

# LEGAL PLURALISM AND ISOMORPHISM IN GLOBAL FINANCIAL REGULATION: THE CASE OF OTC DERIVATIVE COUNTERPARTY RISK REGULATION IN CHINA

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## ABSTRACT

*As economic globalization grows and legal conflicts between state-made domestic law and private-made transactional law become unavoidable, the core concepts instated by the International Swaps and Derivatives Association (ISDA) master agreement such as the close-out setoff mechanism become touchstones for different legal systems in different countries. The close-out setoff, which aims to reduce counterparty risk in the event of counterparty default, may come into conflict with existing bankruptcy law, as is the case for China. China has used a unique deference method to reconcile conflicting state laws and international norms in derivatives trade by localizing the ISDA master agreement and devising the master agreement of the National Association of Financial Market Institutional Investors (NAFMII). The NAFMII master agreement adopted all essential concepts of the ISDA master agreement including the close-out setoff that conflicts with Chinese Enterprise Bankruptcy Law. This Article studies some of the rulings on the legal standing of close-out setoff adjudicated by Chinese provincial courts and the relevant judicial interpretations of the Chinese Supreme Court. This Article also explores how China keeps abreast with the international trend by using mandatory central clearing as an alternative means of reducing counterparty risk. Furthermore, the Theory of Isomorphism is used to explain the driving force behind reconciling legal conflicts in the Chinese derivatives market. The analysis advanced here sheds light on the long-standing debate over conflict resolution in public-private ordering at the transnational and national levels. The analysis provided in this Article may help international finance regulators, lawyers, scholars, and policy-*

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*makers understand how international financial norms and rules become integrated into domestic law.*

## INTRODUCTION

The business world has become more and more transnational with the endless adventure of capital.<sup>1</sup> Economic globalization and innovation has bypassed national borders and blurred the traditional division of state-made law and private-made law.<sup>2</sup> In this context, legal scholarship should continue to investigate not only U.S. state-made law but also private law produced by U.S. businessmen such as the International Swaps and Derivatives Association (ISDA) master agreement because such law spreads out to different corners of the world.

Following the bankruptcy of Lehman Brothers in 2008, various jurisdictions were involved in litigation surrounding the core concepts of the ISDA master agreement.<sup>3</sup> Different jurisdictions ruled differently on the issue because although the ISDA master agreement provides uniform behavior rules for financial players worldwide, jurisdictions' recognition of such rules was uneven.<sup>4</sup> In other words, the ISDA master agreement's characteristic as a new *lex mercatoria* (transnational private law) "motivated by a strong desire by its proponents to free international transactions from the perceived shackles of national law"<sup>5</sup> has led the paths to freedom from the shackles of national law in different jurisdictions to

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1. See Adam Feibelman, *The IMF and Regulation of Cross-Border Capital Flow*, 15 CHI. J. INT'L L. 409, 411 (2014).

2. For a discussion of private and public ordering, see Jacco Bomhoff & Anne Meuwese, *The Meta-Regulation of Transnational Private Regulation*, 38 J. L. & Soc'y. 138, 139 (2011).

3. See generally Peter Marchetti, *Amending the Flaws in the Safe Harbors of the Bankruptcy Code: Guarding Against Systemic Risk in the Financial Markets and Adding Stability to the System*, 31 EMORY BANKR. DEV. J. 305 (2014); see also Kingsley T.W. Ong, *The ISDA Master Agreement: Insolvency Stalemate and Endgame Solutions for Hong Kong Liquidators*, 40 H.K. L.J. 337, 342 (2010).

4. FIN. STABILITY BD., JURISDICTIONS' ABILITY TO DEFER TO EACH OTHER'S OTC DERIVATIVES MARKET REGULATORY REGIMES 2-3 (2014), [http://www.fsb.org/2014/09/r\\_140918/](http://www.fsb.org/2014/09/r_140918/) ("[A]lthough most jurisdictions have in place the authority to make deference decisions, only a small number of jurisdictions have to date made determinations and are already deferring to other jurisdictions for some portion of OTC regulation – only 3 jurisdictions report having some deference arrangements in place as of July 2014. (Australia, Canada, and the US (Commodity Futures Trading Commission (CFTC)); in the European Union, the European Commission (EC) is in the course of proposing deference be granted to a number of jurisdictions with respect to central clearing") [<https://perma.cc/9PLQ-HZHT>].

5. Roy Goode, *Rule, Practice, and Pragmatism in Transnational Commercial Law*, 54 INT'L & COMP. L.Q. 539, 545 (2005).

become diversified, arduous, and even risky. Such processes nevertheless provide snapshots of the appearances and spirits of different legal systems with different origins than common or civil law through the lens of different treatments of derivative setoff. They also open windows for observing the game of legal transnationalism, pluralism, localism, and monism in different jurisdictions, which is essential knowledge for international business lawyers, scholars, financial regulators, and policymakers.

Literature about how the ISDA master agreement provides freedom from the shackles of national law in different jurisdictions needs to be updated frequently since the landscape of financial regulation and rules change globally. Furthermore, although an abundance of literature exists regarding the regulation of over-the-counter (OTC) derivatives market after the 2008 crisis, little focuses on Asia, including China, an emerging market.

China has become the second largest economy in the world<sup>6</sup> and its economic regime is undergoing a great transition from planned to market-oriented.<sup>7</sup> Similarly, China's financial markets, though still underdeveloped, are also undergoing reform from repression to liberalization.<sup>8</sup> For instance, even the derivatives market, the most underdeveloped financial market, has grown very quickly. According to a report on ISDA, the Chinese derivative market achieved a high growth rate of 41% in 2012.<sup>9</sup> This was partly driven by Chinese policymakers' strong desire to establish multi-level financial markets<sup>10</sup> including the derivatives market. Moreover, due to the growing influence of the Chinese economy, China is playing a more important and active role in international financial regulation,<sup>11</sup> which makes China a cornerstone in the construc-

6. *Gross Domestic Product 2017*, THE WORLD BANK, <http://databank.worldbank.org/data/download/GDP.pdf> [https://perma.cc/PM65-MQLG].

7. *China's Economic Transition, a Great Success*. PEOPLE'S DAILY (Nov. 13, 2002) [http://en.people.cn/200211/13/eng20021113\\_106760.shtml#](http://en.people.cn/200211/13/eng20021113_106760.shtml#) [https://perma.cc/AA98-NCZE].

8. Simin Gao, *Seeing Gray in a Black-and-White Legal World: Financial Repression, Adaptive Efficiency, and Shadow Banking in China*, 50 TEX. INT'L L.J. 95, 98–107 (2015) [hereinafter Gao, *Seeing Gray in a Black-and-White Legal World*].

9. See CELENT, *THE ASIAN OTC DERIVATIVES MARKETS: A STUDY PREPARED FOR ISDA 26* (2013), <https://www.isda.org/a/9QiDE/celest-isa-asian-otc-derivatives-markets-final.pdf> [https://perma.cc/Q6CV-RUNY].

10. See Li Keqiang: *Adhere to Directions of Marketization and Legalization in Promoting Development of Multiple-Tiered Capital Market*, CONSULATE-GEN. CHINA L.A. (Sept. 9, 2015), <http://losangeles.china-consulate.org/eng/topnews/t1295878.htm> [https://perma.cc/M9FZ-YZBV].

11. See *The Global Finance Regime*, COUNCIL ON FOREIGN REL. (Jan. 23, 2012) <http://www.cfr.org/financial-regulation/global-finance-regime/p20177> [https://perma.cc/WT59-C8KC].

tion of international financial regulation. As important as Chinese financial regulation is for theory and practice, however, not much is known about how China incorporates international financial rules and norms like those of derivative transactions and regulations, especially with regards to the scenarios that play out when foreign rules or norms conflict with the existing legal regime. This Article explores this area of inquiry by using the conflicts and reconciliation of OTC derivative counterparty risk regulation in China as examples.

This Article uses the conflicts and reconciliation of OTC derivative counterparty risk regulation as examples since they provide a “bird’s-eye view”<sup>12</sup> of public-private ordering at the transnational and national levels. The crown of private governance is the ISDA master agreement, which provides contractual governance through standard clauses that can be directly implemented in transactions to establish the rights and obligations of the parties involved and assist with risk management.<sup>13</sup> The highly technical terms of the ISDA master agreement provides a method through which derivative transactions can successfully cross the barriers of national law<sup>14</sup> because its technical terms can reduce transactional risks and provide added safety to the financial system, making it more likely for a nation state to accept the master agreement. One such core device of the ISDA master agreement is the close-out setoff term designed to reduce counterparty risk.<sup>15</sup> Counterparty risk is the risk that the “default of a firm’s counterparty might affect its own default probability.”<sup>16</sup> Although the close-out setoff clause of the ISDA master agreement can reduce counterparty risk, it may violate the mandatory provisions of various countries’ bankruptcy laws intended to protect equal distribution among creditors. Such scenarios present various questions including Professor Frank Partnoy’s inquiries:

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12. Goode, *supra* note 5, at 545.

13. Simin Gao & Christopher Chen, *Transnationalism and Financial Regulation Change: A Case of Derivative Markets*, 18 EUR. BUS. ORG. L. REV. 193, 197, 199, 208–09 (2017).

14. See Joanne P. Braithwaite, *The Inherent Limits of “Legal Devices”: Lessons for the Public Sector’s Central Counterparty Prescription for the OTC Derivatives Markets*, 12 EUR. BUS. ORG. L. REV. 87, 104 (2011).

15. See generally ISDA, THE LEGAL ENFORCEABILITY OF THE CLOSE-OUT NETTING PROVISIONS OF THE ISDA MASTER AGREEMENT AND THEIR CONSEQUENCES FOR NETTING ON FINANCIAL STATEMENTS 2–3, <https://www.isda.org/a/FgiDE/the-effectiveness-of-netting.pdf> (discussing the ISDA master agreement’s close-out setoff term) [<https://perma.cc/HH73-AZJV>].

16. Robert A. Jarrow & Fan Yu, *Counterparty Risk and the Pricing of Defaultable Securities*, 56 J. FIN. 1765, 1766 (2001).

[H]ow should regulators address pressure between ex ante private specification and ex post public adjudication? . . . [W]hat kinds of duties do counterparties to sophisticated financial contracts owe to each other? How should judges interpret a clause specifying that there are no such duties or that they are minimal?<sup>17</sup>

Regulators and judges in different jurisdictions are facing such questions as they continuously encounter emerging financial innovations. Here, the Theory of Legal Pluralism provides a new perspective from which to reconcile the conflicts that is separate from the top-down coercion from state law to private law.<sup>18</sup> Legal pluralism respects both the pluralistic legal order that allows for the coexistence of different norms and dispute settlement mechanisms as well as coordination and tolerance among various norms.<sup>19</sup>

This Article applies the Theory of Legal Pluralism to explain the areas of conflict and reconciliation relating to the OTC derivative close-out setoff clause vis-à-vis bankruptcy law in China. Specifically, this Article builds a legal conflicts reconciliation model with three different levels—deference, recognition, and convergence—based on Professor Paul Berman’s theory of nine procedures for managing hybridity.<sup>20</sup> Here, *deference* means that state-made rules and non-state rules are assumed to be equal, rather than hierarchical. For instance, the ISDA plays an active role in promoting deference by studying the law of each country to make the “differences” in the master agreement look legitimate under the sovereignty of a country.<sup>21</sup> Furthermore, *recognition* refers to two kinds of private law that are determined by legislation and judicial decisions. For instance, the U.S. bankruptcy law’s safe harbor saves a place for derivatives contracts.<sup>22</sup> Finally, *convergence* refers to seeking of the common ground between private and public spheres by either inviting the private sphere to participate in public governance or by relying on an intermediary (such as a central clearing house that is not an exchange) for governance.<sup>23</sup> Intermediary regula-

17. Frank Partnoy, *The Timing and Source of Regulation*, 37 SEATTLE U. L. REV. 423, 432–33 (2014).

18. See Paul Schiff Berman, *Global Legal Pluralism*, 80 S. CAL. L. REV. 1155, 1157–59 (2007).

19. *Id.*

20. See generally *id.* at 1157–59, 1196–1235 (discussing in general legal pluralism and Professor Berman’s theory of nine procedures for managing hybridity).

21. Caroline Bradley, *Private International Law-Making for the Financial Markets*, 29 FORDHAM INT’L L. J. 127, 158 (2005).

22. 11 U.S.C. §§ 362(b)(6)–(7), (17), (27); 546(g), (j); 553(b)(1); 555–56; 559–62 (2012).

23. Gao & Chen, *supra* note 13, at 204–05.

tion is middle-way governance that is different from both traditional self-regulation and bureaucratic regulation because it can “institutionaliz[e] responsibility” of private players.<sup>24</sup> After the financial crisis of 2008, the G20 countries sought to find a common ground between autonomy and public interest by requiring some derivatives to be settled in a central clearing house.<sup>25</sup>

Since the 2008 financial crisis, China has been active in establishing a central clearing house to reduce counterparty risk and comply with the commitment agreed upon by the G20 countries.<sup>26</sup> The rise of the Chinese derivatives market, however, was not prompted by sophisticated players’ need to hedge in the primary market.<sup>27</sup> Instead, it was prompted by the government’s motivation to use the secondary market to promote the underdeveloped primary market.<sup>28</sup> Therefore, the rise of the Chinese derivatives market is not the result of market forces but the design of the government. Such background is critical for understanding the regulatory logic underlying the Chinese derivatives market as well as the evolution of regulations underlying counterparty risk in China. This is because China has used a unique deference method to reconcile conflicts between state law and international norms regarding derivative transactions by localizing the ISDA master agreement by launching the National Association of Financial Market Institutional Investors (NAFMII), which agreement adopted all essential concepts of the ISDA master agreement including the close-out set-

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24. Neil Gunningham & Joseph Rees, *Industry Self-Regulation: An Institutional Perspective*, 19 L. & POL’Y 363, 406 (1997).

25. See FIN. STABILITY BD., OTC DERIVATIVES MARKET REFORMS: SIXTH PROGRESS REPORT ON IMPLEMENTATION (2013), [http://www.fsb.org/wp-content/uploads/r\\_130902b.pdf?page\\_moved=1](http://www.fsb.org/wp-content/uploads/r_130902b.pdf?page_moved=1) [https://perma.cc/4X26-QGKQ].

26. *Id.* at 89.

27. At the very beginning, the rise of the derivative market was driven and designed by the government. See Wenqian Zhong, *Chang Qing Oral History: The Rise and Fall of the Commodity Industry in China* (常清口述历史: 中国期货业20年沉浮录), SINA (Dec. 27, 2008), <http://finance.sina.com.cn/money/future/fmnews/20081227/02275691779.shtml> [https://perma.cc/Y5Y9-GTZ8].

28. See Jingyu Ma, *PBC, CBRC, CSRC and CIRC (One Bank and Three Commissions) Delve into the Spirit of the Fifth Plenary Session of the 18th CPC Central Committee* (一行三会学习十八大精神 郭树清称要维护市场稳定), SINA (Dec. 17, 2012) [http://finance.sina.com.cn/money/bank/bank\\_yhfg/20121117/080413707344.shtml](http://finance.sina.com.cn/money/bank/bank_yhfg/20121117/080413707344.shtml) [https://perma.cc/FG2R-MXKX]; see also *To Implement the Spirit of the Fifth Plenary Session of the 18th National Congress of the Communist Party of China Central Committee, People’s Bank of China Performs Duties and Responsibilities Scientifically and Efficiently* (深入贯彻落实党的十八大精神 科学务实高效履行中央银行职), CHINESE FIN. NEWS (July 1, 2013), [http://www.financialnews.com.cn/yw/jryw/201307/t20130701\\_35764.html](http://www.financialnews.com.cn/yw/jryw/201307/t20130701_35764.html) [https://perma.cc/G6T7-EXJZ].

off<sup>29</sup> that is in conflict with the Chinese Enterprise Bankruptcy Law.<sup>30</sup> This Article studies the courts' attitudes towards the close-out setoff clause in cases litigated in China and analyzes relevant judicial interpretations from the Chinese Supreme Court.

This Article uses the Theory of Isomorphism to explore the driving force behind conflict reconciliation in derivative transactions in China. Isomorphism is a "process of homogenization" that forces "one unit in a population to resemble other units that face the same set of environmental conditions."<sup>31</sup> The three kinds of isomorphism—coercive isomorphism that "stems from political influence," mimetic isomorphism resulting from "standard responses to uncertainty," and normative isomorphism which "associates with professionalization"<sup>32</sup>—can help explain the conflict reconciliation model in China.

In doing so, this Article provides an in-depth analysis of the long-term debate over conflicts and reconciliation in public-private ordering by analyzing the OTC derivatives market in China with particular attention paid to "the socio-legal context in which the legal regimes operate."<sup>33</sup> The analysis advanced here may help international financial lawyers, scholars, and policymakers understand how international financial norms and rules react with, and are incorporated into, domestic law.

Part I of the Article provides a theoretical framework for the analysis including a review of the theories of standard contract, legal pluralism, and isomorphism. Part II discusses the pluralistic environment and conflict reconciliation in the OTC market in the Western world. Parts III and IV present case studies of legal conflicts and paths towards reconciliation in the Chinese OTC derivatives market and explores the rationales underlying them. Part V describes the implications of this Article and provides suggestions for the Chinese government based on the experience and lessons from the United States.

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29. See NAFMII MASTER AGREEMENT §§ 9(I)–(II) (2009), <http://www.nafmii.org.cn/zgl/bzxy/jrys/201202/W020120226851811293666.pdf> [<https://perma.cc/PY3J-FC3U>].

30. It may conflict with articles 18, 19 to 21, and 40 of the Enterprise Bankruptcy Law of the P.R.C. See *Zhonghua Renmin Gongheguo QiyePochan Fa* (中华人民共和国企业破产法) [Enterprise Bankruptcy Law] (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007) (Chinalawinfo).

31. Paul J. DiMaggio & Powell W. Walter, *The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational Fields*, 48 AM. SOC. REV. 147, 149 (1983).

32. *Id.*

33. Simin Gao & Qianyu Wang, *The U.S. Reorganization Regime in the Chinese Mirror: Legal Transplantation and Obstructed Efficiency*, 91 AM. BANKR. L.J., 137, 140 (2017).

I. THE THEORETICAL FRAMEWORK OF CONFLICT AND  
RECONCILIATION: PRIVATE LAW MAKING, PLURALISM, AND  
ISOMORPHISM

A. *Theory of Standard Contract and Private Law-making*

The ISDA master agreement is a typical example of a standard contract.<sup>34</sup> As Professor Andrew Verstein finds, “[P]reference for ISDA documentation is partially a result of strong network externalities in the form of comprehensibility and fungibility in the eyes of other market participants.”<sup>35</sup> The standard contract is “effected by trade associations or other centralized standard-setting organizations through collective agreement on a standard contract, sometimes involving public agencies.”<sup>36</sup> Furthermore, as Professor Dan Wielsch observes, “[I]n light of the suggested two-pronged change of perspective on law making—from statist to societal and from territorial to functional—these standards appear as powerful tools for legal regulation at the global level: they form contracts similar to public regulation.”<sup>37</sup>

The standard contract is an important form of private law-making. A contract can be viewed as a kind of organization since “contracts often are created by organizations, and, in turn, each contract creates a new organization.”<sup>38</sup> This organizational view of contracts helps explain the order of the world of derivatives where contracts govern the players’ interactions.<sup>39</sup> In such a world, “mass contracting is a key factor in transferring sovereign functions to private actors.”<sup>40</sup> The state also achieves public goals such as deterrence of opportunism and maintenance of order through contracts.<sup>41</sup>

Standard contracts become public only when the state sides with them.<sup>42</sup> There are two main ways for the state to side with standard contracts. First, the legislature may recognize the legitimacy of the

34. Stephen J. Choi & G. M. Gulati, *Contract as Statute*, 104 MICH. L. REV., 1129,1140 (2006).

35. Andrew Verstein, *Ex Tempore Contracting*, 55 WM. & MARY L. REV. 1869, 1909 (2014).

36. Dan Wielsch, *Global Law’s Toolbox: Private Regulation by Standards*, 60 AM. J. COMP. L. 1075, 1078 (2012).

37. *Id.*

38. D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1, 24 (2009).

39. Anna Gelpern, *Commentary*, 51 ARIZ. L. REV. 57, 65 (2009).

40. Wielsch, *supra* note 37, at 1078.

41. *See generally* Anna Gelpern & Mitu Gulati, *Public Symbol in Private Contract: A Case Study*, 84 WASH. U. L. REV. 1627 (2006).

42. Wielsch, *supra* note 35, at 1078–79.



private practice that dominates in the industry; second, courts may side with “one or another party, putting the power of the state behind its privately negotiated position.”<sup>43</sup> The significant concern about the “legitimacy problem of private regulation—asymmetric representation that may favour the particular interests of rule-makers at the expense [of] parties and common interest—becomes especially virulent where [the] private regulatory regime in question allows by-passing a state’s legal subsystem designed to protect the interests of such third parties.”<sup>44</sup> For instance, although the close-out setoff clause of the ISDA master agreement can reduce counterparty risk, it may violate the mandatory provisions of bankruptcy law intended to protect the equal distribution among creditors. Here, the Theory of Legal Pluralism provides a new perspective for reconciling such conflicts that is different from coercion through state law that passes down to private-made law.

### B. *Theory of Private Law and Legal Pluralism*

From the sociological perspective of the law, law has a social function controlling collective behavior and maintaining social order.<sup>45</sup> The elements of law include both state-made law and private-made law, which have a competitive relationship.<sup>46</sup> On the one hand, private law-making is a response to local normative fragmentation, which is highlighted in states’ regulation of markets.<sup>47</sup> On the other hand, the private order faces the recognition of its legitimacy problem by the state.<sup>48</sup> Furthermore, different jurisdictions have disparate models of public-private legal ordering,<sup>49</sup> which compounds the issue. Here, legal pluralism can provide a perspective through which the relationship of public-private ordering can be analyzed.<sup>50</sup>

Legal pluralism began in the 1960s.<sup>51</sup> It embodies two meanings: first, the plural legal ordering based on the coexistence of different norms and dispute resolution mechanisms, and second,

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43. Gelpert, *supra* note 39, at 62.

44. Wielsch, *supra* note 37, at 1078–79.

45. *Id.*

46. Bomhoff & Meuwese, *supra* note 2, at 139.

47. Wielsch, *supra* note 37, at 1077.

48. *Id.*

49. See Braithwaite, *supra* note 14, at 104.

50. J.H. Dalhuisen, *Legal Orders and Their Manifestation: The Operation of the International Commercial and Financial Legal Order and Its Lex Mercatoria*, 24 BERKELEY J. INT’L L. 129, 129 (2006).

51. Jacques Vanderlinden, *Return to Legal Pluralism: Twenty Years Later*, 28 J. LEGAL PLURALISM 149, 157 (1989).

the relations and interactions of plural legal ordering.<sup>52</sup> Legal pluralism regards the law as a heterogeneous body that informs legal ordering as well as the diversity of subjects that form and implement the norms.<sup>53</sup> Legal pluralism focuses on the interaction between statist law and other rules.<sup>54</sup> Moreover, legal pluralism has always been an important issue in the field of international law, comparative law, and jurisprudence.<sup>55</sup> By rebelling against nationalist legal systems, legal pluralism seeks to free norms from the coercion of national law.<sup>56</sup>

There is comparatively little discussion of legal pluralism in the field of private law. However, commercial law has been connected to legal pluralism since its inception. Moreover, in the past twenty years, with the rise of the new *lexmercatoria*, discussion of legal pluralism has further extended into the field of private law.<sup>57</sup> With regards to commercial law being connected with legal pluralism from the beginning of its existence, it is important to note that the origin of private law is pluralistic, which includes national laws and different types of non-state laws known as norms.<sup>58</sup> Norms include trading habits, industry consensus, autonomy of treaties, moral customs, and other similar elements.<sup>59</sup> At the same time, private law is also pluralistic in terms of dispute resolution, which includes litigation and arbitration. Private law's pluralism is important because "values such as autonomy, utility, and community are the building blocks of private law theory."<sup>60</sup> For example, property law does not just focus on establishing exclusive rights because it serves multiple values of freedom such as autonomy, function, labor, personality, community, and distributive justice.<sup>61</sup> Similarly, contract law does

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52. Francis Snyder, *Governing Economic Globalisation: Global Legal Pluralism and European Law*, 5 EUR. L. J. 334, 342-43 (1999).

53. *Id.*

54. Suli Zhu (朱苏力), *FaluGuibi he FaluDuoyuan* (法律规避和法律多元) [*The Evasion of Law and Legal Pluralism*], 6 ZHONGWAI FAXUE (中外法学) [PEKING U.L.J.] 14, 19 (1993).

55. Jingzhe Yang (杨静哲), *FaluDuoyuanhua : Guiji, KunjingyuChulu* (法律多元论: 轨迹、困境与出路) [*Legal Pluralism: Development, Dilemma and Solution*] 2 FALV KEXUE (法律科学) [SCI. L. (J. NORTHWEST U. POL. SCI. & L.)] 3, 3 (2013).

56. Berman, *supra* note 18, at 1155 (2007).

57. Dalhuisen, *supra* note 50, at 129.

58. Ralf Michaels, *The Re-State-Ment of Non-State Law: The State, Choice of Law, and the Challenge from Global Legal Pluralism*, 51 WAYNE L. REV. 1209, 1228 (2005).

59. William K. Jones, *A Theory of Social Norms*, U. ILL. L. REV. 545, 546 (1994); David Chamy, *Illusions of a Spontaneous Order: 'Norms' in Contractual Relationships*, 144 U. PA. L. REV. 1841, 1841 (1996).

60. Hanoch Dagan, *Pluralism and Perfectionism in Private Law*, 112 COLUM. L. REV. 1409, 1410 (2012).

61. *Id.* at 1412.

not only rely on its contents as the sole benchmark of its value, but also provides a variety of systems to meet different social relations and economic functions. Legal pluralism in private law, its legal origins, dispute resolution, and value, holds that the maintenance of its legal ordering is the result of cooperation among multiple rules, systems, and subjects. Thus, the method of resolving rule conflicts under legal pluralism is different from that used under traditional monism of state law that suppresses other regulations.

### *C. Public-Private Law Conflicts and Reconciliation through Legal Pluralism*

Under legal pluralism, the way to resolve rules conflict is different from the traditional monism of state law suppressing other regulations. Legal pluralism respects both the pluralistic legal order that allows for the coexistence of different norms and dispute settlement mechanisms as well as the coordination and tolerance of various norms.

Under legal pluralism, static and private-made law coexist and cooperate in maintaining the social order.<sup>62</sup> Traditionally, conflicts in static and private-made law were repressed by static law.<sup>63</sup> As Professor Berman observes, “instead of trying to stifle conflict either through an imposition of sovereigntist, territorially-based prerogative or through universalist harmonization schemes, communities might sometimes seek (and increasingly are creating) a wide variety of procedural mechanisms, institutions, and practices for managing, without eliminating, hybridity.”<sup>64</sup> Professor Berman’s procedure for managing the hybridity includes the following nine methods:<sup>65</sup> (i) dialectical legal interactions between “static and non-static authority”;<sup>66</sup> (ii) margin of appreciation applied by the courts to respect the “local variation”;<sup>67</sup> (iii) Limited Autonomy Regimes allowing for an autonomous regime in the local community;<sup>68</sup> (iv) subsidiary schemes providing “an ordering principle designed to keep so-called ‘higher’ levels of authority from trenching unduly on the ‘internal life of a community’”;<sup>69</sup> (v)

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62. Sally Falk Moore, *Law and Social Change: The Semi-Autonomous Social Field as an Appropriate Subject of Study*, 7 L. & Soc’y. Rev. 719, 720 (1973).

63. Berman, *supra* note 18, at 1162.

64. *Id.*

65. *Id.* at 1192–1228.

66. *Id.* at 1197.

67. *Id.* at 1201.

68. *Id.* at 1204.

69. *Id.* at 1207.

jurisdictional redundancies providing “a mechanism for managing hybridity;<sup>70</sup> (vi) hybrid participation arrangements allowing citizens to engage in social governance, for example, as on a jury in a trial<sup>71</sup> or, as Karl Llewellyn proposed, as “merchant experts sit as a tribunal to hear commercial disputes”;<sup>72</sup> (vii) mutual recognition regimes harmonizing the different “norms applied to products or services that cross borders”;<sup>73</sup> (viii) safe harbor agreements “that [require] firms doing business abroad [to] abide by some of the standards of that foreign community;<sup>74</sup> and (ix) pluralist approach to conflict of laws that are specifically meant to manage “hybrid legal spaces.”<sup>75</sup>

Professor Berman’s theory provides a new perspective for resolving conflicts from pluralism. Nevertheless, Professor Berman’s theory has two shortcomings. First is a lack of abstraction and systematization because the description of the method itself weighs more than the abstraction of concept and there is no construction of the relationship between the nine methods.<sup>76</sup> Second is the limited nature of the applicable object.<sup>77</sup> The theory is more about the application of the nine methods in international law and conflict law that does not fully take into account its application to more extensive fields such as its use in resolving conflicts in regulations within countries and regions as well as static and private law.<sup>78</sup>

In light of the above problems, this Article further develops the Theory of Legal Pluralism in the following two manners: first, by establishing the logical relation of different methods and second, by demonstrating how the theory can be used to resolve concrete cases involving conflicts of OTC derivatives rules. In this Section, the internal logic of methods is discussed and the application of the method will be discussed in the subsequent Section. Specifically, this Section will begin by outlining Professor Berman’s logic among the nine methods that can be divided into three levels.

The first level is deference, which entails three logical components. First, the nine methods assume that rules are equal and are

70. *Id.* at 1210.

71. Katherine A. Hermes, *Jurisdiction in the Colonial Northeast: Algonquian, English and French Governance*, 43 AM. J. LEGAL HIST. 52, 64–65 (1999).

72. Zipporah Batshaw Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, 100 HARV. L. REV. 465, 512–15 (1987).

73. Berman, *supra* note 18, at 1224.

74. *Id.* at 1227.

75. *Id.* at 1228.

76. For instance, the theory of hybridity is very lengthy. *See id.* at 1162.

77. *Id.*

78. *Id.*

not a part of a hierarchical system, which leads to a dialectical interaction among laws.<sup>79</sup> Second, the nine methods embrace the necessity of different rules existing among different communities, which may provide solutions to pluralistic legal conflicts.<sup>80</sup> Third, the methods accept the redundancy of jurisdiction and the existence of jurisdictional conflict caused by otherness, which leaves space for further coordination rather than arbitrary assertion that low-level rules are invalid as they go against high-level rules.<sup>81</sup>

The second level is recognition, which entails two aspects pertaining to the recognition of different communities' special characteristics on the legislative and jurisdictional levels and the special treatment given to special issues. First, different communities are recognized by limiting the autonomy mechanism, mutually recognizing the mechanism that includes an auxiliary scheme as well as the validity of the community rules, applying customary law to special areas or special groups, respecting community governance, and avoiding the intervention of top-down decision-making,<sup>82</sup> while simultaneously allowing judges to apply community rules based on the principle of free judgment. Second, recognition is established by using a safe harbor provision allowed by legislation to exempt certain acts or groups from certain rules.<sup>83</sup>

The third level is convergence, which seeks to find common ground between the private and the public. Convergence combines deference and recognition to realize the ultimate goal of reducing conflicts and barriers to allow citizens from communities to take part in the governance of the country through mixed participation arrangements.<sup>84</sup>

These three abovementioned levels outline the evolutionary path of different approaches but do not reveal the dynamics behind the evolution. In fact, different factors determine the level of conflict resolution resulting from deference, recognition, and convergence. In the following Section, the factors that regulate conflict in the derivatives market are explored through specific cases.

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79. *Id.* at 1197.

80. *Id.* at 1203.

81. *Id.* at 1210.

82. *Id.* at 1203.

83. *Id.* at 1227.

84. *Id.* at 1218.

D. *Theory of Isomorphism: The Driving Force of Conflict Reconciliation*

The driving force of conflict reconciliation may come from isomorphism. Isomorphism is the “process of homogenization” that forces “one unit in a population to resemble other units that face the same set of environmental conditions.”<sup>85</sup> There are three kinds of isomorphism: coercive isomorphism that “stems from political influence and the problem of legitimacy”; mimetic isomorphism that results from “standard responses to uncertainty”; and normative isomorphism that “associates with professionalization.”<sup>86</sup> Isomorphism can provide the lens to interpret the motivation whereby state law can accept and recognize private lawmaking in the context of globalization. Private lawmaking such as the norms in the derivatives market (e.g., the ISDA master agreement), converges ahead of national law in different jurisdictions.<sup>87</sup> National law accepts internationalized norms on derivatives to gain legitimacy with external constituents in international society.<sup>88</sup> This phenomenon is significant in the margin markets of derivative transactions when these markets adopt the powerful markets’ rules.<sup>89</sup>

Coercive isomorphism happens when the existing institution needs to change, which is likely to lead to new legislation.<sup>90</sup> Private-made law, which reflects the most advanced technology in business transaction, will push new static lawmaking if, as Beckert observes, “existing institutions have been thoroughly discredited, morally or functionally, and, at the same time, if there is a powerful external actor who is able to enforce a new institutional design.”<sup>91</sup>

Professional associations, like the ISDA, play an important role in isomorphism. According to Leicht and Jenkins, “competing states are subject to normative isomorphic pressure through the professional networks of state managers. These states are also pres-

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85. DiMaggio & Walter, *supra* note 31, at 149.

86. *Id.*

87. FIN. STABILITY Bd., *supra* note 4.

88. Verstein, *supra* note 35.

89. *See generally* Gao & Chen, *supra* note 13, at 1.

90. *See* Jens Beckert, *Institutional Isomorphism Revisited: Convergence and Divergence in Institutional Change*, 28 SOC. THEORY 150, 153 (2010) (“[I]somorphic change occurs if existing institutions have been thoroughly discredited, morally or functionally, and, at the same time, if there is a powerful external actor who is able to enforce a new institutional design.”).

91. *Id.*

sured to imitate or mimic policies of other states to keep up in the competition for private investment and economic development.”<sup>92</sup>

The driving force of mimetic isomorphism is “the legitimation that an institutional regulation finds within an organizational field.”<sup>93</sup> The driving force for recognizing the global standard made by private players may occur because lawmakers want to stay abreast of the most advanced states in business transaction. For example, the Japanese lawmakers accept the close-out netting clause in law because, by doing so, they can join “the family of civilized neoliberal nations and speeding the project of global law reform in the service of markets.”<sup>94</sup>

## II. THE PLURALISTIC ENVIRONMENT OF LAW AND CONFLICT IN OTC MARKETS IN THE WESTERN WORLD

### A. *Overview of the ISDA Master Agreement in the OTC Derivatives Market*

The core of legal pluralism is to free norms from the clamp of nation states, as exemplified by the OTC derivatives market. Compared with other financial markets, the OTC derivatives market is characterized by weak regulatory power and a high degree of autonomy.<sup>95</sup> Since many transactions do not go through the central clearing house, the risk of the opponent defaulting is undertaken by the parties to the contract rather than the exchange.<sup>96</sup> Meanwhile, as OTC derivatives are not traded on the exchange, the state’s regulatory power cannot penetrate the OTC derivatives through the exchange.<sup>97</sup>

In the OTC derivatives market, community governance has become an alternative to national governance. Traders established the ISDA in 1985 to form a community governance model. The main function of the ISDA is to create a standardized contract,

92. Kevin T. Leicht & J. Craig Jenkins, *Political Resources and Direct State Intervention: The Adoption of Public Venture Capital Programs in the American States, 1974-1990*, 76 SOC. FORCES 1323, 1327 (1998).

93. Beckert, *supra* note 90, at 153.

94. ANNELISE RILES, COLLATERAL KNOWLEDGE: LEGAL REASONING IN THE GLOBAL FINANCIAL MARKETS 206–07 (2011).

95. Alan Greenspan, Chairman, Fed. Reserve Bd., *Remarks Before the Futures Industry Association* (Mar. 19, 1999), <http://federalreserve.gov/boarddocs/speeches/1999/19990319.htm> [<https://perma.cc/9KMK-MMCN>].

96. Frank D’Souza, Nan S. Ellis & Lisa M. Fairchild, *Illuminating the Need for Regulation in Dark Markets: Proposed Regulation of the OTC Derivatives Market*, 12 U. PA. J. BUS. L. 476, 483 (2010).

97. *Id.* at 473.

which is the ISDA main contract. The ISDA main contract establishes industry practices by providing standard terms that can be directly used by transaction subjects.<sup>98</sup> Although it is not national law or an international treaty, the ISDA standard contract became the “basic law” to regulate the trading of derivatives worldwide.<sup>99</sup>

The ISDA master agreement is “motivated by a strong desire by its proponents to free international transactions from the perceived shackles of national law”<sup>100</sup> with the highly technical terms of legal devices.<sup>101</sup> The two core systems of the ISDA main contract, the netting and guarantee system, are both actually tools to bypass bankruptcy rules.<sup>102</sup>

### B. *Overview of the Counterparty Risk*

Counterparty risk is the risk that the default of a firm’s counterparty might affect its own default probability.<sup>103</sup> Counterparty risk and financial derivatives go hand in hand. It has four distinct characteristics:

1. Uncertainty of damage. When a default occurs, if the non-default party has a negative total economic value of all transactions with the counterparty, this will cause losses.<sup>104</sup> On the contrary, if the total economic value of all transactions is negative, there will be no economic losses.<sup>105</sup> Therefore, there is a much longer time horizon for completing transactions with greater uncertainty regarding the value (and even direction) of the ultimate transfer obligations.<sup>106</sup>

2. Bilateral risk. The price of financial derivatives, subject to the underlying asset or price of the index, will fluctuate with changes in market factors.<sup>107</sup> Therefore, its economic value to both transac-

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98. See *About ISDA*, ISDA, <https://www.isda.org/about-isda/> (last visited Apr. 26, 2019) [<https://perma.cc/59ME-C7XB>]; see also Gao & Chen, *supra* note 13, at 208.

99. *Id.*

100. Goode, *supra* note 5, at 545.

101. Braithwaite, *supra* note 14, at 104.

102. *Id.*

103. Jarrow & Yu, *supra* note 16, at 1766.

104. Gao Chengxing & Fu Wenjia, *Study of Central Counterparties and Counterparty Credit Risk Management*, 5 J. ZHONGNAN U. ECON. & L.74, 77 (2011).

105. *Id.*

106. Robert R. Bliss & Robert S. Steigerwald, *Derivatives Clearing and Settlement: A Comparison of Central Counterparties and Alternative Structures*, 30 ECON. PERSP. 23 (2006).

107. See Hans-Christian Latta & Milena Tantcheva, *United States: Proposals for Broad Regulation of Derivatives Markets Emerge in Congress*, MONDAQ, <http://www.mondaq.com/united-states/x/88674/Commodities+Derivatives+Stock+Exchanges/Proposals+For+Broad+Regulation+Of+Derivatives+Markets+Emerge+In+Congress> (last updated Nov. 3, 2009) [<https://perma.cc/3S8N-7HWN>].



tion parties may be positive or negative, and thus both parties have a two-way credit risk.<sup>108</sup>

3. Risk sustainability. Derivatives contract agreements often last a few years, and the actual transactions consist of multiple agreements nested under a main contract.<sup>109</sup> According to Bliss and Steigerwald, “with derivatives, however, the length of time between the execution of a transaction and settlement is essential to the contract.”<sup>110</sup> Hence the risk is sustained throughout the entire agreement period.

4. Dual harmfulness. Counterparty risk not only directly damages the interests of the parties to the derivatives contract but also may damage the stability of financial markets. For the purpose of risk hedging, trading parties are often involved in the sale of each other’s derivatives deals.<sup>111</sup> The so-called counterparty risk is the impact on default probability of the non-default party itself due to counterparty default.<sup>112</sup> In the whole financial market, the trading subjects of the derivative contract often coincide and the counterparty risk in a single contract can extend to the entire market, resulting in systemic risk.<sup>113</sup> As Singh and James Aitken observe, “In the context of a financial system that includes banks, broker dealers, and other nonbanking institutions (e.g., insurers and pension funds), counterparty risk will be the aggregate loss to the financial system from a counterparty that fails to deliver on its OTC derivative obligation.”<sup>114</sup>

Counterparty risk is a continuous bilateral risk, which not only damages the interests of the parties to the derivatives contract but also may damage the stability of financial markets.<sup>115</sup> Therefore, the governance of counterparty risk involves the cooperation of static rules and dynamic supervision.

108. *Id.*

109. Bliss & Steigerwald, *supra* note 106.

110. *Id.*

111. JINBO LUO, THE CREDIT ENHANCEMENT MECHANISM OF THE OTC: THE CASE OF THE HAISHENG DAMO, THE LAW AND COMMERCIAL RESEARCH No.1 (2011).

112. Jarrow and Yu, *supra* note 16, at 1766.

113. See Manmohan Singh & James Aitken, *Counterparty Risk, Implication on Collateral Flows, and Role for Central Counterparties*, 5, IMF Working Paper No. 173 (2009), <https://www.imf.org/external/pubs/ft/wp/2009/wp09173.pdf> [<https://perma.cc/BL9D-LJNK>].

114. *Id.* at 4.

115. *See id.*

### C. *Close-out Netting Terms in the ISDA Master Agreement*

Because of the bidirectional nature of counterparty risk and the fact that both parties to a transaction have the incentive to look for ways to reduce risk, there is a foundation for reaching consensus. The two parties in derivatives contracts can reduce risk exposure through setting close-out netting terms. Close-out netting refers to the netting term that is used during the early termination of a derivatives trading contract: both parties in the trading derivatives contract set a prior contract termination condition; once the condition occurs, the contract terminates, and the account is closed according to the netting approach.<sup>116</sup> One of the key instances in which close-out netting is used is when one of the parties becomes bankrupt and is unable to honor the agreement.<sup>117</sup> When one party is unable to fulfill its contractual obligations due to bankruptcy, close-out netting will contradict bankruptcy law.<sup>118</sup> The following Sections below describe situations in which bankruptcy is the reason for carrying out close-out netting.

The ISDA master agreement includes close-out netting terms.<sup>119</sup> Close-out netting applies to circumstances in which one party defaults. Specifically, close-out netting refers to “a process involving termination of obligations under a contract with a defaulting party and subsequent combining of positive and negative replacement values into a single net payable or receivable.”<sup>120</sup>

A close-out netting system actually includes two rights: an early termination right and a netting right.<sup>121</sup> The term “automatic early termination” means that if the bankruptcy situation as specified in the agreement occurs, the contract shall terminate immediately and automatically. Netting terms refer to any contract terms that are agreed to between the parties and carried out in the netting of single or multiple qualified financial contracts under the current or future payment obligations, delivery obligations, or request obligations. A close-out netting system treats a series of transactions occurring between the parties as a single agreement in which the parties can net the short and long balance, which results

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116. David Mengle, *ISDA Research Notes: The Importance of Close-Out Netting*, ISDA 1, 1–2 (2010), <https://www.isda.org/a/USiDE/netting-isda-researchnotes-1-2010.pdf> [<https://perma.cc/RE5S-ECX7>].

117. ISDA MASTER AGREEMENT § 6 (2002).

118. *Id.*

119. *Id.*

120. MENGLE, *supra* note 116, at 2.

121. ISDA MASTER AGREEMENT § 6 (2002).

in the net income.<sup>122</sup> A single agreement nets after the termination of the transaction.<sup>123</sup> The ISDA unequivocally shows that netting is indispensable; it can help traders quickly rebalance exposure to risk and reduce the loss during a counterparty default.<sup>124</sup>

The close-out netting method has a certain influence on reducing counterparty risk. Statistics show that the counterparty risk exposure of the derivatives market decreased by about 85% in 2009 through close-out netting according to the statistics of the Bank of International Settlements.<sup>125</sup> However, close-out netting occurs under the condition that one party goes bankrupt and requires the immediate setoff of balance, which contradicts bankruptcy laws.<sup>126</sup> Although the netting agreement can condense the risk exposure of the non-default party in a timely manner, the risk is transferred to the third party (that is, other creditors of the default party). The contradiction between close-out netting in the standard contract and bankruptcy law reflects conflict between industry practice and state law.

#### D. *Three Levels of Conflict Reconciliation under the Pluralism Perspective*

Whether close-out netting can be legitimated by a national court of justice depends on the attitude of legislators and the judiciary. The enforcement of private contracts depends on recognition by the state.<sup>127</sup> Therefore, the different approaches private contracts used to solve conflicts bypass bankruptcy laws and inevitably conflict with various state laws.

The first solution to the conflict between private contracts and state law is deference.<sup>128</sup> Derivatives traders have a set of contractual governance systems that are different from country's laws.<sup>129</sup> The ISDA plays an active role in promoting deference. The ISDA actively studies the law of each country, interprets the contract in a

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122. *Id.*

123. *Id.*

124. MENGLE, *supra* note 116, at 3–4.

125. ISDA MASTER AGREEMENT § 1 (2002).

126. See *infra* discussion in Part III (B)(2).

127. MORRIS R. COHEN, *Property and Sovereignty*, 13 CORNELL L. REV. 8, 8 (1927).

128. Deference means state law should consider the interests of interdependent world market, especially in globalization era. See Joel R. Paul, *The Transformation of International Comity*, 71 L. & CONTEMP. PROBS. 19, 35–37 (2008); see also Berman, *supra* note 18, at 1197, 1203, 1210.

129. See, e.g., NAFMII MASTER AGREEMENT (2009).

way that has no essential contradiction with existing legal mechanisms by reasoning according to juridical dogmatism, and hence bridges the gap between private governance and state governance, making the “differences” look legitimate under the sovereignty of a country.<sup>130</sup>

The second solution is recognition.<sup>131</sup> This approach promotes legislative governance from a market-oriented perspective by promoting a country’s law to legitimize the contractual terms. Under recognition, contracts receive exemption from bankruptcy law, which in turn brings these contracts into the safe harbor of bankruptcy law.<sup>132</sup> For example, the U.S. bankruptcy law’s safe harbor saves a place for derivatives contracts.<sup>133</sup>

The third solution is convergence.<sup>134</sup> As public authority governance partners, the community of derivatives traders transfer command and supervision into cooperation by regulation.<sup>135</sup> For instance, the exchange and the central clearing structure link the country’s regulators and market participants.<sup>136</sup> This kind of public-private interaction offers a “new paradigm of governance”<sup>137</sup> so as to achieve the purpose of convergence. The central clearing approach of OTC products actually partially limits the players’ trading freedom.<sup>138</sup> Traders exchange that freedom such that the government will delegate regulatory powers to the intermediary institutions of the industry rather than retain them at the expense of sacrificing part of trading freedom.<sup>139</sup>

The following Part III discusses the factors that drive the evolution of conflict resolution under the counterparty risk regulatory path by using Chinese derivatives regulation as an example.

130. Bradley, *supra* note 21, at 158.

131. Recognition means courts recognize “vested rights” that private parties obtained in foreign jurisdictions. Paul, *supra* note 128, at 27. *See also* Berman, *supra* note 18, at 1203, 1227.

132. *See, e.g.*, 11 U.S.C. §§ 362(b)(6)–(7), (17), (27); 11 U.S.C. §§ 546(g), (j); 11 U.S.C. § 553(b)(1); 11 U.S.C. §§ 555–56; §§ 559–62.

133. *Id.*

134. Convergence means nation-state legal regimes of the world are increasingly converging and developing a “world law.” *See* Berman, *supra* note 18, at 1190.

135. *See* John Braithwaite, *Accountability and Governance Under the New Regulatory State*, 58 *AUSL. J. PUB. ADMIN.* 90, 90 (1999).

136. *Id.*

137. *Id.*

138. *Id.*

139. *Id.*

### III. CONFLICTS AND RECONCILIATION: A CASE STUDY OF DEFERENCE AND RECONCILIATION IN THE CHINESE DERIVATIVES MARKET

#### A. *Overview of the Chinese Derivatives Market*

The Chinese derivatives market accounts for a very small portion of the world market. However, it is growing very quickly.<sup>140</sup> Big banks not only use derivatives to hedge and arbitrate in their businesses, especially those relating to exchange businesses, but also for the sake of their customers as a kind of investment product.<sup>141</sup>

The rise of the Chinese derivatives market is not promoted by the need for hedging by sophisticated players in the primary market. Instead, the government uses the secondary market to promote the primary market, which is underdeveloped.<sup>142</sup> Therefore, the rise of the Chinese derivatives market is not the result of market forces but of government design.<sup>143</sup> This regulatory logic is important to understand in the Chinese derivatives market and also the evolution of regulations of counterparty risk in China.

The Chinese derivatives market is very complicated because of its dual tracks on national and local levels.<sup>144</sup> The national derivatives market has two parts including the commodity market and the derivatives market.<sup>145</sup> Both of them are underdeveloped with very limited kinds of products.<sup>146</sup>

The essential part of the derivatives market is the commodity.<sup>147</sup> The commodity business began in 1990 in China when the first commodities exchange, the Zhengzhou Grain Wholesale Exchange, opened on October 12, 1990.<sup>148</sup> The legal basis of the commodity market is the Regulation on the Administration of

140. CELENT, *supra* note 9.

141. Jinan Yan, Irving Fisher Comm. (IFC), *Development and Utilisation of Financial Derivatives in China*, IFC Bull. No. 35, at 20, 24 (Feb. 2012), <https://www.bis.org/ifc/publ/ifcb35c.pdf> [<https://perma.cc/44GN-BXRY>].

142. See Jingyu Ma, *supra* note 28.

143. *Id.*

144. See Yuyue Hu, Director, Sec. & Futures Inst. of Beijing Tech. and Bus. U., *Interview at the Roundtable Conference on Visions of the Development of Chinese OTC Market* (Jan. 11, 2014), <http://futures.hexun.com/2014-01-11/161352912.html> [<https://perma.cc/H9QP-676F>].

145. Li Yong & Han Xue, *Reflections on the Domestic Derivatives Market*, 1 J. CENT. U. FIN. & ECON., 46–50 (2015).

146. *Id.*

147. Yan, *supra* note 141, at 20.

148. *Id.*

Futures Trading.<sup>149</sup> The Chinese Security Regulatory Commission (CSRC) is the regulator in this market, and the trading of commodities takes place in the four commodity exchanges.<sup>150</sup> The commodity market is subject to higher regulation compared with the OTC derivatives market since the trades are all executed via the exchange under the CSRC's close monitoring.<sup>151</sup> The CSRC is very cautious with risk. The CSRC approves the stock index futures business on the China Financial Futures Exchange<sup>152</sup> and the HuShen300 stock index futures contracts and business rules.<sup>153</sup> However, stock index futures trade was tightly restricted after the meltdown of the stock market in June 2015, which led to an

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149. Qihuo Jiaoyi Guanli Tiaoli (期货交易管理条例) [Regulation on the Administration of Futures Trading] (promulgated by the State Council Legislative Office, effective Apr. 15, 2007, rev'd Jul. 18, 2013 & Feb. 6, 2016), CLI.2.207815(EN) (Lawinfochina).

150. See *About CSRC*, CHINA SEC. REG. COMM'N, [http://www.csrc.gov.cn/pub/csrc\\_en/about/](http://www.csrc.gov.cn/pub/csrc_en/about/) [https://perma.cc/RM5U-CM5M].

151. See, e.g., Measures for the Administration of Futures Exchange (promulgated by CSRC, effective Apr. 9, 2007, effective Apr. 15, 2007, rev'd Dec. 7, 2017), CLI.4.306145 (EN) (Westlaw China). Provisions of the China Securities Regulatory Commission on the Relevant Issues Pertaining to Futures Exchanges and Futures Companies (promulgated by CSRC, effective Mar. 15, 2010, rev'd Nov. 8, 2016), CLI.4.284226(EN) (Westlaw China). Guidelines for Securities Investment Funds Participating in Stock Index Futures Trading (promulgated by CSRC Apr. 21, 2010, effective Apr. 21, 2010), CLI.4.250365 (EN) (Westlaw China). Guidelines for Qualified Overseas Institutional Investors Participating in Stock Index Futures Trading (promulgated by CSRC May 4, 2011, effective May 4, 2011), CLI.4.150667(EN) (Westlaw China). Announcement No. 37 [2013] of the China Securities Regulatory Commission—Guidelines for the Participation of Publicly Offered Securities Investment Funds in the Trading of Treasury Bond Futures (issued by CSRC Sept. 3, 2013, effective Sept. 3, 2013), CLI.4.209440(EN) (Lawinfochina). Announcement No. 51 [2014] of the China Securities Regulatory Commission—Guideline No. 1 for the Operation of Publicly Offered Securities Investment Funds—Guideline for Commodity Futures Exchange Traded Funds (issued by CSRC Dec. 16, 2014, effective Dec. 16, 2014), CLI.4.240129(EN) (Lawinfochina). Interim Measures for the Administration of Trading in Designated Domestic Futures Products Foreign Traders and Foreign Brokerage Agencies (issued by CSRC July 26, 2015, effective Aug. 1, 2015), CLI.4.250365(EN) (Lawinfochina). ZhengquanGongsiCanyuGuzhiQihuo GuozhaiQihuoJiaoyiZhiyin (issued by CSRC Aug. 21, 2013, effective Aug. 21, 2013), CLI.4.208878 (Lawinfochina).

152. See Zhongguo Zhengquanjianduguanliweiyuanhuiquanyu Tongyi Zhongguo Jinrongqihuo Jiaoyisuo Kaizhan Guzhiqihuo Jiaoyi de Pifu (中国证券监督管理委员会关于同意中国金融期货交易所开展股指期货交易的批复) [CSRC Reply on the Approve the Chinese Financial Future Exchange to Have Stock Index Future] (Jan. 12, 2010).

153. See Zhongguo Zhengquanjianduguanliweiyuanhuiquanyu Tongyi Zhongguo Jinrongqihuo Jiaoyisuo Hushen 300 Guzhiqihuo Heyue he Xiugai Jiaoyiguize Weiguweiyue Chuli Banfa de Pifu (中国证券监督管理委员会关于同意中国金融期货交易所沪深300股指期货合约和修改《交易规则》、《违规违约处理办法》的批复) [CSRC Reply on the approve the Chinese Financial Future Exchange on Shanghai-Shenzhen 300 Stock Index Future Contract and Modify the Transaction Rule and Rule for Managing the Violation and Default] (Feb. 12, 2010).

extreme shrinkage of the trade amount.<sup>154</sup> Compared with the uniform regulation regimes in other financial markets, the regulation regime in the OTC derivatives market is separatism, which is subject to regulation by the People's Bank of China (PBOC or the central bank) and the State Administration of Foreign Exchange (SAFE).<sup>155</sup>

Different regulators have different regulations and exchange platforms. Different from Western markets, state has great influence over the trade rules in the Chinese derivatives market. One reason for the significant state influence over this market may be because the main players in the OTC derivatives market are banking institutions including the state-owned big banks.<sup>156</sup> In addition, the traders association, NAFMII, is under the supervision of the PBOC.<sup>157</sup> The standard contract and the trade rules used by the trade association are all approved and supported by the regulators.<sup>158</sup> Since this market is led by the government instead of market forces, the products the Chinese derivatives market can provide are very limited and cannot meet the market demand. Therefore, this has led to some illegal supplemental markets to arise on the local level.

Different from the national system, the local derivatives markets are growing without sufficient regulation in the wild.<sup>159</sup> There are some local forward markets at play in the gray zone, which are not sufficiently regulated by local regulators and are in some cases beyond regulation.<sup>160</sup> The central government only allows the local market to do commodity trades, which are subject to regulation by the local financial offices.<sup>161</sup> However, many local markets actually engage in the derivatives business and scandals of derivatives trade fraud have occurred, such as the case of illegal futures business by the Jiaxing silk commodity exchange and fraud by the

154. Qingqing Du & Xingwei Zhao, *The Regulator Review with Low Profile and The Stock Index Struggle to Untitle* (监管层低调评估, 股指期货挣扎松绑), YICAI (Jan. 11, 2017), <http://www.yicai.com/news/5203178.html> [<https://perma.cc/G5M6-WDHA>].

155. See STATE ADMIN. OF FOREIGN EXCHANGE (SAFE), <http://www.safe.gov.cn/safe/jbzn/index.html> [<https://perma.cc/5CUM-K5LE>]; see also PEOPLE'S BANK OF CHINA (PBOC), <http://www.pbc.gov.cn/> [<https://perma.cc/QVM8-JFFR>].

156. Yan, *supra* note 141, at 24.

157. See *Association Overview* (协会概况), NAFMII, [http://www.nafmii.org.cn/fzlm/GYWM/201202/t20120227\\_4278.html](http://www.nafmii.org.cn/fzlm/GYWM/201202/t20120227_4278.html) [<https://perma.cc/L7N2-9W62>].

158. Kingsley T. W. Ong & Mark W. H. Hsiao, *From ISDA to NAFMII: Insolvency Stalemate and PRC Bankruptcy Jurisprudence*, 8 CAP. MKTS. L.J. 77, 77 (2013).

159. Bin Qi, *Duocengci Shangpin Shichang Tixi Jianshe* [*The Construction of Multi-level Commodity Markets*], 11 SPECIAL J. RES. CTR. CSRC 20 (2013).

160. *Id.*

161. *Id.*

Huaxia commodity exchange.<sup>162</sup> In response to the boom of derivative trades in local systems, central regulators have had several clean-up campaigns in the past decade where they have issued legal documents to close business in the local exchanges: central regulators have done this through abiding with the Ministry of Commerce's Guideline Opinion to Rectify and Standardize the Forward Market in 2010,<sup>163</sup> the Decision of the State Council on Straightening Out and Rectifying Various Types of Trading Venues to Effectively Prevent Financial Risks in 2011,<sup>164</sup> Implementation Opinions of the General Office of the State Council on Straightening Out, and Rectifying Various Types of Trading Venues in 2012.<sup>165</sup> These rules prohibit using the standardized contract and central clearing<sup>166</sup> to ensure "the orderly return of forward trading markets to spot trading markets."<sup>167</sup> However, the clean-up campaigns cannot completely clean up the derivatives business on the local level because the markets end up moving underground. The birth of the local derivatives markets is driven by market demand and can be seen as a form of adaptive efficiency.<sup>168</sup> A more effective strategy would be for regulators to regulate the derivatives market and control its risks instead of completely cleaning it up. In judicial practice, the courts are facing the challenge of deciding the validity of the derivatives contract in the local markets.<sup>169</sup> Therefore, the

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162. See the *Case of Illegal Future Transaction at Jiaxing Silk Exchange*, Re-trial Again after 10 years, CNGOLD. NEWS (Nov. 1st, 2015), <http://www.cngold.com.cn/zjs/20151101d1897n56443763.html> [hereinafter *Case of Illegal Future Transaction*] [<https://perma.cc/C4MY-8QWF>].

163. Zhongyuanqi Jiaoyi Shichang Zhengdun Guifan Gongzuo Zhidaoyijian (中远期交易市场整顿规范工作指导意见) [Guideline to Rectify and Standardize the Forward Market] (promulgated by the Ministry of Commerce, Feb. 5, 2010) [http://blog.sina.com.cn/s/blog\\_490746480100goio.html](http://blog.sina.com.cn/s/blog_490746480100goio.html) [<https://perma.cc/F5BY-B332>].

164. Guowuyuan Guanyu Qingli Zhengdun Gelei Jiaoyichangsuo Qieshi Fangfan Jinrong Fengxian de Jueding (国务院关于清理整顿各类交易场所切实防范金融风险的决定) [Decision of the State Council on Straightening out and Rectifying Various Types of Trading Venues to Effectively Prevent Financial Risks] (promulgated by the State Council, effective Nov. 11, 2011) [http://www.gov.cn/zwgg/2011-11/24/content\\_2002092.htm](http://www.gov.cn/zwgg/2011-11/24/content_2002092.htm) [hereinafter *State Council Decision on Trading Venues*] [<https://perma.cc/L8MG-YLEC>].

165. Guowuyuan Bangongting Guanyu Qingli Zhengdun Gelei Jiaoyi Changsuo de Shishi Yijian (国务院办公厅关于清理整顿各类交易场所的实施意见) [Implementation Opinions of the General Office of the State Council on Straightening out and Rectifying Various Types of Trading Venues] (promulgated by the State Council, effective July 12, 2012) [http://www.gov.cn/zwgg/2012-07/20/content\\_2187828.htm](http://www.gov.cn/zwgg/2012-07/20/content_2187828.htm) [<https://perma.cc/VDD2-PLFP>].

166. See *id.* arts. 2(2), 2(5).

167. State Council Decision on Trading Venues, *supra* note 164, art. 4.

168. DOUGLAS NORTH, INSTITUTIONS, INSTITUTIONAL CHANGES AND ECONOMIC PERFORMANCE 80 (James Alt & Douglass North eds.) (1990).

169. Gao, *Case of Illegal Future Transaction*, *supra* note 162.



theory of pluralism is helpful for China in dealing with the conflict between standard contracts and static law.

## B. *Deference by Localizing the Master Agreement and Potential Conflicts*

### 1. Localization of the Master Agreement

The derivatives market in China emerged in the 1990s.<sup>170</sup> Regulators repressed it because they were concerned about the risks it presented when it was developing.<sup>171</sup> However, in 2004, the China Banking Regulatory Commission (CBRC) issued the first regulation on derivatives (the 2004 Rule).<sup>172</sup> The 2004 Rule defined derivative<sup>173</sup> and qualified participants,<sup>174</sup> and focused on topics such as entry requirements<sup>175</sup> and risk management.<sup>176</sup> The 2004 Rule further recognized counterparty risk and required financial institutions to pay attention to it by taking *ex ante* mechanisms by examining the qualification of the counterparty and controlling the risks associated with the transaction.<sup>177</sup> This regulation required the financial institution to refer to the internationally recognized legal documents and to use the legal remedy in the event of default.<sup>178</sup> Here, the internationally recognized legal document referred to is the ISDA master agreement. Although the provisions in this regulation are too general and need further implementation of rules for proper execution, it is meaningful for the derivatives market and delivers two important signals to the market. First, that the government is legalizing the derivatives trade in China.<sup>179</sup> Before the issuance of this regulation, the derivatives market was unregulated and growing without clear governing

170. Yan Wang, *The Preliminary Analysis on the Development of the Financial Derivative Market in China*, CHINA FUTURES ASS'N (Aug. 21, 2014), [http://www.cfachina.org/zt/guojijutiao/201408/t20140821\\_1703775.html](http://www.cfachina.org/zt/guojijutiao/201408/t20140821_1703775.html) [<https://perma.cc/NMC5-M7YV>].

171. *Id.*

172. Jinrong Jigou Yansheng Chanpin Jiaoyi Yewu Guanli Zhanxing Banfa (金融机构衍生产品交易业务管理暂行办法) [Interim Measures for the Management of the Dealings of Derivative Products of Financial Institutions] (promulgated by the China Banking Regulatory Commission effective on Mar. 1, 2004), [http://www.cbrc.gov.cn/chinese/home/docDOC\\_ReadView/299.html](http://www.cbrc.gov.cn/chinese/home/docDOC_ReadView/299.html) [hereinafter Interim Measures] [Permalink unavailable].

173. *Id.* art. 3.

174. *Id.* arts. 1, 7.

175. *See id.* ch. II.

176. *See id.* ch. III.

177. *Id.* art. 24.

178. *Id.*

179. *Id.* art. 1.

rules.<sup>180</sup> Second, although it is an emerging market of very small size, that the CBRC hopes the Chinese derivatives market can keep abreast of the development in international markets.<sup>181</sup> Therefore, the CBRC emphasizes this internationally recognized legal document.<sup>182</sup>

However, the big concern of financial risk impedes the growth of the derivatives market. Sixteen of the thirty-four provisions are focused on risk management.<sup>183</sup> This indicates that the regulatory philosophy in the Chinese derivatives market is paradoxical because, while regulators expect to see the fast development and prosperity of the market, they are simultaneously worried about the risk of market expansion. Facing the contradictory pull of financial growth and financial risk, regulators sought a characteristically Chinese way to balance the benefits and risks by localizing the international norm.<sup>184</sup> From the view of Chinese regulators, the unfamiliarity with international norms and foreign law of Chinese participants becomes a significant potential risk, especially because the main Chinese players in the derivatives market are the state-owned big banks.<sup>185</sup> Therefore, Chinese regulators aim to localize the international norms and have Chinese law govern them.<sup>186</sup>

The first attempt to localize the master agreement occurred when SAFE supervised the RMB-FX Forwards and Swaps Master Agreement of the China Foreign Exchange Trade System (CFETS) in 2006 (2006 Agreement).<sup>187</sup> The 2006 Agreement governs the

180. Yu Peng, *The First Financial Derivative Rule was Launched*, SINA (Feb. 5, 2004), <http://finance.sina.com.cn/roll/20040205/1441618918.shtml> [https://perma.cc/K9DX-TQZN].

181. *Id.*

182. See Jiang Xueqing, *China's Banking Regulator Drafting Bankruptcy Rules* (银监会：正在起草《商业银行破产风险处置条例》), CHINA DAILY (Aug. 10, 2017), [http://www.chinadaily.com.cn/business/2017-08/10/content\\_30401338.htm](http://www.chinadaily.com.cn/business/2017-08/10/content_30401338.htm) ("The CBRC will also communicate with the International Swaps and Derivatives Association on establishing a close-out netting arrangement for Chinese commercial banks.") [https://perma.cc/G74E-UAS9].

183. Interim Measures, *supra* note 172, ch. III.

184. See Ong & Hsiao, *supra* note 158, at 78 ("[T]here are several differences between the ISDA and NAFMII Documents. The latter are presented in a more succinct manner to accommodate the unique situation of the Chinese market.")

185. Wang Xianxing, *Standardizing OTC Derivatives and its Practice in China*, CHINA MONEY 45 (2011).

186. *Supra* note 184.

187. David Olsson et al., *New Master Agreement for Financial Derivatives in China*, MONDAQ (Mar. 18, 2009), <http://www.mondaq.com/china/x/76684/Commodities+Derivatives+Stock+Exchanges/New+Master+Agreement+For+Financial+Derivatives+In+China+18+March+2009> [https://perma.cc/TC74-S45S].

RMB-FX forwards and RMB-FX swaps traded through the CFETS system.<sup>188</sup> The 2006 Agreement adopted and reflected the essential mechanism of the ISDA master agreement in regulating counterparty risk such as close-out netting and early termination.<sup>189</sup>

Soon after the issuance of the 2006 Agreement, NAFMII issued standardized documents, including the master agreement (the 2007 Agreement) for derivatives traded in the inter-bank market.<sup>190</sup> NAFMII is a self-regulator, which serves the inter-bank market players.<sup>191</sup> The two agreements coexisted and were used on different exchange platforms, although some problems arose in the crossover between the two agreements.<sup>192</sup> To satisfy the need for uniformity, the NAFMII master agreement (the 2009 Agreement) was issued by NAFMII and confirmed by the PBOC and SAFE.<sup>193</sup> The 2009 Agreement clearly adopted the close-out netting provision from 9(I) of the ISDA master agreement, which is provided by Section 4(III) of NAFMII's 2009 Agreement.<sup>194</sup>

A Party's performance of its payment or delivery obligations in accordance with the terms of the Effective Transaction Agreement shall be subject to the satisfaction of all the following conditions precedent . . . no Event of Default or Potential Event of Default with respect to the other Party has occurred and is continuing . . . .<sup>195</sup>

Although the regulators were eager to engage the international game and encourage the association to make the local norms reflect the close-out netting of 9(I) of the ISDA master agreement, the treatment of it in the bankruptcy courts is still unclear.<sup>196</sup>

## 2. Potential Conflicts With Chinese Bankruptcy Law

Article 40 of Enterprise Bankruptcy Law 2006 (EBL 2006) provided that the creditor who owned the debt for the debtors can claim for setoff. However, it is not clear whether the derivative close-out setoff will be regarded as the qualified setoff under Arti-

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188. *Id.*

189. RMB-FX Forward and Swaps Master Agreement arts. 8, 13 (2006).

190. *Supra* note 182.

191. *Supra* note 184.

192. Olsson et al., *supra* note 187.

193. See (中国人民银行公告) [Announcement No. 4 [2009] of the People's Bank of China] (promulgated by the People's Bank of China, Mar. 11, 2009, effective Mar. 11, 2009).

194. See NAFMII MASTER AGREEMENT § 4(III) (2009).

195. *Id.*

196. See the *infra* discussion in Part III(B)(2).

cle 40. This is because EBL 2006 provides the mechanism to suspend all the debt enforcement activities, which is similar to the “automatic stay” mechanism under the U.S. Bankruptcy Code.<sup>197</sup> All debt enforcements are suspended, including any enforcement via litigation, arbitration, and any allocation by court motion to preserve property.<sup>198</sup> After a people’s court accepts an application for bankruptcy, all actions against the debtor can only be filed to that court.<sup>199</sup> Literally, the close-out setoff provisions under the derivatives master agreement may violate the automatic stay provisions under EBL 2006. Furthermore, Article 18 of EBL 2006 provides that the administrator has the right to choose whether the executive contract will be rescinded or continued.<sup>200</sup> The administrator will only pick up to continue contracts beneficial for the debtors, which is called a cherry pick-up.<sup>201</sup> The close-out setoff is based on the concept of a single contract, which means that the performed and unperformed contracts are regarded as a single contract for the purposes of a setoff.<sup>202</sup> If the close-out setoff is recognized by the courts, the administrator’s right of cherry picking will be hindered. In sum, the close-out setoff provision may be regarded as being in conflict with the mandatory provisions under EBL 2006 by the people’s courts. According to Article 52 of Chinese Contract Law, the provisions of contracts that conflict with the mandatory provisions of Chinese law shall be regarded as invalid by the people’s courts.

### C. *Some Recognition by Courts and Judicial Interpretation*

#### 1. Cases Involving Close-out Setoff in Chinese Courts

The following Section will study the judicial cases to show how the courts respect the localized master agreement, the NAFMII master agreement, and the close-out setoff provision in it. This Section will also show how the courts’ varied attitude on the validity of those derivative contracts not based on the NAFMII master agreement.

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197. 11 U.S.C. § 362 (2012).

198. Zhonghua Renmin Gongheguo QiyePochan Fa (中华人民共和国企业破产法) [Enterprise Bankruptcy Law] (promulgated by the Standing Comm. Nat’l People’s Cong., August 27, 2006, effective June 1, 2007), arts.19, 20 (Chinalawinfo).

199. *Id.* at art. 21.

200. *Id.* at art. 18.

201. The trustee’s power of choice is called as cherry pickup by the scholar. See Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 Yale J. on Reg. 91, 96 (2005).

202. MENGLE, *supra* note 116, at 3.

## a. Citibank (China) Co., Ltd. vs. Yingda Electronics Co., Ltd.

There are a few cases publicly accessible on the legality of close-out setoff. In the only three cases available in the Peking University Center for Legal Information database,<sup>203</sup> the courts all supported the close-out setoff. In the case of *Citibank (China) Co., Ltd. vs. Yingda Electronics Co., Ltd.*, Yingda Electronics Co., Ltd. (Yingda) was in default and failed to provide the collateral that Citibank (China) Co., Ltd. (Citibank) requested, which led Citibank to file suit in the People's Court of the Pudong District of Shanghai for close-out setoff and ask for the payment of balance including delayed interest.<sup>204</sup> The derivatives transaction between Citibank and Yingda was based on the master agreement they signed, and this agreement had the close-out setoff provision.<sup>205</sup> Citibank also provided Yingda a loan.<sup>206</sup> When Yingda's operation was suspended, Citibank first claimed the due date of all the loans was accelerated, then it requested to increase the collateral on the derivative transaction.<sup>207</sup> The People's Court of Pudong District decided that the master agreement signed by Citibank and Yingda was valid since it did not violate any law or administrative rules according to Article 52 of Chinese Contract Law.<sup>208</sup> The court therefore supported the claim of close-out setoff by Citibank.<sup>209</sup>

The court's decision was important because the market was concerned with whether the court will apply Article 52 of Chinese Contract Law to invalidate the close-out setoff. The court's decision evidenced that it regarded the NAFMII master agreement as the generally recognized norm in China's derivatives market.<sup>210</sup> Furthermore, the judges emphasized that the close-out setoff in the ISDA and also NAFMII master agreement, which includes undue transactions does not conflict with the expected principle under Chinese contract law in calculating the loss.<sup>211</sup> The judges believed

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203. See PKU LAW, <http://en.pkulaw.cn/> (providing cases publicly available online) [<https://perma.cc/CXA8-U9WX>].

204. Huaqi Yinhang (Zhongguo) Youxiangongsi Su Yingda Shenghuo Dianqi (Zhongshan) Youxian Gongsi Hetong Jiufen An (花旗银行(中国)有限公司诉樱达生活电器(中山)有限公司合同纠纷案) [*Citibank (China) Co., Ltd. vs. Yingda Life Appliances (Zhongshan) Co., Ltd.*], Pu Min Six (Chu) No. S3800 (Shanghai Pudong Dist. People's Ct. 2014).

205. *Id.*

206. *Id.*

207. *Id.*

208. *Id.*

209. *Id.*

210. *Id.*

211. See *id.*

that this rule respected the international norms in derivative transactions and also reflected the nature of derivative transactions.<sup>212</sup> In this case, the business operation of the defaulting party actually had been suspended and it could not repay the loan because of the acceleration provisions.<sup>213</sup> The court regarded such a situation as a cross-default.<sup>214</sup> The defaulting party did not enter the bankruptcy procedure although it may have been insolvent.<sup>215</sup> However, the court did not discuss the relationship between the close-out setoff and bankruptcy law.<sup>216</sup> The court evaluated this case using Chinese Contract Law and contract principles instead of bankruptcy law.<sup>217</sup>

b. Citibank (China) Co., Ltd. vs. Shanghai Golden Global International Trade Co., Ltd.

The People's Court of the Pudong District of Shanghai also presided over a case where the non-defaulting party was Citibank (China) Co., Ltd.<sup>218</sup> As was with *Citibank (China) Co., Ltd. vs. Yingda Electronics Co., Ltd.*, the two parties in *Citibank (China) Co., Ltd. vs. Shanghai Golden Global International Trade Co., Ltd.* also signed a master agreement.<sup>219</sup> Similarly, Citibank also claimed the close-out setoff after the other party failed to increase the collateral.<sup>220</sup> Here, the collateral was increased due to mismanaged operation of Shanghai Golden Global International Trade Co., Ltd. (Shanghai Golden Global International Trade) that may have undermined its ability to perform.<sup>221</sup> However, the condition of Shanghai Golden Global International Trade was not as bad as Yingda, whose operation was suspended.<sup>222</sup> The court ultimately

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212. *Id.*

213. *Id.*

214. *Id.*

215. *Id.*

216. *See id.*

217. *See id.*

218. Huaqi Yinhang (Zhongguo) Youxian Gongsu Shanghai Jin Huanqiu Guoji Maoyi Youxian Gongsideng JirongYanshengpin Jiaoyi Jiufen An (花旗银行(中国)有限公司诉上海金环球国际贸易有限公司等金融衍生品交易纠纷案) [*Citibank (China) Co., Ltd. vs. Shanghai Golden Global International Trade Co., Ltd.*] (Shanghai Pudong District People's Ct. 2015) (Chinalawinfo) [hereinafter *Citibank (China) Co., Ltd. vs. Shanghai Golden Global Int'l Trade Co., Ltd.*].

219. *See id.*

220. *Id.*

221. *See id.*

222. *Compare* *Citibank (China) Co., Ltd. v. Shanghai Golden Global Int'l Trade Co., Ltd.*, *supra* note 218, *with* *Citibank (China) Co., Ltd. v. Yingda Life Appliances (Zhongshan) Co., Ltd.*, *supra* note 204.

supported the claim of close-out setoff as there was reasonable doubt that Shanghai Golden Global International Trade defaulted.<sup>223</sup>

c. Guangxi Liugong Mechanical Engineering Co., Ltd. vs. Citibank (China) Co., Ltd.

A more interesting case on close-out setoff is from the People's High Court in Guangdong Province. In this case, the two parties did not sign a NAFMII master agreement.<sup>224</sup> Instead, they signed a set of agreements including the financing agreement, the risk disclosure agreement, and the statement and confirmation of derivative transactions.<sup>225</sup> The court decided that the two parties had a contractual relationship on derivative transactions even though they did not sign the special agreement on derivative transactions.<sup>226</sup> The defaulting party, Guangxi Liugong Mechanical Engineering Co., Ltd. (Guangxi Liugong Mechanical Engineering) was the local state-owned enterprise. Therefore, Guangxi Liugong Mechanical Engineering claimed that the contract was invalid because it violated the rule issued by the Guangxi Administrative Bureau of State-owned Assets, which required the approval of the bureau to engage in business beyond the business scope of the state-owned enterprise.<sup>227</sup> However, the court denied the defaulting party's defense based on the Supreme Court's Judicial Interpretation I on Contract Law because only the contracts violating the law made by the National People's Congress and its Standing Committee and administrative rules made by the State Council can be regarded as invalid.<sup>228</sup> The court went further and supported Citibank's claim on the methods of calculating the balance using the close-out setoff.<sup>229</sup> Although the contracts signed by the two parties never mentioned the close-out setoff, e-mails between the

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223. See Citibank (China) Co., Ltd. v. Shanghai Golden Global Int'l Trade Co., Ltd., *supra* note 218.

224. Compare Guanxi Liugong Jixie Gufen Youxian Gongsiyu Huaqi Yinhang (Zhong-gui) Youxian Gongsi Guangzhou Fenhong Jinrong Yansheng Pinzhong Jiaoyi Jiufen Shangsuo An (广西柳工机械股份有限公司与花旗银行(中国)有限公司广州分行金融衍生品种交易纠纷上诉案) [Guangxi Liugong Mech. Eng'g Co., Ltd. vs. Citibank (China) Co., Ltd.] (Guangdong High People's Ct. 2014) (Chinalawinfo), with Citibank (China) Co., Ltd. v. Shanghai Golden Global Int'l Trade Co., Ltd., *supra* note 218 (contracting parties signed a "Derivatives Master Agreement").

225. Guangxi Liugong Mech., Eng'g Co., Ltd. vs. Citibank (China) Co., Ltd., *supra* note 224.

226. *Id.*

227. *Id.*

228. *Id.*

229. *Id.*

parties had mentioned the close-out setoff and Guangxi Liugong Mechanical Engineering never raised any objections.<sup>230</sup> Therefore, the court supported Citibank's claim to use the close-out setoff to calculate the balance.<sup>231</sup>

This decision is meaningful for business practices since the court supported the close-out setoff even though the two parties did not sign the master agreement and did not include the close-out setoff provisions in the written agreements, which is different from the two cases aforementioned cases. However, this decision does not have precedent-setting effect on either of the other courts or future cases since China is not a common-law state.<sup>232</sup> On the other hand, it is important to note that the attorneys representing Citibank stated that it was rare for the court to support all the claims made by the bank in the derivatives transaction against the defaulting party: therefore, the decision of this case is meaningful for the market.<sup>233</sup> Nevertheless, the attorneys mentioned that some courts in China had a very radical attitude on the validity of the derivatives contract and that the courts would decide the parties did not have valid derivatives agreement if the parties did not sign the standard master contract.<sup>234</sup>

In sum, the three cases discussed above indicate some Chinese courts' support of the close-out setoff, whether it was included as a provision in the master agreement signed by the two parties or was mentioned in communication between the contracted parties.<sup>235</sup> Also, the courts showed great respect for the localized master agreement, the NAFMII master agreement, and the close-out setoff provision in it, which was regarded as the norm in the derivatives market and a necessary tool for reducing the risks of derivatives.<sup>236</sup> Compared with the transactions based on the NAFMII master agreement, the courts' attitude on the validity of those derivative

230. *Id.*

231. *Id.*

232. Dong Maoyun, *Code Law, Case Law and Chinese Codification Road*, 11 J. COMP. L. 1, 1-31 (1997).

233. Feng Guan & Jiayan Zhu, *Analysis of the Logic of Trials on Financial Derivative Dispute through the Cases*, KING & WOOD MALLESONS (Feb. 2, 2015), <http://www.chinalawinsight.com/2015/02/articles/dispute-resolution/> [https://perma.cc/9L55-TSWK].

234. *Id.*

235. See Citibank (China) Co., Ltd. v. Shanghai Golden Global Int'l Trade Co., Ltd., *supra* note 218; Citibank (China) Co., Ltd. v. Yingda Life Appliances (Zhongshan) Co., Ltd., *supra* note 204; Guangxi Liugong Mech. Eng'g Co., Ltd. vs. Citibank (China) Co., Ltd., *supra* note 224.

236. See Citibank (China) Co., Ltd. v. Yingda Life Appliances (Zhongshan) Co., Ltd., *supra* note 204; Guangxi Liugong Mech. Eng'g Co., Ltd. v. Citibank (China) Co., Ltd., *supra* note 224.



contracts not based on the NAFMII master agreement are varied. Although the court in the case of Guangxi Liugong Mechanical Engineering recognized the validity of derivative transactions not based on the NAFMII master agreement,<sup>237</sup> some courts had a radical attitude toward invalidating derivative transactions not based on the NAFMII master agreement. However, since court cases in China are not required to be accessible to the public, the three available cases cannot be said to represent broad attitudes of Chinese courts toward close-out setoff. It should also be noted that all three courts in the cases above are in Southeast China, which is the most developed and internationalized area of China.<sup>238</sup> Therefore, the judges in this area may be more likely to have an international perspective in their decisions, which may lead them to harbor a friendly attitude toward international norms and financial innovations. Moreover, even though a defaulting party may actually be insolvent, none of the three abovementioned cases involved bankruptcy procedures, leading the courts to bypass the issue of conflicts between close-out setoff and bankruptcy law. The only clear signal may come from the Supreme Court of China, which issues judicial interpretation on the application of various laws. Such judicial interpretation may lead to some uniformity in the decisions of different courts in China.

## 2. The Weight of Judicial Interpretation

Although the law is inevitably incomplete in the face of a changing world, the law will not change very often since the legislature process is long and costly. In China, however, the Supreme Court plays an active role in filling the legislative gap by issuing judicial interpretations. The same goes for the issue of close-out setoff. The practice saw clarification from judicial interpretation, which might clear the cloud of uncertainty around the status of close-out setoff. The Supreme People's Court issued Judicial Interpretation II on bankruptcy law in 2013, of which some provisions focused on setoff.<sup>239</sup> Judicial Interpretation II clarifies the procedure of setoff:

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237. See *Guangxi Liugong Mech. Eng'g Co., Ltd. v. Citibank (China) Co., Ltd.*, *supra* note 224.

238. The courts are localized in Guangdong, Shanghai & Guangxi respectively, each of which is located in Southeast China.

239. See SUP. PEOPLE'S CT., (最高人民法院于适用《中华人民共和国企业破产法》若干问题的规定(二)) [Provisions of the Supreme People's Court on Several Issues Concerning the Application of the Enterprise Bankruptcy Law of the People's Republic of China (II)] arts. 41–46 (2013).

the creditors shall notify the administrator about setoff.<sup>240</sup> The setoff is effective upon the administrator receiving the setoff notice unless the administrator successfully challenges the setoff in court.<sup>241</sup> This interpretation also provides that the debt owned by the creditor or the debtor is not due and cannot be grounds for an administrator to challenge the setoff.<sup>242</sup> Compared with Article 40, Articles 41-46 of Judicial Interpretation II on bankruptcy law are much clearer on the procedure of setoff. Specifically, it clearly provides the grounds based on which administrators cannot challenge the claim of setoff including issues relating to debts that are not due.<sup>243</sup> The non-defaulting party may therefore claim the setoff of debt that are both due and not due. However, Judicial Interpretation II on bankruptcy law still does not solve the conflicts of the close-out setoff and the administrators' cherry-picking rights under Article 18 of EBL 2006. Moreover, the setoff provisions under Judicial Interpretation II on bankruptcy law require an application procedure to the administrator, which are subject to challenge from the administrators and require a final decision from the courts.<sup>244</sup> Such procedures may take a much longer time than the automatic setoff under the master agreement, which may weaken the designed effect of setoff to reduce contagion.

D. *The Driving Force of Deference and Recognition in the Chinese Derivatives Market*

The path of conflict resolution in China is unique since it is a blend of localization and internationalization, private autonomy, and state support. The international standard contract of the ISDA master agreement is localized in the NAFMII master agreement, which is almost the same as the ISDA master agreement.<sup>245</sup> The NAFMII master agreement was launched by NAFMII, the trade association of derivatives.<sup>246</sup> The PBOC, the central bank of China,

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240. *See id.* art. 41.

241. *See id.* art. 42.

242. *See id.* art. 43.

243. *Id.*

244. *See id.* art. 42.

245. Compare NAFMII MASTER AGREEMENT (2009), with ISDA MASTER AGREEMENT (2002).

246. NAFMII, *Building and Strengthening the Self-regulatory Framework*, [http://www.nafmii.org.cn/english/ourfocus\\_e/selfdiscipline\\_e/](http://www.nafmii.org.cn/english/ourfocus_e/selfdiscipline_e/) ("In October 2007, NAFMII completed drafting and launched the China Inter-Bank Market Derivatives Transaction Master Agreement (2007 Version). On March 16, 2009, NAFMII completed drafting and launched NAFMII Master Agreement (2009 Version) (the Master Agreement), which consolidated its predecessor, NAFMII Master Agreement (2007 Version) and China Foreign

sits behind the localization of the master agreement and supervises NAFMII.<sup>247</sup> The NAFMII master agreement has the close-out setoff clause, as does the ISDA master agreement.<sup>248</sup> However, the close-out setoff clause literally conflicts with the Chinese bankruptcy law.<sup>249</sup> According to cases open to the public, the courts in China show great tolerance to the close-out setoff.<sup>250</sup> However, because of the limited number of sample cases, it is hard to expect that courts in different jurisdictions in China will all support the close-out setoff.<sup>251</sup> Even though the Supreme Court issued a judicial interpretation on bankruptcy law, but uncertainty of the validity of close-out setoff still remains.<sup>252</sup> The driving forces behind the Chinese story of regulating counterparty risk and resolving conflicts can be explained with the Theory of Isomorphism, which are separated into three different categories.

### 1. Coercive Isomorphism

The political desire to be abreast of the most advanced financial innovation technology greatly influenced China's acceptance of coercive isomorphism, especially in light of the Chinese financial market's transition from financial repression to financial liberalization.<sup>253</sup> However, as financial regulators have concerns about financial risk caused by excessive liberalism,<sup>254</sup> China does not accept the ISDA agreement completely. Instead, China uses a Chinese version of the master agreement, although it is almost the same as the ISDA master agreement with respect to the existence of a close-out setoff clause.<sup>255</sup> Similarly, the courts in some cases showed a friendly attitude to close-out setoff because they believed that this clause reflects the norms in the international derivatives market and fits the nature of derivative transactions.<sup>256</sup>

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Exchange Market RMB-Foreign Currency Derivative Master Agreement. By the end of 2009, 564 copies of Master Agreements by 80 institutions had been signed and filed.”) [<https://perma.cc/H4CR-6AAN>].

247. See (中国人民银行公告) [Announcement No. 4 [2009] of the People's Bank of China] (promulgated by the People's Bank of China, Mar. 11, 2009, effective Mar. 11, 2009).

248. See NAFMII MASTER AGREEMENT § 4(III) (2009).

249. See *supra* note 30.

250. See *infra* Part III(C)(2).

251. *Id.*

252. See *infra* Part III(C)(3).

253. Gao, *Seeing Gray in a Black-and-White Legal World*, *supra* note 8, at 98–107.

254. See *Citibank (China) Co., Ltd. v. Yingda Life Appliances (Zhongshan) Co., Ltd.*, *supra* note 204.

255. NAFMII MASTER AGREEMENT § 4(III) (2009).

256. See *id.*

## 2. Normative Isomorphism

Professional associations play an important role in forming the Chinese path. NAFMII is the self-regulatory organization of derivative transactions in China.<sup>257</sup> NAFMII launched the Chinese version of the master agreement that governs derivative transactions in China. Dissimilar to the ISDA, NAFMII is supervised by the PBOC.<sup>258</sup> Such supervisory relationship makes the master agreement and other related documents attain a quasi-legal status on the market. For instance, the PBOC's rule requires that all transactions on interest rate derivatives use the NAFMII master agreement.<sup>259</sup> The NAFMII master agreement reflects all of the core concepts of the ISDA master agreement including the close-out setoff.<sup>260</sup> The special status of NAFMII made its master agreement the one uniformly used in the Chinese derivatives market. Also, NAFMII's special status may contribute to courts' respect for core concepts such as close-out setoff.

## 3. Mimetic Isomorphism

It is important to note that "legitimizing . . . an institutional regulation finds within an organizational field"<sup>261</sup> is the driving force for Chinese trade associations, regulators, and the courts in accepting the mechanism of close-out setoff. The driving force for recognizing the global standard made by private players may be that lawmakers want to stay abreast of the most advanced states in business transactions.

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257. See *About NAFMII*, NAFMII, [http://nafmii.org.cn/english/aboutus\\_e/aboutnafmii\\_e/](http://nafmii.org.cn/english/aboutus_e/aboutnafmii_e/) [Permalink unavailable].

258. See Ong & Hsiao, *supra* note 158, at 77 ("[T]he National Association of Financial Market Institutional Investors (NAFMII), a self-regulatory body, was newly formed by Chinese inter-bank market players working under the direction of the People's Bank of China (PBOC).").

259. Yuanqi Lilv Xieyi Yewu Guanli Guiding (远期利率协议业务管理规定) [Administrative Provisions on Forward Rate Agreement Business] (promulgated People's Bank of China, Sept. 29, 2007, effective Nov. 1, 2007) (Chinalawinfo) (Article 6 provides that "[to] operate FRA business, market participants shall sign the Master Agreement on Trading Financial Derivative Instruments in the Inter-bank Market of China.").

260. NAFMII MASTER AGREEMENT § 4(III) (2009).

261. Beckert, *supra* note 90, at 153.

#### IV. CONFLICTS AND RECONCILIATION: A CASE STUDY OF CONVERGENCE AND RECONCILIATION IN THE CHINESE DERIVATIVES MARKET

After the financial crisis of 2008, national regulators finally realized the potential risks triggered by dealing with the controversy of different rules, with either the method of “reserving differences” or “recognizing legitimacy,” so they reached an agreement on “seeking common ground.” European and U.S. legislators managed to find middle ground that was neither equivalent to government regulation nor the market autonomy. In 2009, the G20 reached an agreement pertaining to high-risk OTC derivatives central clearing at the Pittsburgh Summit.<sup>262</sup> This agreement reflected U.S. and European Union (EU) legislation on some of the higher risk counterparty products to enforce central clearing, which should be included in the governance scope within the agency.<sup>263</sup>

China is an emerging market of derivative transactions. However, Chinese policymakers considered central clearing at the very beginning.<sup>264</sup> Since the Chinese derivatives market is commodity based, the central clearing used by the commodity trade was also used in derivative transactions.<sup>265</sup> The following Section discusses the trend of regulating counterparty risk by intermediary governance, the central clearing of the EU and the United States, and also China’s adoption of central clearing in the derivatives market.

##### A. *Regulation of Counterparty Risk by Central Clearing Institutions*

In the contract governance model, since both parties are of equal status, it is difficult for any party to obtain an advantage by supervising the other party to reduce the risks of that party’s behavior. In contrast, in contract management, a central clearing institution adopts a membership system, and the members must accept regulation from the clearing agency.<sup>266</sup> Specifically, the system can

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262. FIN. STABILITY BD., *supra* note 25.

263. *Id.* at 41, 44–45.

264. Xu Wei, *Chairman of Shanghai Clearing House: Will Accelerate the launch of OTC Derivatives in the next Two Years* (上海清算所董事长许臻：未来两年将加快推出场外衍生), YI CAI, (Sept. 29, 2014), <http://www.yicai.com/news/4024332.html> [hereinafter *Accelerate the Launch of OTC Derivatives*].

265. *Id.*

266. (香港《中央結算系統一般規則》第40章 - 由全面結算參與者負責結算) [Hong Kong CCASS General Rules Chapter 40 - Settlement by Full Settlement Participants], <http://www.hkex.com.hk/-/media/HKEX-Market/Services/Rules-and-Forms-and-Fees/Rules/HKSCC/General-Rules-of-CCASS/chapt40.pdf?la=ZH-HK> [https://perma.cc/K9BM-FX6W].

be divided into three basic subsystems, namely (i) capital reserve that governs requirements for initial margins, collateral money, risk reserve, and etc., (ii) real-time monitoring system that pertains to days without debt, position limits, reporting system for large accounts, and etc., and (iii) the emergency rights of the exchange office.<sup>267</sup>

Margin system is conducive to reducing the risk of counterparty risk because in financial derivatives contracts, different parties of the transaction will discuss requirements of the margin, how much the margin requirements will be, and how to adjust the margin so that everybody can agree on it.<sup>268</sup> However, the law often sets the initial margin for the traders. According to the European Infrastructure Act<sup>269</sup> and the Dodd-Frank Act, such margin system is mandatory.<sup>270</sup> The Dodd-Frank Act requires the establishment of a central settlement organization and other risk prevention mechanisms<sup>271</sup> so that when counterparty risk may cause an actual breach of contract, the settlement center will have certain emergency measures kick in.<sup>272</sup> The European Infrastructure Act stipulates the order of using funds: the first is to be used for initial margin of default members to compensate for the loss caused by the breach of contract and the second is to be used if the deposit is not sufficient to compensate for the losses; if the reserve is still not enough to compensate for the losses, then Article 1, paragraph 41 is used for other sources of funding and if that is still not enough to compensate, other non-default members contribute certain funds.<sup>273</sup> The order in which such losses are filled is conducive to reducing moral hazard.

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267. CRAIG PIRRONG, *THE ECONOMICS OF CENTRAL CLEARING: THEORY AND PRACTICE*, ISDA DISCUSSION PAPERS SERIES NO. 1, at 8 (2011).

268. (香港《中央結算系統一般規則》第36章 - 風險管理措施—持續淨額交收制) [Chapter 36 Risk Management Measures - CNS System of General Rules of CCASS] <http://www.hkex.com.hk/-/media/HKEX-Market/Services/Rules-and-Forms-and-Fees/Rules/HKSCC/General-Rules-of-CCASS/CHAPT36.pdf?la=ZH-HK> [<https://perma.cc/6GYA-CXHJ>].

269. Council Regulation 648/2012 of July 4, 2012, art. 24, 2012 O.J. (L 201) 1, 4.

270. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 § 723, 124 Stat. 1376, 1871 (2010).

271. *Id.* § 725(a).

272. Chapter 37 Default Rules - CNS System of General Rules of CCASS (香港《中央結算系統一般規則》第37章 - 失責處理規則—持續淨額交收制度) <http://www.hkex.com.hk/-/media/HKEX-Market/Services/Rules-and-Forms-and-Fees/Rules/HKSCC/General-Rules-of-CCASS/chapt37.pdf?la=ZH-HK> [<https://perma.cc/695J-M26H>].

273. Council Regulation 648/2012 of July 4, 2012, art. 24, 2012 O.J. (L 201) 1, 4.

B. *Establishing Central Clearing for Derivatives in China*

Since the Chinese derivatives market is government-led and is not market-driven, the trade exchanges regulated by the government were initially used for the national derivative transactions.<sup>274</sup> After the global financial crisis of 2008, financial regulators actively participated in international cooperation in central clearing.<sup>275</sup> China also made the commitment to the G20 for central clearing.<sup>276</sup>

China has shown great interest in staying abreast of the international trend of central clearing.<sup>277</sup> China established Shanghai Clearing House in November 2009 to provide a platform of central clearing.<sup>278</sup> Until 2010 the mandate was as follows: “China’s OTC foreign exchange derivatives, OTC RMB interest rate derivatives and credit derivatives are traded on [an] electronic trading platform, and those derivatives not traded on the platform are reported to relevant departments.”<sup>279</sup> The Financial Stability Board (FSB) commented on the progress made by China in centralized clearing and standardized transactions, recognizing the “efforts to encourage Shanghai Clearing House to establish detailed schemes for central clearing of OTC derivatives” as well as significant steps “toward increasing the use of standardized products and processes” through the improvement of the “Master Agreement and Definition Document.”<sup>280</sup> Based on the great progress of China, G20 gave it “+1” score, which meant full compliance for China’s performance.<sup>281</sup>

To meet its commitments, the PBOC launched a rule on the central clearing of the RMB interest rate swaps in January 2014 (the Swaps Rule).<sup>282</sup> The Swaps Rule requires that “the OTC financial

274. *Accelerate the Launch of OTC Derivatives*, *supra* note 264.

275. *Id.*

276. *Id.*

277. *Id.*

278. *See Company Profile* (公司简介), SHANGHAI CLEARING HOUSE, <http://www.shclearing.com/gwym/gsjj/> [<https://perma.cc/GMU9-D622>].

279. G20 Research Group, 2010 Seoul G20 Final Compliance Rep. 161 (Nov. 6, 2011) <http://www.g20.utoronto.ca/compliance/2010seoul-final/2010seoul-final-06-otc.pdf> [<https://perma.cc/P84N-YJBS>].

280. *Id.* at 161–62.

281. *Id.* at 153.

282. Zhongguo Renmin Yinhang Gunayu Jianli Chanwai Jinrong Yanshengpin Jizhong Qingsuan Jizhi ji Kaizhan Reminbi Lilv Huhuan Jizhong Qingsuan Yewu Youguan Shiyi de Tongzhi (中国人民银行关于建立场外金融衍生品集中清算机制及开展人民币利率互换集中清算业务有关事宜的通知) [Notice of the People’s Bank of China on Issues concerning the Establishment of the Centralized Clearing Mechanism for OTC Financial Derivatives

derivative transactions including RMB interest rate swaps concluded by the participants in the national interbank bond market . . . be subject to the centralized clearing.”<sup>283</sup> The place for central clearing is Shanghai Clearing House.<sup>284</sup> The Swaps Rule requires that all RMB interest rate swaps with “a term of not more than five years . . . all be referred to the Shanghai Clearing House” for central clearing.<sup>285</sup> Participants need to provide reasons to the PBOC for not referring qualified products to the Shanghai Clearing House.<sup>286</sup>

The Shanghai Clearing House issued its own guideline of central clearing.<sup>287</sup> According to the requirement of the guideline, a clearing member must post initial margin,<sup>288</sup> mark-to-market margin,<sup>289</sup> and over-limit margin.<sup>290</sup> The guideline defines the situations of default.<sup>291</sup> When default happens, default management resources need to be used:<sup>292</sup> in such cases, the margin of the default member will be first used and if the margin cannot make up the loss, then the default party’s guarantee fund will be secondarily be used; if the default party’s guarantee fund still cannot make up the loss, part of the reserve fund from the Shanghai Clearing House, which “set aside part of its business income generated from RMB interest rate swaps central clearing service,”<sup>293</sup> will be used; if all of those sources cannot make up the loss, then the bail-in guarantee fund by the other non-default parties will be used and the final resort will consist of using the rest of the reserve fund from the Shanghai Clearing House.<sup>294</sup> The clearing rule for default does not indicate a bailout from the government.<sup>295</sup>

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and the Launching of the Centralized Clearing of RMB Interest Rate Swaps] (promulgated by the People’s Bank of China, Jan. 28, 2014, effective Jan. 28, 2014) (Chinalawinfo).

283. *Id.*

284. *Id.* art. 2.

285. *Id.* art. 3.

286. *Id.*

287. *Yinhangjian Wihui Shichang Renminbi Waihui Xunjia Jiaoyi Zhongyang Duishou Qingshuan* (银行间外汇市场人民币外汇询价交易中央对手清算) [Inter-Bank Central Clearing House, Business Guideline for Central Clearing of RMB Exchange in the National Inter-Bank Bond Market] (promulgated by Inter-Bank Central Clearing House July 2015).

288. *Id.* art. 15.

289. *Id.* arts. 26–27.

290. *Id.* art. 21.

291. *Id.* art. 40.

292. *Id.* art. 47.

293. *Shanghai Launches OTC Derivatives Clearing*, LINKLATERS LLP 1, 2 (Jan. 2014) [http://www.linklaters.com/pdfs/mkt/hongkong/280114\\_SCH%20Central%20Clearing%20Bulletin.pdf](http://www.linklaters.com/pdfs/mkt/hongkong/280114_SCH%20Central%20Clearing%20Bulletin.pdf) [<https://perma.cc/RYZR-9PSM>].

294. *Id.*

295. *Id.*



C. *The Driving Forces for China to Be Active in the Establishment of a Central Clearing House*

The development of a central counterparty (CCP) was based on a phenomenon known as coercive isomorphism, which happened when the existing institution needed changing. Specifically, the CCP and the Shanghai Clearing House has developed through marketization of interest reform and the RMB internationalization in China.<sup>296</sup> Similarly, the marketized and internationalized interest swap market continues to be an important step for achieving the marketized interest rate and RMB internationalization. As Xu Zhen, the director of Shanghai Clearing House, commented:

I think, interest rate swaps and interest rate derivatives product innovation and development, is an important part of the benchmark interest rate system for financial markets. Shanghai Clearing of OTC interest rate through the safe and efficient net derivatives clearing services, escort for the market-oriented reform of interest rates.<sup>297</sup>

Mimetic isomorphism was another important force that drove the development and internationalization of the CCP in China. This was so because establishing the Chinese standard of central clearing avoids long-arm jurisdiction by economic powerful markets like those of the United States and Europe. The Chinese media commented that the United States and Europe required the Shanghai Clearing House to attain a qualification to settle transactions from U.S. and European financial institutions.<sup>298</sup> Asian countries, including China, resisted this long-arm jurisdiction.<sup>299</sup> Since then, the EU replaced the requirement of long-arm jurisdiction with alternative compliance in July 11, 2013.<sup>300</sup> The United States and China also agreed to use the alternative compliance to respect each other's regulatory authority on derivative transactions in their respective territories.<sup>301</sup>

Furthermore, normative isomorphism which "associates with professionalization"<sup>302</sup> can also be used to interpret the fast devel-

296. *Id.*

297. Bill Hodgson, *Development of the Chinese IRD Market, Central Clearing and SHIBOR, The OTC Space* (July 19, 2012), <http://www.theotcspace.com/2012/07/19/development-of-the-chinese-ird-market-central-clearing-and-shibor> [<https://perma.cc/9PLP-Z6XJ>].

298. *Id.*

299. *Id.*

300. *Id.*

301. Press Release, U.S. Dep't Treasury, 2016 U.S.-China Strategic and Economic Dialogue Joint U.S.-China Fact Sheet – Economic Track (June 7, 2016), <https://www.treasury.gov/press-center/press-releases/Pages/jl0484.aspx> [<https://perma.cc/4DU9-3KJL>].

302. DiMaggio & Walter, *supra* note 31, at 149.

opment of the CCP in China and Chinese compliance with the new rule of the G20 and the FSB. Similar to its role in localizing the master agreement, NAFMII also plays an important role in promoting the progress of the CCP by issuing a series of legal documents.<sup>303</sup> Besides NAFMII, the Shanghai Clearing House plays a more important role in promoting the CCP in China.<sup>304</sup> It issued many behavior rules for its members, such as the Business guideline for Settling the Default of RMB Swap Central Clearing discussed above,<sup>305</sup> and the notice relating to the Introduction of Qualified Overseas Entities to Participate in the Centralized Clearing Business.<sup>306</sup> The Shanghai Clearing House is actually working as the regulatory intermediary, which transfers commands and supervises efforts to aid in efforts relating to regulatory cooperation.<sup>307</sup> From the perspective of the world market, the U.S. and European derivative markets are dominant.<sup>308</sup> To break up the monopoly, peripheral markets will endeavor to develop their own international exchanges, as demonstrated in the example of by the Shanghai Clearing House. Xu Zhen, the director of Shanghai Clearing House, addressed the prospects of the Chinese derivatives market as follows: “China’s OTC market is the inter-bank market derivative products, though a late start, few products, but the situation is gratifying, with the deepening of market-oriented interest rate reform, the potential development of [a] very large space.”<sup>309</sup>

## V. IMPLICATIONS AND SUGGESTIONS FOR A FURTHER PATH

Although some courts in China have recognized the validity of close-out setoff, the close-out setoff is most likely not going to be regarded as valid nationwide. Even though the Supreme Court’s

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303. As discussed in *supra* Part III(D).

304. As discussed in *supra* Part IV(B).

305. Yinhangjian Qingsuansuo Gufenyouxiangongsi Renminbi Renminbi Lilv Huhuan Jizhong Qingsuan Ywu Weiyue Chuzhi Zhiyin (银行间市场清算所股份有限公司人民币利率互换集中清算业务违约处置指引) [Inter-Bank Central Clearing House, Business Guideline for Settling the Default of RMB Swap Central Clearing] (promulgated by Inter-Bank Central Clearing House on Sep 22, 2016).

306. Guanyu Yanchang Waihui Jiaoyi Shijian he Yinru Hege jingwai Zhuti Canyu Jizhong Qingsuan Yewu Xiangguan Shiyi de Tongzhi (关于延长外汇交易时间和引入合格境外主体参与集中清算业务相关事宜的通知) [Notice of the Clearing House Financial Markets Co., Ltd. on Issues concerning the Extension of Foreign Exchange Transaction Hours and the Introduction of Qualified Overseas Entities to Participate in the Centralized Clearing Business] (promulgated by Clearing House Financial Markets Co., Ltd. Dec. 28, 2015, effective Dec. 28, 2015).

307. See *supra* note 278.

308. Gao & Chen, *supra* note 13, at 9.

309. Hodgson, *supra* note 297.

judicial interpretation of the procedures and situations in bankruptcy law apply to setoff, that authority only makes the application of close-out setoff become possible.<sup>310</sup> It does not fully confirm that the close-out setoff will be valid throughout the Chinese jurisdiction. To completely solve the uncertainty problem, the legislature needs to recognize the close-out setoff's validity. Close-out netting clauses cannot simply be understood as terms used to gain profit at others' expenses, for they are actually very helpful in reducing risk as well as preventing risk contamination and systemic risk. When the United States faced this conflict, it gave derivatives a fair deal of freedom from mandatory provisions in bankruptcy law so as to bridge the contradictions between industry practices and mandatory provisions.<sup>311</sup> To manage conflict, it is necessary to establish a safe harbor. Here, U.S. experience and lessons may be valuable for China.

A. *“Recognizing Legitimacy” by Safe Harbor: The U.S. Experience and Lessons*

From 1978 to 2005, several changes were passed in the U.S. Bankruptcy Code to include almost all of the financial derivatives into safe harbor.<sup>312</sup> In 2005, after the promulgation of the Bankruptcy Abuse Prevention and Consumer Protection Act, the derivatives of the safe harbor became applicable to automatic stay,<sup>313</sup> preferential transfer,<sup>314</sup> and other mechanisms. In 2005, after the modification for expanding explanation of swaps, the protected financial contracts actually covered almost all possible derivatives trading because almost all of the financial derivative contracts are swap products or are of similar kinds.<sup>315</sup>

The safe harbor for derivatives is actually harming some of the legal interests of bankruptcy law. Therefore, it should not be created casually and needs to be put into practice with careful consideration of different parties' interests.

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310. See discussion *infra* Part III(C)(3).

311. 11 U.S.C. § 362(b)(6), (7), (17), (27); § 546 (g), (j); § 553(b)(1); §§ 555–56, §§ 559–62.

312. *Id.*

313. 11 U.S.C. § 362.

314. 11 U.S.C. § 547.

315. 11 U.S.C. § 101(53B) (A) (2005).

## 1. Measuring the Interests Involved in "Recognizing Legitimacy"

## a. Heterogeneity of Creditors

The event of a firm or a debtor's default will result in losses for each creditor involved in a bankruptcy case. Some creditors will not be able to afford such losses and on a macro-level, the entire social economy cannot afford to bear the external effects caused by the significant losses of some creditors.<sup>316</sup> In such cases, the relationship between creditors and debtors is a highly abstract legal relationship, where creditors only exist as a legal concept and differences among creditors are ignored. Here, it is important to note that creditors are heterogeneous<sup>317</sup> and that different creditors, because of their various economic statuses and assets in their portfolios, vary in their ability to resist the risk of default.

Furthermore, parties of financial derivatives contracts are mostly large banks and securities firms, which are often counterparties to a number of financial contracts.<sup>318</sup> Because participants in financial derivatives contracts between institutions form a close relationship network, one party's bankruptcy is likely to influence other related parties by transmitting risk through trade in the network, leading to a domino effect. In fact, the U.S. Congress revised bankruptcy law and subsumed the futures contract in safe harbor because "the bankruptcy of one derivatives dealer will transfer (its risk) to other dealers," which may cause systematic risk.<sup>319</sup> The U.S. Congress further mentioned that "the rapid liquidation of the position in a bankruptcy is necessary for the market to prevent a sharp reversal of the direction and the mass loss and a sequence of reactions to the bankruptcy."<sup>320</sup> The prevention of systemic risk is the fundamental reason for sparing financial derivatives contracts in bankruptcy law.<sup>321</sup>

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316. Michael C. Munger & Richard M. Salsman, *Is "Too Big to Fail" Too Big*, 11 GEO. J.L. & PUB. POL'Y 433, 435–37 (2013).

317. The theory of creditors was raised by Professor Schwartz. See Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEGAL STUD. 1, 27–28 (1981). See also Ishac Diwan & Mark M. Spiege, *Are Buybacks Back? Menu-Driven Debt-Reduction Schemes with Heterogeneous Creditors*, 34 J. MONETARY ECON. 279, 280 (1994) ("These imperfections give rise to heterogeneity among banks' valuation of developing country debt that can be exploited in a financial restructuring with self-selection.").

318. See Franklin R. Edwards, *Off-Exchange Derivatives Markets and Financial Fragility*, 9 J. FIN. SERV. RES. 259, 263 (1995).

319. H. R. Rep. No. 97-420, at 1 (1982).

320. *Id.* at 4.

321. Edwards, *supra* note 318, at 259–60.

b. Retaining the Fundamentals of Bankruptcy Law: Analysis  
Based on Specific Value Theories of Companies

The purpose of bankruptcy law is to protect the orderly and fair distribution of resources in the event of scarce resources, protect the going concern value, and prevent the competition of looting. A variety of bankruptcy law mechanisms such as those relating to bankruptcy preservation and prevention of biased transfer<sup>322</sup> achieves the system's purpose and prevents creditors in a common pool from reinventing the wheel to enter into any collection or enforcement proceedings against the debtor.<sup>323</sup> Not all of the debtor's assets has a sustainable business value and it is necessary to define the kinds of assets that can be regarded as company-owned assets with unique value. Assets that do not have this characteristic may be an exception to the mandatory system and enjoy the "safe harbor" exemption.<sup>324</sup>

Before elaborating on the safe harbor in bankruptcy law, however, it is important to note that many mandatory regulations governing debtors' assets are rebuttable presumptions. For example, U.S. bankruptcy law Article 362(d) automatically suspends the assumption that all assets have a specific value for the company and therefore need to be incorporated into the public pool.<sup>325</sup> Financial derivatives contracts are not like an enterprise's machinery and equipment, which are irreplaceable for the enterprise's sustainable management. In a fully competitive and adequate product market, replacing derivatives contracts is not difficult.<sup>326</sup> Therefore, allowing the relative person to cancel the contract does not have a significant effect on the value of the debtor's continuing operations. However, the cancellation of financial contracts may be harmful to the other creditors' interests. Because the bankrupt enterprise may pay a higher price (or, depending on the market, pay a price lower than the original) to obtain a new hedge contract, the price of additional payment will reduce the enterprise's assets and be passed on to other creditors.<sup>327</sup> Professor Morrison and Jami Edwards believe that such loss is the price that must be

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322. 11 U.S.C. § 362 (2012) (which provides the automatic stay mechanism).

323. *Id.*

324. *Id.*

325. 11 U.S.C. § 362(d)(1)(2) (2012).

326. Edwards, *supra* note 318, at 263.

327. *Id.* at 263–64.

paid in price competition in the market and will not stop the appearance of the optimal result of Pareto.<sup>328</sup>

c. Potential Risk from Having a Safe Harbor

Safe harbor, if used improperly, may lead to debtors using collateral, triggering a new systemic risk.<sup>329</sup> Financial derivatives trading is often highly leveraged as participants only need to pay a certain proportion of the margin or collateral.<sup>330</sup> When a party to a derivatives contract is in financial trouble, the other party is in a hurry to end the contract. In a crisis, one side has to fire-sale its assets to deal with the opposite party's demand. This will undoubtedly run the party into an even worse crisis and will transmit a crisis signal to the financial market through information contagion, which will affect the price of financial assets.<sup>331</sup> However, the relative persons included in the derivatives contracts permitted under the safe harbor provision of the bankruptcy law are given preferential treatment, which allows them to run freely.<sup>332</sup> These relative persons will make it difficult for the financial crisis institutions to get any new liquidity to survive. Even though companies like AIG, Lehman Brothers, Bear Sterns, and others may have had the opportunity to borrow short-term liquidity in the 2008 economic crisis, the allowance of safe harbor under bankruptcy law may lead to collateral problems.<sup>333</sup>

Moreover, after the financial crisis of 2008, the safe harbor of U.S. bankruptcy law was criticized by the society.<sup>334</sup> In response, the U.S. Congress did not modify the legislation to get rid of the safe harbor but weakened the power of safe harbor in another way. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) stated that the "orderly liquidation" of post-bankruptcy financial institutions that pose systemic risk do not align with common bankruptcy procedures<sup>335</sup> and that they go directly into the "orderly liquidation" program organized by the Federal Deposit Insurance Corporation.<sup>336</sup> After entering orderly

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328. *Id.* at 115.

329. *Id.* at 278.

330. FIN. STABILITY BD., *supra* note 25.

331. Mark J. Roe, *Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 564 (2010).

332. *Id.*

333. *Id.*

334. *Id.*

335. See discussion *infra* Part V(A).

336. See generally Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 Title II—Orderly Liquidation Authority, 124 Stat. 1376, 1871 (2010).

liquidation, the relative persons to the derivative contract are not able to obtain collateral immediately.<sup>337</sup> Although this limit will be lifted after forty-eight hours, this change to the legislation was made to represent the closure of the safe harbor provision.<sup>338</sup> According to Article 210 (H)(1)(b) of the Dodd-Frank Act, the Federal Deposit Insurance Corporation, as an “insolvency trustee,” has the right to choose good assets to be stripped into the bridge bank that also includes incomplete derivatives contracts.<sup>339</sup> This provision<sup>340</sup> is a safe harbor provision in disguise that bypasses the trustee’s right to choose.

### B. *Should China Open a Safe Harbor?* *Several Factors to Consider*

#### 1. Precedent Example

The incorporation of the safe harbor provision in the U.S. law was characterized by a gradual progress over two decades that entailed several modifications to the law.<sup>341</sup> China does not have a precedent example for opening a safe harbor for derivatives in legislation. However, provisions of the Supreme People’s Court on Several Issues concerning the Trial of Futures Dispute Cases (II) (Judicial Interpretation on Futures II) mentions the possibility of creating a safe harbor in the future.<sup>342</sup> Article 4 of the Judicial Interpretation on Futures II provides the following:

where a futures company is the debtor, and the creditor claims for freezing or transferring the following funds or negotiable securities in the account, the people’s court shall not support such claim: 1. funds of a client in the margin account of the futures company; or 2. negotiable securities submitted by a client to the futures company to offset the margin.<sup>343</sup>

This safe harbor is very narrow since it only applies to futures companies as debtor but not to the clients of the future compa-

337. *See id.* § 202(a)(1)(A).

338. *See id.*

339. *Id.*

340. *See id.* § 210 (h)(1)(B)(ii).

341. 11 U.S.C. § 362(b)(6), (7), (17), (27); § 546 (g), (j); § 553(b)(1); §§ 555–56, §§ 559–62.

342. Zuigao Renmin Fayuan Guanyu Shenli Qihuo Jiufen Anjian Ruogan Wenti de Guiding (最高人民法院关于审理期货纠纷案件若干问题的规定 (二)) [Provisions of the Supreme People’s Court on Several Issues concerning the Trial of Futures Dispute Cases (II)] (promulgated by Supreme People’s Court, Dec. 31, 2010, effective Jan. 17, 2011) (Chinalawinfo).

343. *Id.* art. 4.

nies.<sup>344</sup> Although it is narrow, however, it is also a precedent example for safe harbor of OTC derivatives.

## 2. Market Conditions

Although the Chinese derivatives market is not so concentrated as that of the United States, it does show a trend toward concentration. This is because the big players that control the majority of resources of clients and profits are growing.<sup>345</sup> For example, the profits of the ten biggest future companies have more than 34% of the net profits in the nation.<sup>346</sup> Furthermore, derivative products are more concentrated in a few categories. For instance, the top ten most active products amount to more than 77% of the market, and the top twenty most active products amount to more than 96.14%.<sup>347</sup> Therefore, opening a safe harbor based on the overall concentration of the market is meaningful for China since it is heading towards greater concentration.<sup>348</sup>

## 3. Risk Factor

The purpose of opening a safe harbor is to reduce the risk of contagion for the counterparty as well as the systemic risk.<sup>349</sup> Lessons from the United States show that opening a safe harbor may produce a dilemma. On the one hand, if a safe harbor is not established, the counterparties may be affected by risk that causes systemic risk if the default party has many counterparties; on the other hand, if the safe harbor is established, then the run on collateral problem may happen and cause systemic risk.<sup>350</sup>

Facing such dilemma, policymakers should carefully consider whether China should open a safe harbor, especially with regards to the qualified categories of contracts, qualified parties, and the method of opening (either by the legislature or by judicial interpretation). The Dodd-Frank Act requires that the counterparty not immediately obtain collateral within forty-eight hours after the

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344. *Id.*

345. *The diversified of the Future Companies Become Evident and the Concentration of the Industry Increased*, SINA (July 24, 2014), <http://finance.sina.com.cn/money/future/fmnews/20140724/084119804574.shtml> [<https://perma.cc/BV89-PHVF>].

346. Wang Yi, *The Profits of the Future Companies had Small Decrease and the Concentration of the Industry Increased*, 163 MONEY, (Feb. 12, 2014), <http://money.163.com/14/0212/07/9KS9S3NT00252895.html> [<https://perma.cc/52L3-B2WV>].

347. *Id.*

348. *Id.*

349. See Mark J. Roe, *Derivatives Markets in Bankruptcy*, 55 COMP. ECON. STUD. 519, 525 (2013).

350. *Id.*



defaulting party gets into orderly liquidation.<sup>351</sup> The ISDA accordingly changed the clauses of the master agreement and forbid the counterparty to get the collateral within forty-eight hours.<sup>352</sup> The Chinese version of the master agreement, however, did not incorporate a similar change yet.

In sum, safe harbor in China can be based on the Supreme People's Court's Judicial Interpretation on Futures II and can be expanded to apply to OTC derivatives. In practice, a court should decide whether a contract is qualified for safe harbor instead of applying automatically. The judge involved should be able to consider the opinion from the financial regulator to decide whether it applies from the systemic perspective.

### C. *Advantages and Flaws of the Central Clearing Mechanism*

Compared with common traders, central clearing institutions are more capable of enduring risk. That capability comes from several factors. First, central clearing institutions have compulsory legal provisions governing establishment, operation, and risk control and are under stricter supervision, which lead them to maintain a sounder risk control system than common financial institutions.<sup>353</sup> Second, central clearing institutions can adjust to deposits in a timely fashion by incorporating changes in the prices of derivatives underlying assets.<sup>354</sup> Moreover, members who participate in settlement pay the initial margin, which is usually determined by a "mark to market" method.<sup>355</sup> Third, central clearing institutions usually take the structure of a membership. In addition to the initial margins and collaterals that members pay to the counterparties in common derivatives transactions, a certain percentage of risk reserves are contributed to the clearing agencies.<sup>356</sup> In the event that an individual member breaches the rules while the institution concurrently lacks a funding source, all members are required to append a certain amount of money to break even and eliminate losses.<sup>357</sup> Last but not least, the central clearing

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351. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §210(c)(8)(i), 124 Stat. 1376, 1871 (2010).

352. Huw Jones, *Banks Accept Derivatives Rule Change to End "Too Big to Fail" Scenario*, REUTERS, (Oct. 11, 2014, 5:10 PM), <http://www.reuters.com/article/us-banks-derivatives-regulations-idUSKCN0I00T720141011> [<https://perma.cc/9HD7-HGUS>].

353. See PIRRONG, *supra* note 267.

354. *See id.*

355. *See id.*

356. *See id.*

357. *See id.*

institution, as a profit-making organization, has certain asset requirements, and such assets can be used to make up losses when a member is in a serious breach of contract.<sup>358</sup>

However, the risk control system of central clearing institutions does not fundamentally solve the problem of counterparty risk and only transfers it. In the central clearing mechanism, the risk of default on every clearing participant is distributed in certain proportions. This risk-splitting mechanism guarantees that the central clearing institution retain greater risk tolerance than ordinary participants.<sup>359</sup> This method of risk transfer is beneficial to social welfare because it manages to take risk from the vulnerable (such as the non-defaulting party) and transfer it to more capable central settlement organizations by allocating such risk to each member of the central clearing mechanism. Nevertheless, the mechanism of risk transfer by central clearing could lead to other risks that should not be underestimated. One such example relates to the underlying risk of the security deposit mechanism, where the amount of margin that is calculated in accordance with the market valuation method ("mark to market" method) may lead to the risk of falling asset prices.<sup>360</sup> Specifically, the clearing agency will require members to increase the margin when asset prices rise in accordance to the law and those members that are under increased pressure may sell assets or sell positions. When many participants sell assets at the same time, the price of assets on the market will fall sharply.

From a legal point of view, the central clearing mechanism changes the rules of risk allocation and may encourage members to shy away from "self-responsibility," which can easily lead to moral hazard. Under the assumption of a rational person, the actor will be more cautious in order to avoid adverse consequences. Moreover, participants will think for themselves and, in order to promote social welfare, participants will carefully review each counterparty's credit, contributing to the dropout of lower credit participants and the reduction of high risk of trading. In fact, after the introduction of the central clearing agency, the risk distribution system based on "self-responsibility" was broken. The replacement process of the contract changed the original risk allocation rules and led to the original contract no longer directly bearing the adverse

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358. *See id.*

359. *Id.* at 5.

360. *Id.* at 36.

consequences of the other party<sup>361</sup> and the central clearing agency directly bearing the adverse consequences.<sup>362</sup> As a result, once the participants do not have to bear the adverse consequences of their own behavior, moral hazard may stimulate the risky behavior of participants and increase the frequency of high-risk transactions in the market.

Every agency or individual has a limited capacity to bear risks. This is also the case for a central clearing agency. Before the financial crisis of 2008, the derivatives of central clearing institutions had not generated systemic crises because the burden pertaining to settlement was light.<sup>363</sup> However, in the wake of the financial crisis, European and U.S. regulators gradually tried to move most of the OTC derivatives toward the central settlement organization, and this will undoubtedly result in greater pressure to the central clearing organization.<sup>364</sup> Given such pressure, there might be a massive breach and an unavoidable systemic risk once an economic downturn occurs.

#### D. *Further Developing the CCP in China: Factors for Consideration*

Self-regulation by an intermediary is “embedded self-regulation.”<sup>365</sup> Regulation by an intermediary, such as the clearing house:

seeks to redraw the principal line between private institutions’ freedom to regulate their own activities [in] most economically efficient way, on the one hand, and their duty [to] conduct their profit- and risk-generating business activities in accordance with the overarching public interest in preserving financial on the other.<sup>366</sup>

As discussed above, China was very active in promoting the development of the CCP and complying with the commitment of the G20. Now, Chinese policy should account for the following factors when considering promoting the CCP in China:

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361. *Id.* at 35.

362. *See id.* at 16.

363. *See id.* at 5.

364. *Id.*

365. *See* Saule T. Omarova, *Wall Street as a Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. PA. L. REV. 411, 438 (2011).

366. *Id.* at 438–39.

## 1. Path Dependence

Mandatory central clearing actually restricts partial contractual freedom. Whether the market can accept such restriction relates to path dependence. From the perspective of path dependence, a market with a dirigisme tradition is more likely to accept the restriction. The derivatives market in China, which is more driven by the state, is different from those of Western markets that are driven more by market forces. In China, the state plays an active role in establishing the market and is not left open to market forces.<sup>367</sup> The top four futures brokerage companies are all state-owned non-profit companies.<sup>368</sup> Moreover, derivative transactions on the inter-bank market used the electronic exchange platform from the very beginning.<sup>369</sup> As such, the market does not need to transition from OTC to central clearing. In sum, the legitimate derivatives market in China can easily accept the mandatory central clearing due to its history of being subject to stricter regulation.

## 2. The Influence of Having No Autonomy Tradition

Intermediary regulation is a form of middle-way governance that is different from traditional self-regulation and bureaucratic regulation, which can “institutionaliz[e] responsibility” of private players.<sup>370</sup> From this perspective, intermediary regulation can be

367. See discussion *supra* Part III(A).

368. *Overview*, SHANGHAI FUTURES EXCH., <http://www.shfe.com.cn/en/> (“Shanghai Futures Exchange (“SHFE”) is under the uniform regulation of China Securities Regulatory Commission (“CSRC”) and organizes the futures trading approved by CSRC in accordance with the principles of openness, impartiality, fairness and integrity.”) [<https://perma.cc/M35G-3J9T>]; *Brief Introduction*, ZHENGZHOU COMMODITY EXCH., [http://english.czce.com.cn/enportal/AboutZCE/Overview/Overview/H69010101index\\_1.htm](http://english.czce.com.cn/enportal/AboutZCE/Overview/Overview/H69010101index_1.htm) (Zhengzhou Commodity Exchange (ZCE) is the first pilot futures market approved by the State Council. Being one of the four futures exchanges in China, ZCE is under the vertical management of CSRC.) [<https://perma.cc/PH2F-CUA6>]; *The DCE at a Glance*, DALIAN COMMODITY EXCH., <http://www.dce.com.cn/DCE/> (“Founded in 1993, the Dalian Commodity Exchange (DCE) is a futures exchange approved by the State Council and regulated by CSRC.”) [<https://perma.cc/Q42M-JP6K>]; *Introduction*, CHINA FIN. FUTURES EXCH., [http://www.cffex.com.cn/en\\_new/jysjs.html](http://www.cffex.com.cn/en_new/jysjs.html) (“China Financial Futures Exchange (CFFEX) is a demutualized exchange dedicated to the trading, clearing and settlement of financial futures, options and other derivatives. On September 8, 2006, with the approval of the State Council and CSRC, CFFEX was established in Shanghai by SHFE, ZCE, DCE, Shanghai Stock Exchange and Shenzhen Stock Exchange.”) [<https://perma.cc/5PZE-KGW3>].

369. Xianxing Wang (汪贤星), *Changwai Yanshengpin de Biaozhunhua Hengliang ji Zhongguo Changwai Yanshengpin Biaozhunhua de Shijian* (场外衍生品的标准化衡量及中国场外衍生品标准化的实践) [*The Measure of the Standardization of the OTC Derivative and the Practice of the Standardization of Chinese OTC Derivative Market*], 10 ZHONGGUO HUOBI SHICHANG (中国货币市场) [CHINESE MONEY MKT. ISSUE] 42, 45–47 (2011).

370. Gunningham & Rees, *supra* note 24, at 406.

viewed as a blending of autonomy and public interest. Autonomy is essential for intermediary regulation, which ensures the regulation is market oriented and different from bureaucratic regulation. The financial market in China, however, lacks a tradition of autonomy. State-owned exchanges are the controllers and distributors of scarce resources and there is a lack of market players with independent economic interests, which is a possible reason for the lack of an autonomy tradition.<sup>371</sup> Before the establishment of NAFMII, the PBOC took full responsibility of the derivatives market for the inter-banks.<sup>372</sup> Even after the establishment of the NAFMII Shanghai Clearing House and other intermediaries, the financial regulators still practice paternalism.<sup>373</sup> Insufficient autonomy may undermine the efficiency of intermediary regulation.

### 3. The Ignored Illegitimate Market

Regulation in China often takes on a white or black dichotomy.<sup>374</sup> Business by regulated institutions is regarded as legitimate while business by unregulated institutions is regarded as illegitimate, which in turn drives it to the ground.<sup>375</sup> Central clearing only applies to some parts of the regulated institutions' derivative transactions. For derivative transactions on the local illegitimate market, the CCP rule is too far removed to reach them<sup>376</sup> although those derivatives also have a counterparty risk. Therefore, policy makers should include derivative transactions in the CCP system to prevent the systemic risk caused by those transactions. Of course, the first step before including them in the CCP system will be to legitimize those transactions and place them in the same regulatory system as the other transactions on the national market.

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371. Li Lu (鲁篱), *Zizhi Ruhe Xingcheng: Dui Zhengquan Jiaoyisuo Falv Diwei de Lishi Bijiao* (自治如何形成: 对证券交易所法律地位的历史比较) [*How to Self-Governance: A Historical Comparison Concerning the Legal Status of Security Exchange of the PRC*] 4 XIANDAI FAXUE (现代法学) [MODERN L. SCI.] 128, 131 (2004); Bing Peng (彭冰) & Lijia Cao (曹里加), *Zhengquan Jiaoyisuo Jian'guan Gongneng Yanjiu: Cong Qiye Zuzhi de Shijiao* (证券交易所监管功能研究: 从企业组织的视角) [*Regulatory Function of Security Exchanges: Perspective of Firm Organization*], 1 ZHONGGUO FAXUE (中国法学) [CHINESE LEGAL SCI.] 83, 83 (2005).

372. Xiaoye Bao (鲍晓晔), *Woguo Changwai Yanshengpin Shichang Jianguan Moshi de Kunjing yu Gaige* (我国场外衍生品市场监管模式的困境与改革) [*The Trouble of the Regulatory Regime on Chinese OTC Market and the Reform*] 11 QIUSUO (求索) [EXPLORATION] 44, 44 (2015).

373. See discussion *supra* in Part IV(B).

374. See Gao, *Seeing Gray in a Black-and-White Legal World*, *supra* note 8.

375. See Simin Gao, *Disequilibrium Between Regulation and Criminalization to Counter Financial Misconduct: The Case of Shadow Banking in China*, 54 AM. BUS. L.J. 393 (2017).

376. *Id.*

#### 4. CCP is Not a Panacea

The CCP should not be taken as a panacea. The CCP cannot prevent systemic risk if it is overloaded. Also, the current rule of the Shanghai Clearing House shows that defaults on transactions are not backed by PBOC funding.<sup>377</sup> Policymakers in China will be cautious of unrealistic illusions of the capacity of the CCP, especially as the market expands and more products are cleared in the Shanghai Clearing House. Therefore, policymakers may consider supplementary methods of burdening risk. For instance, when a serious default happens that may cause systemic risk, the PBOC may work as a lender of last resort to bail the CCP out. Also, because the CCP is an intermediary with a special function, there may be special regulations relating to its capital ratio, risk reservation funding, and bankruptcy procedures, which must all be further discussed in the future.

#### CONCLUSION

As economic globalization grows and legal conflicts between local law and transactional law become unavoidable, the core concepts instated by the ISDA master agreement such as the close-out setoff mechanism become a Lydian stone for different legal systems in different countries. Market participants use the close-out netting clause to reduce counterparty risk, and such practice was promoted by the ISDA master agreement and gradually became the norm in the industry.<sup>378</sup> The ISDA master agreement, with the core concept of close-out setoff, is a type of private law-making that plays a key role in transferring sovereign functions to private actors.<sup>379</sup> However, the close-out setoff is further proving to be valuable in the context of bankruptcy where treatment of counterparties may raise conflicts with bankruptcy law in different countries such as China.

Unique paths of conflict reconciliation can be observed in the Chinese OTC derivatives market. Chinese financial regulators and industrial associations respected the international norm by localizing the norm with the launch of the Chinese NAFMII master agreement, which has a close-out setoff clause.<sup>380</sup> However, although

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377. See Inter-Bank Central Clearing House, Business Guideline for Central Clearing of RMB Exchange in the National Inter-Bank Bond Market, *supra* note 287, art. 26 (the funding of loss coverage is from the clearing funding (instead of PBOC's bailout funding)).

378. Wielsch, *supra* note 37, at 1078.

379. *Id.*

380. NAFMII MASTER AGREEMENT § 4(III) (2009).

some courts in China have recognized the legal validity of the close-out setoff, the close-out setoff will probably not be regarded as valid nationwide. Even though the Supreme People's Court's judicial interpretation on bankruptcy interpreted the procedure and situations that apply to setoff, this judicial action just makes the close-out setoff possible. It does not confirm that the close-out setoff will be valid across the entire Chinese jurisdiction. To completely solve this uncertainty in application, the legislature needs to recognize its validity.

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