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Paper for the House Committee meeting on 18 December 2015

Report of the Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2015

Purpose

This paper reports on the deliberations of the Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2015 ("the Amendment Rules").

Background

2. There are various futures and options contracts traded on Hong Kong Futures Exchange Limited ("HKFE") and The Stock Exchange of Hong Kong Limited ("SEHK"). In order to minimize the potential impact of the futures and 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 options contracts. A market participant holding a position that has reached the LOP reporting level is required to notify HKFE or SEHK (as applicable) of that position. In general, no market participant is allowed to hold a position in excess of the position limit.

3. Section 35(1) of the Securities and Futures Ordinance (Cap. 571) ("the Ordinance") provides that the Securities and Futures Commission ("SFC") may make rules to prescribe limits on the number of futures contracts and options contracts that may be held or controlled by a person ("position limits"), and to require a person holding or controlling a specified reportable position to notify the recognized exchange company (i.e. SEHK or HKFE) or SFC. These position limits and reportable positions are prescribed in the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap. 571Y) ("the Rules").

Position limits and reportable positions of London Metal Mini futures contracts

4. On 1 December 2014, the Hong Kong Exchanges and Clearing Limited launched three types of London Metal Mini futures contracts (i.e. London Copper Mini futures contract, London Aluminium Mini futures contract and London Zinc Mini futures contract), which are similar to the corresponding metal futures contracts traded on the London Metal Exchange ("LME"). Accordingly, SFC needs to set the position limits and reportable positions for these new types of futures contracts for the purpose of the Rules.

Introduction of general terms to cover all stock futures and stock options contracts on exchange traded funds

5. At present, all stock futures and stock options contracts on individual shares are covered by the general terms in item 1 of Schedule 1 and item 1 of Schedule 2 to the Rules respectively, which were introduced by amendments to the Rules that commenced in February 2006. However, for new stock futures and stock options contracts on exchange traded funds ("ETFs"), it is necessary for SFC to make rules to include each of them in Schedules 1 and 2 to the Rules respectively as and when such contracts are launched by HKFE and SEHK.¹

6. In view of the rapid growth of the ETF market in Hong Kong in recent years, SFC considers it necessary to introduce the following general terms in Schedules 1 and 2 to the Rules to cover all stock futures and stock options contracts on ETFs respectively (while defining ETF and its related expressions in the Rules) –

- (a) "stock futures contracts on shares or units of exchange traded funds"; and
- (b) "stock options contracts on shares or units of exchange traded funds".

The Amendment Rules

7. The Amendment Rules were published in the Gazette on 20 November 2015 to prescribe the position limit and reportable position for each of the London Metal Mini futures contracts and introduce general terms to cover all stock futures and stock options contracts on ETFs, as mentioned in paragraphs 4 and 6 above. The Amendment Rules will come into effect from 15 January 2016.

¹ At the time when the Rules were amended in 2006, there was no stock futures contract on ETFs and only one stock options contract on ETF.

The Subcommittee

8. At the House Committee meeting on 27 November 2015, Members agreed to form a subcommittee to study the Amendment Rules. The membership list of the Subcommittee is in the **Appendix**. Under the chairmanship of Hon CHAN Kam-lam, the Subcommittee has held one meeting with the Administration and SFC.

9. To allow more time for the Subcommittee to prepare a report on its deliberations for submission to the House Committee, the Subcommittee Chairman has given notice to move a motion at the Council meeting of 16 December 2015 to extend the scrutiny period of the subsidiary legislation to 13 January 2016. At the time of submission of this report to the House Committee on 17 December 2015, the motion has not yet been dealt with at the said Council meeting.

Deliberations of the Subcommittee

10. In the course of its deliberations, the Subcommittee has focused on issues relating to the criteria for setting or adjusting position limits and reportable positions, the potential risks associated with the three types of London Metal Mini futures contracts and their potential impact on the stability of the local financial market, reporting responsibilities and penalties for non-compliance. The deliberations are summarized in the ensuing paragraphs.

Position limits and reportable positions

Criteria for setting/adjusting position limits and reportable positions

11. The Subcommittee notes that the position limits and reportable positions prescribed by the Amendment Rules for the three types of London Metal Mini futures contracts are as follows –

Futures contracts	Position limit	Reportable position
London Copper Mini futures contract	50 000 net long or short contracts for all contract months combined	500 open contracts for any one contract month
London Aluminium Mini futures contract	25 000 net long or short contracts for all contract months combined	500 open contracts for any one contract month
London Zinc Mini futures contract	25 000 net long or short contracts for all contract months combined	500 open contracts for any one contract month

12. The Subcommittee has enquired about the criteria for setting or adjusting the position limits and reportable positions in respect of the three types of London Metal Mini futures contracts, and the timing of review.

13. SFC explains that in order to minimize the potential impact of futures and options contracts on the stability of the local financial market, and to facilitate market surveillance, SEHK and HKFE impose LOP reporting requirements and/or position limits on these types of contracts, which are stipulated in the relevant contract specifications of SEHK and HKFE. To ensure sufficient deterrence against non-compliance, SFC made the Rules in April 2003 to prescribe by way of legislation the position limits and reportable positions for futures and options contracts traded on the exchanges, which mirror the corresponding requirements specified in the relevant contract specifications of SEHK or HKFE. In setting or reviewing the position limits, SFC will 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, while SFC will review them regularly, it will exercise caution and not adjust them unless the existing level of reportable positions have become too high to capture sufficient information for effective market surveillance. This will minimize compliance burden on market participants arising from frequent changes in the reportable positions. Given that the exchanges launch new products from time to time, SFC will determine the timing to prescribe the relevant position limits and reportable positions in the Rules, taking into account the time required for undergoing the legislative process.

14. In the current context of the three types of London Metal Mini futures contracts, SFC advises that it has taken into account the corresponding LOP reporting levels and position limits specified in the contract specifications of HKFE. Reference has also been made to the relevant requirements of the Chicago Mercantile Exchange ("CME") and Shanghai Futures Exchange ("SFE") for similar contracts. However, the metal futures contracts traded on CME and SFE are different in that they involve physical delivery of the underlying metals, which warrants different and more complicated requirements on the position limits. For instance, different position limits are prescribed for the "Spot Month" (i.e. the closest contract month to expiration), "Single Month" (i.e. any given contract month outside of the spot period) and "All Month" (i.e. all contract months). The other difference is that the relevant market participants may obtain exemptions from the position limits imposed by CME and SFE. In comparison, the three types of London Metal Mini futures contracts traded on HKFE have a smaller contract size and are cash-settled. The position limits for these contracts under the Amendment Rules are set for any net long or short contracts for all contract months combined only. Besides, there is no

mechanism exempting any person from holding or controlling these futures contracts in excess of the position limits.

15. SFC further advises that as the average daily trading volume of the three types of London Metal Mini futures contracts together is only some 250 contracts and their total position held by market participants is about 500 contracts at present, it is envisaged that the prescribed position limits and reportable positions under the Amendment Rules² will not have any immediate impact on existing investors.

16. The Subcommittee has enquired whether reference has been drawn from Singapore for setting the position limits and reportable positions for the three types of London Metal Mini futures contracts in question. SFC advises that as in other major overseas exchanges, position limits and reportable positions are prescribed for certain futures and options contracts traded on the Singapore Exchange, together with a mechanism for granting exemptions. However, the London Metal Mini futures contracts in question are not tradable on the Singapore Exchange at present.

Reporting responsibilities

17. Given that an intermediary may hold positions on behalf of its clients, the Subcommittee has enquired whether the reporting is required to be made by individual clients or collectively by the intermediary.

18. SFC advises that a person (who can be an investor, intermediary or institution) holding or controlling a reportable position may choose to submit the notice of reportable position to the recognized exchange company concerned directly, or through an exchange participant or its agent where the latter agrees to make the report on the person's behalf. No matter which party is chosen by the person to submit the notice, it remains the responsibility of the person holding or controlling the reportable position to fulfill the reporting obligation. If an intermediary holds or controls futures or options contracts for both itself and for its clients, the intermediary should disaggregate its own position from the position it holds or controls for each of its clients in the application of position limits and reportable positions. If either party (i.e. the intermediary or its client) has submitted the notice of the reportable position to the exchange, the other party will not be required to notify the exchange of the same reportable position. As observed by SFC, most of the futures or options contracts in Hong Kong are held by investment banks and securities firms as their own positions mainly for hedging purposes, and not on behalf of their clients.

² Please refer to paragraph 11 of the report for the position limits and reportable positions prescribed for the three types of London Metal Mini futures contracts.

19. Hon SIN Chung-kai has enquired whether a mechanism is in place to alert an investor that the futures or options contracts held by the investor have reached the relevant reportable position. SFC advises that when an exchange launches a new futures or options contract, it will publicize to the investing public the relevant margin and reporting requirements, etc. Moreover, it is incumbent upon an intermediary to notify its clients for taking necessary actions to report, or make the report on the clients' behalf, if the intermediary is aware that the position held by a client has reached the specified reportable level.

Penalties for non-compliance

20. The Subcommittee notes that any person who, without reasonable excuse, fails to comply with the requirements on position limits and reportable positions commits an offence and is liable on conviction on indictment to a fine at level 6 (currently \$100,000) and to imprisonment for two years; or on summary conviction to a fine at level 3 (currently \$10,000) and to imprisonment for six months. Where an intermediary holds or controls positions on behalf of its client, both the intermediary and the client are liable to the penalties for non-compliance, and the penalties will be determined by the court having regard to the actual circumstances of individual cases, such as how the positions are 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 involves errors or omissions on the part of a person licensed by SFC, the licensed person may be subject to disciplinary actions taken by SFC, in addition to the levying of penalties under the Rules by the court.

London Metal Mini futures contracts

Risks on the local financial market

21. The Subcommittee has sought SFC's assessment of the potential risks of the three types of London Metal Mini futures contracts to the stability of the local financial market. SFC advises that the Rules were introduced in the aftermath of the Asian Financial Crisis in 1997 with a view to curbing over-concentration of positions held by hedge funds, as well as minimizing the risks to clearing houses in case of insolvency of the futures/options contract holders. Currently, the risks associated with the three types of London Metal Mini futures contracts in question on the local financial market are relatively low, given that the underlying instruments are global commodities. SFC points out that only persons licensed by or registered with SFC for Type 2 regulated activity (i.e. dealing in futures contracts) can engage in the trading of the three types of London Metal Mini futures contracts in Hong Kong.

22. SFC further advises that the reporting requirements will facilitate SFC to conduct market surveillance of the London Metal Mini futures contracts closely since the notice of reportable positions is required to be made within one business day following the day on which a person first holds or controls the reportable positions, and thereafter on each succeeding day on which the person continues to hold or control the reportable positions. In other words, the person is required to file the notice on each business day even if his position remains unchanged.

23. Hon Christopher CHEUNG has expressed concern about the potential risks on the local futures market if an intermediary deposits margin on behalf of its clients based on the net long or short futures contracts held by different clients. SFC clarifies that under the current margin requirements, only the long or short futures contracts held or controlled by the same person are nettable. A mechanism is in place by the clearing house for calling of margin when the price volatility of a futures contract exceeds a specified level.

Trading of London Metal Mini futures contracts

24. Hon Christopher CHEUNG has enquired whether local investors can trade the three types of London Metal Mini futures contracts on LME directly, and if so, the incentives for the investors to trade them on HKFE. He considers that the three types of London Metal Mini futures contracts may not appeal to local or Mainland investors as a hedging tool because, unlike similar contracts on CME and SFE, the contracts traded on HKFE are settled without physical delivery of the underlying metals.

25. SFC advises that the three types of London Metal Mini futures contracts traded on HKFE have different specifications and smaller contract size compared to similar contracts traded on LME. The transactions of these London Metal Mini futures contracts are cleared by the clearing house of HKFE. SFC points out that while commodity futures contracts like the three types of London Metal Mini futures contracts have yet to capture more interest from local investors, the launching of the three types of London Metal Mini futures contracts and similar products by HKFE will help enhance investors' understanding of and interest in commodity futures contracts progressively over time.

Introduction of general terms to cover all stock futures and stock options contracts on exchange traded funds

26. Regarding the amendment to introduce general terms in Schedules 1 and 2 to the Rules to cover all stock futures and stock options contracts on ETFs respectively, the Subcommittee notes that this will obviate the need for SFC to make rules to include them one by one in the Rules when the Hong Kong

Exchanges and Clearing Limited launches new stock futures and stock options contracts on ETFs. The Subcommittee has no objection to the amendment.

27. The Subcommittee notes that the position limits and reportable positions for stock futures and stock options contracts on ETFs are as follows –

Futures/ Options contracts	Position limit	Reportable position
Stock futures contracts on shares or units of ETFs	5 000 open contracts for any one contract month	1 000 open contracts for any one contract month
Stock options contracts on shares or units of ETFs	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

28. Hon SIN Chung-kai has sought explanation as to why the position limits and reportable positions for stock futures and stock options contracts on ETFs vary substantially from those prescribed for the three types of London Metal Mini futures contracts³. SFC explains that this is because the underlying instruments are different, i.e. metals in the case of London Metal Mini futures contracts, and individual share or ETF for stock futures and stock options contracts. To facilitate compliance by market participants, the position limits and reportable positions for stock futures and stock options contracts on ETFs follow those prescribed respectively for stock futures and stock options contracts on shares listed on a stock market operated by SEHK.

29. In connection with the general terms introduced by the Amendment Rules to cover all stock futures and stock options contracts on ETFs, the Subcommittee notes that a definition of ETF and its related expressions are also prescribed. Since the ETF market has developed in Hong Kong for some years already, Hon SIN Chung-kai queries why a definition of ETF is only incorporated into the Rules at this stage. SFC explains that ETFs are open-ended collective investment schemes ("CIS") the shares or units of which are listed or traded on a recognized stock market. SFC has been authorizing ETF products via the regulatory framework of CIS under the Ordinance and the trading aspects of ETFs are regulated by the relevant rules of SEHK. As regards the differences between open-ended CIS and close-ended CIS, SFC advises that the shares or units of an open-ended CIS can be created/redeemed at any time and there are no restrictions on the amount of shares/units to be issued, whereas the amount is fixed in the case of a close-ended CIS by issuing a limited number of shares which are not redeemable.

³ Please refer to paragraph 11 of the report for the position limits and reportable positions prescribed for the three types of London Metal Mini futures contracts.

Recommendation

30. The Subcommittee will not propose any amendment to the Amendment Rules and notes that the Administration will not move any amendment to the Amendment Rules.

Advice sought

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

Council Business Division 1
Legislative Council Secretariat
17 December 2015

Appendix

Subcommittee on Securities and Futures (Contracts Limits and Reportable Positions) (Amendment) Rules 2015

Membership list

Chairman Hon CHAN Kam-lam, SBS, JP

Members Hon Alan LEONG Kah-kit, SC
Hon Christopher CHEUNG Wah-fung, SBS, JP
Hon SIN Chung-kai, SBS, JP

(Total : 4 members)

Clerk Ms Angel SHEK

Legal Adviser Miss Joyce CHAN

Date 8 December 2015