Chinese Brokers Expand Abroad

By Bennett Voyles

Over the last 18 months, a number of major Chinese banks and securities firms have beefed up their presence in futures markets outside China.

At least five firms based in mainland China have used their Hong Kong subsidiaries to become trading members of futures exchanges such as CME Group, Eurex, London Metal Exchange and Singapore Exchange. Some have taken a step farther and become members of overseas clearinghouses as well.

While the amount of business they are bringing to these exchanges is relatively small today, the long-term potential could be very significant as Chinese investors and hedgers gain more freedom to trade futures on overseas markets.

"I've seen more change in the past year than I've seen in the past five. This is really big," said Garry Jones, chief executive officer of LME and co-head of global markets at Hong Kong Exchanges and Clearing.

Self-Reliance

Although a variety of factors have led these companies to look for foreign opportunities, the fallout from the MF Global meltdown of 2011 accelerated the trend. When the company collapsed, it took two years for the bankruptcy administrators to recover all of the customer funds it had been holding and return those funds to their rightful owners.

Many Chinese brokers with Hong Kong connections relied on MF Global to provide access to the outside world. After the firm collapsed, Chinese law required that these firms replace the money that was missing from customers' accounts. That forced some firms to sell their claims on MF Global when buyers were only paying around 80 cents on the dollar.

When Peregrine Financial Group failed a few months later, a number of Chinese brokers decided they could no longer take the risk of trading through a Western intermediary, according to Joseph Pucci, general counsel and chief compliance officer at Nanhua USA in Chicago. "They don't want that to happen again," Pucci said. "They want to be the master of their own domain and destiny."

Nanhua, one of the biggest futures brokers in China and one of the first to spread abroad, wasn't alone in feeling burnt. The demise of MF Global and PFG also prompted customers to rethink which brokers they want to use for access to international markets.

"There were quite a lot of Chinese companies that were touched in one way or another," said Andy Gooch, chief executive officer of GF Financial Markets in London, another broker with roots in China. "Certainly that focused them on looking at the potential for Chinese counterparties rather than Western counterparties."

Support in Beijing

The expansion into overseas markets is part of a longer-term effort by the Chinese authorities to integrate their financial services sector with the rest of the world. The move began in 2006, when the China Securities Regulatory Commission allowed an initial group of six mainland firms to set up subsidiaries in Hong Kong (see "China Opens up Its Futures Market" in the January 2012 issue of *Futures Industry*.)

Over time the brokers have begun to use their Hong Kong subsidiaries as the launching pad for international business. While the trend started gradually, it appears that the CSRC is now loosening the reins a bit, letting more banks and brokers operate abroad than they did before, according to Conor Cunningham, head of Asia Pacific Futures, Clearing & Collateral for Citibank.

For example, Bank of China International, the Hong Kong subsidiary of one of China's largest banks, joined LME as an associate broker and clearing member in

2012, and recently hired a former Goldman Sachs executive to ramp up its business. In 2013, the Hong Kong subsidiary of China Merchants Futures, the futures brokerage arm of a state-owned transportation, property and financial conglomerate, joined CME as a clearing member, and this year two Hong Kong-based brokers joined SGX.

It is important to note, however, that many restrictions remain on the flow of business into and out of mainland China, including restrictions on currency conversion. In addition, the Hong Kong subsidiaries function as quasi-independent entities that have their own way of doing business and operate under the regulation of Hong Kong's Securities and Futures Commission rather than the CSRC in Beijing.

There is also a parallel trend of local brokers in Hong Kong that are reaching out to overseas markets. Firms like Marigold International Securities and Quam Securities cut their teeth in the highly competitive retail market in Hong Kong and have joined overseas exchanges as a way to expand the range of products they can offer to their clients. These firms also are catering to a growing number of mainland investors that have been allowed to bring funds into Hong Kong.

While these firms have been able to offer international futures indirectly by relying on foreign brokers to provide access to those overseas markets, they are now taking the extra step to become members themselves.

"This is a great step forward for us into the global derivatives markets," Hudson Ngan, executive director of Marigold International Securities, said in February 2013 after the firm joined Liffe. "This makes us not only a platform for global investment, but also provides proof of our ability to meet internationally recognized standards."

Quam Securities cited similar reasons when it joined SGX in April 2014, pointing in particular to the appeal of the exchange's pan-Asian suite of equity index to its customers in Hong Kong and on the mainland.

"We are delighted to be accepted as a trading member of SGX," Kenneth Lam, deputy chairman and chief executive officer of Quam's parent company, said in April. "This is important in strengthening our ongoing efforts to expand our range of product offering to our clients. We look forward to a solid and fruitful relationship with SGX as we work together to further promote products from the Singapore market to our worldwide clients."

> Our specialization in RMB products and our established network in China enables us to serve as a link between Chinese investors and Singapore's capital markets.
>
> **LIN YONG,** *Haitong International*

Buy or Build

Most of the Chinese brokers that have joined international exchanges have built from within. Nanhua's Hong Kong subsidiary, for example, has become a trading member of three exchanges in the last three years--SGX, Eurex, and NYSE Liffe. More recently, the firm set up a subsidiary in the U.S. In July the subsidiary was officially registered as a futures commission merchant with the Commodity Futures Trading Commission, the first Chinese broker to receive that approval. Though it is not actively handling trades at present, Nanhua USA is a clearing member of all four of CME Group's exchanges and has opened an office on Wacker Drive in Chicago.

Haitong Securities is another example of this approach. The parent company is one of China's largest securities and futures brokers, with 4.6 million retail clients, 12,000 institutional clients and nearly 1 trillion RMB in client assets. Its Hong Kong subsidiary, Haitong International Securities Group, is one of the leading securities brokers in Hong Kong. This year it launched its first foreign subsidiary in Singapore and joined SGX as a trading member of its derivatives and securities markets.

"We are proud to be one of the pioneering non-bank Chinese financial institutions to enter the Singapore market," Lin Yong, deputy chairman and the managing director of Haitong International, said in March. "Our specialization in RMB products and our established network in China enables us to serve as a link between Chinese investors and Singapore's capital markets. We can also connect Southeast Asian investors to opportunities in China."

GF Securities has taken a different approach. In August 2013, GF Futures, a division of GF Securities, acquired the commodities division of the French bank Natixis for approximately $36 million. The acquisition gave GF a big role at LME, where Natixis had been a category one ring-dealing member. Under Gooch's leadership, the London office has resumed its trading, brokering and clearing activities at LME. The London office is also a member of ICE Futures Europe, ICE Clear Europe and LCH.Clearnet.

Still another example is Citic, the mainland-based industrial and financial conglomerate. Citic Securities International, a subsidiary based in Hong Kong, has no direct memberships in overseas markets but through intermediaries it offers trading in futures listed on CME, Eurex, IntercontinentalExchange, Liffe, LME, SGX and Tokyo Commodity Exchange. A different part of Citic focuses on inbound flows through a joint venture with Newedge that does business on the mainland futures exchanges. And still another part of Citic owns CLSA, the Asian regional brokerage formerly owned by France's Credit Lyonnais.

Fitting into the Neighborhood

As Chinese markets are allowed to become more integrated with the rest of the world, Chinese FCMs expect opportunities for both Eastern and Western investors to grow even further. "People in mainland China will have the capability in varying degrees to invest overseas and vice versa," commented GF's Gooch. "I think that as the markets start to open up, people in the West will also have much more opportunity to invest in the Chinese markets than you see today."

The prestige of having a membership is another driver for many of the businesses, said Citi's Cunningham. There is a practical reason as well: cost. Once a company reaches a certain scale, it becomes cheaper to go direct than through a middleman, he noted.

The level of experience of the new firms is generally fairly high, market observers say. Many are already large, established businesses inside China. GF Securities, the parent of GF Futures, has a $10 billion market cap, making it the sixth largest in the country. Nanhua began using servers from Hewlett Packard in 2009 to support automated trading of futures on Chinese exchanges, and the company signed a deal with Progress Apama in 2012 to use its software for automated trading on international markets.

On the other hand, some Chinese regulations make it more difficult for Chinese FCMs to engage in normal operations in overseas markets. One of the biggest is the need to ask the regulator's permission to take money out of the country. GF's Gooch explained that he cannot just ask headquarters to send him more money overnight, unlike someone working for a big Western bank. "It is a bit of a challenge," he said. "The exchange control is happy to work with you, but it takes time."

Red Star Carpet

The Chinese FCMs are also getting a lot of encouragement to set up shop abroad. Most of the world's major exchanges are brushing up on their Mandarin and stepping up their efforts to build a presence in China.

Singapore Exchange, for example, is campaigning vigorously for support from Chinese brokers. The exchange opened a connection point in the HKEx data center in July, making it easier for local firms to access SGX. The exchange also opened an office in Hong Kong in July and is actively marketing its equity index futures to clients in Hong Kong and on the mainland.

In August, the exchange welcomed China Xin Yongan Futures as a trading member, the sixth Hong Kong-based broker to join SGX. And later this year SGX expects to launch futures on RMB, the Chinese currency, with market-making support from Bank of China International.

CME established a telecommunications hub in Hong Kong more than a year ago to help traders access its markets in Chicago, and it allows its customers to use the Chinese currency as collateral for margin requirements. The exchange also is investing in customer education, offering a variety of educational seminars and training courses, and in May it opened an office in Beijing to monitor local developments.

Of all the foreign exchanges, LME should be the best positioned to capitalize on the outbound trend. LME's markets in copper, aluminum and other base metals are closely tied to Chinese demand for these metals, and there is a large amount of arbitrage between LME's copper futures traded in London and copper futures traded on the Shanghai Futures Exchange.

LME also is set to benefit from better access to China through its merger with HKEx. The exchange is rolling out new contracts aimed specifically at Chinese traders and is planning to leverage the large number of Hong Kong brokers that have customers on the mainland. LME estimates that 20% of its orders come out of China at present and expects that number to rise dramatically as China continues to urbanize and Beijing allows more capital to flow into international markets.

"By 2020, they expect there will be more people in the Chinese middle class than there are in the EU!" exclaimed LME's Jones. "I'm not talking about agricultural workers here, I'm talking about people who consume and do what you and I do, including trading, including home portfolios, including acquisitions. This is a massive new market opportunity."

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