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Rules on Participation of Vietnamese Counterparties in Trading of Commodity Derivatives

MAI THI MINH HANG AND NGUYEN DUC TRI

LT Commodity markets; Derivatives; Financial regulation; Vietnam

This analysis focuses on the regulatory framework that governs the commodity derivatives market. We comment first on the existing domestic commodity derivatives market. We discuss the way Vietnam's incomplete regulatory framework affects the hedging instruments that can be offered to Vietnamese entities on a cross-border basis. We also discuss issues that a Vietnamese party confronts when it trades commodity derivatives with a foreign party in a regulatory environment that only permits the sale and purchase of physical commodities. Then, based on current legislation, we explore how Vietnamese entities can participate in the offshore commodity derivatives market. Our analysis excludes gold, as it is subject to separate State Bank of Vietnam (SBV) regulations.

First and simply, when we refer to a commodity derivative, we mean a product whose value derives from, and depends on, the underlying commodity. Commodity derivatives can be used either to hedge or to speculate. At maturity, a commodity derivatives transaction can be settled by either cash netting or by delivery of the underlying commodity. Generic commodity derivatives include futures/forward contracts, option contracts and swap contracts. Derivative products can be traded through exchange platforms or over-the-counter.

Domestic commodity market

Regulations on trading commodity derivatives exist in the Commercial Law (CL) and in Decree 158/2006/ND-CP (Decree 158) of the Government dated December 28, 2006. The CL defines the sale and purchase of commodities on an exchange as:

"[A] commercial activity whereby the parties agree to sell and to purchase a certain quantity of a specific commodity on a commodities exchange subject to standards given by the commodities exchange, at a price fixed at the time of execution of the [sale and purchase] contract, and for delivery at a specified time in the future."

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According to the CL and Decree 158, contracts that can be traded on a domestic commodities exchange include:

- a "forward contract", in which the seller agrees to deliver and the purchaser agrees to receive delivery of a commodity at a specified time and at a fixed price in the future. A forward contract can be either physically settled (by delivery of the underlying commodity at maturity) or non-physically settled by cash without actual delivery at maturity. The reference to a forward contract as an instrument traded on an exchange under the CL may confuse. In an international context, a forward contract is not traded on an exchange, whereas a futures contract is. Vietnamese law does not use the term "futures contract". Fundamentally, however, both contracts have the same basic function: to allow counterparties to buy or sell a specific type and quantity of a commodity at a specified time at a predetermined price. As far as Vietnam is concerned, the difference is just a matter of terminology, and it does not affect the nature of a contract that is traded on a domestic exchange; and
- an "options contract", in which the holder has the right to buy (i.e. call option), or to sell (i.e. put option) a specific type of commodity at a given price. A buyer must pay a premium to purchase this option. The holder of an option contract is not required to execute its rights under the option. That is, the party that buys the option can let it expire.

General legal bases for a domestic commodities exchange were set out in 2006. Detailed regulations were eventually put into place in February 2009. Even so, domestic commodities exchanges have not yet been established. In June 2009, the Government said it intended to set up a commodities exchange in Ho Chi Minh City. However, the idea remains very preliminary. Several embryonic commodities exchanges have been attempted. The latest attempt is a coffee trading centre named the Buon Ma Thuot Coffee Exchange Center (BCEC) launched in December 2008 and located in Dak Lak Province. Transactions executed through BCEC are physical transactions, including auctions, spot and forward transactions. It was expected that BCEC would create an efficient trading platform for the country's large coffee output. However, the number of transactions executed on the BCEC has been small in terms of both value and quantity. Judging from BCEC's infrequent transactions, the goal to permit forward transactions seems distant. BCEC's birthing problems have been explained by some as growing out of the traditional preference of local commodity producers to sell their products through an intermediary who buys agricultural/aquatic products from farmers/fishermen and then sells them to end purchasers or to overseas buyers. This practice is deeply rooted.

Access to the offshore commodity-derivatives markets

Participation in an offshore commodity exchange

The right of Vietnamese enterprises to participate in offshore commodities exchanges is generally recognised under the LC and in Decree 158. According to Decree 158, transactions must be carried out within the schedule, conditions and scope of implementing regulations to be issued by the Ministry of Industry and Trade (MOIT—formerly, the Ministry of Trade). The MOIT has not yet issued implementing regulations.

Prior to the promulgation of Decree 158, the SBV took the initiative and issued Official Letter 8905/NHNN-QLNH on October 18, 2006 (OL 8905). Its primary purpose was to address specific issues that relate to settlement in connection with transactions involving commodity derivatives. It was issued soon after the SBV agreed to permit a number of commercial banks in Vietnam (some of which are named in OL 8905)—on a pilot basis—to provide Vietnamese enterprises with “intermediary services” in connection with “futures contracts” traded on offshore commodity exchanges. OL 8905 aimed to help Vietnamese enterprises hedge risks which arise out of commodity price fluctuations and to stabilise their production costs. OL 8905 defines a commodity futures contract as an agreement to sell and purchase commodities in a “standardized quantity and term of maturity”. The price is fixed and payment is made in the future. An “intermediary” (i.e. a permitted commercial bank) is entitled to a fee. However, these futures transactions are based on physical commodities. The informal position of the SBV is that reference in the OL to a “physical commodity” requires physical delivery of the commodity. OL 8905 by its own language does not include a transaction that is based on the existence of a notional amount of a commodity. The banks that are permitted to provide “intermediary” services must ensure that the futures transactions in which they provide their services, are entered into on the basis of physical commodities. Where there is no actual or physical commodity, settlement by cash generally is not permitted. In other words, the Vietnamese counterparty cannot remit funds to pay the foreign party, unless the “intermediary” bank is satisfied that the transaction involves physical delivery of the underlying commodity.

OL 8905, then, does not create a fully formed system. Moreover, OL 8905 fails to specify the “intermediary” services that a bank can provide. The practice of a permitted bank is that it acts as an intermediary to receive trading orders from Vietnamese customers (normally exporters and importers) and then forwards them to its contracted offshore brokers, who are registered to operate on foreign commodities exchanges. That is, the role

of the bank as it has developed is not to provide exchange settlement services but to act as a liaison between its Vietnamese customer and an offshore broker. That bank is responsible to report to the SBV on transactions that have been placed and executed through it.

While SBV grants the right to provide “intermediary” services, even though undefined, there is no support within the Law on Credit Institutions to permit such services. That is, “intermediary” services are not traditional banking activities defined in the law. Therefore they are not within the jurisdiction of the SBV. This is true even though OL 8905 was issued before Decree 158.

In partial contradiction to OL 8905, the MOIT is given the right to regulate activities on an offshore commodities exchange under Decree 158. Unfortunately, and as we have stated, Decree 158 has not yet been implemented. That is, OL 8905 has moved into a vacuum, but it creates overlap and confusion between the authority of the SBV and that of the MOIT to regulate participation of Vietnamese entities in offshore commodities exchanges. The SBV is only clearly in charge of regulating cross-border payments for offshore transactions. There is no clear remedy in case an authorised credit institution takes action that is inconsistent with Decree 158. To our knowledge, there are no discussions between the MOIT and the SBV to resolve matters. Nor has OL 8905 been updated to become consistent with Decree 158.

In the absence of the comprehensive regulations contemplated under Decree 158, there is no possibility that a Vietnamese enterprise can trade commodities derivatives on an offshore exchange.

Participation in an international over-the-counter commodity derivatives market

There are no regulations on cross-border over-the-counter (OTC) commodity derivatives transactions between a Vietnamese enterprise and an offshore entity (except for gold product derivatives and physical gold products, which, as mentioned, are outside the scope of this article). Neither is there a definition of a contract negotiated directly by the participants and traded OTC (either cross-border or domestically). We discuss below the circumstances in which certain OTC derivatives are permissible:

Forward contracts

By its nature, a commodities forward contract between a foreign party and a Vietnamese counterparty is a cross-border sale and purchase of a commodity. The parties agree on delivery of a specified quantity of a commodity, on a specified date, and at a specified price. This is a regulated permissible commercial activity under the CL. The CL imposes neither restrictions nor conditions on a cross-border

transaction of OTC commodity derivatives. Even so, there are issues that relate to international payment in a transaction that require cash-settlement.

OL 8905, as we discuss above, refers to a “futures contracts”. It is not clear whether the term is intended to refer only to exchange-traded contracts. That is because, as noted above, the terms “futures contract” and “forward contract” tend to be used interchangeably in Vietnam (for example, the CL uses the term “forward contract” for an exchange-traded contract). Since the terms are used interchangeably in Vietnam, the use of the term may refer also to a contract that is not traded on an exchange. If so, the requirement of physical commodities also applies to an OTC traded contract.

If OL 8905 is interpreted not to cover a forward contract, then are cash-settled forward contracts permitted? Payment by a Vietnamese counterparty under a forward contract is for a non-capital purpose (i.e. a current transaction) as regulated under the Ordinance on Foreign Exchange dated December 13, 2005 (the “FX Ordinance”) and Decree 160/2006/ND-CP of the Government, dated December 28, 2006, implementing the FX Ordinance (Decree 160). The general requirement in a non-capital transaction is that the Vietnamese counterparty must present documents required by the payment bank in order for the customer to purchase and remit foreign currency abroad and in order to settle the non-capital transaction. There has been no guidance to specify which documents must be presented to a Vietnamese bank for non-capital transaction purposes.

The lack of precise guidance implies that the Vietnamese bank—through which the Vietnamese counterparty settles each such contract—may have the discretion to decide which documents the Vietnamese counterparty must present in a non-capital transaction. Unlike remittances in respect of traditional transactions for which Vietnamese banks have rather common and standard rules on payment documents, the possibility to remit funds abroad to settle a forward contract and the required documents for such remittance will vary from bank to bank. In view of the lack of clarity on the point and given the SBV’s generally restrictive position on both futures contracts and price swaps, as we discuss below, a Vietnamese bank can be expected to act cautiously. It may seek specific guidance from the SBV before it authorises a remittance. Acting prudently to learn the position of the Vietnamese bank before the transaction is suggested.

The SBV’s restriction as it relates to remittance of payment abroad, of course, does not apply if there is no cash payment from Vietnam. Impliedly, cash settlement in other forms may also be effected. If the Vietnamese counterparty has to make payment to the foreign party upon settlement on a netting basis (e.g. the Vietnamese counterparty is in the short position while the spot price on the settlement date is higher than the delivery price), it will face the same payment issues we discussed in the paragraph above.

There appears to be an alternative to address the restriction on outbound cash settlement. It is possible to create a back-to-back structure under which any net amount payable by the Vietnamese counterparty in the original forward transaction will be set off against a payment liability of the foreign party under another back-to-back transaction. For example, assume a net amount is due to the foreign party from the Vietnamese counterparty. Instead of paying the net amount due, the Vietnamese party has the obligation to deliver a commodity to the foreign party which “receives” the commodity which has a value equivalent to the net amount of cash due. The foreign party then re-sells and delivers such commodity to another Vietnamese party in a back-to-back transaction, say, pursuant to a put option contract, in order to receive cash. This is referred to as a “domestic import/export” arrangement in which:

- the original Vietnamese party sells a commodity to the foreign party under an export contract and the Vietnamese party agrees to deliver the commodity to another Vietnamese party as designated by the foreign party; and
- the second Vietnamese party purchases the actual commodity from the foreign party under an import contract, and pays the foreign party.

The physical delivery of the commodity from the original Vietnamese party to the second Vietnamese party is compulsory in this back-to-back structure as it allows the second Vietnamese party to remit funds to the foreign party. The evidence of physical delivery is the completion of customs procedures and documentation for domestic import/export. The customs procedures for domestic import/export of goods are fairly comprehensive and straightforward. The goods do not have to actually pass through Vietnam’s customs borders but can be delivered directly between domestic parties in Vietnam as designated by the foreign party. There are specific customs clearance procedures for such a situation, but we do not discuss them in this article.

This is not a perfect solution, and it may not always be practical (e.g. a second Vietnamese party may not be available within the required timeframe). However, given the SBV’s restrictions on cash-settlement, a foreign party may want to consider this in order to realise the benefits of the net payment owed from the original Vietnamese party under the forward contract. Some variations may be considered.

Options

The SBV has no guidelines for options. It is generally understood that the rules on forward trades apply to option trading.

Price swaps

The SBV issued official letter 1229/NHNN-CSTT dated October 21, 2003 (OL 1229) to regulate commodity price swap transactions between a

Vietnamese enterprise and a commercial bank in Vietnam. OL 1229 is aimed at creating a structure for a Vietnamese enterprise to hedge its exposure to price fluctuation, on the domestic market.

Specifically, OL 1229 provides that:

“[A] commercial bank¹ shall only perform commodity price swaps [with an enterprise] for the quantity of a commodity to be purchased and/or sold by that enterprise and that enterprise must present its commodity purchase and sale contract upon entering into the commodity price swap contract with the commercial bank.”

The unofficial position of the SBV is that the settlement of swap transactions as contemplated under OL 1229 must be made pursuant to the underlying transaction with actual delivery of commodity. This means that a commodity price swap can be made only where the underlying contract calls for physical delivery of the commodity. The commercial bank must register with the SBV before it enters into a commodity price swap transaction with a customer. This registration is carried out one time only.

OL 1229 also provides that:

“[U]pon entering into a commodities price swap contract with an enterprise operating in Vietnam, a commercial bank shall be entitled to carry out corresponding transactions with banks operating in foreign countries in line with the laws of Vietnam and international customs for risk prevention.”

That is, a commercial bank in Vietnam may enter into a corresponding commodity-price swap transaction with an offshore bank in order to hedge its exposure under the commodity-price swap contract between it and the local customer. The term “corresponding transaction” creates some ambiguity. Does use of the term require underlying physical commodities in the corresponding transaction as is required in the original transaction between the Vietnamese bank and its customer? On the one hand, a bank cannot deliver physical commodities, because by doing so, it could be considered to engage in trading activity. Obviously, trading is not a permitted banking activity. Neither is it clear that a commodity price swap transaction is a permitted banking activity under the Law on Credit Institutions and its implementing regulations.

Article 41.1(a) of Decree 160, allows a commercial bank to participate in the “overseas money market and derivatives market” as a permitted international foreign exchange service. However, it seems that the term “derivatives” relates only to foreign exchange derivatives and does not include commodity derivatives. Even if it is interpreted to include commodity

derivatives, by virtue of Decree 160, in order to enter into a “derivatives” transaction with a foreign party, a commercial bank must obtain a registration certificate to engage in foreign exchange services in an overseas market. Such certificate must specifically permit the bank to participate in overseas derivatives markets. The unofficial position is that the SBV remains unwilling to license a bank to participate in overseas derivatives markets. That is, it is unclear how a Vietnamese bank may enter into a “corresponding transaction” with an offshore party as contemplated under OL1229.

Unlike a price swap between a Vietnamese enterprise and a Vietnamese bank, or between a Vietnamese bank and an offshore party, there are virtually no regulations on price swaps between a Vietnamese enterprise and an offshore party. We are of the view that such a transaction is subject to the foreign exchange requirements that apply to a simple trading transaction to import and export goods and services under the FX Ordinance and implementing documents. That is:

- The foreign currency proceeds generated by a Vietnamese party from the exportation of goods/services or from other non-capital transactions abroad must be remitted to a foreign currency account opened at a permitted credit institution in Vietnam in accordance with the terms of payment in the governing contract or payment documents.
- If the Vietnamese party wants to retain part or all of the proceeds it generates from the export of goods or services in an offshore account, it must obtain approval from the SBV.

We believe that as a result of these requirements a Vietnamese enterprise must obtain specific permission from the SBV in order to enter into a commodity price swap with an offshore party. Given the requirement of physical delivery of the underlying commodity under forwards and price swaps transactions in which a bank in Vietnam is a counterparty, as we discuss above, it may not be simple for a Vietnamese enterprise to obtain SBV’s permission for a cash-settled commodity price swap with an offshore party.

Marketing

A foreign broker of commodities derivatives may directly and privately target a customer or counterparty in Vietnam. Its marketing activities can be in the form of “cold calling”. By this we mean to contact a person in Vietnam and directly offer a commodities derivative product (the underlying commodities are not necessarily Vietnamese commodities; e.g. a Vietnamese party may enter into a forward contract to purchase metals from a foreign party), to respond to the request of a customer/counterparty for information on the products, to have private meetings

1. The term “commercial bank” in the context of OL 1229 refers to banks that have been licensed by the SBV to operate in Vietnam. They include: local banks, joint venture banks, 100% foreign owned banks and branches of offshore banks in Vietnam. The term does not include offshore banks.

with a potential or existing customer/counterparty in Vietnam, and to provide ongoing customer services to a customer/counterparty who has acquired products (including the provision of updated offering documents, performance reporting, etc.). These marketing activities may be carried out in Vietnam without any authorisation. However, given the current requirement of “physical commodities”, it is desirable for a foreign broker to include certain language in documents delivered to a Vietnamese counterparty, along the following lines:

“The [product] is offered for hedging purposes only and not for speculation. This [product] requires physical delivery of commodities. The Vietnamese party is responsible to comply with regulations on remittance of funds into or out of Vietnam.”

If marketing activities are directed to the public in the form of commercial promotional programs, or public advertising of derivatives products, they, like all other forms of advertising are subject to regulations on marketing and may require registration in Vietnam.

Conclusion

While commodity derivatives are generally considered to be a component of the international financial market, in Vietnam they are not. In Vietnam,

transactions involving commodities derivatives are simply considered as goods trading activities that involve the physical delivery of a commodity, rather than financial trading activities that just rely on transaction cash-flows. We note that regulations on other components of the financial market are quite clear. In particular, the Ministry of Finance is in charge of the capital market and insurance market, while the SBV is in charge of the money market and the foreign exchange market.

Oddly, the CL and Decree 158 delegate the authority to regulate commodity exchange activities to the MOIT, which does nothing that relates to financial markets. Although the SBV has certain guidelines, these guidelines tend to treat the trade of commodity derivatives the same way that traditional goods are traded by requiring physical delivery of the underlying commodities. Accordingly, the possibilities for Vietnamese enterprises to participate in offshore commodities derivatives, both on exchanges and on OTC markets, are limited. Of course, variations are possible, for example partial netting of forward contracts. However, the alternatives are not perfect. In order for the Vietnamese enterprise to participate fully in commodity derivatives transactions in offshore markets, we believe that discussions between the MOIT and the SBV are necessary. The objective would be to regulate these transactions as financial market activities rather than as goods sale and purchase activities.