China

Futures Take Dragon Steps

By Nick Ronalds and Wang Xueqin

Is an exchange still an exchange if no product is listed and nothing trades? That's the conundrum the leadership of the China Financial Futures Exchange (CFFEX) must be puzzling over these days. Inaugurated with fanfare and great anticipation last September, the fledgling exchange is creeping toward its first birthday with nary a trade in sight. What gives?

It doesn't seem to be lack of preparation holding things up. The contract specifications for the first contract—futures on an index of Chinese stocks—have been published, and the exchange's rules were formally unveiled this past June. The China Securities Regulatory Commission, the government body that oversees futures exchanges, appointed Zhu Yuchen, the ambitious former head of the Dalian Commodity Exchange, as the new exchange's top executive, and the exchange's 10 departments have been staffed with 120 employees. Regulators approved the trading rules in June, clearing a final hurdle. Over 36,000 would-be brokers and other futures professionals have passed the licensing exams. Over the past year, the China Futures Association has held over 50 seminars for individual and institutional investors to prime them for the new instruments, and the brokerage firms hundreds more. Simulated trading has been in progress since October of last year.

With all systems "go," why hasn't trading started? The leading cause of hesitation is uncertainty over the contract's impact on the cash market. The stock market's nearly 400% rise in the last two and a half years has put the "B" word on some lips. Shorting cash stocks is still not possible, so launching stock index futures would create a new and easy way to take a bearish position. That has sparked a debate over whether the launch could be the catalyst for an abrupt decline, and whether such a correction would be a good thing or a bad thing.

Those in positions of responsibility have another reason to keep their heads down. The 17th National Congress of the Communist Party of China, held roughly every five years, meets in November. Decisions will be taken that will make or break careers. Much like a U.S. presidential election year, the lead-up to the meeting is not considered a good time to take risks or launch a major initiative. Given the cautious political environment and the bubbly cash market, it's impossible to say when a consensus for a launch date will emerge. Optimists hoped for a September launch. Realists suspect they may have to wait until after the National Congress concludes at the end of November.

For the many firms that are ready and willing to trade financial futures, the delay is frustrating, but there is no doubt that the issue is not if, but when. The Chinese government is committed to modernizing the financial system, and there is a widespread understanding that futures markets are an essential mechanism for price discovery and risk management. But they are also convinced that futures markets, if not properly organized, can create problems of their own. Hence, the regulators have taken pains to ensure that sound rules are in place before giving a green light to trading.

Details of the New Contract

A year ago *Futures Industry* described the proposed contract specifications and exchange rules for the new stock index futures (see "The Dawning of Financial Futures in China," November/December 2006 issue of *Futures Industry*). The contract specifications described in this previous article are generally unchanged, with one significant exception and several minor ones. A year ago it was thought that the final settlement price would be the final value of the cash index at the market close. The rules now state that the settlement will be based on an arithmetic average of the cash index during the last two hours of trading.

The exchange fee is now a formula based on .005% of the contracts' value. At the recent level of about 4700, that equates to an exchange fee of (4700 x 300 x .005%) = 70.5 Yuan. The index is the CSI 300, a capitalization-weighted index consisting of the 300 A shares traded on the Shanghai and Shenzhen exchanges. The multiplier remains 300. At the index's early August level of 4700, the contract value would be 1.41 million Yuan, over $186,000 at the current exchange rate. That's a big contract by international standards (the CME S&P 500 E-mini contract is at around $75,000), and positively intimidating by emerging market standards. Margin is 10% of contract value. The large contract size is a deliberate step to limit the participation of small speculators. At the launch of the contract, retail speculation will be prohibited outright; that is, only institutions will be allowed to open trading accounts. This restriction will eventually be relaxed.

Futures Companies

The regulators have bolstered rules for futures brokers involved in the new financial markets. A brokerage firm must employ no less than 15 professionals, three of whom are qualified "senior managers." Every futures company is required to have a chief risk officer responsible for credit and market risk management as well as compliance. To foster stronger financials in the futures industry, the regulator abolished the 50% ceiling on ownership of futures companies by securities firms.

Risk management is an important concern for regulators. In July, the CSRC approved Beijing Yin Jian Futures and Shanghai Jiu Heng Futures Brokerage as the first two companies allowed to trade financial futures. This honor was credited to the two firms' exemplary risk management systems.

The rules allow foreign companies to buy up to a 50% stake in a Chinese futures firm via Hong Kong or Macau-based affiliates. ABN Amro was the first foreigner to take the plunge last year, but has since been joined by Calyon. Calyon has formed a joint venture with Citic Futures, the futures subsidiary of the Chinese trading and investing conglomerate China International Trust and Investment Company.

In a significant development, however, another point of entry is expected to open up to foreigners. According to draft regulations, the so-called QFII's (Qualified Financial Institutional Investors) will be permitted to allocate up to 10% of their investment quota to the new financial futures contract. With margin for the new contract set at 10%, the rule would effectively enable a QFII to double its exposure to Chinese equities—or hedge it completely. It would be the first time foreign investors have direct access to a Chinese futures market.

Membership categories are similar to those elsewhere in the world. "settlement clearing members" are equivalent to "clearing members" in developed-country markets; that is, only they may settle and clear trades with the clearinghouse. "Trading members" may conduct brokerage and (eventually) proprietary trading, but their trades must be cleared by a clearing member. Settlement members are further subdivided based on whether they clear for themselves only, for trading members, or for all categories including non-member clients. Capital requirements differ for each type of member.

The daily price limit is up or down 10% from the previous day's settlement, with a temporary trading halt at 6%. If the market is limit bid or offered at 6%, a trading halt is called. If the market is still lock-limit after five minutes, the 10% limit will go into effect after an additional five minutes, whether or not the market remains locked at 6%.

The speculative position limit for a trader is 600 contracts on one side of the market. Clearing members are limited to a maximum of 25% of a contract's total open interest. Hedgers will be granted larger limits on a case-by-case basis.

Commodity Futures

2006 was the first good year for Chinese futures brokers this decade. Contract volume was up 39.4% from 2005, and notional trading value—on which commissions are based—was up 56%. These robust volumes produced a 57% jump in industry commission revenue from the prior year and a welcome respite after years of losses for all but a handful of brokerage firms.

This year is on track to equal or better last year's performance. Total contract volume in the first six months of the year was up just 9.5% from the same period the previous year, but notional value rose by 43%. The biggest gainers by notional value were copper (146%), rubber (97%), high-quality wheat (365%), and soybeans (144%). The losers were aluminum, fuel oil, cotton, sugar, hard winter wheat (displaced by high quality wheat), corn, soybean meal, soybean oil, and PTA (purified terephthalic acid).

After a long hiatus, the regulators started allowing the commodity exchanges to introduce new contracts, starting with high-quality gluten wheat in 2003. The following year, cotton, fuel oil, corn, and #2 soybeans were added. No new product launches were permitted in 2005, but in 2006 the CSRC allowed trading to begin in futures on sugar, soybean oil and PTA. This year, the Dalian Commodity Exchange was allowed to introduce linear low-density polyethylene, the Shanghai Futures Exchange got the nod for zinc, and Zhengzhou for rapeseed oil. In the pipeline at the DCE is palm oil, while the SHFE hopes to roll out futures on hot-rolled low-carbon steel rods, and the Zhengzhou Commodity Exchange is preparing to list futures on raw silk and rough rice. All listings are subject to regulatory approval.

The most eagerly awaited commodity products are options. Mock trading has been done successfully since the end of 2005. The industry has been ready, and, in fact, hoped to launch options on their major products this year. The one-thing-at-a-time approach to markets means that won't happen now until after the introduction of the stock index contract. With luck, options on commodities will see daylight next year.

Here Come the Funds

The gradual expansion of the domestic market is not the only area where change is underway. The Chinese government has taken steps to allow Chinese companies to participate in international markets. On July 5, new rules went into effect permitting brokers and fund managers to invest outside China for the first time. The list of allowable products includes fixed income securities, stocks, swaps, warrants, and not least, options and futures. The new rules are part of what's known as the QDII (Qualified Domestic Institutional Investor—not to be confused with QFII) program. Brokers and fund managers deemed to meet the CSRC's standards in terms of capital, management, and systems will get the nod. In practice it means the bigger, better capitalized firms will be first. One catch: futures and options may only be used for hedging, not speculation. Chinese regulators will not be the first to discover that defining speculation is not a snap. Presumably, a fully collateralized equity indexing strategy would be allowed. But what if a fund manager wants to increase his exposure to equities by selling bonds and buying stock index futures? Can a fund manager use futures to raise the beta of his foreign cash equity portfolio from 0.8 to 1.0? It remains to be seen.

The first QDII product was launched at the end of June by China Southern Fund Management Co., Ltd., in cooperation with Mellon Financial Corp. It aims to raise up to $1 billion from Chinese institutional investors. By mid-August, several dozen banks and insurance companies had licenses to raise funds locally to invest abroad.

Analysts have put estimates of the likely volume of QDII investment flowing out of China over the next year at between $10 billion and $24 billion. So far, interest among Chinese investors, however, has been tepid. Chinese equities' eye-popping 80% or so returns of the past three year have, for many investors, made diversification abroad seem like betting against a sure thing. It wouldn't be the first time investors forsake diversification just when they could most benefit. ■

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Chinese Futures Contract Volume

January - June 2007

Exchange	Commodity	Contract Sizes (Metric tons)	2007 Volume (Jan - Jun)	Year to Date % Change	Notional Value (Year to Date - billion yuan)	Year to Date % Change	Open Interest (June 30)
SHFE	Copper	5	6,059,999	119.9%	1,920	146.3%	63,307
	Aluminium	5	3,234,582	-54.8%	320	-57.5%	64,849
	Zinc	5	2,159,517	NA	333	NA	21,438
	Rubber	5	23,360,111	121.5%	2,416	96.7%	56,000
	Fuel Oil	10	5,387,854	-23.9%	174	-30.2%	31,601
	Total SHFE		*40,202,063*	*46.0%*	*5,162*	*71.6%*	*237,195*
ZCE	Cotton	5	555,563	-62.0%	38	-65.2%	29,284
	Rapeseed Oil	5	411,605	NA	18	NA	12,154
	Sugar	10	7,959,147	-3.1%	298	-24.0%	132,750
	PTA*	10	1,160,382	NA	50	NA	17,688
	High Quality Gluten Wheat	10	15,085,079	328.9%	276	364.8%	160,085
	Hard Winter Wheat	10	11,578	-31.4%	0.18	-26.7%	317
	Total ZCE		*25,183,354*	*90.7%*	*681*	*21.0%*	*352,278*
DCE	#1Soybean	10	9,975,439	106.0%	319	144.4%	271,538
	#2 Soybeans	10	3,962	-99.8%	0.13	-99.7%	37
	Corn	10	23,665,234	-24.3%	396	-12.8%	389,355
	Soybean Meal	10	12,353,718	-39.6%	319	-33.1%	185,965
	Soybean Oil	10	5,000,707	-29.7%	368	0.1%	61,062
	LLDPE**	5	NA	NA		NA	
	Total DCE		*50,999,060*	*-22.2%*	*1,402*	*-5.1%*	*907,957*
Total			**116,384,477**	**9.5%**	**7,245**	**43.5%**	**1,497,430**

**Purified Terephthalic Acid* ***Linear Low Density Polyethylene, introduced July 31, 2007*