

**DERIVATIVES TRANSACTIONS:
A BASIC EXPLANATION OF THE PRODUCTS INVOLVED
AND A SUMMARY OF PERTINENT LEGAL COMPLIANCE CONSIDERATIONS**

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The world derivatives market is growing at a phenomenal rate, from virtually nothing in the mid 1970's to a \$7 trillion¹ world wide market today.² *IFR Swaps*, a swaps market publication, reported that interest rate swaps (a type of derivatives transaction) increased 25% during 1992³ and 29% during the first half of 1993.⁴ The revenues earned by derivatives dealers have also expanded. The Wall Street Journal reported that Merrill Lynch's derivatives-related revenue exceeded its stock-related revenue for 1993.⁵ Additionally, corporations and individuals are becoming increasingly involved in derivatives for hedging purposes as well as for speculative profit. As a result, it is becoming important for attorneys to have a basic understanding of derivative products, the relevant legal compliance issues, and the current derivatives regulatory environment. The purpose of this article is to provide attorneys with such an understanding.

After describing the derivatives market, this article details the most prevalent types of derivative products and how the transactions are implemented. Thereafter, the relevant legal compliance issues are outlined including documentation and the legal pitfalls which the practitioner must keep in mind when advising on a derivatives transaction. Finally, a summary of the current regulatory environment is provided.

THE DERIVATIVES MARKET

Securities firms and large commercial banks are the primary participants and the driving force behind the world derivatives market. A substantial portion of all derivatives are conducted between these parties. Additionally, commercial banks and securities firms enter into derivatives with corporations of all types, institutional investors, private investors, municipalities and essentially any entity or person which has a need for derivative products or desires to include such products as a part of an investment portfolio. The tremendous growth in the industry has required most large commercial banks and securities firms to form separate departments which handle nothing but derivative products.

Derivatives are financial transactions based upon one or more predetermined market factors where periodic payments (or a one-time lump-sum payment) are made by each of the parties to the transaction based upon the value of the market factor or factors. The amount of the payment(s) made by the parties during the term of the transaction will either: (i) be set at a fixed amount (i.e., based upon a fixed market factor such as a fixed rate of interest) or (ii) fluctuate as the value of the underlying market factor fluctuates. The underlying market factors are items or variables which are subject to market fluctuations; for example, interest rates, currency exchange rates, assets, stock prices, stock index levels, commodities or a combination of one or more of these factors.

Derivatives are normally used either as a hedging device or as an investment vehicle. For example, one type of hedging transaction involves a premium payment made by one party at the beginning of the transaction and a settlement payment made by the other party at the conclusion

of the transaction which is based upon a fluctuating market factor. A simple form of a hedging transaction is a commodity option based upon a given spot oil price. Under such a transaction one party will make a premium payment at the outset and the other party will make a one-time payment at the end of the transaction which is based upon the increase, if any, in the given spot oil price during the term of the transaction (if the price stays the same or decreases there is no final payment made by the other party). This allows the party which made the premium payment to fix (or hedge) its exposure to upward fluctuations in oil prices during the term of the transaction. As discussed in more detail below, derivatives can be constructed to hedge against downward movements in the market factor as well.

All types of derivatives are used for speculative investment. If a person feels that a given market factor, e.g. the Dow Jones Stock Index, will rise within the next six months, then he or she will purchase an index option based upon the movement of the Dow Jones Stock Index during the next six months. Such an option will pay proportionately to the increase in the Index during the term of the transaction.

The derivatives market originated from parallel and back-to-back loans (which primarily had the same effect as an interest rate or currency swap) between United States and United Kingdom corporations which were necessitated by the United Kingdom's regulatory environment. Banks acted as intermediaries for these transactions. The market has since evolved to the point where virtually anything which is market-driven can be used as the underlying mechanism controlling the transaction. For example, as alluded to above, derivatives are now based upon market factors such as stock index levels, bond prices or the reported profit figures of a given corporation.

Types of Derivative Products

For simplicity, this discussion of derivative products has been divided into four categories: (1) swap transactions; (2) swaptions; (3) options; and (4) forward rate agreements.

(1) Swap Transactions

There are two primary types of swap transactions: interest rate swaps and currency swaps. These transactions are sometimes referred to as "vanilla swaps." Interest rate swaps basically involve the exchange of an amount of interest determined at a fixed rate upon a given amount of money (the amount of money being the "notional" amount of the transaction) with an amount of interest determined at a given floating or variable rate on the same "notional" amount of money. For example, a corporation, Smartco, can obtain debt financing at the market prime rate ("Prime") + 2% but desires to fix all or a portion of its borrowing costs at a fixed rate of 7% (which it cannot obtain on the debt markets). Additionally, a commercial bank, Bankinc, can obtain fixed rate funds at 4% per annum, but requires variable rate funds to finance its lending activities and can obtain such funds at Prime. Both parties can benefit from entering into an interest rate swap.

Under transaction, Smartco makes periodic payments to Bankinc equal to the interest on a notional loan of a predetermined amount, e.g., \$10 million, at a fixed rate of 7% and Bankinc

