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Financial and Legal Analysis of Derivatives

Abstract: This article delves into the derivatives market, focusing on its legal and financial dimensions. Derivatives, financial instruments whose values are tied to underlying assets like commodities and currencies, serve pivotal roles in risk management and speculative investment. The discourse outlines the dual utility of derivatives: firstly, as hedging tools that stabilize commodity prices for producers and consumers, thereby insulating them from market volatilities; secondly, as vehicles for speculators aiming to profit from price fluctuations. It categorizes derivatives into forwards, futures, options, and swaps, each with unique characteristics and applications in mitigating specific financial risks such as liquidity and default risks.

The paper also examines regulatory responses, particularly in the aftermath of the 2007-2009 financial crisis, highlighting significant legislative reforms like the Dodd-Frank Act in the U.S. and EMIR and MiFID II in the EU. These regulations aim to enhance market transparency and reduce systemic risks through stringent oversight.

In a comparative light, the document reviews Azerbaijan's regulatory framework, underscoring its alignment with global practices yet pointing out areas for improvement to avoid future crises. This concise overview encapsulates the essence of derivatives, emphasizing their economic significance, the inherent risks, and the critical need for effective regulation.

Keywords: derivatives; financial crisis; legislation of Azerbaijan; hedging; financial risks; interest rate; types of derivatives; over-the-counter; CFTC; Markets in Financial Instruments Directive.

Introduction

Trade of derivatives, as type of financial instruments, became a rapidly developed sector of the financial markets over the past quarter of a century. A derivative is a financial instrument whose value depends on, in the other words, derived from the value of some other financial instrument, called the underlying asset [1]. Stocks, bonds, hard or soft commodities (metals, petroleum, wheat and other mining and agricultural products), currencies, stock exchange indices and etc. For easier understanding, let's define notion, types and explanation of the functions of derivatives.

Types of derivatives: how these derivatives overcome a number of financial risks

Rationale behind derivatives is manage or reduce risk originated from fluctuations in the price movement which is inalienable part of modern economy. In this sense, two functions of using derivatives come to the fore. First is hedging purposes, which buyers and producers of commodities use derivative contracts for lock the price of commodities for a certain period of time in order to

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insure themselves from fluctuations in the market price, other words losing profit[5]. That is called hedging against risk which may be resulted in losing profit. So, what is hedging, let's define in a several words. Hedging is a financial tool that party of a financial contract offsets a long position by taking a short position and vice versa[4]. In other words, party who has taken long position through buying security, then takes a short position via selling this security under financial contract in order to hedging risks. Following example will explain the better understanding of derivatives in general context.

Imagine a wheat farmer who plants a crop is concerned about the price of wheat which may be fell before harvest. Therefore, farmer tends to sell the wheat under forward contract which is type of derivative, in time of planting with a predetermined price, so that can eliminate profit lost in time of harvest if the price has fallen. By doing this, the farmer moves from a long position to a short position. At this time, the buyer of the forward contract holding a long position under the forward contract undertakes to buy the wheat, and the farmer holding a short position undertakes to sell that wheat crop. At the time of harvest, three situations may happen. First, if the actual price of wheat is equal to price of contract, interests of buyer and seller coincides and no one exposure any price risks. In the second situation, actual price of wheat in time of harvest is less that contract price, so farmer gained profit through hedging risks through lock the price with forward contract. Last situation is generated when actual price of wheat exceed the contract price. In this time, farmer is obligated to sell wheat under contract price even so, he could gain more profit according to current price of wheat in time of harvest. Based on this example, it is worth to note that, hedging is not designed to make profit, rather main purpose is the reduce or eliminate the risks against fluctuations in the market prices [2].

Second purpose of derivatives is using them by speculators for gaining profit from volatile price in the market. Traders may use forward contracts to speculate on the future price movements of an asset, hoping to profit from predicting market movements accurately. In this case, derivatives allow additional opportunities for speculators to take on risk in the expectation that they will be able to outguess the market [3]. In this sense, we can say that the purpose of derivatives is to transfer risk from one person to another since risk can be sold and bought through such financial contracts [2].

Four types of derivatives are distinguished in financial markets. These are:

- a) Forward contracts;
- b) Futures contracts;
- c) Options;
- d) Swaps [6].

Forward contracts are fundamental financial instruments in the derivatives market, used by parties to buy or sell an asset at a predetermined future date for a price agreed upon today. These contracts are customizable and traded over-the-counter (OTC), directly between two parties, without the intermediation of exchanges [2].

Generally, hedgers take advantage of forward contracts in order to reduce expected volatility of a price of asset as in wheat harvest example given above. In addition to notion, some specific features of the forward contract should be mentioned for better understanding.

First of all, customization opportunities allow traders to include flexible terms according to circumstances as they want. So that, forward contracts are highly customizable, allowing the contracting parties to specify the terms, such as quantity, quality, and delivery details of the underlying asset, to suit their specific needs and requirements [4]. On the other hand, the underlying asset in a

forward contract can be virtually anything of value, including commodities, currencies, securities, and interest rates.

Other distinguished feature is related to over-the counter (OTC) market. OTC is the market in which financial instruments are traded through broker-dealer network instead of centralized exchanges like the New York Stock Exchange (NYSE) where dealers gathered in person to trade stocks, usually through a system of “open outcry” - shouting bids and offers or using hand signals to make agreements [11]. Unlike futures contracts (will be discussed detailed below) which are standardized and traded on exchanges, forward contracts lack standardization and are negotiated directly between parties [7; 8]. Since these contracts are private agreements, there is a risk that one party may default on their obligations, known as counterparty risk. This risk is higher in forward contracts compared to exchange-traded derivatives, which are typically cleared through a central clearinghouse that guarantees the trade.

Futures contracts, which are essentially the same as forward contracts but differ in their technical characteristics, are widely used by both institutional investors and retail investors. The main feature that distinguishes these two types of derivative financial instruments is the places where they are traded and standardized terms which are peculiar to futures [7; 9].

Futures contracts are much more affordable than forwards that they suffer from two main problems that seriously limit their practicality. First one is liquidity risk called as lack of liquidity and another is default risk [4]. Following example on interest rate forward and future contracts will provide better understanding about those risks, as well as, how futures cover and handle liquidity and default risks.

Interest-rate forward contract is a future sale of an interest-rate based debt instrument such as bonds and have several dimensions: (1) specification of the actual debt instrument that will be delivered at a future date, (2) amount of the debt instrument to be delivered, (3) price (interest rate) on the debt instrument when it is delivered, and (4) date on which delivery will take place [4]. An example of an interest-rate forward contract might be an agreement for the bank to sell to the retail company, one year from today, 1000 AZN face value of the 5s of 2028 bonds of Ministry of Finance (coupon bonds with a 5% coupon rate that mature in 2028) at a price that yields the same interest rate on these bonds as today's, say, 6%. Because retail company will buy the securities at a future date, it has taken a long position, while the bank, which will sell the securities, has taken a short position.

Why would the bank want to enter into such a contract with the company? Because these bonds bought by the bank are medium-term bonds, it is worried about the value of the bonds falling in the future if the interest rate rises. Therefore, the best way to get rid of said risk is to contract to sell these bonds at a future date at the current face value price. In this case, bank get to agreement with the retail company to sell 1000 AZN face value of the 5s of 2028 bonds of Ministry of Finance at par one year from today. By entering into this forward contract, bank has locked in the future price and so have eliminated the price risk the bank faces from interest-rate changes. In other words, bank has successfully hedged against interest-rate risk.

Why would the retail company want to enter into such a contract with the bank? Thus, the retail company intends to invest for the next year in order to obtain premiums from the bonds, but it is wary of the increase in the value of the bonds due to the decrease in the interest rate in the period between now and next year. By using the forward contract, company is able to lock in the 5% interest rate on the MF bonds which will be sold to it by the bank.

The advantage of forward contracts is that they can be as flexible as the parties involved want them to be. This means that parties may be able to hedge completely the interest-rate risk for the exact security it is holding in its portfolio, just as it has in our example.

As we said at the beginning, forwards suffer two main pitfalls: lack of liquidity and default risk. It is hard to find out most appropriate counterparty, since contract itself comprised of specific terms which are customized according to will of the seller [2]. Another reason is that unlike futures contracts, forward contracts typically do not have a secondary market, making them less liquid. Parties generally cannot easily exit their obligations without the consent of the other party, unless they negotiate a cancellation or offsetting contract. Therefore, in the parlance of financial world, forward market suffers from lack of liquidity.

The second problem with forward contracts is that they are subject to default risk [2; 4]. Suppose that in one year's time, interest rates rise so that the price of the 5s of 2028 falls. Retail company might then decide that it would like to default on the forward contract with the bank because it can now buy the bonds at a price lower than the agreed price in the forward contract. Or perhaps company will go bankrupt during the year and therefore no longer exist to meet the terms of the forward contract. Since there is no outside organization guaranteeing the contract, the only recourse is for the bank to go to the courts to sue company, but this process will be costly. Furthermore, if retail company is already insolvent, the bank will suffer a loss; the bank can no longer sell the bonds at the price it had agreed with retail company, but instead will have to sell them at a much lower price because the price of these bonds has fallen. The presence of default risk in forward contracts means that the parties to the forward contract must ensure that each other is financially stable and will fulfill their contractual obligations.

A number of features of futures contracts are designed to overcome the liquidity problem inherent in forward contracts. The first feature is that, unlike forward contracts, the delivered quantities and delivery dates of futures contracts are standardized, which increases the possibility of matching the various parties in the futures market, thereby increasing market liquidity. The second feature is that a futures contract can be traded (bought or sold) at any time after it is bought or sold, until the delivery date. In contrast, a forward contract cannot normally be traded once agreed.

In order to deal with the default risk problem, trading in the futures market is organized somewhat differently from the forward market. Thus, in both types of contracts, the buyer who takes a long position and the seller who takes a short position must participate. However, the parties to the futures contract do not make a contract with each other but with the clearing house or clearing corporation separately [2]. The clearing corporation, which operates like a large insurance company, is the counterparty to both sides of a transaction, guaranteeing that they will meet their obligations. In this case, buyer of the futures contract does not need to worry about the financial health or reliability of the seller, or vice versa, as in the forward market. As long as the clearing house is financially sound, buyers and sellers of futures contracts do not have to worry about the risk of default. Only requirement is to deposit in the minimum amount which is called as margin requirement and demanded by clearing house to assure that none of parties will prejudice contract and will provide financial stability of clearing house [4].

Another instrument for hedging interest-rate, foreign exchange, and stock market risk involves the use of options on underlying assets. The parties to the option are the option writer, who acts as the seller, and the option holder, who acts as the buyer, on the other hand. An option is similar to futures and forward contracts, but unlike the above, an option is an obligation for only one

party. The holder of the option can exercise the option only if it is profitable. Options are contracts that give the purchaser the option, or right, to buy or sell the underlying asset at a specified price, called the exercise price or strike price, within a specific period of time (the term to expiration) [10]. Obligation of the seller is to buy or sell the underlying asset to the buyer, if the buyer who is the option holder afterwards, realize his right to sell or buy. The option holder has no obligation to exercise the option and may even let to expire the option without using it. In contrast, the seller has no choice but to buy or sell the option if it is exercised by the option holder. There are two types of option: call and put options [2].

Call option grants to the option holder the right to buy a underlying asset (stock) from the option writer at a prearranged price within a contract period. For example, any investor buys a call option on shares at a strike price of 100 AZN from any company. If the price shares of company will rise from strike price, option holder will buy it and gain profit. Suppose that, at the end of the contract, price of shares goes up and now price of shares is 130 AZN. In this case, option writer must sell the shares at a strike price, if option holder uses his right to buy. Thus, by buying a share worth 130 AZN at a strike price of 100 AZN, the option holder gets a profit of AZN 30, just as he can sell shares in the open market at the current price.

Put option, conversely, grants to the option holder the right to sell a underlying asset (stock) to the option writer at a prearranged price within a contract period [3; 4]. Let's go back to our example above. Now, investor buys a put option on shares at a strike price of 100 AZN from company. If the value of shares will falls below strike price, option holder will sell them in order to get benefit. For instance, price of shares falls and price of shares is 80 AZN at the end of the contract. Option holder will sell shares at a strike price of 100 AZN and will gain 20 AZN profit.

Through the examples shown, we can see how options stack up against the stock risk that investors may face while trading operations.

Swaps are private agreements between parties to exchange cash flows or other financial instruments [6]. Interest rate swaps and currency swaps are common, used mainly for hedging [7]. Currency swaps are about exchange of set of payments in one currency with exchange of set of payments in another. For example, commercial bank in Azerbaijan enters into a contract to buy USD at a today's rate, let's say at rate of 1.70 in the exchange of AZN with any commercial bank in USA for next year. By doing so, the local bank protects itself from currency risk that may occur within a year. Interest-rate swaps involve the exchange of one set of interest payments for another set of interest payments, all denominated in the same currency. For instance, one party concurs to pay fixed interest rate, and in exchange the counterparty agrees to pay fixed interest rate. In this case, the parties protect themselves against financial loss in the event of interest rate fluctuations by equating their fixed-rate income with their variable-rate liabilities, or vice versa.

Legal regulation of derivatives within the framework of comparison of foreign and national legislation

Financial market risks proves that participants of derivative market is vulnerable in case of absence of comprehensive and well-designed regulatory mechanisms [13]. Therefore, the derivatives market should be regulated at the national or regional level, like the securities market, and institutions should be organized to carry out this regulation. The conducted observations suggest that since derivatives trading is more widespread in the United States and Europe, the relevant mechanisms for their regulation have also been implemented in these regions. Of course, it is an undeniable fact that the financial crisis of 2007-2009 also led to large-scale reforms in the regulation of se-

curities and derivatives markets [17]. Application of Dodd-Frank Wall Street Reform and Consumer Protection Act in USA and The European Market Infrastructure Regulation (EMIR) and The Markets in Financial Instruments Directive II (MiFID II) in EU can be examples for such mechanisms. Also, the “unregulated” or “less regulated” over-the counter (OTC) derivative market, which was left out of centralized public control, was the main reason for the emergence of financial-legal regulations [15].

In USA, the main legal authorities for derivatives regulation are the Commodity Exchange Act (the CEAct) and the regulations of the Commodity Futures Trading Commission (the CFTC) [12]. There is no meaningful regulation of the derivatives markets at the state or local levels, and the CFTC, with certain exceptions, acts as the sole and exclusive regulator of that activity at the federal level.

On the other hand, the Dodd Frank Act was introduced as a response to the financial crisis and to prevent such a crisis from happening again [14]. So that, soft regulations up to crisis, led to extremely risky lending practices, which caused a housing sector bubble that ultimately burst and drove the global crisis, the need for public bailouts of financial institutions, and the recession. Through passing this act, it is established a number of new government agencies whose main tasks are supervising the various components of the law within the financial system. Financial Stability Oversight Council and the Orderly Liquidation Authority were created in order to monitor the financial stability of major financial firms for ensuring financial stability within entire country in national and federal level. Also, the Consumer Financial Protection Bureau (CFPB) was established to prevent predacious mortgage lending practices and assisting to customers to understand the terms of contract before arrangement which were inalienable reasons for 2008-2009 financial crisis [14].

One of the regulatory mechanisms in EU is EMIR which came into force on 16 August 2012 and “introduced requirements aimed at improving the transparency of Over-The-Counter (OTC) derivatives markets and to reduce the risks associated with those markets. In order to achieve this, EMIR requires that OTC derivatives meeting certain requirements are subject to the clearing obligation and for all OTC derivatives that are not centrally cleared that risk mitigation techniques apply. In addition, all derivatives transactions need to be reported to trade repositories (TRs). Finally, EMIR establishes organisational conduct of business and prudential standards for both trade repositories (TRs) and central counterparties (CCPs). In order to achieve its goals, the EMIR is introducing a number of key obligations for counterparties in the derivatives markets [18]”. As a result we can say that, the objective of the European Market Infrastructure Regulation (“EMIR”) framework is to reduce financial infrastructure systemic risk’s.

The Markets in Financial Instruments Directive as another regulatory mechanism of EU, was drafted in 2004 and came into force after 2007 within whole EU territory. But because MiFID was limited to equities and did not regulate derivatives, was replaced by MiFID II in 2018 which is extended the requirements to issuers of all types of securities, including debt securities, derivatives and structured instruments [16].

There are relevant legislative acts regulating the trading of derivatives in the financial market of Azerbaijan. The main normative legal acts in this field include the Civil Code and the Law “On Securities Market” of Republic of Azerbaijan. Article 403-1 of the Civil Code is about derivatives and defines their types, definition, general norms of placement and circulation. As can be seen from the article, only futures, options and swaps are related to derivatives in the Republic of Azerbaijan, and it is determined that their trading should be carried out on the stock exchange [19].

Furthermore, Law “On Securities Market” determines principles and procedures for issue, state registration, public offering of investment securities; depository and post trading systems; circulation of securities and derivative instruments; organization, management and liquidation of persons holding licenses in the securities market and the central depository; legal and economic grounds for relations related to protection of investors’ rights and as well as regulation and supervision in the securities market [20]. This law also regulates the duties and general rules of activities of investment companies that carry out transactions with derivatives, the stock exchange that organizes public trading of derivatives, clearing organizations that carry out settlements, as well as issues related to the prevention of abuses in the derivatives market. It should also be noted that the “Regulation on placement and circulation of derivative financial instruments” adopted by the decision of the State Committee on Securities of the Republic of Azerbaijan regulates technical issues such as placement and circulation of derivative financial instruments through the stock exchange in a standardized form [21].

Conclusion

In conclusion, as a result of the comparative analysis of local and foreign legislation, it can be concluded that the purchase and sale of derivatives is not allowed over-the-counter like in other countries. Perhaps it is for this reason that the regulation of forward contracts, and hence their attribution to derivatives, has not been determined by legislation. Otherwise, derivatives, which are still new concepts in terms of modest financial instruments for our country, would be left out of such lax regulation and centralized state control, putting other market participants in a difficult situation, and worst of all, it could lead to a repetition of the 2007-2009 crisis in the United States.

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Финансово-правовой анализ деривативов

Аннотация: Рассматривается рынок деривативов, его правовые и финансовые аспекты. Деривативы — это финансовые инструменты, стоимость которых зависит от базовых активов, таких как товары и валюты. Они выполняют ключевые функции в управлении рисками и спекулятивных инвестициях. Описываются две основные функции деривативов: во-первых,

♦ Алиев Шамси Гасым оглы — магистрант по специальности административное право, административный процесс, экономическое и финансовое право юридического факультета, Бакинский государственный университет, корпоративный юрист в ОАО "Коммерческий Банк Унибанк". E-mail: aliyevshamsi2000@gmail.com

как инструментов хеджирования, стабилизирующих цены на товары для производителей и потребителей и защищающих их от рыночных волатильностей; во-вторых, как средств для спекулянтов, стремящихся извлечь прибыль из колебаний цен. Анализ классифицирует деривативы на форварды, фьючерсы, опционы и свопы, каждый из которых имеет уникальные характеристики и применение для смягчения конкретных финансовых рисков, таких как риски ликвидности и невыполнения обязательств.

Кроме того, рассматривается реакция регуляторов, особенно после финансового кризиса 2007-2009 годов, выделяя значительные законодательные реформы, такие как Закон Додда-Франка в США и EMIR и MiFID II в ЕС. Эти регуляции направлены на увеличение прозрачности рынка и снижение системных рисков через строгое надзорное регулирование.

В сравнительном контексте рассматривается регулятивная рамка Азербайджана, подчеркивается ее соответствие мировым практикам, но также указывая на области для улучшения, чтобы избежать будущих кризисов. Этот краткий обзор захватывает суть деривативов, подчеркивая их экономическое значение, связанные с ними риски и критическую необходимость эффективного регулирования.

Ключевые слова: деривативы; финансовый кризис; законодательство Азербайджана; хеджирование; финансовые риски; процентная ставка; виды деривативов; внебиржевой рынок; CFTC; Директива о рынках финансовых инструментов.

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