Legal Mechanisms in the Implementation of Stock Exchange Transactions, Current Problems and Proposals for Improvement

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Abstract

Legal regulation of stock exchange transactions is one of the most important mechanisms ensuring the sustainable development of the economy and the free and safe movement of capital. The presented research work is devoted to a comprehensive analysis of the existing legal mechanisms regulating the implementation of stock exchange transactions in the Republic of Azerbaijan. The article examines the national legislative framework, including the Civil Code and the application aspects of the Law "On Securities Market". At the same time, the activity of institutional mechanisms (clearing, settlement, brokerage, and listing) in the stock exchange trading process is analyzed. As a result of the research, a number of conceptual problems were identified, such as gaps in the legal regulation of derivative financial instruments, incomplete formation of the central counterpart (CCP) institution, ineffectiveness of legislation against insider trading, and violation of the rights of minority investors. In order to solve the problems, specific proposals for the modernization of legislation and ways to improve legal mechanisms were submitted, taking into account international experience, in particular the MiFID II directive of the European Union and the practice of advanced developed countries.

Keywords: stock exchange transactions, legal mechanism, securities market, central counterparty, insider trading, investor protection, derivative financial instruments

1.Introduction

One of the most important attributes of the global economy in the modern era is efficient and flexible financial markets. Stock exchanges, which constitute the core of financial markets, play an irreplaceable role in directing free capital to the real sector, ensuring transparency of the investment environment, and financing economic entities (El Wassal, 2013). The success of stock exchange activities depends on the perfection of the legal framework on which it is based, the effectiveness of regulatory mechanisms, and, at the same time, the freedom it provides to market participants. Each transaction, whether spot purchase or sale or complex derivatives, takes place within a strictly structured legal framework.

After the restoration of independence in the Republic of Azerbaijan, the formation of the financial sector, including the securities market, was one of the priority directions in the process of transition to a market economy. Although the establishment of the Baku Stock Exchange in 2000 was an important step in this area, the fact that the trading volume in the market was limited mainly to government securities for a long time and the weak integration of the corporate sector into this process required the revision of legal and institutional mechanisms. This necessity resulted in the adoption of the new Law "On the Securities Market" in 2015. However, the existence of a legislative framework does not guarantee the ideal functioning of all mechanisms in practice. In this regard, the analysis of existing legal regulatory mechanisms and the search for ways to bring them into line with international standards is extremely relevant.

The main object of this article is the legal mechanisms of stock exchange transactions carried out in the Republic of Azerbaijan. The purpose of the study is to reveal the shortcomings of the existing system, analyze persistent problems such as legal regulation of derivatives, sanction mechanisms against insider trading, central counterparty (CCP) functions, and protection of minority investors' rights, and provide real legal proposals for improvement.

2. The Concept and Legal Nature of Stock Exchange Transactions

Stock market transactions are civil-legal transactions concluded between trading participants on an organized and licensed platform, the stock exchange, within predetermined rules, standards, and time frames. However, unlike classical civil law contracts, stock market transactions are governed by a synthesis of both private (civil) and public (state regulation) legal norms (Azərbaycan Respublikasının Mülki Hüququ, 2008). The subject of such transactions, the method of price formation, the registration of the parties, and the process of execution of the transaction are completely subject to the internal regulations of the exchange and the instructions of the state financial control bodies.

From a legal point of view, the main features of stock exchange transactions include mass, standardization, transparency, and centralized execution. Behind each transaction is a chain of issuers, brokers (investment companies), clearing houses, depositories, and investors. The rights and obligations of each of these entities are regulated by specific legal documents - brokerage agreements, clearing rules, and exchange regulations. According to the terms of execution of transactions, they are divided into two main groups: spot (cash) transactions and forward (derivative) transactions. If in spot transactions the transfer of ownership and settlement occur in a short time (T+1, T+2), then in forward transactions (futures, options) the execution of the transaction is postponed to a future date (Hull & Basu, 2016).

3. Existing Legal Mechanisms in the Republic of Azerbaijan

The regulation of stock exchange operations in the Republic of Azerbaijan is based on a hierarchical legal system (Abbasov, 2007). The basis of this hierarchy is the Civil Code, which establishes the general principles of civil circulation of securities. More specific regulation is carried out through the Law "On the Securities Market" dated 2015. This law includes such fundamental issues as the provision of investment services, the establishment and management of the stock exchange, and the organization of post-trade infrastructure. The most important links that ensure the functioning of legal mechanisms are listing, brokerage, and clearing and settlement institutions.

The listing mechanism is the process of admitting securities to stock exchange trading (Qasımov & Həziyev, 2017). The Baku Stock Exchange (BSE) "Rules for Listing, Delisting and Organization of Trading" imposes strict financial, corporate governance, and accountability requirements on issuers. These requirements are designed to protect the interests of shareholders, in particular the general public. As for the intermediary mechanism, the legislation allows only licensed investment companies to participate directly in the stock exchange. Investors carry out their activities under civil law contracts concluded with these companies. The "Rules for the Implementation of Investment Services", approved by the Central Bank, precisely regulate how brokers should handle client funds.

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4. Clearing, Settlement, and Electronic Trading Platforms

The most complicated aspect from the legal side of stock exchange operations is the post-trade settlements (Qasımov & Həziyev, 2017). While the conclusion of the agreement is only the beginning, the actual transfer of property rights and money takes place during the process of clearance and settlement. At the moment in Azerbaijan, the function of clearance and settlement is provided by the National Depository Center (NDC) in line with the legal procedure defined by law. The key legal element of the work of the NDC is the "Delivery Versus Payment" (DVP) rule. It provides legally that the transfer of the securities to the buyer's deposit is done only after the total transfer of his money to the seller's account, reducing the risk of default of one of the parties to zero.

In addition, the introduction of the electronic trading systems (like the CETA system) led to the creation of new legal facts. Every order submitted into the system is legally considered an offer, and the deal is considered made when it is automatically combined in the system with the counter-offer. Legal protection of electronic signatures and digital audit trail serves as irrefutable proof in courts and arbitrations.

The most complicated legal procedure in stock exchange transactions is the post-trade settlement. It is not enough that a deal is done between the parties – the real property rights and money are transferred after the clearance and settlement procedure. In Azerbaijan, this procedure is conducted through the National Depository Center (NDC), according to the law-governed procedure. The key element of this process is the "Delivery Versus Payment" (DVP) rule. This rule legally guarantees that the securities are transferred from the seller's account to the buyer's only if the buyer transfers all his money to the seller's account, thus ensuring no chance of default by either side.

The introduction of electronic trading platforms (such as the CETA platform) has introduced certain legal procedures as well. Each electronic order put into the system is a legally valid offer, and the deal is considered concluded when it is automatically matched in the system with the corresponding counter-order. The recognition of electronic signatures and audit trails of deals is guaranteed by law and serves as irrefutable evidence in courts or arbitration of disputes.

5. Current Problems in the Legal Regulation of the Stock Market in Azerbaijan

However, in spite of the accomplished efforts and regular amendments to the legislation, there are some serious normative and practical issues in the Azerbaijani capital market, which hinder its development at the international level. The existing legal problems can be divided into four main categories: [9]

The first is the incompleteness of the regulation of derivative financial instruments (derivatives). Futures and options account for the majority of liquidity on modern stock exchanges. Although the Law of Azerbaijan "On Securities Market" provides a definition of derivatives, their trading procedures, margin (collateral) requirements, options execution mechanisms, and netting (mutual termination of obligations) system are not sufficiently codified. For this reason, local investors and corporate enterprises experience legal hesitations in insuring currency and commodity risks (hedging) through the national stock exchange.

Secondly, the mechanisms for combating the use of inside information and market manipulation are weak. The most important principle of stock exchange trading is equality of access to information (Bhattacharya & Daouk, 2002). The legislation prohibits the dissemination of inside information and the use of it to make a profit (Bhattacharya & Daouk, 2002). There are also appropriate sanctions in the Administrative Offenses and Criminal Codes. However, in practice, technological monitoring, investigation, and proof of such cases require extremely complicated legal procedures (Coffee, 2006). The almost complete absence of judicial precedents for insider trading in the country indicates that the legislation in this area is highly declarative.

Third, there are gaps in the real protection of the rights of minority shareholders (Gompers et al., 2003) (small investors who constitute a minority). The absolute power of majority (controlling) shareholders in listed joint-stock companies in management leads to the violation of the rights of minority investors (Gompers et al., 2003) when distributing dividends and concluding large transactions. Although civil legislation gives them the right to receive certain information and to apply to the court, the lack of a collective lawsuit (class action) mechanism makes it economically inefficient for small shareholders to protect their rights.

Fourth, the institution of the central counterparty (CCP) is not fully functioning. In international practice, the CCP assumes the settlement risks by acting as a buyer for the seller and a seller for the buyer for all transactions concluded between the parties. Although there are grounds for the establishment of this institution in national legislation, a special regulatory framework has not been formed on the limits of its legal liability, the rules for the formation of insurance funds, and legal protection in bankruptcy.

6. Comparative International Experience in the Legal Regulation of Stock Exchange Transactions

An examination of international practices reveals important aspects of how sophisticated capital markets have managed to deal with issues analogous to those faced by Azerbaijan today. A comparative study of the legislation in the sphere under consideration in the leading financial centers provides a solid basis for effective legislative changes (Kraakman & Armour, 2017).

The Markets in Financial Instruments Directive II (MiFID II), which came into force in 2018, is among the most extensive frameworks regulating the securities market in the European Union (Moloney, 2023). The main features of the directive include the stringent measures concerning pre- and post-trade transparency, algorithmic trading, product governance, and investor protection. In particular, the mandatory reporting for OTC derivatives via recognized Trade Repositories and the best execution obligation for investment firms are directly connected to the regulatory deficiency in Azerbaijan concerning derivative financial instruments.

In addition, the U.S. serves as an example in this regard, specifically with the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010) in reaction to the 2008 global financial crisis. Dodd-Frank requires the standard derivatives to be centrally cleared through CCPs; it implements powerful measures to protect whistleblowers, including monetary compensation of up to 30% of sanctions above one million dollars, and increases the powers of investigation of insider trading by the Securities and Exchange Commission (SEC). The whistleblower protection program of the SEC has been very successful: over five billion dollars in financial penalties have been obtained due to this program since its implementation. The above-mentioned example is directly related to the legislative suggestions made in the context of capital market reforms in Azerbaijan.

The regulatory sandbox initiative of Singapore also deserves mention. The Monetary Authority of Singapore (MAS) regulates the activities of FinTech firms in the regulatory sandbox regime established by the FinTech Regulatory Sandbox Guidelines of MAS. This approach has attracted numerous international fintech enterprises to Singapore's financial ecosystem and could serve as a direct template for Azerbaijan's proposed regulatory sandbox for digital assets and tokenized securities.

The example of Kazakhstan in terms of setting up the Astana International Financial Centre (AIFC) should be taken into consideration in the post-Soviet region. The AIFC runs according to a different set of laws and regulations based on the English common law system, with the existence of an independent court and arbitration center. Even though a complete implementation of this type of system is unlikely to happen in Azerbaijan anytime soon, some aspects, such as applying international standards for contract law and establishing an independent mechanism for dispute resolution for capital market players, can be used as near-term targets.

Finally, it is important to consider the experience of a neighboring country, Turkey, that has a similar legal tradition and a developing capital market. In 2012, the new capital markets legislation (Law No. 6362) was adopted in Turkey, which created a modernized legal system with increased protections for minority shareholders, wider CMB rights to prosecute market manipulations and insider trading, and solid legal ground for establishment of central clearing facilities. As a result, there has been a significant growth in participation of domestic retail investors and international institutional investors in the capital market of Turkey.

In conclusion, the examples of international practice analyzed above confirm that the efficiency of stock exchange regulation not only lies in the presence of laws but also is affected by the quality of their implementation mechanisms and the level of compliance with internationally recognized standards. The legislative reform in Azerbaijan should systematically take into account such precedents in order to promote the development of a competitive capital market.

7. Proposals for Improving the Legal Regulation of Stock Exchange Transactions

In order to resolve current problems and make the Baku Stock Exchange more attractive both on the local and regional levels, the country's laws need to be adjusted according to the advanced international legislation (for instance, the MiFID II directives of the European Union). The following legal adjustments need to be made:

1. Standardization of Derivatives Legislation: It is necessary to create a new chapter named "Derivatives Trading" within the Law "On Securities Market". The said chapter will contain all the regulations for managing margin accounts, the mandatory closure (margin call) procedure, and obligatory registration of OTC derivatives within the exchange system. In particular, the "Netting" transactions' priority in case of bankruptcy law needs to be established.

2. Legalization of the Central Counterparty (CCP) Mechanism: Legislative acts should be adopted to establish a full-fledged Central Counterparty based on the National Depository Center. The formation of guarantee funds for this institution, the legal consequences arising in the event of default by members, and legal ring-fencing to prevent these consequences from spreading to other market participants should be clearly stated.

3. Strengthening Control over Insider Trading: The Central Bank should be given administrative-investigative powers (e.g., access to subjects' communication traffic by court order, confiscation of computer records) to investigate market manipulation. Also, special norms on "whistleblower protection" should be adopted, and a mechanism for protecting the employment and financially rewarding individuals who report illegal activities within a company to the regulatory body should be established. Fines for market manipulation in the Criminal Code should be set at an amount that is several times the amount of illegally obtained profit.

4. Strengthening the Protection of Minority Shareholders: In publicly listed companies, it should be mandatory by law that at least one-third of the Supervisory Board members are independent directors. In addition, the application of norms limiting the participation of majority shareholders in voting when approving large-scale transactions and transactions with related parties will ensure the rights of minority shareholders.

5. Establishment of a Regulatory Sandbox for Digital Assets: A special legal regime should be created that provides for temporary and controlled exemption from licensing requirements for testing technological innovations, tokenized shares, and blockchain-based clearing systems. This will directly facilitate the attraction of foreign fintech companies to the Azerbaijani stock exchange ecosystem.

8. Conclusion

The conducted research and analysis show that the legal regulation of stock exchange operations in the Republic of Azerbaijan is being updated in parallel with the state's economic diversification goals. The 2015 legislation and subsequent regulatory steps taken by the Central Bank have significantly strengthened the foundation of the system. However, the existing legal framework is designed mainly for traditional spot markets and remains insufficient for complex derivatives, high-frequency electronic trading, and fully automated central counterparty systems that determine the dynamics of the global capital market.

It is necessary to implement the proposed legal reforms - in particular, tightening the legislation against insider trading, improving the mechanisms for protecting minority investors, and providing the Central Counterparty institution with full legal protection - in a phased manner. These improvements will not only fill legal gaps in the domestic market but will also foster the trust of foreign portfolio investors in our country, providing the Baku Stock Exchange with a reliable legal platform to become one of the leading financial centers of the Caspian region.

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