Legal Commentary

April 29, 2022

Futures Have a Future, So Do Derivatives

Authors: TieCheng YANG | Yin GE | Ting ZHENG | Eryin YING | Krystal He

Background

The PRC Futures and Derivatives Law (the "**FDL**") was adopted on 20 April 2022 and is scheduled to come into effect on 1 August 2022. This new law is another important milestone in the construction of the rule of law in China's capital market. As the "basic law" of China's futures and derivatives markets, it provides a legal basis for the high-quality development of the futures and derivatives markets, creates favorable conditions for the two-way opening up of the markets, and serves as a giant step for China toward becoming a clean close-out netting jurisdiction.

To provide more insights into the FDL and its potential implications for market participants, we analyze in this newsletter the FDL's key provisions and noteworthy points, taking into account the differences between the first and second reading drafts and the final version. Our previous newsletter on the first reading draft can be found *here*.

Key analysis

I. Applicability of the FDL

Article 2 of the FDL provides that the FDL applies to futures transactions, derivatives transactions and related activities conducted (i) within mainland China; and (ii) outside mainland China which disrupt the domestic market order or damage the lawful interests of domestic traders. In terms of scope of application, the FDL focuses on regulating the futures market while taking into account the derivatives market as well, and leaves room for future reform and innovation.

1. Definition of futures and derivatives transactions

Article 3 of the FDL provides that futures transactions refer to trading of futures contracts or standardized options contracts, while derivatives transactions refer to trading of swap contracts, forward contracts, non-standardized options contracts, and any combination of the aforementioned products, other than futures transactions.

In comparison to the second reading draft, the FDL removes the "standardized" qualifier for swap contracts and forward contracts. This seems to indicate that the trading of swap contracts and forward contracts may be categorized and regulated as derivatives transactions regardless of the standardization of those two types of contracts.

2. Distinction between futures and derivatives transactions

Article 3 of the FDL does not provide a clear means of separating futures and derivatives transactions, especially when "standardization" is not well defined. However, Article 11 of the FDL may provide a clearer standard to separate those two types of transactions, which is in line with international practice:

- futures transactions shall be conducted on futures exchanges or other trading venues as approved by the futures regulator under the State Council (i.e., the China Securities Regulatory Commission ("**CSRC**")), and shall be entered into by way of centralized bidding or other trading methods as approved by CSRC; futures transactions conducted outside of futures trading venues are prohibited; and
- derivatives transactions may be entered into by way of contract, which we understand should mean that derivatives transactions may be entered into through contractual negotiation, or other trading methods as prescribed by the State Council.

3. Cross-border OTC derivatives transactions

The FDL does not expressly provide that the law applies to cross-border OTC derivatives transactions. However, regulators have on many occasions indicated that the FDL established a basic framework in line with international practice and confirmed the close-out netting regime for OTC derivatives transactions documented by ISDA agreements.[1] This implies the FDL is applicable to cross-border OTC derivatives transactions.

4. Repos and securities financing transactions

The FDL, including the close-out netting regime under the FDL, will not apply to repos and securities financing transactions. That said, the China Banking and Insurance Regulatory Commission ("**CBIRC**") expressly confirmed that PRC commercial banks can measure the default risk exposure of counterparties and provide regulatory capital on a net basis for bond repo transactions, so long as they are trading with PRC licensed financial institutions and the repo transactions are documented by a CBIRC-recognized master agreement; see the *Notice on Issues Concerning the Measurement Rules for the Default Risk Assets of Derivatives Counterparties* and a Q&A (the "**CBIRC Circular**"), issued on 26 November 2021.

5. Extraterritorial application of the FDL

The FDL will have extraterritorial effect on offshore entities under certain circumstances, in addition to purely offshore futures and derivatives transactions and related activities which disrupt the domestic

[1] See releases at:
https://www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=1020671&itemId=915&generaltype=0
http://www.csrc.gov.cn/csrc/c100028/c2350718/content.shtml.

market order or damage the rightful interests of domestic traders. These offshore entity provisions mainly include:

- Article 118 of the FDL: offshore futures trading venues will need to register with CSRC and accept its supervision if they provide direct access to onshore entities or individuals to their trading system for trading services, unless otherwise provided by CSRC;
- Article 119 of the FDL: offshore futures, options or derivatives contracts listed on offshore futures trading venues that reference the price of contracts listed on onshore futures trading venues must comply with relevant CSRC rules;
- Article 121 of the FDL: offshore futures trading venues will need to file with CSRC if they intend to set up a representative office in China; and
- Article 122 of the FDL: marketing, promotion and solicitation activities in China's futures market conducted by offshore entities will need to be approved by CSRC and be subject to the relevant provisions of the FDL; onshore entities will also need to obtain CSRC's approval if they intend to engage in the foresaid activities for the benefit of offshore entities. This echoes the increasingly tightened regulatory position over the marketing activities by offshore entities in China.

Notably, the final version of the FDL removes the requirement for offshore futures operation institutions to apply for registration or an exemption with CSRC and accept management and supervision to directly engage in futures trading on onshore futures exchanges on behalf of offshore entities and individuals.

II. Close-out netting

1. Confirmation of close-out netting

The FDL for the first time recognizes in law the enforceability and effectiveness of the close-out netting regime and the single agreement concept.

Article 32 of the FDL provides that where derivatives transactions are entered into by way of a master agreement, the master agreement, supplements to the master agreement, and the agreements on specific transactions (e.g., the confirmations) form a single, complete, and legally binding agreement. This may effectively eliminate concerns over the cherry-picking power of bankruptcy administrators to choose to terminate some transactions while continuing to perform others pursuant to Article 18 of the PRC Enterprise Bankruptcy Law (the "**Bankruptcy Law**").

Article 35 of the FDL further provides that derivatives transactions entered into by way of master agreement in accordance with law may be terminated pursuant to the provisions of the agreement and all profits and losses may be settled on a net basis; the netting settlement may not be stayed, invalidated or revoked due to either party's entry into bankruptcy proceedings. This may effectively eliminate concerns over the claw back right of bankruptcy administrators under Article 31 of the Bankruptcy Law and the uncertainty around the restrictions over insolvency set-offs during bankruptcy proceedings under Article 40 of the Bankruptcy Law. However, the application of Article 35 of the FDL could be uncertain in practice as discussed below.

Confirmation of the close-out netting regime may help China to be recognized as a clean close-out netting jurisdiction and bring about a number of benefits to financial institutions, e.g., financial institutions could calculate the risk exposures of Chinese counterparties on a net basis, reduce counterparty risk exposures, reduce the level of regulatory capital that it must hold in respect of its derivatives positions, and reduce the collateral required to be provided to counterparties.

2. Filing requirement for template master agreement

Article 33 of the FDL requires template master agreements to be filed pursuant to the rules of CSRC or other regulators authorized by the State Council. The following issues await further clarifications with respect to the filing requirement:

- Filing obligor: in comparison to the first and second reading draft, the final version of the FDL removes the reference to filing obligor entirely, which leaves a question mark as to who should be responsible for the filing of relevant master agreement;
- Subject master agreement: it remains unclear what master agreements will need to be filed with competent regulators; for example, whether bespoke agreements and mini-master agreements will need to be filed;
- Duplicative filing: it remains unclear whether the relevant master agreement will need to be filed with different regulators if the master agreement is to be used for derivatives that reference different asset classes.
- According to Article 8 of the FDL, derivatives markets will be regulated by CSRC or the regulators authorized by the State Council in accordance with their respective regulatory functions. Considering China's current derivatives regulatory environment, it is possible that derivatives transactions in relation to foreign exchange/interest rate will be regulated by the People's Bank of China ("**PBoC**") and/or the State Administration of Foreign Exchange, and derivatives transactions related to commodities and securities will be regulated by CSRC. This raises the question as to whether a derivatives transaction agreement referencing different asset classes will need to be filed with each different regulator, which would inevitably add to the burden of filing obligors and be disadvantageous for the conduct of derivatives transactions in practice;
- Consequences for failure to filing: the FDL does not provide consequences for the failure to file the agreements; thus it is uncertain how the filing requirement will be enforced in practice.

3. Uncertainty around enforceability of close-out netting

Uncertainty of interpretation of "in accordance with law" under Article 35

Notably close-out netting under the FDL is no longer expressly conditioned upon filing the relevant master agreement, contrary to the first and second reading drafts. In other words, even if the relevant master agreement has not been filed with the competent regulator, it appears that the close-out netting may still be recognized regardless of the bankruptcy proceeding.

However, close-out netting remains conditioned on the pre-requisite that the derivatives transactions

are conducted “in accordance with law” under Article 35. It remains unclear how to interpret “in accordance with law”; in particular, whether the requirement is satisfied when the applicable master agreement is not filed with the competent regulators.

That said, the CBIRC Circular confirmed the enforceability of close-out netting, quoting comments from the Supreme People's Court that close-out netting should not be subject to the cherry-picking right under the Bankruptcy Law and expressly referring to three qualified master agreements (i.e., NAFMII, SAC and ISDA master agreements); CBIRC made no mention of any filing requirement when the regulator was well aware of the first and second reading drafts of the FDL. This indicates that regulators do not view failure to observe the filing requirement as causing the underlying transactions not to be conducted “in accordance with law”.

Potential uncertainty from the draft PRC Financial Stability Law

On 6 April 2022, PBoC issued a consultation draft of the PRC Financial Stability Law (the “**FSL**”). The consultation period ends on 6 May 2022. Article 30 of the FSL provides that the close-out netting for qualified financial transactions could be stayed during the implementation of financial risk resolution and upon the approval of the responsible regulatory official for risk resolution. While this article does not invalidate the enforceability of close-out netting, it would pose uncertainty to the recognition of China as being a clean netting jurisdiction, as it implies that the non-defaulting party may not be able to exercise its close-out netting right for any reason during the stay period and in particular the FSL does not specify the duration of such stay period.

Temporary stay of close-out netting is necessary in the context of financial institution risk resolution, as the rush into termination of overwhelmingly large volumes of financial contracts by all counterparties solely due to a financial institution's entry into resolution would create further market instability and frustrate the implementation of the measures whose aim is to achieve continuity of the financial institution. To strike a balance between the resolution of a financial institution and normal operation of the close-out netting regime, the Financial Stability Board (“**FSB**”) has provided several conditions for a temporary stay of close-out netting in the Key Attributes of Effective Resolution Regimes for Financial Institutions. The conditions include that stay should be strictly limited in time (for example, for a period not exceeding two business days); and that stay should only apply to early termination rights that arise for reasons of entry into resolution or in connection with the use of resolution powers. Further, the early termination rights of counterparties should be preserved against the financial institution in resolution in the case of any default that occurs before, during or after the period of the stay that is not related to the entry into resolution or the exercise of a resolution power (for example, a failure to make a payment or the failure to deliver or return collateral on a due date).

Notably, the drafting notes to the FSL provide that the introduction of close-out netting stays takes reference from prevailing international practices. Additionally, a similar stay clause has also been provided in Article 95 of the draft PRC Commercial Banking Law issued by PBoC on 16 October 2020, which provides that close-out netting could be stayed for up to two days during the take-over period of a commercial bank. Therefore, we believe the intention of regulators is to align international practices when exercising their resolution power; thus, stays should not affect the enforceability of close-out

netting in practice. That said, we will submit comments to PBoC for the recommended revisions to the FSL to incorporate the conditions proposed by FSB and keep a close eye on the FSL's implications over the enforceability of close-out netting.

4. Title transfer-type performance assurance document

Article 34 of the FDL provides that where parties conduct derivatives transactions, they can provide performance assurance by pledge and other means in accordance with law. While this Article 34 does not expressly confirm that performance assurance could be provided by the internationally prevailing title transfer method (e.g., for satisfaction of variation margin requirement), this article has been drafted in an open-ended manner to cover all possible forms of performance assurance and reveals a positive signal to the market, especially considering that NAFMII released in 2009 a title transfer performance assurance document, which indicates PBoC's support.

Additionally, the Supreme People's Court released the *Guiding Opinions on Providing Judicial Safeguards by People's Courts to Avoid and Mitigate Financial Risks and to Promote Financial Reform and Development* on 10 February 2012, Article 13 of which provides that in examining the legitimacy of innovative financial products, when there is no corresponding provision in laws and administrative regulations or the provision is not clear, the people's courts will follow established market practices, pay sufficient attention to the opinions of financial regulators and not simply deny the legitimacy of innovative financial products because no clear provisions exist in current laws and regulations.

Based on the above, it is likely PRC courts will honor the title transfer-type performance assurance arrangements as an established practice in the international OTC derivatives transaction markets and due to the support by PRC financial regulators.

Some market participants are concerned over the potential recharacterization of the title transfer performance assurance as security assignment or a new type of security interest that is not specifically provided under PRC law. The risk should not be high because:

- performance assurance (or similar concept of credit support in ISDA agreements) is a broader concept than security interest, and Article 34 of the FDL is not limited to security interests;
- collateral transferred outright to the collateral receiver as contemplated under the title transfer performance assurance document are not subject to any restrictions to which security collateral would typically be subject; and
- the title transfer performance assurance document will clearly specify that the outright transfer of collateral thereunder is a transaction under the master derivatives agreement, forming part of the single agreement and under the protection of the close-out netting regime; the denial of the title transfer performance assurance document would be a denial of the single agreement concept and close-out netting regime, and there is no applicable legal ground for a PRC court to invalidate such contractual arrangements.

5. Automatic Early Termination (AET) clauses

AET clauses are intended to ensure all transactions documented by a master agreement could be

early terminated prior to the commencement of bankruptcy proceeding so that close-out netting is not be affected by the implications under the relevant bankruptcy law (e.g., the cherry-picking power as discussed above). Some market participants are curious as to whether they need to continue to use AET clauses after the effectiveness of the FDL. For now, it is advisable to take a wait-and-see approach, as the FDL is new at this stage and there exist uncertainties around the enforceability of close-out netting as discussed above.

III. Business scope of futures companies

In comparison to the first reading draft, Article 63 of the FDL takes a step back that futures companies are no longer expressly allowed to engage in derivatives business. It appears that the legislator is taking a prudent approach on the expansion of futures companies' business scope, and most of the risk management business will still be undertaken by the risk management subsidiaries of futures companies. That said, Article 63(4) of the FDL allows futures companies to engage in “other futures business” upon approval by CSRC, which is broad enough to allow CSRC to gradually permit the expansion of business scope by futures companies when the timing is deemed appropriate.

IV. Prior approval requirement and suitability management requirement for financial institutions

The final version of the FDL added a new Article 31 in comparison to the second reading draft, which provides that all financial institutions should seek approval to engage in derivatives transactions, fulfill their trader suitability management obligations, and comply with relevant regulatory provisions. This has revealed regulator's tightened regulatory position over derivatives business generally, especially after the “Yuan You Bao (原油宝)” incident, a paper crude oil product referencing offshore oil futures contracts, that was available for trading by individual investors and caused significant losses due to a collapse in global oil prices.

Under the current rules, to engage in derivatives business, banking financial institutions need to seek approval from CBIRC, securities companies need to obtain securities proprietary license from CSRC and file with the Securities Association of China, and insurance companies need to report to CBIRC. The derivatives-related rules for different types of financial institutions may need to be updated to reflect the above requirements.

V. Cross-border data transfers

Market participants should be encouraged to see that compared with the first and second reading draft, the express prohibition on the provision of any documents and data relevant to futures activities by any entity or individual to offshore without the consent of CSRC and relevant department under the State Council has been loosened slightly; such documents and data are now prohibited from being provided without consent to offshore regulatory authorities (instead of generally offshore).

VI. Other key points

1. Trading repository

Article 36 of the FDL provides that State Council-authorized regulator or CSRC should set up a derivatives trading repository (“**TR**”) to collect, store, analyze and manage information about the

underlying asset, scale and counterparty of derivatives transactions and to timely disclose the relevant information to the market in accordance with provisions. Detailed rules will be formulated by the State Council-authorized regulator and CSRC. As of today, the China Futures Market Monitoring Center and the China Securities Internet System have obtained formal authorizations and recognized by FSB as TRs for commodity and equity OTC derivatives; NAFMII acts as the TR-like entity for credit OTC derivatives and CFETS acts the TR-like entity for credit, foreign exchange and interest rate OTC derivatives. However, there is currently no FSB recognized TR in China for credit, foreign exchange or interest rate OTC derivatives.

2. **Settlement finality**

While settlement finality for futures transactions has been provided in currently valid rules, Article 43 of the FDL confirms in law the principle of settlement finality and expressly provides that settlement and delivery in accordance with the law may not be stayed, invalidated or revoked due to the entry into bankruptcy proceedings by any party involved in the settlement. As the central counterparty is also a party involved in the settlement of futures transactions, this Article 43 confirms that the bankruptcy of the central counterparty will also not affect settlement finality.

3. **Reversed burden of proof**

Article 51 of the FDL provides that traders should be classified into ordinary traders and professional traders based on factors such as financial condition, trading knowledge and experience, etc. Where there is a dispute between an ordinary trader and a futures operation institution, as opposed to the principle of “he/she who claims bears the burden of proof”, Article 51 of the FDL reverses the burden of proof from the ordinary trader to the futures operation institution; i.e., the futures operation institution instead bears the burden to prove that its acts are not misleading or fraudulent, among other circumstances, otherwise it will be held liable for compensations.

Outlook

The FDL provides important legal certainty as to the enforceability of the close-out netting regime under PRC law and opens a new chapter for the China's futures and derivatives markets. With the future recognition of China being a clean netting jurisdiction, it is expected that more and more foreign market participants will be willing to trade with Chinese counterparties to manage risks and Chinese market participants could also enjoy the benefit of close-out netting and save regulatory capital.

The above said, there are still a number of pending issues under the FDL awaiting clarification by the relevant regulators. We will continue to monitor for developments with respect to the FDL and share our insights in a timely manner.

Important Announcement

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

If you have any questions regarding this publication, please contact:

TieCheng YANG

Tel: +86 10 8516 4286
Email: tiecheng.yang@hankunlaw.com

Yin GE

Tel: +86 21 6080 0966
Email: yin.ge@hankunlaw.com

Ting ZHENG

Tel: +86 21 6080 0203
Email: ting.zheng@hankunlaw.com

© 2022 Han Kun Law Offices. All Rights Reserved.