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Pioneering offshore access to the China commodities futures markets

The INE and its medium sour crude oil contract

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Executive summary

- ***The opening up of the futures markets for commodity products in China has been much discussed and highly anticipated. However, it looks like a crude oil futures contract, listed on the Shanghai International Energy Exchange (INE), will finally be the first Chinese commodity futures contract capable of being directly traded onshore by offshore investors.***
- ***The principle driver for the choice of this contract is to enable China to develop its own benchmark for oil pricing, while increasing the trade of renminbi (RMB) denominated oil.***
- ***There are four paths by which an overseas investor can access the INE. These are to either become (i) a client of a domestic futures firm member, (ii) an Overseas Special Non-Brokerage Participant, (iii) a client of an Overseas Special Brokerage Participant, or (iv) trade through an Overseas Intermediary. Each of these routes has advantages and disadvantages which are discussed below.***
- ***The INE follows the structure of other Chinese futures exchanges but as with such Chinese exchanges, has features that may be unfamiliar to those who have not previously traded on domestic Chinese futures markets. Some of these features are discussed in this note.***
- ***While the launch date for the INE's crude oil contract hasn't been announced, it is widely expected to happen before the end of 2017. Depending on the success of the crude oil contract, the INE may herald the path for other exchanges and other futures products to become accessible from offshore.***

Introduction

The opening up of the futures markets for commodity products in China has been much discussed and highly anticipated. There have been many false dawns since the approval in 2014 of the Shanghai Futures Exchange (SHFE) listing of an oil futures contract accessible to overseas investors. However, it looks like a crude oil futures contract, listed on the Shanghai International Energy Exchange (INE), will finally be the first Chinese commodity futures contract capable of being directly traded on-shore by offshore investors. The INE is a subsidiary of the SHFE and although the crude oil contract is currently its only product, the INE expects to launch other products in the future.

Depending on the success of the crude oil contract, the INE may herald the path for other exchanges and other futures products to become accessible from offshore. It is understood, for example, that the Dalian Commodities Exchange is looking to launch an offshore futures product in iron ore[i].

The design of the INE crude oil contract

The INE crude oil contract specifications include a quality specification for medium sour crude oil of an API gravity of 32.0 degrees and 1.5 per cent sulphur content and a lot size of 1,000 barrels per contract (which will be listed monthly for the most recent 12 consecutive months and for the following eight three-month periods. The minimum margin is set at five per cent of the contract value. The minimum order is one lot and the maximum, 500 lots.

The principal driver behind the choice of this contract is to enable China to develop its own benchmark for oil pricing, while increasing the trade in renminbi (RMB) denominated oil. As the world's largest net importer of oil, there are good reasons for China to seek to change the established perception that global oil prices should be based on WTI or Brent prices set in New York and London respectively. Having access to the INE's crude oil futures contract would give domestic traders the ability to hedge their price risk against a contract that will benchmark not only domestic demand but also demand in the Asia Pacific region.

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[i] http://www.reuters.com/article/china-ironore-futures/china-to-open-up-iron-ore-futures-to-foreign-investors-idUSL3N17B2GA

The difference in crude oil quality also stands out as a feature of INE's benchmark. The grade of oil deliverable against the INE's crude oil contract is comparable against the Dubai/Oman crude contract, which is currently the dominant global sour crude futures contract. As recent US debate has highlighted, there is certainly a case to be answered as to whether light sweet crude oil (currently the benchmark on CME-NYMEX) is the appropriate benchmark when consumption, at least in the U.S. Gulf-Coast, is predominantly of medium sour crude oil. Certainly, the 2016 statistics for the Chinese market published by China's General Administration of Customs highlight that 49 per cent of its 381 million tonnes of crude oil imports (i.e. 183 million tonnes) were of medium sour grade[ii].

The SHFE has described its concept for the INE crude product in terms of as "international platform, net price trading, bonded delivery and RMB denomination"[iii]. This is a helpful short hand way of capturing the gist of the INE's first product. Net trading is a reference to the price traded and set by the exchange being net of or excluding all tariffs and VAT. The physical settlement of the contract is by way of delivery carried out based on bonded oil storage facilities. This enables the contract to be exclusive of import taxes and potentially a "hub to connect both domestic and international oil markets."[iv] The contract is denominated in RMB but US$ and eventually other foreign currencies will be accepted as collateral by the INE.

Removing the legal impediments to offshore futures trading in the PRC

The futures market in China has established a 'five-in-one' joint regulatory system, which involves the China Securities Regulatory Commission (CSRC), regional offices of the CSRC, futures exchanges, the China Futures Market Monitoring Center (CFMMC) and the China Futures Association (CFA). The CSRC is the statutory futures market regulator in China. Futures exchanges are state-authorised not-for-profit organisations which are self-regulating in accordance with their articles of association. CFMMC is a non-profit corporation established by the CSRC. The CFA is a self-regulatory organisation of the futures industry.

The five-in-one system functions in accordance with the principle of 'united leadership, shared resources, separate duties, divided responsibilities, intimate cooperation and concerted regulation.' The CSRC is in charge of the unified supervision, coordination and inspection of the regulatory system. The CSRC and its regional offices monitor and supervise futures companies and their branches. The futures exchanges and CFA together monitor futures companies to ensure they are complying with the applicable laws, administrative regulations, and their articles of association and implementing rules. Finally, CFMMC inspects and monitors the market.

While it is recognised that there is a hierarchy for the sources of law in China[v], so far[vi], there has been no legislation at the highest level of Chinese law that specifically and systematically regulates and adjusts the rights and obligations of all futures market participants. Rather, relevant content in the General Principles of Civil Law, Company Law, Contract Law, Criminal Law and other laws standardises and regulates different aspects of the futures market. However, as regards legislation at the next level down, the Regulations on the Administration of Futures Trading adopted by the State Council on 15 April 2007 and re-promulgated in 2012, does standardise the futures market in a systematic manner. Legislation sources at the third level include supporting policies issued by the Ministry of Finance, State Tax office, CSRC, PBOC, State Administration of Foreign Exchange (SAFE) and customs. Most of these policies are not specific to crude oil futures and have a broader application to other futures products.

However, a series of supporting policies were published during 2015 to specifically address offshore access to the Chinese futures markets for crude oil, iron-ore and other futures products. These policies (i) confirm that bonded delivery of crude oil futures will be (provisionally) VAT-exempt[vii] (this was recently reconfirmed in 2017)[viii], (ii)

[ii] Source, http://www.shfe.com.cn/en/AnnouncementandNews/SHFENews/911327709.html
[iii] Ibid.
[iv] Ibid.
[v] The highest level comprises laws enacted by the National People's Congress or its Standing Committee. At the next level there are administrative regulations promulgated by the State Council subject to the Constitution and other laws. At third level, there are rules and regulations developed and promulgated by the state ministries and commissions under the aegis of the State Council in accordance with and subject to the laws and regulations of the State Council.
[vi] It is reported that the Standing Committee of the National People's Congress has included the futures law in its legislative work plan.
[vii] "Notice of the Ministry of Finance and the State Administration of Taxation on the Value-Added Tax Policies for the Bonded Futures Delivery of Crude Oil and Iron Ores Futures Contracts (财政部国家税务总局关于原油和铁矿石期货保税交割业务增值税政策的通知)" (Caishui [2015] No. 35), published on April 8, 2015.

provide regulations on overseas account opening, clearing, margin requirements and deposits[ix], (iii) address issues concerning regulations on currency used for trading and clearing, the opening and use of RMB-denominated accounts, interest rate determination, special account administration, anti-money laundering and anti-terrorism financing[x], (iv) address regulations on the opening and use of accounts for foreign exchange transactions, the settlement of foreign exchange transactions, the methodology used for calculation of interest rates and international money transfer reporting requirements[xi], and (v) support the bonded delivery of crude oil futures[xii].

As with most international exchanges, Chinese futures exchanges are quasi self-governing. The INE has published its Rulebook in May 2017 setting out the rules governing the exchange. These include the INE's articles of association, general exchange rules, as well as 11 implementing rules[xiii]. The INE is also subject to rules established by the CFA.

Overseas access – the four paths

The four different paths by which an offshore market participant can access the INE are as follows:

	Path 1	Path 2	Path 3	Path 4
Benefits to the overseas investor	Become an Overseas Special Non-Brokerage Participant (OSNBP)	Become a client of an Overseas Special Brokerage Participant (OSBP)	Trade through an Overseas Intermediary	Become a client of a domestic futures firm member (FF Member)
Direct Trade Execution on the INE	Yes	Yes	No[xiv]	Yes
Trade Execution for the investor's customers	No	Yes	Yes	Yes
Need to arrange for a clearing broker	Yes	Yes	Yes	No
Gives Speed of access[xv] to the INE	Slower	Slower	Fast	Fastest
Gives it a right to a Trading Seat[xvi]	Yes	No	No	No

[viii] "Announcement of the State Administration of Taxation on the Administration of Value-added Tax on the Bonded Delivery of Crude Oil Futures of the Shanghai International Energy Exchange (国家税务总局关于上海国际能源交易中心原油期货保税交割业务增值税管理问题的公告)" (SAT Announcement [2017] No.29), published by the State Administration of Taxation on 28 July 2017.
[ix] "Interim Measures for the Administration of Overseas Traders' and Overseas Brokers' Engagement in the Trading of Specified Domestic Futures Products (境外交易者和境外经纪机构从事境内特定品种期货交易管理暂行办法)" (CSRC Order No.116), published by CSRC on 26 June 2015.
[x] "Announcement with regard to Strengthening the Administration of Cross-border Settlement of Trades of Domestic Crude Oil Futures (关于做好境内原油期货交易跨境结算管理工作有关事宜的公告)" (PBOC Announcement [2015] No.19), published by the PBOC on 20 July 2015.
[xi] "Notice of the State Administration of Foreign Exchange on Foreign Exchange Administration for Overseas Traders and Brokers Engaging in Futures Trading under Specific Domestic Categories (国家外汇管理局关于境外交易者和境外经纪机构从事境内特定品种期货交易外汇管理有关问题的通知)" (Huifa [2015] No. 35), published by SAFE on 31 July 2015.
[xii] "Announcement of the General Administration of Customs regarding the Bonded Delivery of Crude Oil Futures Contracts (海关总署关于开展原油期货保税交割业务的公告)" (GAC Announcement [2015] No.40), published by the General Administration of Customs on 20 August 2015.
[xiii] The 11 implementing rules specify the trading rules, clearing rules, delivery rules, risk management rules, membership management rules, overseas special participant management rules, futures trading participant eligibility management rules, information management rules, designated depository banks management rules, enforcement rules, and the standard crude oil futures contract of INE.
[xiv] In practice, Overseas Intermediaries are allowed to introduce overseas clients to domestic FF Members and the overseas clients may then trade as the FF Members' Clients.
[xv] Based on the current state of play with the INE. Over time we anticipate this distinction to be less relevant.
[xvi] A trading seat refers to electronic access that allows a member, OSNBP or OSBP to place orders for execution on the INE's electronic trade matching system.

Overseas clients of an OSBP, FF Member or Overseas Intermediary are required to meet certain trading eligibility criteria during the application process to access the INE. Of these requirements, the most unfamiliar to overseas applicants may be the requirement that the client must be able to demonstrate a record of more than 10 executed orders within the past three years on an overseas futures exchange regulated by the applicant's competent authority, with whom a memorandum of understanding (MOU) exists on regulatory cooperation with the CSRC. This requirement may not be as restrictive as it first appears because as of August 2017 the CSRC has 66 regulatory cooperation agreements currently in place with regulators in 61 countries and regions including Hong Kong, Singapore, the UK, the United States, Japan, Australia, India and the UAE. During its application process, an OSBP must also demonstrate that it is regulated by a regulator with whom the CSRC has an MOU on regulatory co-operation.

Prior to opening an account for any of its clients, an OSBP, FF Member or Overseas Intermediary is required to apply to the INE for a 'trading code' (i.e. a form of alpha-numerical identifier). Traders active on the INE, in trading to "protect their legitimate rights and interests with appropriate means" must not harm the legitimate rights or interests of the State, the society, the community or any others, or disrupt public order or work order of the Exchange. Such an obligation is common in Chinese futures markets. The CSRC, for example, has similar requirements for traders of financial futures.

Market participants (i.e. clients of FF Member(s), OSBP(s) and Overseas Intermediaries as well as Non-FF Members and OSNBPs) may apply for a hedging quota and arbitrage quota. Hedging and arbitrage quotas are a legitimate means to enable clients to exceed the general position limits otherwise not by the INE from time to time. The hedging quota exists to enable the INE to determine whether or not "real hedging needs exist, the hedging products, the positions held, required trading volumes and the hedging period match the production operation scale, historic operational conditions, financial conditions and other related factors."[xvii] These factors can be determined through the documentation required to be submitted to obtain the hedging quota and include details of the business performance of physical commodities in the previous year, a business plan for physical commodities for the current year and next, any purchase and sale contracts. Different documents need to be submitted based on whether the hedging quota is for regular months[xviii] or nearby delivery months[xix] of the relevant futures contract. Similarly, an arbitrage quota requires the submission of documentation to support the applicant's trading strategy and source of funds, as well as to establish whether this relates to time spreads or cross-product spreads. The arbitrage quota exists to enable market participants to take larger positions in relation to time spreads and cross-product arbitrage trades beyond those permitted by the general position quotas.

In general, an OSBP or OSNBP must submit a written application to the INE (with necessary translations in to Mandarin), satisfying the application requirements. The INE will take up to 30 business days to consider the application and, if approved, the applicant will have a further 90 days in which to enter into a number of agreements including: (i) an agreement with the INE, (ii) an authorised clearing agreement with an INE Member and (iii) an agreement with one of the six dedicated Designated Depository Banks to open a futures settlement account.

The other agreements (although not all are relevant to each applicant) are:

Name of agreement	Parties to the agreement
Carrying-Brokerage Agreement[xx]	FF Member/OSBP and Overseas Intermediary
Futures Brokerage Agreement	FF Member/OSBP/Overseas Intermediary and their respective Overseas Clients
Authorised Clearing Agreement	(i) FF Member and OSNBP/Overseas Client (ii) OSBP and Overseas Intermediary
Exchange Membership Agreement	FF Member/Non-FF Member and INE
DDB Business Agreement	INE and each DDB

[xvii] Article 40, Trading Rules of the INE.
[xviii] Regular months of a futures contract refers to the period from the listing day of the contract to the last trading day in the third month prior to delivery.
[xix] Nearby delivery months of a futures contract refers to the two months prior to the delivery month of a futures contract.
[xx] Pursuant to which the Overseas Intermediaries authorizes FF Member to executed its clients' trading orders.

The role of the Designated Depository Bank

The INE has a large number of Designated Depository Banks (DDBs) that can serve domestic clients of the INE but only six DDBs that can serve overseas clients. The role of the DDBs is to engage in futures margin depository business, which essentially means opening and managing the settlement accounts for the INE, the margin accounts for clearing members and the futures settlement accounts for overseas participants. They also have responsibility for the necessary currency conversion of margins to meet the RMB-denominated settlement and payment obligations of the clearing members. These six banks are Bank of China (BOC), Bank of Communications (BoCom), China Merchants Bank (CMB), China Construction Bank (CCB), Industrial and Commercial Bank of China (ICBC) and DBS China (DBS).

Margin

The INE requires each Member to maintain two margin pools with it to cover its obligations to the exchange. These two are the Clearing Deposit[xxi] (described as a type of guarantee fund) and Trading Margin[xxii] (analogous to variation margin). Eligible collateral that may be used to meet these margin requirements, include cash (currently, renminbi (RMB) and US$), standard warrants and treasury bonds. The Clearing Deposit must be held in RMB whereas the Trading Deposit does not have to be. The clearing settlement currency on the INE is RMB. Where the cash collateral is not denominated in RMB, its value is discounted (i.e. a haircut is applied) by a prescribed percentage, and other types of collateral will also be discounted (e.g. standard warrants will have at least a 20 per cent haircut applied).

Clearing and delivery

The INE is both the exchange and the clearing house. This is a typical feature of the structure of Chinese futures exchanges but may be slightly unusual to overseas participants. As a central clearing counterparty, INE interposes itself between the buyer and seller when each transaction is executed, acting as buyer to every seller and seller to every buyer, making settlement in the amount of net value and providing centralised performance assurance for all transactions. For the purposes of assessing trading risk, an overseas client will need to consider the insolvency risk of both the clearing member and the INE under Chinese law.

In the context of the INE, clearing means the transfer of cleared funds between parties based on the trading results once the settlement price of the relevant contract has been published by the INE. The publication of the settlement price leads to the determination of the day's profit and loss (in RMB) in respect of the various positions. In turn, the relevant profit or loss shall be credited to or debited from the member's Clearing Deposit. Any expenses (e.g., transaction fees and taxes) will also be debited from the member's Clearing Deposit. At the end of the daily clearing process, a member is required to hold sufficient Clearing Deposit to cover that member's settlement obligations to the exchange. The fund transfer data determined at the end of the daily clearing process is made available by the INE to the various DDBs, which will promptly execute the necessary debiting or crediting of the respective member's margin account and crediting or debiting of the INE's settlement account.

In contrast, 'delivery' refers to the process whereby in respect of a futures contract that must be settled (e.g. because it has not been offset at maturity), a buyer and a seller transfer ownership of the underlying asset in the contract (i.e. physical delivery) or make cash settlement at the settlement price at the maturity of the contract. Only clearing members may perform such delivery.

Physical delivery will involve either (i) bonded delivery (i.e., delivery within the Customs Special Supervision Areas or the Bonded Supervision Premises) or (ii) duty-paid delivery (i.e. delivery after clearance through customs and payment of associated customs duties or taxes). The medium sour crude oil specifications require bonded delivery to the bonded oil tanks of 'Designated Delivery Storage Facilities'. Although no announcement of the specific warehouses, oil storage facilities etc. as Designated Storage Facilities has been made, as at the date of this note, they will be in place prior to formal launch of the relevant futures contract. Physical delivery will entail the transfer of standard warrants via the 'Standard Warrant Management System'. Standard warrants are the receipt issued by the Designated Delivery Storage Facility entitling the holder to take delivery of the physical commodity. The warrant can be a warehouse standard warrant (where delivery is to a warehouse or storage facility) or a factory standard warrant (where delivery is to the facility of a producer who has been approved by the INE).

[xxi] Clearing Deposits are funds deposited into the Exchange's dedicated settlement account for futures trading and clearing but which are not yet used as margin towards meeting a member's exchange positions.
[xxii] Trading Margin refers to funds deposited in a member's dedicated settlement account for the INE to ensure contract settlement and is used as margin for the member's exchange positions.

Conclusion

It is established practice in many jurisdictions for regulators to restrict access by domestic companies to overseas markets unless they have satisfied themselves of the potential systemic risk that access to such markets could entail. Therefore, the laws of such countries prohibit direct access to many offshore exchanges unless they have been recognised or approved by the relevant domestic regulator. Taking Singapore as an example, an investor is considered to have direct access to a market if the investor can purchase or sell futures contracts on the market without the assistance or intervention of an offshore intermediary and therefore, under the laws of Singapore, the Monetary Authority of Singapore (MAS) would require futures exchanges to apply to be recognised as market operators. In fact, the INE is in process of applying for such status in Singapore and to be classified as an automated trading system in Hong Kong. INE is also interested in registering with the Foreign Board of Trade in the United States, but it does not yet have a clear timetable for that. As for timing for other approvals from needed to attract investors in other jurisdictions, for now the CSRC's attitude is "Singapore and Hong Kong first, Europe and the US second".

After many false dawns, it finally does appear that the INE is ready to launch. Its application to launch has already been submitted to the CSRC and it is awaiting final approval.

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