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Panel on Financial Affairs

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Background brief on proposed amendments to enhance the position limit regime for the futures and options market of Hong Kong

Purpose

This paper provides background information on the enhancements proposed by the Securities and Futures Commission ("SFC") for the position limit regime for the futures and options market of Hong Kong. It also provides a summary of the major views and concerns expressed by Members on the subject during discussions on amendments to the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap. 571Y) ("CLRP Rules") in the Fourth and Fifth Legislative Council.

Background

2. There are various futures contracts and options contracts traded on The Hong Kong Futures Exchange Limited ("HKFE") and The Stock Exchange of Hong Kong Limited ("SEHK"). The position limit regime on futures contracts and options contracts was first introduced in 1999 in the wake of the Asian Financial Crisis with the purpose to prevent and discourage build-up of large positions in the market which may pose a threat to the orderly functioning and stability of the Hong Kong financial market. The position limit regime establishes different levels of position limits and large open position reporting requirements for different futures contracts and options contracts. Under section 35(1) of the Securities and Futures Ordinance (Cap. 571), SFC may make rules to prescribe limits and reportable positions on futures contracts and options contracts. These are set out in the CLRP Rules. The CLRP Rules set out the limits on the number of futures contracts and option contracts that may be held or controlled by a market participant

("position limits"), and the requirement on a market participant holding or controlling a specified position to notify HKFE or SEHK (as applicable) of that position ("reporting requirement").

3. According to SFC, it has made changes to the position limit regime over the past years. For instance, the position limit of stock options contracts was raised from a two-tier system of 5 000 contracts and 25 000 contracts to a one-tier system of 50 000 contracts across the board in 2006, and the position limit of Hang Seng China Enterprises Index ("HHI") futures and options contracts was revised from 6 000 contracts per futures contract month or options series to an aggregate position limit of 12 000 delta applicable to all HHI futures contract months and options series in 2007. Moreover, the Client Facilitation Excess Position Limit ("CFEPL") was introduced in 2007 to provide for an exchange participant ("EP") or its affiliates to seek authorization from SFC to hold or control Hang Seng Index ("HSI") and HHI futures and options contracts in excess of 50% of the prescribed limit if SFC is satisfied that the EP or its affiliate has a relevant business need.

4. Although the existing statutory stock option position limit is 50 000 open contracts per option class in any one market direction for all expiry months combined, at the exchange level, the Hong Kong Exchanges and Clearing Company Limited ("HKEX") adopts a two-tier system of position limits for its stock options contracts. While most stock options contracts currently have a position limit of 50 000 contracts, which is the same as the statutory position limit, a few have a smaller position limit of 30 000 contracts.

Proposed enhancements to the position limit regime

5. Given that HKEX's stock option position limit has been in place since 2006 and with rapid growth in its stock options market in recent years, HKEX conducted a review of its stock option position limit model and issued a consultation paper in April 2016 to invite views from market participants on its proposals to revise the model. In parallel, in light of the resilient market growth over the years, and taking into consideration the role of Hong Kong as an international financial centre and its position as one of the world's leading stock markets, SFC considers that it would be timely to review the position limit regime. SFC issued a consultation paper on 20 September 2016 to seek views on the proposed enhancements to the position limit regime (including HKEX's recommendations to revise the stock option position limit model pursuant to the consultation in April 2016) and associated amendments to the CLRP Rules. The major proposed changes to the regime are set out below.

Raising the cap of Client Facilitation Excess Position Limit

6. As defined in the CLRP Rules, relevant business need means a business need that requires an EP (or its affiliate) to engage in hedging activities to facilitate the provision of services to its clients. The definition was formulated to ensure that excess positions would be sought and authorized only for the purposes of helping EPs and their affiliates to better serve their clients, and not for proprietary trading purposes.

7. SFC has pointed out that as market participants consider that the excess limit of 50% is not significant relative to the size of their business, there has been no strong incentive for them to apply for the excess. Instead, market participants would rely on the over-the-counter derivatives market for hedging purposes. Under such circumstances, CFEPL has not been widely used despite the rapid growth and development of the Hong Kong market. To encourage market participants to establish more of their derivative positions on the exchange markets and to enhance greater market transparency for better assess on potential implications on market stability, SFC proposes to raise CFEPL from the existing 50% to 300%. According to SFC, the proposed six-fold increase is largely in line with the growth of the HHI futures and options market over the past 10 years.

Raising the Stock Options Contracts Position Limit

8. HKEX has noticed that the present position limit of 50 000 on stock options contracts is a key constraint for market participants to utilize the exchange platform, especially for meeting their trading and hedging needs. The Financial Services Development Council has concurred with the need to revise the current position limit regime for exchange-traded derivatives.

9. In the consultation conducted in April 2016, HKEX proposed to raise the position limit for stock options, by replacing its existing two-tier system with a three-tier system with higher position limit levels of 50 000, 100 000 and 150 000 contracts. According to HKEX, majority of respondents¹ to the consultation were in favour of the proposal. Based on its analysis and discussion with market participants, and taking into account HKEX's consultation conclusions, SFC agrees that there is a need to increase the position limit for stock options across the board. SFC supports HKEX's

¹ HKEX received a total of 36 responses from market participants which included 23 EPs, 5 asset management companies, 5 professional and industry associations, 1 listed company and 2 individuals. Among the 36 responses received, 32 out of 34 (94%) corporate respondents and 2 out of 2 (100%) individual respondents supported the proposed model. Among the 23 responses from EPs, 22 (with 67% market share) supported the model.

proposal and considers that the proposed change would not introduce any significant risks to the Hong Kong stock market. SFC proposes to amend the CLRP Rules to increase the statutory position limit of stock options contracts from 50 000 contracts to 150 000 contracts. The proposed statutory limit of 150 000 contracts will be applied to all stock options contracts including those with a lower position limit set by HKEX under its rule.

New excess position limits for index arbitrage activities, asset managers and market makers of exchange traded funds

Index Arbitrage Activity Excess Position Limit

10. An index arbitrage transaction involves the purchase (sale) of stock index derivatives products (in particular stock index futures) and the sale (purchase) of some or all of the component stocks of the underlying index. The intention is to capture the temporary price discrepancy between the value of the stocks and the price of the stock index derivatives. Index arbitrage activities bring important benefits to the market in terms of improving market efficiency and enhancing liquidity.

11. 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, SFC proposes that EPs and their affiliates should be eligible to apply for authorization to hold or control HSI and HHI futures and options contracts in excess of the statutory prescribed limit. The new Index Arbitrage Activity Excess Position Limit will be capped at 300% of the statutory position limit for the relevant contract.

Asset Manager Excess Position Limit

12. The position limit regime currently does not allow an asset manager who manages a number of funds to apply the prescribed limits to each of the funds separately where the asset manager has an investment mandate to buy and sell futures and options contracts for the funds. Some asset managers have expressed concerns that the existing prescribed limits are too restrictive.

13. Considering that asset managers would have a genuine business need to use stock index futures and options contracts to facilitate portfolio management, SFC proposes to introduce a new excess position limit under which it may authorize asset managers to hold or control HSI and HHI futures and options contracts in excess of the statutory prescribed limit. The cap on the excess position limit to be granted will be set at 300% of the statutory position limit. The proposal will provide asset managers with greater flexibility in using HSI and HHI futures and options contracts to

manage different funds under their control, which in turn will help to further promote Hong Kong as an asset management centre.

Exchange Traded Funds Market Maker Excess Position Limit

14. Currently, the CLRP Rules does not provide for exchange traded funds ("ETFs") market makers to seek authorization from HKFE or SEHK to hold or control futures or stock options contracts in excess of the prescribed limit for hedging the risks arising from their ETF market making activities. To enable ETF market makers to effectively perform their market making role, SFC proposes to expand the classes of persons which HKFE or SEHK may authorize to cover ETF market makers.

15. SFC will introduce amendments to the CLRP Rules to implement the proposed changes mentioned in paragraphs 6 to 14 above, and to the Guidance Note on Position Limits and Large Open Position Reporting Requirements which has been issued to help market participants better understand the operation of the CLRP Rules.

Concerns and Views expressed by Members

16. The Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2011², the Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2013³ and the Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2015⁴ were formed respectively to study the relevant amendments made to the CLRP Rules in recent years. The major views and concerns raised by Members on related issues during the deliberations of the subcommittees are summarized

² The Securities and Futures (Contracts Limits and Reportable Positions)(Amendment) Rules 2011 sought to set the position limit and reportable position for A50 ETF stock options contract and CSI 300 ETF stock options contract launched by SEHK in July 2010, as well as the reportable position for the HSI Dividend Point Index futures contract and HSCEI Dividend Point Index futures contract launched by HKFE in November 2010.

³ The Securities and Futures (Contracts Limits and Reportable Positions)(Amendment) Rules 2013 sought to add the HSI Volatility Index futures contract and the US Dollar vs Renminbi (Hong Kong) futures contract and their respective position limits and reportable positions to Schedule 1 of the CLRP Rules.

⁴ The Securities and Futures (Contracts Limits and Reportable Positions)(Amendment) Rules 2015 sought to set the position limits and reportable positions for three new types of future contracts for the purpose of CLRP Rules, and to introduce new general terms on Schedule 1 and 2 to the CLRP Rules to cover all stock futures and stock options contracts on ETFs respectively.

in the ensuing paragraphs.

Position limits and reporting requirements

17. Some Members enquired whether there were cases of non-compliance which prompted the need for amending the CLRP Rules in previous cases, and the factors SFC had taken into account in working out the position limits.

18. SFC advised that reporting requirements and/or position limits on futures and options contracts were imposed in order to minimize the potential impact of the contracts on the financial market stability and to facilitate market surveillance. In setting or reviewing the position limits, SFC would take into account factors such as the market capitalization and trading volume of the underlying instruments of the futures and options contracts (e.g. stocks), and the latest positions held by market participants for a particular futures/options contract. In relation to the reportable positions, SFC would conduct reviews on regular basis, and exercise caution and refrain from making adjustment unless the existing level of reportable positions had become too high to capture sufficient information for effective market surveillance. This would minimize compliance burden on market participants arising from frequent changes in the reportable positions. Given that new futures and options contracts were introduced to the market from time to time, SFC would determine the timing to prescribe the relevant position limits and reportable positions in the CLRP Rules, taking into account the time required for undergoing the legislative process.

19. Some Members enquired if SFC had considered setting the position limits and reportable positions for futures contracts as a certain percentage of all open futures contracts. This mechanism would be more dynamic and more able to reflect the changing market conditions accurately. SFC explained that it would be preferable to set the position limits and reportable positions on the basis of a fixed number of contracts, such that the market participants would not have to keep a close monitoring of their positions in order to fulfill the reporting requirements.

Reporting responsibilities and control measures

20. As an intermediary may hold positions on behalf of its clients, enquiries were raised as whether the reporting was to be made by individual clients or collectively by the intermediary. SFC advised that a person (who could be an investor, intermediary or institution) holding or controlling a reportable position could choose to submit the notice of reportable position to the recognized exchange company concerned directly, or through an EP or its agent where the latter agreed to make the report on the person's behalf. No

matter which party was chosen by the person to submit the notice, it remained the responsibility of the person holding or controlling the reportable position to fulfill the reporting obligation.

21. On Members' concern about potential circumvention by persons of the position limits and reportable positions for futures contracts or options contracts through holding the positions in accounts at more than one company, SFC advised that in accordance with section 4(1) of the CLRP Rules, no person might hold or control futures contracts or options contracts in excess of the prescribed limit. Therefore, the position limit applied to all positions held or controlled by a person. If a person held the positions through different companies which were under his or her control, the person would be required to aggregate the positions for the purpose of applying the position limit and reportable position requirements. SFC had issued the Guidance Note on Position Limits and Large Open Position Reporting Requirements to explain to investors and market participants the requirements of the CLRP Rules. SFC and HKFE/SEHK had procedures in place to monitor the positions reported by market participants, and would make enquiries if there were questions about the identity of position holders.

22. As regards the penalties for non-compliance with the requirements of position limits and reportable limits, SFC advised that a person who contravened the relevant rules of the CLRP Rules without reasonable excuse was liable on conviction to a fine or imprisonment. Where an intermediary held or controlled positions on behalf of its client, both the intermediary and the client would be liable to the penalties for non-compliance, and the penalties would be determined by the court having regard to the actual circumstances of individual cases, such as how the positions were held or controlled, the specific arrangements made between the intermediary and the client in respect of the reporting obligations, and the internal control system of the financial institution or securities firm concerned. If the non-compliance involved errors or omissions on the part of a person licensed by SFC, the licensed person could be subject to disciplinary actions taken by SFC, in addition to the penalties under the CLRP Rules by the court.

Latest development

23. The Administration will brief the Panel on Financial Affairs on the proposed amendments to the CLRP Rules to enhance the position limit regime for the futures and options market of Hong Kong at the meeting on 5 December 2016.

References

24. A list of relevant papers is at **Appendix I**.

Council Business Division 1
Legislative Council Secretariat
29 November 2016

List of relevant papers

Date/Period	Event	Papers/Minutes of meeting
October to November 2011	Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2011	Report of the Subcommittee (LC Paper No. CB(1)239/11-12) Legislative Council Brief Legal Service Division report (LC Paper No. LS99/10-11)
February to March 2013	Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2013	Report of the Subcommittee (LC Paper No. CB(1)699/12-13) Legislative Council Brief Legal Service Division report (LC Paper No. LS23/12-13)
November to December 2015	Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2015	Report of the Subcommittee (LC Paper No. CB(1)309/15-16) Legislative Council Brief Legal Service Division report (LC Paper No. LS11/15-16)
29 April 2016	Consultation paper of the Hong Kong Exchanges and Clearing Company Limited ("HKEX"): "Proposal for Revision of the Stock Option Position Limit Model"	Consultation paper
20 June 2016	Conclusion of HKEX's Consultation	Consultation Conclusion

Date/Period	Event	Papers/Minutes of meeting
20 September 2016	<p>Press release of the Securities and Futures Commission ("SFC") on issuing of the consultation on proposed enhancements to the position limit regime</p> <p>SFC's consultation paper: "Consultation on Proposed Enhancements to the Position Limit Regime and the Associated Amendments to the Securities and Futures (Contracts Limits and Reportable Positions) Rules and Guidance Note on Position Limits and Large Open Position Reporting Requirements"</p>	<p><u>SFC's press release</u></p> <p><u>Consultation paper</u></p>