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Derivative Markets in China

Guest Editors' Introduction

The regulatory framework for the derivatives markets in China consists of national legislation, rules, and regulations made by the China Banking Regulatory Commission (CBRC), the China Securities Regulatory Commission (CSRC), and the guidelines of the Supreme People's Court.

The CBRC has jurisdiction over the financial institutions engaging in trading financial derivatives. In 2004, it promulgated the Interim Measures for the Business Management of Derivative Product Transactions of Financial Institutions (Interim Measures), as amended in 2006. The Interim Measures is not a comprehensive rule regulating financial derivatives, rather it sets out the requirements for major participators of financial derivatives markets, that is, financial institutions. It also provides the requirements for market entry, risk management, and penalties for breach of its provisions. Its 2006 amendment further provides detailed requirements and the procedures for market entry into the derivatives markets.¹ This amendment also focuses on risk management. It states that the board of directors must assess the risk management policies and procedures annually,² the managers must provide the methodologies and indicators of risk calculations,³ and the persons responsible for risk management must be separated from those responsible for financial derivatives trading.⁴

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The CSRC, as the regulator of securities and futures markets, has also issued a number of regulations on financial derivatives. At present, the futures markets are still the dominant financial derivatives markets in China, and therefore the regulations of the CSRC cover most of the markets.

The establishment of China's first commodity futures exchange, the Zhengzhou Commodity Exchange, in October 1990 marked the emergence of a commodity and financial futures market in China.⁵ Since then, China has gradually developed a regulatory framework for its commodity and financial futures markets beginning in 1993, when the government issued its first futures regulation and regulatory document.⁶ In the formative years of the futures markets, the number of futures trading disputes increased sharply and flooded the courts. The Futures Judicial Guidelines 1995 of the Supreme People's Court⁷ was the first comprehensive judicial response to the problematic increase of futures disputes in the courts. This was replaced by the Futures Judicial Provisions 2003 of the Supreme People's Court.⁸

In June 1999, the state council made an important step in regulating the futures market by promulgating the Provisional Regulations 1999,⁹ the first formal regulation on futures trading, which served at that time as an impetus to the standardization of China's new futures markets. The Provisional Regulations 1999 were subsequently amended and replaced by the Regulations on the Administration of Futures Trading (2007 Regulations) with an addition of twenty articles.¹⁰ The major changes include the relaxation of a previous ban on financial institutions engaging in futures trading,¹¹ the creation of a fund to protect futures investors,¹² and a system distinguishing settlement members (*jiesuan huiyuan*) from nonsettlement members (*fei jiesuan huiyuan*).¹³ The 2007 Regulations relaxes some unnecessary restrictions on normal futures trading activities and participants. Nevertheless, it also provides more governmental supervision of the markets.

The 2007 Regulations also makes noticeable changes regarding the regulation of futures companies and their business. It imposes a licensing system that recognizes which futures companies may engage in a wider range of futures brokerage business, including commodity futures, financial futures, futures consultancy business, and offshore futures.¹⁴ Under the 2007 Regulations, the minimum amount of registered capital required to establish a futures company is RMB30 million, which is the same requirement under the Provisional Regulations 1999. However, the 2007 Regulations gives futures regulators discretion to raise the minimum registered capital based on prudential principles and according to the risk levels of the specific futures business.¹⁵ Other areas of improvement are the corporate governance of futures companies and the protection of clients' money.¹⁶ The provisions on futures companies are much clearer and in better shape: they balance the future regulators' needs

for proper control of the market with the futures companies' needs for growth and engagement in a wider range of futures business.

The regulatory standards concerning the operation of futures exchanges set out in the Provisional Regulations 1999 continue to take effect under the 2007 Regulations.¹⁷ If a futures exchange grants a guarantee and there is a breach of contract, the 2007 Regulations are akin to the Provisional Regulations 1999 in requiring its member's deposit to be used first to satisfy the liabilities. If the member's deposit is insufficient, the futures exchange then uses the risk reserve fund and its own fund to satisfy the liabilities on behalf of the member, and thus acquires the right to pursue repayment from the member.¹⁸ This mechanism, together with the provisions in the Futures Judicial Provisions 2003,¹⁹ ensures smooth transactions in futures exchange.

The 2007 Regulations is a step forward in building a balanced regulatory framework for China's commodity and financial futures markets. However, full operation of the regulatory system under the 2007 Regulations very much depends upon the further development of rules and regulations with better clarification. About twenty-five of the ninety-one articles in the 2007 Regulations either leave a provision open²⁰ or refer certain matters to rules and regulations that have yet to be made.²¹ Apart from the uncertainty and confusion that such provisions have created, the 2007 Regulations takes full effect. This leaves the regulatory framework vulnerable to inconsistency amid the competing interests of government authorities.

As empowered by the 2007 Regulations, the CSRC promulgated the Administrative Measures for Futures Companies (Administrative Measures), which detailed the provisions of the 2007 Regulations regarding the futures companies. It replaced the Administrative Measures for Futures Broker Companies 2002 and some notices of the CSRC regarding the futures broker companies.²² The Administrative Measures provides the requirements and procedure for the establishment, alteration, and termination of futures companies,²³ and the corporate governance of futures companies.²⁴ To protect the interest of clients, there are a number of provisions on business rules for the futures companies and the use and management of client margins.²⁵ In strengthening the regulation of futures companies, the Administrative Measures also provides the items reported by futures companies to the CSRC and the probable regulatory measures taken by the CSRC.²⁶ In standardizing the procedures for making securities and futures rules and regulations, the CSRC promulgated the Provisions on the Procedures for the Making of Securities and Futures Rules in October 2008. It provides a comprehensive process for rule making, including the proposal, draft, check, determination, issuance, record, interpretation, amendment, repeal, and translation.

In 1995, the Supreme People's Court issued the Futures Judicial Guide-

lines.²⁷ It addresses the major issues arising from the adjudication of futures disputes, covering the principles for handling futures cases, the jurisdiction of the courts over futures cases, the qualifications necessary to engage in futures trading, the legal status and legal liabilities of brokers, the legal liabilities under contract and tort and invalid futures transactions,²⁸ the trading of foreign exchange deposits, and the standard and burden of proof in futures cases.²⁹ It requires the courts to deal with futures disputes fairly and expediently, protect the lawful rights and interests of the parties, punish illegal trading activities, and maintain order in the futures market.³⁰ This guideline became the first comprehensive provisional guideline addressing substantive law and procedural issues in adjudicating futures disputes.

In July 1999, the Supreme People's Court began drafting a new guideline, based upon the judicial experience. In 2003, the Futures Judicial Guidelines was replaced by the Futures Judicial Provisions. It is the product of consultations with the futures business sector and regulators,³¹ after going through four drafting stages with twenty-eight drafts.³² This guideline represents a uniform understanding of major civil law issues concerning the futures markets as recognized by the courts, the regulators, and the futures business.³³ In comparison with the Futures Judicial Guidelines, the Futures Judicial Provisions provides the courts with a more comprehensive guideline for handling futures disputes. For example, the Futures Judicial Provisions clearly spells out the amount of positions that a futures exchange or a futures broker firm close out must equal to the margin of that futures broker firm or that of its client and the loss caused by an excessive liquidation is to be borne by those forcing the liquidation.³⁴ Such an equity-based principle regarding excessive liquidation was absent in both the Futures Judicial Guidelines and the Provisional Regulations.³⁵

The Futures Judicial Guidelines recognizes that futures disputes are distinct from other economic disputes. This guideline provides the principles for the courts to handle such distinctions,³⁶ including referring to international practice,³⁷ balancing between risks and interests,³⁸ determining the party at fault and the corresponding responsibilities,³⁹ and honoring the agreement of the parties.⁴⁰ These principles are reiterated in the Futures Judicial Provisions⁴¹ and guide the courts in handling futures dispute cases.⁴²

In contrast with the tentative and ad hoc regulations and regulatory documents in the early 1990s, China has gradually established a regulatory framework for the commodity and financial futures markets, with the 2007 Regulations at its center. The recent regulatory development in the revised 2007 Regulations, for example the relaxation of a previous ban on financial institutions engaging in futures trading,⁴³ suggests that China is moving toward building a modern regulatory framework for its commodity and financial futures exchange markets.⁴⁴

The Securities Law of the People's Republic of China (Securities Law), enacted in 2005, and the Securities Investment Fund Law, enacted in 2003, are still the only two major pieces of national securities legislation.⁴⁵ In March 2006, a drafting team was set up to resume the drafting process of the Futures Trading Law.⁴⁶ It is expected that the enactment of the Futures Trading Law will enhance the regulatory framework of China's commodity and financial futures markets, as enacted by the National People's Congress.

Notes

1. "Interim Measures for the Business Management of Derivative Product Transactions of Financial Institutions" (*jirong jigou yansheng chanpin jiaoyi yewu guanli zaxing banfa*), promulgated by the CBRC in 2004, No. 1 order of the CBRC of 2004, amended in 2006, Arts. 7–9.

2. *Ibid.*, Art. 17.

3. *Ibid.*, Art. 19.

4. *Ibid.*, Arts. 19 and 20.

5. Before the introduction of futures trading on May 28, 1993, the Zhengzhou Commodity Exchange operated for two years dealing with the trading of cash-forward contracts. Currently traded on the Zhengzhou Commodity Exchange are wheat, cotton, white sugar, pure terephthalic acid (PTA), rapeseed oil, and green bean futures contracts. Available at www.czce.com.cn.

6. Between 1993 and 1998, central and local governments issued various regulatory documents, including the "Provisional Measures on the Administration of Registration of Futures Broker Firms," the "Notice of the State Council on Firmly Stopping Blind Development of the Futures Market," the "Opinion of the General Office of the State Council Securities Committee on Firmly Stopping Blind Development of the Futures Market," the "Provisional Measures on the Administration of Personnel Working in Futures Business Organizations," the "Regulations on the Administration of Shanghai Futures Market," and the "Notice of the State Council on Further Consolidation and Standardization of the Futures Market."

7. The "Notice of the Supreme People's Court on Circulating 'Minutes of the Symposium of the Supreme People's Court on Adjudication of Cases of Futures Disputes'" (*zuigao renmin fayuan yinfa guanyu shenli qihuo jiufen anjian zuotanhui jiyao de tongzhi*), promulgated by the Supreme People's Court on October 27, 1995 (hereinafter the 1995 SPC Futures Judicial Guidelines).

8. "Provisions of the Supreme People's Court on Several Issues Concerning Adjudication of Cases of Futures Disputes" (*zuigao renmin fayuan guanyu shenli qihuo jiufen anjian ruogan wenti de guiding*), adopted by the Adjudication Committee of the Supreme People's Court on May 16, 2003, effective July 1, 2003 (hereinafter the 2003 SPC Futures Judicial Provisions).

9. "Provisional Regulations on the Administration of Futures Trading" (*qihuo jiaoyi guanli zaxing tiaoli*), promulgated by the State Council on June 2, 1999, effective September 1, 1999 (repealed in 2007) (hereinafter the 1999 Provisional Regulations on the Administration of Futures Trading).

10. The "Regulations on the Administration of Futures Trading 2007" has ninety-one articles, an increase from seventy-one articles in the "1999 Provisional Regula-

tions on the Administration of Futures Trading.” See the “2007 Regulations on the Administration of Futures Trading,” *supra* note 7.

11. Art. 30 of the “1999 Provisional Regulations on the Administration of Futures Trading” listed a number of institutions and individuals, including financial institutions, who may not engage in futures trading and for whom futures broker firms may not accept entrustments to trade futures. See the “1999 Provisional Regulations on the Administration of Futures Trading,” *supra* note 10, at Art. 30. Art. 26 of the “2007 Regulations on the Administration of Futures Trading” has now removed financial institutions from this list. See the “2007 Regulations on the Administration of Futures Trading,” *supra* note 7, at Art. 26.

12. “Provisional Measures on the Administration of Futures Investors Protection Fund” (qihuo touzizhe baozhang jijin guanli zanxing banfa), issued in accordance with Art. 54 of the “2007 Regulations on the Administration of Futures Trading” by the CSRC and the Ministry of Finance on April 19, 2007, effective August 1, 2007. The “2007 Regulations on the Administration of Futures Trading,” *supra* note 7, at Art. 54.

13. In accordance with Art. 8 of the “2007 Regulations on the Administration of Futures Trading,” futures exchanges may adopt a system of membership consisting of settlement members and nonsettlement members. See the “2007 Regulations on the Administration of Futures Trading,” *supra* note 7, at Art. 8.

14. See the “2007 Regulations on the Administration of Futures Trading,” *supra* note 7, at Art. 17.

15. See the “2007 Regulations on the Administration of Futures Trading,” *supra* note 7, at Art. 16.

16. “Administrative Measures for Futures Companies” (qihuo gongsi guanli banfa), promulgated by the CSRC on April 9, 2007. The detailed introduction can be found in the following paragraph.

17. See the “2007 Regulations on the Administration of Futures Trading,” *supra* note 7, chapter 2, Arts. 6–14 (a majority of which are the same provisions as stipulated in chapter 2 of the “1999 Provisional Regulations on the Administration of Futures Trading,” including Arts. 6–20). See also the “1999 Provisional Regulations on the Administration of Futures Trading,” *supra* note 10, at Arts. 6–20.

18. See the “2007 Regulations on the Administration of Futures Trading,” *supra* note 7, at Art. 40 (1).

19. The “2003 SPC Futures Judicial Guidelines,” *supra* note 9, at Art. 48.

20. For example, Art. 16 stipulates a list of conditions for the establishment of a futures company, the last one of which is “any other criteria stipulated by the futures supervision and administration department of the State Council.” See the “2007 Regulations on the Administration of Futures Trading,” *supra* note 7, at Art. 16.

21. For example, in accordance with Art. 46, measures concerning offshore futures trading by institutions or individuals are to be formulated by the futures regulator of the state council in consultation with a number of other government departments and regulators, such as the foreign exchange authority, and to be approved by the state council. See the “2007 Regulations on the Administration of Futures Trading,” *supra* note 7, at Art. 46.

22. These notices are the “Notice on the Issues of the Establishment, Alteration, and Termination of Business Department of Futures Broker Companies,” issued by the CSRC on July 14, 2004; the “Notice on the Alteration of Futures Broker Com-

panies Regarding the Legal Representative, Registered Capital, Shareholders or Ownership Structure, and Place,” issued by the CSRC on July 14, 2004; the “Notice on the Establishment, Termination, M&A of Futures Broker Companies,” issued by the CSRC on July 20, 2007; and the “Notice on the Qualification of Shareholders of Futures Broker Companies and Other Relevant Issues,” issued by the CSRC on September 26, 2005.

23. “Administrative Measures for Futures Companies,” promulgated by the CSRC on March 28, 2008, Arts. 6–32.

24. *Ibid.*, Arts. 33–47.

25. *Ibid.*, Arts. 48–76.

26. *Ibid.*, Arts. 77–90.

27. See *supra* note 8.

28. For example, even if a futures broker firm engages in futures brokerage business without approval and without a license, it is not to be held liable if there is evidence proving that the broker firm carried out the futures trading in accordance with the client’s instructions. In such a case, the loss suffered by the client was merely caused by normal market risk. See the “1995 SPC Futures Guidelines,” *supra* note 8, at section 7.

29. See the “1995 SPC Futures Guidelines,” *supra* note 8, sections 8 and 9.

30. See the “1995 SPC Futures Guidelines,” *supra* note 8, section 1.

31. It took nearly four years for the Supreme People’s Court to complete the draft, during which time it consulted with the CSRC, various futures exchanges, and the Association of Futures Business, *infra*, note 32, at 18.

32. The drafting started on July 21, 1999. The first stage was to work on the new issues and questions that had emerged since 1995 and to incorporate them into the drafts; starting from May 2001, the second stage was to focus on the structure; starting from early 2002, the third stage was to consult with the CSRC, futures exchanges, and the Association of Futures Business; during February and May 2003, the fourth stage was to go through several rounds of discussions by the Adjudication Committee of the Supreme People’s Court. See “Understanding and Application of the ‘2003 Provisions of the Supreme People’s Court on Several Issues Concerning Adjudication of Cases of Futures Disputes’” (zuigao renmin fayuan guanyu shenli qihuo jiufen anjian ruogan wenti de guiding), at 18–19 (compiled by the Second Division Court of the Supreme People’s Court), ed. Jiang Bixin (Beijing: The People’s Court Publishing House, 2003).

33. This was discussed in an interview by a news reporter with Jiang Bixin, then deputy president of the Supreme People’s Court, on the application of the “2003 Provisions of the Supreme People’s Court on Several Issues Concerning Adjudication of Cases of Futures Disputes.” *Ibid.*, note 32, at 19.

34. Art. 39 of the “2003 SPC Futures Judicial Provisions” states that “the number of positions of a futures exchange or a futures broker firm closeout must be basically equal to the amount of margin that a futures brokerage firm or a client has to add up. The loss caused by an excessive liquidation is to be borne by those who take the forced liquidation measure.” The “2003 SPC Futures Judicial Provisions,” *supra* note 9, Art. 39.

35. Section 5 (point 6) of the “1995 SPC Futures Judicial Guidelines” and Art. 41 of the “1999 Provisional Regulations” addressed the issue of forced liquidation, but neither of them addressed the issue of excessive forced liquidation and consequent liabilities. See the “1995 SPC Futures Judicial Guidelines,” *supra* note 8, section 5,

point 6; see also the “1999 Provisional Regulations on the Administration of Futures Trading,” supra note 10, Art. 41.

36. See the “1995 SPC Futures Guidelines,” supra note 8, section 1.

37. Section 1 (1) states that the people’s courts must apply the “1986 General Principles of Civil Law” as a primary source of law and also act in light of central and local administrative regulations and normative documents; where the disputes involve foreign, Hong Kong, and Macao elements, the people’s courts must also refer to international practice. See the “1995 SPC Futures Judicial Guidelines,” supra note 8, section 1 (1).

38. Section 1 (2) states that, given the fact that futures trading involves speculation and high risks, the people’s courts must protect the lawful interests of trading parties and correctly determine the risks the parties must undertake. See the “1995 SPC Futures Judicial Guidelines,” supra note 8, section 1 (2).

39. Section 1 (3) states that the people’s court must carefully analyze whether parties in a dispute are at fault, what the nature of the fault is, how serious the fault is, and whether there is a causal link between the fault and losses, and on the basis of these findings determine their corresponding responsibilities. See the “1995 SPC Futures Judicial Guidelines,” supra note 8, section 1 (3).

40. Section 1 (4) states that the agreement of the parties must be treated as the basis for dealing with the disputes between the parties as long as the agreement does not violate the law, regulations, and custom of futures trading. See the “1995 SPC Futures Judicial Guidelines,” supra note 4, section 1 (4).

41. See the “2003 SPC Futures Judicial Provisions,” supra note 9, Arts. 1–3.

42. See the “2003 SPC Futures Judicial Provisions,” supra note 9, Arts. 1–3 (Art. 1, “When adjudicating futures disputes, the people’s courts are to act in accordance with the law to protect the legal rights and interests of the parties, determine correctly the risk and responsibilities each party bears, and uphold the order of futures markets.” Art. 2, “When adjudicating futures contract disputes, the people’s courts are to determine the liability of the party who breaches the contract in strict accordance with the parties’ contract and agreements therein, so long as the agreements do not violate statutory law, nor mandatory administrative and regulatory provisions.” Art. 3, “When adjudicating futures infringement of right disputes and invalid futures contract disputes, the people’s courts are to determine the civil liabilities of the party at fault after an evaluation of the relative faults of the parties, the characteristics of the faults, the magnitude of the faults, and the causal relationship between the faults and loss suffered.”).

43. See supra note 12.

44. For a discussion on China’s securities regulations and the stages of development since the 1980s, see Zhu Sanzhu, *Securities Regulation in China* (Ardsley, NY: Transnational, 2000), in particular, chapter 1, pp. 1–24. See also Zhu Sanzhu, *Securities Dispute Resolution in China* (Aldershot, UK: Ashgate, 2007), in particular, chapter 1, “The Legal, Regulatory, and Judicial Framework,” pp. 7–41 and chapter 7, “The Development of Securities Dispute Resolution in China,” pp. 197–231.

45. “Securities Law of People’s Republic of China” (Zhonghua renmin gongheguo zhengquan fa), adopted by the Standing Committee of the National People’s Congress, December 29, 1998, effective July 1, 1999, amended on October 27, 2005, effective January 1, 2006; “Securities Investment Fund Law” (zhengquan touzi jijin fa), adopted by the Standing Committee of the National People’s Congress on October 28, 2003, effective June 1, 2004.

46. See Ron Fang and Peng Yong, “Significant Progress Has Been Made with the Legislation of Futures Trading in Our Country” (woguo qihuo jiaoyi lifa qude zhongda jinzhan), Xinhuanet, December 4, 2007.

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