
Consultation Paper 18

**Policy Decisions to
develop the Corporate
Bond Market**

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*Securities and Exchange Commission of Sri Lanka
Level 28 & 29, East Tower, World Trade Center
Echelon Square
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Policy Decisions to develop the Corporate Bond Market

This paper is presented with a view of soliciting public comments on the Policy Decisions approved by the Securities and Exchange Commission of Sri Lanka (SEC) to develop the Corporate Bond Market. The comments received would be subject to consideration by the SEC.

Comments received may be publicly available and will not be treated as confidential unless a special request is made in that respect.

Please send in your comments under the title **"Policy Decisions to develop the Corporate Bond Market"** on or before 22nd August 2013 by registered post or fax or e - mail to:

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The contents of this paper do not constitute legal advice. The finalised policy decisions may change from the draft consequent to the comments the SEC receives and further deliberations or due to any other reason connected with same.

POLICY DECISIONS PROPOSED TO DEVELOP THE CORPORATE BOND MARKET

1. Intermediaries permitted to operate as Debt Dealers

- I. Primary Dealers (PDs)
- II. Stock Brokers
- III. Other Institutions

1.1 General Requirements

- a. Aggressive market making is expected to develop a vibrant corporate debt market.
- b. Intermediaries need to maintain proprietary accounts separately from client accounts.

I. Primary Dealers (PDs) –

- a. To allow PDs to engage in market making activity with their existing minimum capital (Rs.300 Mn).
- b. PDs have been permitted to invest 5% of their portfolio in corporate bonds initially by the Central Bank of Sri Lanka (CBSL). Representations are to be made to the CBSL to get limit increased to 10% specifically for listed corporate bonds in the interest of developing the corporate bond market.
- c. PDs would need to comply with SEC regulations applicable to corporate debt securities & stock dealers

II. Stock Brokers/Stock Dealers

For stock brokers trading equity and/or debt securities and stock dealers dealing in debt securities who have a choice of equity and debt, the exposure limits for asset classes in the balance sheet will be determined by the adjusted net capital requirement, a concept which is similar to the risk weighted capital requirement adopted by banks.

The following risk weights would apply for the respective asset classes:

- (a) Equity – Debtors - 33 1/3 %
- (b) Corporate Debt – Main Board - 20%
Second Board - 25%
- (c) Proprietary Holding of Debt – Main Board - 20% of portfolio value
Second Board - 25% of portfolio value

Stock Brokers are eligible to apply for 'stock dealer' license subject to their ability to manage their capital between equity and debt securities under the following formula:

"The aggregated risk weighted value of "open equity position", "open debt position" and "proprietary trading portfolio of Corporate Debt" shall not at any time exceed the adjusted net capital of the stock broker firm"

For the purpose of this definition:

- a. "open equity position" means the total value of the debtors over T+3 days generated through equity trading.
- b. "open debt position" means the total value of debtors over T+1 days for debt securities traded in TOM board and debtors over T+2 days for debt securities traded in SPOT board listed in either first board or second board"
- c. "proprietary trading portfolio of Corporate Debt" shall mean fully settled corporate debt securities purchased on own account.
- d. "adjusted net capital" shall have the same meaning as specified in section 7.1.1 in the CSE Stockbroker Rules. The current rule will be amended to accommodate debtors arising due to debt trading by stockbroker firms if applicable. The current Net capital Statement set out in Annexure 6 of the Stockbroker Rules will be amended to reflect the diminution of value of corporate debt securities (market value – purchase cost) in relation to debtors and proprietary trading (own account) portfolio as applicable.

III. Other Institutions –

- a. The minimum net capital requirement would be Rs.100 Mn.
- b. Any other institutions who provide financial services may apply for license under this category if they are eligible under the stipulated criteria. (Criteria are to be developed).
- c. Other Institutions who wish to become market makers in corporate debt securities are required to apply for a 'stock dealer' license subject to their ability to manage their capital between corporate debt securities listed on the two boards of the CSE under the following formula:

"The aggregated risk weighted value of "open debt position" and "proprietary trading portfolio of Corporate Debt" shall not at any time exceed the minimum net capital of the firm.

For the purpose of this definition:

- a. "open debt position" means the total value of debtors over T+1 days for securities traded in TOM board and debtors over T+2 days for securities traded in SPOT board listed in either first board or second board"
- b. "proprietary trading portfolio of Corporate Debt" shall mean fully settled corporate debt securities purchased on own account.
- c. "minimum net capital" shall be the aggregated value of the " stated capital and reserves" of the firm.

1.2 SEC Qualification Framework for *Debt Dealer* based on Asset Class

- a. At least 2 persons who deal in debt securities possessing a degree or a professional qualification acceptable to the SEC and a minimum of 3 years experience dealing in debt securities. Evidence of experience in activities relating to debt dealing will need to be submitted.
- b. If such persons do not possess either of the above-mentioned educational qualifications, they should possess a minimum of 7 years experience in dealing in debt securities.

- c. Market intermediaries who already possess the stock dealer license (existing members and existing trading members of CSE) are to be provided 1 year to fulfill the criteria set out in (a) and (b) above.
- d. For those who do not fulfill the above criteria and any new recruits engaging in corporate bond dealing, the following would apply:
 - i. The debt module under the Certificate in Capital Market (CCM) examination needs to be successfully completed to deal in debt securities (listed or unlisted).
 - ii. The designation to be awarded to individuals who complete the debt module, pass the viva and have the relevant work experience is to be decided (E.g. 'Registered Debt Advisor').
 - iii. Market intermediaries who already possess the stock dealer license (existing members and trading members of the CSE) are to be provided 1 year to fulfill the criteria set out in (d) (i) and (ii) above.

2. Trading Platform

- a. Our policy on a trading platform is an order matching, anonymous, screen based electronic trading platform considering the benefits of reduced transaction costs and time efficiency in executing trades.
- b. Accordingly, for this purpose the existing trading platform – Automated Trading System (ATS) at CSE serves the current requirements as it provides order matching, anonymous trading, transparency in price and seamless integration with depository (CDS).
- c. Upgrades to the system will be required such as accommodating Over the Counter (OTC) transactions once the SEC Act is finalised.
- d. Currently the ATS is connected to the CSE/Central Depository System (CDS). Also the CSE/CDS is connected to the CBSL-RTGS system. Accordingly it is possible for corporate debt market transactions to be settled in Central Bank money (through the current accounts maintained with the Central Bank by the direct participants in the National payments & settlements system or through the respective settlement bank).
- e. Other options for facilitating trading corporate bonds are the CBSL platform and/or the Bloomberg/ Reuter's platforms.
- f. All corporate debt trading platforms need to be connected to the CSE-CDS.
- g. Any debt trading system should facilitate improved liquidity, market making activity and adhere to international best practices. The best interest of developing the corporate debt market to be considered when selecting other trading platforms. The Bloomberg/ Reuters or any other trading platform is preferred, to attract the foreign pool of investors.
- h. To facilitate trading of corporate bonds on a platform of choice for investors. The CSE Board approval is required for the selection of any other trading platform.
- i. The CSE platform could be the choice for retail trades and the CBSL and Bloomberg/ Reuter's platforms for the wholesale market.
- j. CSE/CDS to be the title registry (in dematerialised form) of Corporate Bonds.
- k. Infrastructure should be set up for online monitoring by interconnecting all trading platforms (CSE, CBSL and Bloomberg/ Reuters) to the CDS plus facilitate traceability of trades.

- l. The CSE is to facilitate the establishment of a separate platform for the trading of unlisted corporate bonds where such securities will be lodged and settled at the CDS.
- m. Other trading platforms too could facilitate trading of unlisted bonds.
- n. Listing and trading of different types of corporate debt to be facilitated by the CSE.
- o. If unlisted corporate bonds are to be traded in a traded platform, educational programmes should be carried out, coordinated by the CSE, CBSL and SEC to create awareness among the public.

3. Internet On-line Trading Facility

- a. Currently listed corporate debt transactions are taking place through brokers via voice trading (over the phone with voice recording). Facilitating an internet-based online trading for listed debentures will provide more flexibility and anonymity.
- b. This will be cheaper and provide incentives for people to trade corporate bonds through internet.
- c. The SEC is to publish on the SEC website the names of market intermediaries who provide internet trading.

4. Trading Membership

- Any entity which proposes to engage in trading debt securities (listed or unlisted) will need to apply to the CSE to become a trading member for debt securities. The CSE Board to set out criteria for admission as Trading Membership for debt securities subject to SEC approval. Successful trading members are required to obtain a market intermediary license from the SEC to operate as a stock dealer. Subsequently, the SEC Act amendment is to include "Debt Dealers/Market Makers" as a new category of intermediaries.

5. Trade Reporting Platform

- a. For market transparency, a trade reporting platform, to disseminate market information is to be established and it will be owned and maintained by the CSE.
- b. The Trade Reporting Platform will capture data on corporate bond trades (listed and unlisted) and disseminate this information to the market on a website, for the information of investors/ the public.
- c. The SEC is to mandate that all intermediaries are to report specified details of any such transaction, within a specified time of the day, to the trade reporting system or a Central Agency irrespective of whether the trading is done via the CSE, CBSL or Bloomberg/Reuters platforms.
- d. Decide the details of reporting (last traded price/yield, bid/ask rates, tenure of security, etc.)
- e. Decide the time of reporting after execution of a trade (initially end of day).
- f. Make available similar information on Government securities on a daily basis as per CBSL website.
- g. Information on all OTC trades on corporate debt need to be reported on the trade reporting platform subsequent to the SEC Act amendment.

6. Corporate Bond Market Information Quality

- The level of information dissemination will be brought to be on par with the proposed information dissemination in the G-Sec/Money markets.

7. Encourage Public Issuance of Bonds

- It may also be noted that there is a bias towards issuance of bonds through private placement. This is not a transparent method and it impacts the secondary market liquidity in corporate debt. Hence there is a need to encourage public issuance of bonds.

8. Corporate Bond Database

- a. To facilitate policy making, a comprehensive frequently updated centralised data base on corporate bonds to be established by the CSE providing greater bond specific details such as issue size, features, option availability, ratings and updates, regulatory updates and similar market information, etc.
- b. To establish a suitable mechanism between the stock exchange and the rating agencies for any subsequent rating migrations to be promptly reported.
- c. The database to include unlisted corporate bond issue details in the future.
- d. Databases should be available free of cost to the public and web based.

9. Attracting Foreign Investors

- a. Expanding the market access to foreigners particularly to Foreign Institutional Investors.
- b. Foreign investors prefer to invest via a custodian bank or through Bloomberg/ Reuter's platforms.
- c. Credit risk and liquidity risk of corporate bonds are key concerns for foreign investors.
- d. To discuss with CBSL/Controller of Exchange on possibility of local exporters issuing US Dollar denominated corporate bonds in Sri Lanka and if so, enable the listing framework.

10. Central Clearing Corporation

- a. Support the view of the necessity on a Clearing Corporation to mitigate counter-party risks.
- b. A corporate bond trade can be settled between T+1 or T+2 and therefore to address finality of settlement, a CCP is required.
- c. The CSE Board has decided to call for EOI from suitable parties to implement a CCP for all securities traded on the CSE. In light of this decision, the setting up of the CCP is to be deliberated further.
- d. The proposed settlement model is the DVP-III where both the securities and underlying fund obligations are netted and only the net amounts are settled. The CCP will apply a multi-lateral netting process to arrive at the net obligation of funds and securities.
- e. The net obligations are then transferred to the CSE-CDS to record the change in the title ownership of corporate bonds and to the CBSL's Lanka Settle (RTGS) system to settle the cash leg of the transaction.
- f. For the inter dealer market, clearing is preferred to occur through the CCP and reported to the CDS.
- g. For secondary market trades, dealers are to settle through their settlement banks and at the end of the day report to the CDS.
- h. If Short-Selling or Securities borrowing are to be allowed, it would be only after establishing the CCP.

11. Simplifying Issue/Listing Requirements

- Changes have been proposed to the listing rules of debt by the CSE to facilitate corporate bond issuances by simplifying listing requirements and encouraging alternate debt products.

12. Relaxing Investment Restrictions and encouraging Long Term Fund Investments

- a. In view of the long term funding requirements of insurance, provident funds and pension funds are best suited for investment in bonds.
- b. Accordingly, there is a need to revisit the investment guidelines of such institutional investors as the existing mandates of such institutions do not permit large investment in corporate bonds.
 - To make representations to the Secretary to Treasury to enable permission of large scale funds to invest part of their portfolio in listed corporate bonds.
 - To make representations to the Labour Secretariat, Insurance Board of Sri Lanka (IBSL) and other relevant authorities on same.

13. Introduce a Standard Brokerage

- a. Currently all corporate debt transactions are charged with a mandatory fee of 0.02% (2 basis points) by SEC/CSE/CDS for providing the trading platform, dematerialised title registry through CDS and as regulatory fees (CESS).
- b. However, there is no fixed brokerage charge, hence brokerage is negotiable with the client.
- c. To facilitate the development of the secondary corporate debt market steps would be taken to suspend the SEC/CSE/CDS fee in the market.

14. Imposing a Ceiling on Par Value

- To enhance the liquidity of the debt market, par value of a debenture should not be over Rs. 100.

15. Imposing a Ceiling on Subscription

- To enhance retail level participation/affordability, it is proposed to impose an affordable amount (Rs 10,000 or multiples of Rs 10,000) as a minimum subscription.

16. Back Office System

- Market maker's Back Office System should facilitate the minimum requirements for Risk Management, Electronic Reporting and On-line internet trading facility.

17. Awareness Building

- a. Existing and potential investors should be educated regarding the secondary market activities of corporate debentures.
- b. Facilitate a seminar for private and public super-annuation funds to encourage fund managers to invest in listed corporate bonds.
- c. Publishing an advertisement to the members of private and public super-annuation funds on benefits of investing in listed corporate bonds.

18. Benchmark Yield Curve

- a. A long-term (preferably up to 10 years) yield curve for Government securities to be developed and maintained with frequent issues by the CBSL which is crucial for pricing of corporate bonds.