Investor protection

Q 2-05. What laws are there to protect investors that hold sovereign securities in book-entry?

Closely related to laws addressing fair and transparent[1] markets are laws designed to protect investors in keeping secure their property and rights and to protect them against malfeasance. As the measures listed here are remedial in nature, they should not be construed to provide continuous and complete protection from loss.

- Where such have been enacted, there may be laws that provide liability coverage for losses occurring while assets are in the possession of intermediaries: securities protection legislation, e.g., SIPC. Where the custodian has ceased to do business, the laws on bankruptcy and on insolvency may provide a measure of protection.

- There is also the possibility that the laws on torts, property, and contracts could be used to recover losses traceable to conduct that is deliberately malevolent or inadvertently careless on the part of the custodian.

- Finally, one could seek criminal laws sanctions against the custodian, but that may not result in any recovery of the loss.

All of these measures require the intercession of a third party, i.e., an insurer or a court, after the adverse event has occurred. They are also likely to be both time-consuming and expensive and cannot guarantee complete restitution.

Q 2-05.01. How do laws on property rights serve investors?

Investor protection is partly achieved through laws covering property rights and transfer. Under book-entry systems, investors should be afforded full property and transfer rights as in physical-delivery systems. It should be noted, however, that where the property is an intangible, and its ownership interest can be represented simultaneously on the books of two or more intermediaries, conventional property rights are difficult to protect.[2]

[1] It may be argued that laws alone mandating transparency provide little practical protection for the investor who owns securities in a multi-layered book-entry system. The protection probably comes from the regulatory agencies that have oversight over the custodians, i.e., the agencies that oversee banks and securities dealers, and the latter's' integrity.

[2] It appears that the laws that apply in this case are those relating to contractual rights and agent or fiduciary obligations.

The body of laws that protect investors from malfeasance includes laws governing fraud protection and preventing collusion. A further set of laws address conflict of interest laws and practices.

Finally, investor rights must include the right to receive timely interest payments and payment of principal at maturity.

Q 2-05.02. What protection do bankruptcy laws offer the investor?

Security of property includes investor protection laws covering bankruptcy and insolvency. For example, in the area of collateral and secondary markets, it is essential to establish the legal principle that securities held by a financial institution on behalf of a third party, i.e. a customer, will be recognized as an asset of the third party and would not be adversely effected by the insolvency of such institution.

In a book-entry system with intermediaries, bankruptcy or insolvency will require that the law recognize that customer assets, such as securities, are not assets of the depository holding the account and cannot be used to satisfy the claims of the depository's creditors.[3] Conventional formulations of how the law applies to electronic investment records may not suffice: under book-entry, an accounting entry represents the security, i.e., property, and its holding can be simultaneously reflected on the books of several linked intermediaries, including, of course, the one that the owner has chosen. The issuer's records provide no clue as to who that true investor might be.

Q 2-05.03. What is the role of the general law of contracts?

The promise by a sovereign to repay the loan, at a stipulated interest rate, at a fixed maturity date, is a contract. A well-prepared bond indenture meets the key definitions of a contract. A contract identifies the parties and their relationship and a contract sets out their respective rights and obligations one to the other. Further, each intermediary, from the fiscal agent to the depositories and securities dealers to the securities owner, also operates in a network of contracts.

A comprehensive body of contract law is crucial to the development of both primary and secondary markets in sovereign debt. It undergirds any self-regulatory scheme among market participants by giving certainty or trustworthiness to customer agreements. This same sense of trust is thus given to repurchase agreements and primary dealer agreements. By extension, contract law should provide investor protection that instills confidence in the operations of markets. Either law or

[3] Given the intangible nature of the assets, plus the possible proliferation of linked accounts, there are formidable problems of oversight and tracking in any compliance program calculated to assure that customer accounts are adequately protected.

regulations are necessary to assure investors that the markets and the transactions that take place there are protected from collusion, fraud, and deceit.

As in other issues in this section, the law cannot shelter the investor from all risks. The investor chooses the intermediary through which his security is held. The protection and integrity of the arrangement depends on the custodian selected. The investor must bear the risk that his custodian might be dishonest, incompetent, careless, or otherwise a risk to the investor.

Q 2-05.04. Where sovereign debt is held by intermediaries, how is the owner able to pledge them and be assured that the security interest is adequately safeguarded?

Legal systems must be adapted to deal with the pledging of interests in dematerialized securities in a multi-tiered holding system and to ensure that creditors get good collateral. When the pledge is an interest in dematerialized securities, i.e. those held through accounts with a financial intermediary in a book-entry system, most countries treat a pledge as valid only if there is an agreement between the parties and each intermediary between the pledgee and the securities credits the pledgee's interest in such securities to a segregated account in the pledgee's name on its books, or the issuer credits the pledgee's interest in the securities to an account in the name of the pledgee itself.

The main question for financial institutions and for enforcement offices is how to show securities, as collateral, on the books of the institution holding the book-entry account. There are two options: a simple notation if it is considered adequate or removal to a separate and more restricted account, i.e., segregation.

The feasibility of either scheme depends on the extent to which selection of that option impedes the critical challenge of auditing security holdings that are simultaneously maintained through linked custodians. The development of complex chains of custodial arrangements makes audits more difficult, but also even more critical for investor protection.

One element that cannot easily be assessed is the role that electronics and the almost instantaneous data transmission that occurs plays in secondary market transactions. Proponents of book-entry securities try to liken the system to those that provide physical possession and delivery. It might be argued that the exposure to loss has been minimized because of the speed with which electronic transactions are customarily completed. This is problematic, however, as book-entry does not provide an equivalency to possession. These are still unanswered concerns.

Q 2-05.05. Has technology had an impact on investor protection laws?

Traditional contract law relationships have been superseded by an electronic securities system. Arguably, the sovereign's promise to pay the investor is conditioned upon the integrity of the "custodians" of the book-entry accounts that link the issuer (the sovereign) to the ultimate investor.

An additional complication in the evolution of investor protection is the emergence of securitization. A common form of securitization is the packaging, by market participants, of future interest payments on sovereign securities into derivative obligations. Where this has occurred, there is reasonable question as to whether the resulting obligations are Government securities or are somehow different.

Q 2-05.06. What additional rules might be needed due to new technology?

The advance of electronic trading systems (ETS) shows the potential to reshape the fixed-income markets, and markets and governments will have to adapt if it does. Although some types of securities are traded on several electronic platforms, over-the-counter markets have still an important market share. With current ETS mostly focused on dealers, institutional investors have in most cases no direct access. It is likely that this gap will be filled either by electronic broking systems or by customer-to-dealer systems.

The regulatory status of the electronic trading systems varies. In some countries, they have the status of an official (regulated) market, while in others ETS are regulated as a broker. The differences in regulatory approach raise the issue of the need for a level playing field. Government may be forced to permit the operation of private proprietary trading systems, entry of foreign trading systems, or alternative trading systems alongside traditional exchanges that trade government securities. If so, this may raise issues of transparency, access, member, and market rules, and market soundness, that is, the reduction of systemic and credit risks.