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Six Highlights of *Futures and Derivatives Law*

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Introduction

Futures and Derivatives Law of the People's Republic of China (hereinafter referred to as the "***Futures and Derivatives Law***" or the "***Law***"), as adopted at the 34th Session of the Standing Committee of the Thirteenth National People's Congress (**NPC**) on April 20, 2022, shall come into force on August 1, 2022.

Futures and Derivatives Law is the fundamental law in China's futures market. It fills in the gap in the field of Chinese futures and derivatives law and provides the legal basis for regulating trading in futures and derivatives, protecting the lawful rights and interests of traders, and promoting futures and derivative markets to serve the real economy. The Law is a significant milestone in the law-making of the futures and derivatives industry and marks a new chapter in the development of the futures and financial derivatives market in China.

Futures legislation has been deliberated for five times. It was part of the legislative plan of the NPC Standing Committee in its Eighth, Tenth, Eleventh, Twelfth, and Thirteenth sessions. The legislative process was lengthy and difficult. I have personally participated in the futures legislation seminar of the Twelfth NPC Standing Committee. I believe that the legislation is forward-looking and realistic. As I once said in an interview of Securities Times, China's futures market has rich resources with huge trading volumes of both commodity futures products and financial futures products. China is leading the world in the trading volumes of several futures products, but its trading price are not influential in the international market. Futures and derivatives play an important role in the financial markets due to its price discovery and risk management functions.

The Law summarizes past historical experience and draws lessons from international practices. It lays down the top-level design, clarifies the legal positioning and behavioral norms of various participants in futures and derivatives markets, and introduces a series of institutional arrangements.

Based on our long-term practice in the field of futures and financial derivatives, as well as my personal practical experience as the legal advisor and professional committee member of Chinese futures exchanges, we hereby analyzes the following legislative highlights of the *Futures and Derivatives Law* for your reference.

1. The Law aims to serve the real economy and safeguard national economic security.

After more than 30 years of development, China now has a sizable futures market. In addition to the orderly development of financial futures, China's trading volume of commodity futures has led the world for many years. China's futures market has accumulated some effective and well-run principles and regimes regarding futures trading, settlement and delivery, and trading exchange operation. *Futures and Derivatives Law* provides effective rules and regimes for establishing a risk prevention system in all aspects of futures trading, such as the trader eligibility regime, margin requirements, risk reserve system, position limit system, actual control account management system, large trader reporting system, forced position reduction, daily mark-to-market system, central counterparty system, futures market risk monitoring system, and emergency handling mechanism in abnormal situations .

Meanwhile, the rules and regimes derived from China's futures market practice have been recognized at the national legislative level, such as the real-name account regime, one account one code regime, margin depository monitoring regime, and the "five-in-one" regulatory regime. The Law safeguards the fairness and openness of the futures market and prohibits the behavior of fraud, insider trading, and market manipulation. The Law also states that its legislative purpose is to promote the development of the futures and derivative market to serve the national economy, prevent and dissolve financial risks, and safeguard the security of the national economy.

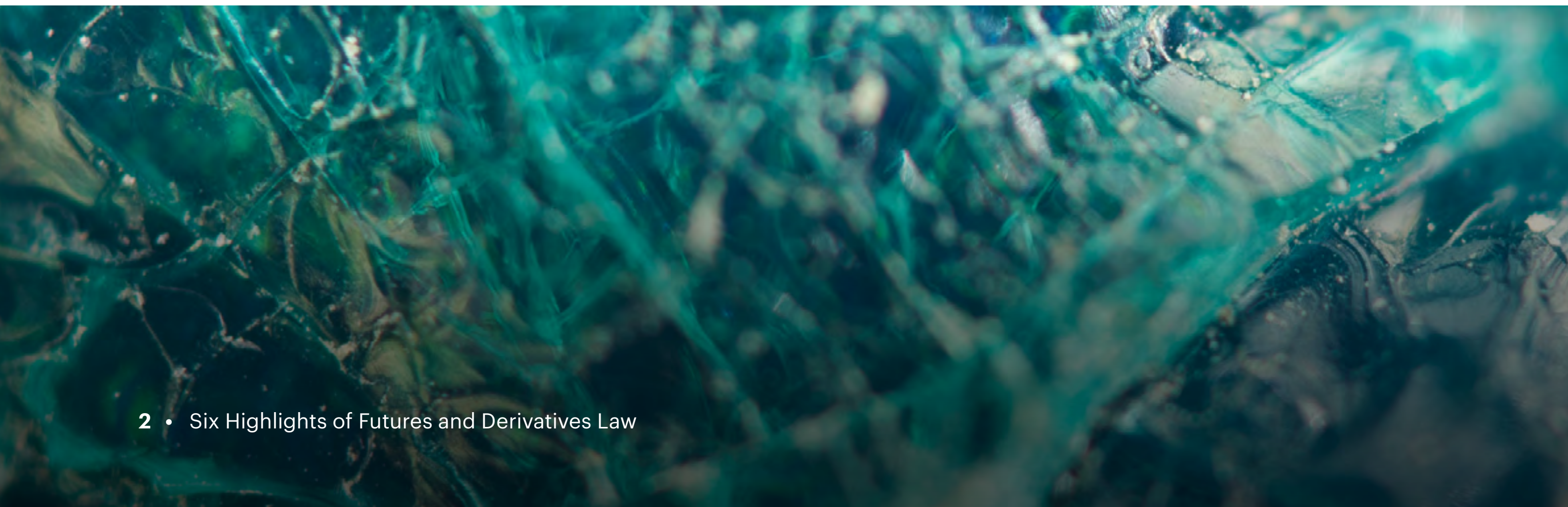
2. The Law defines derivatives trading for the first time, establishes the basic derivatives trading system and clarifies the basic regulatory framework of derivatives

Firstly, *Futures and Derivatives Law* not only regulates the futures market but also covers the derivatives market. In addition to defining futures trading, it defines derivatives trading for the first time at the legislative level and brings derivatives trading into the scope of legal regulation. Meanwhile, in addition to defining futures contract and option contract, the Law also defines that swap contract and forward contract shall be deemed as financial contract according to the Basel Committee and IOSCO's definition of derivatives.

For the purposes of the Law, "trading in derivatives" means the trading activities other than futures trading, which take swap contracts, forward contracts, and non-standard option contracts, as well as their portfolios as the subject matter of transactions.

For the purposes of the Law, "swap contract" means a financial contract under which the specific subject matter shall be exchanged as agreed upon on a given future date. For the purposes of the Law, "forward contract" means a financial contract other than a futures contract, under which a certain quantity of the subject matter shall be delivered as agreed upon on a given futures date at a specified location.

Moreover, after the global financial crisis, the G20, including China, reached a consensus to strengthen the supervision of derivatives markets. However, the basic regimes of global derivatives trading, such as Single Master Agreement, Close-out Netting, and Centralized Settlement, have not been recognized in Chinese law, which may conflict with the PRC Civil Code and Business Bankruptcy Law to some extent. This greatly hinders the development of China's derivatives market.



By learning from the international mature experience and absorbing the derivatives regulatory consensus reached by the G20, *Futures and Derivatives Law* recognizes the regimes of the Single Master Agreement, Close-out Netting, and Centralized Settlement. The trading will not be suspended, invalid, or canceled if one party entered bankruptcy proceedings. This is in line with the mature international market, which is conducive to promoting the opening-up of China's futures market and enhancing the internationalization level of the Chinese futures market.

Furthermore, *Futures and Derivatives Law* expressly states that the derivatives market shall be subject to the supervision and administration of the futures regulatory agency of the State Council or the department authorized by the State Council according to the division of duties. To conduct derivative trading, a financial institution shall obtain approval or confirmation in accordance with the law, perform its trader suitability management obligations, and comply with the relevant regulatory provisions of the state. The department authorized by the State Council and the futures regulatory agency of the State Council shall establish a derivative trading report database. Performance guarantee may be legally provided for derivative transactions in such forms as pledge.

Where derivative trading is settled in a centralized manner by a clearing institution as a central counterparty approved by the department authorized by the State Council or the futures regulatory agency of the State Council, netting may be terminated in accordance with the law.

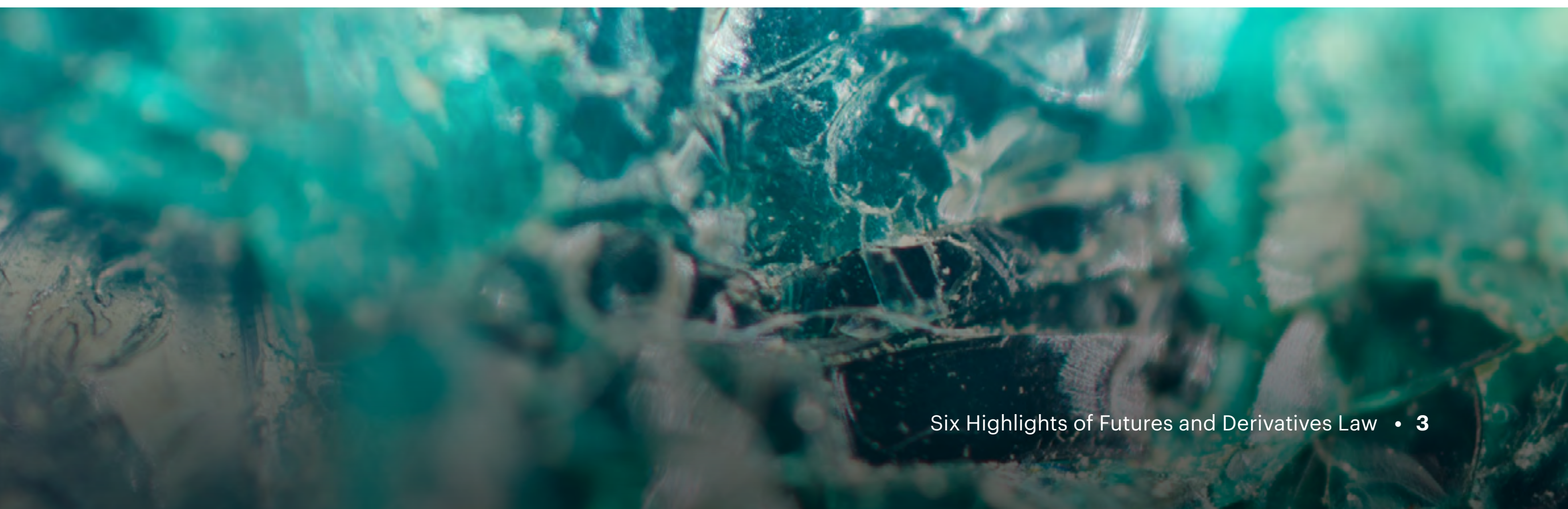
For the derivatives market, the practical and forward-looking provisions of the Law demonstrates the status and development opportunities of the derivatives market in China, which will attract extensive attention from the financial sector.

3. The Law supports the futures market's functions in discovering prices, managing risks, and allocating resources and encourages hedging

Firstly, the Law expressly demonstrates that the state supports the sound development of futures markets and plays the functions of the futures market in discovering prices, managing risks, and allocating resources. Meanwhile, the Law stipulates that the state shall take measures to promote the development of the futures market and derivatives market of agricultural products and guide the production and operation of domestic agricultural products. The newly added function of allocating resource will further serve the real economy and adjust the supply and demand.

Secondly, the Law defines hedging for the first time and encourages enterprises to engage in hedging activities. It also clarifies that whoever engages in hedging and other risk management activities may apply for the exemption of the position limit. Meanwhile, the Law restricts excessive speculation. The administrative measures for position limit and hedging shall be developed by the futures regulatory agency of the State Council.

In addition, the Law changes the current approval system into registration system for listing of new futures contract products. The suspension and resumption of listing and delisting of futures contract products and standard option contract products shall be decided by futures trading venues and filed with the futures regulatory agency of the State Council for recordation. Futures contract products and standard option contract products shall have economic value, be difficult to be manipulated, and conform to the public interest. By optimizing the listing system of futures contracts products, market players may launch more futures products that meet the requirements.



4. The Law allows extraterritorial application and provides for cross-border regulatory mechanisms

At present, China has allowed certain commodities futures products to be traded by foreign investors. There is an urgent need for Chinese enterprises, traders, and brokers to participate in overseas futures and derivatives markets. However, there has been a lack of legal provisions to support the internationalization. Now the Law fills in this gap.

Firstly, in response to China's futures market opening-up, the Law clarifies its effect of extraterritorial application. Where any trading in futures or derivatives and relevant activities outside the PRC disrupt the order of the domestic market of the PRC and cause any damage to the lawful rights and interests of domestic traders, such activities shall be handled, and the violators shall be held legally liable according to the applicable provisions of the Law.

Secondly, the Law provides a special chapter regarding cross-border trading and regulatory cooperation, clarifying the registration requirements for overseas future exchange in providing service to domestic traders, the rules of foreign institutions to set up representative offices and carry out marketing activities in China, the rules for domestic entities to participate in overseas futures trading, and registration requirements for overseas futures operating institutions.

In addition, the Law stipulates the reciprocal bilateral and multilateral cross-border regulatory cooperation mechanisms and procedural requirements for investigation and evidence collection, providing strong legal support for cracking down on cross-border violations and dealing with cross-border market risks.

5. The Law provides rules for traders' classification and suitability management and strengthens the protection of ordinary traders

Based on the principles of openness, fairness, and impartiality, the Law establishes traders' classification mechanism and suitability management rules to strengthen the protection of ordinary traders.

Firstly, traders shall be divided into ordinary traders and professional traders according to their asset status, financial asset status, trading knowledge and experience, professional capability, and other factors. The Law seeks to protect ordinary traders by stipulating burden of proof in case of disputes between ordinary traders and futures trading institutions. Where any ordinary trader is in dispute with a futures trading institution, the futures trading institution shall prove that its conduct complies with laws and administrative regulations, without misleading, fraudulent, and other circumstances. The futures trading institution shall be liable in damages correspondingly, if it is unable to prove it.

Secondly, The Law makes it clear that traders have the right to know, right to query and confidentiality right. The Law enriches the settlement mechanism of futures disputes by introducing a mediation system and the priority of civil compensation, improving the civil compensation litigation system and establishing a national security fund for futures traders. The behavior that disrupts the market order will be cracked down on severely, such as market manipulation, insider trading, false statements, and providing misleading information. The Law increases the cost of violations of laws and regulations by raising the amount of fines in order to protect the legitimate rights and interests of traders.

6. The Law expands the business scope of futures companies, and clarifies the duties of intermediary service agencies

Firstly, Chinese futures companies currently mainly focus on single brokerage business, which accounts for a high proportion of their commission income. This results in single profit source and serious homogeneous competition. According to the Law, in addition to the futures brokerage business, futures companies may operate investment trading consulting, market-making transactions, asset management and other related businesses. The above provisions broaden the existing business scope and allow more room for new business models business development of futures companies, which will enhance the business capacity and risk management ability of futures companies. Meanwhile, according to the Law, futures companies should abide by the law and act with diligence, responsibility, honesty. Otherwise, they may face punishments such as revocation of business licenses, cessation of business operation, warning, confiscation of illegal income, fines, etc.

Secondly, the Law regulates the operation and management of intermediary service agencies. Intermediary service agencies such as accounting firms, law firms, asset appraisal institutions, futures margin depository institutions, delivery warehouses, and information technology service providers shall act with due diligence, adhere to their duties, provide services for futures trading and related activities according to the relevant business rules, and provide relevant materials according to the requirements of the futures regulatory agency of the State Council.

In addition, the institutions that provide information technology system services for futures trading and relevant activities shall comply with the technical management provisions and standards relating to information security of the state and the futures industry, and make record-filing with the futures regulatory agency of the State Council.

Also, in the process of supervision and administration of the futures market, the futures regulatory authority of the State Council should perform the duties of risk monitoring and prevention according to the Law, supervise the fintech and information security of the futures industry, and investigate and punish illegal futures activities.

Conclusion

The enactment and promulgation of the *Futures and Derivatives Law* provides a solid legal basis for the development of China's futures and derivatives market and fills in the gap of financial markets legislations. The Law forms a complete financial legal system together with existing commercial banking laws, securities laws, securities investment fund laws, insurance laws, and trust laws. The provisions of the Law on cross-border transactions and regulations are forward-looking and practical for dealing with the cross-border market risks.

In the long run, the Law will certainly bring huge development opportunities to the futures and derivatives industry, greatly promote the sound development of China's futures and derivatives market, and facilitate the interconnection and bilateral circulation between Chinese market and the international market, and further improve the marketization, legalization and internationalization of China's futures market.

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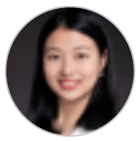

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