

# Actual problems of regulation of the release and circulation of structured financial products

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**Abstract.** The market of structured financial products in emerging economies is a young phenomenon which carries a number of disadvantages. In more developed financial systems in the United States and Europe, it operates in conditions of clearly functioning mechanisms for protecting the rights of consumers of financial services. Despite the efforts made by the Bank of Russia, the system of protection of the rights and legitimate interests of investors, especially individuals, remains incomplete in Russia. There are problems regarding the operation of the information disclosure system, the facts of insider information abuse and market manipulation. Frequent changes in legislation, as well as continuing legislative gaps, create uncertainty. Despite significant discrepancies in the interpretation of the term “structural product”, the grounds for fixing it in legislation and making it “legal” have not yet developed. A structural product, as an artificial or synthetic phenomenon, will be regulated through the application to it of norms relating, respectively, to contracts or securities from which such a product is formed. Also, when purchasing securities on the exchange, the rules on clearing settlements must be observed, and in some cases – on settlements with the participation of a central counterparty, whose functions are traditionally performed by non-bank credit organizations licensed to carry out clearing activities. The task of improving the regulatory framework in order to regulate the issue and circulation of structured products in Russia is especially relevant due to the rapid growth in the number of retail investors.

**Keywords:** Structured financial products · Stock market · Regulation · Derivative financial instruments.

## 1. Introduction

In 2020-2021, the Russian stock market underwent significant changes: reduced inflation and low interest rates on deposits caused an influx of retail investors. The demand for retail investment products has intensified the sale of structured financial products by banks and management companies. New financial instruments for Russia have become a significant addition to traditional ones, in particular deposits insured by the state. Private investors have shown greater demand for such products and instruments as structural type deposits, structural notes and over-the-counter structural type

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financial instruments. Sellers on them offered an increased level of profitability and it was promised that the risks would be moderate. Due to the lack of transparency of these complex instruments, assessing the return on savings invested in them acts as a non-trivial task.

Therefore, two instructive stories can be considered.

In 2020, in addition to the crisis caused by the pandemic, there was another serious shock that affected the structured products market in South Korea. The low level of interest rates contributed to the fact that hundreds of thousands of people opened trading accounts with the desire to benefit from volatility and the expected increased profitability of structural financial instruments (Anic and Wallmeier, 2020). Weak economic growth rates, combined with competition with China for the position of a financial center in Asia, forced the Korean authorities to be loyal to the development process of this market. In a fairly short period of time, the number of trading accounts per capita in South Korea exceeded the United States by half, and with respect to the volume of the market for structural products of 80 billion US dollars, Korea ranked 3rd in the world after the EU and the USA (Arnold et al, 2021). Structural type bonds in Korea have become the most popular throughout the Asian region [5]. After the market collapse due to the introduction of quarantine restrictions against the coronavirus pandemic, autocalls worked and there was a massive early closure of structured products – in fact, the collapse of this market (Baranga, 2019).

The another example is the example of Belgium. After the financial crisis of 2007-2008, interest rates in the debt markets were reset to zero, and a “boom” in the structured products market emerged (Dyachenko and Farkas, 2021). In response to this, the Financial Services and Market Authority (FSMA) of Belgium has introduced a moratorium on the distribution of complex products, affecting individual investors.

It should be noted that in 2021, the Bank of Russia temporarily initiated a ban on investments by investors without proper qualifications in complex instruments without subsequently confirming the required level of qualifications of such investors. The temporary ban imposed has slowed down the development of the market of complex structured products in Russia. Currently, we are observing cautious initial steps towards the formation of a modern market for structured products in the country, a market in which investors can trust not only the issuers themselves, but also their products.

## **2. Materials and Methods**

A comprehensive analysis of the process demonstrating how investors make investment decisions indicates that only a few of these investors can effectively invest in the stock market. Transactions with structured financial products are even more difficult for them. A study of the return on investment of retail investors in South Korea and Europe indicates that the choice of such instruments cannot be considered as successful. Thus, the level of profitability of structured financial products on average in the sample “loses” to low-risk instruments. Taking into account the risk, investors received lower returns than if they had invested in classical forms of instruments.

In Russia, these problems are added to the lack of developed legislation and lack of experience of investors. The growing demand of Russians for complex financial instruments in the absence of proper experience and knowledge is a matter of concern for the regulator.

A study conducted by the analytical center of the National Agency for Financial Research on the OECD methodology showed that the financial literacy index of Russians is 12.37 points out of 21. This level indicates an insufficient level of the ability of citizens to independently manage their personal finances. According to the Global Financial Literacy Survey conducted by the S&P rating agency, the problem of low financial literacy is common to a large number of countries. Under these conditions, the development of the retail market of financial products, which not only do not guarantee a return on investment, but also make it difficult to calculate the probability of income, can significantly undermine the level of confidence in the financial sector.

## **3. Results**

The problems of forming the market of structured financial products in Russia begin already with the fact that the concept of “structural product” is not legal, it is not found in any domestic regulatory act, is not analyzed in judicial practice. For a separate category of financial market instruments, it is necessary to introduce restrictions on the subject composition, when only a limited list of entities meeting certain qualification requirements can acquire certain types of structural products (Zemtsov, 2016).

In particular, only qualified investors have the right to invest in structural bonds, that is, those who have sufficient knowledge in the field of financial markets and are able to assess the market risks associated with the use of certain financial instruments (Gorlovskaya, 2017). A person who is not a qualified investor, to whom a product intended for qualified investors was sold, has the right to demand the termination of the relevant purchase and sale agreement and compensation by the broker (if a transaction was made through him) for the losses incurred by him (Gorlovskaya, 2020).

In addition, if a person is not a professional participant in the securities market, such a person should be assigned some duties traditionally related to professional participants in the securities market (Ghent et al., 2019). In particular, we are talking about information responsibilities, when such a person, “selling” a complex financial product to non-professional market participants, must disclose all information about all risks, explain for certain the mechanism of functioning of products, etc., so that the parties are not in a state of “information asymmetry” (Artemenko, 2019). Therefore, failure to fulfill such an obligation is fraught with the fact that, at the request of the injured party (Gryzunova et al., 2020):

- such a transaction may be declared as an invalid one. This is especially possible if it is established that the “seller” of the product acted intentionally to the detriment of the interests of the counterparty;
- the contract may be terminated at the request of one of the parties due to a material violation of the terms of the contract;
- if as a result of malicious or careless actions of the “seller” of the product, damage was caused to its “buyer”, then in this case the “buyer” has the right to claim compensation for the losses incurred by him.

#### **4. Discussion**

There is a wide variety of structured financial products, especially in the US and European markets. The volume of literature in which studies of this type of products are conducted in terms of investor categorization issues is growing (Zhilyuk and Skorokhod, 2020; Morozova, 2017). Structural financial products are criticized for the fact that their logic is too complex, but issuers, in order to attract more investors, appeal to such arguments as an increased level of profitability, full protection of invested funds, etc. It raises many questions that investors are not fully aware of the level of costs that are imposed on investors when choosing a product. The authors of this study show that issuers have an incentive to hide various kinds of costs when acquiring and handling a structured financial product in order to benefit from the inability of investors to notice or fully take into account all the types of commissions.

Against this background, the authors examined the current legislation and came to the conclusion that the separation of investors on formal grounds does not provide a mechanism for protecting various categories of investors, at the same time creating a problem of allowing investors into the market, including structural products.

Therefore, the proposal to the financial supervisory authorities regarding the improvement of the quality of categorization of investors consists of two parts: firstly, to introduce the practice of conducting a questionnaire so that it is possible to determine the list of assets with which the investor plans to work and which are suitable for the specified risk parameters; secondly, to improve the quality of the tests conducted to determine the level of knowledge of the investor in order to limit or expand the list of tools available to him. It is proposed to include such blocks as investment horizon, investment objective, expected profitability and risk attitude in the risk profiling questionnaire.

Thus, such proposals will help to increase the average level of profitability for structured financial products in general and improve the quality of customer service by improving categorization methods for qualified and unqualified investors at the legislative level.

## 5. Conclusion

Some types of instruments are traded on organized markets, and the order of their sale must comply with the rules of exchange trading established by the regulator and the organizer of trading (Entrop et al., 2018). Also, while purchasing securities on the exchange, the rules on clearing settlements (Krinichansky et al., 2022) must be observed, and in some cases – on settlements with the participation of a central counterparty.

Despite significant discrepancies in the interpretation of the term “structural product”, the grounds for fixing it in legislation and making it legal have not yet developed. This will become possible only if the economic literature unambiguously develops signs that individualize this phenomenon among other essentially similar phenomena. At the same time, given the collective nature of the term “structural product”, it should be noted that economics should ultimately develop such criteria. A structural product, as an artificial and synthetic phenomenon, in our opinion, should be regulated through the application to it of norms relating, respectively, to contracts or securities from which such a product is formed.

The problem of insufficient protection of unqualified investors in Russia in their interaction with the stock market remains very relevant today. Its causes are analyzed in the work and include, among other things, ignorance of investors, a distorted view of the properties of the purchased product, as well as low fiduciary standards of behavior of financial firms. The authors of this study are concerned about the lack of a clear consolidation of the rights and guarantees of the legitimate interests of unqualified investors when selling complex structured products to them.

Ensuring the rights and legitimate interests of this category of investors is, in our opinion, one of the most priority tasks of the Russian financial regulator. The authors see a possible way out as the introduction of special regulation, a brokerage service agreement at the legislative level and the consolidation of minimum guarantees of compliance with the interests of clients, since the general provisions of the Federal Law “On the Securities Market” and the relevant instructions of the Bank of Russia cannot be considered sufficient.

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