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Paper for the House Committee meeting on 7 December 2007

**Report of the Subcommittee on
Securities and Futures (Contracts Limits and Reportable Positions)
(Amendment) (No.2) Rules 2007**

Purpose

This paper reports on the deliberations of the Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) (No.2) Rules 2007 ("the Amendment Rules").

Background

2. At present, section 4 of the Securities and Futures (Contracts Limits and Reportable Positions) Rules ("the Rules") prohibits a person (except an authorized person) from holding or controlling a futures contract or a stock options contract in excess of the prescribed limit set out in Schedules 1 and 2 to the Rules¹. Section 4(4)(a) of the Rules empowers the Securities and Futures Commission (SFC) to authorize a person to hold or control the relevant contract exceeding the prescribed limit if such person is able to satisfy SFC that there are special circumstances which warrant the excess position.

3. The market has raised concerns from time to time that the existing position limits for Hang Seng China Enterprises Index futures and options contracts (H-share contracts) and Hang Seng Index futures and options contracts (HSI contracts) are not adequate to cope with market growth. SFC understands that

¹ Currently, the prescribed limits for Hang Seng China Enterprises Index futures and options contracts and Hang Seng Index futures and options contracts are 12 000 and 10 000 combined contracts respectively.

some exchange participants² are unable to meet their business needs within the existing position limits because they would need to hold larger proprietary positions, particularly in HSI contracts and H-share contracts, in order to provide client facilitation services³. While the existing legislation already allows SFC to authorize exchange participants to exceed the statutorily prescribed limits for futures contracts or stock options contracts to meet "special circumstances", the need for excess positions to provide client facilitation services cannot be construed as "special circumstances". In order to meet market needs, SFC has considered it necessary to introduce a new category of authorization that may be granted by SFC in relation to excess positions on the ground of business need (i.e. where the excess is needed to conduct hedging activities to provide client facilitation services).

4. On 18 May 2007, SFC issued a consultation paper to invite comments on proposed amendments to the Rules and the Guidance Note on Position Limits and Large Open Position Reporting Requirements⁴ to give effect to the aforesaid proposal. The consultation period ended on 18 June 2007 and a total of seven responses were received. According to SFC, most respondents to the consultation were generally supportive of the proposal. Nevertheless, in the light of the comments received, SFC has revised some of its originally proposed amendments when finalizing the Amendment Rules in question.

The Amendment Rules

5. The Amendment Rules amends section 4 of the Rules to empower SFC to authorize an exchange participant or his affiliate⁵ to hold or control a specified contract in excess of the prescribed limit up to the specified percentage (set at 50%) if SFC is satisfied that there is a relevant business need for the excess. In other

² Pursuant to Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571), "exchange participant" means a person (a) who, in accordance with the rules of a recognized exchange company, may trade through that exchange company or on a recognized stock market or a recognized futures market operated by that exchange company; and (b) whose name is entered in a list, roll or register kept by that recognized exchange company as a person who may trade through that exchange company or on a recognized stock market or a recognized futures market operated by that exchange company.

³ Client facilitation refers to the process whereby a broker helps clients to execute orders that cannot be executed directly on the exchange. For example, the client's order may be a unique one whose terms do not match those of the standardized contracts offered on the exchange. The broker may take positions, as principal, to meet the client's order and then cover its trade (outstanding positions) on the exchange. The broker usually maintains market neutrality in these client facilitation transactions. In this example, the exchange transactions are treated as the broker's proprietary positions even though they were in fact executed to facilitate the trading needs of clients.

⁴ The Guidance Note is issued by SFC to help market participants better understand how the Rules are intended to operate in practice and explain compliance requirements of the Rules. It is intended to clarify SFC's policy intent and position on issues raised by the industry and does not have the force of law. The Guidance Note was first published in March 2003 and revised in April 2004.

⁵ Under the Amendment Rules, "affiliate" means, in relation to an exchange participant, any corporation belonging to the same group of companies as the exchange participant.

words, a new category of authorization that may be granted by SFC is to be introduced. The terms "relevant business need", "specified contract" and "specified percentage" are defined in the new section 4(10) as added by the Amendment Rules. "Relevant business need" means a business need that requires an exchange participant or his affiliate to engage in hedging activities to facilitate the provision of services to his clients. "Specified contract" and "specified percentage" are defined to mean respectively a futures contract or stock options contract and the percentage specified by SFC by notice published in the Gazette. New section 4(11) provides that the Gazette notice is not subsidiary legislation.

The Subcommittee

6. At the House Committee meeting on 9 November 2007, Members agreed to form a subcommittee to study the Amendment Rules. The membership list of the Subcommittee is at **Appendix I**. Under the chairmanship of Hon SIN Chung-kai, the Subcommittee has held two meetings with the Administration and SFC.

7. The Amendment Rules were published in the Gazette on 26 October 2007 and tabled at the Council meeting of 31 October 2007. They will come into operation on 21 December 2007. To allow sufficient time for scrutiny, a resolution under section 34(4) of the Interpretation and General Clauses Ordinance (Cap.1) (IGCO) was passed at the Council meeting of 21 November 2007 to extend the scrutiny period for the Amendment Rules to 19 December 2007.

Deliberations of the Subcommittee

8. In principle, members of the Subcommittee have no objection to the Amendment Rules which have been made by SFC to meet market needs. They have nevertheless raised concerns and sought clarification on a number of policy and legal/drafting issues which are summarized in the ensuing paragraphs.

Policy considerations

Need for the Amendment Rules

9. Given that position limits for H-share contracts and HSI contracts have already been prescribed in existing legislation, members have sought further explanation on why it is necessary for SFC to authorize the holding or controlling of positions in excess of the prescribed limits.

10. SFC has highlighted that prescribed limits and reportable positions are used as tools for the monitoring and management of risks in the futures markets. While prescribed limits help prevent the build-up of excessive and

over-concentrated positions, they may also place constraints on the open positions that brokers and their clients may take in the futures markets. SFC has also drawn members' attention to accelerating competition from derivative exchanges in the region and globally and the fact that leading derivative exchanges are offering competing products outside their national boundaries. Meanwhile, some exchange participants have raised concerns that the existing prescribed position limits are unable to meet their full business needs as they often need to hold larger proprietary positions, particularly in HSI contracts and H-share contracts, to meet their business need in providing client facilitation services. As a result, they may shift part of their positions to the over-the-counter and overseas markets, which is not conducive to the development of Hong Kong's derivatives market. By empowering SFC to authorize the holding or controlling of specified contracts in excess of the prescribed limits, exchange participants will be encouraged to establish their positions on Hong Kong Exchanges and Clearing Limited's derivatives market.

Alternative change to the existing regime

11. In the course of scrutinizing the Amendment Rules, members have come to the view that instead of enacting the Amendment Rules in question, the Administration/SFC should consider the feasibility of introducing a more fundamental change to the existing regime. There is the suggestion that to cope with market developments more effectively and proactively, SFC should, in the first place, prescribe higher limits for futures contracts and stock options contracts in the Rules per se, and be empowered to impose a lower limit under specified circumstances. On whether this suggested approach would give rise to the risks of excessive holding or controlling of futures and options contracts, members opine that the existing regulatory requirements on market participants can adequately safeguard against such risks.

12. Whilst noting members' concern, SFC's response is that the suggested approach will have an impact on financial market stability and give rise to operational difficulties. It highlights that the existing prescribed limits were put in place in the wake of the Asian financial crisis in 1998 to prevent the build-up of very large positions that may threaten market stability and its orderly functioning. SFC considers it prudent to take a more cautious approach in deciding whether the position limits should be raised bearing in mind the need to balance market development and market stability. As advised by SFC, market feedbacks and analysis of the positions held in the market indicate that higher limits are needed mainly by exchange participants and their affiliates. For the vast majority of market participants, the existing prescribed limits suffice. SFC has also assured members that it will review the need for change in the light of experience after the Amendment Rules have come into operation and will seek approval from the Legislative Council if adjustments to the prescribed limits are considered necessary.

Nature of the notice referred to in the definitions of "specified contract" and "specified percentage" under the Amendment Rules

13. The Subcommittee notes that under SFC's original proposal that went to consultation in May 2007, the upper limit of 50% on the amount of excess position that could be authorized by SFC was to be specified in the Rules per se. However, most respondents to the consultation suggested that there should be no specified limit on the amount of excess that SFC may authorize as long as there was a justifiable business case. This approach would preserve flexibility where circumstances warrant the need for an excess of more than 50%, and would also be consistent with SFC's existing power under section 4(4)(a) of the Rules (now section 4(5) under the Amendment Rules) to authorize excess position where special circumstances so warrant, which is not subject to any upper limit. After balancing the market's call for greater flexibility and timely response to market needs on one hand, and the regulatory concern to provide certainty in terms of the excess limit that can be permitted on the other, SFC has decided to revise its original proposal by specifying the 50% limit by notice published in the Gazette (which is not subsidiary legislation), instead of specifying it in the Rules as previously proposed. SFC considers that this arrangement will enable SFC to adjust the excess limit in a more flexible and timely manner to respond to market needs and increasing competition from other derivative exchanges.

14. From the regulatory point of view, the Subcommittee has no objection to SFC's decision to impose a 50% limit on the amount of excess position that it can authorize. The main concern of members is the legislative approach to give effect to this arrangement. Members note that pursuant to new section 4(11) of the Amendment Rules, the notice published in the Gazette (which will specify the type of contract, as well as the upper limit on the excess position that can be authorized by SFC) is not subsidiary legislation and will not therefore be subject to the scrutiny by the Legislative Council in accordance with section 34 or 35 of the IGCO. In this regard, SFC has advised that this approach is consistent with the policy adopted in SFO and its subsidiary legislation, which contain provisions similar to section 4(11) of the Amendment Rules. Examples cited by SFC include sections 20(3), 24(7), 41(7), 175(8A), 324 and 402 of SFO; as well as section 25(5) and (6) of the Securities and Futures (Investor Compensation – Levy) Rules (Cap. 571 sub. leg. AB). A summary of the relevant provisions is in **Appendix II**.

15. On the need for timely action by SFC to respond to market needs, members consider that stipulating the specified percentage of upper limit in the Rules (thereby subjecting it to negative vetting by the legislature) does not necessarily mean that flexibility and timely response will be compromised. They recall that on several occasions, SFC has, in response to market feedbacks, made amendments to Schedule 1 to the Rules to adjust the position limits and reporting levels of futures and options contracts. The amendment rules in question, which are of a technical nature, have come into operation as originally scheduled without

being amended⁶.

16. Since the Amendment Rules are made under section 35(1) of SFO which provides, inter alia, that the Commission may make rules to prescribe limits and reportable positions on futures contracts and options contracts, query has been raised as to whether the new section 4(11) of the Amendment Rules stipulating that the Gazette notice is not subsidiary legislation is ultra vires. Members also consider that since the authorization for exceeding the limits is provided under the Rules, which are subsidiary legislation by virtue of section 35(1) of SFO, the upper limit for the excess should also form part of the Rules and be subject to the scrutiny of the Legislative Council.

17. SFC highlights that pursuant to section 398(8) of SFO, rules made by the Commission may provide for the exercise of discretion in specified cases. In the present case, the Amendment Rules, by empowering SFC to authorize excesses up to a "specified percentage" which will be specified by Gazette notice, are in effect providing for the exercise of discretion by SFC as to the granting of authorization and the maximum extent of excess that may be authorized. Nevertheless, having considered members' concerns, SFC has agreed to amend the Amendment Rules to set out the "specified percentage" and the "specified contracts" in the Rules per se. This will mean that any future changes to the "specified percentage" and the "specified contracts" will be subjective to negative vetting by the Legislative Council in accordance with section 34 of IGCO.

Legal basis for the making of the Amendment Rules

18. The Subcommittee notes that section 35(1) of SFO under which the Amendment Rules are made specifies that the rules are to be made by the Commission. Under section 10(2)(b) and Part 2 of Schedule 2 to SFO, no delegation of the Commission's functions shall be made in respect of its function to make subsidiary legislation under or pursuant to any Ordinance. Members are also aware that rules made by SFC prior to the commencement of the Securities and Futures (Amendment) Ordinance (15 of 2006) on 23 June 2006 were signed by the Chairman of SFC who headed both the governing body and the executive arm of SFC. Noting that the Amendment Rules as published in L.N.198 of 2007 have been signed by the Chief Executive Officer (CEO), instead of the Chairman of SFC, members have enquired on the legal basis for the making of the Amendment Rules in question.

19. SFC has confirmed that the Amendment Rules were made by the Commission at its meeting on 29 August 2007 pursuant to section 35(1)(a) and (b)

⁶ Recent examples include the Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) (No.2) Rules 2005 (L.N. 232 of 2005) tabled at the Council meeting on 21 December 2005 and the Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2007 (L.N. 18 of 2007) tabled at the Council meeting on 7 February 2007. The two sets of Amendment Rules came into operation on 10 February 2006 and 30 March 2007 respectively in accordance with the original legislative timetable without being amended.

of SFO. Notice of the making of the Amendment Rules was given by way of a notice published in the Gazette (L.N.198 of 2007) which was signed by the CEO of SFC on behalf of the Commission. As further explained by SFC, the post of CEO was established under the Securities and Futures (Amendment) Ordinance (15 of 2006), the commencement of which transferred the executive responsibilities of the Chairman to CEO; such responsibilities included the signing and notification of the rules made by the Commission. Reference has also been made to section 52 of IGCO which provides that the exercise of any power vested in a body may be signified either by the chairman or by any person from time to time authorized by such body to signify the exercise of such power. Notwithstanding that there is no provision under SFO governing the signing of the rules made by SFC, SFC has confirmed that the Commission has ratified the CEO's authority to sign and formalized the process by giving formal authorization to the CEO at its meeting held on 19 November 2007 for the signing of the Amendment Rules on behalf of the Commission.

Bilingual texts

20. On the drafting aspect, the Subcommittee finds that the bilingual texts of the new section 4(7)(a) and (8) of the Amendment Rules do not match in that the Chinese text includes the meaning of "holding or controlling" which is not reflected in the English text. It is also noted that a similar Chinese text appears in another section of the Amendment Rules, i.e. section 4(4)(a), but its corresponding English text contains the reference to "hold or control" which does not appear in the English text of section 4(7)(a) and (8). Members are concerned whether it would be desirable that the bilingual texts of certain provisions added by the Amendment Rules should match as far as possible in terms of the language used. While pointing out that as currently drafted, there is no discrepancy in the legal meaning of the bilingual texts, SFC would address members' concern about drafting consistency by adding the expression "holding or controlling" to the English text of section 4(7)(a) and (8).

Proposed amendments to be moved by the Administration

21. The resolution to be moved by the Administration to amend new section 4(7)(a) and (8), section 4(10) and section 4(11) of the Amendment Rules is in **Appendix III**. The Subcommittee agrees to these amendments and would not move any amendments in its name.

Recommendation

22. The Subcommittee supports the Amendment Rules and the amendments to be moved by the Administration.

Advice sought

23. Members are invited to note the Subcommittee's recommendation in the preceding paragraph.

Council Business Division 1
Legislative Council Secretariat
6 December 2007

**Subcommittee on
Securities and Futures (Contracts Limits and Reportable Positions)
(Amendment) (No.2) Rules 2007**

Membership list

Chairman Hon SIN Chung-kai, SBS, JP

Members Hon Margaret NG
Hon CHAN Kam-lam, SBS, JP
Hon Ronny TONG Ka-wah, SC
Hon CHIM Pui-chung

(Total : 5 Members)

Clerk Miss Polly YEUNG

Legal Adviser Ms Connie FUNG

Date 16 November 2007

Summary of sections 20(3), 24(7), 41(7), 175(8A), 324 and 402 of SFO and section 25(5) and (6) of the Securities and Futures (Investor Compensation – Levy) Rules (Cap. 571 sub. leg. AB)

(i) Section 20(3) of SFO

Section 20(1) of SFO provides that no transaction may be conducted on a recognized stock market other than dealings in securities, and other financial products which are approved by SFC by notice published in the Gazette either generally or in a particular case. A similar provision that applies to transactions on a recognized futures market is provided in section 20(2). Section 20(3) provides that a notice under section 20(1) and (2) is not subsidiary legislation.

(ii) Sections 24(7) and 41(7) of SFO

Sections 24(1) and 41(1) of SFO respectively require the rules of a recognized exchange company and of a recognized clearing house to be approved by SFC before the rules can take effect. Under sections 24(7) and 41(7), SFC may by notice published in the Gazette declare a class of rules which are not required to be so approved. Such notice is not subsidiary legislation as provided in sections 24(8) and 41(8).

(iii) Section 175(8A) of SFO

Under section 175(1) of SFO, an intermediary or representative for certain regulated activities shall not communicate an offer to acquire or dispose of any securities of, or issued by, a body unless the offer complies with the requirements specified in the section. Section 175(5)(aa)(ii) provides that section 175 does not apply to an offer specified by SFC, by notice published in the Gazette, as an offer to which section 175 does not apply. Section 175(8A) provides that a notice published under section 175(5)(aa)(ii) is not subsidiary legislation.

(iv) Sections 324 and 402 of SFO

Section 324 of SFO empowers SFC to specify by notice published in the Gazette the form of a notification required to be given under that section. Section 402 provides that SFC may, by notice published in the Gazette, specify any form in respect of any other document required to be lodged, filed or submitted with or to SFC for the purposes of SFO. Sections 324(8) and 402(7) provide that such notice is not subsidiary legislation.

(v) Section 25(5) and (6) of the Securities and Futures (Investor Compensation – Levy) Rules (Cap. 571 sub. leg. AB) ("the Levy Rules")

Under section 25 of the Levy Rules, SFC is required to publish an exemption notice in the Gazette under specified circumstances exempting a person from paying any levy under the Levy Rules in respect of a sale or purchase of securities or futures contract that takes place on or after the date specified in the exemption notice. Section 25(6) of the Levy Rules provides that an exemption notice is not subsidiary legislation.

INTERPRETATION AND GENERAL CLAUSES ORDINANCE

RESOLUTION

(Under section 34(2) of the Interpretation and General Clauses Ordinance
(Cap. 1))

**SECURITIES AND FUTURES (CONTRACTS LIMITS AND
REPORTABLE POSITIONS) (AMENDMENT) (NO. 2) RULES 2007**

RESOLVED that the Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) (No. 2) Rules 2007, published in the Gazette as Legal Notice No. 198 of 2007 and laid on the table of the Legislative Council on 31 October 2007, be amended, in section 2 –

- (a) in the new section 4(7)(a) and (8), in the English text, by adding “holding or controlling” before “the excess”;
- (b) in the new section 4(10) –
 - (i) by repealing the definition of “specified contract” and substituting –
 - ““specified contract” (指明合約) means any of the following futures contracts or stock options contracts –
 - (a) Hang Seng Index futures and options contracts;
 - (b) Hang Seng China Enterprises Index futures contracts and options contracts;”;
 - (ii) by repealing the definition of “specified percentage” and substituting –
 - ““specified percentage” (指明百分率) means 50%.”;
- (c) by repealing the new section 4(11).