

# Another step towards the opening up of China's Capital Market - The domestic futures market

While China has been committed to increasing accessibility to the domestic capital market in the past two decades (which has already involved launching QDII, QFII, RQFII and most recently the Shanghai–Hong Kong Stock Connect program), the domestic futures market has still been largely closed to foreign investors. An exception is that QFIIs and RQFIIs may invest in stock index futures, subject to the approval and any agreed trading quota granted by the China Financial Futures Exchange. Interestingly, the China Securities Regulatory Commission (CSRC) has just issued a set of measures (in consultation draft) to bring a big step forward towards opening the futures market, which has been long-awaited by many market participants.

## Background

On 31 December 2014, CSRC issued the *Interim Administrative Measures on the Trading of Designated Domestic Futures Products by Foreign Traders and Brokerage Firms* (Consultation Draft). This Consultation Draft is intended to introduce non-China based foreign traders and foreign brokerage firms (collectively, the Foreign Participants) to the China domestic futures market and introduce better international practices to and improve the price discovery function of the China market through better liquidity.

## Designation of futures products

CSRC will designate, on a case by case basis, the specific futures products available for Foreign Participants. In making these designations, CSRC will take into consideration the current pace of the opening up of the RMB capital account, on-going market participation, available risk management and control and other relevant factors. Since CSRC has, on 12 December 2014, approved crude oil futures trading on the Shanghai International Energy Exchange (which is a subsidiary of the Shanghai Futures Exchange incorporated in the China (Shanghai) Pilot Free Trade Zone), crude oil futures will be designated as the first futures available for Foreign Participants. It has been reported that crude oil futures contract is likely to be listed during the first half of year 2015.

## Overview of the Consultation Draft

The Consultation Draft outlines the general administrative framework for trading by Foreign Participants on the futures market.

### *What access channels are there?*

The Consultation Draft provides Foreign Participants with multiple channels to access the domestic futures market, such that:

- (1) a foreign trader may either appoint a domestic futures company or a foreign brokerage firm to trade the designated futures products, or trade directly on a domestic futures exchange subject to satisfaction of a qualification approval by the relevant exchange;
- (2) upon the entrustment by foreign traders, a foreign brokerage firm may either appoint a domestic futures company to trade the designated futures products in the name of the domestic futures company or, subject to satisfaction of a qualification approval by the relevant exchange, to trade directly on a domestic futures exchange in its own name; and
- (3) subject to the approval of CSRC, a qualified foreign brokerage firm may set up a wholly-owned futures company or a joint venture futures company (with a foreign controlling stake) in a free trade zone to trade designated futures products solely for Foreign Participants.

Except in relation to (3) above which is subject to approval of CSRC, the relevant futures exchange has sole authority to accept applications from the Foreign Participants for direct trading and to decide whether or not to admit them. According to the Consultation Draft, the relevant futures exchange must formulate its detailed application requirements and procedures in relation to the Foreign Participants.

### *What are the eligibility criteria?*

Depending on which of the different access channels are adopted by foreign traders or foreign brokerage firms, certain eligibility criteria would then apply. Generally, foreign traders and foreign brokerage firms which participate directly in trading on the futures exchanges will be subject to the following qualification requirements:

- (1) their domicile country/region has a sound legal and regulatory system;
- (2) they have stable financial status, good credit standing and sufficient working capital;
- (3) they have a sound corporate governance and internal control system and operate in compliance with applicable laws; and
- (4) they meet all other requirements prescribed by the relevant futures exchange.

In addition, for any foreign brokerage firm participating directly on a domestic futures exchange, their local futures regulator must have entered into a memorandum of understanding that addresses regulatory cooperation with CSRC.

### *Are there any risk control measures?*

To ensure that market operation will be stable and risks are measurable and kept under control, the Consultation Draft imposes various risk control measures. These include:

- (1) the relevant futures exchange will act as a central clearing counterparty and provide settlement on a net basis;
- (2) Foreign Participants will contribute margins to the relevant futures exchange which may only be used to settle futures transactions;
- (3) the trading position of Foreign Participants will be liquidated if they fail to maintain margin or close out positions within the prescribed timeline;
- (4) Foreign Participants must report to the relevant futures exchange when their position limit prescribed by the exchange is reached; and
- (5) Foreign Participants are obliged to provide relevant information concerning domestic futures trading upon the request of CSRC or its local agency. They are also subject to inquiries and on-site inspections.

### *What are the legal liabilities and how is regulatory enforcement conducted cross border?*

As the Consultation Draft is based on the *Administrative Rules on Futures Trading* issued by the State Council on 24 October 2012 (Futures Trading Rules), for certain aspects relevant to the trading of futures such as margin, settlement default and consequences of breach, the Futures Trading Rules will generally apply.

In an effort to create a system of orderly futures trading by Foreign Participants, the Consultation Draft mirrors several regulatory sanctions from the Futures Trading Rules. For example, in the event a Foreign Participant's violation seriously jeopardizes the order of the futures market or infringes the interests of traders, they may be subject to administrative penalties or even criminal liabilities.

In addition, the Consultation Draft provides that CSRC will strengthen cross-border regulatory and enforcement cooperation with the futures regulators of the Foreign Participants in accordance with the relevant memorandum of understanding on regulatory cooperation.

## Outstanding issues

Whilst the Consultation Draft has initiated an important step towards a more open and international-facing futures market from China and provides for a relatively flexible administrative regime, there are some issues worth considering and clarifying through the consultative process with CSRC:

### *Coordination with other PRC regulators*

By analogy to the other liberalisation programs to open up the China securities market to foreign investors (such as QFII and RQFII regimes), coordination from the beginning among the relevant China regulators have been necessary and important to ensure an effective administrative system.

As futures trading by Foreign Participants will involve regular cross-border flow of funds and the opening of various accounts onshore, consultation with the appropriate regulators such as the State Administration of Foreign Exchange (SAFE) and the People's Bank of China (PBOC) will be necessary. For example, it is currently unclear whether the opening of accounts for futures trading and to permit funds flow into/out of these accounts will be subject to approval by SAFE or PBOC; whether foreign investors will be able to enjoy exemption from income tax (as applicable under the QFII/RQFII and the Stock Connect regimes); and whether foreign traders are able to enjoy simplified customs procedures to allow delivery of physical products upon execution of the futures contracts.

Under the QFII and RQFII regimes, some rules have been jointly issued by CSRC, SAFE and PBOC. It is worth considering whether a similar approach should be taken now for the futures market, though apparently these authorities are likely to issue their own rules separately.

#### *Distinction between investor and manager*

It is worth noting that the Consultation Draft has defined "foreign traders" as overseas-incorporated institutions or foreign individuals who engage in futures trading and assume the trading results and risks. The current definition would therefore preclude scenarios where an asset manager enters into futures trading for the account of their clients (such as a hedge fund), as under this scenario the result and risks of the trading will be borne by the client rather than the manager. Given that this situation would be common in the international futures market, the Consultation Draft should provide flexibility for foreign asset managers participating in domestic futures trading for their clients and thereby make a distinction with proprietary trading.

Also, some foreign regulators may require the relevant Chinese futures exchange to file with them if such an exchange accepts investors from their jurisdictions. It will be interesting to see how CSRC and the Chinese futures exchanges react to this requirement.

#### Conclusion

Admission of Foreign Participants to the domestic futures market will be a major step towards the long-term objective of CSRC to fully open up the domestic capital market. Although it remains uncertain when CSRC will designate other futures products to be available for trading by Foreign Participants following the crude oil futures, the general development trend is for there to be a further opening up of the market and initiatives to this effect should be anticipated for later.

It should be noted that the Consultation Draft may be further modified following the end of the consultation period on 31 January 2015. It will be interesting to see how the final rules differ from this Consultation Draft.

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