

# Legal Commentary

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## Rules Tightened for Central SOEs in Financial Derivatives

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On 30 April 2021, the State-owned Assets Supervision and Administration Commission of the State Council (“**SASAC**”) issued the *Circular on Matters Related to Further Strengthening the Administration of Financial Derivatives Businesses* (《关于进一步加强金融衍生业务管理有关事项的通知》), which follows SASAC’s earlier issuance of a circular on the same topic on 13 January 2020 (namely, the *Circular on Matters Related to Effectively Strengthening the Administration of Financial Derivatives Businesses* (《关于切实加强金融衍生业务管理有关事项的通知》) (collectively, the “**Derivatives Rules**”). The Derivatives Rules represent a solid step toward tightening controls on derivatives transactions of central state-owned enterprises (“**Central SOEs**”).

SASAC currently manages and supervises 98 Central SOEs<sup>2</sup>, which cover industries and sectors most critical to the Chinese economy and society. Since 2009, SASAC has taken a cautious approach toward financial derivatives on domestic and overseas markets due to significant reported losses of high-profile Central SOEs in the global financial crisis. After China’s largest oil refiner lost nearly US\$700 million in 2018 after being wrong-footed in the zigzagging oil markets, SASAC urged Central SOEs to implement stricter oversight of financial derivatives, as these financial instruments are leveraged, complex, and risky. Trading financial derivatives with Central SOEs has attracted the attention of many international market participants. In this newsletter, we analyze the key requirements of the Derivatives Rules and their major impacts on trading derivatives with Central SOEs.

### Application of the Derivatives Rules

The Derivatives Rules strictly apply to all Central SOEs, but the following points are notable:

- Local SASAC may supervise derivatives transactions of local state-owned enterprises (“**Local SOEs**”) by reference to the Derivatives Rules. When dealing with Local SOEs, counterparties must therefore consider any such local regulatory requirements.

<sup>1</sup> Jonathan Wu also has contribution to this article.

<sup>2</sup> Note: The full list of Central SOEs is accessible at <http://www.sasac.gov.cn/n4422011/n14158800/n14158998/c14159097/content.html> (in Chinese) and <http://en.sasac.gov.cn/directorynames.html> (in English, not current).

- State-owned financial institutions such as banks, securities, or futures firms and insurers are subject to separate regulatory requirements imposed by their competent financial regulators with respect to their participation in derivatives transactions.

## Permitted financial derivatives business

The Derivatives Rules apply to financial derivatives business, which refers to commodity derivatives (such as futures and options with commodity underlyings) and currency derivatives (such as forwards, futures, options, and swaps with currency or interest rate underlyings) in domestic and overseas markets. The types of permitted financial derivatives are to be specified in the Group Board approvals, annual derivatives business plans and Central SOE approvals, which we each discuss below.

## Centralized business qualification approvals

Central SOEs (including group members) are not required to obtain SASAC approval to engage in financial derivatives transactions. However, the Derivatives Rules delegate approval and supervision duties to the board of directors of the ultimate/parent group company of each Central SOE (the “**Group Board**”). Specifically, the Group Board approves the qualifications for member companies within the Central SOE group (“**Operating Entities**”) to engage in financial derivatives transactions. To this end, counterparties trading derivatives with an Operating Entity are advised to pay attention to the following issues for purposes of client due diligence or client onboarding:

- Group Board approvals should specify for each Operating Entity the permissible derivatives trading venues, types, and financial instruments.
- Any member company of a Central SOE group whose debt-asset ratio exceeds the specific risk thresholds imposed by SASAC, which has suffered operating losses for three consecutive years and has a cash shortfall cannot engage in financial derivatives transactions.
- Each Central SOE group should thoroughly review the qualifications of its member companies that have engaged in financial derivatives transactions, and Group Board approvals for relevant Operating Entities not yet authorized are required to be completed by 30 June 2021. Going forward, Central SOE groups are required to review the financial derivatives capabilities of its Operating Entities every three years and may rescind approval for any Operating Entity that cannot satisfy the business or risk conditions that the Group Board imposes.

## Annual derivatives business plans

The Derivatives Rules define the requirements and parameters for the annual financial derivatives business plans of the Operating Entities, which are each to be approved by the Group Board or the central management department designated by the Group Board. Annual derivatives business plans will be adapted to the financial capability and annual business plan of each Operating Entity, and include annual trading size of underlying assets, annual hedging amounts, hedging strategies, capital appropriations, maximum net positions held at any point in time, and stop-loss limits (or loss warning lines), etc. Furthermore, the annual derivatives business plan cannot be altered and where a change in an annual

derivatives business plan is necessary due to a drastic market change, government policy change, or corporate business strategy change, etc., such change will be strictly subject to a new approval process.

### **Trading authority**

In addition to the aforesaid Group Board approvals and annual derivatives business plans, counterparties should further verify the trading authority to be approved by the board of directors or similar decision-making organ within each Operating Entity. Operating Entity board approvals are to specify the list of traders, types, and quotas of permitted derivatives transactions. The responsible person of an Operating Entity cannot execute trades directly.

### **Hedging rules**

The Derivatives Rules reinforce the existing requirement that Central SOEs can only trade derivatives for hedging purposes, and prohibit any form of speculative transactions. The Derivatives Rules further specify the following parameters and restrictions on hedging, and counterparties may request the relevant documents (e.g., underlying asset contracts or financing agreements) from Central SOEs to evidence satisfaction or non-violation of these parameters and restrictions:

- The financial derivatives business is required to have a significant connection with the principal business scope of the Operating Entity. The financial instruments should have clear structure, sound liquidity, and foreseeable risks. Generally, the tenure of position holdings is not to exceed twelve months or the duration of the underlying asset contracts.
- Where a Central SOE group does not engage in relevant overseas commodity business, its Operating Entities cannot enter into financial derivatives transactions in overseas markets. In principle, Operating Entities are required to trade commodity derivatives on exchanges and over-the-counter commodity derivatives limited to their necessary business demands and subject to a separate risk assessment by the Group Board.
- With respect to commodity derivatives of an Operating Entity, the annual hedging amount cannot exceed 90% of the annual transaction size of the underlying assets, amongst which the annual hedging amount for goods trading cannot exceed 80% of the annual trading size. The net position in commodity derivatives at any time point cannot exceed the risk exposure to the relevant underlying assets.
- With respect to currency derivatives of an Operating Entity, in principle, the size and tenure of each derivatives transaction should correspond to, and meet the demands of, a specific underlying financing agreement.

### **Stricter reporting and inspection regime**

Notably, an important aspect of the Derivatives Rules is to rectify issues that were unaddressed in the previous regulations, one being insufficient reporting. The Derivatives Rules provide concrete timelines for when Central SOEs are to submit reports to SASAC:

- Each business qualification report is required to be filed within 20 working days after the corresponding Group Board approval.
- Each annual derivatives business plan is required to be filed before 31 March each year.
- A comprehensive financial derivative business report is required to be filed within 15 days of each quarter end.
- A written report is required to be submitted to SASAC within 24 hours of speculative business, significant loss risk, major legal disputes or other significant events, and subsequently weekly reports are to be made.
- In exigent circumstances, oral reports are accepted, provided that a supplementary written report is submitted within two working days.

The Derivatives Rules reinforce that SASAC will periodically conduct inspections and create a transaction data sharing mechanism jointly with relevant regulatory authorities, which will allow for improved day-to-day supervision and risk warning. Central SOE groups are required to conduct quarterly inspections and audits of all Operating Entities engaging in financial derivatives business each year.

## **Observations**

The Derivatives Rules serve as an important building block to a stricter supervisory regime for the financial derivatives business of Central SOEs. We recommend international market participants who trade derivatives with Central SOEs to consider whether client due diligence procedures and contractual provisions adequately address the new business qualifications, annual derivatives business plans, trading authority, and hedging rules under the Derivatives Rules. It is also notable that, given the improved reporting and inspection regime, it may become easier for SASAC and Group Boards to identify non-compliant derivatives transactions and thus increase the chances of a forced unwinding of any non-compliant derivatives transactions in overseas market. We will continue to monitor relevant regulatory updates and share our views in a timely manner.

## ***Important Announcement***

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