

***Legal and regulatory framework for developing
government bond markets – suggested issues for
discussion***

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General objective of the session on legal, regulatory and supervisory issues²

A fundamental prerequisite for a well-functioning government securities market development is the introduction of a sound legal, regulatory, and supervisory framework. Many of the associated legal and regulatory reforms must be in place before a government securities market can be developed. Moreover, a balance must be struck among the needs for proper risk control, market integrity, and market development. Against this backdrop, the general purpose of this session is to find common ground what a “sound” legal, regulatory, and supervisory framework means in practice.

Legal framework

The fundamental parts of the legal framework supporting an efficient domestic government securities market usually include an explicit empowerment of the government to borrow, budgetary rules for the issuance of government securities, rules for the organization of the primary market, role of central bank as agent for the government, the debt-management framework, rules governing issuance of government securities, and rules pertaining to the secondary market.

In this way, the legal framework defines incentives for all market participants—the issuing government, the central bank, regulatory agencies, market intermediaries, end investors, and any SROs. Some of the more important areas where the legal framework will affect the development of government securities markets include (i) defining the exact parameters under which fiscal budgeting processes will be linked to government securities issuance, (ii) limiting issuance, via

² Much of the material in this document is based on previous outreach meetings of the OECD Working Party on Public Debt Management, including joint meetings with the World Bank (some of that material was compiled in the Handbook for Developing Government Bond Markets by the World Bank).

debt ceilings or other devices such as sinking funds, and (iii) defining the legal properties of government securities and their use as collateral in transactions such as repos. (Below we will discuss governance arrangements for appropriate regulatory authorities and proper definition of their enforcement powers.)

At another level, the legal framework must define the rights and obligations of parties to debt contracts in the primary and secondary markets for issuers, investors, and intermediaries. This definition should include (i) minimum guidelines for disclosure of material information, (ii) liability for entities involved in distributing securities and for entities handling third-party investment accounts, and (iii) vehicles to allow proper legal recourse against mutual funds, pension funds, and even the government as an issuer. Investment regulations need to permit sufficient flexibility for investors, yet create adequate safeguards for prudent operations and for the safeguarding of fiduciary obligations, as in the case of pensions.

--- Experts are invited to identify the key legal policy issues related to the development of government securities markets that need to be addressed by policymakers as high priority.

-- Is there a preferred way for defining the legal basis (constitution or legislation) for the government's borrowing authority? And how can ceilings for government securities issuance best be established?

-- What should the legal boundaries for primary markets be?

Regulation of the government securities market

Earlier discussions of regulatory issues within the OECD Working Party emphasised that there are specific regulatory requirements of government debt

markets. (The limited scope of existing, classical equity-oriented rules normally precludes that securities regulators play a significant role in government debt markets governance.) In practice, the allocation of regulatory and supervisory powers among the MOF, central banks and securities regulators varies quite significantly. In assessing the allocation of regulatory and supervisory powers among it is important to put the emphasis on functional performance of rules rather than on formal (organisational) issues.

-- Do you agree that the functional perspective should be used in allocating regulatory and supervisory powers?

In most countries government securities trade in the secondary market along with all other securities and are, therefore, subject to secondary market regulation. Effective secondary market regulation is necessary to support a viable secondary market. Since government securities are often defined as “exempt securities,” (that is, exempt from regular prospectus requirements) it is important to make sure that this status does not undermine the integrity of the secondary market. Effective regulation of the secondary market 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.

The regulatory structure of securities markets in general is usually built around SROs, 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. As government securities are traded in only a few cases on organised exchanges, the use of SROs for regulation of the bond market is in many countries limited. It is more 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.

-- What role (if any) should there be for self-regulatory organisations (SROs) in the government securities market?

-- Is there such a concept as the “ideal” or “optimal” organisational structure of government securities markets? If yes, how is this structure defined? If not, why?

Capital rules, margin requirements, risk controls, and trading-practice regulations applied to intermediaries are likely to grow in importance with technological advances³. Non-uniformity of 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

³ See *Risk Management of Government Debt*, OECD, 2005.

of capital than non-members, the members will have greater incentives to monitor those financial institutions with lower capital requirements. Capital requirements must take into account liquidity, price, 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.

-- Experts are invited to elaborate on the role of risk-based capital requirements in the regulation of the government securities market. Will risk-based regulation in this market further grow in importance?

The advance of electronic trading systems (ETS) is reshaping the fixed income markets at a high pace. Markets and governments will have to adapt to this new reality. Some types of securities are traded on several electronic platforms. Nonetheless, OTC-markets have still an important market share. ETS are mostly focused on dealers. Institutional investors have in most cases no direct access. It is expected that this gap will be filled by either 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 will need to permit the operation of private proprietary trading systems, entry of foreign trading systems, or alternative trading systems (ATs) alongside traditional exchanges that trade government securities. While transparency is critical, and will naturally improve, it may need public support. Other regulatory concerns include access, member and market rules, and market soundness, namely the reduction of systemic and credit risks.

-- What are the critical issues in the regulation of electronic government securities markets? How can a level playing field best be assured?

Legislation and regulation about the kinds of information that need to be disclosed by market participants is essential for an active and sound government securities markets. These disclosure rules relate to analysts and their responsibilities, public disclosure by broker-dealer firms and by the government as an issuer, credit-rating agencies, and many forms of self-regulatory associations, such as organisations of accountants and auditors. Providing incentives for the preparation and disclosure of high-quality information is important for market development.

-- What kind of information needs to be disclosed? Should disclosure or rules ensure investor protection in the government securities market?

Supervision of the government securities market

Governments support the development of fixed-income securities markets via their role as regulators and supervisors of the market. An important responsibility is ensuring the compliance with market rules of conduct by its participants, including rules on transparency and adequate disclosure. Where there is more than one authority exercising supervision over institutions participating in the government securities market, the actions of these authorities must be coordinated in order to maintain a fair and competitive environment. Where there is cross-border transaction activity in the government securities market, there will be a presence of foreign financial institutions in the domestic market and/or the presence of domestic institutions in foreign markets. This international aspect will require cooperation between domestic supervisors and their foreign counterparts.

Supervisory practices differ significantly across jurisdictions. There seems also to be some discussion how supervision of the government securities market can best be organised in the light of new technological developments (in particular ICT and electronic markets), globalisation, and the supervisory objectives of investor protection and market integrity.

--What are the critical issues in the supervision of secondary government securities markets, including the allocation and definition of enforcement powers?

--Is the issue of a level supervisory playing field across different jurisdictions a big problem?

--Are new supervisory initiatives urgent in the light of new technological developments and globalisation?