

LEGISLATIVE COUNCIL BRIEF

SECURITIES AND FUTURES ORDINANCE (CAP. 571)

SECURITIES AND FUTURES (CONTRACTS LIMITS AND REPORTABLE POSITIONS) (AMENDMENT) (NO. 2) RULES 2005

INTRODUCTION

1. At its meeting on 17 October 2005, the Securities and Futures Commission (the “**Commission**”) made the Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) (No. 2) Rules 2005 (the “**Amendment Rules**”) at Annex 1.

BACKGROUND AND ARGUMENT

2. Section 35(1) of the Securities and Futures Ordinance (Cap. 571) (“**SFO**”) provides that the Commission may prescribe limits and reportable positions on futures contracts and options contracts. These limits and positions are prescribed in the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap. 571Y, sub leg) (the “**Rules**”), and largely parallel those set by the Hong Kong Futures Exchange Limited (“**HKFE**”) (in the case of futures contracts) and the Stock Exchange of Hong Kong Limited (“**SEHK**”) (in the case of options contracts) in their respective rules.

Standardization of Position Limits and Reporting Levels

3. Hong Kong Exchanges and Clearing Limited (“**HKEx**”) proposed to standardize the position limits and reporting levels of stock options contracts. (Position limits and reporting levels of stock futures contracts had already been standardized 4 years ago.) The current position limits and reporting levels of stock options contracts specified under the Rules are based on a two-tier system which is summarized as follows:

	Tier 1 Option Classes	Tier 2 Option Classes
Position Limit	5,000 contracts per expiry month	25,000 contracts per expiry month
Reporting Limit	1,000 contracts per expiry month	5,000 contracts per expiry month

A stock option contract with a nominal value (i.e. to multiply the price of the underlying stock and number of shares in the contract) of above HK\$20,000 at the time when the stock option class is proposed for listing will be a Tier 1 option class. A stock option contract with a nominal value equal to or below HK\$20,000 will be a Tier 2 option class.

4. The existing position limits were introduced when the stock options market was launched in 1995. The market has operated well and grown in size over the years. The market has exhibited a very strong growth in 2004 to 2005. The monthly turnover and month-end open interest of the entire market have increased from 425,773 and 516,569 contracts in September 2004 to 873,042 and 1,181,211 contracts in September 2005.
5. A number of market participants have expressed to HKEx that the existing position limits are not sufficient to meet their own and their clients' trading and hedging needs. HKEx believes that some market participants have shifted part of their positions from the HKEx market to the over the counter market or offshore markets because the existing position limits could no longer cope with the growth of the market.
6. To facilitate the future growth of the stock options market, HKEx proposed to replace the existing two-tier system with a single position limit for all stock option classes at 50,000 contracts in any one market direction for all expiry months combined. HKEx also proposed to standardize the reporting level at 1,000 contracts per expiry month. Long calls/short puts combined are in one direction and short calls/long puts combined are in another direction.

7. The stock options market is currently dominated by market makers. If the position limit were relaxed, it would help to attract other market participants to the market. The Commission believes that a balanced mix of participants is important to the long-term development of the stock options market.
8. Given the relatively small size of the stock options market, the Commission considers it is unlikely that a new statutory limit of 50,000 open contracts per option class in any one market direction for all expiry months combined would pose systemic risk to the financial market.
9. The proposed reporting level of 1,000 contracts is the same as the existing reporting level of Tier 1 stock option classes but is more stringent than the existing 5,000 contracts reporting level of Tier 2 stock option classes. The Commission believes that the adoption of a more stringent reporting level will allow HKEx and the Commission to monitor the stock options market more closely. The Commission does not consider that a new statutory reporting level of 1,000 contracts would create any significant additional burdens on market participants and their clients. The reason being that Tier 1 stock option classes are much more actively traded than Tier 2 stock option classes. Also, market makers (which accounted for over 70% of the open positions) do not need to report their large open positions because their positions are captured on a real-time basis by the clearing system.

Delisting of Suspended Futures Contracts

10. HKFE has delisted the suspended futures contracts at Annex 2. As a result of the delisting, it is necessary to remove the statutory prescribed limits and reporting levels of the delisted futures contracts from Schedule 1 of the Rules.

THE AMENDMENT RULES

11. The Amendment Rules amend the Rules by:

- (a) deleting the current list of stock futures contracts on Hong Kong listed shares in Schedule 1 and inserting a single new category called “Stock futures contracts on shares listed on a stock market operated by the Stock Exchange Company”;
 - (b) deleting the current list of stock options in Schedule 2 and inserting a single new category called “Stock options contracts on shares listed on a stock market operated by the Stock Exchange Company” with a prescribed limit of 50,000 open contracts per option class in any one market direction for all expiry months combined and a reporting level of 1,000 open contracts per option class per expiry month. The reference to “shares” will include all stock options contracts currently listed in Schedule 2 except for the Tracker Fund of Hong Kong stock options contract. Tracker Fund of Hong Kong stock options contract will be retained in Schedule 2 as a separate item; and
 - (c) removing the statutory prescribed limits and reporting levels of the delisted futures contracts from Schedule 1 of the Rules.
12. This new approach will enable the Rules as amended to embrace new stock futures and options contracts (where the underlying is a Hong Kong listed stock) without the need to amend the Rules each time a new stock futures or options contract is introduced by HKFE or SEHK. This will be more market friendly and minimize bureaucracy.
13. Also, by limiting the new category to shares that are listed in Hong Kong, the Commission retains the flexibility to impose different position limits and reporting levels for stock futures or options contracts on other types of financial instruments or shares listed on markets outside Hong Kong.

PUBLIC CONSULTATION

14. As the amendments are essentially of a technical nature and not controversial, the Commission does not consider it necessary to conduct a public consultation.
15. HKEx has consulted 25 Options Trading Exchange Participants including 12 market makers and the majority of them supported HKEx's proposal to standardize position limits and reporting levels.
16. HKEx has submitted the proposal to the Risk Management Committee (formed under section 65 of the SFO) ("**RMC**") for discussion and consideration. RMC endorsed the proposal at its meeting on 26 January 2005.
17. As early as 10 January 2003, the Derivatives Market Consultative Panel of HKEx had already endorsed the proposal.

FINANCIAL AND STAFFING IMPLICATIONS

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

COMMENCEMENT

19. The Amendment Rules will come into operation on 10 February 2006.

PUBLICITY

20. The Amendment Rules will be gazetted on 16 December 2005.

ENQUIRIES

21. For any enquiries on this brief, please contact Lisa Chen, Counsel of the Legal Services Division of the Commission (at 2283 6183), or Stanley Ng, Senior

Manager of the Supervision of Markets Division of the Commission (at 2283
6133).

The Securities and Futures Commission

13 December 2005

ANNEX 1

SECURITIES AND FUTURES (CONTRACTS LIMITS AND REPORTABLE POSITIONS) (AMENDMENT) (NO.2) RULES 2005

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

1. Commencement

These Rules shall come into operation on 10 February 2006.

2. Prescribed limit and reporting level for futures contracts

(1) Schedule 1 to the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap. 571 sub. leg. Y) is amended by repealing items 1 to 37 and substituting –

“1.	Stock futures contracts on shares listed on a stock market operated by the Stock Exchange Company	5 000 open contracts for any one contract month	1 000 open contracts for any one contract month
2.	Three-Month Hong Kong Interbank Offered Rate futures contract	Nil	1 000 open contracts for any one contract month; 4 000 open contracts for all contract months
3.	One-Month Hong Kong Interbank Offered Rate futures contract	Nil	1 000 open contracts for any one contract month; 4 000 open contracts for all contract months

4.	Hang Seng Index futures and options contracts, and Mini-Hang Seng Index futures contracts and options contracts	10 000 long or short position delta limit for all contract months combined, provided the position delta for the Mini-Hang Seng Index futures contracts or Mini-Hang Seng Index options contracts shall not at any time exceed 2 000 long or short for all contract months combined	500 open Hang Seng Index futures contracts for any one contract month; 500 open Hang Seng Index options contracts for any one series; 2 500 open Mini-Hang Seng Index futures contracts for any one contract month and 2 500 open Mini-Hang Seng Index options contracts for any one series
5.	Hang Seng China Enterprises Index futures contracts	6 000 open contracts for any one contract month	500 open contracts for any one contract month
6.	Hang Seng China Enterprises Index options contracts	6 000 open contracts for any one series	500 open contracts for any one series
7.	Three Year Exchange Fund Note (EFN) futures contract	5 000 open contracts for any one contract month except that the limit for the spot month contract during the last 6 trading days is 1 000 open contracts	1 000 open contracts for any one contract month except that the reportable position for the spot month contract

			during the last 6 trading days is 200 open contracts
8.	FTSE/Xinhua China 25 Index futures and options contracts	6 000 long or short position delta limit for all contract months combined	500 open FTSE/Xinhua China 25 Index futures contracts for any one contract month and 500 open FTSE/Xinhua China 25 Index options contracts for any one series”.

(2) Schedule 1 is amended by repealing items 40 to 127.

3. Prescribed limit and reporting level for stock options contracts

Schedule 2 is amended by repealing items 1 to 66 and substituting –

“1.	Stock options contracts on shares listed on a stock market operated by the Stock Exchange Company	50 000 open contracts per option class in any one market direction for all expiry months combined	1 000 open contracts per option class per expiry month
2.	Tracker Fund of Hong Kong stock options contract	50 000 open contracts per option class in any one market direction for all expiry months combined	1 000 open contracts per option class per expiry month”.

Martin Wheatley
Chairman,
Securities and Futures Commission

13 December 2005

Explanatory Note

Under section 35(1) of the Securities and Futures Ordinance (Cap.571), the Securities and Futures Commission may prescribe limits on the number of futures contracts and options contracts that may be held or controlled by any person. It may also prescribe the reportable positions in respect of such contracts. The purpose of these Rules is to amend Schedules 1 and 2 to the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap. 571 sub. leg. Y) to standardize the prescribed limits and reporting levels of all stock options contracts on shares listed on a stock market in Hong Kong and to remove the prescribed limits and reporting levels of the delisted futures contracts.

ANNEX 2

LIST OF SUSPENDED FUTURES CONTRACTS

1. Hang Seng Commerce and Industry Sub-Index Futures Contracts
2. Hang Seng Utilities Sub-Index Futures Contracts
3. Hang Seng Finance Sub-Index Futures Contracts
4. Hang Seng Properties Sub-Index Futures Contracts
5. Hang Seng China Affiliated Corporations Index Futures Contracts
6. HKFE Taiwan Index Futures Contracts
7. Hang Seng 100 Futures Contracts
8. Dow Jones Industrial Average Futures Contracts
9. Hang Seng China Affiliated Corporations Index Options Contracts
10. HKFE Taiwan Index Options Contracts
11. Hang Seng 100 Options Contracts
12. Hang Seng Properties Sub-Index Options Contracts
13. Dow Jones Industrial Average Options Contracts
14. Cisco System Incorporated Stock Futures Contracts
15. IBM Corporation Stock Futures Contracts
16. Intel Corporation Stock Futures Contracts
17. Microsoft Corporation Stock Futures Contracts
18. Oracle Corporation Stock Futures Contracts
19. NTT DoCoMo Incorporated Stock Futures Contracts
20. Sony Corporation Stock Futures Contracts
21. Nippon Telegraph & Telephone Corporation Stock Futures Contracts
22. Fujitsu Limited Stock Futures Contracts
23. Toyota Motor Corporation Stock Futures Contracts
24. Korea Electric Power Corporation Stock Futures Contracts
25. KT Corporation Stock Futures Contracts
26. Samsung Electronics Company Limited Stock Futures Contracts
27. SK Telecom Company Limited Stock Futures Contracts
28. Kookmin Bank Stock Futures Contracts
29. Mosel Vitelic Incorporated Stock Futures Contracts
30. Ritek Corporation Stock Futures Contracts

31. Taiwan Semiconductor Manufacturing Company Limited Stock Futures Contracts
32. United Micro Electronics Corporation Stock Futures Contracts
33. Winbond Electronics Corporation Stock Futures Contracts
34. Options on Cisco System Incorporated Stock Futures Contracts
35. Options on IBM Corporation Stock Futures Contracts
36. Options on Intel Corporation Stock Futures Contracts
37. Options on Microsoft Corporation Stock Futures Contracts
38. Options on Oracle Corporation Stock Futures Contracts
39. Options on NTT DoCoMo Incorporated Stock Futures Contracts
40. Options on Sony Corporation Stock Futures Contracts
41. Options on Nippon Telegraph & Telephone Corporation Stock Futures Contracts
42. Options on Fujitsu Limited Stock Futures Contracts
43. Options on Toyota Motor Corporation Stock Futures Contracts
44. Options on Korea Electric Power Corporation Stock Futures Contracts
45. Options on KT Corporation Stock Futures Contracts
46. Options on Samsung Electronics Company Limited Stock Futures Contracts
47. Options on SK Telecom Company Limited Stock Futures Contracts
48. Options on Kookmin Bank Stock Futures Contracts
49. Options on Mosel Vitelic Incorporated Stock Futures Contracts
50. Options on Ritek Corporation Stock Futures Contracts
51. Options on Taiwan Semiconductor Manufacturing Company Limited Stock Futures Contracts
52. Options on United Micro Electronics Corporation Stock Futures Contracts
53. Options on Winbond Electronics Corporation Stock Futures Contracts

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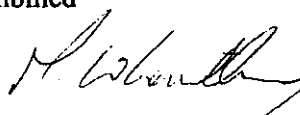
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