clearstream, which will thereby be the only entities with the right to act as safekeepers for the new NGN securities and approve and appoint the CSP.

The list of 'approved' CSPs which will provide asset servicing to the NGN securities will be made available by the ICSDs in due course.

Investors

The cost and impact on investors is expected to be minimal.

Summary

It will be interesting to see just how prevalent the new NGN structure becomes. We expect to see it used for all suitable high grade sovereigns and corporate issuance from 1 July 2006 - which would suggest that (as with the 1 July 2005 deadline to comply with EU 'Prospectus Directive' 2003/71/EC) there may be a rush to update MTN programmes to the new format around mid-year. As noted above, there is no reason why a whole variety of borrowers and structures (including ABS structures) in global bearer form should not seek to use the NGN structure upon its inception and in due course, despite the NGN structure only being relevant to Euro-denominated securities, becoming standard across the euromarkets.

Further Information

The sponsors of the NGN propose to incorporate the new structure into a more general review of the operational flows which underlie the servicing of international debt securities and this review will be incorporated in a standard market protocol (SMP) document intended to establish best market practice for all involved market professionals, with a target publication date of 31 March 2006.

The types of securities which may be Eligible Collateral can be viewed at:
<http://www.ecb.int/pub/pdf/other/gendoc2005en.pdf>
and at: www.ecb.int/paym/coll/assets/html/index.en.html

The following websites feature dedicated articles on the new NGN structure:

www.euroclear.com
www.clearstream.com
www.icma-group.org

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