

Markets, exchanges, and financial entities

Q 2-01. How does sovereign debt alter its markets and market entities?

Sovereign debt affects market institutions by altering the relationship between those institutions and the government as the issuer of sovereign debt securities.

For example, the explicit commitment of the full resources of the nation to satisfying the obligation the debt imposes will make government securities a preferred investment vehicle for institutions governed by “prudent man” rules.¹ Such a commitment must imply maximal relative safety of these securities among those available within the domestic economy. This will influence the investment decisions of *trusts and fiduciaries* and may make sovereign debt a focus of their portfolio decisions. *Insurance companies* may also find themselves subject to a similar standard of prudence in investment policy.²

Related laws of commerce

Q 2-02. In what way do financial laws affect sovereign debt markets?

The legal framework that has been discussed thus far may be extended to include regulation of market participants, market conduct, commercial practices, property and contracts, securities exchanges, self-regulating bodies, and rules for clearing and settlement. The laws that comprise this framework include both those that address debt issuance entities directly and those that address the structure of property and business practice of the broader commercial system.

Q 2-02.01. How do laws covering transactions involving collateral impact the debt process?

Laws may regulate transactions on the exchanges and how property is accounted for by counterparties; such laws address issues concerning pledged assets and collateral and secured transactions. The laws on pledges and on collateralized loans

¹ The *prudent man* rule is stated along the lines of this: “The directors of a company shall establish and the company shall adhere to investment and lending policies, standards, and procedures that a reasonable and prudent person would apply in respect of a portfolio of investments and loans to avoid undue risk of loss and obtain a reasonable return.”

² It is worth considering that prudent man rules are often imposed on entities whose portfolios are to be held for extended periods. This may drive such portfolios toward the long end of the yield curve and thus provide a market for longer-dated sovereign debt.

affect how repurchase agreements and loans are drafted and interpreted, and how the rights of the parties are sorted out when ownership and liability questions arise.

Government debt, with its presumed low risk and relative liquidity, is a principal asset offered as collateral. Demand for government debt (and, hence, its marketability) will be affected by the ways these laws affect transactions in pledged assets.

Q 2-02.02. What is the relationship between sovereign debt and banking laws?

Banking laws become particularly important when securities are traded under a book-entry system. Banks may provide a viable holding system for securities as accounting entries. Further, they may match, by virtue of their maintenance of funds accounts, the sale of securities with payment. Finally, they offer the means of transmitting payments of interest and redemption proceeds to investors.

Banking laws should be reviewed to assure that they do not pose impediments to financial institutions in servicing Government securities. For example, one of the major concerns historically has been the disparate capacities of securities dealers and brokers, on the one hand, and of commercial banks, on the other, to service the Government securities market. The major distinction has been the ability of banks to service both the funds and securities sides of transactions.

Countries sometimes differ in the kinds of banking or savings institutions that provide financial services for their communities.

Q 2-02.03. How do laws related to regulation of market participants affect the debt process?

To create a level playing field, specific laws regulate market participants.³ Market agents are subject to laws and regulations that govern the licensing, examining and supervising of securities dealers and brokers. Participating financial firms are subject to requirements on financial structure to avoid capitalization problems.

Q 2-02.04. What are the concerns of laws and regulations that govern security exchanges?

Laws concerning *securities exchanges* are intended to provide a fair market in which all parties may participate without disadvantage. Such laws may provide authority for the government to oversee the exchanges on which trading occurs or to monitor organizations that provide central depository and clearing services. Oversight may include the means to address investor complaints.

³ Securities laws will also affect a system of primary dealers or the secondary market by prescribing practices for counterparties for trading securities.

Generally, regulatory approval of government securities should be excluded from the purview of any securities commission. Since few states issue debt directly into the exchanges, this guideline should be readily observed.

Market rules and practices

Q 2-03. How do market rules and practices affect the development of the government securities market?

Sovereign debt is an important market asset with a critical role in the construction of many portfolios. The rules that govern markets, therefore, will have an impact on the use and the demand for sovereign debt instruments as they do with all market assets. Market rules may fall under several broad categories including rules concerning securities exchanges, investor protection, contracts, institutions, and taxes.

Perhaps more important than the “other laws” are the rules that govern access to the Government securities market, i.e., the bar that likely exists as to what entities are eligible to be book-entry custodians and to have access to the electronic network through which trades are made. The central bank rules that apply to daylight overdrafts could also be a serious constraint.

Q 2-03.01. Do debt trading practices differ from those of other assets?

Bonds markets differ from equity markets. Bond markets often do not have a centralized exchange or trading system. Rather, in developed bond markets (such as in the United States, Japan and Western Europe), bonds are traded in decentralized, dealer-based, over-the-counter (OTC) markets. In such a market, market liquidity is provided by dealers and other market participants committing risk capital to trading activity.

In the bond market, when an investor buys or sells a bond, the counterparty to the trade is usually a bank or securities firm acting as a dealer. In some cases, when a dealer buys a bond, the dealer carries the bond "in inventory." The dealer's position is then subject to risks of price fluctuation. In other cases, the dealer immediately resells the bond to another investor.

Bond markets can also differ from stock markets in that, in some markets, investors sometimes do not pay brokerage commissions to dealers with whom they buy or sell bonds. Rather, the dealers earn revenue by means of the spread, or difference, between the price at which the dealer buys a bond from one investor—the "bid" price—and the price at which he or she sells the same bond to another investor—the

"ask" or "offer" price. The bid-offer spread represents the total transaction cost associated with transferring a bond from one investor to another.

The rules governing sovereign debt should reflect the needs and practices of the bond market in order to support trade in such securities.

Q 2-03.02. Why are secondary markets of importance?

The existence of a market in which sovereign debt can be traded as any other security gives added value to sovereign debt as an investment. This expands the demand for sovereign debt beyond the passive “buy and hold” market. In most countries, government securities trade in the secondary market along with all other securities and are, therefore, subject to secondary market regulation.

Since government securities are often defined as “exempt securities,” that is, exempt from registration requirements, it is important to make sure that this status does not undermine the integrity of the secondary market.

Q 2-03.03. What additional rules are needed for secondary markets?

Effective secondary market regulation is necessary to support a viable secondary market. It should include (i) regulation of market intermediaries, (ii) market conduct regulation (including trading rules) and market surveillance and (iii) transparency requirements, which will vary according to the choice of market structure.

Q 2-03.04. What oversight is needed for participants in secondary markets?

The capacity of market participants to fulfill contract obligations or to serve as the agent of other participants is critical to the healthy functioning of secondary markets. Capacity is often measured by the ability of the entity to withstand adverse market conditions by use of the firm’s own assets and balance sheet and not by reliance on external financial resources. For this reason, oversight often focuses on capital rules, margin requirements, risk controls, and trading-practice regulations.

The question of capital requirements and adequate reserves is a highly technical issue that has been addressed repeatedly by regulating organizations. Details are beyond this outline.⁴ Capital requirements must take into account liquidity, price,

⁴ As an example of the complexity of the issue, consider the question of uniformity of requirements. Lack of uniformity in capital requirements within the same class of securities market participants, such as brokers or dealers, can increase both systemic and credit risk for individual market participants. In contrast, non-uniformity of capital requirements across different classes of market participants can be an important factor in creating incentives for self-regulation. If members of securities depository and settlement corporations are required to hold higher levels of capital than

and credit risk for assets in the firm's own portfolio, as well as for assets managed on behalf of third parties. Leverage requirements, if imposed, must take account of differing definitions of leverage.

Capital rules, margin requirements, risk controls, and trading-practice regulations applied to intermediaries are likely to grow in importance with technological advances.

Q 2-04. How is the marketability of sovereign debt securities provided?

The regulatory structure of securities markets in general is built around self-regulating organizations, such as exchanges and securities dealers associations, as a supplement to the government regulatory authorities. The regulatory responsibilities of government securities markets often are assigned to more than one government agency. Thus, in some countries the supervision over a primary dealers' arrangement and the issuance process (auctions, for example) is handled by the treasury or jointly by the treasury and the central bank, the regulation of the secondary market by a security regulator (which often is a separate government agency), and the oversight of the settlement arrangements by the central bank.

Q 2-04.01. Do rules governing security exchanges impact the debt process?

In general, government securities are traded in only a few cases on organized exchanges. Hence, the use of exchanges or similar self-regulating organizations for regulation of the bond market is limited.

Q 2-04.02. Who generally regulates the bond market?

It is common to have market oversight and regulation provided directly by the securities market regulator, the central bank, or, in cases where primary dealers are used, by the minister of finance or the public debt-management agency. The authorities also often regulate the relationship between intermediaries and their clients, mainly to ensure best execution of trades.

Q 2-04.03. Have changes in the form of the securities being traded affected the oversight of the market?

The form of the security being traded will determine how oversight will be implemented. Sovereign debt markets are constrained by the "mechanism" through which the securities are held and accounted for. Oversight has had to adapt to the transition of securities trading, particularly for sovereign debt, to assets issued in

non-members, the members will have greater incentives to monitor those financial institutions with lower capital requirements.

book-entry form.

With electronic technology, the issuance, account maintenance, and recording and tracking of transactions in such securities have become computerized. More importantly, there has developed an interactive duality in the accounting for the funds and for the securities. The law may constrain the system of holding book-entries through banks and securities firms by restricting who can have funds accounts at the central bank. As a result, the relationships among the parties have changed. There is, in general, no one-to-one interface between investor and issuer. That relationship has been supplanted by an indirect holding system, one in which the linkage between the owner and the sovereign is through one or more intermediaries.

Q 2-04.04. In what way have market development issues driven sovereign debt legal issues?

Although this phenomenon is not confined to state debt issues, there has been in some countries the establishment of central depository systems and of clearing corporations to reduce the trafficking volume of transactions in such obligations. These developments have reduced the costs and the risk exposure incident to the buying and selling of securities. The cost of this efficiency, however, has been increased responsibility that has fallen on depositories and clearing corporations. To the extent that the legal concerns have become sublimated in the technology, they have become more complicated. The law, at least in the U.S., has developed to rationalize the indirect holding system, but some legal issues remain unresolved.