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New Master Agreements Issued for Securities Derivatives

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On December 27, 2018, the Securities Association of China (SAC), the China Futures Association (CFA) and the Asset Management Association of China (AMAC) jointly issued the *Notice on Issuing the Master Agreement for Derivatives Transactions in the China Securities and Futures Markets*[1]. The name of the *Master Agreement for OTC Derivatives Transactions in the China Securities and Futures Markets (2014 Version)* (the "**2014 Master Agreement**") has now been changed to the *Master Agreement for Derivatives Transactions in the China Securities and Futures Markets* (the "**2018 Master Agreement**"). On the same day, the three associations above, the Shanghai Stock Exchange and the Shenzhen Stock Exchange jointly issued the *Master Agreement for Derivatives Transactions in the China Securities and Futures Markets (Special Version for Credit Protection Contracts)* (the "**SV Master Agreement**")[2], which was formulated for the purpose of standardizing credit protection transactions within the exchanges.

I. The Master Agreement for Derivatives Transactions in the China Securities and Futures Markets

In order to manage the OTC derivatives business in the securities industry, SAC issued on March 13, 2018 the *Master Agreement for Financial Derivatives Transactions in the China Securities Market (2013 Version)* (the "**2013 Master Agreement**") and its supplement, the *Norms for OTC Financial Derivatives Transactions of Securities Companies* and the *Guidelines for Risk Management of OTC Financial Derivatives Transactions of Securities Companies*.

1 The *Notice on Issuing the China Securities and Futures Markets Derivatives Transaction Master Agreement* Please see http://www.sac.net.cn/tzgg/201812/t20181227_137451.html

2 The *Notice on Issuing the China Securities and Futures Markets Derivatives Transaction Master Agreement (Special Version for Credit Protection Contracts)* Please see http://www.sac.net.cn/tzgg/201812/t20181227_137452.html

These rules act to regulate OTC derivatives business in the securities industry and require securities companies to file 2013 Master Agreements with SAC upon signing[3].

On August 22, 2014, to resolve issues relating to OTC derivatives transactions across different markets, SAC, CFA and AMAC jointly issued the 2014 Master Agreement and its supplement, which was revised on the basis of the 2013 Master Agreement. The 2014 Master Agreement extended its applicable scope from securities market to funds and futures markets, and securities companies, fund management companies and futures companies filed 2014 Master Agreements and their supplements with their respective associations upon signing[4].

Four years later, SAC, CFA and AMAC changed the name of the *Master Agreement for OTC Derivatives Transactions in the China Securities and Futures Markets (2014 Version)* to the *Master Agreement for Derivatives Transactions in the China Securities and Futures Markets*. The 2018 Master Agreement applies to OTC derivatives other than credit protection transactions, which means that the new master agreement will not apply to credit protection transactions. Credit protection transactions will instead be governed by the SV Master Agreement. In addition, SAC has also provided for transitioning from the 2014 Master Agreement to the 2018 Master Agreement. According to SAC, any previously signed 2014 Master Agreements and their supplements will continue to be effective. The 2018 Master Agreements and their supplements shall be signed by the counterparties when conducting new securities and futures markets derivatives transactions (excluding credit protection transactions).

Currently China does not have unified supervision of OTC derivatives business, nor has it formulated any unified laws or regulations for OTC derivatives transactions. As a result, there are currently two sets of master agreements existing in the market which govern derivatives transactions. Besides the 2018 Master Agreement, the National Association of Financial Market Institutional Investors (NAFMII) also issued in 2009 the *NAFMII Master Agreement (2009 Version)* (the "**NAFMII Master Agreement**"). When SAC issued the 2013 Master Agreement, the association stated that it would co-operate with NAFMII on master agreements for derivatives transactions, share experiences and formulate a unified master agreement with NAFMII to govern financial derivatives transactions.[5] However, such plans have not yet been implemented. In market practice, banking financial institutions generally sign a NAFMII Master Agreement with their counterparties for derivative transactions, while securities

[3] The *Notice on Issuing the China Securities Market Financial Derivatives Transaction Master Agreement (2013 Version) and Relevant Self-Regulatory Rules*

Please see http://www.sac.net.cn/tzgg/201303/t20130315_61883.html

[4] The *Notice on Issuing the China Securities and Futures Markets OTC Derivatives Transaction Master Agreement (2014 Version)* and the *China Securities and Futures Market OTC Derivatives Transaction Equity Derivatives Definition Document (2014 Version)*

Please see http://www.sac.net.cn/tzgg/201408/t20140822_102261.html

[5] The *Statement on Issuing the Financial Derivatives Transaction Master Agreement and Relevant Rules*
Please see http://www.sac.net.cn/tzgg/201303/t20130315_61882.html

companies, fund management companies, futures companies and other institutions have generally signed the different versions of the SAC-issued master agreement.

II. The Master Agreement for Derivatives Transactions in the China Securities and Futures Markets (Special Version for Credit Protection Contracts)

The SV Master Agreement is a new master agreement to govern derivative transactions which has been jointly launched by the three associations and the two exchanges based on the 2014 Master Agreement. Compared with the 2014 Master Agreement, there are some minor adjustments in the SV Master Agreement, such as extended notice and grace periods for the performance of agreements. In addition, the SV Master Agreement also adjusts and refines terms regarding payment currency, events of default (or potential events of default), termination events, governing law and dispute resolution, and delivery of notices, etc.

The most notable difference between the SV Master Agreement and the 2014 Master Agreement is that the SV Master Agreement generally does not allow for the transfer of any rights or obligations under the agreement. Exceptions to these transfer restrictions include rights to payment in case of default or early termination and certain other related rights to payment, such as interest, compensation and expenses. In addition, the SV Master Agreement specifies that both parties to the transaction will timely file with SAC a signed SV Master Agreement and its supplement (including modifications, if any), which means the filing of SV Master Agreements is only to be conducted with SAC. Correspondingly, on December 27, 2018, SAC also issued the *Guidelines for Record-Filing of the Master Agreement for Derivatives Transactions in the China Securities and Futures Markets (Special Version for Credit Protection Contracts)*[6], stipulating the relevant record-filing procedures.

According to the official introduction provided by SAC[7], "a credit protection contract is an innovative financial derivative which is negotiated and agreed between the two parties to the transaction. During the agreed period, the credit protection seller shall bear the relevant credit risk associated with the reference entity, the specific type of debts and other debts with the features of debt, and periodically charge the credit protection buyer a protection fee in accordance with the contract. Upon the occurrence of any credit event or event of default, the credit protection seller shall compensate the credit protection buyer according to the terms of the contract." In addition, the NAFMII-issued *Business Guidelines for Credit Risk Mitigation Contracts*[8] also state that "a credit risk mitigation contract refers to an agreement reached

[6] The *Notice on Issuing the Guidelines for Record-Filing of China Securities and Futures Markets Derivatives Transaction Master Agreement (Special Version for Credit Protection Contracts)*
Please see http://www.sac.net.cn/tzgg/201812/t20181227_137454.html

[7] The Securities Association of China (SAC) Takes the Lead in Issuing the Master Agreement for Credit Protection Contracts to Help Private Enterprises to Solve Financing Difficulties through Issuing Bonds
Please see http://www.sac.net.cn/ljxh/xhgzdt/201812/t20181227_137453.html

[8] The *Business Guidelines for Credit Risk Mitigation Contracts* issued by the National Association of Financial Market Institutional Investors (NAFMII)

between both parties to the transaction, in which the credit protection buyer shall pay a credit protection fee to the credit protection seller in accordance with the agreed standards and methods within a certain period of time in the future. It is a financial contract under which the credit protection seller provides credit risk protection to the credit protection buyer for the agreed underlying debt, which belongs to a contractual credit risk mitigation instrument." Based on the above descriptions, it can be observed that credit protection contracts are similar to the credit risk mitigation contracts introduced by NAFMII. There are also no substantial differences between the two contracts and credit default swaps (CDS) outside China, all of which are derivative instruments that provide protection against the default risk of underlying assets. The release of the SV Master Agreement may be similar to the co-existence of the NAFMII Master Agreement and the 2018 Master Agreement. This means that the SV Master Agreement may govern risk mitigation instruments offered in the securities exchange markets, while risk mitigation contracts signed in the interbank market may be governed by the NAFMII-issued *Business Guidelines for Credit Risk Mitigation Contracts*.

III. Can credit protection contracts solve the financing difficulties of private enterprises?

On November 1, 2018, Chinese President Xi Jinping gave an important speech at a forum of private enterprises in which he highlighted the importance of solving the financing difficulties of private enterprises[9]. In response, on November 2, 2018, the Shanghai Stock Exchange launched a pilot program for credit market protection instruments under which the first credit protection contracts have been successfully concluded. Guotai Junan Securities Co., Ltd ("**Guotai Junan Securities**") and CITIC Securities Co., Ltd. ("**CITIC Securities**") became the first batch of credit protection sellers, and concluded two credit protection contract transactions, with reference entities including private enterprises of different credit ratings, namely HongShi Holding Group Co., Ltd. and JCHX Mining Management Co., Ltd. Guotai Junan Securities and CITIC Securities also acted, respectively, as the lead underwriters of the corporate bonds issued recently by these two private companies[10]. In addition, the Shenzhen Stock Exchange also launched its first pilot program for credit protection instruments, with a notional amount of approximately CNY130 million. The reference entities are Suning Appliance Group Co., Ltd. and Zhejiang Hengyi Group Co., Ltd.[11].

Please see http://www.nafmii.org.cn/zlgl/xyfx/ywgz/201609/t20160926_57199.html

9 Chinese President Xi Jinping's Speech at a Forum of Private Enterprises
Please see http://www.xinhuanet.com//politics/2018-11/01/c_1123649488.htm

10 The Shanghai Stock Exchange Launches Pilot Program for Credit Protection Instrument to Support Bond Financing for Private Enterprises
Please see http://www.sse.com.cn/home/apprelated/news/c/c_20181102_4671285.shtml

11 The Shenzhen Stock Exchange Launches its First Pilot Program for Credit Protection Instrument to Improve the Efficiency of Bond Financing of Private Enterprises
Please see http://www.szse.cn/aboutus/trends/news/t20181102_557319.html

The issuance of the SV Master Agreement demonstrates the supportive attitude of Chinese regulators regarding credit protection transactions, and provides a new risk mitigation instrument for financial markets. The introduction of credit protection contracts may, to some extent, bring positive elements to the bond market in China. However, the question remains whether this action can effectively solve the financing difficulties of private enterprises in the future. We will continue to monitor these developments and observe their long-term effects.

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