

‘OTC Derivatives Regulation in China: how far across the river?’

Keywords: Chinese Derivatives Regulation 2004, Contract Law 1999, Chinese NAFMII Documents and Enterprise Bankruptcy Law 2006

Mark Hsiao*

Abstract

In 2011, China revised its prudential regulation on the derivatives activities of financial institutions as a result of the global financial crisis. This paper considers how prudential regulation, supervision of conduct and requirements that limit risk-taking are used to achieve policy objectives in the context of regulating derivatives in China. This is particularly pertinent in the case of China, where financial institutions were formerly state-owned enterprises. These objectives are closely related to defining the legitimate purpose of contracts which are used to hedge default risk of credit assets owned by financial institutions. The paper also considers the legal aspects of the executory contract arising from the legal transplant of the ISDA Master Agreement 2002 into China in the form of NAFMII Documents, and the way in which the Contract Law 1999 (CL) and the Enterprise Bankruptcy Law 2006 (EBL) interact to offer a solution to the issue. Finally, the paper offers an explanation of existing Chinese central counterparty (CCP) and finality orders in clearing and settlement systems for possible alignment with international recommendations on OTC derivatives regulation at Pittsburgh in 2009.

INTRODUCTION

The use of derivatives, as they have been transplanted into the Chinese context, has enabled financial institutions to shift the default risk off their balance-sheets by entering into credit protection agreements with other institutions. The purpose of this has been to hedge default risk arising out of its assets portfolio; thus, the previous state-owned financial institutions were able to make use of this tool to hedge default risk of credit assets. Throughout 2009, this legitimate purpose evolved from subtle judicial consent to explicit regulation of such specific usage. This means that the validity of the Chinese derivative contract required a legitimate purpose. This was particularly true before 2004 when no rules had been adopted to clarify the validity of a derivative contract. Instead of a clear regulatory permitted purpose, Chinese financial institutions could only rely on judicial interpretation of the purpose of the derivative contract.¹ By origin, this is a capitalist social welfare concept. According to the China Banking Regulatory Commission (CBRC),² from the enactment of the regulation on derivatives activities in 2004 up until 2009, the domestic interest rate derivative trading reached 461.64 billion yuan.³ With the pressure to reform both the interest rate and exchange rates, the demand for derivatives by the Chinese financial institutions in order to hedge their positions is likely to soar soon.⁴

* Senior Lecturer in Commercial Law, School of Law, University of Leicester

¹ *Bankruptcy of Guangdong International Trust Investment Co., Ltd* (2003) The Higher People's Court of Guangdong Province. [Guangdong International]

² China Banking Regulatory Commission (CBRC) is a division directly under the State Council. It is the banking supervisor and regulator. http://www.gov.cn/gjig/2008-04/25/content_2390.htm . Accessed on 30 November 2012. [CBRC]

³ See Tian Yun 'China's Derivative Market "Great Leap Forward" 2010 in Economic Observer http://www.eco.com.cn/ens/finance_investment/2010/10/28/184139.shtml accessed on 12 January 2013.

⁴ 'Deutsche Bank Economist: China to Speed Up Economic Reforms in 2013' The Wall Street, Journal 14 January 2013. See at <http://online.wsj.com/article/BT-CO-20130114-701804.html> accessed on 15 January 2013.

The regulation of OTC derivatives has once again attracted attention due to the recent global financial crisis.⁵ China has followed suit by revising its prudential regulation which was promulgated to enable financial institutions to hedge their credit assets.⁶ This article reveals the policy and rationale in the initial adoption of derivatives regulation. First, the paper illustrates how and why prudential regulation has been adopted rather than asking if the Provisional Administrative Rules Governing Derivatives of Financial Institutions 2004⁷ (PARGDFI) serve as an effective mechanism in supervising derivatives activities. An initial discussion will highlight the extent to which China's policy on derivatives regulation has been adopted, and how the permitted purpose of derivative contracts to hedge balance sheet assets reduces the state burden in providing financial aid to former state-owned financial institutions. The purpose of hedging, if used appropriately, removes or discharges the burden of the state to inject capital into state-owned financial institutions. Second, this paper also reveals the relationship between the PARGDFI and the CL⁸ concerning the 'purpose' principle.

Prior to the promulgation of the PARGDFI in 2004, in which attempts were made to set market entry through social regulatory techniques, the legal validity and enforceability of the derivative contract was based entirely on judicial interpretation. Thus, in 2003, in the matter of *the bankruptcy of Guangdong International Trust Investment Co., Ltd (Guangdong International)*,⁹ the Higher People's Court of Guangdong Province was asked to determine on the validity of swap contracts by accepting that such swap transactions of interest rates were a financial means widely adopted all around the world for the purpose of lowering the costs of funding, and preventing risks incurred from interest. The court held that the derivatives contract entered into by the insolvent entity did not need to be verified by the State Administration of Foreign Exchange (SAFE),¹⁰ nor did it require an assessment on the hedging risk or the speculative purpose concerning the interest rate swaps.¹¹ Guangdong International's license to trade foreign exchange business, issued by the SAFE, extended to the sale and purchase of foreign exchange derivatives on behalf of its clients.¹² Therefore, those swap transactions were validly upheld by the court. Upholding the validity of derivatives contracts in *Guangdong International* reflected a need for specific regulation of derivatives activities. A socialist policy¹³ that encouraged financial institutions to hedge their asset portfolios could only be upheld by the court by acknowledging that derivatives contracts were a legitimate way of hedging risk outside China. The state policy was reflected in the judgment which recognized the legitimate purpose of the derivatives contract as a means of hedging credit risk. The concept behind this contractual purpose is consistent with Article 58(1)(7) of the General Principle of Civil Law 1986 (GPCL),¹⁴ and Article 52(3)

⁵ L. A. Stout, 'Derivatives and the legal origin of the 2008 credit crisis' (2011) 1(1) Harvard Business Law Review [Stout]

⁶ *Provisional Administrative Rules Governing Derivatives Activities of Financial Institutions 2006 (amendment 2011)* art. 4(1) . [PARGDAFI 2011]

⁷ *Provisional Administrative Rules Governing Derivatives of Financial Institutions 2004* (PARGDFI) (The Rules was enacted in 2004 by the China Banking Regulatory Commission and subsequent revisions in 2006, and in 2011 respectively)

⁸ *Contract Law of the People's Republic of China 1999*, [Contract Law]

⁹ Guangdong International, *supra*, n. 1.

¹⁰ http://english.gov.cn/2005-10/09/content_75318.htm accessed on 1 December 2012

¹¹ Guangdong International, *supra*, n.1.

¹² *Ibid.*

¹³ *General Principles of the Civil Law of the People's Republic of China 1986*, art 6 [GPCL] 'Civil activities must be in compliance with the law; where there are no relevant provisions in the law, they shall be in compliance with State policies' see http://www.npc.gov.cn/englishnpc/Law/2007-12/12/content_1383941.htm accessed on 1 December 2012.

¹⁴ *Ibid.*, art 58(1)(7) 'those that performed under the guise of legitimate acts conceal illegitimate purposes.'

of the CL.¹⁵ Both articles were used by the courts to void contracts if they were made for an illegal purpose but in a lawful form, or by means which the law permitted.¹⁶ Thus, it has served as an important legal element in establishing the validity of contracts in Chinese judicial practice.¹⁷

This purpose correlates with the economic policy of the state which intended to preserve the socialist legacy in the transformation into the socialist market economy. Since the founding of the Communist Party in 1949, all economic sectors have been controlled and managed by the government directly.¹⁸ State-owned banks were supported by the state as they did not have to bear their losses or make profit independently, and neither did they have to be accountable.¹⁹ Banks were *de facto* policy banks where the state would support them financially in their losses.²⁰ In December 1978, the Open-Door policy was inaugurated in order to standardize and modernize the organization and practices of enterprises.²¹ With the development of the banks in dealing with non-performance debts, asset management companies were set up to buy toxic assets from Chinese banks in order to transform bad banks into good banks ready for public ownership and ready to be listed domestically or overseas.²²

The need for a specific law in the risk management of banking assets highlights the need for a comprehensive and systematic set of laws which would govern the operation of derivatives within authorized institutions. A significant problem of the Open-Door policy concerns the value of legal construction. This is especially true in a highly competitive business environment, which the Open-Door policy seeks to create, where the law is the essential framework within which businesses must compete. In implementing laws suitable for a banking environment, China has adopted some concepts which are capitalist in origin. The evolved structure of the socialist market economy is heavily driven by the policy. This policy has contributed to the evolution of the economy at various stages from: (1) a planned economy supplemented by regulation; (2) a planned economy based on public ownership; and (3) a socialist market economy.²³

Regulations of Financial Derivatives 2004 (2006)

The PARGDFI, which received a subsequent revision in December 2006, expanded the original 34 Articles to the current 43 Articles and was brought into force in 2007.²⁴ Its last revision was in February 2011²⁵ and this sought to strengthen prudential regulation

¹⁵ Contract Law, *supra*, n. 8, at art. 52(3)

¹⁶ B Ling, *Contract Law in China* (Sweet & Maxwell HK 2002) p168. [Ling]

¹⁷ *Ibid.*, at p169.

¹⁸ See C. R. Baxter and K. Ong, 'A comparative study of the fundamental elements of Chinese and English company law (1999) 48(1) ICLQ 88-126, although in Chinese company law context, how Marxist theory that production capital belonged to the people of China.

¹⁹ Z.L. Shen & J.B. Lou, "The Contemporary Socialist Market Economy and the Law of the People's Republic of China" in J.J. Norton ed., *Financial Regulation in the Greater China Area: Mainland China, Taiwan and Hong Kong SAR*, International Banking, Finance and Economic Law, vol. 14, (London: Kluwer Law International, 2000) [Shen & Lou]. See Guiguo Wang, *China's Company Law: The New Legislation* (1994) p1 in company context.

²⁰ J.B. Lou, *China's Non-Performance Loan, Workout and Prevention* (Kluwer Ltd., London 2001). [Lou]

²¹ *Ibid.*, also see Naitao Wu, 'Guarantee for Modern Enterprise System', Beijing Review, 4-10 Apr. 1994

²² *Ibid.*, also see Shen & Lou, *supra*, n.19.

²³ Shen & Lou, *supra*, n. 19, at 5-6.

²⁴ China Banking Regulatory Commission on Rules and Regulations section at <<http://www.cbrc.gov.cn/showRegulations.do>> accessed 19 April 2012. Also see <http://www.mallesons.com/publications/marketAlerts/2011/China-derivatives-update---PRC-banks-may-trade-cross-currency-swaps-with-their-clients-and-reforms-on-CBRC-Derivatives-Rules/Pages/default.aspx> accessed on 21 April 2012.

²⁵ *Ibid.*

over the risk management of derivatives activities overseen by the CBRC. Prior to 2004, the People's Bank of China (PBOC) was the supervisory and regulatory body overseeing the banking industry.²⁶ The CBRC was created in 2004 under the direction of the State Council²⁷ in order to succeed the PBOC as the banking authority for banking supervision and regulation.²⁸ As a department under the State Council,²⁹ it is not only responsible for the supervision and regulation of banking institutions,³⁰ but its subsidiary rules also reflect state policy. In no time the CBRC transformed the *Guangdong International* judgment, recognizing the use of a derivative contract as a legitimate way of managing credit assets by passing the PARGDFI. The CBRC's remit is to 'regulate and supervise the derivatives activities conducted by financial institutions in connection with their risk management associated with derivatives' activities'.³¹

Despite the shift of regulatory and supervisory power to the CBRC,³² it is still required to work closely with the PBOC,³³ particularly on derivatives activities involving foreign exchanges, stocks, and commodities or exchange-based activities. The PBC thus played a critical role as gatekeeper for the final launch of the derivative in 2006 where it could be anticipated that most of the forwards, futures, swaps or options would involve some form of foreign exchange, particularly with currency swaps. Thus, the RMB swap was not fully operational until 2006.

One of the legal risks in the derivative contract is the legal re-characterisation of the contract into an insurance or a wagering contract. The ramification of this is that the contract becomes unenforceable. This is especially so in the case of insurance business being regulated separately by the China Insurance Regulatory Commission (CIRC). The PARGDFI³⁴ dealt with the first issue by converting it into what is known as the permitted purposes,³⁵ in association with asset management. In 2004, the Rules created two categories of derivative user. The end-users of derivatives are institutions entering into derivative contracts in order to hedge defaults on their credit assets.³⁶ The market-makers are *ipso facto* financial institutions that sell derivatives to other financial institutions.³⁷ Two types of licence have been created for these purposes, a basic licence,³⁸ and a general licence.³⁹ The PARGDFI deals with legal capacity by utilizing a market entry

²⁶ By the tenth of Congress of China on the 26th of April 2003 which confers the CBRC as the banking supervisor taking over People's Bank of China's role under The People's Bank of China Law 1995, and Commercial Banking Law 1995 respectively. <<http://www.cbrc.gov.cn/chinese/home/jsp/docView.jsp?docID=2418>>

²⁷ CBRC, *supra*, n.2.

²⁸ *Law of the People's Republic of China on Regulation of and Supervision over the Banking Industry*, art 52. [Banking Regulation and Supervision] Its amendments were adopted at the 24th Session of the Standing Committee of the Tenth National People's Congress in 2006. <http://www.npc.gov.cn/englishnpc/Law/2007-12/05/content_1381962.htm>

²⁹ CBRC, *supra*, n. 2.

³⁰ *Ibid.*

³¹ PARGDAFI, *supra*, n. 7, art 1.

³² *Ibid.*, art. 5.

³³ *Ibid.*, art. 6.

³⁴ *Ibid.*, art. 1.

³⁵ *Ibid.*, art. 4.

³⁶ *Ibid.*, art. 4 (1).

³⁷ *Ibid.*, art. 4 (2).

³⁸ *Ibid.*, art. 4. and basic license from insert an additional article in between articles 6 and 7 on (1) basic license, which permits only transactions of hedging

³⁹ *Ibid.* it inserts an additional article in between articles 6 and 7 on (1) basic license, which permits only transactions of hedging and (2) general license, which permits transactions of non-hedging license.

approval that prescribes that financial institutions are: ‘institutions taking deposits from the general public, commercial banks, urban credit cooperatives and rural credit cooperatives and policy banks’.⁴⁰ Financial institutions also include ‘financial asset management companies, trust and investment corporations, finance companies and financial leasing companies’.⁴¹ A derivative contract is a financial contract that derives its value from the prices of one or more underlying assets or indices.⁴² The descriptive elements of the characteristics of derivatives are very broad in scope. This reflects its wide scope in defining a financial contract as one embedded with characteristics of forwards, futures, swaps or options or a combination of more than one.⁴³ In contrast to ISDA Documents which safeguard against the re-characterisation of a credit derivative by including an obligation on the seller regardless of whether the buyer suffers a loss or is exposed to the risk of loss upon the occurrence of a credit event, the PARGDFI dispenses with this re-characterisation issue by citing ‘permitted purposes’.

The common law ‘contract for difference’ has the characteristics of a combined forward and option⁴⁴ illustrating that a derivative contract is potentially at risk of being re-characterized as either an insurance or a gaming contract. The parties to the contract for difference agree to pay, not to deliver, the difference between the contract price and the market price at the time of performance.⁴⁵ According to Halsbury’s, the definition of a contract for difference is where the common intention of the parties is to pay or receive the difference between their prices on one day and their prices on another day.⁴⁶ The payment of the difference has become an important element in preventing the contract from being held as a wagering contract. The payment of the difference results in neither actual losses nor gains for the protection buyer; it is not a wager contract. This is because the loss is offset by the gain. This is described in the common law case of *Carlill v Carbolic Smoke Ball Co*:

a wagering contract is one by which two persons, both professing to hold opposite views touching the issue of a future uncertain event, one shall win from the other and that other shall pay or hand over to him a sum of money or other stake: neither of the contracting parties having any interest other than the sum at stake, will win or lose, there being no other real consideration. If either of the parties may win but can not lose, or may lose but can not win, it is not a wagering contract.⁴⁷

Thus, a contract for difference is an enforceable contract for a legitimate purpose. This was specifically dealt with in the case of *Morgan Grenfell & Co. Ltd v Welwyn Hatfield DC (Islington London BC)*⁴⁸ where a contract may or may not have been a wagering contract depending on the interests of the parties and their purpose in entering into that

⁴⁰ Banking Regulation and Supervision, *supra*, n.28, art 2.

⁴¹ *Ibid.*

⁴² PARGDFI, *supra*, n. 7, art. 3.

⁴³ *Ibid.*

⁴⁴ *Ibid.*

⁴⁵ I. Stout, ‘Why the law hates speculators: regulation and private ordering in the market for OTC derivatives (1999) 48 Duke Law Journal 701, at p714. [Why the Law hates speculators]

⁴⁶ Halsbury’s Laws of England, para. 21.

⁴⁷ *Carlill v Carbolic Smoke Ball Co.* [1892] 2 QB 484 at p490 [Carbolic Smoke Ball]

⁴⁸ *Morgan Grenfell & Co. Ltd v Welwyn Hatfield DC* [1995] 1 All ER 1.

particular contract. Putting this into context, if the plaintiff in the contract of difference holds an inventory of the assets that he/she seeks to hedge against, the profit he/she makes from the market price would offset a pre-existing source of loss rather than create an opportunity for gain. Thus, the contract for difference is what parties may win but cannot lose, or may lose but cannot win. Stout defines this as an indemnity agreement.⁴⁹ In this sense, the Chinese policy of legitimizing the derivative for financial institutions to hedge their credit assets against is analogous to the way in which common law recognizes the ‘contract for difference’.

The last sentence of the *Carlill* quote states that, ‘if either of the parties may win but cannot lose, or may lose but cannot win, it is not a wagering contract’.⁵⁰ This resembles the economic idea of ‘pareto efficiency’. The contract for difference achieves pareto efficiency by taking the profit to offset the loss, and thus produces no gain and no loss. Therefore, there is neither improvement in the protection offered to the buyer nor any worsening of the protection for the seller who obtains a premium prior to the difference. In contrast, the speculative contract involves two parties who hold opposite views about something that neither directly nor indirectly creates an additional risk. This additional risk appears by creating or driving a movement in a particular direction. As a result, this contract is not pareto efficient as the limited source expands to a new risk. Putting this in the context of the speculative contract, it means that it creates new risk between the two parties who do not own or who indirectly own the other party’s creditworthiness. In this way, they expose themselves to new risk.⁵¹ Thus, the two purposes of the PARGDFI reflect the economic policy of the state’s drive behind the Chinese socialist market economy.

Revised Rules concerning counterparty risk

Following the global financial crisis, in January 2011, the CBRC issued Revised Rules 2011 in an attempt to drive growth in the usage of derivatives domestically by expanding the list of defined financial institutions to policy banks, urban credit cooperatives and rural credit cooperatives, among others.⁵² These Revised Rules bore little, if any, difference from its predecessor. The global financial crisis illustrated the way in which the counterparty risk in the transaction has a drastic impact on the systemic risk, especially on the important players. In other words, what concerns a derivative protection buyer is the credit risk of the protection seller. The normative change resulting from the global financial crisis concerning the counterparties’ risk requires the general licensee to satisfy additional capital requirements such as the Measures for Administration of the Capital Adequacy Ratio of Commercial Banks and the Regulatory Guidance on the Internal Model Methods for Market Risk Capital Measurement of Commercial Banks. The market risk capital in a non-hedging derivative transaction cannot exceed three percent of the core capital of such banking financial institutions.⁵³ The CBRC retains the right to inspect records and information concerning derivatives activities as well as risk management

⁴⁹ Why the Law hates speculators, *supra*, n.45., at p719.

⁵⁰ Carbollic Smoke Ball, *supra*, n.47

⁵¹ Stout, *supra*, n. 5.

⁵² PARGDFI 2011, *supra*, n.6., at art. 2.

⁵³ *Ibid.*

procedure.⁵⁴ The documentary evidence of the capacity of risk management control⁵⁵ and relevant matters must be submitted to the CBRC. These activities are to be scrutinized through a processing system which consists of front, middle, and back offices.⁵⁶ First, the institution is required to submit reports, statements and information regarding derivative transactions to the regulator on a regular basis; failure to do so results in a fine.⁵⁷ Second, the law imposes a duty to disclose risks concerning a derivative to a client to whom it is offering a service.⁵⁸

Acquiring information or records on derivatives activities is an important power. The regulator has a right to call in on a financial institution at any time, or to make a regular visit to examine documents and investigate risk management procedures.⁵⁹ The regulator and SAFE are to be notified immediately of any substantial loss resulting from derivatives activities. In 2006, the Revised Rules was an attempt to strengthen the control and credibility of internal risk management.⁶⁰ The regulator was able to confiscate profit generated from derivative transactions made by any unlicensed financial institution.⁶¹ If an institution contravened any administrative regulations, the agreement was deemed to be void.⁶² This provided a basis for restitution where any property obtained under the contract had to be returned.⁶³ If it was impossible to put the party back to the position where it had been, compensation would be made at an estimated rate.⁶⁴ The party at fault had to compensate the other party for the loss caused by the fault.⁶⁵

The objective of efficiency in compliance is converted into criminal liability that can be attached to the individual who is responsible for the breach of the Rules or internal rules by the institution that causes a substantial loss to a client.⁶⁶ On an institutional level, constant failures can lead to the withdrawal of a licence or suspension of a business.⁶⁷ The regulatory objective cannot achieve a specific end without sanctions. When an institution is in breach of the prudential regulation, the institution itself is subject to criminal liability.⁶⁸ This technique shifts the supervisory burden to the senior management in individual financial institutions. Such a breach can lead to two levels of penalty: a fine⁶⁹ at institutional level and the removal of the directorship.

Inherent Counterparty risk under Chinese NAFMII Documents and Contract Law

⁵⁴ *Ibid.*, art. 35.

⁵⁵ *Ibid.*, art. 7.

⁵⁶ *Ibid.*, art. 7(2).

⁵⁷ PARGDFI, *supra*, n. 7, art 40

⁵⁸ *Ibid.*, art. 24.

⁵⁹ *Ibid.*, art. 35.

⁶⁰ H. Wang, Assistant Chairman of the CBRC speech at the First Conference on Business Coordination for Banking Derivatives' Activities (September 2007) <http://www.cbrc.gov.cn/EngdocView.do?docID=20071010A185B59AFD74A2E1FF5C454142571A00> accessed on 15 February 2013. [H Wang]

⁶¹ PARGDFI, *supra*, n. 7, art 39.

⁶² Contract Law, *supra*, n. 8, at art. 52 (5) a contract is invalid where mandatory provisions of laws and administrative regulations are violated.

⁶³ *Ibid.*, art. 58.

⁶⁴ *Ibid.*

⁶⁵ *Ibid.*

⁶⁶ PARGDFI, *supra*, n. 7, at art 38.

⁶⁷ *Ibid.*, art 42

⁶⁸ *Ibid.*, art 38.

⁶⁹ *Ibid.*, art 40

In late August 2007, the National Association of Financial Market Institutional Investors (NAFMII), a self regulatory body, was formed by Chinese inter-bank market players working under the direction of the PBOC.⁷⁰ A standardised set of documents for derivatives transactions was put forward in the following October.⁷¹ The NAFMII Documents are supposed to provide uniform documentation for the inter-bank market participants in financial derivatives transactions in the PRC.⁷² Just like ISDA documents, the NAFMII Documents are used for most OTC derivatives.⁷³ The legal transplant of the ISDA into NAFMII undeniably produced results for Chinese Derivative market participants in similar difficulties.⁷⁴ In this way, it can be seen that the NAFMII protects the non-defaulting counterparty's close-out netting position by suspending the performance of its payment and delivery obligation if an event of default or potential event of default has occurred and is continuing in respect of its counterparty.⁷⁵ In the event of no automatic early termination, the insolvent counterparty has no power to terminate the NAFMII contract. Only the non-fault party can designate a notice to terminate.⁷⁶ Although the defaulting party is in the wrong, it does not follow that the defaulting party will have to make a payment to the non-defaulting party.⁷⁷ It is feasible upon close-out calculation that the non-defaulting party will be out-of-the-money and, therefore, obliged to pay monies to the defaulting party.⁷⁸ Thus, the non-fault party may suspend and wait for the in-the-money alert before assigning a notice to terminate with close-out netting. This legal issue arose from the ISDA Documents and was litigated globally in the case of the Lehman Brothers insolvency proceedings. Ong refers to this as 'Insolvency Stalemate'.⁷⁹

NAFMII Documents and Contract Law

The stalemate arising from the NAFMII has also found its support in the CL where the defence of non-performance protects a party to a contract who is not bound to perform its duty before the other party does.⁸⁰ Therefore, such an insolvency stalemate in the ISDA Master Agreement has not only been operationally transplanted into Chinese NAFMII, but is recognised by the CL and allows the no-fault party not to perform. More importantly, the NAFMII Documents differ from ISDA Documents in that its governing law is that of the PRC.

⁷⁰ NAFMII Constitution. See http://www.nafmii.org.cn/english/aboutus_e/nafmiiconstitution_e/ accessed on 10 January 2013.

⁷¹ K. Ong & M. Hsiao, 'From ISDA to NAFMII: Insolvency Stalemate and PRC Bankruptcy Jurisprudence' (2013) 8(1) Capital Markets Law Journal [Ong & Hsiao]

⁷² NAFMII 2009 stands for National Association of Financial Market Institution which drafts the OTC derivative contract and approved by the People Bank of China in 2009. The standardized contract duplicates mechanism ISDA Master Agreement 2002. The NAFMII is a self-regulatory body, was newly formed in 2007 by Chinese inter-bank market players working under the direction of the People's Bank of China ("PBOC"). In 2007, it was authorised by PBOC to put forward a standardised set of documents for derivatives, which includes the Master Agreement, the Supplement (or Schedule), the Security Agreement and the Definitions (collectively the "NAFMII Documents"). The NAFMII Documents provide a uniform documentation platform for the inter-bank market participants in financial derivatives transactions in the PRC. [NAFMII 2009]

⁷³ Purpose of NAFMII. http://www.nafmii.org.cn/english/aboutus_e/aboutnafmii_e/index.html accessed on 10 January 2013.

⁷⁴ Ong & Hsiao, *supra*, n.71.

⁷⁵ NAFMII Master Agreement, s4 (III)

⁷⁶ S Edwards, 'Legal principles of derivatives'(2002) Jan JBL 1-32, at pp16-17 [Edwards]

⁷⁷ *Ibid.*, at p16

⁷⁸ *Ibid.*

⁷⁹ K. Ong 'The ISDA Master Agreement: Insolvency Stalemate and Endgame Solution for Hong Kong Liquidators' (2010) 40 HKLJ 337 [Ong]

⁸⁰ Ling, *supra*, n. 16, at p263

The executory nature of the contract has long been recognised under the CL which modified most of the commercial contracts prescribed in the CL. This executory nature of the derivative contract was not anticipated at the time of the enactment of the CL. However, it remains the principal reference for the commercial contract as regulated in the GPCL, which laid the fundamental principles of a civil relationship under its Article 6: ‘Article 6 civil activities must be in compliance with the law; where there are no relevant provisions in the law, they shall be in compliance with State policies.’⁸¹ The executory nature of derivatives is confirmed in the rule concerning future derivatives contracts⁸² despite the lack of explicit incorporation in the CL.⁸³ The CL, however, distinguishes between an executory contract and an executed contract,⁸⁴ specifying that the formation of an executory contract requires only a declaration of assent by the parties whilst the formation of an executed contract requires not only a declaration of assent but also actual delivery of the subject matter of the contract.⁸⁵ The CL modifies the delivery requirement in various commercial contracts such as a loan contract and a contract of carriage.⁸⁶ Thus, the CL provides for the non-fault party to suspend its obligation to perform. This creates a stalemate in the situation where the administrator of the bankrupted party does not have the right to terminate. This is unlike the situation in common law jurisdictions where a party at fault could disclaim the executory contract in the event of insolvency on the basis of onerous property or an unprofitable contract.⁸⁷

NAFMII Documents and Enterprise Bankruptcy Law 2006

Like the ISDA Documents, if an event of default occurs and is continuing in a non-automatic early termination situation, the non-defaulting party may give up to 20 days notice in order to designate an early termination date.⁸⁸ If, however, a termination event occurs, this would appear to be a division between theory and practice in that constructive cooperation between the parties is assumed in the giving of notice whilst notice is not usually given by the affected party in such circumstances.⁸⁹ This situation creates problems with regard to following the time limit relating to that notice. Upon receiving any notice, a relevant party may give up to a further 20 days notice in order to allocate an early termination date.⁹⁰

In addition to the NAFMII Documents concerning the right of the non-defaulting party to serve notice, this practice has support from the administration process in which the EBL follows the model of the US and a similar version in the UK Enterprise Act. In the case of a financial institution becoming insolvent, the EBL offers a degree of predictable outcome in light of global litigation, by looking at the comparative nature of the EBL in the US Chapter 11. Article 18 of the EBL recognises the executory contract to which the bankrupted is a party:⁹¹

⁸¹ GPCL, *supra*, n.13, art 6.

⁸² Compilation Rules for Information Disclosure by Companies Offering Securities to the Public No. 15 - General Provisions on Financial Reports (2010 Revision), Announcement of China Securities Regulatory Commission (No. 1 [2010])

⁸³ *Ibid.*

⁸⁴ Ling, *supra*, n. 16, at p86

⁸⁵ *Ibid.*, at p87

⁸⁶ *Ibid.*

⁸⁷ Insolvency Law 1986 (UK) , s178(3) or Australian Bankruptcy Law s133 (1A) or See Ong, *supra*, n.78.

⁸⁸ Edwards, *supra*, n.76, at p8.

⁸⁹ *Ibid.*

⁹⁰ *Ibid.*

⁹¹ *Enterprise Bankruptcy Law of the People's Republic of China 2006*, art 18 [EBL 2006]

After the people's court accepts an application for bankruptcy, the administrator shall have the right to decide to rescind or continue to perform a contract that is concluded before the acceptance yet remains to be fulfilled by both the debtor and the other party and shall notify the other party of his decision. Where the administrator fails to notify the other party within two months from the date when the bankruptcy application is accepted or to give any reply to the exhortation made by the other party with 30 days from the date the exhortation is made, the contract shall be deemed to be rescinded. Where the administrator decides that performance of the contract be continued, the other party shall comply; however, the other party shall have the right to request the administrator to provide guaranty. Where the administrator refuses to do so, the contract shall be deemed to be rescinded.

Article 18 has a few additional clauses. It appears to reconcile the issue of an executory contract in the event of bankruptcy. The contract becomes executed after the court accepts the bankruptcy application. Under the EBL, the bankruptcy court treats the contract as completed upon accepting the bankruptcy application. The right of the non-fault party is shifted to the power of the administrator. However, there is a balance between the creditor and debtor relationship where the administrator has two options. He could continue to perform the obligation under the contract by serving notice. By doing so the non-fault party could ask for collateral or a guarantee of the performance. If the administrator opts to rescind the contract, damages may be awarded.

Ong and Hsiao suggest that:

... in an insolvency, it is important to balance the interests and rights of general creditors of an insolvent estate. Assuming the insolvent counterparty is in-the-money under the derivative contract, allowing a non-defaulting party to suspend its obligations and delay calling an early termination indefinitely will deny the general creditors valuable assets. It was on the basis of this policy consideration that the US Court held that the particular terms of the ISDA contract violated US bankruptcy law.⁹²

This could be seen in the subsequent procedure of the EBL where the administrator was able to dissolve or accept a contract following a normal bankruptcy petition or reorganisation.⁹³ The latter was drafted on the basis of the US Chapter 11 protection.⁹⁴ The autonomy or the freedom of contract after the insolvency event would have violated the position of the following procedure of the EBL, either in a direct bankruptcy petition or reorganisation. In an insolvency petition, the administrator is entitled to dissolve or accept the contract entered and underperformed by the debtor⁹⁵ and either within a 30-day period from the date of notice, the contract is deemed dissolved,⁹⁶ or, if the administrator decides to continue to perform the contract, the counterparty also has to

⁹² Ong & Hsiao, *supra*, n. 71

⁹³ H Zhang, R Parry and C Li, 'The Balance of Power in Insolvency Proceedings: The Case of China (2011) 8 (1) Int. Corp. Rescue 10-18, at 14 [Zheng, Parry & Li]

⁹⁴ *Ibid.* at 17 ; Lijie Qi, 'The corporate reorganization regime under China's New Enterprise Bankruptcy Law,' (2008) 17 Int. Insolv. Rev. 13-32

⁹⁵ EBL 2006, *supra*, n.91 , at art 18.

⁹⁶ *Ibid.*

take action based on the administrator's guarantee which would otherwise render the contract automatically dissolved.⁹⁷ This procedure reflects the power of the administrator and the shift of power from freedom of contract to bankruptcy regime.

The EBL procedure accelerates the contract between debtor and creditor and 'claims [which are] immature at the time of the case being accepted shall be deemed mature'.⁹⁸ The right to dissolve the contract treats the claim of the creditor as a convertible wealth. Where an administrator or debtor can dissolve the contract in accordance with the EBL, damages may be awarded to the aggrieved party.⁹⁹ This concept of damage avoids the possibility of diminishing the value of the administration estate; in other words, preserving the assets of other creditors. Other creditors are protected against a drop in the value of the administration estate as the administrator can opt not to perform but instead to terminate with a payment of the damage or compensation value that is generally less than its value if the contract were to be performed. This resembles the position in the jurisdictions of Hong Kong and Australia where an onerous contract or unprofitable contract can be disclaimed. Apart from the Chinese context of the EBL, once an administrator opts to terminate, the principle is to shift that compensation to show a balance between creditor and debtor.

The EBL also places the court at the heart of bankruptcy proceedings to uphold or to strike a balance between creditors and debtors. This can be seen in Article 1 of the EBL, where the EBL is formulated to 'protect the legitimate rights and interests of creditors and debtors subject to the order of the socialist market economy'.¹⁰⁰ Therefore, in this context, a party to the derivative contract can go into bankruptcy proceedings and the application can be accepted by the court. The stalemate situation is resolved by treating the performances under the contract as completed, namely executed. This presents the administrator with options. In other words, it enables the freedom of contract of a no-fault party to suspend its performance except in the event of bankruptcy. The executory contract will be treated as terminated or executed in the event of bankruptcy.

Where do we go next? Central Counterparty and Finality Orders

The global financial crisis has highlighted the regulatory deficiencies in the OTC derivatives market and the systemic risk it poses for the wider market.¹⁰¹ The mandatory clearing of standardized OTC derivatives transactions through a CCP mitigates the counterparty risk of exposure in the market. This is achieved by the CCP becoming the buyer to every seller and the seller to every buyer. However, this does not prevent the CCP system from systemic risk originating from a participant. Thus, a finality order, applicable to the CCP as a designated clearing house, is vital to avoid this systemic risk.

The finality order will adversely affect the applicability of bankruptcy law to the bankrupted participant in a designated clearing and settlement system. The resulting transfer or settlement through the designated system is final and irrevocable. Transfer

⁹⁷ *Ibid.*

⁹⁸ *Ibid.*, at art. 46.

⁹⁹ *Ibid.*, at art. 53.

¹⁰⁰ *Ibid.*, at art.1

¹⁰¹ Consultation paper on the proposed regulatory regime for the over-the-counter derivatives market in Hong Kong 2011 (Consultation paper 2011) <<http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/doc?refNo=11CP6>> accessed on 20 Dec 2012.

means the funds into or out of an account of a participant. The settlement means settling payment obligations or the settlement of an obligation for the transfer of book-entry securities, or the transfer of such securities. Thus, the transfer or settlement that arises out of this cannot be reversed, repaid or set aside or be subject to an order made by a court for the rectification or stay of such a transfer or settlement. It is, therefore, irrevocable and irreversible, and it cannot be reversed by a court order.

This solution could soon become law in China and is far from being in alignment with international recommendations concerning regulation of OTC derivatives. Reliance on both a finality order and the CCP in dealing with a counterparty's risk was in line with the G20 Agreement in Pittsburgh in September 2009¹⁰² concerning regulation of OTC derivatives through both reporting and clearing regimes. In its Hong Kong Special Administrative Region, the Hong Kong Monetary Authority, the banking regulator, has undergone a regulatory reform structure concerning regulation of OTC derivatives over which it will maintain its jurisdiction in the mandatory reporting of OTC derivative transactions to trade repositories (TRs).¹⁰³ The essence of the CCP clearing model will be in its compliance with the CPPS-IOSCO¹⁰⁴ recommendations and the RTG or Direct Debit/Credit arrangement that will provide a legal certainty and be similar to a finality effect in the settlement of payments. The proposed eligible transactions are interest rate swaps (IRS) and non-deliverable forwards (NDF).¹⁰⁵ These two transactions have a longer duration as compared to the futures exchanges that have a relatively short time to settle.

The NAFMII inter-bank market provides a uniform platform for the CCP clearing system to settle the inter-bank derivative transactions. Although it is a self-regulated body, it is managed and supervised by the PBOC.¹⁰⁶ The members of NAFMII are mostly 'financial institutions' and include policy banks, commercial banks, credit cooperative banks, insurance companies, securities houses, fund management companies, trust and investment companies, and finance companies.¹⁰⁷ Bank clearing and settlement is predominately settled through a department of the PBOC, which is known as the China National Advanced Payment System (CNAPS).¹⁰⁸ The system concerned with this transfer is known as HVPS and BEPS.¹⁰⁹ HVPS settlement is based on real time while the BEPS is settled intraday.¹¹⁰

The securities settlement system in China is presently organized according to market type: the bond market, the corporate securities market or the futures market.¹¹¹ The China

¹⁰² < <http://www.europarl.europa.eu/sides/getDoc.do?language=EN&reference=B7-0082/2009> > accessed on 11 January 2013.

¹⁰³ Consultation paper 2011, *supra*, n. 101, at para 5(1)

¹⁰⁴ <http://www.bis.org/press/p110310.htm> accessed on 12 January 2013.

¹⁰⁵ Consultation Paper 2011, *supra*, n.101., para 7(5).

¹⁰⁶ Article 4 of NAFMII constitution, NAFMII is under direct business guidance, supervision and management by the People's Bank of China (PBOC) and the Ministry of Civil Affairs (MOCA). http://www.nafmii.org.cn/english/aboutus_e/nafmiiconstitution_e/ accessed on 10 January 2013.

¹⁰⁷ http://www.nafmii.org.cn/english/aboutus_e/aboutnafmii_e/index.html accessed on 10 January 2013.

¹⁰⁸ http://www.pbc.gov.cn/publish/english/1169/2009/20090615134648195802677/20090615134648195802677_.html

¹⁰⁹ <http://www.bis.org/publ/cpss107.htm> accessed on 12 January 2013. Also see <http://english.people.com.cn/90001/90778/6250838.html>

¹¹⁰ <http://www.bis.org/publ/cpss107.htm> accessed on 12 January 2013.

¹¹¹ IMF Report on 'People's Republic China: Detailed Assessment Report: CPSS-IOSCO Recommendations for Securities Settlement Systems and Central Counterparties' 2012 <http://www.imf.org/external/pubs/ft/scr/2012/cr1282.pdf>

Securities Depository and Clearing Corporation Limited (SD&C) is the CCP, securities settlement system (SSS), as well as the Central Securities Depository (CSD). There are three commodities exchanges: Shanghai Futures Exchange (SHFE); Dalian Commodities Exchange (DCE); and Zhengzhou Commodities Exchange (ZCE).¹¹² A fourth financial futures exchange (China Financial Futures Exchange (CFFEX)) was established in 2006 as a joint venture. These four exchanges have their own systems of settlement and clearing.

Despite the complex web of agencies responsible for the derivative contracts settlement, the PARGDFI reflects partial international convergence by requiring a mandatory disclosure rule that ‘information concerning risk exposure, loss, and profit of the derivatives activities is required to be made publicly available’.¹¹³ The most important power is its regulatory right to visit a financial institution at any time or at regular intervals to examine documents and investigate risk management procedures.¹¹⁴ The regulator and SAFE should be notified immediately when a substantial loss has been incurred as a result of derivatives activities. The revision of the Rules in 2006 was an attempt to strengthen the control and credibility of internal risk management.¹¹⁵

CONCLUSION

This paper has sought to illustrate the rationale of policy-making through a specific law on derivatives transactions. In so doing, the issues concerning derivative transactions prior to the 2004 Rules have been explained. The mechanism by which the derivatives activities are controlled and regulated in China offers valuable lessons in how this piece of regulation is evolving. In this article, the main features of derivatives regulation in China in the context of prudential regulation have been described, and it has been shown how the common law of the contract for difference resembles Chinese policy in the way in which it has been adopted, particularly in the Rules themselves and the CL. In identifying similarities in policy and differences in the criteria used by the Western model and China, it has been seen that these are due to cultural, philosophical, political and economic reasons. Moreover, it is clear that the underlying conceptions and factual assumptions are, in fact, not only about China, but more especially about the common law. The regulation of derivatives is highly and tightly monitored in China, albeit with caution, as the present derivatives markets are limited to domestic inter-bank markets. This paper has offered an explanation of how the CL and the EBL can be used to deal with issues that can arise from the legal transplant of ISDA Documents into NAFMII Documents. Finally, the author has left the alignment of the Chinese CCP with international recommendations open. There is one interesting aspect of OTC derivatives regulation remaining - how far Chinese authorities would be willing and prepared to cross the river on OTC regulation in order to converge with international practice.

¹¹² Ibid., <http://www.imf.org/external/pubs/ft/scr/2012/cr1282.pdf>

¹¹³ PARGDFI, *supra*, n. 7, art. 34.

¹¹⁴ Ibid., at art. 35.

¹¹⁵ H Wang, *supra*, n.60.