Legislative Council Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) (No. 2) Rules 2007 ("Amendment Rules")

Purpose

This paper briefs Members of the background of the Amendment Rules[1] and sets out the Securities and Futures Commission's (**"SFC"**) response to the letter dated 9 November 2007 from the Clerk to the Subcommittee to the Administration requesting further information on the following issues –

(1) whether the need for a degree of flexibility whilst still providing certainty for the market is a justifiable or desirable ground for the SFC to change its original proposal that went to consultation under which the specified percentage for the purpose of the proposed new category of authorization would be subject to the scrutiny of the Legislative Council; and

(2) whether it is desirable that the bilingual texts of certain provisions added by the above Rules do not match as far as possible in terms of the language used.

Background

2. Under section 35(1) of the Securities and Futures Ordinance, the SFC may prescribe limits and reportable positions on futures contracts and options contracts. To this end, the SFC has made the Securities and Futures (Contracts Limits and Reportable Positions) Rules ("**Rules**").

3. Currently, section 4 of the 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). However, there is a mechanism in place under section 4(4) which allows the SFC to authorize any person to exceed the statutorily prescribed limits for futures contracts or stock options contracts if special circumstances

[1] For details, please refer to the Legislative Council brief tabled at the Legislative Council by the SFC on 31 October 2007.

exist which justify doing so. It should be noted that there is no limit on the amount of excess that may be authorized under the existing provisions at present.

4. The market has raised concerns from time to time that the existing position limits for Hang Seng China Enterprises Index futures and options contracts ("**H-share contracts**") and Hang Seng Index futures and options contracts ("**HSI contracts**") are not adequate to cope with market growth. The SFC understands that some Exchange Participants are unable to meet their business needs within the existing position limits, as they would need to hold larger proprietary positions, particularly in HSI contracts and H-share contracts, in order to provide client facilitation services. While the existing mechanism has already allowed SFC to authorize Exchange Participants to exceed the statutorily prescribed limits for futures contracts or stock options contracts to meet special circumstances, the need for special circumstances suggests that there must be something special or unique about the situation, and the need for excess positions to facilitate the provision of client services cannot be construed as a special circumstance. As a result, some market participants may shift part of their positions to the over-the-counter and overseas markets. This is not conducive to the development of Hong Kong's derivatives market.

5. In view of the above, the SFC believes it is desirable to introduce a degree of flexibility to the existing position limits regime. In addition to authorizing excess positions to meet special circumstances, it is proposed that the SFC be able to also authorize Exchange Participants (and their affiliates) to exceed the statutorily prescribed limits for specified contracts where the excess is needed <u>for a relevant business need</u> (i.e. where the excess is needed to conduct hedging activities to facilitate the provision of client services).

6. A public consultation exercise in relation to this proposal was conducted in May 2007. Proposed amendments to the Rules were also set out in the consultation document. In light of comments received, these amendments were further revised to take into account market participants' concerns. The final amendments, i.e. the Amendment Rules, were then tabled before the Legislative Council on 31 October 2007. 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.

The SFC's Response

7. As requested in the letter dated 9 November 2007 from the Clerk to the Subcommittee to the Administration, the following paragraphs set out the SFC's response to the issues mentioned in paragraph (4)(a) and (b) of LC Paper No. LS12/07-08.

Need for flexibility

8. The public consultation paper issued by the SFC in May 2007 originally proposed to impose a 50% limit on the amount of excess that could be authorized by the SFC, and to specify the limit in the Rules. However, most respondents to the consultation suggested that there should be no limit on the amount of excess that the SFC may authorize provided there was a justifiable business case. They noted that this would preserve flexibility should circumstances warrant the need for excess of more than 50%, and be more consistent with the SFC's existing power to authorize excess (without limit) where special circumstances justify doing so.

9. While the SFC appreciates and accepts the points raised by the market, it is also concerned to provide a degree of certainty for the market in terms of the extent of excess to expect. To balance these concerns, and having considered the current arrangement which does not specify a limit in the Rules, the SFC proposes to specify the limit by Gazette notice instead of setting it out in the Rules. This will enable the SFC to adjust the limit in a more flexible manner (the need for flexibility is discussed further in paragraph 11 below) and to take account of the changing market situation.

10. The proposal to specify the limit by Gazette notice is therefore a change that was prompted as a response to market comments received during the consultation exercise.

11. To retain the flexibility in setting the specified percentage (i.e. the excess limit) will allow the SFC to respond more promptly to changing market needs. This is particularly useful given the fast pace of growth in the financial markets today, and the increasing competition among derivative exchanges, both regionally and globally. If Hong Kong is to become a leading derivatives market in the Asian time zone, a more flexible regime would facilitate our response to changing market needs and

conditions in a more timely manner. This in turn will also help maintain Hong Kong's position as a leading international financial centre.

12. It may also be useful to note that there are numerous instances in the Securities and Futures Ordinance of matters being specified by the SFC by notice in the Gazette, rather than set out in relevant subsidiary legislation. These have been elaborated in LC Paper No. LS12/07-08 dated 7 November 2007 prepared by the Assistant Legal Adviser of the Legislative Council.

Matching of bilingual texts

13. The SFC notes that although the precise words used in the Chinese and English texts of subsections 4(7)(a) and (8) are slightly different, the SFC considers that the two texts are consistent with each other in meaning.

14. With reference to the Assistant Legal Adviser's advice, the SFC has considered whether either the Chinese or English text should be amended so that the precise wordings of the two would become identical with each other. Under the proposed amendments, the Chinese text includes words for "holding or controlling". This makes the text more explicit in meaning and easier to be understood by readers. If, however, the same words "holding or controlling" are added to the English text, it would appear superfluous in the context and render the text cumbersome. Therefore, the SFC considers it better to retain the current wordings of the two texts.

Securities and Futures Commission
14 November 2007