

## PRC PASSES THE FUTURES AND DERIVATIVES LAW, THE FIRST PRC STATUTE ON OTC DERIVATIVES

After one year of public consultation, the *PRC Futures and Derivatives Law* (the "FDL") was passed by the Standing Committee of the National People's Congress of the PRC and promulgated by Chairman Order No. 111 on 20 April 2022. The FDL will take effect on 1 August 2022. Our previous client briefing on this subject can be found [here](#).

The FDL marks one of the most important milestones in the development of the over-the-counter (OTC) derivatives market in the PRC, and is the culmination of intense regulatory engagement by industry bodies, financial market infrastructure, international dealers and law firms over many years. It is widely expected by market participants that this statute will pave the way for recognition of close-out netting in the PRC, as the FDL is the first national level statute that expressly recognises the concept of single agreement and protection of close-out netting against bankruptcy laws.

The FDL also (a) sets out a comprehensive legal framework in the PRC underpinning futures and derivatives trading, settlement and clearing, (b) introduces reporting requirements for derivatives, and (c) enhances regulation of marketing by non-PRC institutions in China.

### SINGLE AGREEMENT AND CLOSE-OUT NETTING

For the first time in PRC statute, the FDL expressly recognises the concepts of single agreement and close-out netting. This is a critical development given the historical uncertainty expressed by the majority of market participants on the enforceability of close-out netting under PRC law.

#### Historical Background – what were the uncertainties on close-out netting before the FDL:

- Before the FDL, although there is no provision under PRC law which was expressly inconsistent with the operation of close-out netting on the insolvency of a PRC counterparty, there was also no statutory provision or judicial interpretation (or precedent) which expressly recognised close-out netting under PRC law. As a result, the "traditional" analysis of PRC netting relied on insolvency set-off.
- The reliance on PRC insolvency set-off to justify enforceability of close-out netting gave rise to some uncertainty. In particular, many market participants considered there were two scenarios where close-out netting might be challenged under PRC law after the acceptance of a bankruptcy

#### Key issues

- For the first time under a PRC statute, the FDL expressly recognises the concepts of single agreement and close-out netting. Equivalent protection will also be provided to cleared derivatives.
- Under the final version of the FDL, recognition of single agreement and enforceability of close-out netting is de-linked from the filing requirement.
- Direct and indirect futures marketing activities by non-PRC institutions inside China are subject to regulatory approval.
- Trading repositories responsible for collecting, storing, analysing and managing the relevant information related to OTC derivatives transactions will be established.

petition by a competent PRC court (the "**Acceptance of Petition**") against a PRC counterparty:

- *Scenario 1*: the administrator exercises its "cherry picking" right under Article 18 of the *PRC Enterprise Bankruptcy Law (2007)* (the "**PRC Bankruptcy Law**") and requires both parties to continue performance of the relevant agreement. It was perceived that there was a theoretical possibility that an administrator may rely on the "cherry picking" right under Article 18 to challenge any attempt to early terminate all OTC derivative transactions under a master agreement (such as an ISDA) after the acceptance of petition; or
- *Scenario 2*: the close-out amount claimed against the insolvent PRC debtor is challenged during the process of filing creditors' claims (the "**Bankruptcy Claim Filing**") pursuant to Article 40 of the PRC Bankruptcy Law (which provides certain restrictions on a creditor's ability to set-off). It was perceived that there was a theoretical possibility that an administrator may rely on Article 40 to deny the use of insolvency set-off to determine the close-out amount.
- Based on the above, prior to the FDL, most international market participants took the view that there was uncertainty on whether close-out netting against an insolvent PRC counterparty would be recognised by a PRC court and how the "cherry picking" right might be exercised by the administrator given the absence of statute, judicial guidance and precedent cases.

The FDL directly addresses these concerns by expressly recognising the single agreement concept, and expressly providing that close-out netting should not be adversely affected by the entry into insolvency of either counterparty.

#### **De-linkage of filing requirement from enforceability of close-out netting**

The initial draft of the FDL (which was originally titled the *PRC Futures Law*) (the "**Initial Draft**") was published for public consultation on 29 April 2021. The second reading of the draft law (renamed to the *PRC Futures and Derivatives Law*) took place between 19 to 23 October 2021. One of the most important changes under the final version of the FDL is the de-linkage of the filing requirement of a master agreement from the enforceability of close-out netting under such master agreement.

The Initial Draft contained a filing requirement which provided 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, the "**Filed MA**", and such requirement, the "**Filing Requirement**").

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

This filing requirement was the subject of significant discussion and concern, as no other major derivatives market globally had an equivalent requirement, and it was unclear how the filing process would operate in practice.

#### **Articles 32-35 of the FDL**

- *Article 32*: Where derivatives transactions are carried out under a master agreement, the master agreement and all supplements to the master agreement and other agreements between the parties on specific transactions constitute a complete single agreement between the parties with legally binding force.
- *Article 33*: The master agreement and other template contracts under Article 32 of this Law shall be filed in accordance with the provisions of the relevant authority authorised by the State Council or the futures regulatory authority under the State Council.
- *Article 34*: When trading derivatives transactions, the parties may provide performance assurance in accordance with law by pledge or other means.
- *Article 35*: With respect to derivatives transactions effected under a master agreement in accordance with law, such transactions may be terminated according to the relevant agreement upon the occurrence of any circumstances agreed therein, whereby the profits and losses of all the transactions under such agreement could be settled on a net basis. The net settlement conducted in accordance with the preceding paragraph shall not be stayed, invalidated or revoked by the entry into bankruptcy proceedings by any transaction party in accordance with law.

Market participants should therefore be very encouraged to see in the final version of the FDL that the concerns of the international derivatives market have been addressed by de-linking the enforceability of close-out netting from the Filing Requirement:

- as opposed to the Initial Draft which provides that a Filed MA together with all supplements and other confirmations thereto constitute a single agreement, Article 32 of the FDL provides that where derivatives transactions are subject to a master agreement, the master agreement together with all supplements and other confirmations thereto shall be deemed as a single agreement, without reference to the Filing Requirement;
- the Filing Requirement is reflected as an independent obligation in Article 33 of the FDL, which provides that the master agreement and other template contracts mentioned under Article 32 of the FDL shall be filed in accordance with the provisions of the relevant authorities; and
- instead of referring to the Filing Requirement or a Filed MA, Article 35 provides that OTC derivatives transactions under a master agreement executed in accordance with law are capable of being closed out upon occurrence of agreed events according to the relevant terms of the relevant master agreement on a net basis. The enforceability of close-out netting shall not be affected (stayed, invalidated or revoked) by the entry into bankruptcy proceedings by any party.

The revised wording in the final version of the FDL will no doubt be much welcomed by market participants as it clearly provides for the Filing Requirement to be separated from the enforceability of close-out netting, so that the Filing Requirement is not a pre-condition for close-out netting to be enforceable under PRC law.

It is also worth noting that in November 2021, the PRC banking and insurance regulator, the China Banking and Insurance Regulatory Commission ("**CBIRC**") released the *Notice on Issues Concerning the Measurement Rules for the Default Risk Assets of Derivatives Counterparties (No. 124 [2021] of the General Office of the CBIRC)* (the "**CBIRC Notice**") together with an explanation press note elaborating on enforceability of close-out netting in the PRC and quoting comments from the Supreme People's Court. The CBIRC Notice and its explanation press note have expressly confirmed the enforceability of close-out netting without mentioning any filing requirement, and the CBIRC Notice expressly refers to the NAFMII Master Agreement, SAC Master Agreement and ISDA Master Agreement (thereby conferring formal regulatory recognition on such master agreements).

Finally, we consider that the development under the FDL is also positive for other types of financial market transactions (such as bond repurchase and securities lending transactions), which are technically not in-scope of the FDL. With the concepts of single agreement and enforceability of close-out netting being expressly recognised at a statutory level under the FDL, there will be stronger arguments to support the enforceability of close-out netting for such financial market transactions too.

## **OTHER KEY ISSUES**

### **Title transfer collateral**

Article 36 of the Initial Draft provided that parties to an OTC derivatives transaction may provide performance assurance by way of, among others,

pledge agreement or "*other contracts with a security feature*" (which was generally considered as an allusion to title transfer collateral). However, in the final version of the FDL, "*other contracts with a security feature*" is removed, although Article 34 of the FDL still reads "[w]hen trading derivatives transactions, the parties may provide performance assurance in accordance with law by pledge or other means".

We consider that the removal is mainly because the National People's Congress did not wish to expressly include in the FDL a concept of property law (such as title transfer collateral) which is not expressly included in the newly adopted *PRC Civil Code (2020)*. The absence of a reference to "*other contracts with a security feature*" under the final version of the FDL, however, should not affect the enforceability of title transfer collateral contemplated under credit support documents entered into by PRC institutions given the provision is clearly not limited to only pledges. It is also helpful that the NAFMII Master Agreement already provides for title transfer performance assurance documentation, which has been endorsed by the People's Bank of China.

#### **Marketing activities**

Under the FDL, unless approved by 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. In addition to this restriction, the FDL further provides that a domestic PRC institution also needs to obtain approval from CSRC in order to conduct any marketing, promotion and solicitation activities relating to the futures on behalf of a non-PRC institution. No entity or individual may conduct such activities in violation of these restrictions.

Please note that no safe harbour is made for specific category of targets (such as professional investors). This clearly signals PRC regulators' determination to strengthen regulation of direct and indirect marketing activities by non-PRC institutions inside the PRC.

#### **Trade reporting**

The FDL provides for the establishment of trading repositories which shall be responsible for collecting, storing, analysing and managing the relevant information related to OTC derivatives transactions. Specific rules on trading repositories will be promulgated separately.

#### **Cleared derivatives**

Article 37 confirms that where an approved settlement institution (such as a clearing house) serves as the central counterparty for conducting centralised clearing, close-out netting can be carried out in accordance with law, and shall not be stayed, invalidated or revoked by the entry into bankruptcy proceedings by any party participating in the central clearance. In addition, cash and securities involved in this process will be prioritised for settlement and clearance without being used for other purposes.

### **LOOKING FORWARD**

With the promulgation of the FDL, we expect that significant changes will be brought to the PRC OTC derivatives market. Besides the significant legal work that will commence shortly to confirm the recognition of close-out netting with PRC counterparties, market participants should also consider compliance steps for implementing regulatory margin with PRC counterparties.

Furthermore, the FDL provides that the State Council will separately prepare and promulgate detailed rules to regulate and monitor derivatives trading and relevant activities in accordance with the principles set forth by the FDL. There are also signs that the PRC regulators may introduce domestic rules on mandatory exchange of margin for OTC derivatives.

The passage of the FDL represents a critical milestone for the international derivatives market, and we anticipate will open up a new chapter of regulatory developments in the PRC on OTC derivatives.

## **AUTHOR**



**Terry Yang**  
Partner

**T** +852 2825 8863  
**E** terry.yang  
@cliffordchance.com

## **CONTACTS**

### **BEIJING**



**Yan Li**  
Senior Associate

**T** +86 10 6535 2284  
**E** yan.li  
@cliffordchance.com



**Dora Pan**  
Associate

**T** +86 10 6535 2297  
**E** dora.pan  
@cliffordchance.com



**Jane Chen**  
Associate

**T** +86 10 6535 2216  
**E** jane.chen  
@cliffordchance.com



**Jessy Cheng**  
Associate

**T** +86 10 6535 4935  
**E** jessy.cheng  
@cliffordchance.com

**SHANGHAI**



**Roy Wang**  
Associate

**T** +86 21 2320 7326  
**E** roy.wang  
@cliffordchance.com



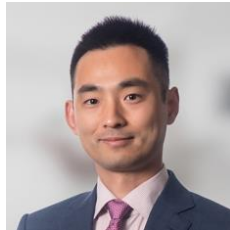
**Yvonne Cheng**  
Trainee

**T** +86 21 2320 7386  
**E** yvonne.cheng  
@cliffordchance.com



**Francis Edwards**  
Partner

**T** +852 2826 3453  
**E** francis.edwards  
@cliffordchance.com



**Lin Lu**  
Registered Foreign  
Lawyer

**T** +852 2826 2427  
**E** lin.lu  
@cliffordchance.com



**Daniel Cai**  
Associate

**T** +852 2826 3521  
**E** daniel.cai  
@cliffordchance.com

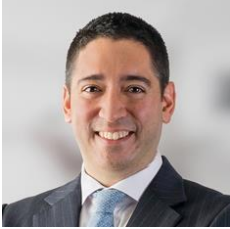


**Karen Jiang**  
Associate

**T** +852 2825 8967  
**E** karen.jiang  
@cliffordchance.com



**SINGAPORE**



**Paul Landless**  
Partner

**T** +65 6410 2235  
**E** paul.landless  
@cliffordchance.com



**Lena Ng**  
Partner

**T** +65 6410 2215  
**E** lena.ng  
@cliffordchance.com



**Miles Binney**  
Counsel

**T** +65 6506 2753  
**E** miles.binney  
@cliffordchance.com



**Mae Yen Teoh**  
Senior Associate

**T** +65 6410 2224  
**E** maeyen.teoh  
@cliffordchance.com



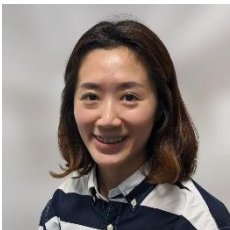
**Allison Tan**  
Associate

**T** +65 6661 2090  
**E** allison.tan  
@cliffordchance.com



**Samuel Kwek**  
Associate

**T** +65 6506 1963  
**E** samuel.kwek  
@cliffordchance.com



**Yaru Chia**  
Associate

**T** +65 6410 2223  
**E** yaru.chia  
@cliffordchance.com



## TOKYO



**Leng-Fong Lai**  
Partner

**T** +81 3 6632 6625  
**E** leng-fong.lai  
@cliffordchance.com



**Hajime Saito**  
Counsel

**T** +81 3 6632 6651  
**E** hajime.saito  
@cliffordchance.com

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One Connaught Place, Hong Kong

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