<u>Reply to LegCo Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2011</u>

The following are SFC's reply to questions raised by the Subcommittee:

1. **To provide the background leading to the introduction of the Amendment Rules.**

   There are various futures and stock options contracts traded on the Hong Kong Futures Exchange ("HKFE") and the Stock Exchange of Hong Kong ("SEHK"). In order to minimise the potential impact of the futures and stock options contracts on the financial market stability and to facilitate market surveillance, HKFE and SEHK impose large open position ("LOP") 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.

   Section 35(1) of the Securities and Futures Ordinance ("SFO") empowers the Securities and Futures Commission ("the Commission") to make rules to prescribe limits on the number of futures contracts or options contracts that may be held or controlled by a person (i.e. the position limit) and to require a person holding or controlling a specified reportable position to notify the recognized exchange company or the Commission (i.e. the LOP reporting requirement).

   In order to create a sufficient deterrent for non-compliance with the LOP reporting and position limit requirements established by HKFE and SEHK, pursuant to the section 35(1) of the SFO, the Commission made the Securities and Futures (Contracts Limits and Reportable Positions) Rules ("Contracts Limits Rules") on 1 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). In general, the prescribed limits and reportable positions set out in the Contracts Limits Rules are similar to those specified in the rules of HKFE and SEHK. Breach of these statutorily prescribed limits and reporting requirements may constitute an offence under section 8 of the Contracts Limits Rules.

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 Contract Limits Rules, the Commission will propose to amend the Contracts Limits 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 iShares FTSE A50 China Index ETF and W.I.S.E - CSI 300 China Tracker traded on SEHK, as well as statutory LOP reportable requirements for the HSI Dividend Point Index futures contract and HSCEI Dividend Point Index futures contract traded on HKFE.

2. To advise the bases upon which the prescribed limits and reporting levels for the stock options contracts of iShares FTSE A50 China Index ETF and W.I.S.E. – CSI 300 China Tracker, as well as the future contracts of HSI Dividend Point Index and HSCEI Dividend Point Index are arrived at.

<u>**Stock Options**</u>

LOP Reporting Level

The LOP reporting level of 1,000 open contracts per options class per expiry month is applicable to all stock options contracts including the new stock options contracts on iShares FTSE A50 China Index ETF and W.I.S.E. – CSI 300 China Tracker.

As this reporting level can capture most of the large open positions held by investors and market participants, it allows SEHK and the Commission to monitor closely a build-up of large positions.

The setting of a single LOP reporting level across the board (instead of a different level for each of the stock options contract) is to adopt a simple and pragmatic approach which can avoid creating undue compliance burden on investors and market participants.

Position Limit

At present, there are 57 stock options contracts traded on SEHK. The stock options on W.I.S.E – CSI 300 China Tracker is the only stock options contract with a lower position limit of 30,000 contracts imposed by SEHK. All the other 56 stock options contracts have a position limit of 50,000 contracts.

Similar to the case of setting the LOP reporting level, the position limits for different stock options are set at the same level as far as possible to minimise compliance burden on investors and market participants.

The Methodology

SEHK uses the following methodology to determine the position limit of a new stock options contract. The position limit is set based on two key factors: (1) market capitalization of underlying securities; and (2) market liquidity of underlying securities. Details of the methodology are summarized as follows:

If the contract-equivalent number, calculated from the higher of criteria (a) or (b) below, is lower than 50,000 contracts, the position limit may be set at 30,000 contracts, otherwise set at 50,000 contracts:

(a) 2.5% of the number of outstanding shares of underlying securities or 10% of past six-month trading volume of underlying securities, <u>whichever is the lower</u>; or

(b) 7.5% of past six-month trading volume of underlying securities.

For example, in respect of stock options on iShares FTSE A50 China Index ETF and W.I.S.E. - CSI 300 China Tracker, the calculation is summarized as follows:

Underlying Stock Name	Contract Size (shares)	Projected Position Limit (Contract)	Projected Position Limit (Contract)	Projected Position Limit (Contract)	Projected Position Limit (Contract)	Capped Position Limit (Contract)
		2008	2009	2010	Apr-Sep 2011	Set by SEHK
iShares FTSE A50 China Index ETF	5,000	214,091	216,488	233,044	149,231	50,000
W.I.S.E. - CSI 300 China Tracker	1,000	93,946	25,673	18,839	9,229	30,000

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 iShares FTSE A50 China Index ETF was 233,044 contracts and thus the position limit was set at 50,000 contracts in accordance with the methodology explained earlier. In the case of the stock option on W.I.S.E – CSI 300 China Tracker, as the projected position limit was 18,839 contracts, SEHK imposed a lower position limit of 30,000 contracts to this stock option according to the methodology.

In the Amendment Rules, we have set the statutory position limit of stock options on W.I.S.E – CSI 300 China Tracker at 50,000 contracts, which is higher than the existing position limit of 30,000 contracts imposed by SEHK. The rationale is to provide flexibility for SEHK to increase the position limit of the contract from 30,000 contracts to 50,000 contracts if the situation warrants as the Commission's approval and the legislative process to amend the statutory position limit would take time to complete.

Dividend Point Index Futures

LOP Reporting Level

The LOP reporting levels of the HSI Dividend Point Index futures contract and HSCEI Dividend Point Index futures contract are the same at 1,000 contracts. Currently, most stock index futures contracts traded on HKFE have a LOP reporting level of 500 contracts.[1] 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. It is therefore proposed to set a higher LOP reporting level for these contracts.

Position Limit

For the position limit, the Commission agreed with HKFE's decision not to impose any position limit on the two dividend point index futures contracts because the levels of the HSI Dividend Point Index and HSCEI Dividend Point Index cannot be manipulated by market participants. Major overseas

[1] For mini-stock index futures, since their contract size is one-fifth of the standard contract, they have a higher LOP reporting level of 2,500 contracts.

exchanges such as Eurex and NYSE LIFFE also do not impose any position limit on their dividend futures contracts.

3. **To advise the effects of substantial fluctuations in the stock options market on the stock market, and the actions taken or to be taken by the authorities with illustrations over the past two years.**

Although the turnover of the stock options market has been growing rapidly during the past few years, the turnover of the stock options market in terms of both notional value and premium is still small when compared to the turnover of the stock market[2]. Therefore, the effects of substantial fluctuations in the stock options market on the stock market are limited. Nevertheless, for risk management purpose and to ensure that the operation of the stock options market is conducted in a fair and orderly manner, SEHK has imposed a number of measures to manage the risks of the stock options market including margin requirements, concentration margins, etc.

Under extreme market circumstances, SEHK (either on its own or in response to the request of the Commission) has the power under its rules to tighten the position limit. In the past two years, we have not experienced a market situation which requires the Commission or SEHK to exercise such powers.

4. **To advise the measures in place to prevent circumvention of the prescribed limits for stock options contracts using different companies.**

In accordance with section 4(1) of the Contracts Limits 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

[2] During the first half of 2011, in terms of notional value, its turnover was about 9% of the total turnover of the stock market. In terms of option premium (i.e. actual value traded), its turnover was at about 0.3% of the total turnover of the stock market.

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. The Commission 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 Contracts Limits Rules. The Commission and HKFE/SEHK have procedures in place in monitoring the positions reported by market participants and will make enquiries if there are questions about the identity of position holders.

Securities and Futures Commission
20 October 2011