



REVISTA INCLUSIONES

CIENCIA EN LOS NUEVOS TIEMPOS

Revista de Humanidades y Ciencias Sociales

Volumen 7 . Número Especial

Julio / Septiembre

2020

ISSN 0719-4706

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REGULATION OF SECURITIES MARKET DERIVATIVES: EXPERIENCE AND PROSPECTS

Dr. Umalt Umarovich Abdulkadirov

Chechen state university, Russia

0000-0003-0855-3577

umalt.abdulkadirov@mail.ru

Dr. Vadim Nikolaevich Zasko

Financial University under the Government of the Russian Federation, Russia

0000-0002-4395-415X

vadim_zasko@mail.ru

Lic. Dmitry Anatolyevich Stepanov

Market Economy Institute of RAS (MEI RAS), Russia

0000-0003-3670-5865

bmk.0952@gmail.com

Fecha de Recepción: 03 de marzo de 2020 – **Fecha Revisión:** 21 de abril de 2020

Fecha de Aceptación: 28 de junio de 2020 – **Fecha de Publicación:** 01 de julio de 2020

Abstract

The article analyzes the current state and prospects of regulation of the market of derivative financial instruments (derivatives) in the Russian Federation. The financial derivatives market in Russia is relatively young, and as a result, many of its aspects are not clearly regulated by Russian law, which naturally creates numerous problems for participants. The purpose of this study is to analyze the legal regulation of the turnover of derivative financial instruments and offer recommendations for improving the regulatory framework to solve the identified problems. The article discusses the prerequisites for the emergence of legal regulation of the financial derivatives market, the initial content, and recent changes. The legislative basis of the new system has been shown, the main legal acts and subjects of regulation have been listed.

Keywords

Derivative financial instruments – Hedging – Speculation – Global crisis – Transparency

Para Citar este Artículo:

Abdulkadirov, Umalt Umarovich; Zasko, Vadim Nikolaevich y Stepanov, Dmitry Anatolyevich. Regulation of securities market derivatives: experience and prospects. Revista Inclusiones Vol: 7 num Especial (2020): 108-118.

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Introduction

In recent decades, the global economy has been undergoing processes related to the liberalization of financial markets and increased liquidity of securities. The economic interest in financial assets was supported by securitization, which was gaining momentum at the time, i.e. the replacement of non-market loans and cash flows with securities that were freely traded on the market. The result of such transformations was an increase in the scale of the derivatives market and the complexity of instruments traded on both the exchange and OTC markets in the United States, Japan, and leading European countries¹. The processes of financial globalization have also contributed to the spread of derivatives in emerging markets. Gradually, DFIs (DFI) began to play a significant role in the entire world economy, setting the vector of its development².

Optimizing the regulation of the derivatives market is an important step towards improving the stability of the relevant sector.

Recently, operations with DFI are becoming more widespread in the organization of risk management procedures in companies in the real sector of the Russian economy³. This is due both to a sharp increase in the level of market risks, fluctuations in exchange rates, and commodity prices and to a deeper understanding of the principles of derivatives as hedging instruments by top management of companies. At the same time, the Russian derivatives market is characterized not only by a constant increase in turnover but also by the complexity of tools used by companies to solve specific investment tasks and the emergence of new structural DFI that reflect complex financial strategies⁴.

Having emerged as a tool for ensuring the risks of economic activity, the derivatives market has taken a speculative direction and has become a destabilizing factor both at the level of individual states and for the global financial system.

Thus, there was significant growth in operations with DFI on the threshold of the global crisis of 2007-2009. In 2007, credit default swap trade reached 63 USD trillion, exceeding world GDP⁵. Due to the development of financial globalization, which leads to the

¹ Yu. V. Mikhalenko; E. G. Shadrina y A. I. Rashidova, "On the Issue of Criminal Prosecution for Market Abuse in Russia and the EU", *Journal of Advanced Research in Law and Economics* Vol: 9 num 4 (2018): 1362-1364 y A. Tatibekova y M. Bubeyev, "How regulation of bank capital adequacy and liquidity affects pricing of bonds of the banks", *Entrepreneurship and Sustainability Issues* Vol: 7 num 3 (2020): 1708-1722.

² S. I. Dolgov; Yu. A. Savinov; E. V. Taranovskaya; V. D. Sekerin y A. E. Gorokhova, "Development of Industrial Cooperation within the EAEU. *Journal of Advanced Research in Law and Economics* Vol: 10 num 2 (2020): 533-541 y V. I. Gayduk; M. D. Kovalchuk; A. A. Ermakov y S. Yu. Kamysheva, "Risks of interaction between government bodies and business structures in the Russian agricultural sector", *Revista Inclusiones* Vol: 7 num Especial (2020): 188-205.

³ T. P. Nikolaeva; T. A. Panovaz y A. A. Vershinina, "Specifics of the Microfinance Market Development in Russia", *Journal of Advanced Research in Law and Economics* Vol: 10, num 2 (2020): 625-630 y V. V. Voroshilo; D. D. Burkaltseva; O. G. Blazhevich; A. P. Bondar; A. V. Betskov; H. Sh. Kilyashkanov y S. A. Zotova, "Current trends in the real estate market in Russia: personal consumption of the population and their investment activities", *Revista Inclusiones* Vol: 7 num Especial (2020): 240-253.

⁴ M. N. Dudin; O. F. Shakhov; N. P. Ivashchenko y M. S. Shakhova, "Development of entrepreneurial competencies in the economy (evidence from digital entrepreneurship)", *Revista Inclusiones* Vol: 7 num Especial Enero-Marzo (2020): 54-68.

⁵ B. K. Irishev, *Krizis evro i globalnye riski* (Moscow: Publishing house "Ves mir", 2014).

increasing interconnections of financial systems of different countries, the local American mortgage crisis turned into a global one. The EU Treaty establishes the free movement of capital between the European integration association and third countries. Structured credit products from the United States based on subprime mortgages, as well as the bankruptcy of Lehman Brothers, the lender of which was the European financial institutions, led to losses of several hundred billion euros in the European states⁶.

At the same time, the following paradox should not be left unnoticed: the instruments created to minimize risks, with an increase in the volume of transactions, themselves began to produce risks, the level of which has recently caused serious concern to financial regulators. It seems that the main reason for most of the problems that arise in DFI transactions is a lack of full understanding of the economic nature and place of derivatives in the financial market system and, as a result, the lack of an effective legal mechanism for regulating this segment of the financial market in Russian legislation.

The history of modern legal regulation of derivatives in Russia is usually counted from the beginning of the 1990s. The terms "option transaction", "futures transaction", "forward transaction" were first used in the Law of the Russian Federation dated February 20, 1992 No. 2383-1 "On Commodity Exchanges and Exchange Trade" (Article 8)⁷. This law was amended only in 2009, as a result of which the concepts of such transactions were excluded from the said law, and the emphasis in the legal regulation of relations from contracts that are DFI concluded at exchange tender was transferred to the provisions of the Federal Law of April 22, 1996 No. 39-FL "On the Securities Market"⁸. In 2010, Article 2 of the Federal Law "On the securities market" introduces a legal definition of a DFI. The latter is defined as a contract that provides for one or more of the obligations specified in this Federal Law. The emergence of a legal definition of DFI to the number of contracts has generated significant interest on the part of civilists in this legal category, which has not disappeared even now. The issues of regulating the turnover of financial derivatives were considered by legal scholars, such as V.V. Antyushina⁹, T.Yu. Safonova¹⁰, N.S. Melnikova¹¹, and many others. However, special scientific research of a complex nature on DFI, as well as their individual types, is clearly not enough. At the same time, the legal qualification (both from the point of view of civil and financial law) remains controversial and requires special analysis. Therefore, research with the development of an independent, reasoned position in this dispute may have a certain scientific novelty.

Research hypothesis: to reduce financial risks, centralized, coordinated, and more stringent legal regulation of transactions with DFI is necessary.

⁶ V. V. Antyushina, "Antikrizisnoe regulirovanie rynka derivativov v ES na sovremennom etape", *Innovatsii i investitsii* Vol: 11 (2019): 49-52.

⁷ The law of the Russian Federation of February 20, 1992 N 2383-1 "On commodity exchanges and exchange trade" (repealed). *Vedomosti of the Congress of People's Deputies of the Russian Federation and the Supreme Council of the Russian Federation*, 1992, N 18, Art. 961.

⁸ Federal Law of 04.22.1996 N 39-FL (as amended on December 27, 2019, as amended on April 7, 2020) "On the Securities Market". *Collected Legislation of the Russian Federation*, N 17, 04.22.1996, Art. 1918

⁹ V. V. Antyushina. *Antikrizisnoe regulirovanie...*

¹⁰ T. Yu. Safonova, "Rynok proizvodnykh finansovykh instrumentov kak samostoyatelnyi sektor finansovogo rynka", *Dengi i kredit* Vol: 11 (2016): 34-40.

¹¹ N. S. Melnikova; A. V. Konnova y A. S. Logvinova, "Problemy i puti ikh resheniya na rynke proizvodnykh finansovykh instrumentov v sovremennykh usloviyakh", *Nauchnyi rezultat. Ekonomicheskie issledovaniya* Vol: 5, num 2 (2019): 59.

Methods

Taking into account the fact that relations related to the turnover of derivatives in financial markets are regulated by both civil and financial law, the work used general and special scientific research methods that are typical of civil and financial law. The main feature of this research was the dialectical method of cognition of reality, which combines the historical method that allowed tracing the formation of legal regulation of financial derivatives and the statistical method that allowed confirming the relevance of problems with specific figures. The comparative research method had shown that it is possible to solve the problems of legal regulation by applying international experience and harmonizing legislation.

Results

A DFI or derivative is a contract under which the parties that have entered into it have an obligation or right to perform the actions specified in the contract concerning the underlying asset. The derivative gives the opportunity to buy, sell, provide, or receive certain goods or securities. A distinctive feature of a derivative is its standardization and the fact that its price change is associated with a change in the price of the underlying asset¹². In accordance with the legislation of the Russian Federation, derivatives include futures and forward contracts, swaps, and options. DFI are OTC and exchange. Options and futures contracts belong to exchange ones, forward contracts, and swaps belong to OTC ones¹³.

In science, there are two main models of state regulation of the financial market. According to the first model, the main role in regulating the financial market belongs to the state. Moreover, such a model, according to L.A. Merkulova, suggests that regulation and control is carried out by an independent state body (the United States is an example). This model also allows for the creation of a branch of government that is subordinate to another government body. The second model, according to the scholar, provides for the division of regulatory functions between the state in the person of authorized bodies and self-regulating organizations¹⁴. Even though Russia is assigned to the second model of regulation of relations in the financial market by several scholars¹⁵, today in Russia the state regulation of transactions with DFI is carried out according to the first model, mainly by the Bank of Russia. Along with the Bank of Russia, the regulation of certain issues related to DFI is the responsibility of the Ministry of Finance and Rosfinmonitoring. However, the importance and scope of this regulation are not comparable to the role of the Bank of Russia, which has the status of a mega-regulator. The Bank of Russia carries out state regulation of operations with DFI in accordance with Chapter 10.1 "Regulation, control and supervision in the sphere of financial markets" by the Federal law dated July 10, 2002. N 86-FL "On the Central Bank of the Russian Federation (Bank of Russia)"¹⁶, Chapter 4.

¹² I. M. Podkolzina, *Sovremenniy ekonomicheskii slovar* (Moscow: Nauka i Prosveshchenie, 2018).

¹³ N. S. Melnikova; A. V. Konnova y A. S. Logvinova, *Problemy i puti...*

¹⁴ L. A. Merkulova, *Finansovo-pravovye aspekty operatsii s proizvodnymi finansovymi instrumentami (derivativami)*. Ph.D. Thesis. (Moscow, 2011).

¹⁵ M. I. Galochkin, "Samoregulirovanie v razvitii sistemy rynka derivativov", *Vestnik SamGUPS* Vol: 1 num 23 (2014): 54-58.

¹⁶ Federal Law of 10.07.2002 N 86-FL (as amended on April 3, 2020) "On the Central Bank of the Russian Federation (Bank of Russia)". Collected Legislation of the Russian Federation, July 15, 2002, N 28, Art. 2790.

The Law "On Organized Tenders"¹⁷ provides for the right of the Bank of Russia to regulate activities for conducting organized tenders, including the adoption of regulatory acts regulating activities for conducting organized tenders, as well as other normative acts provided for by the Law on Organized Tenders. The Bank of Russia regulates a wide range of issues according to the Law "On Organized Tender": the issues related to pursuing uniform state policy in the field of the organized tender; licensing issues; issues related to the implementation of organized tender; and issues related to the treatment of derivatives; issues related to the monitoring of the implementation of derivative transactions; the issues associated with the establishment of requirements to the order of storage and protection of information and documents related to the organized tenders, as well as to the duration; other. The Law "On Organized Tenders" essentially consolidates the competence of the Bank of Russia to regulate exchange transactions with DFI. This law does not regulate relations related to transactions in DFI that are not concluded at organized tenders.

Another law that sets out the range of issues that the Bank of Russia regulates is the law on the securities market. The Law "On the Securities Market" granted the Bank of Russia the following rights (Article 44): to qualify securities and financial derivatives in accordance with the procedure established by the Bank of Russia and define the types thereof; to determine securities and financial derivatives intended for qualified investors; to establish requirements for the procedure for providing information related to transactions with such securities and financial derivative contracts.

These regulations establish the competence of the Bank of Russia to regulate primarily operations with exchange-traded DFI.

In terms of regulating operations with OTC derivatives, the Bank of Russia regulates depository activities (licensing and reporting issues) and the activities of Forex dealers.

For operations with derivatives, the concept of the financial market is essential, since all operations with them, as well as the derivatives themselves, are divided into exchange and OTC. If exchange operations are carried out by dealers, brokers and management companies (professional participants in the securities market), as well as by the Bank of Russia and the Federal Treasury in accordance with part 1, 4 of Article 16 of the law "On Organized Tenders", then OTC operations with derivatives can already be concluded by persons without the status of a professional participant in the securities market. In this regard, the competence of the Bank of Russia in this area is seen as blurred, and regulation is insufficient.

Discussion

It should be noted that at the moment the Russian market of financial derivatives is inferior to the markets of Europe and the United States in terms of development as if repeating what they have passed. At the same time, it has a pronounced speculative orientation. Imperfect regulation of the relevant sphere hinders the development of trade in DFI. However, all necessary efforts are being made to optimize it, in particular, there is a gradual introduction of international standards in this area. In this regard, it is obvious that the American and European experience, which has a much greater historical practice, may be of interest to Russia.

¹⁷ Federal Law of November 21, 2011 N 325-FL (as amended on December 27, 2018) "On Organized Tenders". Collected Legislation of the Russian Federation, November 28, 2011, N 48, Art. 6726.

Government regulation is implemented at two levels in the United States. The first level is carried out by Federal bodies based on adopted Federal laws. The second level, as discussed above, is carried out by self-regulating organizations. In 1934, in accordance with the Securities Exchange Act of 1934, the United States Securities and Exchange Commission (SEC) was established. The law gives the SEC broad powers over all aspects of the securities market. The securities and tariffs commission exercises its powers to regulate and control operations carried out on financial markets, and the commission also regulates clearing and reporting issues. The law also grants powers to register, regulate, and control participants in the securities market. The Commission also has disciplinary powers against regulated entities and related persons¹⁸. Also, the U.S. Commodity Futures Trading Commission (CFTC) was established in the United States. The Commission promotes transparency, competition, and financial stability of operations in the derivatives market. The Commission works to avoid systemic risk and seeks to protect market users, their funds, consumers, and the public from fraud, manipulation, and abuse related to derivatives and other products covered by the Commodity Exchange Act (CEA). The Commission also oversees participants in the derivatives market¹⁹. The Commission was established as an independent Agency in 1974, taking over responsibilities that had previously belonged to the Ministry of Agriculture since the 1920s. Historically, the Commission was authorized by the CEA as the Supervisory authority for commodity futures markets. These markets have existed since the 1860s, starting with agricultural commodities such as wheat, corn, and cotton. Over time, these commodity futures markets, known as designated contract markets (DCM) regulated by the Commission, have expanded to include markets for energy commodities and metals such as crude oil, fuel oil, gasoline, copper, gold, and silver. The agency also currently controls DCM for financial products such as interest rates, stock indexes, and foreign currency.

After the 2008 financial crisis, which was largely caused by the unregulated swap market, President Obama and Congress strengthened the CFTC's regulatory authority. With the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the agency now also controls the swap market for more than 400 USD trillion, which is about twelve times the size of the futures market²⁰.

Today, the total volume of open positions (notional amount), according to various estimates, for OTC derivatives exceeds 700 USD Trillion. This is more than 10 times the global GDP²¹.

One of the most important problems of the global derivatives market is, of course, the opacity of the OTC derivatives market, which creates uncertainty, especially during periods of market instability. Parties using OTC derivatives to "insure" their risks cannot adequately assess the reliability of such a possibility if the counterparty's risks are unclear²².

¹⁸ R. E. Bailey, *The Economics of Financial Markets* (Cambridge University Press, 2005).

¹⁹ F. J. Fabozzi; F. Modigliani y F. J. Jones, *Foundations of Financial Markets and Institutions*. 4th Edition. Pearson Education. 2010.

²⁰ A. E. Degtyar, "Subekty gosudarstvennogo regulirovaniya operatsii s proizvodnymi finansovymi instrumentami (derivativami) v Rossiiskoi Federatsii, Ssha i Evropeiskom Soyuze", *Colloquium-journal* Vol: 6-11 num 30 (2019): 168-169.

²¹ I. V. Sokolova; D. A. Kaplun y M. M. Novikov, "Osobennosti razvitiya rossiiskogo rynka derivativov: problemy integratsii v mirovuyu finansovuyu sistemu", *Colloquium-journal* Vol: 13-10 num 37 (2019): 108-112.

²² C. M. Baker, "Regulating the Invisible: The Case of Over-the-Counter Derivatives", *Notre Dame Law Review*, Vol: 85 (2010): 1287.

Consequently, there may be a situation when a market participant who does not have information about the financial viability of a counterparty anticipates its risks based on a disproportionate assessment of the default risk of such a counterparty²³. The lack of transparency in the OTC derivatives market also makes it very difficult for regulators to obtain the necessary information to properly control the market since they do not have data on the size of the market as a whole and its individual segments.

Thus, the main trend in the global regulation of derivatives is to ensure transparency in the OTC derivatives market.

The course to tighten regulation of OTC derivatives trading was announced at the G20 summit in Pittsburgh in September 2009. In the context of the initiated reform, OTC derivatives meant assets traded on an unregulated market, i.e. outside not only exchanges but also other organized tender systems. The new European market control regime for these assets, which came into force on August 16, 2012, should increase its transparency and stability. It is enshrined in the relevant EU regulation No 648/2012 of July 4, 2012, on OTC derivatives, central counterparties, and transaction registration points, revised in 2014. This legal act is legally binding and does not require changes to the national legislation of European countries. The transition to the considered regulatory system is stretched over time.

Currently, the development of so-called technical standards that specify the main initiatives is continuing. In accordance with it, participants in operations are divided into financial and non-financial. The first category includes institutions that provide relevant services – credit institutions, insurers, investment funds, and so on. The second category includes organizations that are not engaged in professional derivatives trading. The concept of threshold values of operations with various types of derivatives is introduced. Most of the OTC transactions were carried out with the help of so-called Central Counterparties (CCP), which act as intermediary organizations²⁴.

Another important innovation is the transfer of detailed data on all transactions with all derivatives, including exchange-traded ones, to special data collection points. Their list is set by the relevant integration-level regulator, the European Securities and Market Authority (ESMA). This obligation was introduced on February 12, 2014. Its implementation is associated with an increase in the volume of work of the personnel of the affected structures since it is required to provide quite extensive information for each contract. Data about the counterparty of the transaction, details about the transaction, its collateral, and cost are highly sought. To improve the quality of information control, operations, assets, and parties to transactions are assigned special identification codes that are used when transmitting information to registration points. In total, filling in about 85 columns per transaction is required.

The transfer of information affected contracts valid as of August 16, 2012, as well as those concluded at that time or later. At the same time, market participants are also required to make payments that serve as a source of funding for the above-mentioned supervisory authority. Information about the conclusion or termination of the relevant contract, as well as the revision of its terms, must be transmitted no later than the next business day.

²³ L. A. Garslyan, "Obektivnaya neobkhodimost pravovogo regulirovaniya rynka vnebirzhevykh derivativov", *Pravo i ekonomika* Vol: 5 (2016): 8.

²⁴ L. A. Garslyan. *Obektivnaya neobkhodimost...*

This function can be delegated to third parties, which in no way means that they are responsible for the accuracy of information. This option is often used by small businesses. If the data is transmitted independently, organizations can choose a registration point. It is worth noting that the requirements of these instances differ. This option is preferred by large structures. OTC transactions that are performed directly between the parties require compliance with additional risk management rules. This issue is covered in detail in the so-called technical standards, which also have legal status. First of all, they relate to operational risk and counterparty default risk. It is also necessary to cover the relevant transactions with a large amount of equity and meet certain requirements for securing derivatives. Confirmation of the transaction from both parties is also required, if possible in electronic form. Thus, the control applies to all transactions with derivatives without exception. Financial organizations, as well as non-financial organizations, in case of exceeding the threshold values of operations with derivatives, are required to re-evaluate the relevant assets at market value daily (if it is impossible to implement it, the use of settlement prices is allowed), and then transmit the data to the information collection point. In addition, information on the provision of derivatives is required. Failure to comply with the above rules will result in penalties²⁵.

The second directive and regulation on financial instruments markets (Markets in Financial Instruments Directive II, MiFID II; Markets in Financial Instruments Regulation, MiFIR), which entered into force in July 2014, also have a significant impact on the derivatives market in the European Union. They require the concentration of trading in derivatives, transactions with which are subject to execution through Central Counterparties, on organized tender platforms²⁶. The next innovation is the recording of telephone conversations, facsimiles, and e-mail messages related to stock market transactions. Customers should be notified in advance. The said regulation also establishes new transparency rules for all trading systems related to disclosure of information before and after transactions. National regulators determine exceptions to this rule that are subject to approval by the ESMA. Interested parties should receive this information free of charge, except for a short period of only 15 minutes immediately after the transaction.

Non-financial organizations are exempt from the obligation to disclose information before trading on hedging operations of risks to be measured that are closely related to their business activity or the attraction of financial resources. Information transfer requirements are also introduced, similar to those established in the previously reviewed regime for regulating the market of DFI, which differ in much less detail. In some cases, they do not work and it remains only to fulfill the obligation to send data to registration points. Local regulators should be able to obtain some information about derivatives transactions within five years²⁷.

Conclusion

It is hardly possible today to seriously say that the legal framework governing the derivatives market is completely formed: numerous issues related to the activities related to the use of derivatives remained outside the scope of regulatory acts: protection of an unskilled consumer of services, protection against unfair actions of other legal entities, etc.

²⁵ V. V. Antyushina, Antikrizisnoe regulirovanie...

²⁶ S. R. Barth, Regulierung des Derivatehandels nach MiFID II und MiFIR (Institut fuer Wirtschaftsrecht der Martin-LutherUniversitaet Halle Wittenberg, 2015).

²⁷ V. V. Antyushina, Antikrizisnoe regulirovanie...

The resolution of these issues is on the agenda, amendments to legislative acts are being prepared, so this topic may be very promising for future research on the legal regulation of DFI. According to the research, many problems of regulating the financial derivatives market can be successfully solved by implementing a set of measures aimed at increasing and improving the regulatory framework, creating unified regulatory bodies, increasing the level of protection of participants by introducing stricter rules for monitoring and reporting, etc., which confirms the hypothesis of the study. It is likely that such measures, discussed above, can bring the functioning of derivatives markets to a completely different level. Such changes can help attract additional speculative and investment capital as a result of increased confidence in the reliability of financial derivatives, increase the effectiveness of legislative regulation and ultimately give an impetus to economic growth in both the financial system and the Russian economy as a whole.

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