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**Paper for the House Committee**

**Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2011**

**Purpose**

This paper reports on the deliberations of the Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2011 (the Amendment Rules).

**Background**

2. Section 35(1) of the Securities and Futures Ordinance (Cap. 571) (SFO) provides that the Securities and Futures Commission (SFC) may make rules to prescribe limits on the number of futures contracts and options contracts that may be held or controlled by a person, and to require a person holding or controlling a specified reportable position to notify the recognized exchange company or SFC. These limits and reportable positions are prescribed in the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap. 571, sub. leg. Y) (the Rules).

3. In July 2010, the Stock Exchange of Hong Kong Limited (SEHK) launched two stock options contracts on two A-shares related exchange-traded funds, namely iShares FTSE A50 China Index ETF (A50 ETF) and W.I.S.E. – CSI 300 China Tracker (CSI 300 ETF). In November 2010, the Hong Kong Futures Limited (HKFE) launched the HSI Dividend Point Index futures contracts and the HSCEI Dividend Point futures contract. SFC proposes to amend the Rules to set a position limit and reportable position for each of the A50 ETF stock options contract and CSI 300 ETF stock options contract, as well as a reportable position for the HSI Dividend Point Index futures contract and HSCEI Dividend Point Index futures contract.

## **The Amendment Rules**

4. The limits and reportable positions are established and specified for the futures contracts and stock options contracts respectively in Schedules 1 and 2 to the Rules. The Amendment Rules seek to repeal the existing Schedules 1 and 2 and substitute each with a new one as follows -

- (a) New Schedule 1 re-numbers the existing items and adds items 10 and 11 to specify the large open position reporting levels of the HSI Dividend Point Index futures contract and HSCEI Dividend Point Index futures contract; and
- (b) New Schedule 2 re-numbers the existing items and adds items 3 and 4 to specify the position limits and large open position reporting levels for the A50 ETF stock options contract and CSI 300 ETF stock options contract.

## **The Subcommittee**

5. At the House Committee meeting held on 7 October 2011, Members agreed to form a Subcommittee to study the Amendment Rules. The membership list of the Subcommittee is in **Appendix I**. Under the chairmanship of Hon James TO Kun-sun, the Subcommittee has held one meeting with the Administration and SFC.

6. The Amendment Rules were published in the Gazette on 8 July 2011. They will come into operation on 25 November 2011. To allow sufficient time for scrutiny, a resolution was passed at the Council meeting on 19 October 2011 to extend the scrutiny period for the Amendment Rules to 9 November 2011.

## **Deliberations of the Subcommittee**

7. In the course of deliberation of the Amendment Rules, Subcommittee members have examined issues relating to the need for the Amendment Rules, the prescribed limits and reporting levels, as well as control measures. The discussions are summarized in the ensuing paragraphs.

### Need for the Amendment Rules

8. Some Subcommittee members have enquired whether there were cases of non-compliance which prompted the need for making the Amendment Rules. According to SFC, there are various futures and stock options traded on HKFE and SEHK. In order to minimize the potential impact of the futures and stock

options contracts on the stability of the financial market, and to facilitate market surveillance, HKFE and SEHK impose large open position (LOP) and reporting requirements and/or position limits on the futures and stock options contracts. A market participant holding a position that has reached the LOP reporting level is required to notify HKFE or SEHK of that position. In general, no market participant is allowed to hold a position in excess of the position limit. To ensure sufficient deterrent for non-compliance with the LOP reporting and position limit requirement established by HKFE and SEHK, SFC (pursuant to section 35(1) of SFO) made the Rules in April 2003 to prescribe limits and reportable positions in respect of the various futures and options contracts traded on the recognized exchange companies (i.e. HKFE and SEHK). The prescribed limits and reportable positions set out in the Rules are generally similar to those specified in the rules of HKFE and SEHK. Breach of these statutory prescribed limits and reporting requirements may constitute an offence under section 8 of the Rules.

9. SFC has further advised that from time to time, HKFE and SEHK launch new futures contracts and stock options contracts. If the LOP reporting requirements and position limits for the new contracts are not covered by the existing Rules, SFC will propose to amend the Rules to set statutory position limit and LOP reporting requirements for the new contracts. The Amendment Rules seek to set statutory position limits and LOP reporting requirements for two new stock options contracts on A50 ETF and CSI 300 ETF traded on SEHK, as well as statutory LOP reporting requirements for the HSI Dividend Point Index futures contract and HSCEI Dividend Point Index futures contract traded on HKFE.

#### Prescribed limits and reporting levels

10. Some Subcommittee members have enquired the bases upon which the reporting levels and prescribed limits for A50 ETF, CSI 300 ETF stock options contracts, as well HSI Dividend Point Index and HSCEI Dividend Point futures contracts are arrived at.

#### *Stock options*

11. SFC has advised that the LOP reporting level for all stock options contracts, including the new stock options contracts on A50 ETF and CSI 300 ETF, is set at 1 000 open contracts per options class per expiry month. The application of a single LOP reporting level across the board to all stock options contracts aims to avoid creating undue compliance burden on investors and market participants. As the reporting level can capture most of the large open positions held by investors and market participants, it allows SEHK and SFC to monitor a build-up of large positions.

12. As regards the position limit, SFC has advised that SEHK will take into account the following two key factors in determining the position limit of a new stock options contract -

- (a) market capitalization of underlying securities; and
- (b) market liquidity of underlying securities.

If the contract-equivalent number<sup>1</sup> is lower than 50 000 contracts, the position limit may be set at 30 000 contracts, otherwise at 50 000 contracts. As the calculation shows that, at around the time of preparing the launch of the two stock options, the projected position limit for the stock option on A50 ETF was 233 044 contracts, SEHK imposed the position limit of 50 000 contracts to this stock option. In the case of the stock option on CSI 300 ETF, the projected position limit was 18 839 contracts and thus the position limit was set at 30 000 contracts.

13. Of all the 57 stock options contracts presently traded on SEHK, CSI 300 ETF is the only stock options contract with a lower position limit of 30 000 contracts imposed by SEHK. All other stock option contracts, including A50 ETF, have a position limit of 50 000 contracts. To minimize compliance burden on investors and market participants, the Amendment Rules propose to set the statutory position limit for CSI 300 ETF at 50 000 contracts as in the case of the LOP reporting level which is set at the same level for different stock options as far as possible. The statutory position limit is higher than the existing position of 30 000 contracts imposed by SEHK. This would allow flexibility for SEHK to increase the position limit of CSI 300 ETF from 30 000 to 50 000 contracts if the situation warrants, as SFC's approval and the legislative process to amend the statutory limit would take time to complete.

#### *Dividend point index futures*

14. SFC has advised that at present, most stock index futures contracts traded on HKFE have a LOP reporting level of 500 contracts<sup>2</sup>. In the case of dividend point index futures contracts, their contract size is less than 5% of the contract size of HSI futures and HSCEI futures contracts. Therefore, a higher

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<sup>1</sup> Contract-equivalent number is calculated from the higher of criteria (a) or (b) below –

- (a) 2.5% of the number of outstanding shares of underlying securities or 10% of past six-month trading volume of underlying securities, whichever is the lower, or
- (b) 7.5% of past six-month trading volume of underlying securities.

<sup>2</sup> For mini-stock index futures, they have a higher LOP reporting level of 2 500 contracts because their contract size is one-fifth of the standard contract.

LOP reporting level is set for these contracts. By the same token, the Amendment Rules propose to set the same LOP reporting levels for the HSI Dividend Point Index futures contract and HSCEI Dividend Point Index futures contract at 1 000 contracts.

15. As regards the position limit, SFC has advised that there is no position limit on HSI Dividend Point Index futures contract and HSCEI Dividend Point Index futures contract under the contract specifications of HKFE. It is because market participants will not be able to manipulate the levels of the underlying dividend point indices of these futures contracts. SCF agrees with HKFE's decision not to impose any position limit on the two dividend point index futures contracts. Besides, major overseas exchanges, such as Eurex and NYSE LIFFE, also do not impose any position limit on their dividend futures contracts.

#### Control measures

16. Some Subcommittee members have enquired the effects of substantial fluctuations in the stock options market on the stock market, and the actions taken by the authorities over the past two years. SFC has advised that while the stock options market has been growing rapidly during the past few years, its turnover in terms of both notional value and premium is still small when compared to the turnover of the stock market<sup>3</sup>. Therefore, the effects of substantial fluctuations in the stock options markets on the stock market are limited. Nevertheless, SEHK has imposed a number of measures, including margin requirements and concentration margins, to manage the risks of the stock options market, and to ensure that the operation of the stock options market is conducted in a fair and orderly manner.

17. In response to some Subcommittee members' enquiry on the measures in place to prevent circumvention of the prescribed limits for stock options contracts using different companies, SFC has advised that in accordance with section 4(1) of the Rules, no person may hold or control futures contracts or stock options contracts in excess of the prescribed limit. Therefore, the position limit applies to all positions held or controlled by a person. If a person holds the futures positions or stock options positions using different companies which are under his or her control, the person will be required to aggregate the positions for the purpose of applying the prescribed limits and reportable position requirements. SFC has issued a Guidance Note on Position Limits and Large Open Position Reporting Requirements to explain to investors and market participants the requirements of the Rules. SFC and HKFE/SEHK have procedures in place to monitor the positions reported by market participants, and will make enquiries if there are questions about the identity of position holders.

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<sup>3</sup> During the first half of 2011, the turnover of the stock options market in terms of notional value and option premium (i.e. actual value traded) was about 9% and 0.3% of the total turnover of the stock market respectively.

**Amendments to the Amendment Rules**

18. The Administration and the Subcommittee have not proposed any amendment to the Amendment Rules.

**Advice sought**

19. Members are requested to note the deliberations of the Subcommittee.

Council Business Division 1  
Legislative Council Secretariat  
2 November 2011

**Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2011**

**Membership list**

**Chairman**                      Hon James TO Kun-sun

**Members**                      Hon WONG Ting-kwong, BBS, JP  
Hon CHIM Pui-chung

(Total : 3 Members)

**Clerk**                              Miss Becky YU

**Legal Adviser**                Mr Timothy TSO

**Date**                                12 October 2011