

The Diversity of Financial Instruments Traded on the Stock Exchange

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Abstract: The present study aims to accomplish an in depth analysis of the types of financial instruments traded on the stock exchange, showing in detail both their characteristics and their implications in terms of expected earnings but also the level of associated risk. Depending on the timeframe considered and their own aversion to assumed risk, investors must realize optimal selection of the financial instruments in which they aim to place their funds. Thus, for a long-term investor who does not want to assume a high risk is indicated purchasing bonds, government securities or structured products such as capital protected certificates. If the same long-term investor decides that he can take a higher risk in order to obtain higher gains, he can choose to purchase shares or structured products such as index certificates. The third situation targets investors who seek to obtain short-term gains, but with certain aversion towards the level of assumed risk, for whom is recommended to purchase ETF fund units. At the same time, experienced investors pursuing short-term placement of funds and obtaining substantial gains regardless of the level of risk assumed opt, generally, for structured products such as turbo certificates or derivative financial instruments such futures and options.

Keywords: financial instruments, stock exchange, investors, timeframe, risk

JEL Classification: G23, G28

1. Introduction

The role of the capital market is to create both continuous liquid markets so that companies can get the necessary financing as well as efficient markets that allocate funds to their most productive uses. Also, not infrequently, the stock market has functioned as a true barometer of a country's economy, being a good estimator of periods of expansion or recession which it was to cross.

The stock exchange represents the key factor of any functional capital market, in whose development it contributes by providing a regulated framework for organizing and functioning, as well as for on-going and closing transactions. At the same time, considering the stock exchange's role of main financier of the economy, it is important that both funds solicitors (issuers) and bidders of funds (investors) to know in detail the implications of the financial instruments they are going to sell or buy, in order to conclude transactions as profitable as possible. In this context, an analysis of the types of financial instruments traded on the stock exchange and their characteristics appears to be particularly useful.

Thus, in the present study are presented in detail both primary, classical, financial instruments, as well as their modern version in the form of hybrid and derivative financial instruments, after which we can identify the type of financial instrument suitable for every investor, depending on the time frame taken into consideration and the level of risk assumed.

2. Financial Instruments – overview

In Romania, legal regulations define financial instruments in a manner similar to the European Community legislation¹ in the field.

Thus, under Article 2, section 11 of the Law no.297 / 2004 on the capital market, published in Official Gazette 571 / 29.06.2004 as amended and supplemented, financial instruments include the following elements:

- Securities;
- Units in collective investment undertakings;
- Money market instruments including government securities with maturity less than one year and deposit certificates;
- Financial futures, including equivalent cash-settled instruments;
- Forward rate agreements (FRA);
- Interest rate, currency and equity swaps;
- Options on any financial instrument in a) - d), including equivalent cash-settled instruments; this category includes options on currency and interest rate;
- Derivatives on commodities;
- Any other instrument admitted to trading on a regulated market in a Member State of the European Union or for which an application has been made for admission to trading on such a market;

Thus, the financial instruments traded on the stock market consist of primary financial instruments (including the vast majority of securities, units in collective investment undertakings and money market instruments), hybrid financial instruments (certain types of securities) and derived financial instruments (futures, forwards, swaps, options, etc.).

Regarding the first and most important category of financial instruments, securities, according to article 2, section 33 of the Law no.297 / 2004, they may be:

- Shares in companies and other securities equivalent to shares, traded on the capital market;
- Bonds and other debt securities, including government securities with maturities greater than 12 months, negotiable on the capital market;
- any other securities normally dealt in, giving the right to acquire such securities by subscription or exchange, giving rise to a cash settlement, excluding instruments of payment;

Consequently, in terms of terminology, the primary financial instruments of type stocks, bonds or Treasury bond with maturity greater than one year are considered securities only when they are subject to capital market transactions (Dragota,2009).

Coverage of securities, although similar, is more comprehensive defined by European regulations in the field. Thus, according to Directive 2014/65 / EU of the European Parliament and of the Council of 15 May 2014 on markets of financial instruments, securities means classes of value titles that can be traded on the stock market, with the exception of instruments of payment, such as for example:

- Shares in companies and other securities equivalent to shares in companies, in partnership companies or other entities, as well as certificates of deposit for shares;
- Bonds and other securitized debt instruments, including certificates of deposit

¹ Instruction 2004/39/CE of the European Parliament and Council regarding markets of financial instruments published in the Official Journal of the European Union from 30.04.2004, p.287-288, Annex 1, Section C

for such securities;

- any other titles giving the right to buy or sell such securities or giving rise to a cash settlement, established in relation to securities, currencies, interest rates or yields, commodities or other indices or units;

Thus, we can provide a European level fundamental definition of hybrid financial instruments, as representing those securities that lead to a cash settlement, established in relation to an underlying asset that can be represented by a different type of securities (stocks, bonds), a stock exchange index, exchange rate, interest rate or commodity.

We see from the above, that the financial instruments traded on the stock market are as numerous as they are diverse, but only some of these are traded on stock exchanges. Shown in Figure 1 are the types and categories of financial instruments traded on Bucharest Stock Exchange.

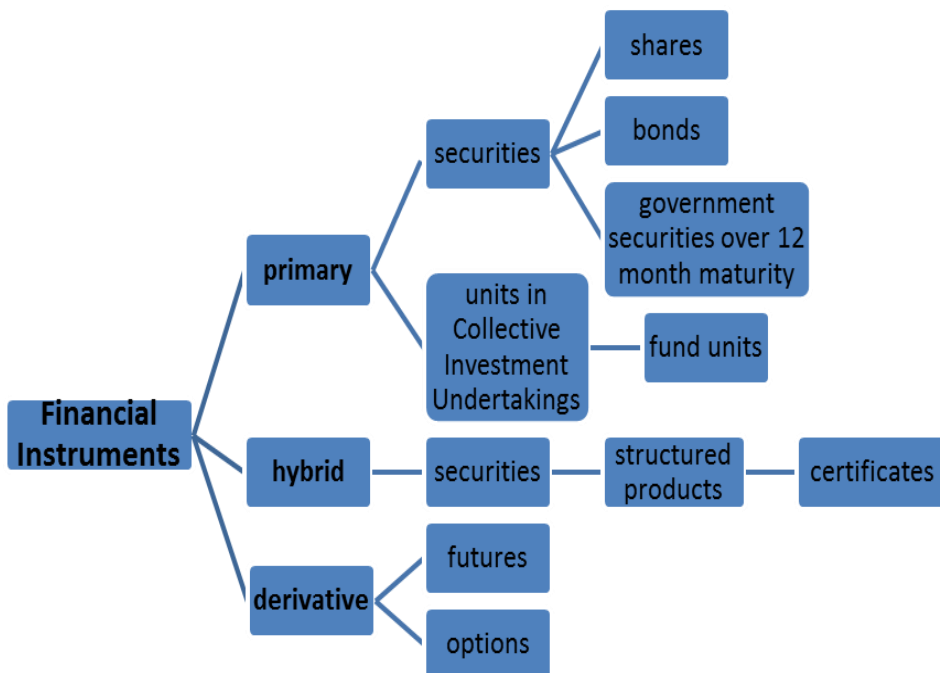


Figure 1 - Financial instruments traded on Bucharest Stock Exchange

Source: author processing according to the data of BSE available online at <http://www.bvb.ro/> and to the Bucharest Stock Exchange Code updated november 27th, 2014

3. Shares

Shares are securities issued by companies with appropriate legal form of organization² that certify ownership of their holder to a portion of the assets of the issuing company. Companies that aim listing on the stock exchange or those already

² In Romania, Law no.31/1990 regarding companies, republished in the Official Monitor 1066/2004 states that only companies constituted as joint-stock or joint-stock limited companies can issue shares; companies constituted under other forms will issue social parts

listed may issue shares on the primary market capital both in the formation phase of social capital, as well as in the expanding phase, through cash contributions or by incorporation of existing reserves or debt consolidation (Prisacariu, Ursu and Andries, 2008, p.71).

In general, shares provide to their owner access to two categories of rights:

- Social rights, namely the right to vote in decisions that significantly affect the company's activity, such as election or revocation of management, business analysis and approval of its annual dividend policy or funding direction followed by the company.

- Property rights, namely the right to collect income as dividends, the right to sell their shares at a price offered by the market or negotiated, the right to charge a portion of the liquidation value of the company, in the event and time of its dissolution.

- Social and patrimonial rights may be granted proportional to the number of shares held or on different considerations, therefore we meet the following types of shares:

- Common or ordinary shares, which provide both social and patrimonial rights, in proportion to the number of shares held;

- Preferential shares, which offer either more social rights (double voting shares) or more patrimonial rights (shares with preferential dividend, fixed)

- Shares without voting rights, referred to as participation vouchers, that offer only patrimonial rights;

- Treasury shares (Stancu, 2007, p.381) which do not offer any social or patrimonial rights, represented by the common shares of the company, redeemed by it from the market following the decision of the General Meeting of Shareholders, within a predetermined quote of issued share capital; these shares have voting and dividend rights suspended during their ownership by the issuing company itself;

Also, depending on the shareholders' facility to transmit the ownership right of shares held, these may be:

- Nominative shares, which are amenable to sale-purchase transactions only with the consent of the general meeting of shareholders; in order for transactions to be conducted through the stock exchange is required converting them into bearer shares;

- Bearer shares, in which case the holder's name is not listed and the ownership right transfer, private or through the stock exchange, can be done quickly;

When a company wants to trade its shares, it must turn to the primary market, the sale and purchase being made through a private placement, a rights offering or an Initial Public Offering.

Private placement is equal to obtaining funds from selling shares directly to an investor or a small number of investors, persons or financial institutions, while the rights offer is the operation by which new shares of the company are sold to existing shareholders.

Regarding public offering, it is defined in the specialized literature as the communication addressed to persons, in any form and by any means, presenting sufficient information on the terms of the offer and the securities to be offered so as to enable investors to take a decision on the sale, purchase or subscription of the securities in question (Obreja Brasoveanu, 2011, p.148). Public offerings can have as underlying objective the sale or purchase of shares, special attention being paid to sale public offerings, because only through them the company's shares can then be listed on the stock exchange.

Thus, depending on the time of the issue of shares and the company's quality³

³ Closed or open company

at the time of the issue, there are several types of sale public offerings:

- Initial public offering (IPO) is the first public sale of shares of a closed company; usually companies do not "open" unless they aim subsequent listing on the stock exchange, a process in which the conduct of IPO is an essential first step;
- Primary public offering consists in developing a new issue of shares of a company already open, with the main goal to obtain additional financing through capital increase;
- Secondary public offering made in case of sale of a certain number of shares previously issued by an open company;

Usually, public offerings are made through an intermediary appointed by the investment bank or investment dealer⁴. Because the investment bank is not a long-term investor, nor a bank to take deposits, we subscribe to the Canadian term, respectively investment dealer, to designate the intermediary of public offerings. The main operation made by the investment dealer is the subscription one, or purchasing the shares of the issuer at a specified price and risk taking reselling them to the public at a superior price. Also, the investment dealer provides for the issuer both consulting services on the issue and securities distribution services.

In case of significant issues of shares, the investment dealer co-opts as partners other dealers to form an intermediation union. The initial investment dealer and intermediation union members then form a selling group (Gitman, 2009, p.340), together with other brokerage firms, each member of the selling group committing to sell a certain part of the issue to investors, in exchange for a fee.

Usually, sale public offerings made by companies already listed on the stock exchange have the effect of lowering the market price of their shares, so it is recommended that the moment when such activities are carried out should coincide with a period when the shares are overvalued on the market.

4. Bonds

Bonds are defined as securities that provide the owner the quality of creditor of the issuing company, conferring, within the same issue, the same claims to the same denomination. Thus, the bond issue is a collective agreement between the issuer and the underwriters (Brezeanu, 2009, p.301).

Bonds are titles whose remuneration is fixed or guaranteed, because the interest is generally contracted at a fixed rate and at fixed payment terms. Thus, unlike shares, gain provided by bonds does not depend on the results recorded by the company, its character being much safer. Also, in the event of bankruptcy, creditors are compensated with priority, so the risk of bonds once again proves to be lower than that associated to shares (Dragota, Ciobanu, Obreja et al., 2003). Despite the advantage of cashing firm revenues, bondholders are exposed to the risk of interest rate changes on the market, its growth having as a direct effect the reduction in the market value of the bonds held in the portfolio.

Under Articles 220-223 of the Law no.297 / 2004 on the capital market as amended and supplemented, in Romania, in order for bonds issued by companies, public authorities and international organizations to be admitted for trade on a regulated market, it is necessary that the issuer to be established and operate in accordance with the laws in force and the loan amount cannot be less than the equivalent in RON of 200,000 euros. Also, convertible bonds may be admitted to

⁴ In USA is used the term "investment banker", meanwhile in Canada is considered that the intermediary is an "investment dealer"

trading on a regulated market only if the securities in which they can be converted are listed, in turn, on a regulated market.

Under Article 229 of the same law, following the issue of bonds, the issuer company should provide all the facilities and information necessary to enable holders to exercise their rights, namely:

- To public notices concerning the meetings of holders of debt, interest payment, the exercise of any conversion, exchange, subscription or repayment rights;
- To appoint as paying agent a financial institution through which bondholders to exercise their financial rights, unless the issuer itself provides these services;

5. Government securities

According to Article 2, Paragraph 13 of Law no.313/2014 on public debt, published in MO no.577 / 29 June 2004, government securities are financial instruments certifying public debt in the form of bonds, treasury bills including treasury bills for the population unredeemed matured and transformed into certificates of deposit or other financial instruments constituting state loans in local or foreign currency on short, medium and long term. They can be issued in certificated or dematerialized form, registered or bearer, and may be negotiable or non-negotiable.

The issue prospectus of a series of titles includes all of the characteristics of the government security, providing through specific terms and conditions essential information on the issue, such as the type and frequency of payment of remuneration or the title's validity.

Thus, in terms of remuneration offered to investors, government securities can be:

- interest-bearing government securities that are sold to investors at nominal value (or with a discount and bonus), interest being paid periodically by the issuer under the conditions set by the issue prospectus;

- discount government securities, not bearing interest, the gain of the buyer being the difference between the nominal value of the title and its initial, lower price;

Depending on the time frame covered, bonds may be issued:

- ✓ on short term, when repayment duration does not exceed one year; they may be treasury bills or treasury certificates bearing interest or discount;

- ✓ on medium term when repayment duration is between one and five years;

- ✓ on long term when repayment duration exceeds five years; government securities on medium and long term are state bonds with repayment duration between 1 and 5 years or over 5 years, bearing interest or discount;

Central and local public administration institutions as well as international institutions must ensure all conditions and information needed by investors to exercise their rights and their underlying obligations are similar to those of the debtor companies, namely:

- To publish information on general meetings of holders of debt securities, payment of interest and repayment of loan;

- To appoint a paying agent through which holders of debt securities may exercise their financial rights;

6. Units in Collective Investment Undertakings

According to the Law no.297 / 2004 on the capital market, units are represented by fund units or shares in collective investment undertakings, according to their constitution form. The same law defines undertakings for collective investment as

organized entities, with or without legal personality, which draw in a public or private manner financial resources of individuals and / or legal entities in order to invest them.

Fund units have different characteristics as they are issued by closed-end or open-end investment funds.

Open-end investment funds are investment companies that sell and redeem fund units continuously, directly from investors without transactions taking place through the stock exchange or any other organized forms of secondary market.

Closed-end investment funds are investment companies that issue fund units which they make available to investors through an initial public offering, subsequently these becoming the object of transactions on the stock exchange or the OTC market, if the fund is listed. Capitals obtained by the fund are then invested in accordance with the investment policy declared through the issue prospectus. Unlike open-end investment funds, once completed the IPO, closed-end investment funds do not issue additional fund units for sale to investors, nor redeem the existing ones (Anderson, Born and Schnusenberg, 2010, p.4).

Tradable investment funds (Exchange Traded Fund-ETF) are open-end investment funds that track the evolution of an underlying asset through a transparent investment policy, predetermined by the issue prospectus, and whose unit funds (called ETF units) are listed on stock exchanges.

We find, therefore, that the fund units traded on the stock exchanges may be units issued by closed-end investment funds and ETF units, issued by open-end funds, when those investment funds are listed on the stock exchange.

In fact, for an investor, ETF units show undeniable advantages as opposed to fund units, which we present below.

Unlike fund units issued by closed-end investment funds, the number of ETF units is neither fixed nor limited, but varies proportionally with demand and supply registered on the primary market. Since they are based on transparent asset structures ETFs listed on stock exchanges adopt investment policies that follow closely the evolution of a stock exchange index (most), of a basket of shares, of one or several commodities or other type of assets defined in the prospectus (BSE, Investor's Guide to ETF). Basically, buying ETF units, owners can quickly place their funds in investments that evolve in the same way and time to market trends, without having to dispose of very significant capital to build a diverse portfolio.

Thus, with a relatively small amount can be replicated a performance that would otherwise had required allocating significantly higher amounts in order to individually acquire the component assets. At the same time, ETFs and their units beneficiate from a much higher transparency compared to closed-end funds listed on the stock exchange, by displaying in real time during the trading session, the indicative net asset value (INAV) and daily the unitary net asset value (UNAV), which is certificated by an independent entity called Depository. Moreover, increased transparency is assured by the fact that the structure of the index tracked by the ETF in question is always known.

7. Structured products

According to the Code of Bucharest Stock Exchange updated November 27, 2014, structured products are financial instruments of the nature of securities that are based on an underlying asset, are issued in accordance to a base prospectus and to the completion documents related to this prospectus, and that may be admitted to trading on the regulated market administered by B.S.E. Issuers of structured products may be credit institutions, investment firms as well as other financial institutions subject to authorization and regulation of the competent authorities of member or non-member

states. Structured products can be: certificates, warrants and other types of structured products.

In the outlook of Community legislation⁵ structured finance products are those securities created for securitization and transfer credit risk associated with a group of financial assets, which entitle the holder to receive regular payments that depend on the cash flows from the underlying assets. In terms of the certificates, the main type of structured products and so far the only traded on B.S.E., they are defined as securities that are negotiable on the capital market and which, in case of repayment of the investment by the issuer, is situated above shares, but below instruments of bonds unguaranteed or other similar instruments.

In fact, any certificate is based a certain underlying asset, which may be another financial instrument (for instance, shares), a stock exchange or rate index, an interest rate, a commodity, as well as combinations resulting from joining these instruments or other assets. Thus, the price of the certificate evolves closely with the price of the underlying asset to which it relates. In this way, certificates are diversified investment tools that allow an industry, region or activity to be covered by a single transaction (Tolle, Hutter, Ruthemann and Wohlwend, 2008, p.68).

Depending on the predicted investment timeframe but also the degree of risk that each investor is willing to assume, on the stock markets can be traded three kinds of certificates:

- Investment certificates (index certificates) are preferred by the fund holders pursuing undertaking medium and long term investments, the risk being equivalent to the market risk; through them investors benefit directly from the evolution of the underlying asset, as if they had made a direct investment in the respective underlying asset, allowing efficient management of portfolio risk; thus, due to their simple and transparent construction, index certificates emerge as a financial instrument popular among investors;

- Capital protected certificates are especially assigned to medium and long-term investors with a moderate or high aversion to risk, as they hold a component of capital protection, partial or total, but only valid if maintaining position until the maturity of the certificate; capital protection is applied to the nominal value of the certificate, not the purchase price thereof, which may be influenced by the price and volatility of the underlying asset or financing costs incurred by the issuer when issuing the certificate;

- Turbo certificates are used mainly by experienced investors, with a high speculative profile and pursuing mainly short-term opportunities for resource investment; they offer investors the opportunity to benefit from the market trend of the underlying asset both upward and downward ,by long and short turbo certificates; in the formula for determining the price of the certificate appears the exercise price, sizing the value of the investment being made by proportion and giving, thus, rise to the leverage effect; considering the action of the leverage effect, the evolution of the underlying asset value will disproportionately influence the price of the certificate, bearing the possibility too obtain both a yield higher than that of the underlying asset, and a more significant loss than that of the underlying asset, when the market evolves favorably or unfavorably to the investor, corresponding with the type of turbo certificate owned (long or short);

⁵ Article 2 of the Regulation no.600/2014 of the European Parliament and the Council from May 15, 2014 regarding the markets of financial instruments published in the Official Journal of the European Union no.173/12.06.2014

8. Derivative financial instruments

Derivative financial instruments or simply derivatives are defined in domestic legislation by Article 2, section 12 of Law no.297 / 2004 on the capital market as being represented by:

- Financial futures, including equivalent cash-settled instruments;
- Options with support such as : securities, units, money market instruments, futures, including equivalent cash-settled instruments, exchange rate, interest rate and commodities;
- Derivative financial instruments on commodities;
- Combinations of these and other such qualified instruments via CNVM regulations;

In the literature, the approach on derivative financial instruments is done in a relatively uniform manner. Thus, a derivative can be defined as:

- A contractual agreement to execute a trade at a certain date in the future; the term "derivative" comes from the fact that the agreement "derives " its value from the price of an underlying asset such as stock or debt securities, an exchange rate or a commodity(Whaley, 2006, p.3);
- A product designed mainly to transfer risk and, in the absence of the use of derivatives in trade, commodities, investment and finance, major fluctuations would occur in what concerns the offer and prices, along with high uncertainty (Loader, 2005, p.9);
- A contract between two parties that sets the conditions - in particular, the data and the resulting values of the underlying assets – for the execution of future payments between the parties to the contract (Rubinstein, 1998);

Synthesizing the above definitions we can say that derivatives are instruments whose value depends on the evolution of one or more underlying elements such as shares and bonds, interest rate, exchange rate, stock indices, etc.

As can be seen in Figure 1, at Bucharest Stock Exchange, only two types of derivatives are being traded, futures and options respectively.

A futures contract consists of a standardized commitment assumed by a buyer and a seller to buy / sell, no matter in what order, a certain commodity, financial security or monetary instrument at a price negotiated at the time of the transaction, the liquidation of the contract being made at a future date fixed by the exchange.

Organized futures markets, as we know them today, have appeared in the second half of the nineteenth century in Chicago, through the Chicago Mercantile Exchange (CME), having at first as underlying assets only commodities under the form of agricultural goods. Currently, financial futures based on currencies, financial indices or debt instruments are traded currently on the market.

Table 1 Evolution of the notional value⁶ of derivatives traded on stock exchanges and OTC markets (trillion dollars)

Market type/Timeframe	December 2012	December 2013	June 2014	December 2014
Stock Exchanges	54,11	64,10	77,87	64,86
OTC Markets	635,69	710,63	691,49	Unavailable data

Source: author processing according to the Bank of International Settlements available online at <https://www.bis.org/statistics/>

⁶ Total value of the underlying assets of derivatives.

As we can see in table 1, the notional value of derivatives traded on OTC markets totaled in June 2014, 691 trillion dollars, compared to only 78 trillion dollars for stock exchanges, making it obvious that investors prefer to trade these financial instruments markets on deal markets, not on organized ones.

The second type of derivative instrument traded on the stock exchanges is the option, buying it giving the holder the right, but not the obligation, to buy (call) or sell (put) a financial instrument at a specified strike price at a specified future date (European-style options) or even before that (American-style options) (Eales, Choudhry, 2003, p.6).

Analyzing the significance of the option as a derivative, we can say that a call option is favorable for its owner as long as the sum between the strike price and the paid bonus is less than the market price of the underlying asset, while a put option presents advantages for the owner as long as the difference between the strike price and the paid bonus is superior to the market price of the underlying asset.

9. Conclusions

Analyzing the multitude of financial instruments traded on the stock exchanges, we see that they are as diverse as they are complex.

Thus, if in the past the only securities traded on the stock exchange were the primary ones, either in the form of equity securities (shares), or in the form of debt securities (bonds, treasury bills), currently hybrid securities as structured products become increasingly more attractive among investors. At the same time, derivatives have evolved from futures that had as underlying asset only one commodity, agricultural products, into futures and options on a variety of financial instruments such as interest rates, exchange rates of different currencies, stock or financial indices.

At the same time, it should be mentioned that investors must select the financial instruments in which they wish to place their funds in accordance to the timeframe considered and to their own aversion towards assumed risk. Thus, for an investor who does not seek immediate gains nor wants to assume a high risk is indicated purchasing bonds, government securities or structured products of the type of capital protected certificates. If the same long-term investor decides that he can take a higher risk in order to obtain higher gains, can choose to purchase shares or structured products such as index certificates, following a rigorous fundamental analysis of the issuing company concerned.

The third situation targets investors who seek to obtain short-term gain, but with certain aversion towards the level of assumed risk, for whom is recommended to purchase ETF fund units as they follow, most often, the evolution a stock index or a basket of shares, having therefore a composite structure and thus being less influenced by market pressures.

Last but not least, experienced investors pursuing short-term placement of funds and obtaining substantial gains regardless of the level of assumed risk can achieve this goal by purchasing structured products such as turbo certificates as well as derivatives such as futures and options these offering, by their nature, the possibility of obtaining a higher yield than that registered by the market.

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