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**Paper for the House Committee meeting on 15 March 2013**

**Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2013**

## Purpose

This paper reports on the deliberations of the Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2013 ("the Subcommittee").

## Background

2. Under section 35(1) of the Securities and Futures Ordinance (Cap. 571) ("SFO"), the Securities and Futures Commission ("SFC") may prescribe limits on the number of futures contracts that may be held or controlled by any person. SFC may also prescribe the reportable positions[1] in respect of such contracts. Those limits and reportable positions are established and fixed for the futures contracts specified in Schedule 1 to the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap. 571 sub. leg. Y)("The Rules").

## The Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2013 ("the Amendment Rules")

3. L.N. 13, made by SFC under section 35(1) of SFO, amends the Rules by adding the HSI Volatility Index futures contract ("VHSI futures contract") and the US Dollar vs Renminbi ("RMB") (Hong Kong) futures contract ("USD/CNH futures contract") and their respective position limits and reportable positions as items 12 and 13 of its Schedule 1.

[1] "Reportable position" is defined in section 35(6) of the Securities and Futures Ordinance (Cap. 571) as an open position in futures or options contracts the number or total value of which is in excess of a number or total value specified by rules made under the section.

These two futures contracts were launched by the Hong Kong Exchanges and Clearing Limited ("HKEx") in February 2012 and in September 2012 respectively.

4. L.N. 13 will come into operation on 12 April 2013.

## The Subcommittee

5. At the House Committee meeting held on 8 February 2013, members agreed to form a Subcommittee to study the Amendment Rules. The membership list of the Subcommittee is in **Appendix**. Under the chairmanship of Hon James TO Kun-sun, the Subcommittee has held two meetings with the Administration and SFC to discuss the Amendment Rules. The Subcommittee has also invited Hong Kong Monetary Authority ("HKMA") to brief members on the possible impact of the Amendment Rules on the stability of the currency market.

6. To allow sufficient time for scrutiny, a resolution was passed at the Council meeting of 20 February 2013 to extend the scrutiny period of the Amendment Rules to 27 March 2013.

## Deliberations of the Subcommittee

7. The Subcommittee notes that for VHSI futures contract, Hong Kong Futures Exchange Limited ("HKFE") has formed a working group comprising market participants to study the subject matter. The working group agreed with the proposed reporting levels and position limits. In the case of USD/CNH futures contract, apart from consulting the market participants, HKFE has also consulted the regulatory bodies, such as SFC and HKMA. All parties consulted consider the proposed position limits acceptable. The Subcommittee has not received any public views on the Amendment Rules.

8. The Subcommittee has examined issues relating to the need of the Amendment Rules, the basis upon which the position limits and reporting levels are set, as well as risk management measures and settlement arrangements for the future contracts. The deliberations of the Subcommittee are set out in the ensuing paragraphs.

### Need of the Amendment Rules

9. The Subcommittee notes from SFC that there are various futures contracts traded on HKFE. In order to minimise the potential impact of

the futures contracts on the financial market stability and to facilitate market surveillance, there is a need for HKFE to impose large open position ("LOP") reporting requirements and/or position limits on the futures contracts. In gist, a market participant holding a position that has reached LOP reporting level is required to notify HKFE of that position. As a general rule, no market participant is allowed to hold a position in excess of the position limit.

Position limits and reporting requirements

10. The Subcommittee has examined the basis upon which the position limits and reporting requirements for VHSI futures contracts and USD/CNH futures contracts are set.

*VHSI futures contracts*

11. The Subcommittee notes that VHSI futures offer a convenient and cost-effective way to hedge and manage volatility exposure in the Hong Kong stock market. VHSI measures the 30-calendar-day implied volatility of the Hang Seng Index ("HSI") using the prices of the two nearest-term expiration months of HSI options currently traded on HKFE. The futures contract will have a contract multiplier of HK$5,000 and will be settled in cash.

12. SFC proposes to set a position limit of 10 000 open contracts for any one contract month and the LOP reporting level at 1 000 open contracts for any one contract month for the VHSI futures contract.

13. SFC has explained that the proposed position limit of 10 000 open contracts for any one contract month is the same as that of HSI futures and options contracts, and it is tighter than the position limits for similar products set by Chicago Board Options Exchange ("CBOE"). It also advises that the accumulation of a huge position of VHSI futures contracts will not have direct impact on the level of VHSI. To strike a right balance between risk management and business operations, SFC considers that the proposed limit is reasonable.

*The USD/CNH futures contracts*

14. The Subcommittee notes that as the internationalization of the RMB accelerates, the demand to hedge currency risk in the CNH[2] market is increasing. The USD/CNH futures contract provides a way to easily manage USD/CNH exchange rate risk on the HKFE's electronic trading

[2] CNH refers to the Renminbi (“RMB”) circulated in Hong Kong.

platform. USD/CNH futures contract has a contract size of US$ 100,000 and is a physical delivery contract settled in RMB. Upon expiration of the contract, sellers will be required to deliver the principal (the contract size in USD) and the buyers will deliver RMB based on the final settlement price. The final settlement price will be based on the spot USD/CNH (HK) fixing published at 11:15 am on the last trading day (i.e. two business days prior to the third Wednesday of the contract month) by the Treasury Markets Association of Hong Kong. In general, the difference between the original execution price of the contract and the final settlement price is used to calculate the profit/loss of buyer/seller.

15. SFC proposes to set a position limit of 8 000 net long or short contracts for all contract months combined except that the limit for the spot month contract during the last 5 trading days is set at 2 000 open contracts, and the LOP reporting level at 500 open contracts for any one contract month for the USD/CNH futures contract.

16. The Subcommittee notes that the rationale behind setting a lower position limit for spot month contract on the last five days before expiry is to ensure that the USD/CNH futures contract would not adversely affect the CNH spot market (i.e. cash market) near expiration. Currently, market estimate for the CNH spot daily turnover in the interbank market is about US$2 billion to 3 billion. The level at 2 000 contracts (with a contract sum of about US$ 200 million) was determined with reference to the level of CNH spot daily turnover in Hong Kong which is about 10% or less of the current CNH spot daily turnover, whereas the position limit of 8 000 contracts (with a contract sum of about US$ 800 million) represents 40% or less of the current CNH spot daily turnover. The LOP reporting level of 500 contracts is the same as that of the HSI futures contracts.

17. The Subcommittee notes that in determining the position limits, reference has been drawn from overseas markets and other jurisdictions. SFC reports that Chicago Mercantile Exchange ("CME") which formally launched the USD/CNH futures in February 2013 also uses 2 000 open contracts as the upper limit, whereas Johannesburg Securities Exchange and Brazilian Securities, Commodities & Futures Exchange did not set any position limit for such contracts. It is understood that the trading volume of these future contracts globally has been low. Since market participants are required to comply with the reporting requirements and the position limits specified in the HKFE rules, SFC did not consider it necessary to conduct public consultation on the Amendments Rules as the proposed limits and reporting levels are the same as those in the HKFE rules.

18. The Subcommittee has also deliberated on the benefits of lowering

the upper limit of 2 000 on the last 5 trading days to 1 000 for the sake of prudence. After taking note of the explanation from SFC, it is considered more appropriate to maintain the 2 000 level because there are several drawbacks if the limit is lowered to 1 000. Firstly, some market participants may prefer the CME which sets the limit at 2 000 to HKFE, resulting in loss of business for the local financial institutions. Secondly, since the CME does not have to report the positions to the Hong Kong regulatory authorities regarding the trading of these futures contracts, there will be less market information, which might warrant precautions, available to the Administration. Thirdly, as a result of the second drawback, Hong Kong may still have to suffer sudden fluctuations in the financial market and could not get prepared for any complicacy in the market and the purpose of lowering it to 1 000 to protect the stability of the financial market will be defeated. It is learnt that the trading of USD/CNH futures through CME is also settled in Hong Kong, but CME needs not report details of the relevant trading to regulatory authorities in Hong Kong.

Risk management measures

19. The Subcommittee has expressed concern about the potential impact arising from an accumulation of huge position of USD/CNH futures contracts on the CNH spot market near expiration if several market participants had to deliver a significant amount of CNH for settlement.

20. In cases of failure to fulfill obligations upon final settlement, SFC has advised that HKFE would take such actions against the defaulting participants as it considers appropriate. It may execute buy-in and/or borrowing of the currency to effect settlement.

21. Regarding the impact on the currency market if there is a sudden demand for RMB, HKMA explains that when setting the position limit at 2,000 contracts, they have considered the related impact on the stability of the currency market and whether the banking system as a whole will be affected. For individual investors, if they still have open positions upon expiration of the contract, sellers will be required to deliver the principal (the contract size in USD) and the buyers will deliver RMB based on the final settlement price. If buyers do not have sufficient RMB to settle the contracts, they may go out to the market to borrow or buy RMB. For an individual investor having 2,000 contracts, it would mean US$200 million and the same worth of RMB would be needed. With the current CNH spot daily turnover of about US$2 billion to 3 billion, it is considered not a big problem. HKMA also advises that with the contract expected to be a potential hedging tool for SMEs, it would be rare to have them already sold the CNH and come to the point of delivering it while

they do not have it. Given the circulation of 720 billion RMB in Hong Kong as at the end of 2012, there should be sufficient supply of RMB to the investors. In addition, experience in overseas futures markets tells that most of the futures contracts do not involve delivery on the date of expiry. Usually, the position has been closed in advance. And as for the extreme situation that there are a lot of deliveries needed, then the HKEx would remind the relevant brokers as well as the position holders that they need to get ready well in advance for the deliveries. In the event of a default by member(s), the HKEx has an option to settle the contract in currencies other than the renminbi, if needed.

22. The Subcommittee has examined whether the reportable position and position limit could be set as a certain percentage of all open futures contracts which would be more dynamic and reflect more accurately the changing market conditions. SFC has explained that while consideration may be given to setting the reportable position and position limit as a percentage of the total outstanding contracts, it would be more preferable to use a fixed number of contracts held by market participants, otherwise they will have to keep a close monitoring of their positions, taking into account the latest changes announced by SFC in order to fulfill the reporting requirements.

23. For risk management purposes, in addition to the prescribed limits, the HKFE may impose other position limits on market participants for a particular contract where situations warrant such action.

24. Regarding the penalties for non-compliance of the reporting requirements, SFC has advised that a person who contravenes the relevant Rules without reasonable excuse is liable on conviction to a fine or even to imprisonment under the existing law.

## Conclusion

25. The Subcommittee is in support of the Amendment Rules and will not propose any amendments to the Rules.

## Advice sought

26. Members are invited to note the deliberations of the Subcommittee.

Council Business Division 1
Legislative Council Secretariat
14 March 2013

**Appendix**

## Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2013

### Membership list

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| **Chairman** | Hon James TO Kun-sun |
| **Members** | Hon Abraham SHEK Lai-him, SBS, JP (up to 26 February 2013)<br>Hon Ronny TONG Ka-wah, SC<br>Hon Starry LEE Wai-king, JP<br>Hon Christopher CHEUNG Wah-fung, JP<br>Hon SIN Chung-kai, SBS, JP<br><br>(Total : 5 Members) |
| **Clerk** | Ms Sophie LAU |
| **Legal Adviser** | Miss Carrie WONG |
| **Date** | 26 February 2013 |