

DERIVATIVES REGULATION IN AZERBAIJAN

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I. Introduction

The formation of securities markets in Azerbaijan reportedly dates back to the late 19th century, with the establishment of the Baku Commodities Exchange, on which bonds and promissory notes were traded.¹ Further development of the securities markets was followed by creation of the Baku Trade Bank and several joint stock companies operating mainly in the petroleum industry in independent Azerbaijan.²

While prospects of mature securities markets were stalled by the annexation of Azerbaijan by the Soviet Union in 1920, the restoration of the country's indepen-

dence from the Soviet Union in 1991 has started a new chapter in the development of Azerbaijani securities markets.

Soon after gaining independence, Azerbaijan adopted the Law “*On Securities and Stock Exchanges*”³ (now repealed), which regulated the securities market with the objective of protecting the interests of investors. At the same time the government launched the First State Privatization Program⁴, creating a hundreds of joint stock companies and thousands of shareholders on the basis of privatized state enterprises. The State Committee on Securities of the Republic of Azerbaijan (the “State Securities Committee”)⁵ was established in 1998, followed soon thereafter by the establishment of the modern Civil Code of the Republic of Azerbaijan.⁶ Not surprisingly, this period also coincided with signing of the first production sharing agreement in 1994, allowing foreign investment in the hydrocarbon sector of the place where the international oil industry was born in the mid-19th Century. The Baku Stock Exchange was established in 2000.⁷

However, until very recently, Azerbaijani derivatives regulation remained rather fragmented and undeveloped, consisting largely of a few general provisions in the Civil Code,⁸ the cornerstone of Azerbaijani civil and commercial law, together with several pieces of secondary legislation enacted by the State Securities Committee. Indeed, there did not seem to



be any need to regulate the almost non-existent local derivatives market, as the country was enjoying a steady stream of revenues from hydrocarbon exports for nearly a decade, and local investors were free to invest in derivatives products abroad.

With the recent sharp decline in the price of oil, Azerbaijan has recently stepped up its efforts to develop its financial sector further. Part of that effort was to modernize the legislation, which has lead the Azerbaijani Parliament, the *Milli Majlis*, to adopt a new *Securities Market Law* in 2015,⁹ as well as introducing amendments to the key sections of the Civil Code dealing with derivatives. In this article we discuss these recent legislative developments in derivatives regulation in Azerbaijan.

II. Recent Developments in Derivatives Regulations

A. Amendments to the Civil Code

The most crucial part of the amendments to the Civil Code was introduction of a new concept of the derivative financial instrument, defined as a contract to buy, sell or swap underlying assets, securities, foreign exchange, interest spots, profitability, derivative financial instruments, commodities, financial indices, credit risk, and the like may serve as underlying assets.¹⁰

The law provides for three types of derivative financial instruments - futures, options, and swaps.¹¹

Futures are derivative financial instruments for the sale and purchase of a predetermined type and amount of an underlying asset at an agreed date and price. *Options* are defined as derivative financial instruments that grant a unilateral right

to the holder to buy, sell or swap an underlying asset. Finally, *swaps* are derivative financial instruments under which two parties exchange the same type of underlying asset.¹²

The concept of derivative financial instrument was strategically included under Chapter 20 of the Civil Code (*Contact Law*). Previously, derivatives were considered to be securities. Including derivatives regulation in the section of the Civil Code pertaining to contracts might possibly signal a legislative intent to exempt non-standardized derivative financial instruments from the existing securities regulations, while regulating those that are traded over the stock exchanges in Azerbaijan.

Finally, these amendments to the Civil Code expressly excluded derivative financial instruments from the scope of the Azerbaijani gaming laws, clarifying once and for all that derivative financial instruments have legitimate a economic and commercial purpose.

B. New Securities Market Law

The Securities Market Law, which was adopted on the same day as the amendments to the Civil Code discussed above, completely overhauled the regulation of the securities and derivatives market in Azerbaijan.

Despite the fact that derivatives are no longer designated as securities, the definition of the *regulated market* set forth in the Securities Market Law includes both securities and derivative financial instruments that are being traded on a stock exchange. (In fact, the State Securities Committee¹³ has recently adopted the relevant rules, which are discussed later in this article).

The Securities Market Law introduced new

licensing requirements in relation to certain activities related to derivative financial instruments. Namely, engaging in any of the following *primary* and *auxilliary* investment services in Azerbaijan now requires an investment company license.

1. Primary investment services

Primary investment services are defined to include:

- the acceptance and execution of clients' orders in relation to transactions with derivative financial instruments;
- the management of individual investment portfolios, including those consisting wholly or partially of derivative financial instruments;
- the management of clients' accounts, including executing transactions related to encumbering derivative financial instruments;
- lending funds or securities to investors for trading with derivative financial instruments; and
- conducting investment and financial analysis related to derivative financial instruments.¹⁴

2. Auxiliary investment services

Auxiliary investment services include:

- lending funds or securities to investors for trading with securities and derivative financial instruments;
- conducting investment and financial analy-

sis related to securities and derivative financial instruments;

- acting as a security trustee for secured bonds; and
- foreign exchange activities in relation to conducting primary investment services.¹⁵

It should be noted that, prior to the adoption of the Securities Market Law, separate licenses were required for brokers, dealers and underwriters, which were issued for a period of five years, while licenses for investment companies are now issued for an indefinite period of time.¹⁶ Primary and auxiliary investment services are subject to further reporting, implementation, bookkeeping, auditing, and other requirements under the Securities Market Law.¹⁷

The Central Bank of the Azerbaijan is expressly authorized to enter into transactions relating to securities or derivative financial instruments on its own behalf without obtaining a license for investment company activities, provided that such transactions are entered into for the benefit of the State.¹⁸

C. Other Relevant Legislation; Use of ISDA Documents

1. Advertising Law

The new Advertising Law¹⁹ contains certain restrictions related to the advertising of securities, as well as financial, bank, and investment services, in Azerbaijan. The act of advertising is defined as information distributed using various means and methods in any form for the purpose of attracting the attention of the consumer to the subject-matter of the advertisement, creating and maintaining interest in and increasing awareness

about the product and stimulating the sale thereof.²⁰

These restrictions include, along with a previously enacted prohibition against the advertising of unregistered securities, restrictions related to the advertising of securities before a decision on the sale of such securities is adopted, providing information that contradicts information contained in a prospectus, promising or guaranteeing future performance based on the historical track record on past performance, as well as withholding information about existing or anticipated risks or the terms of a contract that might affect financial outcomes for consumers.²¹

2. Secondary Regulations

In the months following the adoption of the Securities Market Law, the State Securities Committee has introduced a number of regulations, including rules for the placement and trading of derivative financial instruments listed on a stock exchange. While these rules lack detail, they set forth the minimum content, placement and trading requirements for derivative financial instruments. Further details are set forth in the internal rules of the stock exchange. (The Baku Stock Exchange is currently the only licensed stock exchange in the country).²²

3. ISDA Master Agreements

During the past several years there has been a gradual but noticeable increase in the use of ISDA Master Agreements by local counterparties, and particularly the Central Bank of the Azerbaijan (CBA), the State Oil Fund of Azerbaijan (SOFAZ), and local banks and corporates, both privately held and state-controlled.

Prior to enactment of the Securities Market

Law, the enforceability of netting provisions of ISDA Master Agreements was based primarily on the fact that Azerbaijani law provided for the concept of *set-off*, by which an obligation is deemed satisfied in full or in part by a set-off against a counter claim, where such counter claim has already matured, or where there is no indicated term of maturity, or where the instrument will mature on demand (with a few exceptions).²³ The Securities Market Law has also introduced the concept of *netting*, i.e., the netting of claims and obligations arising from transfer orders sent or received by clearing members to (or from) other clearing members in such a way that, after such netting, only a single claim or liability is created.²⁴

III. The Future of Derivatives Regulation in Azerbaijan

In spite of the enactment in Azerbaijan of the first specific provisions relating to derivative financial instruments, which provide a degree of additional clarity on the subject, the legislation remains very general and incomplete. As derivative transactions become more widespread among the various players in Azerbaijan, it is likely that more detailed regulations will be enacted, addressing the uncertainty that still causes hesitation by foreign financial institutions.

Efforts are currently under way to establish a single regulator of financial markets, the Financial Markets Supervision Chamber which, upon approval of its Charter, will replace the State Securities Committee, the State Insurance Supervision Service under the auspices of the Ministry of Finance, and the Financial Monitoring Service under the auspices of the Central Bank.²⁵

While the Charter and authorities of the Cham-

ber are yet to be determined, this body was stated to be created for the purposes of licensing, regulation, and oversight over the securities market, the activities of investment funds, insurance companies, credit institutions (banks, non-bank credit institutions and the postal operator), and payment systems, as well as improving controls in the field of prevention of the legalization of proceeds from crime and terrorist financing.²⁶

The Financial Markets Supervision Chamber was created in the form of a *public legal entity*, a quasi-state entity, for the purposes of engaging in activities of national significance.²⁷ The Azerbaijani financial community is awaiting with interest the forthcoming establishment of the Chamber and the adoption of further regulations, both of which should eliminate the uncertainty and foster the use of derivative financial instruments in the country.

ENDNOTES:

¹“Azərbaycan Respublikasında qiymətli kağızlar bazarının yaranma tarixi” [History of the securities market in the Republic of Azerbaijan] (http://scs.gov.az/qiymetli-kaqizlar-bazari/qkb_haqqinda). Retrieved January 2, 2016.

²Mir Yusif Mir-Babayev, *Azerbaijan's Oil History: A Chronology Leading up to the Soviet Era*, Azerbaijan International, Summer 2002 (10.2), Pages 34-40 (http://www.azer.com/aiweb/categories/magazine/ai102_folder/102_articles/102_oil_chronology.html). Retrieved January 2, 2016.

³“Qiymətli kağızlar və fond birjalari haqqında” Azərbaycan Respublikasının Qanunu [Azer. Law on Securities and Stock Exchanges], No. 383, dated November 24, 1992, Azərbaycan Respublikasının Qanunvericilik Toplusu [Azer. QT] [Republic of Azerbaijan Collection of Legislation] 1992, No. 22, Item 952. (Azer.)

⁴“Azərbaycan Respublikasında 1995-1998-ci

illərdə dövlət mülkiyyətinin özəlləşdirilməsinin Dövlət Proqramının” təsdiq edilməsi haqqında [Decree of the President of the Republic of Azerbaijan. On Approving the State Program for the privatization of state property in the Republic of Azerbaijan in 1995-1998] No 1120, dated September 29, 1995, is available at <http://e-qanun.gov.az/framework/9472#>.

⁵“Azərbaycan Respublikasının Prezidenti yanında qiymətli Kağızlar üzrə Dövlət Komitəsinin yaradılması haqqında” Azərbaycan Respublikası Prezidentinin Fərmanı [Decree of the President of Azer. on Providing for the Activity of the State Committee for Securities under the auspices of the President of the Republic of Azerbaijan] No 58, dated December 30, 1998, Azərbaycan Respublikasının Qanunvericilik Toplusu [Azer. QT] [Republic of Azerbaijan Collection of Legislation] 1998, No. 12, Item 772.

⁶Azərbaycan Respublikasının Mülki Məcəlləsi [Azer. MM] [Azer. Civil Code], is available at <http://e-qanun.gov.az/code/8#>.

⁷“[Bakı Fond Birjasının] Tarixcə[si]” [Brief History of the Baku Stock Exchange] (<http://bfb.az/tarixce/>). Retrieved March 25, 2016.

⁸Civil Code (Azer.), art.1078-3.

⁹“Qiymətli kağızlar bazarı haqqında” Azərbaycan Respublikasının Qanunu [Azer. Securities Market Law], No. 1284-IVQ, dated May 15, 2015, Azərbaycan Respublikasının Qanunvericilik Toplusu [Azer. QT] [Republic of Azerbaijan Collection of Legislation] 2015, No. 07, Item 813 (Azer.).

¹⁰Civil Code (Azer.), art.403-1.1.

¹¹*Id.*, art.403-1.3.

¹²*Id.*, art.403-1.4-403-1.6.

¹³The State Securities Committee has recently, among other governmental authorities, been reorganized into the Financial Markets Supervision Chamber, which was established further to “Azərbaycan Respublikasının Maliyyə Bazarlarına Nəzarət Palatası publik hüquqi şəxsin yaradılması haqqında” Azərbaycan Respublikası Prezidentinin Fərmanı [Decree of the President of Azer. on Establishing the Finan-

cial Markets Supervision Chamber of Azer. Public Legal Entity], No. 760, dated February 3, 2016 (Azer.), is available at: <http://e-qanun.gov.az/framework/31990>.

¹⁴Securities Market Law (Azer.), art.30.4.

¹⁵*Id.*, art.30.4.

¹⁶*Id.*, art.64.3.

¹⁷*Id.*, art.3.4, 3.5, 37, 38, 39, 40, and 41.

¹⁸*Id.*, art.30.5.

¹⁹“Reklam haqqında” Azərbaycan Respublikasının Qanunu [Azer. Advertising Law], No. 1281-IVQ, dated May 15, 2015, Azərbaycan Respublikasının Qanunvericilik Toplusu [Azer. QT] [Republic of Azerbaijan Collection of Legislation] 2010, No. 07, Item 812 (Azer.), art.33.

²⁰Advertising Law (Azer.), art.2.0.1 and 33.1.

²¹*Id.*, art.33.2.

²²“Törəmə maliyyə alətlərinin

yerləşdirilməsi və tədavülü Qaydası”nın təsdiq edilməsi barədə” Azərbaycan Respublikasının Qiymətli Kağızlar Üzrə Dövlət Komitəsinin Qaydaları [Rules of State Securities Committee of Azer. on Placement of and Trading with Derivative Financial Instruments], No. 32-q and dated December 14, 2015 (Azer.), is available at: <http://e-qanun.gov.az/framework/31783>.

²³Civil Code (Azer.), art.540 and 545.

²⁴Securities Market Law (Azer.), art.1.0.21.

²⁵Decree of the President of Azer. on Establishing the Financial Markets Supervision Chamber of Azer. Public Legal Entity (Azer.), art.4.

²⁶*Id.*, art.1.

²⁷“Publik hüquqi şəxslər haqqında” Azərbaycan Respublikasının Qanunu [Azer. Public Legal Entities Law] (Azer.), No. 97-VQ, dated December 29, 2015, art.2.1, available at: <http://e-qanun.gov.az/framework/31994#>.