Legal Research on the Regulation of OTC Derivatives in Developed Market and Suggestions to Chinese Legislation

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Abstract: The generation and development of financial derivatives are the result of the development of information technology and the interaction with the international financial market. In the past 30 years, international financial derivative products have developed rapidly in developed countries such as Europe and the United States, the market scale has expanded rapidly, and the transaction volume has also increased. However, due to the unrestrained encouragement of financial innovation by various countries in recent years, the scale of the international financial derivatives market has expanded rapidly, and the financial risks caused by its leverage effect have also multiplied. Therefore, it is very necessary to impose necessary supervision and regulation on financial derivatives by reasonable legal means, and to control their potential risks to the greatest extent. China's financial derivatives appeared relatively late, the market maturity is still in continuous improvement, and there are many problems. In this context, actively introducing and learning from developed countries' financial derivative product supervision models and experiences, and constantly improving relevant laws and regulations, are crucial to the innovation and development of my country's financial market.

1. Introduction

With the development of financial market, OTC derivatives play the increasingly important role in it. As we know, the derivatives could increase the liquidity of financial markets and promote the further development of financial markets, but sometimes it may cause financial risks, because it is difficult to be supervised in the financial market compared to Exchange Traded Derivatives. Therefore, we need to implement legal rules to make this system constantly improved.

There are some developed countries have made a series of laws to regulate derivatives, such as USA and South of Korea. However, compared with these developed countries, China does not have enough laws to regulate and supervise derivatives. At present, they are mainly managed at the legal level in accordance with the Banking Supervisory and Administrative Law. So for OTC derivatives, they are also mostly regulated by administrative regulations, such as the measures on the administration of derivatives business of financial institutions. However, since most regulatory measures made by different administrative departments, regulatory agencies work independently, which leads to overlapping supervision and even a regulatory vacuum area, and even may cause regulatory chaos, produce some loopholes of supervision and increase the instability of the financial system.[1] Although CBRC and CRIC have merged in 2018, there are some departments are independent, such as CSRC. Therefore we need to take some measures to fill this gap. I think that comparing other countries with matured derivatives legal system is a good way, because we can find from how these countries regulate the OTC derivatives market and absorb their legal supervision experience. Therefore, this paper plans to discuss the derivatives legal supervision system between different countries and find out the current legal problems of OTC derivatives existing in China. In addition, it also will discuss the current regulations or measures made by China.

[1] See Bao Xiaoye, Legal Research on the Regulation of OTC Derivatives Market, East China University of Political Science and Law, Doctor Thesis, p. 71.

2. Why dose China Needs OTC Derivatives Supervisory Law?

2.1 OTC Financial Derivatives are Updated Quickly

We know that OTC derivatives have many advantages through researching the development of financial market around the world, for example, improving the market liquidity and letting consumers understand the prices of different products in various periods, and then predicting the price of commodities, which can help traders avoid financial risks. It can also reduce financing costs, such as using good corporate reputation, borrowing low-yen yen bonds, and using the RMB as a swap to use the US dollar, which is cheaper than directly converting to the US dollar. Although financial derivatives can promote the financial market, financial derivatives are also a double-edged sword, which may also bring some negative effects. For example, the continuous updating of financial derivative products will make it difficult to regulate the previous laws, resulting in weakened supervision of financial risks. In addition, the high returns and low investment of financial derivatives attract a large number of people to invest, but ignoring its high risks. Therefore, excessive investment and lack of supervision even triggered the financial crisis of 1995, which caused China to close the futures market that year. China's market of derivative products originated in the 1990s, compared with other developed countries, in fact, its history is not last long. The financial derivative market is not as stable as the non-derivatives market. As long as there are loopholes in the legal and regulatory system, investors can use the loopholes to obtain profits, and even harm the non-financial derivative market and disrupt financial stability. Therefore, it is necessary to understand how financial derivatives are regulated and operated, and to help us improve China's financial derivatives system by comparing mature derivative regulatory systems in other countries.

2.2 OTC Financial Derivatives Have High Risks

OTC derivatives are inherently highly risky. While managing risks and creating wealth, they also hide risks of varying degrees. Therefore, their risk characteristics are different from on-exchange derivatives and other financial products, which are realistic for legal supervision demand.[2] The successive bankruptcies of the British Bank of Barings and the Tokyo Securities Company of Japan are examples of risk out of control. The risks of financial derivatives mainly include five aspects: The first is market risk. Due to the information asymmetry in the financial market, once the price of financial derivative products undergoes a reverse change, it will bring huge losses to the users of derivative products. The second is liquidity risk. It mainly includes the risk that traders cannot liquidate their positions due to insufficient market volume, and the risk that they cannot perform payments when the contract expires due to insufficient liquidity. The third is credit risk. Once the counterparty of a financial derivative product fails to fulfil its contractual obligations, it will cause unimaginable losses to itself. The fourth is legal risk. The virtuality and immediacy of financial derivatives make it relatively difficult to sign written contracts and provide evidence. Many investors have to bear huge economic losses due to difficulties in providing evidence.

In actual over-the-counter derivative risk events, the above-mentioned multiple risks often affect each other. The increase of market risk will increase the possibility of default by market participants, thereby increasing credit risk, and the degree of market risk exposure that is adversely affected will further increase. Liquidity risk and legal risk will affect contract performance and capital operation, thereby triggering credit risk and market risk. The emergence and development of over-the-counter derivatives have brought various financial markets closer together, and the spread of risks between markets has accelerated, and the possibility of systemic disorder has increased. This series of chain reactions caused risks to be transmitted to other types of financial markets, affecting other countries or regions, resulting in serious systemic risk problems and even triggering financial crises. Therefore, it is necessary to strengthen its supervision to prevent the occurrence of financial crises.

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[2] See Bao Xiaoye, Legal Research on the Regulation of OTC Derivatives Market, East China University of Political Science and Law, Doctor Thesis, p. 71.

3. The Current Mechanism of Supervising OTC Derivatives in China

3.1 The Development of Financial Derivatives in China

Financial derivatives have a history of more than 100 years, but their real rapid development was after the 1970s. At that time, the state's macroeconomic policies began to change and the market was deregulated, so the traditional operating models of investment banks and commercial banks gradually disappeared. China's financial derivatives started in the Zhengzhou Commodity Exchange in the 1990's, but at that time, the regulatory system was very chaotic, and a large number of futures exchanges were established without even a special law regulating them. Therefore, in 1993, the State Council of China issued an administrative decree to stop the blind development of the futures market. In 1999, the State Council of China promulgated the "Interim Regulations on the Administration of Futures Trading" to formally incorporate the Chinese futures market into the legal system. However, it can also be seen that China's financial derivatives market is not like many other countries that have developed for many years. It was created under the guidance of the government. In addition, China's regulatory and legal system for derivative products is subject to very strict restrictions, and there are even large differences from international standards, such as the internationally applicable ISDA and CSA agreements. However, some provisions of China's securities law and company law conflict with them. In addition, there are some legal flaws in China's OTC derivatives system. For example, financial law does not specifically regulate financial derivatives, and the extent of transaction subjects is very small.

3.2 The Limitations of the Current Mechanism of Supervising OTC Derivatives in China

3.2.1 The Legislative Level of Financial Derivatives Supervision is Low

China's laws and regulations on financial derivative product supervision are mainly limited to administrative regulations, rules, etc., and their structure is rather chaotic. The laws and regulations on financial derivative product supervision have not yet formed a complete system. In addition, the regulation of financial derivatives is obviously lagging behind at the legal level, causing some urgent problems to be solved. For example, further innovation and opening up of the financial derivatives market requires legal support and the lack of a law that uniformly regulates on- and off-market financial derivatives.

3.2.2 The Financial Derivatives Information Disclosure System is not Perfect

The information disclosure system is not only an important way for the derivative product supervision department to obtain information, but also an important guarantee for the protection of consumer rights and interests of financial derivative products. Although China currently has a series of regulations such as the "Administrative Regulations on Futures Trading" to improve the information disclosure system, it can be seen from the current regulations that its legislation still lags behind. In addition, this will also lead to insufficient communication between regulatory agencies. The establishment of information disclosure rules is often due to the occurrence of a certain financial derivative product risk event in the market, and when various regulatory authorities lack communication and coordination when formulating information disclosure rules, it will lead to inconsistencies between the applicable rules and disclosure content of financial institutions.[3]

3.2.3 Multiple Regulatory Agencies Cause Regulatory Conflicts

China's financial derivatives are subject to the supervision of different departments due to different business entities, and they comply with the regulatory regulations issued by different departments, and the regulatory agencies operate independently, resulting in overlapping supervision. Therefore, China's regulatory system seems to be a comprehensive regulation, but it still cannot effectively solve the problem of inefficient regulation caused by duplication of regulation. At the same time, because the over-the-counter financial derivatives market is a

[3] See Yang Lei, Research of Financial Derivatives Supervisory System, Southwest University of Political Science and Law, Master Thesis, p. 12.

cross-field market, the uncoordinated regulatory mechanism is also prone to repeat supervision or unmanned supervision. This not only reduces the efficiency of supervision and wastes supervision resources, but also unable to monitor the risks that may arise in the market, which will cause the destruction of market stability.[4]

As the number of participants in the over-the-counter financial derivatives market continues to increase, the coordination and connection between regulatory agencies has become more and more prominent, so the regulatory coordination mechanism needs to be further expanded and enriched.

4. Developed Capital Market OTC Derivatives Supervision Model

4.1 The U.S. Regulatory Model

In order to solve these problems, China needs to learn from foreign mature management systems for supervision, because if the derivatives market is to develop healthily, it must be backed up by sound laws. The United States is the birthplace of financial derivatives and the largest and most innovative derivatives market in the world today, leading the development of the world's derivatives sector. Therefore, studying the development and economic environment of American derivative products can accurately understand the deficiencies of China's current derivative products, which are also the important reference for China's relevant laws on derivative products.

Firstly, let us look at the development of the US financial regulatory system. Until the 1930s, the United States had limited financial services. However, after the Great Depression in the United States, President Roosevelt enacted the Banking Law, which divided banks into commercial banks and investment banks and supervised them separately. This law integrates the US financial system and relaxes financial controls, expanding the scope of the US financial industry. However, due to excessive deregulation, the continuous accumulation of financial risks eventually led to the outbreak of the global economic crisis in 2008. Therefore, the United States urgently needs a new law to regulate the financial system, namely the Dodd-Frank Act.[5]

The first part of the act is to strengthen the protection of consumer rights and establish a special consumer protection agency. In addition, the act was enacted during the economic crisis in which financial risks continued to accumulate. So a considerable part of the act is legal supervision of financial derivatives, restricting financial institutions from conducting investment transactions to prevent financial risks. And a financial stability supervision committee has been set up to prevent systemic financial risks. Its main function is to identify and respond to risks affecting the stability of the financial system. And the committee has the right to submit regular reports to the US Congress every year, show the US financial system and form, and then provide recommendations. Thirdly, it introduced Volcker rule to try to increase defense mechanisms between bank investment and traditional banking activities. The act also requires large financial institutions to prepare bankruptcy plans, which helps regulators better understand financial institutions. If the financial institution cannot provide a plan, it will be required to implement more stringent regulatory measures, such as higher regulatory requirements, or more restrictions on the size of its business and funding. Fourthly, the act is mainly to improve market transparency and strengthen accountability mechanisms for the derivatives market. Because financial derivatives provide traders with effective risk management tools and can promote financial stability and economic growth. And for standard financial derivatives, they must be traded in specific venues. Fifthly, reforming the functions of the Federal Reserve System. The act strengthens the Fed's protection of consumers, guards against risks, and cooperates with the newly established Financial Stability Regulatory Commission. In addition, the information disclosure standards of financial institutions are improved, which increases the transparency of financial markets. Sixthly, strengthening jurisdiction over credit rating agencies. Establishing a credit rating office within the Securities and Exchange Commission, which has the

[4] Liao Wenjuan, Cai Yaping. (2016) The Inspiration of“Twin Peaks”Supervision Mode to the Supervision Mode of China's OTC Financial Derivatives Product Market. China Forestry Economics, 4, 32.

[5] See Xu Shan, Reform of U.S. and EU Regulatory System on OTC Financial Derivatives: China's Reference, Enlightenment and Improvement, East China University of Political Science and Law, Master Thesis, p. 17.

right to impose fines on credit rating agencies. And the act could require credit rating agencies to make more disclosures, requiring them to provide rating methods, rating content, and rating records. It can be seen that the "Dodd-Frank Act" has established a comprehensive regulatory system for the US financial system. But its supervision is not to restrict the development of financial institutions, but to try to find a balance between the development of the financial industry and the stability of the financial market. In addition, reducing the influence of rating agencies internally on ratings, supervisors of rating agencies must not participate in rating. Rating agencies must not associate internal staff wages with ratings, and have to protect its independence. Violators will be suspended or their licenses are revoked.

4.2 South Korea's regulatory model

In addition we'd better study the matured experience, especially in Asia area, like Hong kong and South of Korea that they learn many mature derivatives trading rules, making their financial derivatives markets mature within a few years.[6] For instance, South Korea was strongly affected by the Asian financial crisis in 1997. One of the most important factors was the failure of South Korea to improve its financial risk management and regulatory rules. After drawing lessons from the prevention of the financial crisis, South Korea has vigorously promoted the development of the financial derivatives market through transplanting some of financial regulatory rules of USA. In a short period of time, a sound supervisory system was established, so the current trading volume of stock index derivatives has increased rapidly. In contrast, from 1980s to 1990s, in order to promote the development of financial markets, Thailand issued a series of laws to promote the development of financial derivatives. However, due to the lack of effective laws to control it, Thailand's financial risks continue to accumulate, resulting in heavy losses in the Asian financial crisis. I think these examples are quite valuable for the construction of China's financial derivatives supervision system in the future.

5. Specific measures that China can learn from

5.1 Establish a unitary supervision agency

Therefore, if China wants to improve financial supervision, especially the supervision of financial derivatives, it can take some measures. First of all, the supervision of financial derivatives in China is regulated by different institutions. With the continuous development of China's financial market, a specialized institution or an effective contact mechanism needs to be established to contact different departments to fill the regulatory gap. We can learn from the model of Singapore. Singapore is a typical representative of a unified regulatory model. The Monetary Authority of Singapore (MAS) implements comprehensive supervision of the country's financial market. Singapore's OTC financial derivatives transactions are also under the unified supervision of MAS under this framework. At present, MAS has become a unified regulator that comprehensively supervises various financial institutions in Singapore including banks, insurers, capital market intermediaries, investment advisers, and stock exchanges, etc. In February 2008, the legal provisions on commodity futures in the Commodity Trading Law have been incorporated into the Securities and Futures Act. In 2012, MAS and the International Enterprise Development Bureau jointly proposed that other commodity derivative transactions should also be included in MAS for unified supervision. In addition to government regulation, at the level of self-regulation, the self-regulatory organizations of the Singapore financial derivatives market also include Singapore Financial Market Association and Foreign Exchange Market Committee. In addition to the government's supervision of the financial derivatives market, at the level of self-regulation, the self-regulatory organizations of the Singapore financial derivatives market also include the Singapore Financial Market Association and the Foreign Exchange Market Committee. Therefore, MAS, as a unified regulatory body that integrates monetary policy enforcement power and financial industry regulatory power, has an absolutely strong regulatory status and independence, and

[6] See Yu Xijiao, The study of Regulation of OTC Derivatives in Hong Kong, HuaZhong University of Science & Technology, Master Thesis, p. 30.

self-regulatory regulatory organizations supplement government regulation, which is more conducive to the improvement of the regulatory system.[7]

5.2 Formulate a unified financial supervision law

In addition, the regulatory system for financial derivative products in China is basically regulated by administrative regulations, and normally only regulates special issues. These laws have low rank and lack a code to regulate them. And for regulatory objectives and regulatory bodies, their functional regulations are very vague. Like Hong Kong, although Hong Kong's financial derivatives are also managed by different institutions, such as the HKMA and the SFC. However, the main legal basis for regulating OTC derivatives transactions in Hong Kong is the Securities and Futures Ordinance and its subsidiary legislation. Unlike the Mainland, each department has its own management rules. Therefore, if a financial supervision law can be formulated, it will have a great effect on the improvement of China's financial supervision system.

Conclusion

We all know financial derivatives are the products of globalization and have international characteristics. China's financial derivatives market also needs to accelerate its internationalization to promote the further development of China's financial market and improve its competitiveness in this field. But there are also lessons learned from Thailand during the financial crisis, that is, excessive internationalization and liberalization. Because this is likely to lead to the exploitation of regulatory loopholes, resulting in huge losses. In short, if there is no effective monitoring mechanism, the instability of the financial system will be exacerbated, and even worse, it will trigger an economic crisis. Therefore, we should learn the concepts of developed areas for adjusting the entire regulatory system and strengthen supervision of financial markets. It is even necessary to strengthen international financial supervision cooperation, such as establishing an information sharing system and establishing bilateral agreements to strengthen international cooperation in financial derivatives market supervision.

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