

An Approach to Regulation on Financial Derivatives in the Spanish Law

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ABSTRACT

This review examines the major reforms implemented in the regulations governing the trading of financial derivatives in Spain. This new regulation is intended to harmonize the treatment of derivative products with the legal standards of international markets in the European area as well as improving their competitiveness by enhancing the trading of new products and business lines in the Spanish markets while reducing the systemic risk associated to the clearing and settlement of derivatives contracts. Including measures regarding the conversion of OTC derivatives into assets quoted on organized markets into Spanish law has made an important contribution to a better regulation, security and transparency of the financial system.

Keywords: derivative products, options and futures, financial markets

1. Introduction

We have been able to see over the last two decades an extraordinary development of the financial sector, partly due to deregulation and privatization which contributed to an increase of the offer seeking market niches in which highly speculative financial products and activities were developed. Among them are financial derivatives, and the outcome has been a fast evolving and deep changing innovation process. A process in which law and regulation have at any time gone one step behind the financial economy.

Spain has made a considerable effort to catch up with the most advanced economies. Financial institutions—banks, saving banks and other financial intermediaries— worked to offer the best products and to create markets which turned the financial system more efficient. Suffice to mention, among others, the emergence of markets in futures and options as a cornerstone of the new development of the Spanish financial market. However, the onset of the financial crisis in 2007-2008 underscored the fact that the financial economy, especially the derivative products, had become so complex and sophisticated that it made it absolutely essential a new and more precise regulation which gave more security and reliability against the systemic risks created. Regarding derivative products, issues such as the share of the price to be paid in cash, the daily settlement procedure, trading practices, fees, the spread between the bid and ask, the role of the clearing houses for derivatives, among others were deeply reviewed in order to identify their shortcomings. Moreover, the reform momentum resulting from the crisis in the financial markets focused on this kind of products, traditionally deregulated and with the potential to create systemic risks of material consequences.

2. Background and rationale

Before approaching some of the changes undertaken by the new Spanish regulations, it is necessary to explain the economic rationale of financial derivatives markets¹. Options², futures³, CDS⁴ etc. are hedging instruments to

¹ Please refer to the Works of Kolb, R.W. (1991). *Understanding futures market*. New York: Institute of Finance, and, more recently, Hull, J.C. (2008) *Options, Futures and Other Derivatives* (Seventh Edition). Prentice Hall International, for a deeper understanding of the basics of financial derivatives.

² Standard contract allowing the buyer to obtain the right, but not the obligation, to buy (CALL) or sell (PUT) the underlying security at a given agreed price (the strike price) on a future date (settlement date). This contract can only be exercised either on the expiration date (European Option) or at any time before the expiration date (American Option) according to the general terms and conditions of each contract.

[<http://www.meff.es/asp/Comun/Pagina.aspx?l1=Normativa&f=NorGlosario&id=ing>]

cover financial risks, hedging being the technique intended to reduce the market risk associated with a given portfolio, that is to say, the eventual loss before adverse market fluctuations in underlying assets prices⁵.

Financial derivatives are not issued nor subscribed —they are not proper securities but real contracts—, therefore it is not possible to difference between primary and secondary trading markets. Derivatives are entered into or agreed under terms and conditions fully and previously established by the governing body which defines or designs them and, given that they are not transferable, the liquidation of the relevant positions (buyer-seller) takes place through the conclusion of a new contract/ agreement inverse to the previously entered into. The outcome of using these instruments is the passing of that part of the risk which the agent does not want to take or cannot take. The party to the contract bears the interest, market or solvency risks of certain transactions, and receives in exchange certain profitability without having to invest the corresponding amounts for which the said risks are taken, but usually a minimum amount. Given that derivatives literally relate to the activities of other financial markets, they provide facilities to manage the risks they raise, hence they are traded separately from the underlying asset from which they derive⁶.

The OTC derivatives market (“Over the Counter”, or non-regulated market) is currently the market raising major concerns because its size is considerably bigger than that of the financial derivatives traded on regulated markets⁷. The value of the volume of the OTC worldwide market is (despite the difficulties involved in its assessment), according to data from the Bank for International Settlements (BIS) of USD 638 trillion near 10 times the world GDP and a 9% less than the previous year. On the other hand, the volume of contracts traded on stocks and stock exchanges and derivatives organized markets worldwide amounted to USD 60 trillion less than 10% of the total value of the derivatives existing in the world then⁸.

Despite the fact that the OTC market has been traditionally a non-regulated market without central clearing houses which guarantee non-compliance with the terms and conditions of contracts by one party, it has attracted a number of large financial and industrial corporations which used it on a regular basis to hedge the financial risks associated with their transactions. But beyond the serious problems caused to larger financial institutions, the most far-reaching concern of international authorities has been the damaging potential that OTC markets may have on the global financial system, the evidence of which has been the situation, close to the bankruptcy, of Bear Stearns and AIG, companies which were not able to meet the derivatives they sold on OTC markets.

Face to the systemic risks of OTC markets in the European Union, the Member States legislatures, according to the proposals of G20 and the Financial Stability Forum, undertook a process of revision of the financial rules on derivatives. In Spain, the result of this momentum of reform was articulated in the Royal Decree 1282/2010 of October 15, regulating Secondary Markets for Futures, Options and other Financial Instruments, and which is currently in force (hereinafter, “Royal Decree 1282/2010”)⁹. This law contains measures regarding the conversion of those OTC derivatives into assets traded on organized markets.

³ A standard forward contract obligating the buyer to purchase the underlying security and the seller to sell it at an agreed future price (price of the future) on a future date (settlement date). Until that date or until the contract is closed, daily settlements of gains and losses are made.

[<http://www.meff.es/aspx/Comun/Pagina.aspx?l1=Normativa&f=NorGlosario&id=ing>]

⁴ English acronym for *Credit Default Swaps*: Hedging instruments as a way of protection against default which have always stood above other derivatives in OTC markets. In recent years, CDS have been criticised by international authorities because of their central role in the global financial crisis and for having multiplied the impact of the Greek crisis. Banking institutions have traditionally used CDS, but as CDS were beginning to develop during 2003, they became more and more popular for those investors desiring to cover the eventual losses in their portfolios. Today CDS amount to a volume of USD 25 trillion according to International Swaps and Derivatives Association.

⁵ The asset for which an option, future or other financial instrument exists. For example, in a stock on an option the holder can buy or sell the said stock under certain conditions, being the stock the underlying asset on which the option is defined. Underlying assets are: government bonds (fixed income), indexes, Spanish stocks, European stocks (equity funds), commodities, currencies, and interest rates.

⁶ De Contreras y Vilches (2006), page 41.

⁷ Please see: Hudson, A. (1996). *The Law on Financial Derivatives*. London: Sweet & Maxwell (Part. 2, 3 y 6) for more details on markets, products and legal issues on OTC derivatives.

⁸ http://www.bis.org/publ/otc_hy1211.pdf

<http://www.bolsasymercados.es/esp/publicacion/infmercado/2012/InformedeMercado2012Pre.pdf>

⁹ <http://www.boe.es/boe/dias/2010/10/16/pdfs/BOE-A-2010-15785.pdf>

3. Spanish Regulatory Framework

In Spain, the trading of equity derivative financial instruments has seen a dramatic increase. Several decades of economic upswing have made that Spanish derivatives markets are fully developed and with a state of the art technology that has allowed competing with major financial derivative markets in Europe, especially after great concentrations around Euronext and Eurex¹⁰ took place, all that in a country in which it did not exist a tradition of trading this kind of products and where the supervisory authorities were always especially concerned about controlling markets seen as potentially dangerous to investors.

That development both in terms of volume as of sophistication on top of the experience of the investors operating in the derivative financial products markets revealed the need of an overall revision of the regulation governing the said markets. The MEFF¹¹ (the major derivatives market in Spain) used this reform to draft a new regulation, in force since 2011 and which benefits from the experience of over 20 years of operation.

MEFF [*Spanish for Mercado Español de Futuros Financieros* (Spanish Financial Futures Market)], included within the holding *Bolsas y Mercados Españoles* [Spanish Stock Exchanges and Markets] (BME), is the trader for Spanish securities markets. It is the official secondary market since 1992; therefore it is regulated, controlled and monitored by the Spanish economic authorities (*Comisión Nacional del Mercado de Valores* and Ministry of Economy and Finance). MEFF main activities are trading, clearing and settlement of stock-index (IBEX 35) futures and stocks. During 2012 the volume of contracts was similar to the previous fiscal year amounting to a total of 67.1 million contracts traded¹².

The basic legal content under which derivative products in Spain are regulated can be found in Article 59 of the *Ley 24/1988, de 28 de julio, del Mercado de Valores* (Law 24/1988, of July 28, [Securities Market Law] (hereinafter, LMV)¹³ as amended by Law 47/2007 of December 19¹⁴. As for the implementing regulation, it is worth mentioning the said Royal Decree 1282/2010, the entry into force of which is part of the reform tendency of the of the financial system repealing Royal Decree 1814/1991, of December 20.

4. Main Legal Developments

Royal Decree 1282/2010 contains a regulation significantly different from the repealed law in several issues.

Extension of products that can be traded and registered

One of the most noteworthy changes in the new legal framework of derivatives markets is having extended the list of products that can be traded and registered on the derivatives markets. Now, those products are not limited only to futures or options, but comprise as well all derivative financial instruments included in Article 2 of LMV (as amended for the accurate transposition of the Markets in Financial Instruments Directive (the Mifid Directive))¹⁵. It falls to the *Comisión Nacional del Mercado de Valores* [National Securities Market Commission, the Spanish agency in charge of supervising and inspecting the Spanish Stock Markets] (hereinafter, "CNMV"), at request of the governing company, to approve the general conditions of the contracts subject to trade, registry, clearing and settlement and counterparty as well as the amendments thereof.

Clearinghouse and central counterparty (CCP)

The new legal framework provides for the possibility for the market governing company to offer trading, registry and central counterparty services, or registry and central counterparty services, or only trading services. The

¹⁰ For further details on the organization and operation of derivatives markets in Spain from an economic point of view, see: Fernández, M.A. (1996). *Gestión de riesgos con activos derivados*. Castellón de la Plana: Universidad Jaume I, Fernández, P. (1996). *Opciones, Futuros e instrumentos derivados*. Bilbao: Ediciones Deusto, y HERAS, J. (2001). *Diccionario de mercados financieros*. Barcelona: Gestión 2000.

¹¹ <http://www.meff.es/>

¹² <http://www.bolsasymercados.es/esp/publicacion/infmercado/2012/InformedeMercado2012Pre.pdf>

¹³ See Kirchner, P. / Salinas, C. (1999), *La reforma de la ley del mercado de valores*, Valencia: Tirant Lo Blanch for a detailed review of LMV.

¹⁴ See: <http://www.boe.es/buscar/act.php?id=BOE-A-1988-18764>

¹⁵ http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm

purpose of the clearinghouse role is to act as central counterparty (Article 10 of Royal Decree 1282/2010)¹⁶, which means that the governing company shall provide, or guarantee to provide through another institution, and prior approval of the CNMV, central counterparty for all the contracts, interposing between the parties to guarantee the enforcement of certain obligations, acting as purchaser before the seller and as seller before the purchaser. Therefore, it guarantees the counterpart the success of those transactions in which it is taking part. By taking the risk of default either from the purchaser or from the seller, the maximum risk taken by the clearinghouse shall be the accumulated loss during the trading session. In order to cover this risk, collateral is required for open position and it is mandatory to deposit this amount in order to take any position.

The equity required to the governing company shall not be less than EUR 18 million, or the sum of the collateral provided. However, the Minister of Economy is entitled either by itself or authorising the CNMV for that purpose to set a lower minimum amount considering the features of the relevant market. There are not major amendments as regards the role of the governing company, neither with respect to supervision or management roles, nor with the economic regime, compared to the provisions of the repealed law.

With regard to the governing company providing central counterparty services, Royal Decree 1282/2010 implements the possibility of that governing company providing counterparty services for contracts not traded on the relevant market, either because those contracts have been directly traded between the members of the market themselves, or between the members of the market and their clients, or between the clients. The said Royal Decree allows also that the governing company may provide counterparty services for contracts traded on markets or trading systems not managed by the said governing company provided that it had entered into the relevant agreements in order to undertake these role, or that the said markets or trading systems are managed by the governing company itself under the rules contained in the Rule Book¹⁷.

Collaterals Scheme

The collaterals (as provided for in Articles 23-27) required to perform the role of counterparty are of particular importance. Royal Decree 1282/2010 diversifies the scheme, adding both the collateral provided by the market itself and the collective collateral. The basic idea to draw from this new collaterals scheme is that there is a duty to create and keep the collateral. The collateral shall be provided for in favour of the governing company by the members and the clients, although the Rule Book may establish a collective collateral scheme which shall be compulsory for all the members or, eventually, for any category of members according to the stipulations thereof. Additionally, the Rule Book may set a scheme of collateral to be deposited by the governing company. The amount of the collateral shall be calculated on a daily basis and shall be updated from time to time as provided for in the Rule Book.

In particular, the collateral scheme of MEFF operates from the collateral provided in cash or in financial assets which the participants must deposit when a position is opened. A clearing and settlement of gains and losses takes place daily at MEFF. Through this process, the clearinghouse debits/credits the participants in the market the daily gains and losses at the end of each trading session. Thus, all the positions are valued at a market price.

Members of the Market

It is also worth mentioning another point in the new regulations (Article 21 Royal Decree 1282/2010): the members of the market, which are those institutions that are entitled to negotiate derivatives contracts on the market and to apply for the registration of contracts for counterparty purposes according to market provisions.

¹⁶ "The clearing house is the cornerstone of market operation not only because it clears and settles all the contracts entered into guaranteeing the compliance thereof and avoiding the risk of insolvency of the parties (since the clearing house is the counterparty for any party), but also because its permanent interference in the trading through the setting of collaterals reduces dramatically the risk of illiquidity, thus providing the market with efficiency, liquidity and legal certainty". De Contreras y Vilches, A (2006) p. 115.

¹⁷ Royal Decree 1282/2010 provides for the necessary requirements so as to create in Spain official futures and options markets. Therefore, it acknowledges the potential existence of several markets (Article 2). This point can be seen as a change brought in by the new law, since MEFF has no longer the statutory official monopoly existing under the previous law, so that other official futures and options markets can be created. Besides MEFF, it also exists the "Mercado de Futuros de Aceite de Oliva" [Olive Oil Futures Market] (MFAO) where Olive Oil futures contracts are traded. It is the only market in the world where this commodity is traded (<http://www.mfao.es>).

Only those institutions mentioned in Article 59.3 LMV (which refers to Article 37 thereof; among others, Spanish credit institutions, investment firms (*empresas de servicios de inversión* —“ESI”—, Central State Administration) are eligible to acquire the status of members of the market. This status is granted by the governing company prior application lodged by the incumbent according to the requirements as provided for in the Rule Book. The application shall only be refused or the member status withdrawn due to non-compliance with the requirements provided for in the Rule Book.

There have been also some legal changes regarding the regulatory regime of the members of the markets. Now, members of the markets can be basically trading members and registry members for counterparty purposes and they rank depending on if they act on their own behalf or in the name of a third person, or both, or if they take part or not in the settlement, although it is allowed that the Rule Book set other categories, and there are specific rules for those who desire to gain member status with functions limited to trading and registry application for counterparty purposes only with respect to futures and options and others financial instruments with non-financial underlying.

Contracts

The wording of the terms and conditions for derivatives contracts shall be clear and accurate and it shall include a minimum content as provided for in Article 11.2 of Royal Decree 1282/2010. The CNMV reserves the right to suspend the trading or the registry of certain contracts where special circumstances capable of disturb the normal course of transactions in the market or it is advisable to protect the investors (Article 12). It fall to the governing company to exclude contracts on grounds of insufficient financial liquidity or the overall interest of the market, which in any case may lead to remove the obligations and rights of any contracts not cleared at the relevant moment (Article 13).

Trade Repositories

Trade Repositories are regulated in detail by Royal Decree 1282/2010. This is no doubt due to the influence of the goals of supervisory authorities all over the world, which come from G-20 proposals. These proposals have already been taken into account is laws as the Dodd-Frank Act in the United States of America¹⁸ in order to gain control over the trading of OTC derivatives either through public registers or at least able to be checked by supervisors. Governing companies of derivatives markets are now entitled to undertake registry activities for contracts traded through the market, but also for contracts traded through other exchange systems, either on secondary markets or other multilateral trading systems as well as for contracts traded bilaterally between members, between members and clients or between clients, or bilaterally and over the counter.

On this regard it is worth noticing that the new legal framework distinguishes between central register and detail register. Although it can exist a single register run by the governing company, it is allowed that in the Rule Book that register is split so that it exists a central register run by the governing company and which is supplemented by the detail registers corresponding to the contracts of the clients of the members of the market that they run separately, although the Rule Book must contain provisions guaranteeing the total correspondence between the market reality and the registry of the relative contracts, and between the central register and the sum of the detail registers. Additionally, it should be stressed that Royal Decree 1282/2010 provides for the type of accounts to include in the register, distinguishing between the accounts of the members, which have to be registered in the central register on behalf of the member and where all the positions of the holder member in the market have to be entered, and the accounts of the clients, which may be entered either in the central register, although always through a member, or in the detail register kept by the authorized member. Plus, there is a difference, within the accounts kept in the detail register, between those which are kept for calculation and providing of collaterals purposes, separation among the positions of the clients and those of the member and those in which, despite a separated system of bookkeeping is kept to identify who is the holder of each contract and of each position, there is not separation for calculation and providing of collaterals purposes, although the possibility of being the holder of any of these accounts is limited for the institutions having the status of eligible counterparties although, according to the wording of the LMV. There can be accounts of the clients in the central register in which, for calculation and providing of collaterals purposes, it exists a separation between the positions of the clients and those of the member and those in which that separation does not exist.

¹⁸ <http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>

Moreover, it is required an equity amounting to EUR 18 million, or alternative requirements guaranteeing an equivalent solvency level to be set as provided for in the Rule Book, for a member to keep the detail registers or accounts. The minimum equity required amounts to EUR 500 million in case that the detail registers for contracts of clients accounts in which it does not exist separation, for calculation of collaterals purposes, between own positions and member positions. The fact that these accounts are kept in detail shall not release the members from the obligation to provide the information that the CNMV, the market governing company or any other supervising authority.

System of Sanctions for Infringements

Last, it is worth mentioning the system of sanctions for infringements (Articles 28-32 of Royal Decree 1282/2010). The Rule Book lays down the applicable system in case of infringement of the obligations of members and clients and establishes the grounds of infringement, the measures to be taken for the events of infringement as well as the procedures to follow for the adoption of the said measures and the relevant actions to undertake by the governing company or by the members of the market. The appropriate measures in case of noncompliance may be: (1) temporal suspension of the member or client. (2) closure or removal of registered contracts (3) the enforcement of the collaterals and, last, (4) the loss of the member or client status.

5. Conclusion

The events on the OTC markets over the last few years have ended proving the regulated markets right. The regulated markets have continued to bring transparency, liquidity and security to a volatile financial system all along the financial crisis. In this respect, the Spanish reform of the derivatives market, which came into force in 2010, may be considered a necessary and positive step which meets the expectations of G-20 commitments in 2009 in order to reform the world financial architecture through measures channelling the trading of these products from bilateral trading on OTC markets towards electronic platforms on organized markets as a way for a growing standardization thereof.

As it has been examined in this review, Spanish regulation provides for two major measures implemented on derivatives: clearing of derivatives through central counterparties and inclusion of OTC transactions difficult to be standardized. The purpose of reforms is to mitigate the systemic risk by improving risk management reducing the interconnection of positions and improving transparency. In the same vein, these reforms had already been passed in the United States (through the Dodd-Frank Act) and are beginning to be implemented. Nevertheless, the obligation to use central counterparties is proving to be the most difficult issue since not all OTC derivatives transactions are standardized enough as to be cleared and, however, have to potential to present systemic risk. Both Basel Committee and IOSCO have proposed to make the margin and collateral deposit also compulsory for this type of derivatives not cleared through central counterparties¹⁹.

To conclude, the new regulation of derivatives in Spain has meant a major step forward to harmonize with the legal standards of international markets, improving competitiveness by enhancing the introduction of new products, services and business lines into derivatives markets, at the same time that it has succeeded in reducing the systemic risk associated to the clearing and settlement of derivatives contracts.

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¹⁹ <http://www.bolsasymercados.es/esp/publicacion/infmercado/2012/InformedeMercado2012Pre.pdf>

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