

# **Legal Framework and Market Regulation**

**for**

## **Developing Government Securities Markets**

**Thomas P. Briggs, Senior Advisor  
Government Debt Issuance and Management Program  
Office of Technical Assistance, U.S. Treasury Department  
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# Sovereign Debt Law Essentials

1. Affirmation that the debt is a direct obligation of the sovereign as issuer
2. Affirmation that the debt is absolutely and unconditionally guaranteed.
3. Permanent and indefinite appropriation for the payment of all debt service
4. Parity for all sovereign debt
5. Limitation on total debt
6. Establish a national debt ledger and provide for public reports on the debt
7. Authorize the types of securities that may be issued
8. Authorize payment of issuance and debt service costs
9. Establish management organization and responsibility
10. Define the relationship with the central bank as fiscal agent
11. Establish the borrower
12. Grant authority to the Minister of Finance to act as the sole borrowing agent for the State
13. Authorize the Minister of Finance to select instruments for borrowing
14. Authorize the Minister of Finance to issue regulations to implement the law
15. Provide for recognition of the actual liability when a guarantee is called
16. Establish the audit and accountability process

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# Rationale for Government Securities Markets (primary and secondary) Regulation

- Benefits
  - Efficient price discovery
  - Reduced systemic risk
  - Correct market imperfections/failures
  - Enhance investor confidence
  - Minimize moral hazard problems
- Economic Trade-Off
  - Accept inefficiency of regulation in return for reduced counterparty risk, reduced systemic risk and increased confidence

# Legal Framework as Source of Basic Investor Rights

*Regulation is not the primary source of investor rights*

The majority of investor rights will be found in:

- Public debt law
  - security
  - right to be paid
  - permanent and indefinite appropriation
  - permanent authority to refund
- Bankruptcy and reorganization law
- Property rights and property conveyance law
- Secured transactions law
- Contract enforcement

# Special Nature of Government Securities

## *Fiscal Policy Features*

- Source of noninflationary finance for the state
- Large, one-time nonpublic debt operations
- Shift timing of government expenditures
- Stakes may be financial, or even political, survival

## *Monetary Policy Considerations*

- Organized market provides immediacy for OMO
- Efficient market allows more precise OMO
- Risk-free securities improves transmission of OMO policy signals by eliminating noise due to price of credit risk
- Eliminates credit risk from central bank balance sheet
- Primary dealer system may reduce counterparty risk
- Least complicated tool for discount window operations in times of crisis

## *Financial Market Features*

- Risk-free
  - credit risk
  - liquid even in times of crisis
- Secondary reserve asset for banks
- Foundation for efficient money and capital markets
  - basis for derivatives
  - direct hedging
  - benchmark yield curve

# Special Nature of Government Securities Markets Regulation

- Issuer and securities are exempt from registration
  - *Cannot subordinate deficit finance – the will of the parliament – to a regulatory body*
- Ministry of Finance should always retain rule making authority for the government securities markets
- Ministry of Finance may delegate other regulatory activities to capital market or bank regulatory authorities

# Benefits of Regulation

## Issues NOT addressed by regulation

- Default due to behavior
  - failure to appropriate interest
  - failure to permit refunding
- Disclosure of credit and economic factors
  - budget law provides for disclosure of the budget
  - treasury act provides for disclosure of cash position
  - debt law requires disclosure of liability position
- Debt limits
- Loss of value due to market risk

# Benefits of Regulation

## Reasonable Expectations from Market Regulation

- Price transparency
- Anti-fraud protection
- Ownership integrity
- Counterparty risk

# Two Models for Regulatory Activities

## Supervisory Model

- Rule making
- Licensing
- Supervision
- Examination
- Compliance
- Enforcement

## Conflict Resolution

- Rule making
- Conflict resolution
- Licensing

# Sequencing Issues

*Practical world differs from theoretical construct*

- It is not necessary to build the entire framework for a mature market while the market is immature.
- Therefore, it is possible to sequence development of the entire framework without loss.

# Sequencing Issues

## *Examples of Practical Sequencing*

- Banks are initial purchasers. Banks tend to buy and hold.
  - Therefore, the only regulation necessary at the start is a set of reasonable auction rules.
- The next stage is likely to be a primary dealer system.
  - By definition, this will be a professional market. Therefore, little in the way of anti-fraud (consumer) protection is required.
  - Capital requirements are indicated as a means of limiting counterparty risk and reducing systemic risk.
- If significant retail participation develops, the next logical step is assurance of ownership integrity in a high volume environment and anti-fraud protections.

## Caveats Regarding the U.S. as a Model

- System evolved over 75 years. It was not created whole in a thoughtful, analytical way.
- The U.S. structure is based on our concept of shared sovereignty between the central government and the states.
- The sovereign issuer is exempt from registration and disclosure requirements.
- Subsovereign issuers are exempt from registration, but not anti-fraud provisions.
- The U.S. makes heavy use of SROs.
- We have functional regulators, such as the CFTC and SEC, operating in the same markets.

# Current Problems in Regulation

## Regulation in a global economy

- Over-regulation rapidly drives trading to other countries
- Potential speed and magnitude of capital flows
  - increases risk to individual institutions
  - increases the complexity of the regulatory task
  - focuses regulatory activities on risk-based measures and away from simple capital requirements
    - makes external regulation insufficient
      - forces reliance on compliance operations
      - requires transparency

## Large, complex banking organizations

- Rehabilitation (banks) v. strict compliance (brokers)

# Current Problems in Regulation

## Functional v. Institutional Regulation

- Broker-dealer v. bank treatment
- Something of a false argument\
- Always going to be messy
- Transition problems