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For discussion
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Legislative Council Panel on Financial Affairs

Proposed enhancements to the position limit regime in Hong Kong

PURPOSE

This paper briefs the Panel on the Securities and Futures Commission's ("SFC") proposed enhancements to the position limit regime for the futures and options markets.

BACKGROUND

2. The position limit regime in Hong Kong was first introduced in 1999 in the wake of the Asian Financial Crisis. Under the regime, the SFC is empowered to prescribe position limits and large open position ("LOP") reporting requirements for futures and options contracts in the Securities and Futures (Contract Limits and Reportable Positions) Rules (Cap. 571Y) ("CLRP Rules"). In respect of a futures or options contract, the position limit denotes the maximum size of position that may be held or controlled by a person. The aim of position limits is to deter and prevent the build-up of large positions that may affect the stability and orderly functioning of the Hong Kong financial market.

3. Over the years, the SFC has regularly reviewed, and amended as appropriate, the position limits to ensure that a proper balance is struck between maintaining financial stability and facilitating market development. In light of recent growth and developments in the Hong Kong securities and futures markets, the SFC considers it timely to review the position limit regime. Taking into account feedback from market participants, the SFC proposes various changes to the position limit regime so that it remains appropriate to the needs of the Hong Kong financial market.

THE SFC'S PROPOSALS TO ENHANCE THE POSITION LIMIT REGIME

4. On 20 September 2016, the SFC issued a public consultation paper on the proposed enhancements to the position limit regime, as well as the associated amendments to the CLRP Rules and the SFC's Guidance Note on Position Limits and Large Open Position Reporting Requirements [1]. Respondents were invited to provide views by 21 November 2016. The proposed enhancements comprise the following five areas –

(a) raising the cap on the excess position limit for client facilitation;

(b) introducing a new excess position limit for market makers of exchange traded funds ("ETFs");

(c) introducing a new excess position limit for index arbitrage activities;

(d) introducing a new excess position limit for asset managers; and

(e) increasing the statutory position limit for stock options contracts.

Details are set out in the following sections.

Client Facilitation Excess Position Limit

5. Currently, under the CLRP Rules, the SFC may authorize an exchange participant ("EP") or its affiliates to hold or control a specified contract, i.e. any of the Hang Seng Index ("HSI") and Hang Seng China Enterprises Index ("HHI") futures and options contracts, in excess of the prescribed limits by up to 50%. The SFC may authorize such excess position limit if the firm has a "relevant business need"[2] that requires it to use the HSI and/or the HHI contracts to hedge its exposure acquired from the provision of services to clients[3]. The criteria were designed to ensure that excess positions would be sought and authorized only for the purpose of helping EPs and their affiliates to better serve their clients.

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1 The consultation paper is available at: http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=16CP3

2 Currently, "relevant business need" is defined in section 4(10) of the CLRP Rules to mean a business need that requires an exchange participant or its affiliate to engage in hedging activities to facilitate the provision of services to its clients.

3 For example, the firm may have sold an over-the-counter ("OTC") derivatives product to a client and wants to use the futures contract to hedge the risk of the OTC derivatives product.

6. Despite the growth of the Hong Kong market in recent years, the SFC notes that the client facilitation excess position limit has not been widely used. Some market participants explained to the SFC that the maximum cap on the excess limit of 50% is not large enough vis-à-vis the size of their business activities; instead they would rely on the OTC derivatives market for hedging purposes. They also expressed that they would prefer to use more exchange-traded contracts to meet their business needs as exchange markets offer better price transparency, operation efficiency and capital efficiency. Raising the cap on the excess position limit will not only encourage market participants to move their OTC derivative positions to the exchange market, resulting in greater market transparency, but also enable the SFC to better assess the potential implications on the stability of the financial market.

7. In view of the above, the SFC proposes to raise the cap on the excess position limit from its current level of 50% to 300%[4]. The proposed increase is largely in line with the growth of the HHI futures and options markets in the past years. Although the HSI futures and options markets did not experience the same level of growth, the SFC proposes to apply the same cap to the HSI futures and options contracts to maintain a simple structure and build in flexibility to cater for any future growth.

8. Currently, to apply for the excess position limit, an EP or its affiliates or their holding company is required to have "adequate financial capability", i.e. either a net asset value of not less than $2 billion as set out in the latest audited financial statements or a qualifying credit rating[5]. To ensure that applicants have sufficient financial capability to manage the risk exposures that result from the higher position limit, the SFC proposes to tighten the financial requirements by raising the net asset value requirement to the level of not less than $5 billion. In addition, the SFC will continue to apply the existing criterion that applicants must have effective internal control procedures and risk management systems to manage the potential risks arising from the excess position.

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[4] As in the case of the maximum cap on the excess limit of 50%, the proposed cap of 300% is an upper limit. The SFC will determine the size of the excess position to be authorized on a case-by-case basis after taking into consideration various factors such as the needs of the applicants and prevailing market conditions.

[5] As defined in Schedule 1 to the Securities and Futures Ordinance ("SFO"), a qualifying credit rating means (1) a rating of A3 or above for long term debt; or a Prime-3 or above for short term debt issued by Moody's Investors Service; or (2) a rating of A or above for long term debt; or A-3 or above for short term debt issued by Standard & Poor's Corporation.

Exchange Traded Funds Market Maker Excess Position Limit

9. At present, under the CLRP Rules, certain market makers and liquidity providers may be authorized by the Stock Exchange of Hong Kong ("SEHK") or the Hong Kong Futures Exchange ("HKFE") to hold or control futures or stock options contracts in excess of the prescribed limits for the purposes of conducting market making or liquidity providing activities, or hedging the related risks[6]. Nonetheless, these provisions do not cover ETF market makers who may also have a need to hedge their ETF market making positions using futures and options contracts. If the futures and options contracts held by ETF market makers get close to the position limits, they may not be able to effectively hedge the risks of any additional ETF positions. This could hinder them from performing their market making function and adversely affect investors who want to trade the relevant ETFs[7].

10. In view of the above, the SFC proposes to expand the classes of persons specified under the CLRP Rules such that the SEHK or the HKFE may authorize ETF market makers to hold or control futures or options contracts in excess of the prescribed limits for hedging the risks that arise from their ETF market making activities. This will facilitate ETF market makers in discharging their market making function and managing the associated risks.

Index Arbitrage Activity Excess Position Limit

11. Index arbitrage is a trading strategy that attempts to capture profit arising from price discrepancies between the value of the stocks comprising an index and the price of the derivatives product with that index as the underlying, e.g. stock index futures. Index arbitrage activities can help to correct any mispricing between the two markets by bringing the prices back to a fair level. This price adjustment process is important, as the closer the stock index derivatives track the index component stocks, the more effective they would be as hedging instruments. On the contrary, if there is misalignment between the price of the stock index derivatives and the value of the constituent stocks of the underlying index, investors would face a higher cost using the stock index derivatives to hedge their exposure.

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[6] These are (a) market makers and liquidity providers of stock options contracts registered with the SEHK, (b) market makers and liquidity providers of futures contracts registered with the HKFE, and (c) issuers of structured products listed under the Listing Rules and their related corporations acting as liquidity providers in respect of the listed securities (e.g. liquidity providers of derivative warrants or callable bull/bear contracts).

[7] The ETF market in Hong Kong has been expanding significantly over the past decade. During the period from 2005 to 2015, the average daily turnover of ETFs tracking the HSI and the HHI grew at an annualized rate of 44% and 67% respectively.

12. In view of the benefits of index arbitrage activities to the market and the expected need for an excess position limit to facilitate such activities, the SFC proposes that EPs and their affiliates should be eligible to apply to the SFC for authorization to hold or control HSI and HHI futures and options contracts in excess of their prescribed limits. The cap on the excess position limits to be granted will be set at 300% of the prescribed limits.

13. Similar to the case of the client facilitation excess position limit, such authorization will only be granted to EPs or their affiliates who meet the following criteria –

(a) the excess position limit must be used for genuine index arbitrage activities;

(b) the EPs or their affiliates should have strong financial capability to cover the potential risks arising from the excess position. In this regard, the SFC proposes to apply the new financial capability requirement for client facilitation excess position limit, i.e. the EPs or their affiliates or their holding companies are required to have either a net asset value of not less than $5 billion or a qualifying credit rating; and

(c) the EPs must have effective internal control procedures and risk management systems to manage the potential risks arising from index arbitrage activities.

Asset Manager Excess Position Limit

14. Under the CLRP Rules, an asset manager who has the mandate to buy and sell futures and options contracts for funds under his management is required to aggregate all the futures and options positions of each fund for the purpose of compliance with the prescribed limits. As a result, some asset managers have voiced concerns that the existing prescribed limits are too restrictive.

15. It is expected that asset managers may have a genuine business need to use stock index futures and options contracts to facilitate portfolio management. Therefore, the SFC proposes to introduce a new excess position limit under which the SFC may authorize asset managers to hold or control HSI and HHI futures and options contracts in excess of the prescribed limits. The cap on the excess position limits to be granted will be set at 300% of the prescribed limits. This will provide asset managers with greater flexibility in managing different funds under their control and in turn help to further promote Hong Kong as an asset management centre.

16. As the build-up of substantial positions could have a significant impact on the stability of the financial market, the SFC also proposes some safeguards to minimise any undesirable impact. To be eligible for the excess position limit, an asset manager must satisfy the following criteria–

(a) be an intermediary licensed or registered for Type 9 regulated activity (i.e. asset management) under the SFO and its total value of assets under management ("AUM") should be no less than $100 billion;

(b) demonstrate that it has a genuine business need to use HSI and HHI futures and options contracts to facilitate its asset management activity; and

(c) has effective internal control procedures and risk management systems to manage the potential risks arising from the excess position.

Stock Options Contracts Position Limit

17. The Hong Kong Exchanges and Clearing Limited ("HKEX") issued a consultation paper[8] on its proposal to revise its stock option position limit model in April 2016. One key aspect of the HKEX's proposal is to raise the position limit for stock options. The HKEX proposes to replace its existing two-tier position limit model (i.e. 30 000 and 50 000 contracts) with a three-tier model. The three-tier system will have higher position limit levels of 50 000, 100 000 and 150 000 contracts, and the HKEX will assign position limit tiers to individual stock options contracts using a methodology based on market capitalization and liquidity of the underlying securities of the stock options contracts. The assigned tiers will be reviewed both on a regular and ad-hoc basis. The consultation conclusions[9] were published in June 2016. A majority of respondents were in favour of the proposal.

18. At present, the prescribed limit for all stock options contracts under the CLRP Rules is 50 000 contracts. This position limit has been in place since 2006. On the other hand, the stock options market has since experienced significant growth. The number of underlying stocks has increased from 42 in 2006 to 84 in 2015, whilst the average daily turnover has also risen from 73 390 contracts to 374 346 contracts.

[8] The consultation paper is available at: https://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp201604.pdf

[9] The consultation conclusions are available at: https://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp201604cc.pdf

19. Based on the SFC's analysis and discussion with market participants, the SFC agrees that there is a need to increase the position limit for stock options across the board and that the proposed increase in the stock options position limit would not create any significant risks to the Hong Kong stock market.

20. To facilitate the HKEX's implementation of its proposal, the SFC proposes to amend the CLRP Rules to increase the prescribed limit of stock options contracts from 50 000 contracts to 150 000 contracts. The proposed limit of 150 000 contracts will be applied to all stock options contracts including those with a lower position limit set by the HKEX.

BENEFITS OF THE PROPOSALS

21. The SFC considers that the proposed amendments to the existing position limit regime will bring benefits to the Hong Kong market and encourage market participants to establish their positions on the exchange-traded market, resulting in greater market transparency. The proposals will also help to promote Hong Kong as a risk management centre and an asset management centre. Various measures are included in the proposals to minimise the associated risks to the Hong Kong market or any potential adverse impact on market stability.

COMMENTS FROM THE PUBLIC

22. Respondents to the consultation paper generally supported the proposed enhancements to the position limit regime. The SFC is studying the comments received and will issue the consultation conclusions in Q1 2017.

WAY FORWARD

23. The SFC will take into consideration all comments received before finalizing the proposals. It aims to table the proposed rule amendments before the Legislative Council for negative vetting in Q1 2017.

ADVICE SOUGHT

24. The Panel is invited to note the above proposals to enhance the position limit regime in Hong Kong.

Financial Services and the Treasury Bureau
Securities and Futures Commission
25 November 2016