UNDERSTANDING FINANCIAL DERIVATIVES THROUGH THE CIVIL CODE*

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ABSTRACT

It is one thing to understand derivative transactions in finance, and it is another thing to understand their legal nature within the framework of the law on obligations and contracts. When their contractual validity and enforceability are in dispute, it is lawyers and judges who are called to the task of defining and interpreting their juridical character and effects, not the financial engineers who design them or the fund managers who use them. This paper proposes a way of understanding financial derivatives from the viewpoint of legal professionals, pursuant to the most authoritative statutory guidance on contractual defects: the Civil Code. *First*, this paper shows why textbook definitions of financial derivatives are inadequate for the purpose of legal analysis, particularly when contractual validity and enforceability issues are involved. *Second*, it examines the juridical character of the three major classes of derivatives (forwards, swaps, and options), and proposes legal definitions that distinguish these instruments from other securities, pooled investments, insurance, and wagering transactions. From this, it extrapolates a general legal definition of derivatives. *Finally*, this paper applies the proposed legal definitions in examining the legal status of (i) Philippine index futures, (ii) bilateral hedging contracts in the Wholesale Electricity Spot Market, and (iii) Philippine Depositary Receipts.

I. INTRODUCTION

There is only one provision in the Civil Code that explicitly describes a financial derivative.[1] It pertains to a simulated sales contract whereby two parties, without contemplating an actual delivery of the object of sale, merely exchange the difference between the stipulated price at

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[1] CIVIL CODE, art. 2018.

present time and the object's market price at some future time.[2] This is precisely the description of a standard "non-deliverable forward", otherwise called "cash-settled forward" or "contract for difference."[3] It is a valid, legitimate, and enforceable risk management tool in energy markets all over the world,[4] except in the Philippines, where it is void under Article 2018 of the Civil Code if it covers "goods, securities or shares of stock" as underlying assets.

There is only one Supreme Court Decision that thoroughly discusses the nature of a financial derivative: *Onapal Philippines Commodities, Inc. v. Court of Appeals*.[5] The central issue in the case involves the validity of a written trading agreement that bears the earmarks of a commodity futures contract,[6] which is essentially a sales contract with future delivery, and customarily settled through the offsetting of the stipulated price (called the "forward price") and future market price (called the "spot price").[7] The Court did not rule that all commodity futures contracts fall under Article 2018.[8] It did not characterize this particular derivative as a gambling agreement, which is void.[9] Instead, it ruled that the "transaction implementing the contract" constituted gambling because the parties, wanting to wager on the movement of commodity prices in the Tokyo Exchange, did not intend to deliver the commodity.[10] Therefore, the

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[2] Art. 2018. "If a contract which *purports* to be for the delivery of goods, securities or shares of stock is entered into with the intention that the difference between the price stipulated and the exchange or market price at the time of the *pretended* delivery shall be paid by the loser to the winner, the transaction is *null and void.* The loser may recover what he has paid." (Emphasis supplied.)

[3] Andrew Lepone & Jin Yang, *Informational Role Of Market Makers: The Case Of Exchange Traded CFDs*, 23 J. EMPIRICAL FIN. 84-92 (2013); Donald Lien & Yiu Kuen Tse, *Physical Delivery Versus Cash Settlement: An Empirical Study On The Feeder Cattle Contract*, 9 J. of Empirical Fin. 4, 361-371 (2002).

[4] *See* Napeng Yu, Abhishek Somani & Leigh Tasfatsion, *Financial Risk Management In Restructured Wholesale Power Markets: Concepts And Tools*, POWER AND ENERGY SOCIETY GENERAL MEETING, IEEE, 1-8 (2010).

[5] Hereinafter "*Onapal*," G.R. No. 90707, 218 SCRA 281, Feb. 1, 1993.

[6] *Id.* at 289. "As a contract in printed form, prepared by petitioner and served on private respondent, for the latter's signature, the trading contract bears all the indicia of a valid trading contract because it complies with the Rules and Regulations on Commodity Futures Trading as prescribed by the SEC."

[7] Gary Gorton & K. Geert Rouwenhorst, *Facts And Fantasies About Commodity Futures*, 62 FIN. ANALYSTS J., 2, 47-68 (2006).

[8] *Onapal*, 218 SCRA at 290 (1993). "The written trading contract in question is not illegal[.]"

[9] *Id.* at 289. "The trading contract signed by private respondent and Albert Chiam, representing petitioner, is a contract for the sale of products for future delivery[.]"

[10] *Id.* "[W]hen the transaction which was carried out to implement the written contract deviates from the true import of the agreement as when no such delivery, actual or

"transaction implementing the contract," not the contract itself, is void under Article 2018.[11]

This distinction is specious. There is a reason why commodity futures are not simply called sales contracts: from the onset, parties do not expect and do not intend to effectuate delivery.[12] They engage in these transactions only for three purposes: arbitrage, hedging, or speculation.[13] Commodity futures are usually entered into by banks, trust funds, investment houses, and other entities that have nothing to do with the business of trading physical goods.[14] Although there is a standard delivery clause stipulated in their Master Agreement,[15] and there is legally nothing that prevents the parties from enforcing their option to deliver,[16] non-delivery is the norm and delivery is the exception.[17]

What Article 2018 seems to characterize as a void gambling agreement is an indispensable feature of derivative transactions, i.e. "offsetting" or "netting" arrangements, or the payment of the difference between the stipulated price at one time and the market price at a later time as a substitute for the delivery of the underlying asset.[18] In certain cases, offsetting is not merely a mode of implementation, but an integral element of the derivative contract, without which it becomes an ordinary nominate contract, like a sale or loan.[19]

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constructive, of the commodity or goods is made, and final settlement is made by payment and receipt of only the difference in prices at the time of delivery from that prevailing at the time the sale is made, the dealings in futures become mere speculative contracts in which the parties merely gamble on the rise or fall in prices."

[11] *Id.* at 290. "[T]he transaction between the petitioner and the private respondent purportedly to implement the contract is in the nature of a gambling agreement and falls within the ambit of Article 2018 of the New Civil Code."

[12] Leland Johnson, *The Theory Of Hedging And Speculation In Commodity Futures*, 27 THE REV. OF ECON. STUD. 3, 139-151 (1960).

[13] Svitlana Denga & Akansha Jain, *Definition, Classification And Use Of Derivative Financial Instruments*, 71 OBLIK I FINANSI 90 (2016).

[14] Hassan Tanha & Michael Dempsey, *Derivatives Usage In Emerging Markets Following The GFC: Evidence From The GCC Countries*, 53 EMERGING MARKETS FIN. AND TRADE 1, 170-179 (2017).

[15] Jeffrey Golden, *Setting Standards In The Evolution Of Swap Documentation*, 13 INT'L FIN. L. REV. 18 (1994).

[16] David Lynn, *Enforceability Of Over-The-Counter Financial Derivatives*, 50 THE BUS. LAW. 1, 291-337 (1994).

[17] Shie-Jie Deng & Shmuel Oren, *Electricity Derivatives And Risk Management*, 31 ENERGY 6, 940-953 (2006).

[18] Robert Bliss & George Kaufman, *Derivatives And Systemic Risk: Netting, Collateral, And Closeout*, 2 J. OF FIN. STABILITY 1, 55-70 (2006).

[19] *See, e.g.*, Donald Lien & Yiu Kuen Tse, *Physical Delivery Versus Cash Settlement: An Empirical Study On The Feeder Cattle Contract*, 9 J. OF EMPIRICAL FIN. 4, 361-371 (2002)

The bigger question, therefore, is whether all derivatives, insofar as they are settled through offsetting arrangements, are defective contracts under the Civil Code. The apparent answer is that derivatives are valid and enforceable because the Securities Regulation Code ("SRC") recognizes these as a legitimate and registrable security,[20] and the Bangko Sentral ng Pilipinas ("BSP") sanctions and regulates their use as financial instruments by banks.[21] However, it is the Civil Code, not SRC or BSP regulations, that ultimately provides authoritative guidance on contractual validity, enforceability, and defects.

While derivatives are legally recognized in Philippine statute books, the standard clauses and customary commercial practices surrounding their use are susceptible to being characterized as gambling arrangements.[22] If these clauses and practices are rendered void or unenforceable, then existing derivatives transactions are exposed to a costly legal risk, and there is no chance for the nascent Philippine derivatives market to further develop if the legality of derivatives is always uncertain.[23] It is also noted that there has been no attempt to examine the legal nature of financial derivatives in Philippine jurisprudence or legal research.[24] This is why it is offered that there be a legal definition and interpretation of derivatives, informed by concepts from the law on obligations and contracts in the Civil Code, for the guidance of lawyers and judges in possible legal disputes about the nature and effects of derivatives.

II. PHILIPPINE DERIVATIVES MARKET AND REGULATION

The Philippine derivatives market is largely underdeveloped. In 1985, the Manila International Futures Exchange ("MIFE") served as the

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(providing the switch of feeder cattle and live/lean hogs contracts from physical to cash settlement in the Chicago Mercantile Exchange).

[20] SEC. REG. CODE, § 3. Rep. Act No. 8799 (2000).

[21] BSP Circ. No. 594 (2008).

[22] *See* SEC. REG. CODE, Rep. Act No. 9160 (2001) or the "Anti-Money Laundering Act of 2001", Rep. Act No. 9238 (2004), Rep. Act No. 9337 (2005), Rep. Act No. 9856 (2009) or "The Real Estate Investment Trust (REIT) Act of 2009", and Rep. Act No. 10365 (2013).

[23] Lynn, *supra* note 16.

[24] For a sample legal analysis of financial derivatives, *see, e.g.* Hock Beng Lee, *The English Courts' View Of Financial Derivatives* (2016), *available at* researcharchive.vuw.ac.nz/handle/10063/6325 (last accessed on Dec. 21 2017); Bashar H. Balkawi, *Financial Derivatives Between Western Legal Tradition And Islamic Finance: A Comparative Approach*, 15 J. OF BANKING REG. 1, 41-55 (2014).

only organized exchange for the trading of financial derivatives in the Philippines.[25] It was closed down in 1997 by the SEC.[26] Trading of commodity futures has also been suspended pursuant to the SRC.[27] There is currently no trading platform for derivatives in the Philippines and all derivative transactions are conducted over-the-counter.[28] In 2010, the International Monetary Fund ("IMF") reported that the notional amount of stand-alone derivatives in Philippine banks averaged USD 50 billion between February 2008 and August 2009, while the notional amount of embedded derivatives averaged USD 275 million for the same period.[29]

The SEC serves as the main regulatory agency for the issuance and registration of derivatives, while the BSP exercises regulatory oversight over derivatives activity in financial institutions. The main sources of regulatory rules on financial derivatives in the Philippines are the 2015 Implementing Rules and Regulations ("IRR") of the SRC and BSP Circular No. 594, series of 2008. The former provides guidance on the public offering, issuance, and registration of derivatives,[30] while the latter provides a list of allowable derivative transactions among financial institutions.

There is no statutory or administrative guidance on the formulation and contractual design of financial derivatives. This area is left to commercial customary practices, such as the use of International Swaps and Derivatives Association ("ISDA") Master Agreements, which set out uniform terms and conditions of some standard derivative transactions.[31] To date, there is no Supreme Court jurisprudence applying, interpreting, legitimating, or invalidating any of the standard clauses in the ISDA Master Agreements. This also signifies the lack of derivatives market activity in the Philippines.

The SEC and self-regulated organizations ("SROs") are exploring prospects for setting up a derivatives exchange. In 2013, the Philippine Stock Exchange (PSE) and the Singapore Exchange Ltd. (SGX) agreed to

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[25] Lourdes Treviño, *Development And Volume Growth Of Organized Derivatives Trade In Emerging Markets*, 24 ENSAYOS REVISTA DE ECONOMIA 2, 31-82 (2005).

[26] *Id.*

[27] SEC. REG. CODE, § 11.

[28] Lawrence Velasco, *Factors Influencing Derivatives Usage By Selected Listed Companies In The Philippines*, 21 PHIL. MGMT. REV. (2014).

[29] *Id.*

[30] 2015 Implementing Rules and Regulations (IRR) of SEC. REG. CODE, § 12.1.3.

[31] Sean Flanagan, *The Rise Of A Trade Association: Group Interactions Within The International Swaps And Derivatives Association*, 6 HARV. NEGOT. L. REV. 211 (2001).

develop a trading infrastructure for Philippine index futures.[32] In 2016, the SEC reported that it is interested in proposals for the creation of an infrastructure for a futures market.[33] In the first quarter of 2017, the Philippine Electricity Market Corp. ("PEMC") stated that it is conducting feasibility studies in the development of an electricity derivatives market.[34] In the third quarter of 2017, the PSE bared its plans to launch surveillance services for interest rate swaps, and develop exchange-traded funds, new indices, structured warrants, and other financial derivatives.[35] Philippine derivatives market activity is expected to gain more prominence once more sophisticated financial instruments are introduced and an organized derivatives exchange is in place.

III. INADEQUACY OF TEXTBOOK DEFINITION OF DERIVATIVES FOR LEGAL ANALYSIS

Textbook definitions of financial derivatives do not give a clear legal conception of their nature and juridical character.[36] As a result, the line between derivatives and other contracts become blurred, so that it can be difficult for a lawyer or judge to distinguish it from an ordinary security, insurance contract, pooled investment, wagering transaction, or pure casino bet.[37] Consider the following definitions from the 2015 Implementing Rules and Regulations (IRR) of the SRC, the IMF, and the U.S. Department of Treasury:

1. "Derivative [sic] is a financial instrument whose value changes in response to changes in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates,

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[32] Neil Morales, *PSE, SGX launch Phl-linked derivatives*, PHILSTAR, Nov. 13 2013, *available at* http://www.philstar.com/business/2013/11/13/1255941/pse-sgx-launch-phl-linked-derivatives.

[33] Keith Mariano, *SEC sees derivatives demand amid rising uncertainty*, BUSINESSWORLD, Nov. 1 2016, *available at* http://www.bworldonline.com/content.php?section=TopStory&title=sec-sees-derivatives-demand-amid-rising-uncertainty&id=135681.

[34] Victor Saulon, *PEMC undertakes feasibility study into power derivatives market*, BUSINESSWORLD, Mar. 7 2017, *available at* http://www.bworldonline.com/content.php?section=Economy&title=pemc-undertakes-feasibility-study-into-power-derivatives-market&id=141768.

[35] Doris Dumlao-Abadilla, *PSE to launch short-selling, other products in 2018*, PHIL. DAILY INQUIRER, Oct. 18, 2017, *available at* http://business.inquirer.net/238792/pse-launch-short-selling-products-2018.

[36] *See* Timothy E. Lynch, *Derivatives: A Twenty-First Century Understanding*, 43 LOY. U. CHI. L.J. 1 (2011).

[37] *Id.*

credit rating or credit index, or similar variable or underlying factor."[38]

2. "Financial derivatives are financial instruments that are linked to a specific financial instrument or indicator or commodity, and through which specific financial risks can be traded in financial markets in their own right."[39]

3. "A derivative is a financial contract whose value is derived from the performance of some underlying market factors, such as interest rates, currency exchange rates, and commodity, credit, or equity prices."[40]

A. Evaluation of the Textbook Definitions

What can a lawyer or judge make of these definitions? *First*, a derivative always involves a reference variable, which may or may not even be an object capable of appropriation.[41] Note how the phrase "underlying asset" is avoided. Other textbooks and finance literature simply use the word "underlying."[42] The intent is not to restrict the "underlying" to property or assets.[43] Its nature is deliberately kept vague, which is why the definitions above use the terms "variable," "underlying factor," and "market factor," so that it can literally mean anything that takes on a numerical value.[44] This has given rise to several exotic derivatives, such as weather derivatives, interest rate derivatives, inflation derivatives, and other derivatives whose payoffs or values do not depend on transactions involving property.[45] This is also why financial derivatives are reputed to be mere wagering transactions, similar to

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[38] 2015 IRR of SEC. REG. CODE, § 3.1.9.

[39] Robert Heath, *The Statistical Measurement of Financial Derivatives*, INTERNATIONAL MONETARY FUND WP/98/24 (1998), *available at* https://www.imf.org/en/Publications/WP/Issues/2016/12/30/The-Statistical-Measurement-of-Financial-Derivatives-2514.

[40] Office of the Comptroller of the Currency, *Derivatives*, U.S. Department of Treasury, *available at* https://www.occ.treas.gov/topics/capital-markets/financial-markets/derivatives/index-derivatives.html (last accessed Mar. 15 2017).

[41] Lynch, *supra* note 36.

[42] Jordan Barry et al., *Amicus Curiae Brief in Gelboim v. Bank of America (Libor Manipulation Litigation) on Behalf of Financial Markets Law Professors in Support of Plaintiffs-Appellants* (2016), *available at* https://ssrn.com/abstract=2839130 (last accessed Mar. 17 2017).

[43] Lynch, *supra* note 36.

[44] *Id.*

[45] Melanie Cao, et al. , *Weather Derivatives: A New Class of Financial Instruments* (2003), *available at* https://ssrn.com/abstract=1016123 (last accessed on Mar. 15 2017); Aakansha Ranjan, et al., *Financial Aspects of Interest Rate Derivative* (2013), *available at* https://ssrn.com/abstract=2329351 (last accessed Mar. 15 2017).

a bet in a horse race.[46] This conception presents a problem in Philippine jurisdiction because wagering transactions are void and unenforceable.[47]

Second, the presence of any title or interest over the underlying asset by any party is irrelevant.[48] The definitions above make no mention of any contract involving the underlying asset. Two parties can enter into a derivative transaction without holding title over the asset subject of the derivative transaction.[49] And when the derivative contract stipulates clauses that have the semblance of a sale, exchange, transfer, or assignment of asset, the parties can ultimately settle their obligations and terminate the transaction without any title passing from one party to the other, through offsetting arrangements.[50] This further blurs the line between financial derivative and gambling agreement, and financial derivative and simulated contracts.[51]

Third, payoffs are contingent on the value of the underlying asset or reference variable, but the definitions do not state the jural relationships that justify the payoffs.[52] An insurance contract gives rise to a payoff in the form of an insurance claim when an insurable loss occurs, and this payoff is justified by the juridical concept of "indemnity".[53] A share of stock gives rise to a payoff in the form of dividends when declared by the Board of Directors, and this payoff is justified by the juridical concept of "stock ownership".[54] A loan gives rise to a payoff in the form of interests, and this payoff is justified by the juridical concept of *mutuum*.[55] In the case of derivatives, there seems to be no conceivable juridical justification for the existence of such payoffs. While the insurance claim is contingent on the

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[46] Lynch, *supra* note 36.

[47] CIVIL CODE, art. 2018.

[48] Lynn Stout, *Derivatives and The Legal Origin of the 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1 (2011) ("[D]erivatives are in essence agreements that do not involve any immediate payment or transfer of assets, but only the exchange of mutual promises to pay some amount of money determined by the performance of a currency, interest rate, commodities price, stock, or stock index.")

[49] Eric Posner & E. Glenn Weyl, *An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to 21st Century Financial Markets*, 107 NW. U. L. REV. 1307 (2013).

[50] Timothy Lynch, *Gambling By Another Name: The Challenge Of Purely Speculative Derivatives*, 17 STAN. J.L. BUS. & FIN. 67 (2011).

[51] Gregory Scopino, *The (Questionable) Legality of High-Speed 'Pinging' and 'Front Running' in the Futures Markets*, 47 CONN. L. REV. 607 (2015).

[52] Kelly S. Kibbie, *Dancing with the Derivatives Devil: Mutual Funds' Dangerous Liaison with Complex Investment Contracts and the Forgotten Lessons of 1940*, 9 HASTINGS BUS. L.J. 195 (2013).

[53] Posner & Weyl, *supra* note 49.

[54] Roy III v. Herbosa, G.R. No. 207246, Apr. 18, 2017.

[55] Spouses Sy v. Westmont Bank, G.R. No. 201074, 806 SCRA 541, Oct. 19, 2016

extent of the loss, the dividend amount on percentage of stock ownership, and interest on the principal amount of the loan and the agreed interest rate, the payoffs in derivatives purely depend on price movements of assets over which the parties may or may not have any interest at any time during the contract.[56]

Fourth, the definitions are so broad that they include all securities and pooled investments.[57] For instance, units of participation in a mutual fund or Unit Investment Trust Fund are also financial instruments whose values depend on the underlying securities and assets held by an investment company, trust fund, or other pooled investment vehicles, and yet these are clearly not financial derivatives, but ordinary securities representing participation rights in companies that further invest in securities.[58]

Fifth, while financial derivatives are included in the definition of "securities" under the SRC,[59] and warrants and options are included in the definition of "shares of stock" under the National Internal Revenue Code (NIRC) of 1997,[60] derivatives have no discernible resemblance with shares, bonds, and other securities. Securities, in general, are defined as units of participation in the profits of an enterprise.[61] They always involve an issuer, whose purpose is to raise capital for the enterprise.[62] This is not so in the case of derivatives. Derivatives do not bestow participation in the profits of an enterprise.[63] They need not be issued by an issuer,[64] and they are not entered into for financing.[65] They are simply contracts between two parties who exchange payoffs based on the numerical values of a reference variable, which may or may not involve the shares or bonds of an enterprise.[66]

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[56] Timothy E. Lynch, *Coming Up Short: The United States' Second-Best Strategies for Corralling Purely Speculative Derivatives*, 36 CARDOZO L. REV. 545 (2014).

[57] Lynch, *supra* note 36.

[58] Sameer Jain, *An Introduction to Alternative Investments* (2014), *available at* https://ssrn.com/abstract=2408144 (last accessed Mar. 15, 2017).

[59] SEC. REG. CODE, § 3(1)(d).

[60] TAX CODE, § 22(L).

[61] SEC. REG. CODE, § 3(1).

[62] SEC. REG. CODE, § 3(2).

[63] T.V. Somanathan and V.A. Nageswaran, *Definition and Typology*, THE ECONOMICS OF DERIVATIVES (2015).

[64] Baitshepi Tebogo, *Financial Derivatives in Theory* (2011), *available at* https://ssrn.com/abstract=1918724 (last accessed Mar. 15, 2017).

[65] Eddy Wymeersch, *Regulation and Case Law Relating to Financial Derivatives*, University of Ghent Financial Law Institute Working Paper No. 2012-03 (2012), *available at* https://ssrn.com/abstract=1988925 (last accessed Mar. 15, 2017).

[66] Colleen M. Baker, *Regulating The Invisible: The Case Of Over-The-Counter Derivatives*, 85 NOTRE DAME L. REV. 1287 (2009).

B. Derivatives and Gambling

What the definitions also do not mention is that all derivatives are zero-sum games, such that one party has a positive payoff only if the other has a negative payoff.[67] In short, there will always be one party that emerges as the "winner" and another party as the "loser."[68] This sounds like plain vanilla gambling, yet our statutes and regulations treat derivatives as legitimate business transactions.[69] For this, we need to get a clear picture of the meaning of "gambling."

We define a gambling contract as an agreement between two parties to exchange a sum of money contingent upon the happening of a random event, whereby one party emerges as the winner and the other emerges as the loser.[70] Consider a game of baccarat as a contract between a player and the house. The contract has the following elements: a random event, a finite set of discrete outcomes, an experiment, a bet, and a zero-sum payoff structure. The random event is the drawing of cards. The set of possible outcomes are "banker" or "player". The experiment refers to a particular act of drawing cards to produce one outcome. The player and house make a bet by guessing the outcome of an experiment, and attaching a peso amount to that guess. The payoff structure is as follows:

Outcomes	Bet	Payoff multiplier	Payoff	Profit (Loss)
Win	1,000.00	2	2,000.00	1,000.00
Lose	1,000.00	-	-	(1,000.00)

The payoff structure has a zero-sum character. One player's gain is another's loss. The winner's prize is funded by the loser's bet. There can be no doubt, therefore, that a game of baccarat is a gambling contract.

The same can almost be said about derivative transactions. This is not because derivatives are gambling contracts, but because something has

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[67] Lynch, *supra* note 50.

[68] Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, And Insurance*, 24 ANN. REV. BANKING & FIN. L. 375 (2005).

[69] Steven D. Levitt, *Why Are Gambling Markets Organised So Differently From Financial Markets?*, 114 THE ECON. J. 495, 223-246 (2004).

[70] Lynn A. Stout, *Insurance or gambling?*, 14 THE BROOKINGS REV. 1 (1996).

been left unsaid in the textbook definitions. What is missing is the legal conception of "derive." The important legal question is: how does a derivative "derive" its value from an underlying asset or reference variable?

What is also missing from the definitions is the meaning of "payoffs." Payoffs in derivative transactions do not mean the same thing as insurance claims, dividends, interests, or returns when one talks about an ordinary insurance contract, share of stock, bond, or any other security. In the following sections, we will show that this process of "deriving" payoffs from a derivative contract is a result of several legitimate and valid jural relations that have become merely non-obvious because of the speed of transactions and efficiency of the financial markets.

IV. PROPOSED LEGAL DEFINITIONS OF DERIVATIVE INSTRUMENTS

There are three general types of derivatives: forwards, swaps, and options.[71] We shall discuss them individually in the following sections. Each section provides a textbook definition of the derivative instrument, followed by an application and criticism of the textbook definition, and the proposed legal definition. From these individual discussions, we shall extrapolate a general legal definition of derivatives.

A. Forward Contract

The textbook definition of a forward contract is: "[A]n over-the-counter derivative contract in which two parties agree that one party, the buyer, will purchase an underlying asset from the other party, the seller, at a later date and at a fixed price they agree upon when the contract is signed."[72]

To illustrate, suppose XYZ Airline Co. regularly purchases fuel for its fleet from ABC Oil Co. One major problem faced by XYZ Airline Co.'s management is the volatile fluctuation of the price of fuel in the market, exposing the company to cost unpredictability that materially affects its earnings performance. To manage this risk, the management of XYZ Airline Co. negotiates with ABC Oil Co. to lock in the price of fuel within a specified future period. It can do this by entering into a simple sales contract

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[71] These instruments may appear under different variants, such as "caps", "floors", and "collars". *See, e.g.,* Martin J. Luby, *The Use Of Financial Derivatives In State And Local Government Bond Refinancings: Playing With Fire Or Prudent Debt Management?*, 24 J. OF PUB. BUDGETING 1 (2012).

[72] *See* WENDY L. PIRIE, DERIVATIVES WORKBOOK: CFA INSTITUTE OF INVESTMENT SERIES (2017).

with purchase orders committed in advance, with the fuel to be delivered at specified future dates, and with prices fixed as of the date of perfection of the contract. Hence, even if the price of fuel fluctuates 10 months from the date of perfection, XYZ Airline Co. is only liable to pay the price fixed in advance. It becomes indifferent to price movement within the period of the contract. Meanwhile, ABC Oil Co. absorbs the risk of future price fluctuation: it is better off if the price of fuel at time of delivery is below the stipulated price, and it is worse off if otherwise. The price risk was transferred from the buyer to the seller. Under the textbook definition, the sales contract with future delivery entered into by XYZ Airline Co. constitutes a forward contract.[73]

This definition, however, is imperfect because it merely describes a simple sales contract. The contract is perfected upon the fixing of the object and the price, even though the delivery happens at a later time. Nothing is surprising about this, because sale is a consensual contract and title over the object need not lie on the seller at the time of perfection; price can be fixed in advance, while the seller need only to have ownership of the object at the time of delivery.[74] This is not very helpful to lawyers, courts, and regulators in appreciating the nature of a forward contract as a derivative transaction.

To gain a more accurate view of how forward contracts are used in the real world, consider the same fuel price fluctuation problem. To recall what we have stated in the introduction, parties engage in derivative transactions only for three purposes: arbitrage, hedging, or speculation. In the case of XYZ Airline Co., management wants to create a perfect hedge, in the sense that it wants to completely eliminate the risk of price fluctuation by committing to a fixed future price at the present time.[75]

Suppose that XYZ Airline Co. anticipates a significant increase in purchase price in ten months, but is unable to negotiate with ABC Oil Co.

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[73] *See, e.g.,* Vadhindran K. Rao, *Fuel Price Risk Management Using Futures*, 5 J. OF AIR TRANSPORT MGMT. 1, 39-44 (1999).

[74] Alcantara-Daus v. Sps. De Leon, G.R. No. 149750, June 16, 2003. ("[T]he seller's ownership of the thing sold is not an element in the perfection of the contract of sale.")

[75] *See, e.g.,* Christopher L. Culp & Barbara T. Kavanagh, *Structured Commodity Finance After Enron: Uses and Abuses of Prepaid Forwards and Swaps, in* CORPORATE AFTERSHOCK: THE PUBLIC POLICY LESSONS FROM THE COLLAPSE OF ENRON AND OTHER MAJOR CORPORATIONS 174 (2003). ("Consider, for example, a firm that is buying natural gas in Tulsa, Oklahoma, from a pipeline with a supply source in San Angelo, Texas. If that firm seeks to lock in its future purchase price for gas to protect against unexpected price spikes, it might enter into a forward purchase agreement with Enron, thus leaving Enron to bear the risk of a price increase.")

to lock in the price of fuel at existing rates. Nevertheless, XYZ Airline Co. continues engaging in "spot" transactions (i.e. sale with immediate delivery at market price as of date of delivery) with ABC Oil Co. In this case, XYZ Airline Co. absorbs the risk of future price fluctuation because the price is not fixed in advance.[76]

Suppose, too, that TUV Hedge Fund has a different view about future prices of fuel and in fact expects a decrease in price. XYZ Airline Co. then enters into a forward contract with TUV Hedge Fund, with XYZ Airline Co. as the buyer and TUV Hedge Fund as the seller. It is important to note, however, that TUV Hedge Fund is a financial institution. It is not engaged in the business of supplying fuel. XYZ Airline Co. is aware of this, and does not expect TUV Hedge Fund to actually deliver the fuel in 10 months (recall that XYZ Airline Co.'s spot sales contract with ABC Oil Co. subsists). Nevertheless, a uniform forward contract still contains a standard stipulation on physical delivery, so that if the buyer opts for the underlying asset, the parties may legally enforce actual delivery. XYZ Airline Co., however, also has the option to settle in cash, or to "offset" their financial positions on the date of delivery,[77] so that their obligations on the 10th month are as follows:

1. If the market price on the 10th month is *more than* the price stipulated on the 1st month, then TUV Hedge Fund will pay the difference to XYZ Airline Co., and

2. If the market price on the 10th month is *less than* the price stipulated on the 1st month, then XYZ Airline Co. will pay the difference to TUV Hedge Fund.[78]

This offsetting arrangement occurs in cash-settled forwards.[79] The seller in a forward contract, instead of delivering the physical commodity, pays the market value of the commodity at the time of delivery. The buyer, on the other hand, pays the stipulated purchase price. But to offset their

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[76] *See e.g.,* Jayashree B. Gokhale, *Hedge To Arrive Contracts: Futures Or Forwards*, 53 DRAKE L. REV. 55 (2004); Chris Attfield, et al. *Options And Forwards Compete For Best Hedge*, 1 QUANTITATIVE FIN. 1 (2001).

[77] For various examples of creating offsetting positions through forwards, *see* ARON A. GOTTESMAN, DERIVATIVES ESSENTIALS: AN INTRODUCTION TO FORWARDS, FUTURES, OPTIONS, AND SWAPS 1 (2016).

[78] The pricing and valuation of forwards and futures are more complicated in reality. *See, e.g.,* MICHEL VELLEKOOP, *FORWARDS AND FUTURES*, ENCYCLOPEDIA OF QUANTITATIVE FINANCE (2010).

[79] Lien & Tse, *supra* note 19.

mutual monetary obligations, the seller will simply pay or receive the balance to or from the buyer. Through the forward contract, XYZ Airline Co. has perfectly hedged the risk of price fluctuation. If the market price increases in 10 months, XYZ Airline Co. pays the increased market price to ABC Oil Co., but at the same time it receives the difference between the market price and the stipulated price from TUV Hedge Fund. If the market price decreases in 10 months, XYZ Airline Co. pays the decreased market price to ABC Oil Co., but instead of pocketing the savings, it pays the difference between prices to TUV Hedge Fund.[80]

Based on this scenario, there are two elements that distinguish the forward contract from an ordinary sales contract: (i) the existence of an alternative prestation to deliver the object or to pay the market price of the object, and (ii) a provision for mutual compensation ("offsetting") should the buyer choose the latter prestation. Hence, our proposed legal definition of a forward contract is as follows:

> A forward contract is a sales contract, with future delivery date, a pre-determined fixed price (called the "forward price"), and an alternative prestation on the part of the seller (i) to deliver the object, or (ii) to pay the object's market price (called the "spot price") as of the time of delivery, at the option of the buyer. If the buyer chooses the latter prestation, the forward price and spot price at the time of delivery shall be mutually compensated, and the party having residual debt after the set-off shall pay the balance to the other.

Is this a gambling agreement? If it is, then it is for a legitimate business purpose: to hedge the risk of price fluctuation. XYZ Airline Co. bets that the price of fuel will rise, while TUV Hedge Fund bets that the price of fuel will drop. It is a zero-sum game whereby one party emerges as winner and the counter-party as the loser. But it is not true that XYZ Airline Co. is purely speculating on the rise and fall of fuel prices. It has a valid interest in eliminating risk. It does not seek to be enriched by the transaction. In fact it becomes indifferent to the price of the commodity.[81]

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[80] For a more complete explanation on the uses of cash settlement, *see* Lien & Tse, *supra* note 19.

[81] For examples of legitimate hedging transactions through forward contracts, *see* Wayne R. Guay & S.P. Kothari, *How Much Do Firms Hedge With Derivatives?*, 70 J. OF FIN. ECON. 3, 423-461 (2003); Bernadette A. Minton et al. *How Much Do Banks Use Credit Derivatives To Hedge Loans?*, 35 J. OF FIN. SERVICES RES. 1, 1-31 (2009).

To operationalize the hedging transaction, XYZ Airline Co. enters into two contracts: the spot sales contract with ABC Oil Co., and the forward contract with TUV Hedge Fund. The spot sales contract exposes XYZ Airline Co., as a buyer, to normal market price fluctuations: it is better off if the market price decreases, and worse off if otherwise. On the other hand, the forward contract "neutralizes" the economic burdens and benefits of market price fluctuations. The payoffs in the forward contract are structured in such a way as to eliminate the probability of a gain and the probability of a loss under the spot sales contract.[82] Hence, the real test of whether XYZ Airline Co. is merely gambling on the price of fuel is to consider the totality of facts and circumstances, instead of characterizing the forward contract as a conclusive indicator of gambling.

B. Swap Contract

The textbook definition of a swap contract is as follows:

> A swap is an over-the counter derivative contract in which two parties agree to exchange a series of cash flows whereby one party pays a variable series that will be determined by an underlying asset or rate and the other party pays either (1) a variable series determined by a different underlying asset or rate or (2) a fixed series.[83]

In legal parlance, "exchange a series of cash flows" simply means that one party trades the fruits of his security for the fruits of another party's security, or the interest obligations arising from a principal liability for the interest obligations arising from another party's principal liability.[84] This exchange takes place without assignment, substitution, subrogation, or any transfer of the underlying asset or principal liability.[85] "Variable series" means the unpredictable rate of return on the security, such as dividends on a share of stock.[86] "Fixed series" means a pre-determined rate of return on

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[82] *See, e.g.,* Yong Chen, *Derivatives Use and Risk Taking: Evidence from the Hedge Fund Industry*, 46 J. OF FIN. AND QUANTITATIVE ANALYSIS 4, 1073-1106 (2011) (arguing that derivatives use in the hedge fund industry is associated with risk reduction, rather than increase in risk-taking activities).

[83] *See* WENDY L. PIRIE (ED.), DERIVATIVES, CFA INSTITUTE INVESTMENT SERIES (2017).

[84] Sergey Chernenko & Michael Faulkender, *The Two Sides of Derivatives Usage: Hedging and Speculating With Interest Rate Swaps*, 46 J. OF FIN. AND QUANTITATIVE ANALYSIS 6, 1727-1754 (2011).

[85] *See* RICHARD R. FLAVELL, SWAPS AND OTHER DERIVATIVES (2010).

[86] *See* ANDREW M. CHISHOLM, DERIVATIVES DEMYSTIFIED: A STEP-BY-STEP GUIDE TO FORWARDS, FUTURES, SWAPS AND OPTIONS (2010).

the security, such as interest payments on a corporate bond.[87] Hence, a swap allows a holder of a share of stock to exchange the dividends on his stock for the dividends on another stock held by another party. It allows a holder of a bond to exchange the interest on his bond for the interest of another bond held by another party. It also allows an exchange of monetary obligations, so that the issuer of a corporate debt may trade his interest rate obligations for another issuer's interest rate obligations on another corporate debt.[88] To complicate matters, a swap contract even allows this exchange of cash flows to take place even if the parties *do not actually hold* the reference securities.[89]

Swaps are the most prevalent derivatives in the financial markets, and are very useful to banks and financial institutions.[90] This is because swaps are capable of transforming the risk profile of an asset, security, or portfolio of investments.[91] To illustrate, suppose XYZ Corporation obtains a loan from ABC Bank, with a variable interest rate that changes according to market rates. This is called borrowing at a "floating rate." One standard benchmark floating rate is the Libor (acronym for London Interbank Offered Rate).[92] Borrowing at a floating rate tied to Libor means that the interest rate automatically escalates and de-escalates according to the periodic movements of the Libor. Hence, at the time of the perfection of the loan, XYZ Corporation does not know its total interest obligation. This uncertainty is a risk that it can eliminate through a swap.[93]

XYZ Corporation wants a fixed interest rate loan to better manage its cash flow, but it need not renegotiate the original terms of the loan. XYZ Corporation can enter into a swap with a third party, let's say TUV Swap Dealer, wherein XYZ Corporation exchanges his floating interest rate obligations for fixed interest rate obligations. The contract between XYZ Corporation and TUV Swap Dealer replicates the original terms of the loan between XYZ Corporation and ABC Bank, so that they are merely matching all the terms of the original loan with the "purported" new loan, except that

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[87] *See* FRED D. ARDITTI, DERIVATIVES: A COMPREHENSIVE RESOURCE FOR OPTIONS, FUTURES, INTEREST RATE SWAPS, AND MORTGAGE SECURITIES (1996).

[88] *Id.*

[89] *See* HOWARD CORB, INTEREST RATE SWAPS AND OTHER DERIVATIVES (2012).

[90] Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events*, 13 FORDHAM J. CORP. & FIN. L. 705 (2008).

[91] *See* AMIR SADR, INTEREST RATE SWAPS AND THEIR DERIVATIVES: A PRACTITIONER'S GUIDE (2009).

[92] Farshid Jamshidian, *LIBOR and Swap Market Models and Measures*, 1 FIN. AND STOCHASTICS 4, 293-330 (1997).

[93] Sheridan Titman, *Interest Rate Swaps And Corporate Financing Choices*, 47 THE J. OF FIN. 4, 1503-1516 (1992).

the interest stipulations in the "purported" new loan are pegged at a fixed rate. We say "purported" because the principal amount in this new loan is merely "notional," *i.e.* it is merely stipulated for the purpose of calculating the interest rate obligations between XYZ Corporation and TUV Swap Dealer, but the principal does not actually change hands, and there is no legal obligation to pay the principal amount.[94]

One legal question that arises is: what kind of contract gives rise to an interest rate obligation when there is no loan and, therefore, no principal obligation? Can an interest stipulation exist without *mutuum*? After all, this is what XYZ Corporation and TUV Swap Dealer apparently did in the example. With the swap arrangement, XYZ Corporation pays the fixed interest to TUV Swap Dealer, while the latter pays XYZ Corporation the floating interest. Meanwhile, XYZ Corporation uses the floating interest received to pay ABC Bank. TUV Swap Dealer may profit from the floating interest rate, perhaps because it expects Libor to rise in the future. Meanwhile, XYZ Corporation has eliminated the risk of paying higher interest rates should the Libor indeed rise.[95]

This arrangement is unheard of in the Civil Code and possibly constitutes an innominate contract of *do ut des*, with the most analogous contract being *mutuum*. We must, however, further interpret the nature of the "notional" principal. If the swap contract is a "purported" new loan whereby XYZ Corporation does not receive any principal from TUV Swap Dealer, is this then a case of simulated loan? It is submitted that a swap is not a simulated loan, but is actually composed of two mutual loans. Recall that there are two interest rate obligations in the swap. XYZ Corporation gives fixed rate interest payments to TUV Swap Dealer while the latter gives floating rate interest payments to XYZ Corporation. Both interest payments are based on the same "notional" principal amount. This means that XYZ Corporation and TUV Swap Dealer are mutual borrowers and lenders of each other under two mutual loans that have equivalent principal amounts but different interest stipulations. The principal amounts under the mutual loans, being equal, are mutually compensated at inception.[96] Hence, the proposed complete legal definition of a swap contract is as follows:

> A swap contract is composed of two simultaneous contracts of *mutuum*, whereby the parties are mutual borrowers and lenders of

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[94] Peter A. Abken, *Beyond Plain Vanilla: A Taxonomy Of Swaps*, 76 ECON. REV. - FEDERAL RESERVE BANK OF ATLANTA 2 (1991).

[95] Titman, *supra* note 93.

[96] Oskari Juurikkala, *Financial Engineering Meets Legal Alchemy: Decoding The Mystery Of Credit Default Swaps*, 19 FORDHAM J. CORP. & FIN. L. 425 (2014).

> each other, for the same amount of principal, which are mutually compensated at inception, but with different interest stipulations.

C. Option Contract

The textbook definition of an option contract is as follows:

> An option is a derivative contract in which one party, the buyer, pays a sum of money to the other party, the seller or writer, and receives the right to either buy or sell an underlying asset at a fixed price either on a specific expiration date or at any time prior to the expiration date.[97]

This definition seems to fit what is referred to in Article 1479 of the Civil Code.[98] However, this cannot be accepted as a complete description of an option as a financial derivative. To make a derivative out of a plain option contract, it must be coupled with an alternative prestation and an offsetting arrangement, similar to forwards as discussed above. The Supreme Court in *Eulogio vs. Sps. Apeles*[99] defines an option as "a contract by which the owner of the property agrees with another person that the latter shall have the right to buy the former's property at a fixed price within a certain time."[100] More formally, an option contract has the following elements: (1) underlying asset;[101] (2) the right, but not the obligation, to buy or sell the underlying asset;[102] (3) strike price;[103] (4) exercise date;[104] (5) consideration distinct from the price;[105] and (6) option style.[106]

The underlying asset is the object in a contract of sale should the option-holder decide to exercise the option. The option has two parties: the

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[97] Pirie, *supra* note 83.

[98] CIVIL CODE, art. 1479. "An accepted unilateral promise to buy or to sell a determinate thing for a price certain is binding upon the promisor if the promise is supported by a consideration distinct from the price."

[99] G.R. No. 167884, 576 SCRA 561, Jan. 20, 2009.

[100] *Id.*

[101] Ruppert v. Alliant Energy Cash Balance Pension Plan, 716 F. Supp. 2d 801 (2010).

[102] Deutschman v. Beneficial Corp., 668 F. Supp. 358 (1987), hereinafter "Deutschman".

[103] Stephen A. Ross, *Options and Efficiency*, 75 THE QUARTERLY J. OF ECON. 75 (1976).

[104] Steele v. Northup, 143 N.W.2d 302 (1966).

[105] CIVIL CODE, art. 1479.

[106] Hollingshad v. Deutsche Bank AG, Civil Action No. 3:05-CV-2235-L., N.D. Tex., Oct. 3, 2006, *available at* https://www.gpo.gov/fdsys/pkg/USCOURTS-txnd-3_05-cv-02235/pdf/USCOURTS-txnd-3_05-cv-02235-0.pdf.

owner of property and the holder of the option.[107] The option-holder is the party given the right, but not the obligation, to buy the property.[108] It is possible, however, that the owner of property is also the option-holder. This arises when the option is an option to sell the asset.

The strike price is the stipulated price of the underlying asset should the option-holder decide to exercise the option.[109] The exercise date is the date when the option-holder can decide to avail of his right to buy or sell the underlying asset.[110] If the exercise date lapses and the option-holder fails to exercise the option, the option contract expires.[111] The consideration in entering the option must be distinct from the price. Otherwise, the option is invalid and the offer to buy or sell the underlying asset may be withdrawn before the option is exercised.

The option *style* refers to the period during which the option-holder can exercise the option.[112] The style can either be European or American. Under the European style, the holder can only exercise the option at (and not before) the agreed exercise date. Under the American style, the holder can exercise the option any time before and at the agreed exercise date.[113]

As we have stated, this is still an incomplete legal definition of the option as derivative contract. Once the option-holder exercises his right to buy or sell the underlying asset, the seller must have the alternative prestation to deliver the object, or to pay the object's market price as of exercise date. This alternative prestation must be at the option of the buyer, just like in a forward contract. If the buyer chooses to receive the market price, the respective debts of both parties are mutually compensated.[114]

Hence, the proposed legal definition of an option contract is as follows:

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[107] In actual commercial practice, a party to an option giving the option-holder a right to buy the underlying asset does not even have to be the owner at the time of execution of the option contract. *See* People v. Daman, No. C069199 (Cal. Ct. App., Feb. 25, 2013).

[108] Deutschman, 668 F. Supp. 358 (1987).

[109] Wasserman v. Triad Securities Corp., Case No. 8:05-cv-1898-T-24TBM. (M.D. Fla. June 12, 2006).

[110] Allaire Corp. v. Okumus, 433 F.3d 248 (2d Cir. 2006).

[111] Lerner v. Millenco, L.P., 23 F. Supp.2d 337 (S.D.N.Y. 1998).

[112] *See* New Millennium Trading, LLC v. Commissioner, 131 T.C. 275 (T.C. 2008).

[113] *See* Thomas Investment Partners, LTD v. U.S. (Nos. 09-55638, 09-55639, 09-55641, 09-55642, 09-55650., 9th Cir. July 20, 2011).

[114] F.J. Jones, *The Economics Of Futures And Options Contracts Based On Cash Settlement*, 2 J. OF FUTURES MARKETS 1, 63-82 (1982).

> An option contract is an accepted unilateral promise giving the option-holder a right, but not the obligation, to purchase or sell an asset at a stipulated fixed price (called the "strike price"), to be exercised by him within a given period or at a fixed future date, and supported by a consideration distinct from the price. If the option is exercised, the sale may be performed with an alternative prestation on the part of the seller: (i) to deliver the object; or (ii) to pay the object's market price (called the "spot price") as of exercise date, at the choice of the buyer. If the buyer chooses the latter prestation, the strike price and the spot price shall be mutually compensated, and the party having residual debt after the set-off shall pay the balance to the other.

D. General Legal Definition

From the foregoing, we conclude that every financial derivative has an underlying nominate contract already recognized by the Civil Code, like sale, loan, or option under Article 1479, coupled with two special stipulations: an alternative prestation and an offsetting arrangement. The *nominate contract* gives rise to an obligation to deliver an asset or to pay a sum of money. The *alternative prestation* permits the obligor to substitute the obligation to deliver the asset with an obligation to pay its market price at the time of delivery. However, the substitution is at the option of the obligee, and not of the obligor. An *offsetting arrangement*, on the other hand, is one where reciprocal debts in money arising from the underlying nominate contract are mutually compensated, and where the party having the residual debt must pay the balance to the other. This *residual debt*, which arises after setting off the parties' reciprocal obligations in money, is what the textbook definitions mean by a derivative's "payoff", and this is how derivatives "derive" their value.

The alternative prestation and the offsetting arrangement are interdependent. In the case of forwards and options, offsetting takes place only because there is an alternative prestation to pay a sum of money instead of delivering the underlying asset, and the obligee elected a substitution. In the case of swaps, there is no alternative prestation because there is no obligation to deliver an underlying asset in the first place, the parties agreeing to exchange sums of money at the onset.[115]

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[115] *See* Ahmad Ali Ghouri, *The Law And Regulation Of OTC Derivatives: An Anglo-American Comparison And Lessons For Developing Countries*, NORDIC J. OF COMM'L LAW 1, 1-45 (2010); J. Jakeways, *The Legal Nature Of Credit Derivatives*, *in* CREDIT DERIVATIVES: LAW, REGULATION AND ACCOUNTING ISSUES (1999) *as cited in* Oskari Juurikkala, *Financial Engineering Meets Legal Alchemy: Decoding The Mystery Of Credit Default Swaps*, 19 FORDHAM J. CORP. & FIN. L. 425 (2014); Dmitry Vlasov, *Derivatives Regulation in the UK and Russia*,

V. APPLICATION OF PROPOSED LEGAL DEFINITIONS

A. Philippine Index Futures

In 2013, SGX and PSE executed a Memorandum of Understanding to develop the SGX-PSE MSCI Philippines Index Futures.[116] Futures are similar to forward contracts, except that they are traded in an organized exchange, with standardized stipulations. Usually, there is no expectation of actual delivery of the underlying asset.[117] The Philippine Index Futures are traded in the SGX.[118] The underlying asset consists of the MSCI Philippines Index, which is a basket of PSE-listed stocks and measures the performance of large and mid cap segments of the Philippine stock market.[119]

The Philippine Index Futures allow traders and investors in Singapore to gain economic exposure to Philippine equities without trading listed shares in the PSE.[120] A trader in Singapore does not need to be an owner of a Philippine stock to obtain financial benefits and suffer losses associated with the underlying asset.[121] Through forwards and futures, one only needs to enter into a contract of sale, which is consensual and does not require title at the time of perfection,[122] and stipulate the two special clauses that transform this underlying nominate contract into a derivative: (i) an alternative prestation to pay the market price of the underlying asset; and (ii) an offsetting arrangement. This is how the Philippine Index Futures mirror the risks and benefits of Philippine stock ownership, *without actual ownership*.[123]

To illustrate: suppose Investor A and Investor B reside in Singapore and are able to trade through the Singapore Exchange. Investor A expects

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COMPARATIVE ANALYSIS (2011), *available at* https://ssrn.com/abstract=2035826 (last accessed on March 15, 2017); Vinod Kothari, *Legal Aspects of Credit Derivatives*, *in* CREDIT DERIVATIVES AND STRUCTURED CREDIT TRADING 317 (2012).

[116] Morales, *supra* note 32.

[117] Johnson, *supra* note 12.

[118] *EUREX MSCI Philippines Index Futures (report)*, Quandl, *available at* https://www.quandl.com/collections/futures/eurex-msci-philippines-index-futures (last accessed Dec. 21, 2017).

[119] *Id.*

[120] *Id.*

[121] *Id.*

[122] Dalion v. Court of Appeals, G.R. No. 78903, Feb. 28, 1990.

[123] Naohiko Baba et al., *Foreign Exchange Futures, Forwards, And Swaps*, *in* HANDBOOK OF EXCHANGE RATES, 623-645 (2012).

XYZ Philippine Shares to go up, while Investor B expects the opposite. Hence, Investor A wants to purchase and Investor B wants to sell XYZ Philippine Shares. They enter into a futures contract, whereby Investor A promises to buy an agreed volume of XYZ Philippine Shares from Investor B, who likewise makes the binding promise to sell. Note, however, that Investor B does not have title over the shares at the moment.[124]

As the prices of XYZ Philippine Shares move during the period of their contract, Investor A and Investor B experience market gains or losses. Because their expectations and financial positions are completely opposite, Investor A's gain is Investor B's loss, and *vice versa*. To realize these gains or losses, they can trade their futures to other parties. It is highly likely that Investor A and Investor B do not even know each other, because they operate under an organized exchange with a central clearing house and a system of matching orders between buyers and sellers who never have to meet to execute a trade. At the end of a certain period, a present holder of the futures contract may elect an actual delivery of the XYZ Philippine Shares, if the stipulations in the futures contract allow this. These stipulations are standardized by the exchange. More often than not, parties will not opt for actual delivery, though they have a right to enforce it. It is also possible that there is no stipulation for delivery, depending on the rules of the exchange.[125]

If the futures contract, under the rules of the exchange, do not allow delivery at the onset, then there is no alternative prestation to speak of, because the only prestation is the payment of the market price of the asset. In such a case, this fails our proposed legal definition of financial derivatives, and rightly so—because under Article 2018, such contracts are wagering transactions, which are void. However, if the standard stipulations of the exchange allow delivery as an alternative prestation, the derivative instrument is valid and enforceable.[126]

B. Bilateral Hedging Contracts in the Wholesale Electricity Spot Market

Bilateral hedging contracts have been institutionalized since 2006 by the Philippine Electricity Market Corporation ("PEMC"), the government-owned and controlled corporation tasked with the governance of wholesale

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[124] ANDREW M. CHISHOLM, DERIVATIVES DEMYSTIFIED: A STEP-BY-STEP GUIDE TO FORWARDS, FUTURES, SWAPS AND OPTIONS (2010).

[125] BSP Circ. No. 594 (2008).

[126] *Onapal,* 218 SCRA at 281.

electricity trading in the Philippines.[127] These contracts dominate the volume of trades in the Wholesale Electricity Spot Market ("WESM"), which is the only organized exchange for competitive wholesale electricity trading in the country.[128] The Energy Regulatory Commission (ERC) approves Power Supply Agreements ("PSA"), which may be of two kinds: Physical PSAs and Financial PSAs.[129] Physical PSAs are undertakings to deliver actual electricity, while Financial PSAs serve as the written instrument for bilateral hedging contracts.[130]

Under a bilateral hedging contract, a Generation Company ("GenCo") promises to sell a specified quantity of electricity to a Distribution Utility ("DU") at a future date, but with the actual intent of hedging against market price volatility rather than effecting a physical delivery of electricity.[131] To operationalize this, the parties fix a stipulated price over a given period and commit themselves to transact at this amount regardless of changes in market price.[132] During the course of the agreement, they exchange the difference between the stipulated price and the market price.[133] If the market price is higher than the stipulated price, the GenCo pays the difference to the DU. However, if the market price is lower than the stipulated price, the DU pays the difference to the GenCo.[134]

In short, bilateral hedging contracts are "non-deliverable forwards" or "contracts for difference," which fall squarely within Article 2018. In *Onapal*, the Supreme Court ruled that "payments made under said contract were payments of difference in prices arising out of the rise or fall in the market price above or below the contract price[,] thus making it purely gambling and declared null and void by law." This ruling was applied in the Cease and Desist Order issued by the Securities and Exchange Commission (SEC) against Metistrade, Inc. in 2016.[135]

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[127] Rolando A. Danao, *Market Power in the Philippine Power Market*, UPSE DISCUSSION PAPER NO. 2009-09, *available at* http://www.econ.upd.edu.ph/dp/index.php/dp/article/view/87/78.

[128] *Id.*

[129] *Id.*

[130] *Id.*

[131] *Id.*

[132] Adoracion Navarro et al., *Post-EPIRA Impacts of Electric Power Industry Competition Policies*, PIDS Working Paper No. DP 2016-15 (2016), *available at* https://dirp3.pids.gov.ph/websitecms/CDN/PUBLICATIONS/pidsdps1615.pdf (last accessed on Dec. 21, 2017).

[133] Danao, *supra* note 127.

[134] Ma. Joy V. Abrenica, *Detecting and Measuring Market Power in the Philippine Wholesale Electricity Market*, 46 PHIL. REV. OF ECON. 2 (2010); *Onapal,* 218 SCRA 281.

[135] In the Matter of: Metistrade Inc., SEC CDO Case No. 04-15-016, May 14, 2015.

Not many market participants are aware of the far-reaching legal implications of Article 2018 and the *Onapal* Decision in energy trading markets, *i.e.* a bilateral hedging contract, on its face, is void. It also fails the legal definition of a financial derivative proposed here, which requires the presence of an alternative prestation of actual delivery. At the onset, the parties in a Financial PSA already know that they will not deliver the underlying asset.[136]

It is clear, however, that there is a legitimate business context surrounding the use of bilateral hedging contracts: to eliminate financial risk.[137] The Financial PSAs are part of an overall strategy to hedge against price movements. This hedging strategy is operationalized as follows:

> The buying and selling of electricity subjected to a hedge contract will thus involve two separate financial transactions. The first transaction will be for electricity supply through the market, where the purchaser will pay the market operator the market clearing price for the contracted electricity purchased during a trading period. This market clearing price will be paid by the market operator to the generator for the electricity sold to the market. The second transaction is a bilateral off-market financial transaction where the electricity is priced at the difference between the market price and the contracted price. The net effect of the two transactions is that the purchaser will pay and the generator will receive the electricity price set by the bilateral off-market hedge contract.[138]

Hence, whether or not a party is engaged in a purely gambling transaction should not be based on one isolated contract. One must examine the totality of facts and circumstances involving the parties' motivation for entering the transaction in question. In the case of GenCos and DUs, the Financial PSA supplements their financial risk exposure under the Physical PSAs. It is therefore unreasonable for lawyers and judges to construe the Financial PSA in isolation, and make a blanket conclusion that it is a gambling agreement under Article 2018.

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[136] Sameh El Khatib & Francisco D. Galiana, *Negotiating Bilateral Contracts In Electricity Markets*, 22 IEEE TRANSACTIONS ON POWER SYSTEMS 2, 553-562 (2007).

[137] Iñigo Herguera, *Bilateral Contracts And The Spot Market For Electricity: Some Observations On The British And The Nordpool Experiences*, 9 UTILITIES POLICY 2, 73-80 (2000).

[138] Geoffrey Brown et al., *Philippines: Power Sector Profile and Roadmap*, Staff Consultant's Report, ADB (2005), *at* https://www.adb.org/sites/default/files/project-document/68769/ta4151-phi.pdf.

C. Philippine Depositary Receipts

Through a depositary receipt, an issuer or holder of shares of stock enters into a deposit agreement with a bank or financial institution.[139] Under the agreement, the issuer or holder, called the "depositor," transfers ownership of the shares of stock to the bank or financial institution, called the "depositary," who in turn issues a negotiable financial instrument to third party investors.[140] The instrument is the "depositary receipt," which represents the shares of stock in the hands of the depositary.[141]

The transaction involves two contracts: the deposit agreement, which is between depositor and depositary, and the depositary receipt, which is between depositary and holder of the depositary receipt.[142] These two contracts are stipulated in such a way that the returns on the depositary receipt mirror the returns on the underlying shares of stock.[143] This "mirror" effect is the mechanism by which control or voting rights of the shares are decoupled from the economic or cash flow rights.[144] The depositary remains to be the legal titleholder and record owner of the underlying shares.[145] As such, it retains the control rights, including the right to vote.[146] Through the issuance of a depositary receipt, however, the depositary effectively transfers its economic rights in the shares to another entity.[147] When the depositary receives dividends on the underlying shares, it pays the holder of depositary receipt an amount representing the dividend issuance, so that the depositary receipt holder ultimately benefits from the economic rights.[148]

The holder pays the depositary a consideration for the issuance of the depositary receipt in exchange for the enjoyment of economic rights over the underlying shares of stock.[149] This consideration is equal or nearly equal to the market exchange price of the underlying shares, plus

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[139] Guy P. Lander, *American Depositary Receipts*, 29 THE INT'L LAW. 897 (1995).

[140] G. Andrew Karolyi, *The Role Of American Depositary Receipts In The Development Of Emerging Equity Markets*, 86 RE. OF ECON. AND STAT. 3, 670-690 (2004).

[141] Lander, *supra* note 139.

[142] Mark Saunders, *American Depositary Receipts: An Introduction To US Capital Markets For Foreign Companies*, 17 FORDHAM INT'L L.J. 48 (1993).

[143] *Id.*

[144] *Id.*

[145] Joseph Velli, *American Depositary Receipts: An Overview*, 17 FORDHAM INT'L L.J. 38 (1993).

[146] *Id.*

[147] *Id.*

[148] Lander, *supra* note 139.

[149] Amar Gande, *American Depositary Receipts: Overview And Literature Survey*, 6 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 5, 61-83 (1997).

commissions and fees for the services of the depositary as an issuer.[150] The depositary recoups his expenditure from purchasing the underlying shares by receiving the consideration given by the holders of the depositary receipt.[151] The depositary ultimately profits from commissions and fees, and not from the returns on the purchased underlying shares of stock.[152]

The depositary receipt is usually publicly listed and traded in a foreign stock exchange.[153] Ownership of the depositary receipts passes from one holder to another without affecting the depositary's ownership of the underlying shares.[154] The price of the depositary receipt tracks the price of the underlying shares in the home country.[155]

The issuance of depositary receipts is an alternative to cross-border transfer of investments.[156] The issuer of publicly listed shares of stock is usually domiciled in a country where it has corporate nationality, which we shall call the "home country."[157] In order to open up foreign ownership of its publicly listed shares of stock, the issuer must have the shares listed and traded in the foreign stock exchange—a process called "cross-listing."[158] However, this requires the issuer to meet the rules of the foreign stock exchange and to manage foreign currency and foreign tax issues.[159]

Depositary receipts help issuers to obtain funding from foreign investors without the need for cross-listing.[160] The depositary purchases the underlying shares in the home country and issues depositary receipts in the foreign country.[161] The underlying shares are publicly traded in the local stock exchange of the home country, while the depositary receipts

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[150] *Id.*

[151] *Id.*

[152] *Id.*

[153] Shelly E. Webb et al., *An Examination of International Equity Markets Using American Depositary Receipts*, 22 J. OF BUS. FIN. & ACCT. 3, 415-430 (1995).

[154] *Id.*

[155] *Id.*

[156] Andreas Charitou & Christodolous Louca, *Cross-Listing and Operating Performance: Evidence from Exchange-Listed American Depositary Receipts*, 36 J. OF BUS. FIN. & ACCT. 1, 99-129 (2009).

[157] *Id.*

[158] *Id.*

[159] *Id.*

[160] Jonathan W. Royston, *The Regulation of American Depositary Receipts: Americanization of the International Capital Markets*, 10 NCJ INT'L L. & COM. REG. 87 (1985).

[161] *Id.*

representing those shares are then listed and traded in the foreign stock exchange.[162]

Depositary receipts representing shares of Philippine corporations have existed since 1990.[163] However, in 2012, there was a sudden increase in the number of Filipino corporations registering their shares with the U.S. Securities and Exchange Commission, through The Bank of New York Mellon, for the purpose of issuing depositary receipts to foreign investors.[164]

Are depositary receipts financial derivatives? Applying the textbook definition of financial derivatives, it would seem that they are derivative contracts. A depositary receipt is a financial instrument whose value or payoff is contingent on the value or price of an underlying asset or reference variable. In this case, the underlying asset is a share of stock. However, applying our proposed legal definition, they are not financial derivatives. While there is an underlying asset, there are no alternative prestations to deliver the underlying asset or to pay its market price at the time of delivery. Consequently, there is no offsetting arrangement where the stipulated price and market price are mutually compensated.

To illustrate: in 2006, Primebridge Holdings, Inc. held 22.6% of the total outstanding shares of BDO Universal, Inc., which is a full-service universal bank providing corporate, commercial and retail banking services in the Philippines. During the year, Primebridge subsequently sold 9,399,700 Global Depositary Receipts (GDR), with each GDR representing 20 BDO shares, for a total of 187,994,000 underlying BDO shares. The GDRs were listed and traded at the London Stock Exchange, with initial offer price of USD 12.70 per GDR. The sale was done pursuant to Rule 144A and Regulation S, under the U.S. Securities Act of 1993. Primebridge remained as the record owner of the underlying shares, and the GDR holders do not exercise voting rights, which were retained by Primebridge. The GDR holders, however, can exercise their right to convert the GDRs into BDO shares. Hence, by end of 2006, 4,724,214 GDRs were converted into 94,484,280 BDO shares. In 2011, only 9,600 GDRs remain unconverted. In 2013, BDO launched its American Depositary Receipts (ADR) Level 1 program, with Deutsche Bank acting as depositary. The ADRs were since

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[162] *Id.*

[163] Citi Depositary Receipt Services, *Global DR Directory, at* https://depositaryreceipts.citi.com/adr/guides/uig.aspx?pageId=8&subpageid=34 (last accessed Mar. 15 2017).

[164] Deutsche Bank Depositary Receipt Services, *DR Directory, at* https://www.adr.db.com/drwebrebrand/dr-universe/dr_universe_type_e.html (last accessed Mar. 15, 2017).

then traded over-the-counter in U.S. capital markets. BDO states that the program is "meant to tap the pool of US ADR investors, enhance visibility and global presence and diversify and broaden the Bank's shareholder base." In the same year, BDO also terminated its GDR program with the Bank of New York in the London Stock Exchange because of low trading activity.[165]

It is possible that a depositary receipt may contain an *embedded derivative*. An embedded derivative is a financial derivative that is contained in a non-derivative host contract. One example is when a depositary receipt contains an option to purchase the underlying shares of stock represented by the receipt. In 2007, GMA Holdings, Inc., which operates a commercial broadcast television and radio network, offered 822,115,000 Philippine Deposit Receipts (PDRs), which represent the same number of underlying GMA common shares. The offer price was PHP 8.50 per PDR. Each PDR holder has a right to "cash distributions (net of applicable taxes and operating expenses) in respect of cash dividends on the Common Shares". The PDR also grants the holder a *right to the delivery or sale of the underlying GMA common shares*, but the prospectus dated 14 July 2007 states that this is subject to nationality restrictions relating to the ownership of the underlying shares. This right to delivery or sale is actually an option *embedded* in the depositary receipt, the non-derivative host contract.[166]

VI. SUMMARY

In order to determine whether an instrument is a financial derivative, it is not enough to refer to the textbook definitions of common derivative transactions. Three elements are necessary: (i) an underlying nominate contract that gives rise to an obligation to deliver an asset or pay a sum of money; (ii) alternative prestations of actual delivery or payment of the object's market price (except in the case of swap contracts, there being no obligation to deliver an object in the first place); and (iii) an offseting arrangement. These are summarized as follows:

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[165] BDO, *Disclosure On Establishment Of ADR Level 1 Program, at* https://www.bdo.com.ph/sites/default/files/pdf/dc2013-3206_BDO.pdf (last accessed Mar. 15, 2017).

[166] GMA Holdings Inc. *Information Statement Pursuant To Section 20 Of The Securities Regulation Code, available at* https://aphrodite.gmanetwork.com/corporate/disclosures/ghi_-_preliminary_information_statement_-_asm_2017_1492742105.pdf (last accessed Dec. 20, 2017).

Instrument	Textbook Definition	Proposed Legal Definition
Forward	A forward contract is an over-the-counter derivative contract in which two parties agree that one party, the buyer, will purchase an underlying asset from the other party, the seller, at a later date at a fixed price they agree on when the contract is signed.	A forward contract is a sales contract, with future delivery date, a pre-determined fixed price (called the "forward price"), and an alternative prestation on the part of the seller (i) to deliver the object, or (ii) to pay the object's market price (called the "spot price") as of the time of delivery, at the option of the buyer. If the buyer chooses the latter prestation, the forward price and spot price at the time of delivery shall be mutually compensated, and the party having residual debt after the set-off shall pay the balance to the other.
Swap	A swap is an over-the counter derivative contract in which two parties agree to exchange a series of cash flows whereby one party pays a variable series that will be determined by an underlying asset or rate and the other party pays either: (1) a variable series determined by a different underlying asset or rate; or (2) a fixed series.	A swap contract is composed of two simultaneous contracts of *mutuum*, whereby the parties are mutual borrowers and lenders of each other, for the same amount of principal, which are mutually compensated at inception, but with different interest stipulations.
Option	An option is a derivative contract in which one party, the buyer, pays a sum of money to the other party, the seller or writer, and receives the right to either buy or sell an underlying asset at a fixed price either on a specific expiration date or at any time prior to the expiration date.	An option contract is an accepted unilateral promise giving the option-holder a right, but not the obligation, to purchase or sell an asset at a stipulated fixed price (called the "strike price"), to be exercised by him within a given period or at a fixed future date, and supported by a consideration distinct from the price. If the option is

		exercised, the sale may be performed with an alternative prestation on the part of the seller: (i) to deliver the object; or (ii) to pay the object's market price (called the "spot price") as of exercise date, at the option of the buyer. If the buyer chooses the latter prestation, the strike price and the spot price shall be mutually compensated, and the party having residual debt after the set-off shall pay the balance to the other.
Financial derivatives in general	Derivative is a financial instrument whose value changes in response to changes in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or similar variable or underlying factor.	A financial derivative is any contract that gives rise to an obligation to deliver an asset or to pay a sum of money, coupled with alternative prestations of delivery and payment of market price, at the option of the obligee. Should the obligee elect the latter prestation, an offsetting arrangement takes place whereby the parties' reciprocal debts in money are mutually compensated, and the party having residual debt after the set-off shall pay the balance to the other. The presence of alternative prestations is not required in swap contracts, there being no obligation to deliver an asset in the first place.

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