China's Futures Markets: The Door Opens Another Crack More

By Gary DeWaal

After years of anticipation, it appears that China may soon give overseas investors more access to China's futures exchanges. At year-end 2014, the lead Chinese futures industry regulator, the China Securities Regulatory Commission, published proposed rules that establish a framework for permitting foreign entities to trade for hedging and speculative purposes.

The proposed rules, the so-called Interim Measures, will apply initially to just one contract, the crude oil futures contract listed on the Shanghai International Energy Exchange, but the issuance of these proposed rules marks another important milestone in the gradual opening of China's futures markets to the outside world.

China's futures markets have a great allure to many foreigners because of their sheer magnitude. In 2014, 2.5 billion contracts traded on the four mainland exchanges with volume spread among 38 commodity futures products and two financial futures products. The four exchanges—the Dalian Commodity Exchange, the Shanghai Futures Exchange, the Zhengzhou Commodity Exchange and the China Financial Futures Exchangeall ranked in the top 20 derivatives exchanges in the world in terms of their volume in 2014.

Up to now these markets have been largely off-limits to traders and investors based outside of China. The Chinese authorities have created some openings, allowing a small number of joint ventures between foreign brokers and local firms and permitting certain qualified foreign investors to use the stock index futures market in Shanghai. The authorities have put numerous restrictions on these openings, however, and as a general rule it is very difficult for foreign entities to access these markets.

Although no firm date has been established for the launch of SIEE's crude oil contract, CSRC is said to be eager to see the launch of this contract as a pilot program to gain experience in the trading of a domestic contract that is widely accessible by overseas traders. Chinese officials have spoken of their desire for the oil contract to become an important regional benchmark for oil prices, and they have commented on the value of international participation to its acceptance as a benchmark. This is part of the reason why SIEE is located in the Shanghai free trade zone, which was set up in September 2013 as a testing ground for economic reforms.

Recent Developments

This latest development occurs after years of cautious advances regarding the opening of China's futures markets to foreigners and the authorization to Chinese citizens and entities to trade on international futures and options exchanges.

The earliest outbound futures trading authorized from China was for certain state-owned enterprises (SOE) under the auspices of the CSRC, the Ministry of Commerce and the State Administration of Foreign Exchange. Under this regime, which has been in place since 1999, 31 SOEs have been approved for international futures trading, limited to specific commodities and an annual trading quota.

In 2005, CSRC authorized the establishment in China of joint ventures between Hong Kong and Macao-based futures brokers and China futures brokers. Although these joint ventures could only service China-based clients, they permitted overseas firms to gain experience conducting business as a futures broker in China, while granting China-based futures brokers insight into the practices and standards of their new overseas partners. Among international brokers that have taken advantage of this program were JP Morgan, RBS (legacy ABN Amro) and Newedge (see "China Opens Up Its Futures Market" in the November 2011 issue of *Futures Industry*). More recently Goldman Sachs and UBS also have taken interests in futures brokers in China.

In 2006, CSRC permitted six domestic futures brokers to set up subsidiaries in Hong Kong. The brokers, who were required to register with the Securities and Futures Commission of Hong Kong, were permitted to solicit local business, including from China-based clients located in Hong Kong. Some of these subsidiaries subsequently became members of international exchanges, including CME Group, Eurex, London Metal Exchange and the Singapore Exchange (see "China Brokers Expand Abroad" in the November 2014 issue of *Futures Industry*).

The first authorized opening of any kind to foreign traders occurred in 2011 when CSRC permitted certain qualified foreign institutional investors to trade stock index futures on CFFEX. However, these investors were restricted to trade for hedging purposes only and subject to a quota. Speculation was (and is) not permitted.

Initially the only product offered by CFFEX was the CSI 300 index futures contract, which is based on an index comprising stocks of companies with the largest market capitalization and liquidity selected from all listed A share companies in China.

In September 2013, CFFEX also listed a 5-year China Treasury bond futures contract. This marked the re-introduction of bond futures trading in China that had been suspended in 1995 following manipulative trading activities in February of that year that resulted in the collapse of Shanghai Wanguo Securities and the jailing of its chief executive officer–the so-called "327 incident" (327 referred to the code of the relevant futures contract).

Other innovations implemented recently in China include the introduction by SHFE in 2013 of the continuous trading program (e.g., night trading) for certain commodity futures contracts, including gold and silver futures and various non-ferrous metals contracts. The following year DCE and ZCE introduced night trading on their exchanges. For all three exchanges, the extended hours overlap with the opening of futures markets in the U.S. based on similar commodities.

> "The Chinese authorities also have made an initial step toward permitting **the development of an options market.**"

Towards the end of 2014, the China Futures Association (the futures self-regulatory organization in China) issued new rules governing how China futures companies may set up subsidiaries to engage in the asset management business. Previously futures brokers were limited to providing asset management for individual clients only (so called "1:1 trading"). Under the new rules, future brokers may establish asset management subsidiaries, and both futures brokers and their subsidiaries may manage clients' funds pursuant to a collective scheme (so called "1:many" trading).

The Chinese authorities also have made an initial step toward permitting the development of an options market. In January 2015, the CSRC authorized the Shanghai Stock Exchange to launch a pilot program to trade options on the SSE 50 Index ETF, an exchange-traded fund that tracks the 50 largest stocks traded on the exchange. These options began trading on Feb. 6. Several futures exchanges have started mock trading of commodity options, and it is anticipated that the pilot program will be expanded to include options on additional ETFs and individual stocks, commodities and stock indices.

Towards the end of 2014, CSRC authorized a trading link between Shanghai and Hong Kong—known as the Shanghai-Hong Kong Stock Connect—to further open up China's capital markets. With this link, non-China based investors, including international money managers and retail investors, are able to buy and sell China A-share equities "north-bound" from Hong Kong while Chinese investors can access Hong Kong shares "south-bound" from China, all through their local brokers. In March, the authorities further expanded this scheme, allowing investors to short-sell shares available via the link. Initial flows have not been very large, but over time this trading link may serve as a model for similar innovations regarding futures and options trading.

Volume on China's Four Exchanges

Ranked by number of contracts traded and/or cleared. Futures and options volume broken down by subsidiary exchanges.

Exchange	Sum of 2013 Volume	Sum of 2014 Volume
Dalian Commodity Exchange	**700,500,777**	**769,637,041**
Block Board	1,988,112	17,760,375
Coke	115,306,637	63,688,294
Corn	13,313,633	9,329,939
Corn Starch (*Dec-14)	—	71,958
Egg	1,951,323	35,188,187
Fibre Board	2,374,759	15,354,378
Hard Coking Coal	34,259,550	57,605,436
Iron Ore	2,189,215	96,359,128
Linear Low Density Polyethylene (LLDPE)	72,142,084	71,754,393
No. 1 Soybeans	10,993,500	27,197,413
No. 2 Soybeans	7,236	6,952
Polypropylene (*Feb-14)	—	24,781,150
Polyvinyl Chloride (PVC)	1,787,233	1,471,673
RBD Palm Oil	82,495,230	79,996,388
Soybean Meal	265,357,592	204,988,746
Soybean Oil	96,334,673	64,082,631
Shanghai Futures Exchange	**642,473,980**	**842,294,223**
Aluminum	3,305,575	13,926,276
Bitumen	3,134,301	650,169
Copper	64,295,856	70,510,306
Fuel Oil	1,039	1,469
Gold	20,087,824	23,865,406
Hot Rolled Coil (*Mar-14)	—	1,255,424
Lead	172,759	1,457,822
Rubber	72,438,058	88,631,586
Silver	173,222,611	193,487,650
Steel Rebar	293,728,929	408,078,103
Wire Rod	3,862	665
Zinc	12,083,166	40,429,347

Exchange	Sum of 2013 Volume	Sum of 2014 Volume
Zhengzhou Commodity Exchange	**525,299,023**	**676,343,283**
Common Wheat (PM)	1,894	1,203
Cotton No. 1 (CF)	7,452,748	31,782,665
Early Rice (ER) (**May-13)	358,249	—
Early Rice (RI)	515,471	332,910
Ferrosilicon (*Aug-14)	—	767,619
Flat Glass (FG)	186,105,091	78,725,549
Japonica Rice (JR)	40,480	**10,005**
Late Rice (LR) (*Jul-14)	—	52,116
Methanol (MA) (*Jun-14)	—	14,048,540
Methanol (ME)	3,497,720	10,566,232
PTA (TA)	76,283,987	117,865,244
Rapeseed (RS)	1,174,626	17,219
Rapeseed Meal (RM)	160,100,378	303,515,966
Rapeseed Oil (OI)	11,853,858	13,897,650
Rapeseed Oil (RO) (**May-13)	855,411	—
Silicon Manganese (*Aug-14)	—	361,462
Strong Gluten Wheat (WH)	1,871,991	1,025,946
Strong Gluten Wheat (WS) (*May-13)	1,035,689	—
Thermal Coal (TC)	4,357,384	5,646,295
White Sugar (SR)	69,794,046	97,726,662
White Sugar (SR)	69,794,046	97,726,662
China Financial Futures Exchange	**193,549,311**	**217,581,145**
5 Year Treasury Bond	328,795	922,871
CSI 300 Index	193,220,516	216,658,274
Grand Total	**2,061,823,091**	**2,505,855,692**

** Date contract began trading. ** Date contract stopped trading.*

The Interim Measures

The potential access by international investors to the SIEE crude oil contract marks another step in this gradual process of liberalization.

The exchange has not yet spelled out all of the details of the new contract but some key features are known. The contract will be denominated in RMB, the Chinese currency, but margin may be accepted in foreign currency. The contract will have physical delivery at expiration, and it is expected that the price will reflect the cost of crude oil imported into China.

As proposed in the Interim Measures, international traders would be permitted to access this contract (and later, other designated contracts) either through China-based or overseas brokers, or directly in their own name, subject to applicable approvals. It is not precisely clear from the Interim Measures, but it appears that only local China-based brokers initially can be clearing members of the SIEE. However, the Interim Measures appear to suggest that overseas brokers that establish or control entities in free trade zones such as the one located in Shanghai could become clearing members too.

Although it appears that clearing firms would maintain omnibus accounts with SIEE, the identity of each ultimate customer would be disclosed apparently. It is not clear whether give-up transactions would be authorized.

Overseas trades would have to satisfy eligibility requirements established by CSRC and SIEE. Authorized overseas brokers would have to be subject to oversight by a home jurisdiction regulator. The regulator would have to enter into a memorandum of understanding with CSRC governing cooperation where the overseas broker is a member of SIEE and grants direct market access of an overseas trader. SIEE, China-based futures companies and overseas brokers would all have to establish and administer a suitability system in connection with trading by overseas traders. Overseas traders would also be required to maintain a suitability system although it is unclear what this would entail.

The Interim Measures contemplate the establishment of a large trader reporting regime in connection with futures positions, and would require overseas traders to submit to regular or random onsite inspections.

CSRC retains the right to penalize any futures exchange, domestic futures broker, overseas trader or overseas broker for violations of law. Potential criminal activities may be referred to a judicial authority and prosecuted accordingly.

If this experience proves successful, it is anticipated that other futures contracts will be opened up, and outbound trading by Chinese persons, whether through an arrangement like the Shanghai-Hong Kong Stock Connect or otherwise, could quickly follow.

Indeed, in May 2014, the China State Council, the highest administrative authority in the government, released a document entitled *Opinions on Promoting the Healthy Development of the Capital Markets*—the so-called "New Nine Directives"—that indicated that CSRC would launch pilot programs to facilitate overseas trading by domestic persons in the near future.

It appears that after many years of patient waiting by the international community, the long anticipated opening of China's futures markets to both inbound and outbound traffic may soon finally occur.

> "The Interim Measures appear to suggest that overseas brokers that **establish or control entities in free trade zones** such as the one located in Shanghai could become clearing members too."

There is an ancient Chinese proverb that loosely translates as, "patience is power, with time and patience the mulberry leaf becomes a silk gown." With tremendous trading opportunities awaiting on China's markets and with the apparent liberalization of laws and rules being enacted to accommodate greater inbound and outbound China business, it appears that soon both international and Chinese citizens and entities will have the opportunity to wear silk gowns—a reward for their patience in waiting for the maturation of the futures industry in China.

....

Gary DeWaal is currently special counsel to Katten Muchin Rosenman LLP, based in New York. He previously served as global general counsel and in other senior capacities for Newedge and its predecessors for 27 years. He was formerly a director of Citic Newedge Futures Co. Ltd, a China-based futures broker. He publishes a weekly publication regarding the financial industry entitled *Bridging the Week* at www.bridgingtheweek.com.