

LEGISLATIVE COUNCIL BRIEF

Securities and Futures Ordinance (Cap. 571)

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

INTRODUCTION

Pursuant to section 35(1) (a) and (b) of the Securities and Futures Ordinance (Cap. 571) (“**SFO**”), the Securities and Futures Commission (“**SFC**”) has made the Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) (No. 2) Rules 2007 (“**Amendment Rules**”) at the **Annex**.

BACKGROUND

2. Section 4 of the Securities and Futures (Contracts Limits and Reportable Positions) Rules (“**Rules**”) prohibits any person from holding or controlling futures contracts or stock options contracts exceeding the limits set out in the Rules (i.e. the prescribed limits) unless they are persons referred to in subsections (2) (i.e. persons authorized under the rules of the recognized exchange company concerned) or (4) (i.e. persons authorized by the SFC to meet special circumstances).

3. On 18 May 2007, the SFC issued a consultation paper inviting comments on proposed amendments to the Rules and the Guidance Note on Position Limits and Large Open Position Reporting Requirements. The consultation period ended on 18 June 2007 and a total of 7 responses (including one joint response from 7 financial institutions) were received. A number of changes were made in light of the comments received (the changes are discussed in greater detail below).

4. The revised proposal involves introducing legislative amendments that will allow the SFC to authorize an Exchange Participant (or its affiliate) to exceed the limits prescribed in the legislation on a case-by-case basis. The SFC’s power to grant authorizations will however be subject to several limitations –

- (a) the authorization can only apply to specified contracts (currently proposed to comprise only Hang Seng Index futures and options contracts (“**HSI contracts**”) and Hang Seng China Enterprises Index futures and options contracts (“**H-share contracts**”));
- (b) the excess can only be up to a maximum percentage of the limits in the Rules, such maximum to be prescribed by Notice in the Gazette (the initial proposal was to specify the maximum percentage at 50% in the Rules themselves);

- (c) the excess position must be for a relevant business need, i.e. where the excess position is needed to facilitate the provision of services to clients;
- (d) the exchange participant or the affiliate must have adequate financial capability to cover the potential risks arising from such excess; and
- (e) the exchange participant must have effective internal controls and risk management systems to manage the potential risks arising from such excess.

5. The SFC believes that the proposed amendments will better meet market needs and promote the growth of Hong Kong's futures and options markets. They will also enhance transparency and thereby enable the SFC to better assess potential implications for the market.

6. The Focus Group on Financial Services formed under the Economic Summit on "China's 11th Five Year Plan and the development of Hong Kong" has also recommended that the position limits of HSI and H-share index futures and options contracts be adjusted.

THE AMENDMENT RULES

7. The Amendment Rules amend section 4 of the Rules and essentially provide as follows.

Subsection (4)(a)

8. The existing subsection (4)(a) already empowers the SFC to authorize a person to exceed the prescribed limits for any futures contract or options contract but only if it can be shown that there are special circumstances warranting the excess position. The current proposal however does not envisage that the applicant may be facing a unique or special situation – the need for excess positions to serve clients need cannot be construed as a special circumstance. It is necessary therefore to amend the legislation to provide for a new category of authorization by the SFC to facilitate market growth.

9. Accordingly, the existing subsection 4(a) is redrafted to cater for two different categories of authorization –

- (a) subsection 4(4)(a)(i) (which is the existing category of authorization) – deals with authorizations needed to meet "special circumstances"; and
- (b) subsection 4(4)(a)(ii) – which deals with authorizations needed to meet a "relevant business need".

Subsection (5)

10. New subsection (5) reiterates the existing conditions for granting authorizations to meet "special circumstances". There is no substantial change from the existing criteria.

Subsections (6) to (8)

11. New subsections (6) and (7) set out the ambit of the SFC's power to grant authorizations to meet a "relevant business need". They incorporate the limitations and preconditions discussed in paragraphs 4(a) – (e) above.

12. New subsection (8) is intended to avoid overlap between the powers of the SFC and those of the Stock Exchange of Hong Kong Ltd ("SEHK") or Hong Kong Futures Exchange Ltd ("HKFE") in authorizing excess positions. Accordingly, if an application is one that may be dealt with by the SEHK or HKFE, it cannot be considered by the SFC.

Subsections (9) to (11)

13. Subsection (9) deals with the validity of authorizations, imposition of conditions and withdrawals.

14. Subsection (10) sets out key definitions, including those of "adequate financial capacity", "relevant business need", "specified contract" and "specified percentage".

15. Subsection (11) clarifies that any notice in the Gazette specifying a futures contract or options contract as "specified contracts" or a percentage as the "specified percentage" for the purposes of the Rules will not be subsidiary legislation.

Appellate jurisdiction

16. A refusal by the SFC to authorize excess positions may be appealed against to the Securities and Futures Appeals Tribunal by virtue of section 217 of the SFO and item 78 under Division 1 of Part 2 of Schedule 8 to the SFO.

PUBLIC CONSULTATION

17. Most respondents to the Consultation were generally supportive of the proposed amendments. In light of the comments and suggestions received, the SFC made further amendments to the Rules. Some of the key comments and the SFC's responses are set out below –

- (a) A number of respondents suggested that the limits prescribed in the Rules – particularly limits for HSI contracts and H-share contracts – should be increased to allow all market participants to benefit. The SFC believes it is preferable to take a more cautious approach in relaxing the position limits regime. It therefore proposes to leave the prescribed limits unchanged for now.
- (b) A number of respondents suggested removing the 50% upper limit from the Rules and allowing the SFC to authorize any amount of excess positions. The SFC has decided to amend the Rules so that the upper limit of 50% is not specified in the Rules themselves, but by notice in the Gazette. This will enable the SFC to change the upper limit within a shorter period of time if necessary and therefore to provide greater flexibility. Separately, there were respondents who submitted that the 50% upper limit should not be applied on a per group basis (which was originally proposed). SFC agrees with the comments as the per group limit was included to address concerns about

concentration risks, and it is actually possible to tackle the concentration risk issue without imposing the per group limit given the limitations set out in the proposed section 4(4)(b) of the Rules, i.e. the SFC cannot authorize an excess position if it will prejudice the interest of the investing public.

- (c) A number of respondents submitted that the SFC should not be limited to authorizing only Exchange Participants and their affiliates, and that other persons should also be allowed to apply for excess positions. The SFC believes it is not appropriate to extend the current proposals to all persons at this stage. An analysis of the positions held in the market shows that it is mainly Exchange Participants and their affiliates who hold positions close to the prescribed limits. Thus, there appears to be no need to extend the current proposals to other persons at this time.
- (d) Some respondents submitted that the range of specified contracts was too limited and this might still prevent applicants from reacting quickly to meet urgent client demands. However the SFC does not believe it is necessary to expand the range of specified contracts at this stage and should the need arise to extend the current proposals to other contracts in future, the SFC has the flexibility to do this by gazette notice.
- (e) There were several comments and suggestions regarding the scope of relevant business need. Some respondents suggested that the current proposals be extended so that the SFC can authorize excess positions on the basis of other business justifications also, i.e. not just on the basis of there being a relevant business need. The SFC does not consider it appropriate to make such a change at this stage.
- (f) Some respondents suggested that the applicant should be entitled to choose whether the financial capability requirement will be met by the Exchange Participant or by its affiliate. The SFC agrees that it is not critical for the SFC to determine who meets the financial capability requirement so long as it is satisfactorily met. This is reflected in subsection (7) (b).

FINANCIAL AND STAFFING IMPLICATIONS

18. There are no financial or staffing implications for the Government.

COMMENCEMENT DATE

19. The commencement date for the Amendment Rules will be 21 December 2007.

PUBLICITY

20. The Amendment Rules will be published in the Gazette on 26 October 2007. The SFC will issue a press release on the same day.

ENQUIRIES

21. For any enquiries on this brief, please contact Ms Thrity Mukadam of the Supervision of Markets Division of the SFC at 2840 9209 or Ms Mary Ahern of the Legal Services Division of the SFC at 2283 6809.

Securities and Futures Commission
October 2007

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

(Made by the Securities and Futures Commission under section 35(1)(a)
and (b) of the Securities and Futures Ordinance (Cap. 571))

1. Commencement

These Rules shall come into operation on 21 December 2007.

2. Restrictions on number of contracts held or controlled

Section 4(4) of the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap. 571 sub. leg. Y) is repealed and the following substituted –

“(4) A person may hold or control a futures contract or stock options contract in excess of the prescribed limit if –

- (a) the person –
 - (i) is authorized under subsection (5) to hold or control such excess; or
 - (ii) is authorized under subsection (6) to hold or control such excess;
- (b) the Commission is satisfied that the excess would not be prejudicial to the interest of the investing public having regard to the prescribed limit and the liquidity of the futures contract or stock options contract in question; and
- (c) the Commission has given the person notice in writing that it is satisfied –
 - (i) where paragraph (a)(i) applies, of the matters referred to in paragraph (b) and subsection (5); or
 - (ii) where paragraph (a)(ii) applies, of the matters referred to in paragraph (b) and subsection (7)(a), (b) and (c).

(5) The Commission may authorize a person, other than a person who may be authorized under subsection (3), to hold or control a futures contract or stock options contract in excess of the prescribed limit if the Commission is satisfied that there are special circumstances which warrant the person holding or controlling such excess.

(6) Subject to subsections (7) and (8), the Commission may authorize an exchange participant or an affiliate of an exchange participant to hold or control a specified contract in excess of the prescribed limit by up to the specified percentage.

(7) The Commission shall not authorize an exchange participant or an affiliate of an exchange participant to hold or control a specified contract in excess of the prescribed limit unless the exchange participant satisfies the Commission that –

- (a) the exchange participant or the affiliate (as the case may be) has a relevant business need for the excess for which authorization is sought;
- (b) either the exchange participant or the affiliate has adequate financial capability to cover the potential risks arising from such excess; and
- (c) the exchange participant has effective internal control procedures and risk management systems to manage the potential risks arising from such excess.

(8) The Commission shall not grant an authorization under subsection (6) if the excess for which authorization is sought may be authorized under the rules of the recognized exchange company concerned as referred to in subsection (2).

(9) An authorization granted under subsection (5) or (6) –

- (a) subject to paragraph (b), shall be valid for such period as the Commission may specify in the notice given under subsection (4)(c);
- (b) may be withdrawn by the Commission, at any time, by at least 5 business days' notice in writing to the person authorized and, where the person authorized is an affiliate of an exchange participant, also to the exchange participant; and
- (c) shall be subject to such reasonable conditions as the Commission may specify in the notice given under subsection (4)(c) and the Commission may, at any time, by at least 5 business days' notice in writing to the person authorized and, where the person authorized is an affiliate of an exchange participant, also to the exchange participant, amend or revoke any such condition or impose new conditions as may be reasonable in the circumstances.

(10) In this section –

“adequate financial capability” (充足財政能力), in relation to an exchange participant or an affiliate of an exchange participant, means such exchange participant or affiliate or his holding company having –

(a) a net asset value of not less than \$2 billion as set out in his or its latest audited financial statements; or

(b) a qualifying credit rating;

“affiliate” (聯繫人), in relation to an exchange participant, means any corporation belonging to the same group of companies as the exchange participant;

“relevant business need” (相關業務需要), in relation to an exchange participant or an affiliate of an exchange participant, means a business need that requires such exchange participant or affiliate to engage in hedging activities to facilitate the provision of services to his clients;

“specified contract” (指明合約) means any futures contract or stock options contract that is specified by the Commission by notice published in the Gazette for the purposes of this definition;

“specified percentage” (指明百分率) means the percentage specified by the Commission by notice published in the Gazette for the purposes of this definition.

(11) A notice referred to in the definition of “specified contract” or “specified percentage” in subsection (10) is not subsidiary legislation.”.

Martin WHEATLEY
Chief Executive Officer,
Securities and Futures Commission

23 October 2007

Explanatory Note

Section 4 of the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap. 571 sub. leg. Y) (the “principal Rules”) prohibits a person (except an authorized person) from holding or controlling a futures contract or stock options contract in excess of the prescribed limit.

2. The purpose of these Rules is to amend section 4 of the principal Rules to provide that the Securities and Futures Commission (the “Commission”) may authorize an exchange participant or his affiliate to hold or control a specified contract in excess of the prescribed limit up to the specified percentage if the Commission is satisfied that there is a business need for the excess and that the exchange participant or the affiliate has adequate financial capability and effective internal control procedures and risk management systems to manage the potential risks arising from such excess.