

# DERIVATIVES AND DIALECTICS: THE EVOLUTION OF THE CHINESE FUTURES MARKET

VICTOR L. HOU\*

There is internal contradiction in every single thing, hence its motion and development.<sup>1</sup>

## INTRODUCTION

Recently, financial papers have been inundated with accounts of the heady risks and dizzying consequences of derivatives gambling gone bad. Losing bets have caused the demise of a centuries-old bank.<sup>2</sup> Elsewhere, corporations worldwide have been dealt severe losses,<sup>3</sup> and governments have gone bust.<sup>4</sup> Yet conceptually, derivatives<sup>5</sup> are hardly new.

As early as 2000 B.C., Chinese rice producers bargained with merchants to deliver specified quantities of rice at a future date for a stated price.<sup>6</sup> These contracts were typically entered into before the rice was planted in order to guarantee the merchant a specific quantity of rice at a predetermined price and assure the rice producer a market for the crop.<sup>7</sup> Later, in the Song Dynasty, imperial China dallied in

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<sup>1</sup> Mao Tse-Tung, On Contradiction, in 1 Selected Works of Mao Tse-Tung 311, 313 (1937).

<sup>2</sup> See Nick Denton & John Gopper, All That Glitters: The Fall of Barings, Fin. Times, Sept. 21, 1996, at 7 (providing account of Barings Bank collapse).

<sup>3</sup> See, e.g., G. Bruce Knecht, Bankers Trust Wins Derivatives Case; Court Ruling May Affect P&G Suit, Wall St. J., Dec. 4, 1995, at A7E (describing Bankers Trust derivatives dispute with Indonesian firm); Stephen K. Yoder et al., Sumitomo Says Unauthorized Dealings in Copper Caused \$1.8 Billion in Losses, Wall St. J., June 14, 1996, at A3 (detailing massive futures losses of Japanese bank).

<sup>4</sup> See, e.g., Phillipe Jorion, Big Bets Gone Bad: Derivatives and Bankruptcy in Orange County (1995) (describing derivatives losses bankrupting Orange County).

<sup>5</sup> For purposes of this Note, the term "derivatives" is used broadly to encompass structured financial instruments such as futures trading (agreements to deal at a fixed price on a future date), options, and foreign exchange contracts. Although this usage is somewhat imprecise, this Note focuses on the general utility of this financial and commodity market. Therefore, because the Chinese tend to equate futures with derivatives, the two terms will be used synonymously throughout the Note.

<sup>6</sup> See Russell R. Wasendorf, *Commodities Trading: The Essential Primer* 3 (1985).

<sup>7</sup> See id.

the grain market to secure adequate grain for its citizens and stabilize the agricultural market against excessive market speculation.<sup>8</sup> Nearly a millennium has since passed, and the stereotypically cautious Chinese government (along with its citizenry) has reentered the volatile derivatives fray with a vengeance.<sup>9</sup>

In an attempt to facilitate its market evolution in 1990, China set up its first commodity exchange in Zhengzhou.<sup>10</sup> By late 1994, at the market's apex, there were more than sixty registered and unregistered futures markets throughout China,<sup>11</sup> featuring such diverse commodities as mung beans, copper, refined oil, wire rods, and treasury bonds futures.<sup>12</sup> Given the thriving Chinese economy<sup>13</sup> and the ambiguous regulatory climate,<sup>14</sup> there was an immediate and enthusiastic response from state-owned enterprises (SOEs) and speculating investors who poured money into futures contracts and other derivatives on the numerous exchanges.<sup>15</sup> As futures trading intensified, prices began

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<sup>8</sup> In the Song Dynasty (A.D. 960-1279), the revolutionary minister Wang An-Shih (A.D. 1021-1086) promulgated a system resembling a "futures" market that allowed the state to collect and resell goods (grain or tribute) and use the funds at its disposal to procure goods at the most convenient time and place. See generally W. Theodore de Bary et al., *Sources of Chinese Tradition* (1964); Pierre-Étienne Will & R. Bin Wong, *Nourish the People* (1991).

<sup>9</sup> The head of the governmental research institution on economic reform in China called for the "positive but cautious development of futures trading." Li Zhurun & Ni Siyi, *Government "Cautious" Regarding Futures Markets*, *Xinhua*, F.B.I.S., *China Rep.*, Jan. 13, 1994, at 54, 54.

<sup>10</sup> Once opened, the Chinese futures markets were incredibly active. In May 1995, for example, the "Zhengzhou Commodities Exchange turned over 320,000 futures contracts a day in mung beans alone," tantamount to the same volume on the Chicago Board of Trade for 30-year Treasury bond futures on a sluggish day. *Derivatives Exchange; The Mung Bean and Its Adventures*, *The Economist*, May 27, 1995, at 70, 70-71 [hereinafter *Mung Bean*].

<sup>11</sup> Given the lack of central coordination and regulation, data for even the exact number of futures exchanges in China is unavailable. This paucity of economic news may be partly the result of a recent government decree restricting the flow of financial information from China. See *infra* Part III.B.3 (discussing recent restriction of press).

<sup>12</sup> See Jiang Mingshua, *An Empirical Analysis of the Economic Impact of China's Futures Markets*, *Jingji Kexue*, Oct. 20, 1994, translated in *Futures Markets: Achievements, Features, Problems*, F.B.I.S., *China Rep.*, Jan. 4, 1995, at 59, 59 (providing survey of Chinese futures markets).

<sup>13</sup> See, e.g., Marcus W. Brauchli, *China Stays Magnet for Overseas Money*, *Wall. St. J.*, Jan. 14, 1997, at A14 (detailing foreign investment in China and China's economic expansion).

<sup>14</sup> One effusive foreign investor likened the "unregulateable" Chinese futures market to the "robber-baron environment of the United States in the late 19th century—the new Rockefellers, Carnegies and Vanderbilts are going to be defined." David Nusbaum, *The China Syndrome*, *Futures*, Feb. 1995, at 52, 52.

<sup>15</sup> SOEs are the dominant economic organizing structure in China and the predominate sources of energy and industrial production, transportation, and telecommunications. See *infra* notes 167-72 and accompanying text (explaining significance of SOEs in Chinese economy). See generally Robert C. Art, *China Incorporated: The First Corporation Law*

fluctuating wildly, causing widespread trading losses.<sup>16</sup> Fearing inflationary impacts, the Chinese government responded rapidly by banning trade in the overheated and speculative markets, product by product, in ad hoc succession. This boom and ban cycle continued until late 1995—the number of futures exchanges had been cut to fifteen, with authorities threatening to further reduce this number down to five or six.<sup>17</sup> Further, in March 1996, Beijing severely limited all futures trading by SOEs.<sup>18</sup>

The purpose of this Note is to examine the development of the Chinese futures market in the context of China's economic reform. This Note contends that a developed futures market has a crucial role in this reform by facilitating greater economic efficiency, commodity pricing, financial forecasting, and circulation of goods while also serving as a means to secure important commodities in times of need. Yet the Chinese have banned important commodity and financial instrument futures in an effort to combat the speculation that led to market instability and perceived inflationary pressures. While excessive speculation was certainly a problem, the bans on trading in important commodity futures have been counterproductive and may have even exacerbated speculation in the remaining secondary commodities markets.

China's encounter with the futures market typifies the country's broader conundrum: as it shifts from a planned economy to a market economy, China must accept some level of economic volatility and resist the temptation to intervene excessively in the futures market to achieve the desired economic efficiencies. This fundamental contradiction stands at the heart of many tertiary contradictions that China will need to face before its futures market is able to perform its in-

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of the People's Republic of China, 20 *Yale J. Int'l L.* 273 (1995) (discussing role and reform of SOEs). For examples of SOEs that engage in derivatives transactions, see *infra* notes 74-93 and accompanying text (discussing Minmetals, UNIPPEC, and CITIC Shanghai). Speculation in the domestic and international futures markets has been attributed to SOEs who have flocked to futures trading to secure profits. See, e.g., Holman W. Jenkins, Jr., In China, Beer and Capitalism Don't Mix, *Wall St. J.*, Nov. 21, 1995, at A17 ("Huge sums flow into the casino-like stock and futures markets, and nobody doubts that state managers are behind the speculation and pocketing the proceeds."); see also David Ress, *Evolving Economy; Despite Progress, Government Still Dominant Force*, *Richmond Times Dispatch*, Jan. 14, 1996, at E1 (quoting exchange president as predicting that more than three-quarters of investors on Zhengzhou futures market are "simply speculators").

<sup>16</sup> See, e.g., Crackdown on Illegal Forex Futures Trading, *Xinhua*, F.B.I.S., China Rep., Dec. 28, 1994, at 46, 47 [hereinafter Crackdown] (stating that 90% of customers report losses in foreign exchange futures trading).

<sup>17</sup> See Fewer Futures Exchanges Urged, *S. China Morning Post*, Dec. 1, 1995, available in LEXIS, ASIAPC Library, SCHINA File [hereinafter Fewer Futures].

<sup>18</sup> See Tony Walker, China Tightens Futures Trading, *Fin. Times*, Mar. 2, 1996, at 3 (describing new regulations on SOE futures trading).

tended macroeconomic functions of pricing, circulation, and risk management. For Mao Tse-Tung, contradiction could be understood only by isolating the subordinate contradictions and discerning each one's salient features. And under such examination, Mao viewed contradictions as relative and not necessarily absolute.<sup>19</sup> This Note presents the salient contradictions of the Chinese futures market and argues that these contradictions may be synthesized if properly understood.

Part I explains the derivatives instrument itself and examines several recent derivatives disputes to illustrate the problems of both the domestic futures market and Chinese derivatives investments abroad. This Part also describes the dominant features of China's current futures market and the interlocking web of regulatory agencies and governmental bodies overseeing that market.<sup>20</sup>

Part II describes some "distinctly Chinese characteristics" that broadly define the Chinese futures market. In particular, this Part explores China's unique situation in the context of the law of agency, economic development, excessive investor speculation, the role of SOEs, and notions of social ethics as points of possible departure from traditional futures market analysis.

Part III contends that a futures market is at odds with China's current economic and regulatory regime. Initially, this Part maintains that understanding the evolving futures market begins with understanding the SOEs' enormous role in Chinese economic reform generally and in the futures market specifically. In an attempt to make SOEs competitive, economic reform has given SOE managers greater decisionmaking powers and has transferred responsibility for losses and profits to the enterprise itself. Unfortunately, it is precisely these reforms that have played a large role in fueling futures market speculation. Later, the Note directs attention to the contradictions that face Chinese regulatory efforts to "control" the futures market. This Part concludes by outlining the adverse effects of futures markets on macroeconomic policy imperatives and considers the market's dynamic potential to reverse these effects. Such an exploration into de-

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<sup>19</sup> To illustrate this observation, Mao used the historical example of the Japanese invasion of China in 1937. The Communist Party and the Guomindang (KMT), themselves bitter enemies, ceased their hostilities and joined forces against the Japanese threat in an example of what Lenin called the "unity of opposites." See Mao, *supra* note 1, at 312-14.

<sup>20</sup> At this time, there is no futures law or statute that uniformly governs Chinese derivatives activity. In December 1995, the State Council and its subordinate commissions and ministries drafted and submitted to the Standing Committee of the National People's Congress a law to regulate futures trading (Futures Law). The Futures Law is presently under consideration and its passage is not likely until sometime in 1997. See China's Futures Law May Be Delayed to '97—Report, Reuters Fin. Serv., Mar. 20, 1996, available in LEXIS, ASIAPC Library, REUFIN File [hereinafter China's Futures Law].

derivatives trading isolates the subordinate contradictions of the Chinese shift toward a market economy and may begin to rationalize the often inapposite aims of Chinese policy toward futures. Though China has turned to the market to maintain its economic stability (and hence its social stability), the market cannot readily confer its intended benefits absent the various signals that a robust futures market is capable of providing through its macroeconomic functions. To realize these long-term benefits, the Chinese must accept the potential cycles of short-term instability of the futures market during its evolution.

Finally, in Part IV the Note argues that the current chaotic domestic futures market and unsuccessful foreign derivatives trading should prompt the Chinese to develop a rational derivatives policy that can serve China's twin economic aims of efficiency and fairness. This Part suggests ways to monitor the success of the Chinese futures market.

China has bet heavily on the futures market to help sustain economic growth,<sup>21</sup> and thus the country's social order,<sup>22</sup> well into the next century. But as recent history suggests, derivatives have been very risky and are rarely associated with market stability. This Note attempts to explain the seemingly contradictory gamble made by the Chinese. In such light, the gambler's saw "you have to lose big to win big" is just the element of contradiction that Mao envisioned for development, in this instance, of futures markets in China.

## I

### AN OVERVIEW OF THE CHINESE FUTURES MARKET

Though the title of this Part suggests a monolithic market in futures, the Chinese futures market in reality is hardly a centralized entity and is not readily susceptible to uniform observation and criticism. There are a number of regional exchanges and entities that trade in a diverse number of derivatives products.<sup>23</sup> Accordingly, this Note analyzes the prominent features that apply to all of the various markets that comprise the domestic futures market and Chinese trading in foreign futures markets.<sup>24</sup>

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<sup>21</sup> See, e.g., Han Baocheng, *Futures Chinese Style*, Beijing Rev., May 9-15, 1994, at 15, 15 (noting establishment of futures market to boost rapid development of China's market economy).

<sup>22</sup> See, e.g., Jen Hui-wen, *Beijing Political Situation*, Hsin Pao, Dec. 2, 1994, translated in Jiang Zemin Appraises China's Economic Situation, F.B.I.S., China Rep., Dec. 6, 1994, at 27, 28. Vice Premier Zhu Rongji explained that economic development and reform was "the foundation for social stability and the country's long-term tranquillity." Id.

<sup>23</sup> See *infra* notes 54-73 and accompanying text.

<sup>24</sup> While this Note endeavors to be comprehensive in its analytical approach to features of the Chinese futures market and its regulation, it is not intended to be an exhaustive

### A. *A Brief Primer on Derivatives*

The complicated and often arcane jargon of derivatives should not obscure an understanding of the use of these financial instruments in the Chinese marketplace.<sup>25</sup> However, a brief primer may be necessary before proceeding further. A derivative is commonly described as a financial contract whose value is derived from an underlying asset or index.<sup>26</sup> Derivatives contracts serve to transfer risk from one party to another.<sup>27</sup> This fact underscores the essentially zero sum nature of derivatives contracts.<sup>28</sup> There are various types of derivatives agreements (which will be discussed in turn below) that typically serve three general financial aims: securing optimal financing terms, hedging, and speculative profit taking.

While there are many varieties of derivatives, they generally fall into two expansive categories: "forward" type contracts<sup>29</sup> and "option" type contracts. Forward type contracts obligate a buyer and a seller to trade a fixed amount of a particular commodity, currency, or other financial instrument at a set price on a future date. A futures price incorporates what the market predicts the underlying commodity price is likely to be. This prediction depends on the supply and

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survey of the futures market or a thorough examination into derivatives products themselves. Rather, this Note is more concerned with the role and effect of such transactions in the broader scheme of Chinese economic reform. For comprehensive discussion of the derivatives market, see generally Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 *Yale L.J.* 1457 (1993); Symposium, *Derivative Securities*, 21 *J. Corp. L.* 1 (1995); David M. Lynn, *Comment, Enforceability of Over-the-Counter Financial Derivatives*, 50 *Bus. Law.* 291 (1994).

<sup>25</sup> For the purposes of this Note, only the fundamental aspects of the derivatives market are discussed. Many of the terms are therefore simplified. For more on the vocabulary of derivatives, see Wasendorf, *supra* note 6, at 155-63; Gareth Hewett, *Slashing at the Jungle of Jargon*, *S. China Morning Post*, Feb. 28, 1994, available in LEXIS, ASIAPC Library, SCHINA File.

<sup>26</sup> See John Hull, *Options, Futures, and Other Derivative Securities* 1 (2d ed. 1989); Jorion, *supra* note 4, at 38.

<sup>27</sup> There are two ways in which such agreements are transacted: standardized contracts traded on exchanges (because the contracts are standardized, the only variable is price) or negotiated contracts between parties which are called "over-the-counter" (OTC) derivatives.

<sup>28</sup> There are of course benefits that may accrue to a party even if it is on the "wrong" side of the derivatives bet. A derivatives instrument can provide its purchaser with fixed prices in a volatile market so as to facilitate long-term objectives. In the same vein, derivatives offer parties the opportunity to hedge—that is to reduce exposure to specific varieties of risk such as fluctuations in prices and interest rates. By definition, hedging is not for profit taking.

<sup>29</sup> Examples of forward financial products include swaps and forward rate agreements. In a swap, parties agree to exchange a stream of payments over a time period according to a predetermined rule.

demand conditions that are expected to prevail in the future.<sup>30</sup> Futures are exchange-traded forward contracts where the particular exchange (or a neutral clearinghouse) acts as the counterparty to both buyer and seller by guaranteeing payment in the case of default by either party.<sup>31</sup> In exchange, the buyer and seller must put up collateral (or margin) equal to a set percentage of the agreement's underlying value.<sup>32</sup>

Option agreements, by contrast, do not obligate the contracting parties to perform but instead give the purchaser an "option" to require performance by the option seller in exchange for an up-front fee or premium.<sup>33</sup> In other words, the option purchaser is entitled to buy or sell some underlying asset or value at a predetermined price over a predetermined term. The option's primary purpose is to protect its purchaser from large, unexpected swings in the price of the underlying asset. An option purchaser cannot lose more than the price of the option itself, while the seller's loss exposure is theoretically without limit.<sup>34</sup> Basic option agreements can take several forms, while more complex options derivatives can contain nearly limitless permutations.<sup>35</sup>

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<sup>30</sup> See Mark Britten-Jones, *Mastering Management, Part 9, An Introduction to Futures Markets: Insurance, Liquidity, Immediacy*, *Fin. Times*, Jan. 5, 1996, at 12. These market expectations will typically "change by the hour and by the minute." *Id.*

<sup>31</sup> See Hull, *supra* note 26, at 3-5, 26 (explaining futures exchanges and clearinghouses); Barbara D. Granito et al., *Portfolio Surprise: "Derivatives" Pose a Risk for Unsuspecting Investors*, *Asian Wall St. J.*, Aug. 12, 1993, at A1 (same). Clearinghouses are often set up independent of the exchange so that the exchange itself is not forced to bear the risk of default. See Britten-Jones, *supra* note 30, at 12.

<sup>32</sup> Typically, an initial margin is deposited in the clearinghouse (or exchange guarantee fund) when a position is opened and a daily system of "variation margins" (payments) are collected based on the movements of the relevant futures price. See Britten-Jones, *supra* note 30, at 12.

<sup>33</sup> Most options derivatives are not settled upon delivery of the actual underlying asset. Instead, the options are settled for cash equal to the difference between the spot value and the aggregate "strike" price, the agreed-to price at which the option purchaser could buy or sell the underlying asset. See Hewett, *supra* note 25, at 18.

<sup>34</sup> See Granito et al., *supra* note 31, at A1 (defining option). A commonly used option derivative is the "put option," with which a purchaser has the right to sell an underlying asset or investment at a given price over a given time period. A "call option" operates under the same principle, giving the purchaser the right to buy an underlying asset or investment at a given price over a given time period. When a party wants to hedge or reduce its risk exposure, it can seek a call or put option derivatives instrument.

<sup>35</sup> Derivatives become more complex when they embody multiple derivative types (e.g., the "swaption"—an option entitling purchaser to future swap with another party).

### B. *Metals & Mung Beans: The Chinese Futures Market*

Throughout history, Chinese leaders have been concerned about social stability.<sup>36</sup> The central tenet to maintaining the social order of the world's largest population was recognized in imperial China in a compilation of writings recorded in the centuries preceding the Han Dynasty: "When the granaries are full, [the people] will know propriety and moderation; when their clothing and food are adequate, they will know [the difference between] honor and shame."<sup>37</sup> This ancient concept of *yang min*, or the state's responsibility for feeding its people, still preoccupies modern Chinese leaders.<sup>38</sup> Today, China must feed twenty-two percent of the world's population on less than seven percent of its arable land<sup>39</sup> and continue to support its expansive economy and industrial output. Thus, it is no surprise that to meet these demands, China has become a major producer of many commodities and products that are traded on the international futures exchanges.<sup>40</sup> This factual context helps to define (at least initially) the distinct characteristics of China's futures markets.<sup>41</sup>

Given its burgeoning population, Chinese agricultural needs are particularly vulnerable to environmental calamities and poor harvests.<sup>42</sup> In recent years, poor grain harvests throughout China wreaked havoc on the Chinese populace.<sup>43</sup> Despite its tremendous agricultural output, such poor harvests coupled with the sheer size of the Chinese population and the loss of arable land due to industriali-

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<sup>36</sup> Hsun Tzu, the famous Han Dynasty (298-238 B.C.) philosopher, wrote that: "[T]he sages of antiquity . . . set forth clearly propriety and righteousness to transform [the people], instituted laws and governmental measures to rule them, so that all will result in good order and be in accord with goodness." A Sourcebook in Chinese Philosophy 131 (Wing-Tsit Chan trans., 1963).

<sup>37</sup> Allyn W. Rickett, *Guanzi: Political, Economic, and Philosophical Essays from Early China* 52 (1985).

<sup>38</sup> See Will & Wong, *supra* note 8, at 1.

<sup>39</sup> See Minister on Opening Agriculture to Foreign Investment, *Zhongguo Xinwen She*, Dec. 31, 1994, transcribed in F.B.I.S., *China Rep.*, Jan. 3, 1995, at 70, 70.

<sup>40</sup> For example, as of 1993, China was the world's largest producer of cotton (comprising 23% of the world's production), rapeseed (canola) (26%), tin (25%), rice (35%), and wheat (19%). See Nusbaum, *supra* note 14, at 56 (exhibiting chart ranking China's commodities).

<sup>41</sup> The defining characteristics of China's futures market are further synthesized *infra* Part II.B.

<sup>42</sup> See Make All-Out Effort to Carry Out Autumn Grain Procurement and Winter Planting, *Zhejiang Ribao*, Nov. 25, 1994, translated in *Zhejiang Teleconference on Grain Work*, F.B.I.S., *China Rep.*, Dec. 6, 1994, at 49, 49 [hereinafter *Grain Work*] (explaining huge harvest losses due to multiple natural disasters).

<sup>43</sup> See *China: Review 1996*, Asia & Pac. Rev. World Info., Nov. 1, 1995, available in LEXIS, ASIAPC Library, CURNWS File (detailing effects of drought and shrinkage of agricultural lands); Enter the Middle Kingdom, *Energy Economist*, Jan. 1, 1996, at 5, 8 (characterizing China's basic problems as lack of water, food, and oil).



zation<sup>44</sup> have caused China to evolve from a grain exporter to a significant grain importer.<sup>45</sup> Moreover, as China's economy grows and its citizenry becomes more affluent, demand for agricultural goods will rise as more family income is spent on an increasingly diversified diet, including grain-intensive products like poultry, beef, and pork.<sup>46</sup> The uncertainty of agricultural productivity underscores the importance of a large-scale futures market to secure adequate stores of commodities in times of economic prosperity, as well as in times of need. By trading in futures markets, China may be able to maintain a stable food supply for its citizens.<sup>47</sup>

The Chinese government has encouraged the use of derivatives for their conservative hedging utility since the opening of its own futures market in 1990.<sup>48</sup> Both foreign and domestic derivatives have been used primarily in the commodities markets, to secure materials necessary to nourish China's domestic population and also to guarantee supply and pricing of materials to sustain China's industrial and economic growth.<sup>49</sup> These rationales for governmental involvement in the futures market mirror the economic goals and cultural values of efficiency and fairness that prompted Wang An-Shih to pursue grain sales in the Song Dynasty.<sup>50</sup> Such goals have been repeatedly emphasized by Chinese leaders ever since.

Derivatives play two major roles in the modern Chinese economy—they are important in the domestic futures market<sup>51</sup> and in

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<sup>44</sup> See *The New Economics of Food*, Bus. Wk., May 20, 1996, at 78, 81 (discussing loss of Chinese farmland due to urban sprawl and industrial development).

<sup>45</sup> See George Moffett, *Grain Glut Gone as Global Supply Shrinks*, Christian Sci. Monitor, Apr. 3, 1996, at 1, 10 (describing China's shift from grain exporter to significant grain importer).

<sup>46</sup> See *id.*

<sup>47</sup> See *China's Market Orientation Still Depends on Centralized Purchases*, Milling & Baking News, Oct. 10, 1995, at 46 [hereinafter *Centralized Purchases*] (explaining centralized futures purchases).

<sup>48</sup> See Geoffrey Murray, *Chinese Gov't Takes Heat Out of Futures Markets*, Japan Econ. Newswire, June 22, 1996, available in LEXIS, ASIAPC Library, JEN File (noting commitment of Chinese government since 1990 to use futures to hedge against price fluctuations).

<sup>49</sup> See *infra* notes 259-64 and accompanying text (discussing use of derivatives for hedging and price stability).

<sup>50</sup> See discussion *supra* note 8.

<sup>51</sup> At this stage, China's futures markets are not open to foreign participation. According to Li Jiange, Vice Chairman of the China Securities Regulatory Commission (CSRC), China's primary futures regulatory agency, foreign investors will not be permitted to trade in the Chinese domestic futures market until the market develops and convertibility of China's currency progresses. See *China to Tighten Control over Futures Trading*, Reuter Asia-Pac. Bus. Rep., Mar. 5, 1995, available in LEXIS, ASIAPC Library, REUPB File (noting that Vice Chairman ruled out any immediate foreign participation in Chinese futures market until local currency convertibility develops). But Gao Shangquan, head of a

China's overseas purchase and trading of derivatives on the international futures exchanges and with foreign investment banks. The domestic futures market serves an important role in the distribution of products throughout China and helps to provide pricing signals to all sectors of the Chinese economy. Foreign futures markets and derivatives transactions allow the Chinese government (through designated SOEs) to trade in strategic materials and to hedge against various economic risks. Accordingly, both of these futures markets and their regulation will be analyzed in turn.

### 1. *Domestic Futures Trading*

Commodity futures trading and financial instrument trading occur on separate decentralized exchanges. The most voluminous futures trading in China occurs in the domestic commodities market.<sup>52</sup> The largest commodity exchanges are located most prominently in the coastal open zones and the more economically developed regions such as Shanghai, Shenzhen, Suzhou, Nanjing, and Zhengzhou.<sup>53</sup> Each exchange was founded by different entities<sup>54</sup> and is organized either as an institutional corporation for profit, a nonprofit business, or an institutional corporation.<sup>55</sup> The city of Shanghai has two of the most prominent exchanges in China: the Shanghai Metals Exchange, which opened in May 1992 (listing copper and aluminum), and the Shanghai Grain and Edible Oil Commodity Exchange, which opened in June 1993 (listing corn, soybeans, wheat, rice, radish seed oil, and soybean oil).<sup>56</sup> Before the government crackdown of late 1995, there were at least thirty-four registered commodity futures exchanges operating throughout China,<sup>57</sup> with eighteen exchanges trading nonferrous metals, eleven exchanges trading grains and livestock, twelve exchanges trading petroleum and energy products, and seven exchanges providing futures in chemicals and building materials.<sup>58</sup>

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governmental research institution on economic reform, indicates that "participation in the world futures market is the ultimate goal of China." Li & Ni, *supra* note 9, at 55.

<sup>52</sup> See Jiang, *supra* note 12, at 59.

<sup>53</sup> See *id.*

<sup>54</sup> The Ministry of Domestic Trade, for example, helped found both the Shanghai Metals Exchange and the Shanghai Grain and Edible Oil Commodity Exchange, while municipal governments played a large role in the establishment of exchanges in Shenzhen, Suzhou, Nanjing, and Zhengzhou. See *id.* (exhibiting chart noting founding units of six Chinese futures markets).

<sup>55</sup> The CSRC is calling for reorganization that will make all exchanges nonprofit. Such a reorganization, it is argued, will result in fewer incentives for market fraud. See *infra* notes 128-29 and accompanying text.

<sup>56</sup> See Jiang, *supra* note 12, at 59 (exhibiting chart describing two Shanghai exchanges).

<sup>57</sup> See *id.* at 13-17.

<sup>58</sup> See Nusbaum, *supra* note 14, at 56.

China also has an active financial instruments futures market. In December 1993, the Futures Integrated Exchange was established to expand the market for financial instruments such as banking futures and options trading.<sup>59</sup> The Shanghai Securities Exchange, in addition to the sale of securities, sold treasury bond futures.<sup>60</sup> But in February 1994, the bond futures market spun out of control when one of the most prominent securities firms in China, Shanghai International Securities (Shanghai International), was accused of trying to manipulate the bond futures market.<sup>61</sup> Shanghai International was charged with breaking exchange rules by ignoring trading limits and selling bond futures short<sup>62</sup> in an attempt to extricate itself from huge losses it previously suffered from wrongly betting that the bond market would take a downward turn.<sup>63</sup> Shanghai International purchased more treasury bond futures in order to flood the market in hopes of driving down the price of the futures.<sup>64</sup> This misguided effort failed. Shanghai International was devastated by the scandal, incurring an estimated \$100 million loss on its trades, an amount nearly equal to its total registered capital.<sup>65</sup> After the Shanghai International incident, the central government and its regulatory agencies strongly criticized the management of the stock exchange, resulting in the ouster of the exchange head and the investigation and subsequent arrest of several top executives at the brokerage firm.<sup>66</sup> In May 1994, the Chinese gov-

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<sup>59</sup> See Han, *supra* note 21, at 19.

<sup>60</sup> Treasury bonds (*guokujuan*) were first issued in China in January 1981 in an attempt to "balance state revenue, expenditure, stabilize market prices, and collect idle money to meet urgent needs in national construction." China's Economic Reforms 318 (Lin Wei & Arnold Chao eds., 1982). The Shanghai Securities Exchange was the largest trader in China of state treasury bond futures. See Shanghai Stock Exchange Increases Trading, Xinhua, Dec. 27, 1994, transcribed in F.B.I.S., China Rep., Dec. 28, 1994, at 46, 46.

<sup>61</sup> The incident became known as the "327" scandal because it involved contract 327, based on a three-year bond with a 9.7% coupon. See Geoffrey Murray, System Weakness of China's Futures Markets Exposed, Japan Econ. Newswire, Dec. 24, 1995, available in LEXIS, ASIAPC Library, JEN File.

<sup>62</sup> "Short selling" is the practice of borrowing financial instruments and then immediately selling at market value, hoping to later replace the borrowed instruments, bonds in this case, at cheaper prices. See Stephen A. Ross et al., Corporate Finance 882 (4th ed. 1996).

<sup>63</sup> See Murray, *supra* note 61.

<sup>64</sup> See *id.*

<sup>65</sup> See Seth Faison, Shanghai Stock Market Cited for Scandal, N.Y. Times, Sept. 22, 1995, at D3 (describing effect of Shanghai International scandal on Shanghai stock market).

<sup>66</sup> See *infra* text accompanying note 93 (discussing investigation of Shanghai International scandal); Disgraced Shanghai Brokerage Head Faces Probe, Reuters, July 6, 1995, available in LEXIS, ASIAPC Library, REUAPB File (same).

ernment banned trading in treasury bond futures on all of China's exchanges.<sup>67</sup>

Despite the outbreak of these trading scandals, the Chinese futures market has steadily developed. The daily value of contracts traded on all of China's futures exchanges reached \$1.3 billion at the end of September 1994.<sup>68</sup> The Chinese futures exchanges are conducted through open price competition, utilizing a computer-matching transaction form<sup>69</sup> that facilitates increased trading efficiency and fairness. As the Chinese futures market has matured, the delivery settlement rate has decreased<sup>70</sup> because parties typically offset their positions before delivery.<sup>71</sup> In addition, the Chinese quickly added their own contributions to traditional commodities available on the futures trading floor. The Shenzhen Metals Exchange was the first exchange to introduce antimony and magnesium into the futures market.<sup>72</sup> Also, despite warnings by futures market experts, the Suzhou Commodity Exchange successfully initiated the world's first rolled steel futures market in October of 1992.<sup>73</sup>

## 2. *Overseas Futures Trading*

Various Chinese SOEs are authorized to trade on foreign futures exchanges to hedge against risk exposure and to secure strategic materials for the national stockpile.<sup>74</sup> The potential advantages of these cross-border derivatives transactions, however, have been overshadowed by their failures. In 1994, three notable disputes between Chinese entities and foreign investment banks over OTC derivatives trading losses came to the fore. A brief examination of these high-

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<sup>67</sup> See Faison, *supra* note 65, at D3.

<sup>68</sup> See Nusbaum, *supra* note 14, at 56.

<sup>69</sup> Other trading floors use trading rings, where transactions are concluded by hand signals and then later confirmed in writing. See Jiang, *supra* note 12, at 61.

<sup>70</sup> In most developed futures markets, futures are usually offset before the delivery date. See *supra* note 33 and accompanying text. The average delivery settlement rate is around 3% for developed markets. See Jiang, *supra* note 12, at 62.

<sup>71</sup> For example, on the Shanghai Metals Exchange in June 1992, the delivery settlement rate was 86% before dropping steadily to 2.8% by September 1993. See Jiang, *supra* note 12, at 62. For the same period, the delivery settlement rate also dropped on the Shanghai Grain and Edible Oil Commodity Exchange. See *id.*

<sup>72</sup> See Han, *supra* note 21, at 19.

<sup>73</sup> See Jiang, *supra* note 12, at 61. Futures experts were skeptical about a market in rolled steel due to its lack of certifiable standards. Yet trading for iron rod futures grew steadily each month from its inception (22 transactions for a total of 1980 tons in October 1992) up until a year later, when transactions totaled 1.09 million tons. See *id.* Admittedly, some of this growth in rolled iron futures might also be attributed to speculative investors seeking a new futures market after trading in other important markets was banned.

<sup>74</sup> See *infra* note 259 and accompanying text (providing example of metals hedging).

profile cases illustrates the potentially devastating effects of derivatives investments on both Chinese entities and foreign investment banks. These cases also highlight the primary issues concerning Chinese futures trading abroad, namely, questions regarding agency law and misconceptions as to the role of the Chinese government in transactions involving SOEs and foreign parties.

China National Metals and Minerals Import and Export (Minmetals) lost \$44.7 million from foreign exchange transactions and \$8.8 million related to an interest rate swap with Lehman Brothers near the end of 1993.<sup>75</sup> When Minmetals failed to honor its alleged debts, Lehman Brothers filed suit in the Southern District of New York for breach of contract.<sup>76</sup> Minmetals counterclaimed for fraud, seeking \$28 million in compensatory damages and \$100 million in punitive damages.<sup>77</sup> In a second case, which mirrors the Minmetals dispute, China International United Petroleum and Chemicals (UNIPEC) lost \$44 million in a series of foreign exchange and swaps transactions that were allegedly unauthorized by UNIPEC's board.<sup>78</sup> Lehman Brothers again filed suit in the Southern District of New York for breach of contract and UNIPEC swiftly counterclaimed, seeking \$8 million in compensatory damages for fraud.<sup>79</sup>

Underlying these disputes was a particularly acrimonious war of words between the parties.<sup>80</sup> Cao Yongfang, then President of

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<sup>75</sup> For more detailed accounts of the Minmetals dispute, see Lehman, *Minmetals War of Words Escalates*, *Metals Wk.*, Dec. 26, 1994, at 8 [hereinafter *War of Words*]; Craig S. Smith & Sara Webb, *China's Minmetals May File Suit Challenging Lehman*, *Asian Wall St. J.*, Dec. 20, 1994, at 3.

<sup>76</sup> See *Lehman Bros. Commercial Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co.*, Fed. Sec. L. Rep. (CCH) ¶ 98,841, at 93,061 (S.D.N.Y. June 26, 1995). The case is still pending after Judge Keenan denied Lehman's motion to dismiss the fraud counterclaims.

<sup>77</sup> The thrust of Minmetals's counterclaim was that Lehman Brothers "entice[d]" an "unauthorized trader" to enter into "unsuitable [derivatives] transactions." *Lehman Bros. Commercial Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co.*, Fed. Sec. L. Rep. (CCH) ¶ 99,001, at 93,884 (S.D.N.Y. Oct. 16, 1995).

<sup>78</sup> Lehman Brothers disputes this account and has alleged that UNIPEC president Jiang Yunlong provided written authorization for a deputy manager to enter into swaps with Lehman. See Henny Sender, *Hell to Pay: Lehman Brothers Sues Chinese Firms in U.S.*, *Far E. Econ. Rev.*, Dec. 1, 1994, at 78 (discussing UNIPEC dispute).

<sup>79</sup> *Lehman Bros. Commercial Corp. v. China Int'l United Petroleum & Chem.*, Fed. Sec. L. Rep. (CCH) ¶ 99,000, at 93,878 (S.D.N.Y. Oct. 16, 1995) [hereinafter *UNIPEC*]. The case is still pending after Judge Keenan granted Lehman's motion to dismiss business disparagement claims but allowed fraud counterclaims. UNIPEC's counterclaim sounds of the same allegations of fraudulent practices as those in the *Minmetals* case.

<sup>80</sup> The exchange of words became so bitter that UNIPEC filed business disparagement claims accusing Lehman Brothers of defaming UNIPEC and other Chinese businesses. Judge Keenan dismissed the charges, stating that Lehman's comments about "welshing" and "stiffing people" were "reasonably related" to the dispute at hand. *UNIPEC*, Fed. Sec. L. Rep. (CCH) ¶ 99,000, at 93,882.

Minmetals, accused Lehman Brothers officials of "improper and unfair marketing, trading and investment services" for failure to disclose the full risks of the trades to the inexperienced Minmetals trader.<sup>81</sup> Lehman Brothers lambasted this accusation, commenting that Minmetals's accusations "betray[] an active imagination but absolutely no understanding of the relevant facts."<sup>82</sup> This rhetoric stresses the underlying mistrust and fundamental misunderstanding that often forms a chasm between Chinese firms and their overseas investment partners. The misunderstanding centers on the belief held by foreign investment banks that they are dealing with business entities ultimately owned by the Chinese government and that losses by these entities will therefore be covered by the government in instances of default.<sup>83</sup> To Chinese officials, this view is misguided.<sup>84</sup> As one official of the Ministry of Foreign Trade and Economic Co-operation (MOFTEC) observed: "It's not strange to see contractual conflicts. However, these cannot be regarded as anything related to government action' . . . ."<sup>85</sup> A more detailed description of the last of these three disputes is instructive not only as to the risks of the derivatives market, but also as to the effect of such losses on the Chinese futures market.

For several years, a subsidiary of the China International Trust and Investment Corporation (CITIC) traded futures and options contracts on the London Metals Exchange. The trades concerned base metals (such as aluminum and copper) and were completed through exchange brokers on behalf of CITIC's Chinese clients.<sup>86</sup> This subsid-

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<sup>81</sup> War of Words, *supra* note 75, at 8.

<sup>82</sup> *Id.* Lehman responded similarly to UNIPPEC's counterclaim, asserting that UNIPPEC's "actions and allegations [were] simply a smoke screen to renege on their obligations." China's/UNIPPEC/U.S. Lehman: Lehman Says Trades Legal, Dow Jones Int'l News Serv., Mar. 15, 1995, available in WESTLAW, DJINS database.

<sup>83</sup> For discussion of this tendency of foreign investors to view transactions with Chinese corporations as actually being transactions with the Chinese government, see *infra* note 141 and accompanying text. Foreign parties have actively pressed the Chinese government to make good on defaulted loans made to SOEs. See, e.g., Geng Xiao, Learning from Deutsche Bank's Debacle in China, *Asian Wall St. J.*, May 22, 1996, at 8 (detailing SOE default on foreign loan).

<sup>84</sup> These disputes, which go to the heart of the consequences of SOE reform, are discussed *infra* Parts II.C, III.A.

<sup>85</sup> Xiao Wang, Some Investors Misled by Inaccurate Media Reports, *China Daily*, Dec. 18-24, 1994, transcribed in China's Foreign Investment Policies Defended, F.B.I.S., *China Rep.*, Dec. 19, 1994, at 43, 43 (discussing reaction to inaccurate media reports on Chinese government's business practices).

<sup>86</sup> See Ren Kan, CITIC Shanghai on Futures Losses, *China Daily*, Dec. 18-24, 1994, transcribed in Advisor Discusses "CITIC Shanghai" Losses, *China Daily*, F.B.I.S., *China Rep.*, Dec. 19, 1994, at 44, 44 (discussing CITIC Shanghai's settlement of its losses in international metal futures deal).

iary, CITIC Shanghai Co., Ltd. (CITIC Shanghai), incurred heavy trading losses in the copper futures markets on both the London and Shanghai metal exchanges in early 1994.<sup>87</sup> Betting that copper would rise in value, CITIC Shanghai traders bought huge quantities of copper futures at top prices for China's strategic stockpiles<sup>88</sup> without approval from key authorities.<sup>89</sup>

After the purchase of copper futures, copper's market value plummeted, resulting in a loss to CITIC Shanghai estimated at between \$42 and \$44 million.<sup>90</sup> Because the trading was done (albeit without central government permission) for the state's strategic stockpile, the Ministry of Finance was forced to assume payment for the highly priced copper futures.<sup>91</sup> Unlike the preceding cases, this dispute was settled out of court for an estimated \$14 million.<sup>92</sup> The immediate fallout from the dispute and its subsequent settlement was the arrest of two dealers and two managers (including the president of CITIC Shanghai) on charges of corruption.<sup>93</sup> The trading losses pointedly alerted Beijing to the fact that the futures commodities market was fast becoming "a casino for rich individuals and government companies."<sup>94</sup> The disputes also drove foreign investment banks to scrutinize their own agreements with Chinese companies to verify that their Chinese counterparts were properly authorized to engage in derivatives agreements.<sup>95</sup> Finally, in March 1994, the Chinese government banned all new overseas futures trading.<sup>96</sup>

### C. Regulatory Efforts

As more and more investors plunged into the futures market for speculative profit making, the Chinese government prohibited the

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<sup>87</sup> See *id.*; see also Peter Seidlitz, Crackdown on Futures Dealers, S. China Morning Post, June 24, 1994, available in LEXIS, ASIAPC Library, SCHINA File (describing CITIC's metal futures trades); Sara Webb, Citic Unit, Banks Near Settlement of Dispute Over \$42 Million Trading Debt, Wall St. J. Eur., Mar. 1, 1995, at 12 (same).

<sup>88</sup> At the time, selected "trustworthy" Chinese companies were permitted to buy and place orders for the state's strategic stockpile reserves in base metals and other materials. See Seidlitz, *supra* note 87.

<sup>89</sup> CITIC Shanghai needed special permission from its parent company, CITIC, to borrow foreign funds to carry out the metals trading in the first instance. Under its own internal regulations, the CITIC Shanghai traders did not even have authority to request credit lines from the major international banks and brokers who extended the credit to the subsidiary. See *id.*; Ren, *supra* note 86, at 44.

<sup>90</sup> See Webb, *supra* note 87, at 12.

<sup>91</sup> See *id.*

<sup>92</sup> See *id.*

<sup>93</sup> See *id.*

<sup>94</sup> Seidlitz, *supra* note 87.

<sup>95</sup> See, e.g., Webb, *supra* note 87, at 12.

<sup>96</sup> See *infra* notes 121-23 and accompanying text.

trading of many of these commodities. Although there are approximately eleven exchanges currently authorized to trade a reduced range of commodities, the government is still pressing for further consolidation in the near future.<sup>97</sup> Chinese regulatory efforts on futures trading have been largely reactive. Instead of erecting uniform standards for trading and for exchange membership and structures, Chinese regulation has merely shut down those markets and exchanges that showed signs of overheated speculation. Several factors have contributed to the chaotic futures market: the absence of any uniform futures regulations, the proliferation of regional exchanges (each with its own internal controls), and the natural volatility of the futures market itself. Moreover, the lack of any coherent national policy has undoubtedly fueled the growth of unregistered and often "underground" futures trading, investor speculation, and market instability.<sup>98</sup> Until the Futures Law<sup>99</sup> takes effect, the work of futures regulation has been dispersed to several regulatory agencies and the regional exchanges.<sup>100</sup>

### 1. *Exchange Controls*

An exchange's greatest impact on management of futures trading is its function of setting limits on allowable volumes of trading in a given market. In addition to setting caps, exchanges may use several other means to regulate investor behavior. First, exchanges promulgate their own offsetting controls. For example, when speculation mounted in plywood futures in October 1995, the Shanghai Commodities Exchange ordered that members of the exchange reduce their holdings by twenty-five percent on the basis of positions held on a previously set date.<sup>101</sup> Such measures were intended to discourage

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<sup>97</sup> See *Fewer Futures*, *supra* note 17.

<sup>98</sup> See Jiang, *supra* note 12, at 60 (discussing China's existing futures market problems); see also *The Growing Threat of International Organized Crime: Current Trends in Transnational Chinese Enterprise Crime*, Before the Subcomm. on Crime of the House Judiciary Comm., Federal Document Clearing House Congressional Testimony, Jan. 25, 1996, available in LEXIS, LEGIS Library, CNGTST File (testimony of Willard H. Myers, III, Director, Center for the Study of Asian Organized Crime) [hereinafter *Myers Testimony*] (noting emergence of Chinese enterprise activity in illegal sugar futures).

<sup>99</sup> For background regarding delays in enacting China's long-awaited Futures Law, see *China's Futures Law*, *supra* note 20.

<sup>100</sup> Decentralized regulation of the futures market developed pursuant to a circular by the State Council in 1993. See *infra* note 120.

<sup>101</sup> See *Hot Money Fuels New China Futures Trading Scandal*, *Reuter Asia-Pac. Bus. Rep.*, Oct. 9, 1995, available in LEXIS, ASIAPC Library, REUAPB File [hereinafter *Hot Money*] (discussing scandals that have swept futures markets in China). Those members failing to comply with the compulsory "offset" (50% over two days) were forced to liquidate their positions at the settlement price of the day. *Id.*



short-term holdings because they are generally speculative in nature and are not used for other hedging or risk-management purposes. Second, an exchange sets margin requirements for forward contracts and can set new limits for additional margin requirements should investors take new positions above a certain number of lots. Thus, parties can be made to ante up more collateral when their risk exposure in a particular position has increased. Those brokerage and trading firms that violate exchange controls generally have their trading rights suspended.<sup>102</sup> Unfortunately, the threat of such sanctions has failed to deter speculation by investors.

There are drawbacks to present exchange controls. Due to the lack of uniformity among the regional exchanges, there are varying margin requirements<sup>103</sup> and permissible trading volumes.<sup>104</sup> Additionally, the differing organizational types of the exchanges (ranging from membership systems to profit-making exchanges) was a source of concern for Beijing, which feared the for-profit exchanges would be prone to market manipulation in pursuit of their self interests.<sup>105</sup> Even those exchanges that operate on a membership basis are not immune to market disturbances due to uneven membership standards among these exchanges. The differing organizational standards contribute to overall market instability by failing to exclude firms and brokerages that are insufficiently capitalized.<sup>106</sup> Moreover, the ex-

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<sup>102</sup> See, e.g., *id.* (noting suspension of Shanghai Zhongjing Industry Co. for alleged plywood futures trading violations).

<sup>103</sup> For example, before treasury futures bond trading was banned, brokers required their customers to deposit "merely 500 yuan (\$60) for every 20,000 yuan-worth of contracts" they purchased. Mung Bean, *supra* note 10, at 71.

<sup>104</sup> Each of these variations allows speculators opportunities to exploit the differences between exchanges that trade similar commodities and products. Varying levels of trading tend to decrease the uniformity of pricing from region to region. The consequence is a lack of price rationality and excessive arbitrage.

<sup>105</sup> See *infra* note 129 and accompanying text (CSRC reforming all exchanges toward membership system). For instance, the Shenzhen Metals Exchange operates on a membership basis (as opposed to a for-profit structure) and has set standards for economically "strong" member enterprises that must be approved by both a Board of Directors and the local authorities. See Han, *supra* note 21, at 16. Only approved members are qualified to appoint personnel for brokers. See *id.* Exchanges based on membership are likely to be more stable because individual members of an exchange will have a vested interest in the continuing viability of the exchange itself. In contrast, exchanges that are based solely on profit structures will likely skew incentives toward short-term and self-interested profit taking. Such an environment would result in less stable exchange controls.

<sup>106</sup> Brokerage firms are required to register with the State Administration of Industry and Commerce (SAIC) prior to joining exchanges. See *infra* note 136 and accompanying text. However, the exchanges themselves rarely check for registration and often fail to ensure that their members are fully capitalized as required by the SAIC. See Lu Wen, *Futures Market Regulations Imperative*, *Jinrong Shibao*, F.B.I.S., China Rep., Jan. 4, 1995, at 56, 57 (describing inconsistent enforcement of regulations). SAIC internal studies show that on the four largest exchanges in Shanghai, only 11.2% of all exchange members were

changes on the whole have proven not to be able or willing to curb excessive market speculation and often turn a blind eye toward market destabilizing speculation.<sup>107</sup>

The gravest limitation on exchange controls is the general lack of a developed "clearinghouse" structure.<sup>108</sup> Typically, in the trade of standardized futures contracts (done on the exchange), the particular exchange acts as the "clearinghouse" or "counterparty" for both buyer and seller, bearing the risk in the event either party defaults.<sup>109</sup> Clearinghouses are particularly critical in derivatives contracts because the contracts are settled in the future, and the creditworthiness of the parties is an issue.<sup>110</sup> In China, the de facto role of clearinghouse has most often fallen to the central government.<sup>111</sup> Recently, the Chinese government has taken several steps to correct the tendency of SOEs and other actors to rely on its intervention because such action works against the government's aim of economic efficiency.<sup>112</sup> Beijing also has started to ameliorate deficiencies in the decentralized exchanges and has exerted a strong hand in determining the future composition of the exchanges.<sup>113</sup>

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registered with the SAIC and many of the members (even those registered) did not have the required amount of registered capital. See *id.* at 57.

<sup>107</sup> See, e.g., Mung Bean, *supra* note 10, at 71 (noting Zhengzhou Exchange director statement that "[s]o far, there is no sign of speculative funds getting into the market" in spite of massive speculative flows).

<sup>108</sup> Of course, China is not the only country without a viable clearinghouse structure. Other countries with newly established futures markets have encountered similar difficulties due to either the lack of an adequately capitalized clearinghouse or the complete absence of a clearinghouse structure. See, e.g., *id.* at 70 (noting that Hong Kong Futures Exchange defaulted in 1987 when stock market collapsed and clearinghouse lacked sufficient capital to cover defaults). The World Bank's offshoot, the International Finance Corporation (IFC) has played the role of the clearinghouse for private corporations from several emerging markets in an effort to introduce derivatives and risk management into these economies. See Janine Schultz, *How LDCs Hedge Their Bets and Debts*, Institutional Investor, Feb. 1, 1992, at 111, 115-16 (IFC acting as intermediary for companies eager to do swaps and derivatives but lacking creditworthiness).

<sup>109</sup> See *supra* notes 29-30 and accompanying text (describing forward futures contracts).

<sup>110</sup> This is especially true in China and other emerging markets, where the creditworthiness of new corporations tends to be "murky." Mung Bean, *supra* note 10, at 70.

<sup>111</sup> But see *supra* notes 75-85 and accompanying text (detailing Chinese government's refusal to cover trading losses by Minmetals and UNIPPEC).

<sup>112</sup> See *Make Conscientious Efforts to Improve Efficiency—On Intensively Launching "China's Deep-Going March Toward Economic Efficiency,"* Xinhua, Apr. 25, 1994, translated in *Renmin Ribao Stresses Economic Efficiency*, F.B.I.S., China Rep., Apr. 28, 1994, at 46, 46-47 [hereinafter *Economic Efficiency*] (discussing government's goal of economic efficiency).

<sup>113</sup> Beijing ousted the general manager of the Shanghai Stock Exchange after the Shanghai International treasury futures debacle. See Andrew Browne, *Shanghai Stock Exchange Chairman to Step Down*, Reuter Asia-Pac. Bus. Rep., Aug. 19, 1995, available in LEXIS, ASIAPC Library, REUAPB File; see also *supra* notes 61-66 and accompanying text (detailing treasury bond futures scandal). The Chinese government has taken addi-

## 2. Central Regulatory Oversight

The central government's initial response to speculative markets and wild market fluctuations has been a piecemeal campaign of bans on the trading of important commodities.<sup>114</sup> Beijing (through its various regulatory organs) also issued a patchwork of circulars and directives to discourage and prohibit investor manipulation of the derivatives trade.<sup>115</sup> Because these efforts had little effect on investor speculation, Beijing next began shutting down the futures exchanges themselves in a further effort to end excessive speculation.<sup>116</sup>

The most glaring defect in China's regulation of the futures market is the multitude of agencies and state organs that share overlapping jurisdictions in the area. For instance, when the State Council ordered an investigation into the Shanghai International treasury bond futures scandal,<sup>117</sup> no less than six commissions and governmental bodies were charged with carrying out the investigation.<sup>118</sup> This problem of overlapping jurisdiction is due to the lack of cohesion in China's futures regulation. To further illustrate this issue, it is helpful

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tional measures to regulate not only brokerages but the composition of the exchanges. See *infra* notes 129-30 and accompanying text.

<sup>114</sup> The CSRC, China's designated futures regulatory agency, has banned trading in many commodities that, in the government's view, were rife with speculation, including cotton (which was never permitted), coal, diesel oil, heating oil, sugar, steel bars, some varieties of rice, and edible oil. See *China Futures Markets Appeal for More Products*, Reuters, Sept. 15, 1995, available in LEXIS, ASIAPC Library, REUAPB File [hereinafter *China Futures*]; Nusbaum, *supra* note 14, at 53. The State Council banned the trading of equity index products and overseas trading in foreign futures exchanges. See *id.*

<sup>115</sup> A good example of this effort occurred in November 1994, when the CSRC, the State Administration of Exchange Control (SAEC), the SAIC, and the Ministry of Public Security issued a joint circular "pledging to investigate and punish" illegal futures trading in the foreign exchange market. Ren Kan, *Crackdown on Illegal Exchange Speculators*, *China Daily*, Nov. 7, 1994, reprinted in *Authorities Halt "Illicit Futures Trading," F.B.I.S., China Rep.*, Nov. 7, 1994, at 58, 59. But as *Xinhua* reported, "lured by potential high profits," some institutions completely disregarded both the circular and a prohibition by the Beijing Exchange and continued to trade in foreign exchange futures. *Crackdown*, *supra* note 16, at 47.

<sup>116</sup> See, e.g., *Despite Its Crackdown in Commodities, China Favors Trading of Bond Futures; Markets: The Debt Instruments Have Become the Government's Chief Cash Crop*, *L.A. Times*, June 27, 1994, at D3 [hereinafter *Bond Futures*]. When Beijing decided that speculation on the price of oil was igniting inflation, it ordered the doors of the Beijing Petroleum Exchange to be bolted shut. See *id.* The government eventually banned all trading in petroleum and oil products. See Henny Sender, *China: Rigger Mortis*, *Far E. Econ. Rev.*, May 26, 1994, at 80.

<sup>117</sup> See *supra* notes 61-66 and accompanying text.

<sup>118</sup> The government entities included the State Secrets Bureau, the Supreme People's Court, Ministry of Supervision, the CSRC, the Ministry of Finance, and the People's Bank of China (PBOC). See Andrew Browne, *Beijing Ends Silence on Huge Bond Scandal*, *Reuter Asia-Pac. Bus. Rep.*, Sept. 21, 1995, available in LEXIS, ASIAPC Library, REUAPB File.

to consider each of the main regulatory actors and their respective roles in futures regulation.

*a. Primary Regulatory Actors.* While numerous other state commissions are involved in the regulation of futures trading, there are six primary actors: the State Council, the China Securities Supervision and Management Commission (CSSMC), the China Securities Regulatory Commission (CSRC), the State Administration of Industry and Commerce (SAIC), the State Administration of Exchange Control (SAEC), and the People's Bank of China (PBOC). These regulatory agencies will be discussed briefly in turn.

The State Council, the cabinet of the Chinese government, is the chief governmental entity that supervises all regulation of the futures trade not falling within the jurisdiction of ministries and commissions. Under the Chinese Constitution, the State Council is charged with a broad supervisory mandate that includes the power to "adopt administrative measures, enact administrative rules and regulations and issue decisions and orders in accordance with the Constitution and the statutes."<sup>119</sup> These broad powers of the State Council have played a large role in Chinese attempts to unify and centralize regulation of the futures industry. The Council influences futures policy by issuing circulars which generally call for broad goals, while delegating implementation and enforcement to subordinate commissions.<sup>120</sup>

In an about-face from its previous policy, a recent Council circular called for the centralization and standardization of regulation in the futures industry because of the chaotic market and its patchwork of controls.<sup>121</sup> The directive severely limited the scope of futures trad-

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<sup>119</sup> Xianfa, art. 89, sec. 2, para. 1 (1982). The State Council is "to exercise unified leadership over the work of the ministries and commissions" and to "direct all other administrative work of a national character that does not fall within the jurisdiction of the ministries and commissions." *Id.* at para. 3. Also within the Council's purview is the power to "direct and administer economic affairs." *Id.* at para. 6.

<sup>120</sup> In 1993, the State Council issued its "Circular on Resolutely Checking the Unregulated Development of the Futures Market" (1993 Circular), which called for the decentralization of futures regulation. The 1993 Circular enhanced the power of localities and relevant departments to supervise and take appropriate measures to sanction improper behavior in their respective localities. See State Council "Opinions" on Futures Market, F.B.I.S., China Rep., June 20, 1994, at 49, 49 [hereinafter State Council]. Due to the resulting proliferation of futures exchanges, lack of standardized operations, fraudulent practices, and speculative trading losses, the State Council then called for steady development of the futures market through "standardization." *Id.*

<sup>121</sup> In April 1994, the State Council passed Directive 69 known as the "Rectification Program," which aimed to centralize regulation of the futures industry. See Nusbaum, *supra* note 14, at 53 (discussing Rectification Program); see also State Council, *supra* note 120, at 49 (analyzing directive). The Rectification Program called for several marked changes. First, the directive called for the immediate halt of examinations and approval of

ing in China and opportunities for futures trading abroad by Chinese SOEs. However, the directive had a grandfather clause allowing those SOEs and state financial institutions that traded in derivatives prior to the directive to continue trading, but solely for the purpose of hedging.<sup>122</sup>

The CSRC has emerged as the primary regulatory actor in the futures industry and acts as the "unified supervis[ory] organ" to prevent collapse of the futures market.<sup>123</sup> The CSRC exerts its influence in several ways. First, it often responds to extreme market volatility and cracks down in markets where it sees excessive futures speculation and market manipulation.<sup>124</sup> In response to volatile markets in plywood and rice futures, for example, the CSRC imposed several re-

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the establishment of new futures exchanges by government corporations, local municipalities, and other levels of provincial government. See *id.* The program set out new operational requirements under which the CSSMC would select exchanges for futures trading approval (subject to State Council approval) and provided that the new exchanges that did not meet these requirements would be prohibited from all futures trading. See *id.* This aspect of the program was directed not only at reducing the total number of futures exchanges, but also at developing more stringent and standardized operational requirements. The directive's second goal called for stricter control and examination of future brokerage firms to ferret out those brokerages without adequate capitalization. See *id.* Applications for new brokerages were suspended. Existing brokerages were required to first meet CSSMC requirements and then be registered with the SAIC prior to opening for business. See *id.* The final thrust of the directive exerted stricter control over the scope of futures transactions and confined the majority of futures trading to commodity-type futures. The program banned the trading of all index futures and left the future of other financial derivatives in question by refusing to rule out an outright ban on trading. See *id.* The Council also severely restricted the ability of domestic brokerages and firms to trade in the overseas futures markets by banning all new transactions save by those firms that had previously engaged in such agreements. These companies were ordered not to accept any new orders or new clients and to settle their positions prior to their actual settlement date. See *id.*

<sup>122</sup> Banks and other nonfinancial institutions that were designated or permitted by the SAEC to execute foreign exchange transactions were allowed to continue foreign exchange futures for hedging subject to the approval of both the CSSMC and SAEC. See State Council, *supra* note 120, at 49. Those entities engaging in foreign exchange futures now have to obtain a license from the CSSMC. See *id.* Entities qualifying for the continuation of previous futures trading are still confined to trading in futures products and markets that had CSSMC approval, and they can only do business with foreign futures corporations approved by the CSSMC. See *id.*

<sup>123</sup> China Financial Risk Control: China to Beef Up Financial Risk Control, Xinhua News Agency, Dec. 8, 1995, available in LEXIS, ASIAPC Library, XINHUA File.

<sup>124</sup> In September and October 1995, the CSRC took strong measures to stop futures speculation in plywood futures in Shanghai and in rice futures on the Guangzhou commodity futures exchanges. See Cheung Lai-Kuen, CSRC Tightens Curbs on Futures, *S. China Morning Post*, Oct. 25, 1995, available in LEXIS, ASIAPC Library, SCHINA File; see also Crackdown, *supra* note 16, at 46-47 (CSRC issuing ban on foreign exchange futures trading). But the flurry of circulars issued by the CSRC and other commissions on the subject of futures regulation may result in confusion regarding which decrees are controlling in the event of overlapping or contradictory directives.

quirements on all futures exchanges in China, including position ceilings (or caps) on all futures exchanges for such volatile products and additional margin requirements equal to fifty percent of the trade volumes for any positions above set caps.<sup>125</sup> The CSRC also prohibits traders from building new positions on the margins used for old positions or with profits garnered after unwinding old positions on the same day.<sup>126</sup> Exchanges are instructed to monitor their respective markets to ensure trader compliance with trading caps, and those exchange members who do not comply with CSRC rules are subject to fines, loss of illegal income earned, and revocation of exchange memberships and trading licenses.<sup>127</sup>

Second, the CSRC began to reshape the organizational structure of the regional exchanges by ordering that all of the exchanges be restructured into nonprofit, membership organizations by 1996.<sup>128</sup> In large part, this change came in response to fears that exchanges organized for profit were frustrating the orderly development of the futures market.<sup>129</sup> Finally, the CSRC has promulgated long-term regulations to shape the futures industry by drafting a "Five-Year Plan" spanning from 1995 until the coming millennium.<sup>130</sup> The Plan is an explicit acknowledgment of the potential economic ramifications and social instability that could result from the development of China's futures markets if they are not properly managed.<sup>131</sup>

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<sup>125</sup> See Cheung, *supra* note 124, at 12; see also China to Crack Down on Futures Market Manipulation, Xinhua News Agency, Oct. 24, 1995, available in LEXIS, ASIAPC Library, XINHUA File. The "crackdown" had severe penalties. Zheng Yifan, a 23-year-old trader convicted of using state funds to speculate in plywood futures, was sentenced to death. See David Ibisson, Iguchi Joins Club of Billion-Dollar Barrier Breakers, S. China Morning Post, Sept. 27, 1995, available in LEXIS, ASIAPC Library, SCHINA File.

<sup>126</sup> See Cheung, *supra* note 124, at 12.

<sup>127</sup> In cases where the exchange fails to supervise the market or rein in market manipulation, the CSRC could stop its operation, force the particular exchange to reorganize under the CSRC, or in serious cases, disqualify the exchange. See *id.*

<sup>128</sup> See China to Standardize Futures Market Operations, Int'l Sec. Reg. Rep., Aug. 3, 1995, available in LEXIS, ASIAPC Library, ISRR File.

<sup>129</sup> See Josephine Ma, China Slashes Futures Traders, S. China Morning Post, Dec. 2, 1995, available in LEXIS, ASIAPC Library, SCHINA File. By requiring membership in the exchange and reducing the number of members, short-term speculators having little stake in the stability of the exchanges are forced out. The CSRC has also taken steps to reduce by half the number of commodity exchanges allowed to open client accounts. This measure purports to curb futures speculation as firms engaged in proprietary trading will no longer be able to pass trading losses onto their clients. See *id.*

<sup>130</sup> See China Plans Strategy for Securities, Xinhua News Agency, July 9, 1995, available in LEXIS, ASIAPC Library, XINHUA File [hereinafter Securities Strategy]. According to CSRC chairman Zhou Daojiong, the plan calls for "building a national unified securities and futures market and a centralized market management system" to eliminate speculation. *Id.*

<sup>131</sup> The CSRC expressed its desire to balance the need for "standardization" with the need for experimentation necessary for the development of the futures market. *Id.*; see

In March 1996, the CSRC and the State Council issued a heavy-handed directive banning SOEs from speculating in futures markets.<sup>132</sup> Under the new regulation, SOEs will be allowed to engage in commodities futures trading only in markets relevant to their production and operation.<sup>133</sup> The March circular also prevents financial institutions and futures brokerages from commodities futures trading for clients or for themselves,<sup>134</sup> and calls for the eventual introduction of international market commodities on leading exchanges.<sup>135</sup>

The SAIC has supervisory oversight over all industrial and commercial activities in China. In the futures realm, the SAIC licenses and approves futures brokerage registrations. All brokerage firms are required to register with the SAIC prior to becoming members of particular exchanges.<sup>136</sup> The SAIC also plays a role in price administration by issuing circulars warning against the "illegal practices of driving up and cheating on prices" of commodities such as grain, cooking oil, and meat.<sup>137</sup>

The SAEC is vested with the oversight of economic activities that might affect foreign exchange.<sup>138</sup> Futures brokerages need SAEC approval before sending customer funds overseas<sup>139</sup> and before engaging in any foreign exchange futures trading authorized under the State

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also Renee Lai, Supervisors to Regulate Market, S. China Morning Post, July 10, 1995, available in LEXIS, ASIAPC Library, SCHINA File. The plan can be summarized in several points: (1) the CSRC will set up an inspection system to investigate and settle market irregularities; (2) a computer system will be established to assist the CSRC in the instantaneous monitoring of trading activity; and (3) supervisory authority will be granted to local governments and departments to examine and settle regulatory violations, deal with investors' complaints, and supervise the activities of listed companies, securities and futures companies, and other regional intermediary institutions. See Securities Strategy, *supra* note 130.

<sup>132</sup> See China Bans State Firms from Futures Speculation, Reuters Fin. Serv., Mar. 1, 1996, available in LEXIS, ASIAPC Library, REUFIN File [hereinafter Futures Speculation].

<sup>133</sup> See Christine Chan, Red Start Augurs Well for Markets, S. China Morning Post, Mar. 5, 1996, available in LEXIS, ASIAPC Library, SCHINA File.

<sup>134</sup> See *id.*

<sup>135</sup> See Futures Speculation, *supra* note 132.

<sup>136</sup> But because some exchanges fail to ensure that their members are registered with the SAIC, this regulatory requirement has been largely circumvented. See Lu, *supra* note 106, at 56-57 (observing that firms are not registering with SAIC). New brokerage firms desiring registration must have over 10 million *renminbi* (China's currency) of registered capital and employ at least 20 full-time futures brokers. See *id.* at 57.

<sup>137</sup> Circular Urges Market Supervision During Holidays, Xinhua, F.B.I.S., China Rep., Jan. 10, 1995, at 47, 47.

<sup>138</sup> China has a foreign exchange retention policy. See generally Wei Jia, Chinese Foreign Investment Laws and Policies 99-105 (1995) (describing Chinese foreign exchange policy).

<sup>139</sup> See Nusbaum, *supra* note 14, at 53.

Council's Rectification Program.<sup>140</sup> Chinese SOEs and institutions that are recognized as official foreign exchange windows are explicitly guaranteed by the SAEC, which has obvious implications for foreign investment banks dealing with such entities.<sup>141</sup> The SAEC and other commissions have issued joint circulars regarding illegal foreign exchange futures trading, ruling that neither party to an unapproved foreign exchange trade will be protected by Chinese law.<sup>142</sup>

The PBOC, China's central bank, has also expressed a strong desire to "carry out supervision of the new [futures] business."<sup>143</sup> Since the CITIC Shanghai trading scandal,<sup>144</sup> all foreign currency allocations needed for letters of credit in commodities futures trading must now be approved by the PBOC.<sup>145</sup> Shifting approval to the PBOC has both centralized the process and eliminated another avenue of market manipulation.

After the Barings Bank fiasco,<sup>146</sup> the PBOC requested that all of its customers (domestic Chinese banks) check their margins for their foreign exchange derivatives-related activities.<sup>147</sup> In this regard, the PBOC may have been covering open positions on behalf of its customers who themselves may have been using derivatives to hedge

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<sup>140</sup> See *supra* notes 121-22 and accompanying text.

<sup>141</sup> See Sender, *supra* note 78, at 78, 80. Foreign corporations regard the debt of such entities as "sovereign" because of the explicit SAEC guarantee. See *id.*

<sup>142</sup> See Ren, *supra* note 115, at 58, 59.

<sup>143</sup> China Explores Ways to Curb Derivative Risks, Reuters, Nov. 21, 1995, available in LEXIS, ASIAPC Library, REUINT File [hereinafter *China Explores*]. Yet the PBOC itself is a questionable source of regulatory authority. In addition to its own admitted lack of "regulatory expertise" in the futures area, a fact that foreign investment banks are quick to confirm, see, e.g., Renee Lai, S. China Morning Post, Yuan Derivative Deals Regarded as Too Risky, Nov. 3, 1995, available in LEXIS, ASIAPC Library, SCHINA File, the PBOC is rumored to have engaged in several derivatives transactions itself. In August 1995, there were widespread rumors that the central bank was engaging in options-related deals in international markets, suffering options losses up to \$5 billion. See China Says Central Bank Has No Int'l Options Deals, Reuters, Aug. 14, 1995, available in LEXIS, ASIAPC Library, REUFIN File [hereinafter *Central Bank*]. The SAEC maintained that the PBOC engaged in no options-related dealings in international markets, and the Bank itself refused to comment. See *id.*

<sup>144</sup> See *supra* notes 86-93 and accompanying text.

<sup>145</sup> See Seidlitz, *supra* note 87. Formerly, traders could obtain letters of credit from Chinese banks that organized currency on regional swap markets. See *id.* This often resulted in the development of relationships between commodity traders and the managers of regional swap exchanges, thereby leading to questionable market practices. See *id.*

<sup>146</sup> See generally Denton & Gopper, *supra* note 2, at 7.

<sup>147</sup> See Central Bank, *supra* note 143; see also Jane Macartney, China Denies Central Bank Exposed in Dollar Derivatives, Reuter Asia-Pac. Bus. Rep., Aug. 14, 1995, available in LEXIS, News Library, REUAPB File.



their positions.<sup>148</sup> The PBOC in such cases acts as a backstop for risk in the derivatives market.<sup>149</sup>

*b. Industry/Trade Group Self-Enforcement.* The nascent futures industry has its own trade group, the National Futures Exchange Association (NFEA), a self-regulatory group which was established by authorized exchanges in September 1994.<sup>150</sup> The CSRC delegated to the NFEA a primary role in its campaign to reduce the number of broker members allowed to trade on behalf of clients (to roughly half of the current 3000 exchange members) by leaving it the difficult task of recommending the remaining eligible members.<sup>151</sup>

The International Options Market Association (IOMA) is the trade group of the international futures market. The IOMA has more than fifty members in over twenty countries and is the sole international body representing major options and futures exchanges in the world.<sup>152</sup> In the fall of 1995, the Zhengzhou Commodities Exchange in central China's Henan province was accepted by the IOMA as the first member from China.<sup>153</sup> The NFEA and IOMA both serve as valuable sources of information for member exchanges and may facilitate the development of industry-wide best-practices guidelines.<sup>154</sup>

After its brisk start, China's derivatives market has taken hard losses in both the domestic and foreign fronts. Prompted by losses suffered by speculating investors and SOEs, the Chinese government has tightened control of futures trading and has banned trading in many markets. And while trading losses in derivatives are not unique to China, several features of China's economic and cultural history do stand apart from other markets. Isolating these characteristics gives a background against which to evaluate the somewhat contradictory development of China's futures market. These characteristics are discussed in the following section.

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<sup>148</sup> See Macartney, *supra* note 147.

<sup>149</sup> See generally Lawrence C. Wolken, *The Restructuring of China's Banking System Under the Economic Reforms 1979-1989*, *Colum. J. of World Bus.*, Spring-Summer 1990, at 55-58 (discussing role of PBOC).

<sup>150</sup> See Ma, *supra* note 129.

<sup>151</sup> See *id.*

<sup>152</sup> See Zhengzhou Commodities Exchange Accepted by IOMA, Xinhua News Agency, Sept. 2, 1995, available in LEXIS, ASIAPC Library, XINHUA File.

<sup>153</sup> See *id.*

<sup>154</sup> See generally *infra* notes 305-06 and accompanying text (discussing Chinese cooperation with Singapore and Hong Kong exchanges).

## II

DISTINGUISHING CHINESE TRAITS IN THE  
FUTURES MARKET

The improvident use of derivatives instruments has severely affected numerous business and governmental enterprises globally. While many sweeping patterns can be identified as common to all derivatives debacles,<sup>155</sup> the focus here will be on those traits of the market that might be considered distinctly Chinese.<sup>156</sup>

Initially, one must recognize the sheer size of the Chinese economy and its population as distinguishing factors. Moreover, the methodical transition<sup>157</sup> from China's traditional, socialist economy toward a market-oriented one is nearly without precedent as to its scale and its ambition. Several other related elements should be considered to put the Chinese futures experiment into context: The relatively new Chinese market economy and its implications for speculating investors, the centrality of SOEs as economic actors, the uniquely Chinese social values typified by the Iron Rice Bowl metaphor, and the differences in Chinese law dealing with agency all distinguish China from other emerging market economies. These elements are considered separately below.

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<sup>155</sup> While analysis of these overarching patterns might be helpful in demonstrating the inherent instability of derivatives markets, it falls outside the scope of this Note. For discussion regarding the pathology of the derivatives market generally, see, e.g., Jerry W. Markham, *Guarding the Kraal—On the Trail of the Rogue Trader*, 21 J. Corp. L. 131, 135-39 (1995); see also Ibison, *supra* note 125, at 8 (compendium of "rogue actions" by employees of Barings, Daiwa, Chemical Bank, Tokyo Securities, Coledeco Bank, Showa Shell Sekiyu KK, and others).

<sup>156</sup> There is a preoccupation of Chinese leaders to differentiate the path that China has taken in its historical and economic development. Yet, the Chinese government has also been mindful of foreign experience and has historically attempted to "make foreign things serve China." In fact, this phrase "goes back to the late Qing (Ch'ing) dynasty (1616-1911) and has since proved to be an indispensable part of the Chinese cultural heritage." Wei, *supra* note 138, at 2.

<sup>157</sup> To facilitate its market transition, the Chinese government has sought to change SOEs and their decisionmaking processes quickly yet cautiously through "experimentation" and "pilot projects." *Deepen Reform of Enterprises and Do a Good Job of Establishing a Modern Enterprise System at Selected Units on a Trial Basis—Wang Zhongyu*, Minister in Charge of State Economics and Trade Commission, Xinhua, translated in Wang Zhongyu on Enterprise Reform, F.B.I.S., Jan. 3, 1995, at 43, 48 [hereinafter *Enterprise Reform*] (interview by Xinhua and Renmin Ribao reporters). Selected SOEs participate in experiments of management and operational autonomy that are designed to give Beijing "theoretical guidance" for deciding which of those market reforms are suitable for later "popularization." *Id.*

*A. Digging Channels: China's New Role in the Market Economy*

The Chinese use two recurring metaphors to describe their position as a new player in futures markets. One Chinese economist likened the State Council's penchant for "pilot projects" and experimental approaches toward the development of the futures market as "dig[ging] a 'canal' first and then divert[ing] water into it, instead of letting it overflow."<sup>158</sup> The president of one of China's largest futures trading companies compared the Chinese futures industry to a "sampan," as compared to the "gigantic ship" of the developed countries, and remarked, "How can the gigantic ship be allowed to sail in China when the country has yet to dig the channel?"<sup>159</sup> These analogies help to illustrate how the Chinese government has charted its economic course by consciously constructing a market structure rather than by waiting for one to evolve.<sup>160</sup> This policy is both deliberate and cautious, with the grand design of controlling the flow of positive market effects while keeping out negative effects. China will not allow the disruptions of either speculating domestic or foreign investors in the Chinese futures market until it has finished constructing its safe harbor.<sup>161</sup>

Having only recently made the difficult transition from a planned economy, China is also a relatively new participant in the international market economy. This difficult transition was alluded to by China's General Secretary Jiang Zemin:

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<sup>158</sup> Li & Ni, *supra* note 9, at 54.

<sup>159</sup> Futures Market in Pre-Int'l Stage, Beijing Rev., Feb. 21-27, 1994, at 5, 5 [hereinafter Pre-Int'l Stage].

<sup>160</sup> See Chen Yangting et al., On Price to Be Paid for Establishing Socialist Market Economy, Qiu Shi, Dec. 1, 1994, translated in F.B.I.S., China Rep., Jan. 11, 1995, at 42, 42 (observing that "China cannot follow a spontaneous road in establishing its market economy" but instead must implement "conscious process").

<sup>161</sup> Several hurdles remain to be cleared before foreign participants can readily enter China's futures market. Due to currency convertibility problems and other operational concerns, the Chinese futures market may not yet be developed enough to allow foreign trading in its exchanges. The range of commodities available for futures trading must also be expanded before Chinese futures markets can be opened to foreign investors. See Pre-Int'l Stage, *supra* note 159, at 5. Another factor that (at least in the short term) may hinder foreign efforts to enter the domestic futures market is Chinese mistrust of foreign investors, especially in the futures market context. The overseas derivatives disputes between Chinese entities and foreign investment banks also demonstrate that such mistrust extends to perceived foreign efforts to lure inexperienced Chinese traders toward exotic and inherently more volatile financial products. See, e.g., *supra* note 81 and accompanying text (describing Chinese fear of improper marketing of derivatives products). Finally, China may not welcome foreign investors into their domestic futures market until regulatory measures and market structures have matured and are able to withstand the rush of foreign investment anticipated once China truly opens the door to international markets. See Pre-Int'l Stage, *supra* note 159, at 5.

Establishing the market economic structure is an unprecedented pioneering undertaking in China. The Western world has spent 300 years but we have just started and what we are establishing is a socialist market economic structure, which is even more difficult. . . . The relationship between reform, development, and stability must be correctly handled.<sup>162</sup>

The most conspicuous aspect of China's recent entrance into the market economy and futures market is that the Chinese economy appears to have skipped the typical evolutionary pattern of other countries in developing complex market systems. According to the Deputy Director of Policy Research at the PBOC, most countries follow typical stages of economic evolution: first, financial spot markets are developed; second, spot capital markets and money markets emerge; and finally, a financial futures market evolves.<sup>163</sup> The Chinese have started at this end point.

One consequence of this relative market immaturity has been the quixotic boom and ban cycle of the futures market. Without a developed spot market (and products that can absorb capital), futures prices in China are not necessarily dependable as future predictions of product supply and demand. Rather, futures prices are likely to reflect artificial demand for speculative purposes only. In a developed market, the futures price and spot price work together to provide price signals for future supply of product and its demand.<sup>164</sup> Therefore, that the futures market—with its natural starts and stops—is not allowed to evolve naturally within prudently devised regulations may in fact doom China's goal of "correctly" handling its futures market.

### B. *The You Zhi Phenomenon*

The transition from a planned economy to a market-oriented economy has also unleashed an expansive wave of investor speculation known as *you zhi* or "hot money."<sup>165</sup> Under the planned economy, there were few conduits for investments for the savings-conscious populace. With the market transition, the confluence of new investment opportunities, due to the opening of futures and securities exchanges, the liberation of SOEs to participate in these mar-

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<sup>162</sup> Jen Hui-wen, Jiang Zemin Appraises China's Economic Situation, *Hsin Pao*, Dec. 2, 1994, at 35, translated in Columnist on Jiang Zemin's Economic Appraisal, F.B.I.S., China Rep., Dec. 6, 1994, at 27, 27.

<sup>163</sup> See Financial Futures Not Yet in China Says Researcher, Xinhua News Agency, July 17, 1995, available in LEXIS, ASIAPC Library, XINHUA File.

<sup>164</sup> See infra note 258 (discussing pricing function of futures market).

<sup>165</sup> See Anne F. Thurston, A Society at the Crossroads, *China Bus. Rev.*, May-June 1994, at 16, 16 ("China is pulsing with a new refrain: 'I don't want power or rights. I just want money.' Everyone, it seems, is out to strike it rich.").

kets, and the newly realized wealth of entrepreneurs, an outpouring of speculative money is being wagered in the futures marketplace.<sup>166</sup> The Chinese Academy of Social Sciences estimates that there is somewhere between 150 and 400 billion yuan in hot money being held by SOEs, local and government banks, and cash-rich investors.<sup>167</sup> The effect of this repository of *you zhi* has been excessive market speculation, which in turn is thought to have been a major cause of rising commodity prices.<sup>168</sup> These rising prices have been blamed for increasing inflationary pressure on the Chinese economy.<sup>169</sup> Understandably, Chinese authorities are concerned that its economic modernization is being "partially undermined by speculative chaos in its fledgling securities markets."<sup>170</sup>

### C. State-Owned Enterprises

Though the Chinese have begun the shift toward a market economy, many prominent vestiges of its state-run economy still remain.<sup>171</sup> In China, SOEs are the dominant economic actors and are considered the "main channel" for funneling the country's economic growth.<sup>172</sup> SOEs are firms that operate in nearly every aspect of China's economy including finance, trading, industrial production, and agriculture. The central government continues to rely on SOEs to perform many macroeconomic functions including pricing functions. Because state-imposed prices are being canceled as part of market-oriented reform,<sup>173</sup> SOEs are using the futures market to safeguard the value of their products and to provide a role in distributing and circulating

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<sup>166</sup> Some SOEs divert money from loans that should be used to improve market share and capital expenditures and instead speculate in the futures market in hopes of earning high returns. See Jenkins, *supra* note 15, at A17.

<sup>167</sup> See Murray, *supra* note 61.

<sup>168</sup> See Myers Testimony, *supra* note 98.

<sup>169</sup> See *id.* (perceiving rising prices as inflationary). This view, however, is misguided in developed futures markets as futures prices merely reflect cash prices and do not themselves cause rising prices.

<sup>170</sup> Murray, *supra* note 61.

<sup>171</sup> It is universally recognized that SOEs are the backbone of the Chinese economy. In his report to the Second Session of the Eighth National People's Congress in March 1994, Premier Li Peng called large and medium SOEs the "pillars of the economy." Li Peng, Report on the Work of the Government, reprinted in *Beijing Rev.*, Dec. 6, 1994-Jan. 7, 1995, at i, ix.

<sup>172</sup> Pan Gan & He Jingsong, Zhang Haoruo Stresses the Need to Strengthen Macroeconomic Regulation and Control Over Important Commodities and Promote a Stable Circulation Order at the National Conference on the Circulation of Commodities, *Xinhua*, Dec. 27, 1994, translated in *F.B.I.S., China Rep.*, Jan. 5, 1995, at 43, 43 (arguing that SOEs function as "main channel" in circulation and pricing); see also Chen et al., *supra* note 160, at 45 (noting that SOEs are "lifeblood of the national economy").

<sup>173</sup> See *infra* note 256 (discussing elimination of central price controls).

those products.<sup>174</sup> In addition to sheer economic output, the Chinese government relies upon SOEs for several very critical social services. For example, the enterprise employing "units" provides housing, day care, clinics, and dining halls for their workers.<sup>175</sup>

Though technically SOEs remain the property of the people and therefore of the state, under China's new Company Law of 1994 SOEs are given a wide range of economic and property rights.<sup>176</sup> Because the primary economic actors in the Chinese economy are not purely self-interested private corporations, analysis of the Chinese futures market must include the critical features of the SOEs and their ongoing reformation.

#### D. *Iron Rice Bowl and Chinese Social Ethics*

The core essence of Mao's vision for the relationship between the state and its citizens is best contained within a metaphor. The Iron Rice Bowl (*tie fanwan*) represents the state's social network, which has for the past forty years guaranteed education, food, housing, medicine, and a stipend in old age to workers employed by SOEs.<sup>177</sup> The Iron Rice Bowl is also a metaphor for the deep-seated belief that citizens and SOEs share regarding the state's ultimate responsibility for each citizen's or company's well-being, irrespective of actual work performance. This belief is visible in a variety of contexts.<sup>178</sup> But necessarily, the *tie fanwan* concept has weakened as China moves toward a market-driven economy. The remaining remnants of the Iron Rice Bowl indicate the persistently high value that the Chinese government continues to place on social order.<sup>179</sup>

Finally, there is a very strong ethical standard as to the conduct of citizens in the economic sphere.<sup>180</sup> Chinese culture is rooted in duties

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<sup>174</sup> See Pre-Int'l Stage, *supra* note 159, at 6; see also discussion *infra* Part III.C.2.

<sup>175</sup> See Anne Stevenson-Yang, Re-Vamping the Welfare State, *China Bus. Rev.*, Jan.-Feb. 1996, at 8, 8; see also *id.* ("Work units were required to provide jobs to a quota of newcomers each year, mediate personal disputes, organize political education, and carry out other social responsibilities.").

<sup>176</sup> The corporatization of SOEs is discussed *infra* Part III.A.

<sup>177</sup> See China's Economic Reforms, *supra* note 60, at 287 (defining "Iron Rice Bowl").

<sup>178</sup> See, e.g., *infra* notes 206-07 and accompanying text (noting reluctance of firms to accept responsibility for losses).

<sup>179</sup> The state fears the resulting social dislocation if SOEs are allowed to go bankrupt. See *infra* Part IV.A.2.

<sup>180</sup> Chinese citizens are asked to subordinate their own economic interests and encouraged by the Communist Party to "unify" toward improving the quality of the country's economic welfare. See, e.g., Li Anding, Weekend Economic Commentary: Quality and Efficiency—The Two Wheels of Favorable Economic Growth, *Xinhua*, Jan. 6, 1995, translated in F.B.I.S., *China Rep.*, Jan. 13, 1995, at 29, 29 ("We should unify our thoughts, really stress quality and efficiency in economic growth in our economic work, and focus on these very important and urgent tasks.").

owed by citizens both to each other and the state. Citizens are expected to mold their conduct to the betterment of the state. Even in the SOE reform process, the Chinese government has called upon its citizenry as "masters of their own house[s]" to contribute advice and suggestions to reverse SOE budget deficits.<sup>181</sup> These ethical considerations are highlighted in the Chinese Constitution, which makes it the duty of citizens to "keep state secrets, protect public property and observe labour discipline and public order and respect social ethics."<sup>182</sup> The Constitution also forbids the "[d]isturbance of the orderly functioning of the social economy or disruption of the state economic plan by any organization or individual."<sup>183</sup> These ethical duties are particularly evident in the manner in which the state characterizes its punishment of those individuals and investors who act contrary to state economic initiatives.<sup>184</sup>

### *E. Chinese Law*

Questions about Chinese law, especially in the area of agency, will impact potential derivatives disputes between Chinese entities and foreign counterparts.<sup>185</sup> As is the case of typical derivatives disputes, placing blame on the rogue traders who participated in the ill-fated trades does not appear to answer the question of how these unauthorized trades came about in the first instance. One commentator observed wryly: "[I]t seems that people are authorized to take a profit, but no one is authorized when it comes to take a loss."<sup>186</sup> Perhaps the more probative inquiry asks "whether any profits were paid

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<sup>181</sup> Wang Zhongyu, *Exerting a Real Effort at Turning Deficits into Profits*, Qiye Guanli, Oct. 1, 1994, at 5-7, translated in Economic Trade Commission Chief on Enterprise Losses, F.B.I.S., China Rep., Jan. 9, 1995, at 41, 44.

<sup>182</sup> Xianfa, art. 53 (1982).

<sup>183</sup> Id. art. 15.

<sup>184</sup> The Company Law stipulates that "those who break the law should be held legal responsibility [sic] for the sake of upholding the social economic order." Wu Naitao, *Corporation Law: Guarantee for Modern Enterprise System*, Beijing Rev., Apr. 4-10, 1994, at 14, 15 (providing overview of Company Law). With regard to the state's grain procurement policy, those grain dealers who "hoard grain for speculation, dominate the grain market, or drive up grain prices" are subject to serious punishment. Grain Work, *supra* note 42, at 50.

<sup>185</sup> As the head of a commodities dealing branch in the United States observed: "China is one big black box . . . Who has the authority? Who can you rely on for guarantees? What do you ever really know?" Sender, *supra* note 78, at 78.

<sup>186</sup> Webb, *supra* note 87, at 12 (quoting Joseph A. Grundfest, Professor of Law, Stanford University).

(to the company)' before it ran up a loss."<sup>187</sup> If applied, this inquiry might more accurately answer issues of authorization and ratification.

Agency law, therefore, figures prominently in derivatives disputes.<sup>188</sup> In general, principals are liable for trades executed on their behalf by their agents (traders).<sup>189</sup> Under both common law and Chinese civil law, however, a trader theoretically bears responsibility for any trades that are not ratified by the principal, or where the trader fails to perform his duties and causes the principal to lose money.<sup>190</sup> The question is then one of ratification. Did the principal authorize the trade either expressly or after the fact? This question is especially interesting in instances where previous profitable transactions have been implicitly approved through the company's acceptance of profits.<sup>191</sup> Under common law, the principal is liable for the actions of an agent when the principal has led others to believe that the agent is acting with the principal's authority. This applies even in cases where the principal has not in fact authorized or ratified the agent's actions.<sup>192</sup> Interestingly, though China has incorporated many common law concepts of contract into its Civil Code, apparent authority does

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<sup>187</sup> *Id.* Lehman alleged that Minmetals in fact earned a \$28 million profit the previous year on similar derivatives trading, yet did not raise any concerns about the appropriateness of its agent's trading. See Sender, *supra* note 78, at 78.

<sup>188</sup> See, e.g., *Cunningham v. Waters Tan & Co.*, 65 F.3d 1351 (7th Cir. 1995) (regarding client ratification of broker's unauthorized futures trading); *Drexel Burnham Lambert, Inc. v. CFTC*, 850 F.2d 742 (D.C. Cir. 1988) (same); *Dohmen-Ramirez v. CFTC*, 837 F.2d 847 (9th Cir. 1988) (same); *Cange v. Stotler & Co.*, 826 F.2d 581 (7th Cir. 1987) (addressing inherent authority issues and unauthorized futures trading); *Master Commodities, Inc. v. Texas Cattle Management Co.*, 586 F.2d 1352 (10th Cir. 1978) (discussing apparent authority and unauthorized futures trading).

<sup>189</sup> Compare Restatement (Second) of Agency § 140 cmt. a (1958) ("[A] principal is subject to liability upon a transaction conducted by his agent, whom he has authorized or apparently authorized to conduct it in the way in which it is conducted, as if he had personally entered into the transaction."), with General Principles of Civil Law of the People's Republic of China, art. 63, reprinted and translated in [3 Bus. Reg.] *China Laws for Foreign Bus.* (CCH) ¶ 19-150 (Apr. 12, 1986) [hereinafter *Civil Code*] ("The principal shall assume civil liability for the representing acts of the agent."). For a brief analysis of the principal-agency conflicts related to the trading of derivatives, see Hu, *supra* note 24, at 1492-95.

<sup>190</sup> See *Civil Code*, *supra* note 189, art. 66.

<sup>191</sup> A principal is liable for the unauthorized actions of his agent if, subsequent to the actions in question, the principal becomes aware of and approves of these actions. Compare Restatement (Second) of Agency § 143 (1958) (stating that, upon ratification, principal becomes responsible for action of agent "as if the transaction had been authorized"), with *Civil Code*, *supra* note 189, art. 66 (stating that civil liability is assumed by principal "following ratification").

<sup>192</sup> See Restatement (Second) of Agency § 159 cmt. a (1958) ("Apparent authority . . . is the power of an apparent agent to affect the legal relations of an apparent principal with respect to a third person by acts done in accordance with such principal's manifestations to such third person that such agent shall act as his agent.").



not appear to be one of them.<sup>193</sup> Thus, where Chinese law controls, differences in the law of agency should be considered.

Having discussed areas where China's futures market experience may differ from other markets, the next Part discusses the contradictory regulatory positions that China has taken. But before isolating these various contradictions that underlie and work against the development of the Chinese futures market, the paradoxical role that SOEs play in that development ought to be understood.<sup>194</sup>

### III

#### SMASHING THE IRON RICE BOWL: CONTRADICTIONS OF THE CHINESE FUTURES MARKET

The wide-scale reform in SOEs brought on by the Company Law of July 1994 (and by the march of reforms preceding that law) contains the strongest ingredients for the successful evolution of the futures market. However, these precise features of liberalized decisionmaking and the encouragement of the profit motive have themselves caused market instability inimical to the stable development envisioned by the Chinese leadership.<sup>195</sup> Even as the central government is abandoning the notion of the Iron Rice Bowl, many sectors of the Chinese economy that have welcomed the recent market orientation still have not completely turned away from their dependence on the communal pot. This paradox bears closer scrutiny.

##### *A. State Enterprise Reform*

The central government has pursued SOE reform as the linchpin to serving the greater macroeconomic aims of controlling inflation and

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<sup>193</sup> See Civil Code, *supra* note 189, art. 66 ("Civil liability for acts performed without agency, beyond the scope of agency or after termination of agency rights shall *only* be assumed by the principal following ratification by the principal." (emphasis added)); see also Gary J. Dernelle, Note, Direct Foreign Investment and Contractual Relations in the People's Republic of China, 6 DePaul Bus. L.J. 331, 344-45 (1994) ("[I]t does not appear that the common law notion of apparent authority exists under the Civil Code.").

<sup>194</sup> The effects of this contradiction are not limited to the Chinese in the futures marketplace. Foreign investment entities that have engaged in transactional relationships with Chinese SOEs and investors are also caught on the horns of a dilemma. Many companies share Lehman Brothers's frustration with the Chinese about alleged financial irresponsibility and fear future defaults by Chinese entities, but may also fear being shut out of the growing market if they complain. See Sender, *supra* note 78, at 78 ("For the Chinese, [Lehman's] lawsuits are a rather novel experience. Few aggrieved foreign firms, eager as they are to keep a foot in the China market, have dared go public with default problems, let alone play hardball to recover damages.").

<sup>195</sup> See Jen, *supra* note 22, at 27 ("State-owned enterprise reform is the crux of economic structural reform but state-owned enterprise reform is a big problem, which needs everyone to offer advice and requires us to introduce the advanced management experiences of state-owned enterprises in different countries.").

increasing economic efficiency.<sup>196</sup> Many Chinese economists fear that without SOE reform, previously implemented macroeconomic reform measures will fall short of the mark (and could even be reversed). Such a failure, it is feared, would "affect progress on establishing the entire market economy system."<sup>197</sup> The development of a market economy in China hinges on the success of reforming these SOEs to behave like market actors.

### *1. The SOE Is Dead; Long Live the SOE*

The imperative of SOE reform is easily stated. The Company Law sounded the death knell of the old SOE system with its call for the creation of the modern enterprise. The old SOE system was inefficient and was considered unable to adapt to market mechanisms because of its dependence on central government capital infusions.<sup>198</sup> A difficult question remains as to how the government should assist the newly reformed SOE through its growing pains. Herein lies the first paradox: the SOEs are the "main pillars" of the economy and the key factor to controlling inflation, but the government, which has been pursuing an inflation-fighting scheme by tightening credit, must print more yuan to "inject blood into anaemic enterprises."<sup>199</sup> Ironically, China, which has pinned its hopes on SOEs to combat inflationary pressures (through pricing), has in fact precipitated inflationary effects by printing more money to save these SOEs. Moreover, by saving moribund SOEs from bankruptcy (whether to mitigate the social disruption of unemployment or to help the SOE save itself), China may be interfering with those natural market forces it would prefer to cultivate in its bid for economic efficiency. Consequently, the more China attempts to remake its debt-ridden SOEs, the more the modernized SOEs begin to take on their previously inefficient and market-adverse characteristics.

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<sup>196</sup> In a 1994 symposium on SOE reform in China, delegates uniformly believed that the reform of SOEs was a "crucial point for conversion of the entire economic system" and urged the acceleration of that reform. Wu Ming, Summary of International Symposium on China's State Enterprise Reform, Jingji Ribao, Nov. 18, 1994, translated in International Symposium Discusses Enterprise Reform, F.B.I.S., China Rep., Jan. 4, 1995, at 37, 37. The macroeconomic goals of the Chinese are discussed in further detail later in this Part. See *infra* Part III.C.

<sup>197</sup> Wu, *supra* note 196, at 37.

<sup>198</sup> The State Statistics Bureau estimated that 40% of the SOEs were in the red during 1994, while the total financial burden imposed by the SOEs on the state budget increased by 27.6% that same year. See Sherman Chen, Statistics on "Snowballing" Debt Among State Firms, HongKong Standard, Jan. 3, 1995, at 7, transcribed in F.B.I.S., China Rep., Jan. 4, 1995, at 39, 40.

<sup>199</sup> *Id.*

## 2. *Act Like Bosses, Not Mothers-In-Law*

The Chinese solution to this paradox has been to let market forces make SOEs more efficient. This revolutionary reform of Chinese SOEs has garnered widespread commentary both in China<sup>200</sup> and in the United States.<sup>201</sup> Hence, the discussion here will focus only on the broadest themes of enterprise reform. The fundamental aspect of these reforms is the development of property rights within the SOE system. Until the 1994 Law, the scope of property rights, and therefore the autonomy of SOEs, was ambiguous.<sup>202</sup> Since the advent of property rights,<sup>203</sup> however, SOE managers no longer have to look to the central government for all production goals and for approval to improve the balance sheet of the enterprise.<sup>204</sup> This increased autonomy of SOE managers in making investment and planning decisions was intended to correct the long-standing management malaise that

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<sup>200</sup> See, e.g., Jiang Zemin Calls for Further Reform of State Enterprises, Xinhua, July 3, 1996, transcribed in F.B.I.S., July 8, 1996, at 50, 50-51 (stating views of Chinese President and Party head on SOE reform); Major Measures in Accelerating and Pushing Forward the Work of Building the New Structure, Liaowang, Feb. 7, 1994, at 24, 24-25, translated in Journal Interviews Economist on Future Reforms, F.B.I.S., China Rep., Mar. 8, 1994, at 50, 50-53 (interview by Zhou Yuanhong with economist Fan Hengshan) (discussing SOE reform); Zhang Youcai, Reducing Losses and Increasing Profits Is a Major Issue in the Current Economic Work, Jingji Ribao, Aug. 15, 1994, translated in Vice Finance Minister on Losses, Profits, F.B.I.S., China Rep., Oct. 4, 1994, at 52, 52-55 (stating views of Vice Minister of Finance on SOE reform).

<sup>201</sup> See, e.g., Fang Liufang, China's Corporatization Experiment, 5 Duke J. Comp. & Int'l L. 149 (1995) (analyzing legal framework established by China to accommodate SOE corporatization and noting ways that this framework stifles innovative reform); Andrew Xuefeng Qian, Riding Two Horses: Corporatizing Enterprises and the Emerging Securities Regulatory Regime in China, 12 UCLA Pac. Basin L.J. 62 (1993) (examining SOE reforms and evolving securities regulation); Deborah K. Johns, Note, Reforming the State-Enterprise Property Relationship in the People's Republic of China: The Corporatization of State-Owned Enterprises, 16 Mich. J. Int'l L. 911 (1995) (noting role of corporatization on reforming SOEs but arguing that Chinese culture of state intervention inhibits further progress).

<sup>202</sup> See Modern Enterprise System Investigation and Study Group, Establish a Modern Enterprise System That Is in Keeping with the Socialist Market Economic Structure, Renmin Ribao, Dec. 21, 1993, translated in Article on Creating Modern Enterprise System, F.B.I.S., China Rep., Jan. 19, 1994, at 52, 53 [hereinafter Enterprise Study Group] ("Under the traditional planned economic structure, state-owned enterprises, as the subsidiaries of state administrative organizations, did not have the status of independent legal persons.").

<sup>203</sup> There are, however, limits to these property rights in SOEs. See Zhang Jinsheng, Xinhua, Nov. 15, 1994, translated in Rules for State-Owned Enterprises Formulated, F.B.I.S., China Rep., Nov. 29, 1994, at 51, 51 (noting that State Administration of State Property has formulated procedures for SOE exercise of property rights).

<sup>204</sup> See Enterprise Study Group, *supra* note 202, at 53 (noting that SOEs are now expected to "operate independently and assume sole responsibility for profits and losses").

paralyzed decisionmaking.<sup>205</sup> As the Vice State Economic and Trade Commission Minister observed, “[o]nce [enterprise managers] become ‘bosses,’ they can no longer act as a ‘mother-in-law’. We should . . . regulate their conduct, and establish an asset management responsibility system, so that they will be responsible for the guaranteed and increased value of state assets.”<sup>206</sup> Accompanying this autonomy is the responsibility of the manager to pursue profits and take responsibility for losses.<sup>207</sup> When vested with responsibility, an SOE manager will be less likely to act in the archaic stereotype attributed by the Chinese to mothers-in-law who feel entitled to complain often, yet constrain themselves from acting.<sup>208</sup>

### 3. *Remnants of the Rice Bowl*

SOE reform has had a revolutionary impact on the evolving domestic futures market and influenced Chinese futures investment abroad. For the first time, SOEs are responsible for the profits and losses of their enterprises. Consequently, SOE managers seeking to improve their bottom lines viewed the futures market not only as a means of locking in gains (by hedging) but as an independent means of profit taking. SOEs charged with augmenting state strategic reserves by engaging in derivatives agreements also began making large speculative forays into the international futures market.<sup>209</sup> One result of this speculation has been market instability. When speculation and misplaced derivatives bets resulted in massive losses, the new

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<sup>205</sup> Yet much of this poor management still exists. See Zhang, *supra* note 200, at 53 (noting that Vice Minister of Finance Zhang Youcai observed that “[a]t present, some enterprises are failing to make full use of their newly acquired decision-making power. They do not devote great efforts to tap their potentials. Instead, they still wholeheartedly expect to get more preferential treatment from the higher authorities.”).

<sup>206</sup> *Arduous Task of Enterprise Reform, 10 Measures to Be Launched*, Xinhua, Dec. 30, 1994, translated in *Trade Official on 1995 Enterprise Reform*, F.B.I.S., China Rep., Jan. 13, 1995, at 27, 28 (interview by Mo Xinyuan & Li Anding with Chen Qingtai, Vice State Economic and Trade Commission Minister); see also Ma, *supra* note 129 (noting remarks of Beijing Commodity Exchange head who lamented: “A lot of market players recognise only profits but not losses. They always complain in different ways and hope the government will intervene (to write off the loss) . . .”); *Economic Efficiency*, *supra* note 112, at 46 (“[I]t is still difficult basically to halt the phenomena of ‘assuming responsibility for profits only but not for losses,’ of losing state-owned assets, and of shifting the economic efficiency of enterprises in other directions.”).

<sup>207</sup> See, e.g., Zhang, *supra* note 200, at 53 (arguing that SOEs must take responsibility for profits and losses).

<sup>208</sup> The Chinese government also hoped that the economic reforms would “persuade individuals to shoulder some of the costs of their own upkeep, and release the urban proletariat from its iron bonds to the original employer [SOE].” Stevenson-Yang, *supra* note 175, at 9.

<sup>209</sup> See *Hot Money*, *supra* note 101 (reporting that retail investors and Chinese companies “have reserved huge amounts of working capital to speculate in futures”).

entrepreneurial spirit retreated to historic reliance on the state. This rampant speculation thus contributed significantly to the Chinese government's retrenchment policies that precipitated a wide-scale suspension of futures trading in key commodities and the closure of many regional exchanges.

### *B. Paradoxical Impact of Futures Crackdown*

A developed futures market is an important Chinese economic goal. Yet as Chinese regulatory agencies and the State Council continue to tighten their control of the futures industry, several unexpected consequences of these actions surface. These results frustrate the original aim of a futures market, namely, to provide market direction to the SOEs, China's main economic actors. Several of the more prominent contradictions arising from China's futures regulation are discussed below.

#### *1. The Contradiction of Centralization: Too Many Uncles, No Father*

Beijing's crackdown and closure of many local exchanges was clearly a movement to restore stability to a decentralized and chaotic atmosphere where conflicting interests in local exchange rules frequently gave rise to market corruption and overheated speculation. The morass of local rules coupled with the lack of a central regulatory framework prompted some commentators to describe the Chinese futures market as having "too many uncles but no father."<sup>210</sup> The analogy predicts that without a central authority figure to lay down the law, the nascent futures market will be unevenly disciplined by a multitude of disinterested or doting uncles. Yet a complete centralization of the futures market represents tough love that may alienate the child. At a minimum, this retrenchment will impede development of the Chinese futures market in several ways.

First, without a diversity of exchanges throughout the country, the exchanges cannot service the state aim of regulating market supply and price control.<sup>211</sup> There is a marked difference between achieving centralized control of local exchanges through limiting their numbers and achieving the same control by implementing centralized standards that all local exchanges must meet before conducting futures trading. By electing to control the total number of local exchanges, Beijing has chosen a misguided path inimical to the long-term development of its futures market. Local exchanges should be

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<sup>210</sup> Jiang, *supra* note 12, at 60.

<sup>211</sup> See *infra* notes 254-76 and accompanying text.

allowed to form where economic conditions warrant, so long as the exchanges abide by uniform minimum standards set by the central government. Local exchanges should be viewed as necessary veins in a greater circulatory system, carrying essential pricing information to the outer extremities. Without an optimal distribution of local exchanges, product supply and demand are not truly being gauged on a national or comprehensive scale.<sup>212</sup> Second, further consolidation of the exchanges might detrimentally affect the circulation of products in the futures market because not all commodities would be available to most localities.<sup>213</sup> Third, there is a rising conflict between central governance's goal of "standardization" and the interest in freeing local provincial and municipal governments to regulate the exchanges and members within their respective locales.<sup>214</sup> Though fair criticism has been leveled against the unevenness of local exchange controls,<sup>215</sup> more local control may be needed to truly check excessive speculation because local regulation may be more responsive and adaptive to local trading intricacies than centralized oversight.<sup>216</sup> Moreover, by encouraging decentralized control, regulatory competition will develop among the local exchanges within the standardized parameters set centrally by Beijing.<sup>217</sup> Through this regulatory competition, local regulators will develop more innovative institutions to attract capital

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<sup>212</sup> Due to insufficient data, a fundamental benefit of the futures market as an accurate indicator of future supply and demand would be neutralized. Cf. David S.G. Goodman, *The Politics of Regionalism: Economic Development, Conflict and Negotiation in China Deconstructs: Politics, Trade and Regionalism* 5-14 (David S.G. Goodman & Gerald Segal eds., 1994) (discussing importance of decentralization of economic management in movement toward market economy).

<sup>213</sup> Such a consequence would conflict with the state's aims of "deepen[ing] the reform of the circulation system" and "expanding and improving commodity markets." Li, *supra* note 171, at ix.

<sup>214</sup> Local exchanges (and their members) may resent the interference of government officials in their market, fearing that such intervention would translate into "local resentment" and "uncertainty among investors." Andrew Browne, *Shanghai Stock Exchange Chairman to Step Down*, *Reuter Asia-Pac. Bus. Rep.*, Aug. 19, 1995, available in LEXIS, ASIAPC Library, REUAPB File.

<sup>215</sup> See *supra* notes 103-08.

<sup>216</sup> Cf. *China Futures*, *supra* note 114 (reporting protests against Beijing's ban on trading in key commodities futures). There are signs that Beijing may be warming up to the idea of decentralizing exchange controls once more. See, e.g., *China Frees State-Controlled Metals Exchange*, *Reuter Asia-Pac. Bus. Rep.*, Sept. 1, 1995, available in LEXIS, ASIAPC Library, REUAPB File [hereinafter *SME*] (allowing Shanghai Metals Exchange to be administered by its members).

<sup>217</sup> Cf. Tian Guoqiang, *Reforming State Enterprises, Transforming the Economic System—Three Stages of Economic Reform*, *Jingji Yanjiu*, Nov. 20, 1994, at 3-9, translated in *Article Sees Three Gradual Stages of Economic Reform*, *F.B.I.S., China Rep.*, Jan. 13, 1995, at 45, 47 (noting decentralized policy making as reducing information costs and promoting incentives).

while serving as local regulatory experiments for possible standardization on a national scale if innovations are proven successful.

Sophisticated futures trading almost always involves the trade of important minerals and metals. Many of these commodities are necessary for China's strategic stockpile. Thus, even if exchange control is decentralized once more, the central government may have a particular incentive to avoid market fluctuations within the domestic market so it can retain unfettered access to vital commodities. The Chinese government may be especially reluctant to allow strategic materials and commodities to be left to the whim of the domestic marketplace where excessive speculation has distorted pricing. Thus, it may be tempted to hold tight reins on exchange rules governing the eligibility of traders as another means to preserve state purchasing goals.<sup>218</sup> Beijing also may succumb to the temptation of imposing price caps at the local exchanges on key commodities should futures trading in those markets resume. But this response would also completely undermine market pricing because it would substitute a market price with an administrative one.<sup>219</sup> While maintaining state control over the purchase of key commodities would not be philosophically inconsistent with the state's SOE reforms,<sup>220</sup> such a policy would undermine the success of the domestic futures market if trading in important commodities is halted altogether or if prices are not allowed to be set by natural market forces.<sup>221</sup>

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<sup>218</sup> In the domestic futures markets, the Chinese government retains tight control over the trading and supply of key commodities including wheat, rice, corn, and soybeans. See *Centralized Purchases*, *supra* note 47, at 46. While the government cannot exert the same influence in the international marketplace as it can in its home market, Beijing constricts its international purchases and reduces the chances of speculation by limiting trading on world markets to a select few SOEs. See *id.*

<sup>219</sup> Beijing resorted to this tactic in May 1994, when it announced a formula for determining the price at which a petroleum contract on the Shanghai Petroleum Exchange settled for instead of allowing the market to set the price. See *Sender*, *supra* note 116, at 80.

<sup>220</sup> Cf. *Enterprise Reform*, *supra* note 157, at 46 ("[T]he state can hold shares of enterprises in competitive trades; but must control the shares of key enterprises in the pillar and basic industries.").

<sup>221</sup> Perhaps the Chinese could follow the United States example of state intervention in the market to stabilize prices. In the area of domestic oil prices, the United States has at times sold barrels from its strategic stockpile to drive down the cost of gas. See, e.g., *Energy Dept. Sees Lower Prices at the Pump*, *N.Y. Times*, June 14, 1996, at D4 (describing Department of Energy's strategic oil sales to drive oil prices lower); see also Philip Gawith, *Federal Reserve Intervenes to Curb Dollar Decline*, *Fin. Times*, Apr. 4, 1995, at 40 (describing Federal Reserve Bank's intervention to curb fall of dollar). Within the market framework, China can still protect its legitimate interest in stabilizing prices of key commodities that it perceives as necessary to ensure social stability.

## 2. *The Contradiction of Banning Key Commodities in Futures Trading*

The Chinese government has cracked down on excessive speculation in the domestic futures markets through ad hoc bans on trading commodities and financial instruments.<sup>222</sup> Yet banning markets where overheated speculation has taken place flatly contradicts Chinese futures market aims. First, because trading in so many key strategic commodities (coal, sugar, steel, petroleum products) is banned in hopes of decreasing market volatility, legitimate opportunities for hedging are severely reduced.<sup>223</sup> This happens because the remaining markets after futures trading in important commodities is banned are only secondary markets.<sup>224</sup> Moreover, there is even more opportunity for market manipulation in these secondary markets because the spot market is considerably smaller. Consequently, these smaller markets are susceptible to manipulation because one party can more readily corner the market.<sup>225</sup> The result is the exaggeration of artificial demand for the futures product as an end in and of itself and not for the underlying asset.<sup>226</sup> Major commodities, in contrast, are able to absorb more capital, making the market itself larger and less vulnerable to manipulation by individual parties.<sup>227</sup> While some speculation is a healthy function of any futures market, the expansive ban on commodities is counterproductive and self-defeating in light of Beijing's stance against speculation.

The second paradox of the extensive ban on important commodities has been its utter ineffectiveness in controlling speculation. The ban may have actually increased speculation because of the nature of the remaining products available for futures trading. When one commodity is banned, speculating investors often simply shuttle funds

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<sup>222</sup> See *supra* note 114 and accompanying text.

<sup>223</sup> The head of the Guandong United Futures Exchange noted that "China's futures market had been ineffective in performing its hedging functions because of the limited availability of products." *Fewer Futures*, *supra* note 17, at 5.

<sup>224</sup> In other words, there are not natural spot markets deep enough to support the legitimate trade of such products. See *China Futures*, *supra* note 114 (reporting official statements that spot market for secondary commodities was "thin"). In fact, the majority of commodities that are legally traded on China's futures exchanges are now arguably of "little interest" and have "become purely speculative." *China Futures Exchanges Urge Market-Driven Trade*, *Reuter Asia-Pac. Bus. Rep.*, Jan. 15, 1996, available in LEXIS, ASIAPC Library, REUAPB File [hereinafter *Futures Exchanges*].

<sup>225</sup> See *Futures Exchanges*, *supra* note 224.

<sup>226</sup> Artificial demand or speculative trading is not itself bad for the market because of its effect on increasing liquidity as long as the market is deep enough with bona fide purchasers who have an interest in the underlying product. See *infra* note 278 (discussing speculation and liquidity).

<sup>227</sup> See *Futures Exchanges*, *supra* note 224.



from one hot ticket commodity to another.<sup>228</sup> A broader liquid market is needed to absorb more capital without being displaced by speculation. This can only occur if Chinese regulators lift bans on key types of commodity futures and expand the variety available in the marketplace. To lift the bans, the Chinese must separate the legitimate aim of controlling market manipulation from the desire to shield the market from natural volatility. In so doing, the Chinese can achieve both the hedging use they envisioned for futures market trading and a decrease in market manipulation by permitting legitimate trading markets to bloom.

A third contradiction of the ban is its disproportionate enforcement effect. By banning trade in various markets, Beijing sought to punish speculators who were destabilizing the futures markets. The brunt of this punishment, however, has been shouldered by those SOEs and investors that were legitimately using these markets for hedging while speculators have simply moved their dealings underground.<sup>229</sup> Forced to liquidate their holdings in suspended markets, legitimate investors are being punished for precisely the conduct Beijing had encouraged when it opened its futures markets. Moreover, should these banned markets reopen, legitimate investors, having been stung once, may be reluctant to reenter the volatile futures markets absent iron-clad indications from the government that their investments will be protected from further ad hoc bans. Evolution of legal protections then is an integral part of generating investor confidence and facilitating the return of capital to the futures markets.

### 3. *The Contradiction of Information: Killing the Messenger*

State newspapers and commentators have consistently charged both the domestic and international press with releasing "misleading" statements about the futures markets that have led investors to seek

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<sup>228</sup> See, e.g., China Domestic Share Markets Surge on Futures Ban, Reuter Asia-Pac. Bus. Rep., Mar. 4, 1996, available in LEXIS, ASIAPC Library, REUAPB File (noting rapid increase in hot money to equities after futures ban); More China Efficiency Facilitates Hot Money Flows, Reuter Eur. Bus. Rep., Oct. 19, 1995, available in LEXIS, BUSFIN Library, REUEUB File [hereinafter China Efficiency] (discussing flow of hot money to rubber futures after ban on plywood futures).

<sup>229</sup> See William D. Grossman, Are There Futures in China's Future?, Asian Wall St. J., June 5, 1995, at 6 ("[L]egitimate firms abiding by the [overseas trading] suspension are suffering losses while underground firms are profiting."); Lincoln Kaye, System Failure: Exchange Closures, Cotton War, Highlight Deficiencies, Far E. Econ. Rev., Oct. 27, 1994, at 29 (describing developing black market); Myers Testimony, supra note 98 (same). Underground profiteering has also occurred in the domestic market. For instance, when edible oils were banned from futures trading, edible oil producers set up smuggling operations for both import and export. See Circular Issued on Measures Against Edible Oil Smuggling, Xinhua, May 19, 1996, transcribed in F.B.I.S., China Rep., May 22, 1996, at 50, 50.

"sudden wealth."<sup>230</sup> The Chinese government has also been highly critical of "distorted" foreign press accounts alleging that the "Chinese Government tends to break business contracts."<sup>231</sup> These suspicions may have prompted the State Council's recent decision to enact a measure tightening government control over the dissemination of financial and economic news in China.<sup>232</sup> Under the plan, all foreign news agencies are required to register with Xinhua (the official news source of the Chinese Communist Party), making it China's sole conduit for all foreign news and financial information.<sup>233</sup> This development will have a deleterious effect on both the domestic futures market and on Chinese SOEs' attempts to participate in the international futures market.<sup>234</sup> While the regulation does not ban certain uses of economic information supplied by foreign economic news, fears persist that Xinhua will now "hold up the flow of real-time information, making it impossible for mainland-based speculators to make the snap decisions necessary to take part in the global marketplace on an equal footing with their foreign counterparts."<sup>235</sup>

#### 4. *The Contradiction of Efficiency*

As China begins to standardize exchange operations and the trading systems become more efficient, another antinomy develops. While exchanges and brokerages work more closely with banking authorities to facilitate trades, brokerages can settle accounts more quickly after the positions are closed. This increase in efficiency has the effect of facilitating the flow of "hot money."<sup>236</sup> Yet one should not allow this short-term paradox to overshadow the necessity of encouraging systemic efficiency in the first instance.

The efficiency and rate of transactions on a futures market are key indicators of its effectiveness in risk dispersion and market circu-

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<sup>230</sup> Jiang, *supra* note 12, at 60.

<sup>231</sup> Xiao, *supra* note 85, at 43 ("So when things go sour, the [foreign] media tend to pull the Chinese Government into the equation.").

<sup>232</sup> See Jasper Becker et al., Xinhua's New Data Monitoring Power Threatens to Stifle Mainland Markets; Big Brother to Hinder the Flow of Finance News, *S. China Morning Post*, Jan. 18, 1996, available in LEXIS, ASIAPC Library, SCHINA File; Joseph Kahn et al., Chinese Firewall: Beijing Seeks to Build Version of the Internet That Can Be Censored, *Wall St. J.*, Jan. 31, 1996, at A1.

<sup>233</sup> See Becker et al., *supra* note 232.

<sup>234</sup> See generally Jiang, *supra* note 12, at 60 (noting importance of information in futures trading).

<sup>235</sup> Becker et al., *supra* note 232; see also Graham Earnshaw, China News Controls May Affect Financial Markets, *Reuters Fin. Serv.*, Jan. 17, 1996, available in LEXIS, ASIAPC Library, REUFIN File. As one foreign exchange dealer noted: "If [Xinhua] start to monitor all news then information will slow down . . . . Speed for us is money." *Id.*

<sup>236</sup> China Efficiency, *supra* note 228.

lation. Systemic efficiency in China's exchanges has increased the turnover (or switching rate) for contracts.<sup>237</sup> As repetition in contract turnover grows, so will strong market negotiability and the enhancement of risk dispersion in China's futures market because the increase of available futures contracts will allow futures contracts to be held among more investors.<sup>238</sup> Furthermore, end-users will have more opportunities to lock in to the desired futures price and offset that position quickly should needs change.<sup>239</sup> Therefore, despite its apparent facilitation of hot money flows, continuing improvement in the efficiency of futures trading will be a critical factor in realizing Chinese goals for the futures market and China's bid to open these markets to global participation.

Additionally, regulations severely restricting the ability of SOE managers to trade in derivatives instruments may prove to be imprudent.<sup>240</sup> If SOE managers are required to seek permission or authorization before engaging in futures trading for the purposes of hedging, allowing time for such approval and authorization may be inimical to a futures market system where prices rise and fall rapidly: "[T]he best opportunities [will] have quietly slipped away by the time [SOE managers] have requested instructions and reported in."<sup>241</sup> Thus, preventing SOE managers from making rapid investment decisions could backfire on the best intentions of Chinese regulators. Moreover, by further distancing SOE managers from constantly shifting market signals and information, Beijing once again has handicapped its SOE managers in a marketplace where economic success is achieved only by the swift.

### *C. The Paradox of Macroeconomic Goals and the Futures Market*

Though the derivatives industry is practically defined by its inherent risk and instability (and may even impede macroeconomic aims), there are several ways in which the use of derivatives can serve Chi-

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<sup>237</sup> See Jiang, *supra* note 12, at 62.

<sup>238</sup> See *id.* As futures contracts are held among more of these actors, there will be an increase in market liquidity and optimal risk dispersion.

<sup>239</sup> The futures market can provide protection from price volatility for both consumers and producers. Price volatility is a salient feature of the futures market that has both good and bad effects. Volatility is good for the market because it also encourages liquidity as individuals seek to offset their positions quickly and contracts are retraded more easily. But price volatility for consumers and producers (if caught on the "wrong side" of the volatility) is potentially devastating. For example, in cyclical industries such as farming, should the price of a particular crop plummet at harvest, the sheer price drop could spell bankruptcy for the farmer. Futures trading can secure prices against such volatility.

<sup>240</sup> See *supra* notes 132-33 and accompanying text.

<sup>241</sup> Jiang, *supra* note 12, at 60.

nese macroeconomic policy goals.<sup>242</sup> Historically, the chief economic concern for the Chinese state has always been inflation, due to its causative relationship to social order.<sup>243</sup> The Chinese view of inflationary impacts is well summarized by Wu Bangguo, a member of the CPC Central Committee Political Bureau and the Secretariat who recently observed: "Inflation will harm economic development, confuse economic relations, mislead resources disposal, twist the interest structure, and cause social instability."<sup>244</sup> Closely related to the goal of controlling inflation is the admittedly general aim of economic efficiency, including the Chinese leadership's goal that SOEs adopt market rationality in order to streamline their operations.<sup>245</sup> The reform of SOEs plays a large role in achieving both macroeconomic goals—curbing inflation and enhancing the quality and efficiency of economic growth.<sup>246</sup> Yet the development of the futures market is necessary to make SOEs efficient<sup>247</sup> and facilitate their vital role in price rationality and in controlling price volatility.<sup>248</sup> Moreover, the domestic futures market also creates a distinct market for SOEs to sell their products to other Chinese SOEs. A developed domestic futures market provides a neutral layer in transactions between SOEs. This additional market layer might help reduce the so-called "triangular debt" problem that occurs when SOEs purchase commodities and goods from each other without ever repaying.<sup>249</sup> By selling their products on

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<sup>242</sup> These macroeconomic policy goals are frequently discussed by Chinese leaders. See, e.g., Jen, *supra* note 22, at 27-28 (detailing Jiang Zemin's opinions on macroeconomic policy); Wu Shuzhi, *Change Government Functions and Develop a Market Economy Under Macroeconomic Regulation and Control*, Renmin Ribao, Dec. 11, 1994, at 5, translated in *Article on Macroregulation of Market Economy*, F.B.I.S., China Rep., Jan. 3, 1995, at 59, 59-61 (outlining Chinese macroeconomic policy goals).

<sup>243</sup> "Inflation connotes cataclysm to China's leaders in a way the Federal Reserve or the Bundesbank could never fathom. It was inflation that generated public support for the democracy movement that culminated in the Tian An Men tragedy in 1989." Bond Futures, *supra* note 116, at D3.

<sup>244</sup> Li Anding & Mo Xinyuan, *Wu Bangguo Discusses Enterprise Reform*, Xinhua, Dec. 20, 1994, translated in F.B.I.S., China Rep., Jan. 3, 1995, at 49, 50. Inflation in China has been a subject of foreign investor concern as well. See, e.g., Agatha Ngai, *Index Set for a Hesitant Climb Along Wall Street; Heavy Futures Activity Forecast*, S. China Morning Post, Nov. 28, 1994, available in LEXIS, ASIAPC Library, SCHINA File (noting that high inflation in China "weigh[s] on investors' minds").

<sup>245</sup> See, e.g., *Reversal of Enterprise Losses Demands Immediate Attention*, Qiye Guanli, Oct. 1, 1994, at 3, translated in *Enterprise Losses Cause "Conspicuous Problems"*, F.B.I.S., China Rep., Jan. 6, 1995, at 50, 51-52 (arguing that SOEs lack efficiency in operations).

<sup>246</sup> See Li & Mo, *supra* note 244, at 50 (discussing role of SOEs in stabilizing prices and controlling inflation).

<sup>247</sup> Making the SOEs efficient will help make them self-sufficient. This in turn will curb the necessity for capital infusions from the state treasury.

<sup>248</sup> See Pan & He, *supra* note 172, at 43-44.

<sup>249</sup> See Xiao, *supra* note 85, at 8 (describing "endemic" problem of "inter-firm debts").

the futures market, SOEs can collect on their receivables.<sup>250</sup> However, because the futures market has itself been the cause of some economic concern, this Note first examines the detrimental effects of derivatives trading and then turns to consideration of their potential for serving China's macroeconomic goals.

Speculation by investors and SOE managers has been blamed for the price fluctuation of certain commodities in the futures markets<sup>251</sup> and consequently in the food markets.<sup>252</sup> It is widely recognized that rising food prices are the principal contributor to inflation in the Chinese economy.<sup>253</sup> It cannot be disputed then that the development of the futures market is a key factor in the success of China's macroeconomic policy.<sup>254</sup> As the country moves toward a market economy, the SOEs will need market direction before making pricing and distributional choices that affect other long-term planning and policy decisions. The futures market will play a critical role in these decisions in at least three areas: pricing, circulation of commodities, and risk management.<sup>255</sup>

### 1. Pricing

As the promotion of market forces overtakes the diminishing policies of state-imposed pricing,<sup>256</sup> domestic and international futures markets (along with the spot markets) will be crucial to provide pricing guidance to SOEs and economic actors who seek to stabilize the value of their products.<sup>257</sup> During its short existence, Chinese partici-

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<sup>250</sup> See *id.* (giving example of SOE's success at selling on futures market).

<sup>251</sup> However, prices may have been artificially low to begin with because of government price controls. See Luo Zhiling, *We Need to Sum Up Our Experiences and Get a Clear Understanding of the Situation to Focus Our Energies on Fighting Inflation*, Jiage Lilun Yu Shijian, Oct. 20, 1994, at 5, 5-11, translated in *Planning Vice Minister Views Inflation Causes, Cures*, F.B.I.S., China Rep., Jan. 13, 1995, at 39, 39-42 (discussing state price control efforts). It might be argued that futures trading may have only caused the price of commodities to rise to their natural market equilibrium point.

<sup>252</sup> See Myers Testimony, *supra* note 98 (noting that illegal futures trading has driven up food prices and caused inflation).

<sup>253</sup> See *id.*

<sup>254</sup> See *Fewer Futures*, *supra* note 17, at 5.

<sup>255</sup> See Han, *supra* note 21, at 19 (recognizing that futures exchanges play role in regulating market supply and demand).

<sup>256</sup> By 1994, China had lifted price controls on 90% of consumer goods and 70% of the means of production. See Lin Sha, *Causes of, and Countermeasures Against, Losses in State-Owned Enterprises*, Renmin Ribao, Apr. 1, 1994, translated in *Renmin Ribao on Losses in State Enterprises*, F.B.I.S., China Rep., Apr. 15, 1994, at 27, 27 (analyzing causes of losses incurred by SOEs).

<sup>257</sup> While the state-planned economy used to absorb price risk for producers in the form of price subsidies, in a market-oriented economy the futures market is the market mechanism for price protection. See Grossman, *supra* note 229, at 6. But for the futures market to have any prognostic utility, China will have to phase out its central pricing structures in

pation in the futures market has already had beneficial economic effects. Not only has the market provided price signals to all sectors of the economy,<sup>258</sup> but it has also helped to stabilize prices and reduce volatility.<sup>259</sup> For example, prior to establishment of the futures market, the price for rolled steel and nonferrous metals had historically mirrored the cycles of China's economic growth.<sup>260</sup> Between May 1992 and September 1993, rolled steel prices increased exponentially, almost tripling their starting price<sup>261</sup> before plummeting sharply in October 1993.<sup>262</sup> In contrast, nonferrous metals prices (which were being traded on the futures market) during that same time period underwent four fluctuation cycles, but with far less volatility.<sup>263</sup> Though prices for nonferrous metals fluctuated more frequently than their rolled steel counterparts, the "price volatility momentum" for the prices of nonferrous metals was less than that of rolled steel.<sup>264</sup> Thus, as the example illustrates, the paradox of how futures trading encourages fluidity and fluctuation while decreasing harmful volatility can be resolved.

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the spot markets since futures prices reflect trends within the spot markets. Otherwise, the futures market will only be "second-guessing" administrative prices and governmental "meddling." Kaye, *supra* note 229, at 29.

<sup>258</sup> In a well-developed futures market, the futures price itself is a strong indicator of analysts' future projections of supply and demand for a particular commodity or instrument. See Britten-Jones, *supra* note 30, at 12; see also *supra* Part I.A for discussion regarding the role of forward contracts in pricing. Thus, one need not engage in futures market trading to take advantage of the valuable information futures prices provide for both the spot market and projected supply and demand.

<sup>259</sup> For instance, the Chinese futures market maintained the price stability of nonferrous metals (before trading was banned). See, e.g., Chris Chapel, *Leverage Problems Blamed on Products*, S. China Morning Post, July 4, 1994, available in LEXIS, ASIAPC Library, SCHINA File (noting that derivatives provide protection from volatility); Han, *supra* note 21, at 17 (describing how Anhui Metals purchased copper at considerably lower prices on foreign markets while selling reserves in domestic market and was still able to turn profit when domestic prices fell in line with international market). SOEs play another indirect role in controlling price increases by sending market signals to private vendors who will respond to keep prices competitive. See Wang Lingling, *State Presence Can Reduce Market Price Swings*, China Daily, Jan. 12, 1995, at 4, transcribed in *State Sector Tries to Control Food Market*, F.B.I.S., China Rep., Jan. 13, 1995, at 33, 33 (discussing role of SOEs in marketing and pricing).

<sup>260</sup> See Jiang, *supra* note 12, at 62 (describing how futures provide price signals).

<sup>261</sup> The domestic construction industry was expanding during this period. See Han, *supra* note 21, at 19.

<sup>262</sup> See Jiang, *supra* note 12, at 62.

<sup>263</sup> See *id.* at 63.

<sup>264</sup> See *id.*

## 2. *Circulation*

The circulation and reserves of grain have been a Chinese preoccupation since imperial China.<sup>265</sup> At the end of 1994, after the Zhejiang province had been particularly hard hit by natural disasters and was anticipating a grain shortage, a provincial leader called for making the peasants understand the state's grain procurement strategy (collection), stressing to peasants that it was their duty to "plant and sell grain according to state plans."<sup>266</sup> Under a more market-oriented and efficient economy, producers can instead turn toward the market for planting direction. The goal of economic efficiency presupposes the existence of a robust futures market that can more efficiently alleviate problems surrounding the availability of grain and other staple commodities as state planning diminishes. Indeed, even the United States has moved recently to abandon central price signals in favor of relying on the futures market to set price and planting needs for certain agricultural goods.<sup>267</sup>

Another empirical example is instructive. SOEs operating in Henan have utilized the Zhengzhou Commodity Exchange to sign forward grain purchase contracts with local peasants for grain, while selling the same amount of grain on the spot market.<sup>268</sup> This practice has several positive consequences. First, SOEs and small producers are able to control the timing of grain sales and can thus market better-quality grain.<sup>269</sup> Second, futures prices give peasants the advantage of future price signals to encourage farming production and to facilitate long-term planting schedules. Finally, a developed futures market will generate incentives for farmers to produce a greater variety and quantity of goods by providing stable prices and legal profits.<sup>270</sup> By selling

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<sup>265</sup> See *supra* note 8 and accompanying text (discussing Wang An-Shih's policies).

<sup>266</sup> Grain Work, *supra* note 42, at 49. The principles underlying this speech reflect both historical Chinese grain policy and the duty imposed upon Chinese citizens to contribute to the success of state economic initiatives. See *supra* Part I.D (discussing interplay between Chinese social ethics and reciprocal duties held between state and its citizens typified by Iron Rice Bowl).

<sup>267</sup> See, e.g., Agricultural Market Transition Act, Pub. L. No. 104-127, 1996 U.S.C.A.N. (110 Stat.) 896. The revolutionary Act eliminates government agricultural programs and price controls dating back to the Roosevelt Administration. See generally *id.* Under current government United States farm policy, traditional government set-aside programs that idled land have been phased out and farmers will now decide how to divide their land between certain agricultural products like soybeans and corn according to market signals. See Greg Burns, *A Cold Spring Has Futures Sizzling*, *Bus. Wk.*, Apr. 22, 1996, at 36.

<sup>268</sup> See Jiang, *supra* note 12, at 63.

<sup>269</sup> See *id.*

<sup>270</sup> Under current governmental policy, provincial boards and municipalities have the primary responsibility for buying grain and other products from farmers that are forced to grow these staples. See Willy Wo-Lap Lam, *Legislators Urge Immediate Action to Avert*

to futures markets, farmers will be able to sell cash crops (instead of just government-mandated staples) and get more for their products than generally available to farmers when they sell to government purchasing agents.<sup>271</sup> This stimulation of peasant production assists in the development of a "good commodity circulation cycle."<sup>272</sup>

### 3. Risk Management

As SOEs conduct more business internationally, purchase products globally, and invite foreign lending, risk management will become vitally important both to safeguard lending rates (because of interest rate volatility) and to hedge positions.<sup>273</sup> In 1994, the Chinese Premier called on the PBOC to "tighten its control over the [foreign exchange] market, facilitat[e] buying and selling, regulat[e] the supply of foreign exchange when necessary and prevent[ ] drastic fluctuations in the rates."<sup>274</sup> Though foreign exchange futures trading is currently banned for most SOEs, allowing more SOEs to engage in such overseas trading will create another means for the state and SOEs to protect their investments and cash reserves against foreign exchange rate fluctuation.

Chinese producers currently supply a major share of the commodities traded on the world's futures markets.<sup>275</sup> To hedge against unexpected price decreases, these producers can lock in prices through futures contracts on international and domestic exchanges. This option provides protection for the agricultural producer against price drops in the crop and enables producers to efficiently plan for

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Grain Crisis, S. China Morning Post, July 15, 1996, at 10, transcribed in F.B.I.S., China Rep., July 16, 1996, at 43, 43. Unfortunately, this state-imposed system has failed to generate the farmers' "enthusiasm" to grow the staple products and has instead caused farmers to "cover up" the use of fields designated for grain for growing other commodities to sell on black markets. *Id.*; see also Kaye, *supra* note 229, at 29. In addition, the bans on futures trading in key commodities have also driven farmers to underground black markets for futures trading in lucrative products. See *id.* By reopening futures markets in key commodities, farmers will not have incentives to hide their planting strategies or sell inferior products because of certifiable quality rules on exchanges. The government will benefit through repatriation of funds spent on underground trading. Such markets and the information generated by those markets will also enable the state to better reconcile agricultural production with actual need.

<sup>271</sup> Cf. Kaye, *supra* note 229, at 29 (discussing discrepancy between state acquisition prices and market prices).

<sup>272</sup> Jiang, *supra* note 12, at 63; see also Zhu Rongji Stresses Stable Agricultural Production, Xinhua, June 23, 1994, reprinted in F.B.I.S., China Rep., June 24, 1994, at 21, 21 (discussing need for reforming agricultural production and circulation).

<sup>273</sup> For instance, in 1995 the Chinese government took a reported \$6 billion charge on its yen-denominated loans when it failed to hedge against the rising value of the yen. See Grossman, *supra* note 229, at 6.

<sup>274</sup> Li, *supra* note 171, at ix.

<sup>275</sup> See *supra* note 40 and accompanying text.



their harvests. Such price protection will be particularly important for cyclical industries. The futures market will also provide valuable pricing signals for other sectors of the economy that do not purchase futures at all. Other industries that may depend on certain commodities for industrial production can use futures prices as the most up-to-date supply and demand estimates and can thus plan their purchases in the spot market accordingly.<sup>276</sup>

#### IV

#### AN EMERGING SYNTHESIS: A FUTURE FOR CHINESE FUTURES

As the Chinese face the emerging paradoxes raised by their current futures policy, there is a strong need for the contradictions to give way to a clearly synthesized Chinese derivatives policy. Despite the market's ability to improve the nation's economic efficiency, China clearly has retreated from market dictates through a series of crack-downs on exchanges and futures trading. But China should not turn away from the powerful utility of a developed futures market simply because of its intrinsic volatility. In order to harness this economic potential, China must ride out periodic market fluctuations and risks that accompany any futures market without resorting to draconian intervention.

##### *A. China's Futures Market Imperative*

One commentator used the analogy of riding two horses to explain China's dual policies of approaching the market to achieve efficiency and other macroeconomic goals while keeping the reins on social stability through traditional state planning methods such as price control and production planning.<sup>277</sup> This analogy is particularly insightful in analyzing the future of Chinese derivatives policy.

##### *1. Resolving the SOE Reform Paradox*

SOE reform is the government's primary instrument for achieving its general macroeconomic goals of economic efficiency and inflation control. It is increasingly apparent, however, that SOE reform itself cannot succeed without a developed futures market. Additionally, by serving as a vehicle for risk management, the futures market

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<sup>276</sup> Industrial and agricultural concerns with reserves or inventories can reduce their price exposure (between time of purchase and eventual sale) by purchasing forward contracts or put options to guarantee a certain price or hedge against significant price decreases.

<sup>277</sup> See Qian, *supra* note 201, at 97.

independently helps to further macroeconomic goals. China cannot persist in pursuing market efficiency and SOE reform while concurrently shutting down futures markets because of their instability. While excessive speculation has been a problem, the Chinese government's bans on important futures commodities have been counter-productive.<sup>278</sup> In fact, these misguided bans may actually have exacerbated speculation in the remaining secondary commodities markets.<sup>279</sup>

The answer to SOE speculation can be crudely simplified: speculation is best controlled by making those who speculate responsible for their losses. If China refuses to intervene on behalf of ailing SOEs that encounter substantial losses in unsponsored speculation, SOE managers will be more inclined to confine their use of derivatives and futures trading to their intended purposes. Fidelity to such a policy will result in the rationalization of SOE management decisions.<sup>280</sup> Further, SOEs that have incurred debts above their assets may be likely candidates for bankruptcy, and a policy of nonintervention would ensure that central governmental resources would not be needlessly expended to buoy inefficient enterprises.<sup>281</sup>

If SOE reforms separate the functions of government from the operating functions of the enterprise, there will be an accompanying increase in decisionmaking efficiency<sup>282</sup> and a decrease in the corruptive influence that powerful and politically aligned SOEs have historically enjoyed on regional exchanges.<sup>283</sup> In fact, many of the largest players on local exchanges are *de facto* arms of the Chinese government.<sup>284</sup> Powerful SOEs that are charged with making the state's

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<sup>278</sup> Speculation is a natural element of any modern futures market. Cf. Britten-Jones, *supra* note 30, at 12 (explaining speculation and liquidity theory). Some speculation is necessary because it provides liquidity. Liquidity in turn ensures more opportunities for risk aversion and offsetting. But excessive speculation is dangerous because it distorts market realities and can create inflationary pressure. See *supra* notes 168-70 and accompanying text (discussing inflationary effects of excessive speculation).

<sup>279</sup> See *supra* note 228 and accompanying text.

<sup>280</sup> Cf. Lin, *supra* note 256, at 28 (arguing that leaving enterprise autonomy unsettled allows SOE to "continue to use the state's 'iron bowl' and . . . still . . . not assume responsibility for management risks or for even bankruptcy").

<sup>281</sup> See Zhang, *supra* note 200, at 53 ("However, for those [SOEs] with debts exceeding assets, it is better to let them go bankrupt, as there is no hope of their eliminating losses, let alone earning profits.").

<sup>282</sup> See Li Nanling et al., *New Thinking on Realizing Separation of Government Functions from Those of Enterprises*, Liaowang, Nov. 21, 1994, at 4, 4-5, translated in F.B.I.S., *China Rep.*, Jan. 6, 1995, at 47, 47 (discussing need to separate functions between government and SOEs).

<sup>283</sup> Cf. Ma, *supra* note 129, at 1 (noting that many exchanges faced "too much administrative interference" from SOEs, which were most powerful exchange members).

<sup>284</sup> See Sender, *supra* note 116, at 80.

purchases in a particular commodity are directly supervised by the Domestic Trading Ministry.<sup>285</sup> Since the Trading Ministry sets the import quotas, the most significant factor affecting prices is known to the trading SOE—putting investors with less cozy governmental connections at a decided disadvantage.<sup>286</sup> These opportunities for insider trading emphasize the need for separating SOEs from governmental functions to put all investors on equal footing.<sup>287</sup>

Speculation in the futures market should also decrease because reform will cause SOE managers to focus on *long-term* profits and the novelty of the futures market will wear thin. Moreover, as conceptions of shareholder rights take hold in China, SOEs will become more responsive to shareholders in order to increase the value of the enterprises. The future privatization of SOEs also will cause SOEs to become more profit and loss conscious as these entities get further away from the state's safety net.

## 2. *The Social Cost of SOE Reform and Futures Market Evolution*

For a society that has relied upon the concept of the Iron Rice Bowl for the past forty years, the change to market orientation has not completely seeped into the popular consciousness. SOEs still turn to the government to intervene when large losses are incurred. Fundamentally, the change from a planned to a market economy has been a clash between the historic value of fairness and the need for economic efficiency to better serve the populace through stability and access to goods.<sup>288</sup> These two values must somehow coexist if China is to withstand the social chaos brought about by its rapid economic development.<sup>289</sup> Indeed, the social cost of China's movement toward

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<sup>285</sup> See *id.* The Domestic Trading Ministry was also responsible for setting up many local exchanges. See *supra* note 54 (discussing Ministry's role in founding Shanghai futures exchanges).

<sup>286</sup> See Sender, *supra* note 116, at 80.

<sup>287</sup> Coincidentally, opponents to Wang An-Shih's imperial grain trading policies based their opposition on the belief that the government should not denigrate itself by competing with its citizens in the marketplace. See de Bary et al., *supra* note 8, at 426-27.

<sup>288</sup> For more on the dichotomy of fairness and efficiency, see Peter Nolan, *China's New Development Path: Toward Capitalist Markets, Market Socialism or Bureaucratic Market Muddle?*, in *The Chinese Economy and its Future: Achievements and Problems of Post-Mao Reform* 106, 128-29 (Dong Fureng & Peter Nolan eds., 1990) (discussing trade-off between economic growth and distributional equity).

<sup>289</sup> See Chen et al., *supra* note 160, at 43.

Though a society with only fairness but no efficiency cannot satisfy the ever-rising needs of its members, a society with only efficiency but no fairness is similarly unable to satisfy the needs of most of its members. These two values also constrain and act as preconditions for each other in the process of their materialization. Without high efficiency, fairness at a relatively advanced level cannot be attained . . . .

efficiency will be great, and the dislocation of workers employed by poorly run SOEs allowed to go bankrupt will be dramatic.<sup>290</sup> Moreover, China's great economic boom brings with it tremendous uncertainty for those who are left out of its prosperity. This will have an equally staggering impact on the national psyche.<sup>291</sup> Accordingly, the Chinese leadership may well have to utilize the efficiencies won through tough SOE reform to subsidize the well-being of surplus workers in the interest of equitable wealth distribution.

Commentators have observed the necessity for making the change toward the market economy as quickly as possible.<sup>292</sup> This rapid change will certainly magnify disruption in the short term, but it may be the best way to restore domestic tranquillity in the long run. If the futures market's macroeconomic functions are harnessed earlier by the Chinese, then the potential benefits of the market may well improve economic fairness by providing rational pricing, controlling inflation, and keeping grain stores full. Additionally, by eliminating the expectations of the Iron Rice Bowl outright, the Chinese government may sooner direct its citizens and SOEs toward true economic independence.

### *B. The Potential for Synthesis*

Though Chinese futures regulation may reflect a largely contradictory policy of permitting rapid expansion in futures trading while overreacting when the markets become volatile, it may be that this dialectical path is the only means by which China can bring its futures market into existence. Thus, what may often appear to be contradictory regulatory aims might be better understood as necessary elements of a painful stop-and-go move toward a market economy.

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Id.

<sup>290</sup> See China: Review 1996, *supra* note 43 ("Streamlining [SOEs] is a dangerous political option since that would cause major unemployment with a consequent risk of social unrest."); Thurston, *supra* note 165, at 17 (noting effects of rapid economic reforms including widespread migration, begging, and unemployment).

<sup>291</sup> For a society that has been rooted in values fundamentally based on "a correct ordering and hierarchy of human relations," both under Confucian and later under Communist values, the Chinese may find that at the heart of economic uncertainty lies a "crisis in values." Thurston, *supra* note 165, at 17. Because economic insecurity replaces the Iron Rice Bowl, the individual identity once associated with the hierarchy within SOEs is cast adrift. The resulting disruption of social relationships may be an inevitable consequence of widespread economic reform.

<sup>292</sup> See Chen et al., *supra* note 160, at 44.

[U]nder current conditions the transformation of the economic pattern in China cannot go on and on over a long period of time, as did the establishment of the prototypical market economy in the West. The only choice we have is to accomplish it quickly, within the space of a few decades.

Id.

China's progress toward market evolution will depend in large part on the development of its futures market because of the pressing macroeconomic and socially stabilizing goals served by such a market. It may then be helpful to construct a general framework from which to measure the evolution of the Chinese experiment in futures and assist in resolving future contradictions raised by derivatives regulation. Each element of this rudimentary framework is discussed below.

The central government initiated a severe crackdown on rampant futures speculation by banning products for futures trading (and even entire exchanges) and by seeking to ban traders and customers who defied its policies.<sup>293</sup> China should now discontinue its ad hoc boom and ban campaign. Further regulatory efforts should reflect a more tempered national strategy toward standardized requirements for exchanges and qualifications for brokerages and exchange members without succumbing to the temptation to subject the local exchanges to central oversight.<sup>294</sup> Governmental functions and SOE business and investment decisionmaking ought to be separated so as to restore fairness in the marketplace and enable SOEs to make more autonomous business decisions unfettered by political interference. Moreover, uniform requirements for clearinghouse structures should be instituted to create stability in the exchanges and to help prepare the economic environment for eventual foreign participation in its markets.<sup>295</sup> Finally, to avoid regulatory confusion and to encourage consistent enforcement, regulatory authority should be consolidated within the CSRC and not dispersed among diverse regulatory actors.<sup>296</sup>

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<sup>293</sup> See *supra* Part I.C.

<sup>294</sup> The central government could set uniform standards for local exchanges to be run on a nonprofit and membership basis while also setting up capitalization requirements.

<sup>295</sup> The existence of a viable clearinghouse guarantees that parties will not need to resort to the state or to lawsuits for settling the majority of their disputes. A clearinghouse will serve as a filter to ensure that exchange participants have adequate equity and margins to guarantee their trades, thus driving down transaction costs and eliminating the need for parties to independently assess the creditworthiness of their counterparty. Neutral and viable clearinghouses are hallmarks of modern futures systems. See, e.g., Britten-Jones, *supra* note 30, at 12 (noting that London Clearing House (LCH) serves as counterparty for all trades for London International Financial Futures and Options Exchange (Liffe)); see also *supra* notes 108-11 and accompanying text (discussing clearinghouses). By setting up stable clearinghouses, China will improve investor confidence in the market, and this will pave the way for eventual foreign participation in those markets.

<sup>296</sup> See Jiang, *supra* note 12, at 60.

[W]hile various management agencies, such as the State Administration for Industry and Commerce, the System Reform Commission, and banks, can all proceed from their own management jurisdictions to manage futures exchanges, there is no one management agency with full management responsi-

While centralized standards for local exchanges and their membership should be set by the Chinese government, Beijing should allow local exchanges to grow according to market needs. This way SOEs and other market participants that are relied upon by the government to serve circulatory and pricing functions will have local markets in which to operate and exert more influence on local actors. The central government should not attempt to set the total number of allowable exchanges. Instead, it should ensure that those exchanges that do materialize conform to a floor of minimum standards of creditworthiness and membership. Decentralized control of the local exchanges may also facilitate regulation more responsive to the specialized needs of the local futures market.

The time is also ripe for China to lift its ban on key commodities<sup>297</sup> and financial futures trading.<sup>298</sup> Maturation of the Chinese futures system requires primary markets in the products that are available for futures trading. Because the range of trading products is unduly constrained, the futures market is especially prone to wild speculation and instability. Moreover, lifting the bans on key futures products will also begin to ease Beijing's anxieties about international futures market prices and their effect on the Chinese market. By developing a healthy futures market for those products for which China is a primary exporter (and opening such markets to foreign trading), China may begin to develop "authoritative prices" that serve to influence and stabilize world market prices.<sup>299</sup>

The cultivation and expansion of institutional investors in China will be another key barometer of Chinese futures market maturation. Institutional investors provide a degree of stability in the markets and may reflect the existence of investment relationships that are more conducive to carefully planned instruments designed peculiarly to a particular client's needs.<sup>300</sup> Yet for institutional investors to prosper,

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bility. Too many policy jurisdictions and departmental conflicts of interest often leave futures exchanges with no rules to follow in normal operations.

Id.

<sup>297</sup> See China Futures, *supra* note 114 (noting futures exchanges presidents' call for re-summing trading in "major items" banned under economic austerity program).

<sup>298</sup> See *supra* note 55 (noting positive economic effects of treasury bill futures).

<sup>299</sup> NPC to Mull First Futures Law, Xinhua, Dec. 15, 1995, available in LEXIS, ASIAPC Library, XINHUA File (quoting leading Chinese economist, Dong Fureng).

<sup>300</sup> See Tong Ting, China Plans to Standardize Its Securities Market, China Daily, Jan. 16, 1995, at 7, transcribed in Official on Need to Standardize Securities Markets, F.B.I.S., China Rep., Jan. 17, 1995, at 60, 60 (describing need to standardize securities market to develop institutional investors).

there will need to be a variety of financial futures available for use in managing risk.<sup>301</sup>

By increasing the operational efficiency of its futures markets, China will be able to increase the turnover rate of futures contracts. While this efficiency may facilitate *you zhi* flows in the short term, the long-term benefits of greater market liquidity simply outweigh this drawback. The macroeconomic utility of the futures market is contingent on the free flow of information to traders and economic actors who respond rapidly to supply and demand signals. This transparency will also be necessary if the futures market is to send legitimate market indicators to the rest of the economy. Moreover, Beijing's stranglehold on economic information must loosen so as to cultivate market conditions that make it attractive for foreign investors and capital.

Giving SOE managers true autonomy will serve economic efficiency aims. When managers are responsible for profits and losses—including trading losses—enterprises that make optimal investment decisions will prosper. Inefficient entities that excessively speculate in the futures market will not be bailed out by the government and should be permitted to close. Moreover, this shift toward SOE autonomy will make foreign investors regard SOEs as typical market actors whose transactions must be subjected to credit scrutiny. Foreign investors will conduct individual risk analyses without regard to intervention by the Chinese government.<sup>302</sup> And in the wake of the derivatives disputes between Chinese entities and international institutions like Lehman Brothers, such a readjustment has already started to take place.<sup>303</sup>

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<sup>301</sup> See Peter Montagnon, Survey—China 1996: Solving the Capital Conundrum, *Fin. Times*, June 27, 1996, at 4 (discussing need to provide institutional investors with financial futures). China might also need to reopen its bond futures market to facilitate domestic capital markets needed to finance the country's infrastructure needs. See *id.*; China's Economic Reforms, *supra* note 60, at 318.

<sup>302</sup> Consistent refusal by the Chinese government to make debts incurred by wayward SOEs sovereign will help China establish transactional norms for direct foreign investment. These norms will not require the government to be the silent partner on every transaction with a foreign party. See Lao Chang, Rules Seek Power Investment Without State Backing, *China Daily*, June 2-8, 1996, transcribed in *Direct Investment Without State Guarantee to Become Norm*, F.B.I.S., *China Rep.*, June 6, 1996, at 68, 68 (reporting government's desire to encourage foreign investment without Chinese governmental guarantee); Xiao, *supra* note 83, at 8 (arguing that assumption of SOE debt would set "very bad precedent").

<sup>303</sup> See Dede Nickerson, Finance Ministry Calls for Further Analysis, *S. China Morning Post*, Apr. 20, 1995, available in LEXIS, ASIAPC Library, SCHINA File (discussing Moody's downgrading debt ratings of two major state banks); Webb, *supra* note 87, at 12 (noting that foreign firms are individually reviewing Chinese credit). But in other contexts, foreigners may still be clamoring for China to step in and assume bad loans made to SOEs.

Following the traditional Communist mantra of "learning from others," the Chinese have turned to the international community for guidance and assistance in the development of the domestic futures market.<sup>304</sup> A futures regulation cooperation accord between the CSRC and the Hong Kong Securities and Futures Commission that was signed in 1994 will help the development of futures regulatory systems both in Hong Kong and China.<sup>305</sup> Further, in November 1995 the CSRC signed a memorandum of understanding with its regulatory counterpart in Singapore (the Monetary Authority of Singapore) to promote cooperation, mutual understanding, exchange of information, and the sound development of their securities and futures markets.<sup>306</sup> Moreover, as evidenced by recent activity by the NFEA<sup>307</sup> and the recent acceptance of the Zhengzhou Commodities Exchange into the IOMA,<sup>308</sup> the Chinese futures industry is developing a self-policing mechanism and a means by which to exchange expertise and knowledge within its own borders and with international markets.<sup>309</sup> Working with the international community will also help China develop its own futures market alongside international benchmarks. These developments, combined with the "internationalization" of Chinese securities,<sup>310</sup> will hasten the eventual opening of Chinese domestic futures markets to international participation.

### CONCLUSION

The imperial design that led to the use of markets resembling futures in the Song Dynasty still animates their use today. While China remains preoccupied with notions of nourishing its people and main-

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See, e.g., Xiao, *supra* note 83, at 8 (discussing Deutsche Bank request that Chinese government repay debt incurred by SOE).

<sup>304</sup> In the development of its Futures Law, the Chinese have reportedly been studying the commodity markets in England, Hong Kong, and the United States, paying particular attention to the Chicago Board of Trade rules and the Commodity Futures Trading Commission Act of 1974. See Nusbaum, *supra* note 14, at 53.

<sup>305</sup> See Mark O'Neill, *China Futures Industry Experimental But Improving*, Reuters, July 4, 1995, available in LEXIS, ASIAPC Library, REUFIN File (discussing CSRC chairman's speech after signing futures regulation accord with Hong Kong).

<sup>306</sup> See China, Singapore, Sign MOU on Securities Activities, Xinhua News Agency, Nov. 30, 1995, available in LEXIS, ASIAPC Library, XINHUA File.

<sup>307</sup> See *supra* notes 150-51 and accompanying text.

<sup>308</sup> See *supra* notes 152-53 and accompanying text.

<sup>309</sup> See, e.g., Beijing Commodity Exchange Changed to Membership System, *Zhongguo Xinwen Shi*, May 16, 1996, transcribed in F.B.I.S., China Rep., May 17, 1996, at 36, 37 (reporting cooperation between Beijing Commodity Exchange and international exchanges).

<sup>310</sup> More State Enterprises Apply to List Overseas, *Zhongguo Xinwen Shi*, Dec. 31, 1994, transcribed in F.B.I.S., China Rep., Jan. 3, 1995, at 68, 68-69 (discussing "internationalization" of Chinese securities).



taining social stability, continuity in the state's overall policy must be served by a dialectical route. To fortify itself economically, socialist China has been forced to embrace contradiction by adopting market attributes to serve the competing values of economic efficiency and fairness. Installing prudent levels of regulation that allow the futures market to develop according to market supply and demand will cause more rapid maturation than any attempts to soften its economic volatility through reactive bans and irrational proscriptions. The contradictions of these regulatory efforts can be understood and then ultimately resolved, however, through an understanding of the salient aspects of China's futures crackdown. Chinese leaders have learned from both foreign systems and from the past in adapting those features suitable for China's unique position. The same is true of China's derivatives policy. This Note has examined broad features of the Chinese futures market and the complicated regulatory regime that has been erected to control that market. This examination has focused mainly on the critical internal contradictions that both constrain and propel evolution of the futures market and has attempted to lay out a factual and theoretical groundwork for prospective analysis of that rapidly changing marketplace.<sup>311</sup>

To be sure, Chinese SOEs and investors have lost many gambles in the nascent derivatives market in China and overseas. But this market ultimately holds great promise for China's economy. China must first accept the economic volatility of the futures market to realize the macroeconomic end of economic stability. It is a paradox that Mao would have understood well.

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<sup>311</sup> Many areas still warrant further consideration. For example, as indicated earlier, application of Chinese law may have interesting consequences for disputes hinging on questions of agency law. See *supra* notes 185-93 and accompanying text. Moreover, within the Chinese futures market, other tertiary but equally important contradictions remain but were not discussed. In addition, interesting cultural questions arise in the context of the transactions between the Chinese and foreign entities that may have colonial roots. Such issues, however, fall outside the scope of this Note.