

# FINANCIAL MARKET INSTRUMENTS

IN CASE STUDIES

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# Foreword

Financial market is the core of the economy. It has a profound impact on many of its sectors and allows it to function. It is due to various instruments which are created to fulfill the needs of its participants. They are more and more complex and thus better and better tailored to their users' necessities. The book presents some of these products, especially those which are not well developed on the Polish market that is mortgage instruments, foreign exchange forwards, options, credit derivatives and structured products. The aim of it was to show the difference between the Polish and other markets. It was reached by giving these products characteristics and present state of development in the world markets as well as in Poland.

The book consists of six chapters. Each of them is devoted to one instrument, describes its most important features and usage, as well as shows how popular it is in well developed markets and in Poland.

**The first** chapter written by dr. Justyna Maliszewska-Nienartowicz from the Nicolaus Copernicus University in Toruń, shows the most important law standards for the financial market. It is a base for other chapters.

**The second** chapter by dr. Anna Szelągowska from the Technical University of Radom, is devoted to mortgage financial instruments. The author proves that these instruments develop rapidly thanks to the dynamic mortgage growth for the last ten years. Although it is emphasised that Poland has still many to be done to reach EU15 Members' levels, the author is optimistic about the future of the Polish mortgage market and its financial instruments.

**The third** chapter prepared by dr. Iwona Piekunko-Mantiuk from Białystok Technical University, provides a thorough look at forward OTC contracts. The author stresses their increasing role in the global financial market and shows that these instruments are much diversified between developed and developing markets.

**The fourth** chapter was written by dr. Izabela Pruchnicka-Grabias from the Warsaw School of Economics. The author begins with a short discussion of options' risk factors and motivates the chapter with a presentation of their listings on important world exchanges, as well as depicts their OTC volume. It is compared to the Polish financial market. The final conclusion is that the number of traded options grows year by year and therefore these contracts have perfect chances for further development both in Poland and abroad.

**The fifth** chapter was prepared by dr. Paweł Niedziółka from the Warsaw School of Economics. It focuses on credit derivatives which are instruments designed to transfer credit risk. The author presents two local markets of these instruments (the Polish one and the American one) and finds reasons for large differences in their development stages.

**The sixth** chapter provided by dr. Krzysztof Borowski from the Warsaw School of Economics, is devoted to structured products. It gives a view to the most important of them, gives examples, presents classifications, definitions and emphasises their benefits. The chapter ends with trends predicted in the structured products market.

All in all, I would like to take this opportunity to give my thanks to all these who helped me to create the contents of the book. I particularly want to thank the authors for their contribution, as well as reviewers whose helpful remarks allowed to improve its quality.

*Izabela Pruchnicka-Grabias*

*April 12, 2007 in Warsaw, Poland*

# Principles of the Law on the Capital Market in the European Union and in Poland

*Justyna Maliszewska-Nienartowicz*



## 1.1. Introductory Remarks



There is no doubt that the more integrated and complex markets become, the harder they are to regulate. In particular, it is difficult to decide “what” and “how” to regulate. Some aspects of the markets do not need specific legal provisions as they are, by their nature, self-regulating. Also the law on the markets cannot be too detailed because this can limit the freedom of action of economic entities. There are, however, such matters which have to be regulated, even in details, in order to ensure the protection of investors, transparency, fairness of the markets etc.

The presentation of the basic regulations on the capital market should be preceded by the description of its relations with the financial market. The latter can generally be defined as the place where the money transactions are undertaken. The structure of the financial market covers: capital, money, currency, derivatives and credit markets. All of them are regulated in a specific manner and the presentation of these provisions is not possible in one chapter. Therefore, further remarks will concentrate only on one of the segments of the financial market – the capital one.

There is no doubt that the development of capital markets all over the world has led to the situation in which regulations concerning particular securities and relating to these securities have ceased to be sufficient to protect an investor. A quick, mass trading in securities and other instruments of the capital market has required a special regulation concerning the organisation of the market, intermediation in transactions as well as facilitating the investment decision-making process (an obligation to present information about the issuer to investors as well as information

about the security itself)<sup>1</sup>. Therefore, certain standards relating to the capital market have been introduced.

As the single market of the European Union includes the free movement of capital and financial services, the common aspects have been regulated on the European level. This allows investment firms to provide services throughout the whole Union.

While creating the Polish capital market, the experiences of other countries have been taken into account. Moreover, the legal framework concerning public offering, trading in financial instruments and the capital market supervision has been based on the EU Directives, which ensures that it is similar to other countries' regulations.

## **1.2. Definitions of Basic Concepts – the Capital Market and the Law on the Capital Market**

The European Union and Polish law do not contain material definitions of the capital market. The only definitions that can be found have a descriptive character – they indicate what kind of operations are conducted on the capital market or what segments it includes. For example, art. 2 (6) of the Polish Act on capital market supervision predicts that capital market should be understood as:

- the market of securities and other financial instruments and
- the market of services offered by investments funds and other collective investment undertakings and
- commodities market.

As far as economic functions of the capital market are concerned it can be described as a place which is a centre for raising the long-term capital necessary for business and public authorities. As it was mentioned above, it is one of the elements of the financial market. The capital market should also be distinguished from the money market which deals in short-term funds eg. bills of exchange, treasury bills, interbank money and discount house deposits. The Polish Act on trading in financial instruments defines the money market as “a system for trading in financial instruments which represent solely monetary claims and mature within a year from the date of their issuance or acquisition in primary trading” [art. 3 (27)].

One of the basic features of the capital market is that it consists of several segments and that it involves more economic entities than the money market<sup>2</sup>. Participants of

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<sup>1</sup> Information from the internet site: [http://www.kpwig.gov.pl/f1a1\\_ang.htm](http://www.kpwig.gov.pl/f1a1_ang.htm)

the transactions conducted on the capital market can be divided into two main groups: creditors who want to invest money or borrowers. The transactions on the capital market can be risky because of the long terms of the return of the invested money. Therefore, the participation in these transactions should be preceded by getting the basic knowledge on the mechanisms of the capital market.

The law on the capital market can generally be defined as: regulations which relate to the capital market. Thus, this is a narrower concept than the law on financial market. In the Polish legal system the scope of the law on capital market includes *inter alia*: the law on trading in securities and other financial instruments, on bonds, on investment and pension funds, capital and investment spheres of actions of financial institutions (banks and brokerage houses)<sup>3</sup>. Although it is close to civil and commercial law, it cannot be treated as their part.

The law on the capital market is a distinct legal field with specific features. One of them is its interdisciplinary character – elements of private law are dominating but administrative and criminal regulations play also a big role<sup>4</sup>. The latter aim at strengthening of the market participants' security and provide for sanctions for the infringement of the rules on trading.

### 1.3. Principles of the Law on the Capital Market in the EU

#### 1.3.1. Regulations Concerning Different Sectors of the Capital Market

The EU regulations in the field of the capital market take form of the directives which are instruments of harmonisation. The directives set the results which have to be obtained by the Member States, using their own methods. Although, some of the directives concerning the capital market contain very detailed provisions, they still leave the Member States with a certain scope of freedom in the sphere of their implementation into their own legal systems.

According to the regulations of the EU directives there are several sectors (circles) of the capital market. They differ from each other by the intensity of the regulation. Thus, we can distinguish: the unregulated, public, regulated and official stock-exchange listing markets.

<sup>2</sup> Compare: W. Dębski, *Rynek finansowy i jego mechanizmy. Podstawy teorii i praktyki (The Financial Market and Its Mechanisms. The Bases of Theory and Practice)*, Warszawa 2005, p. 95.

<sup>3</sup> A. Chłopecki, *Obrót instrumentami finansowymi na rynku kapitałowym w: Prawo papierów wartościowych. System prawa prywatnego, Tom 19, A. Szumański (red.), (Trading in Financial Instruments on the Capital Market in: The Law of Securities. The System of Private Law, Part 19, A. Szumański (ed.)), Warszawa 2006, p. 750.*

<sup>4</sup> Ibidem.

**The unregulated market** – this sector of the capital market is not formally regulated by the EU directives. However, their provisions indicate indirectly when securities and other financial instruments are offered and traded on the unregulated market - it happens when they are not offered to the public. Thus, the European Parliament and Council Directive 2003/71/EC of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading<sup>5</sup> by defining the concept of “the offer to the public” at the same time defines the unregulated market from a negative point of view<sup>6</sup>. It should also be mentioned that this segment of the capital market is the domain of highly specialised investors who are protected by the risk by their professional knowledge. This group includes in particular banks and insurance undertakings.

**The public market** is the next sector of the capital market in the European Union. Its limits are determined by the definition of “the offer of securities to the public” contained in the above-mentioned Directive 2003/71/EC. It is defined as: “a communication to persons in any form and by any means, presenting sufficient information on the terms of the offer and the securities to be offered, so as to enable an investor to decide to purchase or subscribe to these securities; this definition shall also be applicable to the placing of securities through financial intermediaries” [art. 2 (d) of the Directive]. Thus, it is not predicted how many investors should be addressees of the communication in order to treat this offer as a public one. However, it should be mentioned that art. 3 (2b) of the Directive provides for the exemption from the obligation to publish a prospectus if “an offer of securities is addressed to fewer than 100 natural or legal persons per Member State, other than qualified investors”.

**The regulated market** is the third sector of the capital market in the European Union. It is regulated by the Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments<sup>7</sup>. The Directive contains the definition of the regulated market – it is “a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its non-discretionary rules - in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with the provisions of Title III of the Directive” [art. 4 (14) of the Directive]. It should be underlined that the previous Council Directive 93/22/EEC did not contain such definition. It predicted that the regulated market is a market for certain financial instruments<sup>8</sup> which:

<sup>5</sup> O.J.L 345, 31.12.2003, p.64-89.

<sup>6</sup> A. Chłopecki, *Prawo Wspólnot Europejskich a prawo polskie, Tom 4, Rynek kapitałowy, (Law of the European Communities, Part 4, The Capital Market)*, Warszawa 2000, p. 29.

<sup>7</sup> O J.L 145, 30.04.2004, p. 1-44. The Directive repealed the previously binding in this field Council Directive 93/22/EEC. It also amended Directives 85/611/EEC, 93/6/EEC and 2000/12/EC.

- appears on the list drawn up by the Member States and forwarded to other Member States and the European Commission (the lists of the regulated markets have been published by the European Commission in the Official Journal of the European Union every year)
- functions regularly,
- is characterised by the fact that regulations issued or approved by the competent authorities define the conditions for the access and operation of the market and, where Directive 79/279/EEC<sup>9</sup> is applicable, the conditions governing admission to listing imposed in that Directive,
- requires compliance with all the reporting and transparency requirements predicted in the Directive 93/22/EEC [art. 1 (13) of this Directive].

It can be noticed that only the main features of the regulated markets were mentioned in this provision. Now the definition is more developed but it still does not refer to the legal character of the regulated market (e.g. if it has a public or private legal character).

**The official stock-exchange listing market** is the sector of the capital market regulated in the most detailed way, mainly by the Directive 2001/34/EC of the European Parliament and of the Council of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities<sup>10</sup>. The Directive provides for the coordination of the minimum conditions for the admission of securities to official listing on stock exchanges situated or operating in the Member States. This is supposed to “facilitate both the admission to official stock exchange listing, in each such State, of securities from other Member States and the listing of any given security on a number of stock exchanges in the Community” and “make for greater interpenetration of national securities markets by removing those

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<sup>8</sup> Listed in the Section B of the Annex. The list includes transferable securities, units in collective investment undertakings, money-market instruments, financial-futures contracts, including equivalent cash-settled instruments, forward interest-rate agreements (FRAs), interest-rate, currency and equity swaps, options to acquire or dispose of any of the previously mentioned instruments.

<sup>9</sup> The Council Directive 79/279/EEC of 5 March 1979 coordinating the conditions for the admission of securities to official stock exchange listing, O.J. L 66, 16.03.1979, p. 21-32.

<sup>10</sup> O.J.L 184, 6.07.2001, p. 1-66. It repealed four directives which previously regulated this sector of the capital market:

- Council Directive 79/279/EEC coordinating the conditions for the admission of securities to official stock-exchange listing;
- Council Directive 80/390/EEC coordinating the requirements for the drawing up, scrutiny and distribution of the listing particulars to be published for the admission of securities to official stock-exchange listing;
- Council Directive 82/121/EEC on information to be published on a regular basis by companies the shares of which have been admitted to official stock-exchange listing;
- Council Directive 88/627/EEC on the information to be published when a major holding in a listed company is acquired or disposed of.

obstacles that may prudently be removed and therefore contribute to the prospect of establishing a European capital market” (paragraph 2 of the Directive Preamble).

It should also be added that the described sectors of the capital market in the European Union present the following circles. As a result the regulations which concern outer circles apply to inner circles. It means that the regulations of the public market apply to the regulated market and the official stock-exchange listing market is regulated by all of the above-mentioned Directives.

Moreover, there are such regulations which are not confined only to one sector of the capital market in the European Union. For example, the Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions<sup>11</sup> or the Directive 97/9/EC of the European Parliament and of the Council of 3 March 1997 on investor-compensation schemes<sup>12</sup> regulate questions which concern investors active on the capital market in general. Thus, they influence different sectors of this market.

Similar remarks can be made on the Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse)<sup>13</sup>, although its scope is not so general. Nevertheless, it applies not only to financial instruments admitted to trading on a regulated market in at least one Member State but also to such instruments for which a request for admission to trading on such a market has been made, irrespective of whether or not the transaction itself actually takes place on that market (art. 9). This means that the Directive is not confined to the regulated markets but also takes in other types of markets (such as Alternative Trading Systems) which can be used for insider trading or market manipulation in connection with financial instruments negotiated on regulated markets<sup>14</sup>.

Finally, it should be noticed that typical operative segments of the capital market such as the primary and secondary market are also distinguished in the European Union. The primary market is this part of the capital market on which issuers sell securities to investors who engage their financial resources in order to earn money (they treat it as a better investment than earning the money e.g. on a bank account or savings-bank deposit). The secondary market includes trading in securities which have been introduced on the primary market. However, issuers cannot take part in these transactions<sup>15</sup>.

<sup>11</sup> O.J.L 141, 11.06.1993, p. 1–26. Amended by the Directives 98/31/EC, 98/33/EC, 2002/87/EC, 2004/39/EC and 2005/1/EC.

<sup>12</sup> O.J.L 84, 26.03.1997, p. 22–31.

<sup>13</sup> O.J.L 96, 12.04.2003, p. 16–25.

<sup>14</sup> Information from the internet site: <http://europa.eu/scadplus/leg/en/lvb/l24035.htm>

<sup>15</sup> See further W. Dębski, *op.cit.*, p. 129.