

DRAFT PRC FUTURES LAW: WHAT TO EXPECT FOR EXCHANGE- TRADED AND OTC DERIVATIVES TRADING?

The National People's Congress of the PRC¹ published on its website the draft of the *PRC Futures Law* for public consultation (the Draft Futures Law) on 29 April 2021, after review and deliberation by the Standing Committee of the National People's Congress, the country's top legislature.

The public consultation period lasts until 28 May 2021. It will be the PRC's first statute on exchange-traded and over-the-counter (OTC) derivatives and includes a number of key potential developments, which may have a significant influence on international market participants trading in the PRC or dealing with PRC counterparties.

Crucially, for the very first time at the level of a national statute, the Draft Futures Law brings OTC derivatives trading into its purview and recognises the concept of single agreement and enforceability of close-out netting mechanics adopted under the relevant industry-wide master agreements. It is also important to note that the Draft Futures Law covers other important areas in the derivatives market, such as providing detailed and specific operating and regulatory requirements in relation to the trading, settlement and clearance of futures and options, and setting out the framework for cross-border regulatory cooperation of enforcement.

In this briefing, we highlight these key developments and examine their implications on international market participants trading in the PRC or dealing with PRC counterparties.

1. OTC Derivatives

The Draft Futures Law introduces a concept of "Other Derivatives", which is defined as any non-standard contract with a future settlement date, the value of which is derived from changes in the value of the referenced assets, including options, swaps and forwards. This concept captures OTC derivatives.

The Draft Futures Law further specifies that underlying assets can be commodities, "services" (such as freight) and their related indices, financial products (such as securities), interest rates and exchange rates as well as their

Key issues

- For the very first time at the level of a national statute, the Draft Futures Law brings OTC derivatives trading into its purview and recognises the concept of single agreement and enforceability of close-out netting mechanics
- The Draft Futures Law establishes more comprehensive futures trading, settlement and clearance rules and codifies prohibitions on misconduct in futures trading (such as market manipulation and insider dealing)
- Extraterritorial application of the Draft Futures Law is worth noting and a wide range of market participants may find themselves technically caught by the Draft Futures Law, including non-PRC futures exchanges and non-PRC futures brokers, to which a registration requirement shall apply. There are also express rules on cross-border marketing activities

¹ PRC stands for the People's Republic of China.

related indices. Interestingly, the current draft definition does not cover credit, carbon emission or climate related allowances as underlying assets, but this may be amended in the next version of the Draft Futures Law.

Single agreement and close-out netting

The Draft Futures Law provides that industry associations or other institutions organising OTC derivatives trading (each a Trading Venue) should file the form of master agreement used for OTC derivatives trading with the relevant authority authorised by the State Council (such master agreements, Filed MA, and such requirement, the Filing Requirement), but it is unclear whether all master agreements entered into by PRC counterparties need to be filed with PRC authorities.

The Draft Futures Law also recognises the concepts of single agreement and close-out netting, and provides that :

- a Filed MA, and all supplements and other confirmations thereto shall be deemed as a single agreement (Single Agreement); and
- upon any agreed event, OTC derivatives transactions under a Single Agreement are capable of being closed out according to the relevant terms and conditions of the Filed MA on a net basis. The enforceability of such close-out netting mechanics shall not be affected by the entry into bankruptcy proceedings by any party.

Although several issues may require clarification or revision under the Draft Futures Law, the recognition of close-out netting mechanics under PRC statute marks an exciting breakthrough for the international derivatives community. If the Draft Futures Law is finalised and promulgated, the long-running uncertainty and debate on the enforceability of close-out netting in the context of a PRC counterparty's insolvency proceedings may finally be resolved. This development will fundamentally change the landscape of cross-border OTC derivatives trading with PRC institutions by reducing regulatory capital costs for foreign institutions. However, it is worth remembering that resolving close-out netting in the PRC will also introduce other regulatory issues such as the application of margin rules for PRC counterparties and recognition of PRC central counterparty (CCP) status.

We note that PRC domestic industry associations such as the National Association of Financial Market Institutional Investors (NAFMII) and the Securities Association of China (SAC) have already filed their respective master agreements with the corresponding regulators. However, in a cross-border context, two issues remain uncertain under the Draft Futures Law, and will require clarification through corresponding judicial interpretation and/or subsidiary regulations or revisions in the final version of the PRC Futures Law:

- whether the Filing Requirement is intended to capture only PRC-law governed master agreements. If so, it is necessary to clearly define the industry associations and Trading Venue caught under the Filing Requirement; and
- if the Filing Requirement applies to non-PRC-law governed master agreements, whether filing is a pre-requisite for the enforceability of close-out netting under such master agreements.

In addition, it is currently doubtful that the definition of Other Derivatives is sufficiently broad to cover master agreements relating to repurchase transactions and stock lending transactions. There is also uncertainty as to how mini-master agreements used by market participants will be treated under the Draft Futures Law. These will be issues which the industry will need to clarify with the PRC regulators in due course.

Reporting and Central Clearing Requirements

The Draft Futures Law also provides that the relevant authority authorised by the State Council shall establish trading repositories which shall be responsible for collecting, storing, analysing and managing the relevant information related to OTC derivatives transactions.

In addition, where central clearing is required for a specific type of OTC derivatives transactions, such central clearing shall be processed by a duly-approved organisation as the CCP for such transactions.

Whilst these two requirements are consistent with the global OTC derivatives reform mandated by G20, the Draft Futures Law remains silent on margin requirements for OTC derivatives transactions, and it is less clear whether PRC regulators have any plans to establish margin requirements for the trading of OTC derivatives.

2. Futures /Exchange-Traded Derivatives

Currently, international investors may access the PRC futures market mainly via (i) direct access to the relevant futures exchanges for trading designated commodity futures contracts², (ii) the qualified foreign investor regime (QFI)³, (iii) setting up a trading-type wholly foreign-owned entity in china (WFOE)⁴, and/or (iv) otc products that are offered outside the PRC to gain synthetic exposure to the PRC futures market⁵.

While access to the PRC financial markets have been gradually liberalised, the absence of a unified set of legal rules for futures trading has limited the internationalisation of this market, as new entrants need to carry out regulatory analysis based on rules scattered across different PRC legal sources. The Draft Futures Law has addressed this issue by codifying such rules in the form of a statute.

Futures trading rules

² Under the direct access channel, international investors may trade designated commodity futures directly. See our briefing "[A Milestone Development for the China Futures Market – Crude Oil Futures Trading on the Shanghai International Energy Exchange Officially Inaugurated](#)" for the specific mechanisms of such direct access. To date, via this channel, offshore investors may access 7 types of commodity futures contracts so designated, which are crude oil contracts, TSR 20 contracts, low sulfur fuel oil contracts and copper (bc) contracts listed on Shanghai International Energy Exchange, iron ore contracts and palm oil contracts on Dalian Commodity Exchange and PTA on Zhengzhou Commodity Exchange.

³ Under the QFI scheme (see more details from our recent briefing "[China Combines QFII and RQFII Regimes and Expands Investment Scope](#)"), an investor with QFI licence is permitted to trade financial futures contracts listed on China Financial Futures Exchange (CFFEX), commodities futures and listed options. However, besides stock index futures on CFFEX, other types of futures and listed options to be permitted as well as the trading methods still remain to be determined by the relevant exchanges and the China Securities Regulatory Commission (CSRC).

⁴ International investors may establish WFOEs in the PRC to carry out trading activities. Such WFOEs may trade on PRC futures exchanges through PRC futures brokers to hedge or manage risks arising from their physical trading activities. These WFOEs are viewed as PRC domestic investors and shall comply with the relevant regulations and rules that apply to PRC domestic investors.

⁵ International investors may also buy market access products such as total return swaps and participation notes from non-PRC institutions, which have access to the PRC futures market via channels like the QFI regime, to get synthetic exposure to the relevant PRC futures contracts.

Section 2 of the Draft Futures Law specifies rules for futures trading. Compared with the current Administrative Regulations on Futures Trading (2017 Amendment) (the Futures Trading Regulations) that has been implemented for many years, the following aspects are worth noting.

- **Eligible margin** – Under the Futures Trading Regulations, "margin" refers to cash or negotiable securities with stable value and strong liquidity such as standard warrants and treasury bonds. The Draft Futures Law broadens the scope of eligible margin by specifying that eligible margin may also include securities with strong liquidity such as shares and fund units.
- **Reporting of actual control relationship** – Under the Draft Futures Law, investors with an "actual control relationship" are required to report the existence of such relationship to futures brokers or exchanges. "Actual control relationship" is defined as the power of one person to direct the operation of or exercise significant influence over the futures account of another person. Though PRC futures exchanges have promulgated various exchange rules on the supervision of accounts with actual controlling relationship, this is the first time that such a reporting mechanism is specified in law. Detailed reporting measures will be further issued by CSRC.
- **Programme trading** – Though PRC futures exchanges have already imposed filing or reporting requirements on programme trading, the Draft Futures Law unifies such requirements and further provides that utilisation of programme trading may not impact the security of exchange systems and normal operation of the futures trading venues. This is an important issue for many hedge funds that operate algorithmic trading (or similar strategies), and we look forward to further clarity on the acceptability of programme trading in the PRC financial markets.
- **Market manipulation** – The Draft Futures Law provides a list of conduct regarded as prohibited market manipulation activities if they impact or are intended to impact the pricing or volume of futures trading, which include:
 - (a) leveraging advantages of funding, position holding or access to information to make joint or successive trading of contracts (independently or through conspiracy with others);
 - (b) trading futures with others at the time, price and method agreed in advance;
 - (c) trading futures between accounts controlled by the same person;
 - (d) using false or uncertain material information to induce investors to trade futures;
 - (e) frequent or massive order submission and cancellation which are not for the purposes of concluding trades;
 - (f) making public comments, giving forecasts or investment advice on the futures trading or the trading of underlying assets while holding the relevant contracts;

- (g) hoarding spot commodities in order to influence pricing on futures market;
- (h) using improper means to circumvent position restrictions when approaching the delivery month or during the delivery month and therefore creating an advantage on positions holding; and
- (i) manipulating the futures market through activities in other related markets.

In respect to item (f), the restrictions under current law only capture futures trading by an investor which is inconsistent with such investor's public comments, forecast or investment advice. However, the Draft Futures Law seems to prohibit any public comments, forecast or investment advice, irrespective of their direction, as long as the investor itself is holding the relevant futures contracts.

It will be important for market participants offering exposure to the PRC futures market to carefully consider the potential impact of trades which they facilitate on the PRC market, and to observe how PRC regulators develop a track record on enforcement which will guide market participants on what constitutes acceptable trading behaviour.

- **Insider dealing** - The Draft Futures Law further expands the scope of inside information under the Futures Trading Regulations, and specifies that the following information shall be recognised as inside information:
 - (a) policy, information or data under formulation of or to be announced by CSRC or other related authorities, which may have significant impact on futures trading price;
 - (b) decisions made by futures exchanges, clearing agencies and industry associations which may have significant influences on futures trading price;
 - (c) details of cash movements or trading of exchange members or investors;
 - (d) major abnormal trading information in other related markets; and
 - (e) other information that may have significant influences on futures trading price as recognised by CSRC.

As the liberalisation of the PRC futures market gathers pace, we expect PRC regulators to closely scrutinise market participants for what such PRC regulators may consider to be abusive trading activity. As with other jurisdictions, it will be important to pay close attention to how PRC regulators choose to interpret these policy-based rules, which will form a guide for future behaviour by market participants.

Settlement and Clearing of Futures Trading

The settlement and clearing rules proposed under the Draft Futures Law remain largely consistent with those under the Futures Trading Regulations and the relevant judicial interpretations. For example, the Draft Futures Laws reinforces the principle of mark-to-market settlement, requires the segregation of client

margins and premiums from proprietary moneys of the relevant clearing agencies or exchange participants, and reiterates the sequence of applying the relevant assets or reserves to make up for the shortfall in case of a default in the settlement process.

Importantly, Article 21 confirms that trades executed and settled in accordance with the business rules of PRC futures exchanges are final and can only be changed by the relevant futures exchange in very limited circumstances and in accordance with a strict procedure under law.

Another prominent development lies in Article 46, in relation to the treatment of the margins, premiums, settlement reserves and risk reserves collected by futures exchanges. It specifies that these assets may not be seized, frozen or enforced against. In addition, it provides that the margin posted by any broker (as a settlement participant), delivery warehouse or investor and the relevant assets to be delivered for settlement shall be firstly applied to the settlement of the relevant futures contracts, even when such broker, warehouse or investor, as the case may be, enters into bankruptcy proceedings or liquidation procedures. Before the completion of the settlement, such margin or assets may not be used for any other purposes. This provision overrides the asset allocation arrangement of the PRC Enterprise Bankruptcy Law (2007) and further reinforces settlement finality.

3. Extraterritoriality

The Draft Futures Law provides for extraterritorial application and a wide range of market participants may find themselves technically caught by it. We would note that although these provisions appear to be brand new rules, in practice they simply codify some existing practices (and are consistent with the commonly adopted approach and practices of some other jurisdictions as well) and set out a framework at the statute level.

- **General extraterritorial application** - Article 2 of the Draft Futures Law provides that any futures or OTC derivatives trading and related activities conducted outside the PRC with the effect of disrupting the order of the PRC market shall be subject to this law. While the Draft Futures Law does not provide any further detailed parameters in this aspect, as was the case under the PRC Securities Law (2019 Amendment), this provision demonstrates the PRC government's claim of jurisdiction over activities taking place outside the PRC but which adversely affect the onshore market in the PRC, and can provide a legal basis for PRC regulators to take cross-border enforcement activities. We expect that in the short term, this relies on bilateral or multilateral regulatory cooperation arrangements, such as is the case under Stock Connect.
- **Futures exchanges** - According to Article 131 of the Draft Futures Law, any non-PRC futures exchanges that provide entities or individuals within the territory of the PRC with direct access to its trading system for trading, shall register with the CSRC or apply for exemption, and shall be subject to the supervision of the CSRC. By a literal reading of this provision, it suggests that the crux is whether direct access is provided to domestic investors. In other words, it appears that if PRC investors trade futures contracts through participants of a non-PRC exchange, but without "direct access" to

such exchange's trading system, this registration/exemption requirement will not be triggered. The registration procedures and the available exemptions will be key considerations when assessing the compliance burden for non-PRC futures exchanges, which are expected to be clarified through subsidiary regulations.

Furthermore, if a non-PRC futures exchange offers a derivatives contract which is settled by reference to the price of a futures contract listed on a PRC futures exchange, such overseas futures exchange will need to comply with the relevant rules of CSRC.

- **Brokers** - Article 133 provides that, if a non-PRC broker is engaged by a PRC futures broker for such PRC futures broker's futures trading, such non-PRC broker shall register with the CSRC or apply for an exemption. Similarly, registration is also triggered if an overseas broker is instructed by an overseas investor to trade futures in the PRC directly. Again, more implementation details will become available in subsidiary regulations.
- **Marketing activities** - Unless approved by the CSRC, a non-PRC institution may not conduct marketing, promotion and solicitation activities related to futures in the PRC (or set up a branch to do so), and no entity or individual may conduct such activities in the PRC for non-PRC futures exchanges or futures brokers.
- **Export of futures related documents and materials** - Many firms may find themselves placed in a difficult position due to the last paragraph of Article 136, which prohibits any entity or person from providing any document or material related to futures business activities to parties outside the PRC, unless with prior consent of the relevant authorities. This requirement could be less stringent if market participants take the view that this requirement only applies in the context of international enforcement cooperation including, for example, mutual assistance in the investigation of non-compliance and disposal of cross-market risks. Bearing in mind the PRC Data Security Law (2021 Consultation Draft) and related initiatives of the PRC government, we would recommend extra caution when dealing with cross-border data sharing activities.

4. What to Expect Next

The deadline for the submission of comments on the Draft Futures Law is 28 May 2021. Preparation and promulgation of the Draft Futures Law is a key item on the legislation plan of the PRC for 2021, and it is anticipated that the draft will be revised and finalised shortly. As several key developments in the PRC (including recognition of close-out netting) may happen shortly, market participants should assess the potential implications due to, among others, the switching on of close out netting for its PRC counterparties.

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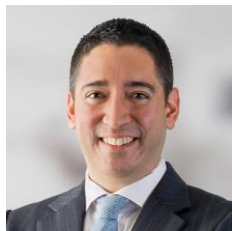
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