

Financial

Key Points of the Draft Futures and Derivatives Law – Derivatives Trading

Just a few months after the release of the Futures Law of the People's Republic of China (Draft) (the "First Draft"), the Futures and Derivatives Law of the People's Republic of China (the Second Draft) (the "Draft Futures and Derivatives Law") was offered for a second review and made available for public comments. The most noteworthy change is that the law is renamed "Futures and Derivatives Law" and consolidates the previous two chapters in the First Draft, i.e., "Chapter II: Futures Trading" and "Chapter III: Other Derivatives Trading," into one chapter of "Futures Trading and Derivatives Trading". This briefing will focus on the significant legislative developments with respect to derivatives trading and highlight key provisions to facilitate further discussion.

1. Amending the Definition of "Derivatives Trading"

Aiming to redefine *derivative trading*, the Draft Futures and Derivative Law first redefines futures trading in a way consistent with Article 2 of the *Administrative Regulation on Futures Trading*,

stipulating that futures trading shall include both trading of futures contracts and trading of standardized option contracts, bringing more of the futures trading, aside from the trading of futures contracts, under the purview of the law. Based on the broadened definition of *futures trading*, it further defines *derivatives trading* as "a trading activity apart from futures trading, which includes trading of non-standardized option contracts, swap contracts, forward contracts or a combination of the foregoing activities." By defining *futures trading* and *derivatives trading* in this manner, it hones the scope of derivatives trading to be more precise and comprehensive, as well as highlights the distinguishing characteristics of derivatives trading, i.e., a non-standardized transaction.¹ Although "other derivatives trading" proposed by the First Draft is more likely to meet with the common sense that futures constitute parts of derivatives, as a legislative technique, it is reasonable to distinguish *futures trading* from *derivatives trading* in the Draft Futures and Derivative Law, as we can see similar definitions

¹ We hold the view that, the Draft Futures and Derivatives Law adopts a restrictive method to define "standardized", namely, only financial contracts that are uniformly formulated by specific futures trading venues for the future delivery or the option for future delivery at a specified time and place or future delivery of certain amounts of underlying assets will be regarded as "standardized" financial contracts. Some products in the market such as interest rate swaps, forward interest rates and

bond forward contracts, though standardized in terms of certain transaction elements, should fall within the concept of "derivatives" under the Draft Futures and Derivatives Law – such interpretation is also in line with the current situation that the futures regulatory authority of the State Council and the People's Bank of China and other authorities regulate different types of derivatives products separately.

in the *Regulations on Over-the-Counter Businesses of Financial Derivatives Trading of Securities Companies* released by the Securities Association of China (SAC);² and from a judicial perspective, the *Rules on Causes of a Civil Lawsuit* also regards the “futures trading-related dispute” and “financial derivatives trading-related dispute” (the latter is a cause of action subordinate the “securities trading-related disputes”) as separate causes of action, echoing the method of defining futures trading and derivatives trading differently as adopted by the Draft Futures and Derivatives Law.

Additionally, when defining the derivatives trading, it removes the description of “contracts that derive value from an underlying asset” and no longer enumerates the underlying assets, while adding that “trading of a combination of typical derivative contracts” shall constitute a “derivatives trading,” which in whole is a remarkable step in response to the real market needs and lifts unnecessary limitations on the types and scope of derivatives trading, so as to leave space for financial derivative market to produce derivative products that link to one or more underlying assets, indices, or specific events, or produce hybrid financial instruments carrying multiple characteristics of forwards, swaps and options.

2. Clarifying the Entity That Organizes Derivatives Trading

The First Draft introduced a concept of “institutions that organize other derivatives trading.” As can be inferred in the context of the First Draft, such an institution is seemingly opposed to counterparties of derivatives trading, but it still needs further clarification. The Draft Futures and Derivatives Law has filled the gap by clarifying that only venues duly established and approved can

organize derivatives trading. We are inclined to believe that such a venue does not mean to refer a dealer or contracting party in traditional OTC derivatives markets through bilateral negotiation as the eligible entity that can organize derivatives trading, instead, by targeting venues under duly approval, the legislature may aim to follow the example of the United States in establishing a regulated facility, venue, or platform for derivatives trading (like the Swaps Execution Facility (SEF), which was established under the Dodd-Frank Act) with an aim to impose overall centralized supervision on derivatives trading. Furthermore, we hold the view that at the current stage, only derivatives trading involving highly standardized and liquid derivative contracts in the OTC markets can be done in the “venues that organize derivatives trading,” while the tailor-made derivatives trading based on the specific needs of end-users may not yet be eligible to be executed in a specific derivatives trading venue, but whether this will change remains to be seen.

While it clarifies the venues that organize derivatives trading, there remains uncertainty as to how derivatives trading executed in the traditional OTC markets through dealers (i.e., the OTC trading through bilateral negotiation), representing a large proportion of the financial derivative market, will be treated under the Draft Futures and Derivatives Law. It requires further clarification at a legislative level as to the issues such as the requirements for dealers’ qualification to derivatives trading, whether derivatives trading executed through bilateral negotiation needs to apply the filing requirement for a master agreement, and whether it needs to be reported to the regulatory departments.

3. Retaining the Filing Requirement for

² The *Regulations on Over-the-Counter Businesses of Financial Derivatives Trading of Securities Companies*, Article 2: The “financial derivatives” of the Regulations refer to the forward, swap and option financial contracts whose value derives from the underlying assets such as equity, creditor’s rights, credit, fund, interest rate, exchange rate, index, futures, as well as a

combination of one or of the foregoing activities. The “derivative trading” of this Regulation means transactions executed directly between a securities company and a counterparty outside a centralized trading venue and in accordance with an agreement entered between them.

Master Agreements

The Draft Futures and Derivatives Law retains the filing requirement for master agreements adopted in the First Draft with some amendments to the scope of filing and the responsible regulatory departments. To be specific, it amends the scope of filing from “the master agreement and other such standard agreements adopted in the other derivatives trading” to “master agreements and other model contracts,” specifying that only the model master agreement issued by the industry associations rather than the master agreements executed for each specific derivatives trading need to be filed for record. Meanwhile, in addition to the “departments authorized by the State Council,” it adds that “the futures regulatory authorities of the State Council” can also be responsible for accepting the filing of the master agreements, which runs parallel with the legislative technique used in the *Securities Law of the People’s Republic of China* and to some extent addresses the issue of how master agreements issued by international industry associations would be filed with PRC regulatory departments.

Compared with the First Draft, it keeps silent on the party who shall be responsible for filing the master agreements. Hence, it is less clear under the Draft Futures and Derivatives Law whether the industry associations, venues that organize the derivatives trading, or dealers are able to file the master agreements while introducing another issue of whether the international industry association can file the master agreement on their own. Though the Draft Futures and Derivatives Law has not yet fully addressed market concerns about the filing requirement of master agreements, we expect that the specific practical issues about the filing of master agreements will be addressed through subsequent regulations rather than in such a law. Given the signals in the Draft Futures and Derivatives Law of respecting derivatives market practices, we are inclined to believe that the current filing requirements will not become a barrier for the further application of widely used

model master agreements issued by PRC industry associations and international industry associations.

4. Recognizing the Close-Out Netting

In our earlier JunHe Client Briefing “Single Agreement and Netting Provisions Concerning Other Derivatives Trading – Our Observations of the Draft Futures Law,” we pointed out that the First Draft seems only to specify that the completed close-out netting will not be invalidated or rescinded due to the bankruptcy proceedings, whilst providing no clarification on whether close-out netting can apply to a circumstance where either party enters into the bankruptcy proceedings before completion of close-out netting. The Draft Futures and Derivatives Law deals with the issue by explicitly providing that close-out netting conducted according to a filed master agreement will not be stayed in the event of a counterparty’s bankruptcy. This means that any uncompleted close-out netting will not be suspended, subject to the relevant stipulations of the *Bankruptcy Law of the People’s Republic of China* (in particular, the administrator’s right to cherry-pick favorable agreements under Article 18), which provides a more comprehensive legal protection and recognition of the close-out netting mechanism. Similarly, it further clarifies that the centralized settlement of derivatives trading shall not be stayed, invalidated, or rescinded in the event of a settlement participant’s bankruptcy.

5. Amending the Performance Assurance Method Concerning Derivatives Trading

The First Draft previously stipulated that participants of other derivatives trading may use pledge contracts or other contracts with the function of guarantee to provide the performance assurance to other derivatives trading, which stimulated widespread concern that the terms of a “title transfer collateral arrangement” would be understood to be “other contracts with the function of guarantee” thereby applying the rules on an

assignment guarantee. It is now amended by the Draft Futures and Derivatives Law as “the performance assurance to the derivatives trading may be provided by pledge contracts or other lawful methods.” To this end, the legislature indicates a positive sign that they will respect other types of performance assurances lawfully entered into by parties of derivatives trading rather than the traditional guarantees, with an objective to ease market concerns. Nevertheless, legally speaking, how to position the “title transfer collateral arrangement” under the current civil law framework is still a relatively complex issue. It remains uncertain under the Draft Futures and Derivatives Law whether the close-out netting mechanism will also apply to the specific trading

under the “title transfer collateral arrangement” together with all multiple derivative transactions under a master agreement, and this issue will require clarification or guidance in future judicial practice.

Our Observations

In summary, this Draft Futures and Derivatives Law has responded to certain concerns of the market and generally conveys a positive signal of respecting market practices with respect to derivatives trading. We will continue to monitor the situation and keep our clients apprised of any important developments

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