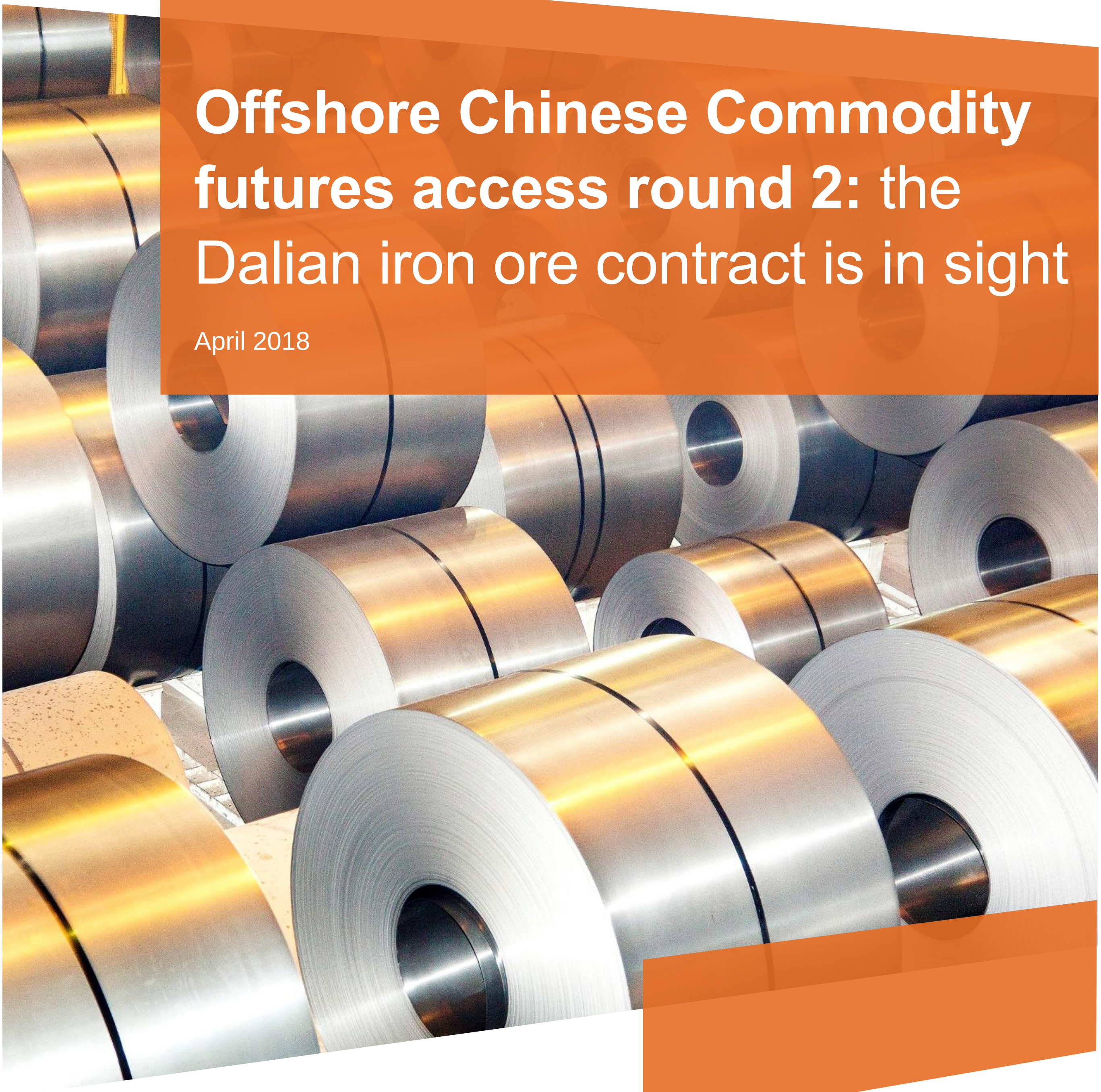

Offshore Chinese Commodity futures access round 2: the Dalian iron ore contract is in sight

April 2018

Driving progress
through partnership

Contents

The door to China’s futures markets opens a little wider as the Dalian Commodity Exchange published its final rules on 27 March 2018, which, once launched, will allow overseas investors access to its existing iron ore futures contract.

The futures markets for commodity products in China continues to open up with the approval of the China Securities Regulatory Commission (CSRC) for the iron ore futures contract listed on the Dalian Commodity Exchange (DCE) to be made available to overseas investment.

By contrast to the long-anticipated listing of the crude oil futures contract on the recently established Shanghai International Energy Exchange (INE), which commenced trading on 26 March 2018, the iron ore contract on the DCE will be an amendment to an existing contract with more than three years’ trading history, high trading volumes and liquidity.

The primary objective of providing offshore access to this particular contract is to enable China to increase its influence over global iron ore pricing through internationalising its own benchmark.

There are two ways in which an overseas investor can access the DCE: either become (1) a client of a domestic futures firm in China that is a DCE member or (2) a client of an overseas broker, who then trades through a domestic futures firm in China that is a DCE member. The advantages and disadvantages of these options are discussed below.

The DCE is structured similarly to other Chinese futures exchanges, and so for those who have not previously traded on domestic Chinese futures markets, certain of its features described in this note may be unfamiliar.

The publication of the final rules making the DCE’s iron ore contract available to overseas investors hot on the heels of the crude oil contract highlights the potential for other commodities to follow suit.

Introduction

On 2 February 2018, the China Securities Regulatory Commission (CSRC) announced its approval of the proposal by the Dalian Commodity Exchange (DCE) to open up its existing iron ore contract to overseas investors. The DCE sprang quickly into action and, on 7 February 2018, released a draft set of rules for public comment. At the end of the public consultation, the DCE published its final rules on 27 March 2018.

The DCE's publication of its rules allowing access to its popular and highly liquid iron ore futures contract follows on from the listing by the Shanghai International Energy Exchange (INE) of an oil futures contract accessible to overseas investors, which launched on 26 March 2018. These back-to-back announcements indicate that the opening up of the futures markets for commodity products in China is truly gathering pace. There are several important differences between the DCE's iron ore contract and the INE's crude oil contract that are worth noting. Unlike the INE, the DCE will not launch a separate iron ore contract for overseas investors. Instead, overseas investors and domestic investors will trade the same iron ore contract on slightly revised terms. This contract has, since its launch in October 2013, grown into a product with large trading volume[1] and high liquidity. This compares with the newly designed INE crude oil contract, available to overseas investors via the INE, which was established as a subsidiary platform of the Shanghai Futures Exchange (SHFE), and whose only product for the time being is the crude oil contract. The success of these two contracts from the perspective of offshore participation is likely to pave the way for a further opening up of the futures markets in China that have previously been closed to overseas investors.

For further information on the INE's crude oil futures contract, please refer to our update published in September 2017[2]

Features of the DCE iron ore contract

The DCE iron ore contract specification and iron ore quality standard are set out in appendices 1 and 2 of this note. The quality is comparable to the standardised specification used on Platts IODEX.[3] Delivery units are 100 metric tonnes per contract (listed monthly for the most recent 12 consecutive months), and the maximum order is 1,000 lots. The minimum margin is set at 5% of the contract value.[4] The contract is denominated in renminbi (RMB) but U.S. dollars (USD) can be deposited for use as collateral and offshore RMB (a.k.a., Chinese yuan (CNY)) can be deposited and directly used to participate in the futures trading at a 1:1 ratio.[5] By comparison with the INE crude oil contract, the DCE iron ore contract price is duty paid rather than a net price, and delivery under the iron ore contract includes both bonded and duty-paid delivery modes.

The principal driver behind the choice of this contract is to enable China to internationalise its own benchmark for iron ore, while increasing the trade in RMB-denominated iron ore. This ambition is unsurprising, given that China is the world's largest net importer of iron ore, comprising over 60% of the market.

A stand-out feature of this contract is that it provides for physical delivery in the settlement of the contract, using bonded iron ore storage facilities.[6] The reason for physical delivery is presumably that the new rules extend an existing futures contract that, until now, serviced the domestic market with its high consumption demands, which required physical delivery at the conclusion of a trade, rather than being motivated by pure speculation.

One of the practical issues physical delivery creates for overseas investors is that of how and when the contract is priced. The contract pricing depends upon the quality of substitute products, with a system of premiums and discounts that are applied to reflect impurities in the delivered iron ore. The premiums and discounts are fixed for three years, which may not accurately reflect the true dynamics of price changes to silica and alumina penalties in the physical iron ore markets.[7]

Overseas access – two routes

The DCE rules provide for two routes by which an overseas investor can access the DCE iron ore futures contract.

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[1] According to Futures Daily, in 2017 a total of 329 million lots of iron ore (representing about 32.87 billion metric tonnes of physical iron ore) were traded on the DCE; for further information, see: http://www.dce.com.cn/dalianshangpin/xwzx93/jysxw/6089930/index.html

[2] https://www.reedsmith.com/en/events/2017/11/offshore-participation-in-china-futures-market

[3] For further information, see: https://www.platts.com/price-assessments/metals/iodex-iron-ore

[4] For further information, see: http://www.dce.com.cn/DCE/Products/Industrial/Iron%20Ore/491886/index.html

[5] For further information, see: http://m.dce.com.cn/DCEENMO/Media_Center44/Exchange_News9/6079687/index.html

[6] For further information, see: http://www.chinadaily.com.cn/business/2017-02/28/content_28371376.htm

[7] For further information, see: https://www.platts.com/latest-news/metals/singapore/china-allows-dalian-exchange-to-open-iron-ore-26885335

	Route 1 (As client of a domestic futures firm member (FF member))	Route 2 (As client of an overseas brokerage firm (OBF))
Benefits to the overseas investor	Trade through a domestic futures brokerage firm member (FF member)	Trade through an overseas brokerage firm (OBF) that in turn trades through a FF member
Direct trade execution ability on the DCE	Yes	Yes
Carry out clearing on the DCE	Yes, through the FF member	Yes, through OBF, which in turn carry out clearing through the FF member
Gives speed of access to the DCE	Faster than Route 2	Slower than Route 1
Gives it a right to access a trading seat8	Yes	Yes
Cost	Less expensive than Route 2	More expensive than Route 1
Governing law	Chinese law governs the brokerage agreement between the investor and FF member	Potential for governing law to be agreed between the overseas investor and OBF (otherwise Chinese law)
Dispute resolution forum	Chinese court or arbitration	Potential for forum other than Chinese courts to be agreed between the overseas investor and OBF

Under Route 1, the domestic futures firm member (FF member) will handle the formalities of opening the trading account (including the application for a 'trading code' (i.e., an alpha-numerical identifier), execute trading orders, and carry out clearing and delivery services for the overseas investor. Opening the trading account is a fairly straightforward process and can normally be completed within 1–2 weeks depending on the specific FF member's process.

Under Route 2, the OBF will handle the opening of the trading account for the overseas investor, with assistance from the FF member with which the OBF enters into an entrustment agreement. Overseas investors place orders through the OBF, and the OBF, in turn, places such orders through the FF member on the DCE trading system. Clearing and delivery for executed trades will be handled solely through the FF member pursuant to the entrustment agreement between the OBF and the FF member.

Eligibility of the overseas investor

Overseas investors are required to meet certain trading eligibility criteria during the application process for a trading account to access the DCE. Of these requirements, the most unfamiliar to an overseas applicant may be the requirement that the applicant be able to demonstrate a record of executed orders within the past three years on an overseas futures exchange regulated by the futures market regulatory authority of applicants' jurisdiction, with which a memorandum of understanding (MOU) exists for regulatory cooperation with the CSRC. This requirement may not be as restrictive as it first appears because, as of February 2018, the CSRC had 67 regulatory cooperation agreements in place with regulators in 61 countries and regions[9] including Hong Kong, Singapore, the United Kingdom, the United States, Japan, Australia, India and the United Arab Emirates. Applicants are also required to pass a futures knowledge exam, which is expected to be offered in Chinese and English.

Eligibility of the OBF

The conditions for an overseas brokerage firm to be eligible to act as an OBF include the following: (1) it is a duly incorporated financial institution that has obtained a licence from the futures regulatory authority of its jurisdiction to accept investors' funds and trading orders and execute futures trades in its own name; (2) it has a continuing operational history of more than one year; (3) it is regulated by a futures regulatory authority with which the CSRC has signed a MOU; (4) its net capital is not less than RMB 30 million or equivalent amount in foreign currency; (5) it has sound corporate governance and internal control; (6) its business facility and technology system comply with the applicable technical standards and are in good working condition; and (7) any other conditions that the DCE may impose.

An OBF must enter into an entrustment agreement with an FF member of the DCE in order to carry out futures trading (including clearing and delivery) for its overseas clients. Before the FF member can carry out futures trading business for

[8] According to Futures Daily, in 2017 a total of 329 million lots of iron ore (representing about 32.87 billion metric tonnes of physical iron ore) were traded on the DCE; for further information, see: http://www.dce.com.cn/dalianshangpin/xwzx93/jysxw/6089930/index.html

[9] For further information, see: http://www.csrc.gov.cn/pub/csrc_en/newsfacts/release/201802/t20180214_334341.html

the OBF, it must submit the entrustment agreement with the OBF together with any materials demonstrating that the OBF meets the above-mentioned conditions and other required documents to the DCE for filing. The DCE will review these documents and decide whether to issue a filing number for the OBF within 15 trading days upon receipt of all application materials.[10]

The role of the designated depository bank

The DCE has 14 designated depository banks (DDBs) that can serve domestic investors but has not yet designated DDBs that can serve overseas investors. These DDBs are due to be published now that the DCE has issued the final contract rules. We anticipate these will be released shortly. The role of the DDBs is to engage in futures margin depository business, which essentially means opening and managing settlement accounts for the DCE, margin accounts for clearing members and futures settlement accounts for overseas investors. DDBs are also responsible for the necessary currency conversion of margins to meet the RMB-denominated settlement and payment obligations of the clearing members.

Contracts enabling overseas participation

The following contracts are necessary to enable the overseas participation under the different routes for accessing the DCE:

	Route 1	Route 2
	Trade through a domestic futures firm member (FF member)	Trade through an overseas brokerage firm (OBF) which in turn trades through a FF Member
Client agreement	N/A	Entered into by OBF and overseas investor
Futures Brokerage Contract[11]	Entered into by overseas investor and FF member	Entered into by OBF and FF member
Bank opening account agreement	Entered into by overseas investor and a DDB	Entered into by overseas investor and a DDB;
DDB Business Agreement	Entered into by a DDB and the DCE	Entered into by OBF and a DDB

Margin

Similar to the INE, the DCE requires each FF member to maintain two margin pools, in order to cover the FF member's obligations to the exchange. These two margin pools are the clearing deposit[12] (described as a type of guarantee fund) and the trading margin[13] (analogous to a variation margin). Eligible collateral that may be used to meet these margin requirements, include cash (currently, RMB and USD), standard warrants and treasury bonds. The clearing deposit must be held in RMB, and the clearing settlement currency is RMB, whereas the trading deposit does not have to be held in RMB. Where cash collateral is not RMB-denominated or other types of collateral are used, the value of the collateral is discounted by a prescribed percentage (e.g., standard warrants will have at least a 20% discount applied).

Clearing

As is common for futures exchanges in China, the DCE is both the exchange and the clearing house. This may be slightly unusual to overseas investors. As a central clearing counterparty, DCE interposes itself between the buyer and seller when each transaction is executed, acting as buyer to every seller and seller to every buyer, making settlement in the amount of net value and providing centralised performance assurance for all transactions. For the purposes of assessing trading risk, an overseas investor will need to consider the insolvency risk of both the FF member (which is also a clearing member) and the DCE under Chinese law.

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[10] Article 7 of the Measures for Administration of Futures Company Members Carrying-Brokerage Business Authorized by Overseas Brokers with Futures Trading Business of Specified Domestic Futures Products.

[11] According to Futures Daily, in 2017 a total of 329 million lots of iron ore (representing about 32.87 billion metric tonnes of physical iron ore) were traded on the DCE; for further information, see: http://www.dce.com.cn/dalianshangpin/xwzx93/jysxw/6089930/index.html

[12] Clearing deposits are funds deposited into the DCE's dedicated settlement account for futures trading and clearing but are not yet used as margin toward meeting a member's exchange positions.

[13] Trading margin refers to funds deposited in a member's dedicated settlement account for the DCE to ensure contract settlement and is used as margin for the member's exchange positions.

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

Delivery

'Delivery' refers to the settlement of a futures contract (e.g., because it has not been offset at maturity) through the seller transferring ownership of the underlying asset to the buyer (i.e., physical delivery, rather than being cash or financially settled, as iron ore futures are on international investment exchanges). Only FF members may perform such delivery.

Physical delivery will involve either bonded delivery or duty-paid delivery. Bonded delivery means delivery at a bonded warehouse designated by the DCE and located within the customs special supervision areas or on the bonded supervision premises. Currently, the DCE has only designated one bonded warehouse in Dalian; it is understood that the DCE will gradually grant approval to other warehouses that are currently authorised to take unbonded delivery. Duty-paid delivery means delivery after clearance through customs and payment of associated import duty, VAT and other taxes. Delivery under the DCE's iron ore contract takes three different forms: (1) one-off delivery, (2) exchange of futures for physicals and (3) bill of lading delivery. Each form of delivery has a different process and timeframe.[14] Among them, one-off delivery is the most common type.

The DCE rules state that overseas investors (including sellers and buyers) will only be allowed to participate through FF members via bonded delivery (as opposed to duty-paid delivery) because overseas sellers are not able to issue a VAT invoice.[15] Domestic investors can participate in both bonded and duty-paid deliveries. The DCE rules provide for a delivery mechanism under which bonded standard warrants will be delivered to overseas buyers on a priority basis[16]. Presumably this is to help offset the effect of restrictions on delivery methods for overseas buyers. To ensure overseas buyers get bonded standard warrants, the DCE has approved 12 warehouse receipt service providers that can provide the relevant warrant swap services such that overseas buyers can receive bonded standard warrants to take delivery.

Risk management system

Similar to other Chinese futures exchanges, the DCE provides for several risk management tools, including margin requirements, daily price limits, position holding limits, large position reports, trading limits and forced liquidation.[17]

The daily price limit sets the price floor and cap within which the trading price of the contract can fluctuate. Generally, this is set at the applicable percentage of the last trading day's settlement price for the contract. The position holding limit imposes a maximum amount on the position that an investor can hold. Where the DCE grants a hedging or arbitrage quota to an investor (upon application), the investor's hedging or arbitrage holding position does not count toward the applicable position holding limit. When an investor's holding of a speculative position reaches 80% of the applicable position holding limit for that speculative position, it must report, through the FF member, particulars of the investor's holding, funding, etc. (i.e., large position reporting). A trading limit is the maximum set on the trading position an investor is permitted to open for the iron ore contract and during such period as published by the DCE from time to time.

It is established practice in many jurisdictions for regulators to restrict access by domestic companies to overseas markets unless they have satisfied themselves of the potential systemic risk that access to such markets could entail. Therefore, the laws of such countries prohibit direct access to many offshore exchanges unless they have been recognised or approved by the relevant domestic regulator. In Singapore, for example, an investor is considered to have direct access to a market if the investor can purchase or sell futures contracts on the market without the assistance or intervention of an offshore intermediary and therefore, under the laws of Singapore, the Monetary Authority of Singapore (MAS) would require futures exchanges to apply to be recognised as market operators. The DCE has made applications for such recognition but this has not yet been obtained, which may be one reason for the restrictions on direct access to the DCE for overseas investors. Both the DCE and INE have now established offices in Singapore.

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[14] See chapters II, III and V of the Detailed Delivery Rules of Dalian Commodity Exchange.

[15] For further information, see: http://www.dce.com.cn/dalianshangpin/xwzx93/jysxw/6089140/index.html

[16] Article 49 of the DCE Detailed Rules on Delivery and the Warehouse Receipt Services Management Measures.

[17] See the draft revised Measures for Risk Management of DCE for details of such risk management measures.

Overseas investors need to consider other legal and compliance implications of trading under the iron ore contract on the DCE, including the gap between know-your-customer standards in China and their home jurisdictions and, to the extent physical delivery under the futures contract is involved, how to comply with the investors' home jurisdiction sanction laws.

DCE – impact on the SGX iron ore contract?

Currently, global iron ore prices are based on the futures contract listed on the Singapore Exchange (SGX),[18] and this is currently a key market for iron ore and coking coal hedging instruments used by market participants to reduce risk upstream for the steel industry. Ever since the DCE first started trading iron ore futures contracts, comparisons have been made between the products on the two exchanges. The SGX iron ore USD-denominated swaps have been favoured by miners and traders, while the DCE's futures are used primarily by Chinese mainland steel mills and domestic investors. This parallel demand has been due to the prior restrictions on access to trading on the DCE for overseas traders, and so the SGX has acted as a proxy market. Because of the global prominence of China in the steel industry, iron ore is seen as the 'purest play' on growth in China.[19] Therefore, there is likely to be demand from overseas investors for the DCE contract.

The domestic futures contract market in China serves as the benchmark. Some sources suggest that the SGX reflects real demand more accurately as it is used by consumers to hedge their physical position, rather than purely to speculate.[20] Others suggest the reason the market is still driven by the SGX is that institutional investors account for a higher proportion of trading.[21] It will be interesting to see which of the two arguments play out over time. In reality, the ability to access the DCE contract from offshore will have some impact on the SGX iron ore contract. It is, however, unlikely that the DCE contract will suit all market players equally and therefore the SGX's contract will continue to have demand, at least in the short to medium term.

Conclusion

While opening up the futures market in China to allow overseas investors to access the DCE iron ore contract trading presents exciting business opportunities for currency and market arbitrage, especially given the high liquidity of the iron ore futures market in China, it is likely that practical issues surrounding the timing of the discounting pricing system, the physical delivery settlement structure and China's concerns about managing systemic risks posed by overseas investors will require aspects of the contract and rules to be tweaked over time. Nonetheless, as the instant liquidity of the INE contract immediately following its launch shows, there is clearly investor appetite and demand for Chinese futures products.

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[18] The SGX holds a 90% share of the offshore iron ore market. For further information, see: http://asiaetrading.com/successful-debut-of-sgx-otc-iron-ore-and-ffa-options/

[19] For further information, see: https://www.macrobusiness.com.au/2013/08/a-brief-history-of-iron-ore-markets/

[20] For further information, see: https://asia.nikkei.com/Markets/Commodities/China-seeks-alternative-benchmark-for-iron-ore?page=2

[21] For further information, see: http://www.afr.com/business/mining/iron-ore/singapores-sgx-punches-above-its-iron-ore-weight-20161021-gs86u0

Appendix 1 – Dalian Commodity Exchange Iron Ore Futures Contract

Product	Iron Ore
Trading Unit	100 MT/Contract
Price Quote	CNY/MT
Tick Size	0.5 CNY/MT
Daily Price Limit	4% of last settlement price
Contract Months	Monthly contracts (12 contracts per year)
Trading Hours	9–11.30am, 1.30–3 pm Beijing time, Monday–Friday, with extended hours trading session from 9pm to 11.30pm, and other trading hours announced by the DCE
Last Trading Day	10th trading day of the delivery month
Last Delivery Day	3rd trading day after the last trading day
Deliverable Grades	In accordance with the DCE Iron Ore Delivery Quality Standard
Delivery Location	The warehouses and delivery locations designated by the DCE
Minimum Trading Margin	5% of the contract value
Delivery Form	Physical delivery
Ticker Symbol	I
Exchange	Dalian Commodity Exchange

Appendix 2 – DCE Iron Ore Delivery Quality Standard[22]

1 Par grade product quality requirements

Target	Quality standard
Iron (Fe)	=62.0%
Silicon dioxide (SiO_2)	≤4.0%
Aluminium oxide (Al_2O_3)	≤2.5%
Phosphorus (P)	≤0.07%
Sulphur (S)	≤0.03%
Trace elements	Lead (Pb) ≤0.02% Zinc (Zn) ≤0.02% Copper (Cu) ≤0.20% Arsenic (As) ≤0.02% Titanium dioxide (TiO_2) ≤0.80% Chlorine + fluorine ≤0.20% Potassium oxide (K_2O) + Sodium oxide (Na_2O) ≤0.30%
Grain size	Not more than 20% are broader than 6.3mm and not more than 35% are finer than 0.15mm

2 Substitute product quality allowances (premiums and discounts)

Target	Tolerance	Premium/Discount (CNY/MT)
Iron (Fe)	≥60.0%	≥60.0% & $<$62.0%: −1.5 per 0.1% decrease
		$>$62.0% & ≤65.0%: +1.0 per 0.1% increase
		$>$65.0%: Pricing at 65.0%
Silicon dioxide (SiO_2) + Aluminium oxide (Al_2O_3)	≤8.5%	0
Silicon dioxide (SiO_2)	≤6.5%	$>$4.0% & ≤4.5%: −1.0 per 0.1% increase; $>$4.5% & ≤6.5%: −2.0 per 0.1% increase (calculated accumulatively)
Aluminum oxide (Al_2O_3)	≤3.5%	$>$2.5% & ≤3.0%: −1.5 per 0.1% increase; $>$3.0% & ≤3.5%: −3.0 per 0.1% increase (calculated accumulatively)
Phosphorus (P)	≤0.15%	$>$0.07% & ≤0.10%: −1.0 per 0.01% increase
		$>$0.10% & ≤0.15%: −3.0 per 0.01% increase (calculated accumulatively)
Sulphur (S)	≤0.20%	−1.0 per 0.01% increase
Grain size	Not less than 70% are finer than 0.075 mm	0

[22] For further information, see: http://www.dce.com.cn/DCE/Products/Industrial/Iron%20Ore/491886/index.html

3 Iron ore is priced on a dry basis, where the weight of moisture is deducted. The measured moisture rounded up to one decimal place shall be deducted when determining the weight of the delivered physical iron ores (e.g., 6.3% weight should be deducted for 6.32% moisture).

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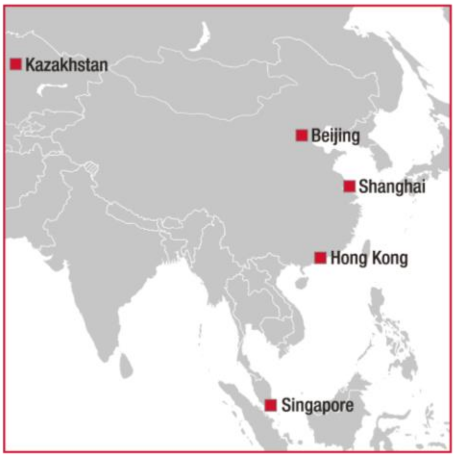

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