



SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

Consultation Conclusions on proposed amendments to the Securities and Futures (Contracts Limits and Reportable Positions) Rules and proposed corresponding amendments to the Guidance Note on Position Limits and Large Open Position Reporting Requirements

Hong Kong
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Introduction

1. On 18 May 2007, the SFC issued a consultation paper (“**Consultation Paper**”) inviting comments on proposed amendments to the Securities and Futures (Contracts Limits and Reportable Positions) Rules (“**Rules**”) and the Guidance Note on Position Limits and Large Open Position Reporting Requirements (“**Guidance Note**”).
2. The proposed amendments aim to introduce a degree of flexibility to the existing position limits regime by –
 - enabling the SFC to authorize an Exchange Participant (or its affiliate)
 - to exceed the statutorily prescribed limits for specified contracts (currently proposed to comprise only Hang Seng Index futures and options contracts (“**HSI contracts**”) and Hang Seng China Enterprises Index futures and options contracts (“**H-share contracts**”))
 - by up to 50%
 - where there is a relevant business need, ie where the excess position is needed to conduct hedging and/or arbitrage activities to facilitate the provision of services to clients.
3. The consultation period ended on 18 June 2007. A total of 7 written submissions from 13 respondents were received. (The submissions are accessible via the SFC’s website and a list of the respondents is at **Annex 1**.)
4. This document considers the various comments and suggestions put forward and summarises the SFC’s response to them. Additionally, in light of the comments and suggestions received, the SFC proposes to further amend the Rules and Guidance Note as shown in **Annex 2** and **Annex 3** respectively. (For easy reference, the further amendments are highlighted in yellow.) This paper should therefore be read in conjunction with the Consultation Paper.

B. Key comments and SFC’s response

5. Most respondents were generally supportive of the proposed amendments although many also suggested relaxing the regime even further. The issues raised are discussed below.

Increasing the prescribed limits

6. A number of respondents suggested that the limits prescribed in the Rules – particularly limits for HSI contracts and H-share contracts – should be increased to allow all market participants to benefit.
7. The SFC believes it is preferable to take a more cautious approach in relaxing the position limits regime. We therefore propose to leave the prescribed limits unchanged for now. However, the SFC will closely monitor market activities in HSI contracts and H-share contracts following implementation of the current proposals. Based on market participants’ usage of the prescribed limits and

market growth, the SFC will review whether there is any need to adjust any of the prescribed limits.

Removing the 50% upper limit

8. A number of respondents suggested removing the 50% upper limit and allowing the SFC to authorize any amount of excess positions. They noted that this would provide greater flexibility and be more consistent with the provisions relating to the “special circumstances” category of authorization by the SFC (which does not set an upper limit). Separately, some respondents also suggested that the 50% limit should either be applied on an individual basis (rather than on a per group basis as we had proposed) or, alternatively, that it should exclude excesses relating to the asset management businesses within a group.
9. We agree that removing the 50% upper limit will provide greater flexibility. However, it may also provide less certainty for the market and lead to disputes as to the extent of excesses that should be authorized. Moreover, as already mentioned, the SFC believes it is preferable to take a more cautious approach, particularly at this initial stage.
10. To balance these concerns, the SFC proposes to amend the Rules so that the upper limit is not specified in the Rules themselves, but by notice in the Gazette. This will enable the SFC to change the upper limit within a shorter period of time if necessary. We propose specifying the upper limit at 50% initially. The relevant amendments in this regard are set out in sections 4(6), 4(10) and 4(11) of the Rules and paragraph 3.11(3) of the Guidance Note.
11. As for the point about either removing the per group limit or excluding excesses relating to asset management businesses, we clarify as follows –
 - (1) The per group limit was included to address concerns about concentration risks – ie the build up of excessive and over-concentrated positions held by different members within a particular group.
 - (2) On reflection however, we believe it is possible to address these concerns without imposing a per group limit given the limitations imposed by the proposed section 4(4)(b) of the Rules – by virtue of that section excess positions can only be authorized if the SFC is satisfied that they will not prejudice the interest of the investing public.
 - (3) We therefore propose deleting the previously proposed section 4(7) of the Rules, and amending paragraph 3.11(3) of the Guidance Note to clarify that the SFC, in assessing if the requirement under section 4(4)(b) of the Rules is met, will consider whether any other members in the same group have been authorized to hold excess positions and if so, how many and to what extent.

Not limiting authorization to Exchange Participants and their affiliates

12. A number of respondents submitted that the SFC should not be limited to authorizing only Exchange Participants and their affiliates, and that other persons should also be allowed to apply for excess positions. Some respondents also asked the SFC to clarify if the SFC would decide who is authorized (ie as between the Exchange Participant and its affiliate), or whether it would be up to the applicant to decide this.
13. The SFC believes it is not appropriate to extend the current proposals to all persons at this stage. Earlier market feedback (ie prior to the issue of the Consultation Paper) and an analysis of the positions then held in the market indicated that it was mainly Exchange Participants and their affiliates who needed to hold positions beyond the prescribed limits. The current positions held in the market also show that it is mainly Exchange Participants and their affiliates who hold positions close to the prescribed limits. There therefore appears to be no need to extend the current proposals to other persons at this time.
14. The above said, the SFC will keep this matter under review. Should the need arise in future, the SFC will consider introducing a similar authorisation mechanism for other market participants.
15. As to whether it is the SFC or the applicant that decides who should be authorized to hold the excess position, we clarify as follows –
 - (1) The SFC expects applications to be submitted by the group Exchange Participant irrespective of who in the group is to be authorized.
 - (2) It will be up to the applicant to decide which of its members in the group need the excess positions and hence need authorization. The SFC will not dictate this.
 - (3) However, where any member of a group is authorized to hold or control excess positions in respect of a particular contract, the SFC will normally expect all of its holdings in that contract (ie not just the excess positions) to be carried through the Exchange Participant. It follows therefore that the Exchange Participant will in any event need to be authorized under the new section 4(6) of the Rules.

Expanding the range of specified contracts

16. Some respondents submitted that the range of specified contracts was too limited and this might still prevent applicants from reacting quickly to meet urgent client demands.
17. The SFC does not believe it is necessary to expand the range of specified contracts at this stage. Earlier market feedback (ie prior to the issue of the Consultation Paper) and an analysis of the positions then held in the market indicated that participants mainly needed larger positions in respect of HSI

contracts and H-share contracts. The SFC will however continue to monitor positions in the market. Should the need arise to extend the current proposals to other contracts in future, the SFC will do so. The gazettal process gives the SFC the flexibility to do so relatively quickly.

18. As for the concern that the gazettal process may still be too slow, the SFC does not agree. The gazettal process itself can take as little as one week. The more important issue is whether the proposals should be extended to other contracts at all. That issue has been addressed in the previous paragraph.

Relevant business need and client facilitation

19. There were several comments and suggestions regarding the scope of relevant business need and client facilitation. We deal with each in turn.
20. First, some respondents suggested that the current proposals be extended so that the SFC can authorize excess positions on the basis of other business justifications also, ie not just on the basis of there being a relevant business need.
21. The SFC does not consider it appropriate to make such a change. The current proposals are designed to facilitate larger holdings only where these are needed to serve clients needs. The “relevant business need” requirement has been intentionally included to meet this objective.
22. Secondly, some respondents noted that while arbitrage trading should be included within the scope of “relevant business need”, there was some inconsistency within the definition since arbitrage trading was generally not client-driven, nor conducted to facilitate client services. They also noted that client facilitation should be broadly defined in the Rules to include proprietary hedging for client-driven OTC derivatives over a broad range of products.
23. To avoid doubt, we propose amending the definition of “relevant business need” as follows –

“ ‘relevant business need’ (相關業務需要), in relation to an exchange participant or an affiliate of an exchange participant, means a business need that requires such exchange participant or affiliate to engage in hedging ~~or arbitrage~~ activities to facilitate the provision of services to his clients;”

24. As for the term “client facilitation”, this is intended to cover client transactions conducted either on-Exchange or off-Exchange. It will therefore cover proprietary hedging for client-driven OTC derivatives over a broad range of products. To avoid doubt, we propose amending paragraph 3.10 of the Guidance Note as follows –

“The phrase ‘relevant business need’ is defined in Section 4(10) and essentially means a need to engage in hedging ~~and/or arbitrage~~ activities as a result of providing client facilitation services (i.e. services to facilitate client transactions – whether conducted on

exchange or off, and in futures or options contracts or other products).
The definition is designed to ensure that ...”

(We do not propose any change to the Rules in this regard as the term “client facilitation” is not used there.)

25. Thirdly, some respondents asked the SFC to clarify whether and how applicants would be asked to evidence the use of excess positions and what type of reporting requirements to expect.
26. We take the point raised and clarify as follows –
- (1) The SFC intends Exchange Participants/their affiliates to be able to apply for excess positions not only in respect of a particular client or client transaction, or after receiving an actual request from a client, but also in anticipation of clients’ prospective needs based on past experience. Moreover, once authorization is granted, the SFC will not require that the excess positions be used in respect of a particular client transaction, or even in respect of a particular client. The only requirement is that it must be used to hold positions that facilitate client transactions.
 - (2) The SFC will only expect authorized Exchange Participants/their affiliates to provide an overall description of the positions they have taken; not details in relation to each client on an individual basis. To that end, we will expect the authorized Exchange Participant/affiliate to submit regular reports confirming the amount of excess used, the type of clients involved, and a general description of the nature of the client transactions including their notional and market values. Initially, we expect to normally require reports to be submitted quarterly within two weeks of the end of the relevant quarter. We may however require more frequent reporting, or additional reporting, in individual cases as necessary.

We propose amending the Guidance Note to clarify the above. (See paragraphs 3.24 and 3.25 of the Guidance Note.)

27. Lastly, some respondents requested that additional examples be included in the Guidance Note to demonstrate the scope of relevant business need. Useful examples were also suggested by the respondents and these have been included at Appendix 1 of the Guidance Note.

Financial capability requirement

28. Some respondents suggested that the applicant should be entitled to choose whether the financial capability requirement will be met by the Exchange Participant or by its affiliate.
29. On reflection, we consider that it is not critical for the SFC to determine who meets the financial capability requirement so long as it is satisfactorily met. We

therefore propose amending the Rules and Guidance Note accordingly. The relevant amendments are to section 4(7)(b) of the Rules and paragraph 3.12 of the Guidance Note.

30. Additionally, one respondent suggested that the SFC determine eligibility for excesses by considering only the applicant's financial capacity to maintain the large open position and its track record of participation in an orderly manner.
31. We agree that financial capacity is crucial and have therefore already proposed including this as a pre-requisite. As for referring to the applicant's track record, while we agree that this factor is relevant, we do not believe it is necessarily conclusive in all cases. For example, there may be external factors affecting a participant's previous performance, or the participant may be new and have no previous performance, or the participant may have previously had a poor performance but has since taken remedial action (eg it may have changed its management or put in place new internal controls and systems, etc).

Internal control requirements

32. Some respondents suggested that as Exchange Participants are already licensed corporations, the SFC would already be aware of the robustness of their internal control procedures and risk management systems. As such, a detailed examination of these should not be necessary. Alternatively, this requirement could be changed to require the Exchange Participant to satisfy itself that the internal control procedures and risk management systems are effective.
33. We appreciate the concern raised. However, given the SFC's inclination to take a more cautious approach, we do not propose either deleting this requirement, or relying on Exchange Participants alone to be satisfied as to the effectiveness of their procedures and systems.
34. That said, the SFC does not anticipate having to conduct a detailed examination of Exchange Participants' internal control procedures and risk management systems in every case. We expect our review will mainly focus on determining whether the Exchange Participants will be capable of managing the excess positions. To facilitate the review process, we will expect Exchange Participants to summarise or highlight those aspects of their internal control procedures and risk management systems that are relevant to managing the potential risks arising from the excess positions sought to be authorized – paying particular attention to the matters noted in paragraph 3.19(3)(b) of the Guidance Note.
35. The SFC will also take into account any other relevant information in its possession which it considers relevant (eg whether any disciplinary action has been taken that casts doubt on the adequacy or effectiveness of the Exchange Participant's internal control procedures and risk management systems and if so, the remedial action taken by the Exchange Participant).

36. Based on all of these, the SFC will then assess whether further information or clarification is needed or not, and whether the Exchange Participant's procedures and systems are satisfactory.

Transparency

37. One respondent commented that the proposed changes do not go far enough to make transactions more visible. They added that the limitations also mean that only issuers of derivatives will be able to enjoy relaxations and end users with genuine hedging needs will still need to go off-market or overseas.
38. The SFC believes the current proposals will encourage on-Exchange transactions and thereby enhance transparency. Additionally, as mentioned above, market feedback and an analysis of positions held in the market suggest that it is mainly Exchange Participants and their affiliates who need to hold positions beyond the existing prescribed limits. The SFC therefore believes there is no need to extend the current proposals to other persons at this time.

Carrying of trades

39. A number of respondents sought clarification regarding the carrying of trades. In particular, respondents asked –
- (1) whether holdings had to be kept in the account of an HKCC clearing participant or with the Exchange Participant who was also the HKCC clearing participant;
 - (2) whether excess positions could be carried through a regulated affiliate; and
 - (3) whether non-Exchange Participants could use external brokers for execution.
40. We clarify as follows –
- (1) Where an Exchange Participant or its affiliate has been authorized excess positions in a particular contract, all of their holdings in that contract must be carried (ie held) by the Exchange Participant within the same group. Additionally, if the group Exchange Participant is not an HKCC clearing participant, positions must be carried through both the group Exchange Participant and a general clearing participant of HKCC appointed by the group Exchange Participant.
 - (2) Positions can be carried through a regulated affiliate, but must be carried through the group Exchange Participant at the Exchange level. Hence, if the regulated affiliate is not an Exchange Participant but the group wants the positions to be carried through the regulated affiliate, then the positions must be carried through both the group Exchange Participant (at the Exchange level) and the regulated affiliate.
 - (3) As regards execution (ie acquisition and disposal), on reflection, we do not consider it necessary to compel execution through the group

Exchange Participant. Accordingly, any execution broker may be used (including the group Exchange Participant).

We propose amending the Guidance Note to clarify the above. The relevant changes are to paragraph 3.13 of the Guidance Note.

Authorization and withdrawal

41. Several issues were raised regarding authorizations and withdrawals.
42. First, a number of respondents raised concerns about the authorization process noting that a lengthy review process would be too burdensome and not commercially practicable. One respondent also asked whether authorizations would be a one-off process, and some suggested that authorizations should be for an indefinite period as it would otherwise hinder the management of long-dated positions and be an administrative burden. It was also suggested that the SFC's response time be reduced – from 4 weeks to less than 10 business days (for new applications) and from 10 business days to 5 business days (for renewals).
43. The SFC appreciates the commercial limitations and will endeavour to process applications as quickly as possible. We expect also that over time, as experience is gained, it will be possible to streamline the application process and provide greater clarification on the type of information needed. This should facilitate and speed up the authorization process further.
44. Separately, it is also expected that applications for authorization may be made in advance and on the basis of past experience (ie rather than on the basis of an immediate client request). Moreover, while we do not believe an indefinite authorization is either prudent or necessary, we do expect authorizations to be valid for a substantial length of time (possibly up to one year), whereupon they may be renewed by way of a new application. This should help address concerns about possible time delays, the process being burdensome and concerns about long-dated positions.
45. We propose amending the Guidance Note to clarify the above. The relevant changes are to paragraph 3.17 of the Guidance Note.
46. Secondly, some respondents noted that it was unnecessary for the SFC to have the power to withdraw authorization on 7 days' notice as a similar limitation could be imposed by way of a condition. Alternatively, the time limit should either be extended or some discretion built in to allow the SFC to specify a longer period. They also noted that the notice period should in any case be in terms of "business days" rather than just "days".
47. The SFC believes it is better for the Rules to include an express power regarding withdrawal as that can help avoid dispute and doubt in future. As for the length of the notice period, the proposal is to impose a minimum 7 day notice, so a longer notice period is still possible. We would also note that the

withdrawal powers are not intended to be exercised lightly but only in serious circumstances as set out in paragraphs 3.28 and 3.29 of the Guidance Note.

48. We take the point on using business days rather than just days and propose amending the notice period from “7 days” to “5 business days”.

Conditions

49. A few comments were raised regarding the conditions to be imposed on authorization. In particular, some respondents suggested that the SFC should only impose conditions after engaging in dialogue with the applicant. They also suggested that the SFC make available a list of possible pre-conditions which should then be imposed consistently and fairly. They also noted that amendments to a condition should not be treated materially differently from a withdrawal of authorization and should therefore be preceded by a similar notice period.
50. The SFC appreciates the concerns raised in relation to the imposition of conditions and accordingly clarifies as follows –
- (1) We do expect to be in dialogue with the applicant and the company to be authorized before imposing any conditions. This should also, to some extent, address concerns about the absence of a list of possible pre-conditions.
 - (2) We agree that amending conditions should be given a similar notice period as withdrawals and propose amending the Rules and Guidance Note accordingly. The relevant changes in this regard are to section 4(9)(c) of the Rules and paragraph 3.22 of the Guidance Note.

Other comments

51. A few other comments were made.
52. Appeal rights: One respondent noted that decisions on variation of conditions or withdrawal of authorizations should also be subject to appeal. The SFC notes however that there is already a right to appeal against a refusal to authorize excess. The SFC believes this should suffice. However, we will keep this matter under review.
53. Penalties: Some respondents suggested that the criminal liability for breaching the Rules should be removed noting that in all other markets, breaches of this nature trigger civil penalties. This issue falls outside of the scope of the current consultation exercise, and will have to be considered on another occasion.
54. Special circumstances: One respondent sought clarification on the term “special circumstances”. Unfortunately, it is difficult to be more specific, but essentially the SFC would expect the circumstances to be unusual or out of the ordinary. So, for example, requiring excess positions to serve a regular business need would not be regarded as constituting special circumstances.

C. Closing remarks

55. The SFC would like to thank all respondents for their time, effort and valuable comments in response to the consultation paper.

ANNEX 1

List of Submissions and Respondents

1. Barclays Capital Asia Limited
2. Clifford Chance
3. Credit Suisse (Hong Kong) Limited
4. Fimat Hong Kong Limited
5. Hong Kong Stockbrokers Association Limited
6. Linklaters on behalf of 7 financial institutions
 - a. Citigroup Global Markets Asia Limited
 - b. Deutsche Bank AG, Hong Kong Branch
 - c. J.P. Morgan Securities (Asia Pacific) Limited
 - d. Merrill Lynch (Asia Pacific) Limited
 - e. Morgan Stanley Asia Limited
 - f. UBS AG
 - g. One who wished to remain anonymous
7. Macquarie Group

ANNEX 2

SECURITIES AND FUTURES (CONTRACTS LIMITS AND REPORTABLE POSITIONS) (AMENDMENT) (NO. 2) RULES 2007

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

1. Commencement

These Rules shall come into operation on [] 2007.

2. Restrictions on number of contracts held or controlled

Section 4(4) of the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap. 571 sub. leg. Y) is repealed and the following substituted –

“(4) A person may hold or control a futures contract or stock options contract in excess of the prescribed limit if –

- (a) the person –
 - (i) is authorized under subsection (5) to hold or control such excess; or
 - (ii) is authorized under subsection (6) to hold or control such excess;
- (b) the Commission is satisfied that the excess would not be prejudicial to the interest of the investing public having regard to the prescribed limit and the liquidity of the futures contract or stock options contract in question; and
- (c) the Commission has given the person notice in writing that it is satisfied –
 - (i) where paragraph (a)(i) applies, of the matters referred to in paragraph (b) and subsection (5); or
 - (ii) where paragraph (a)(ii) applies, of the matters referred to in paragraph (b) and subsection (87)(a), (b) and (c).

(5) The Commission may authorize a person, other than a person who may be authorized under subsection (3), to hold or control a futures contract or stock options contract in excess of the prescribed limit if the Commission is satisfied that

there are special circumstances which warrant the person holding or controlling such excess.

(6) Subject to subsections (7), ~~and (8) and (9)~~, the Commission may authorize an exchange participant or an affiliate of an exchange participant to hold or control a specified contract in excess of the prescribed limit by up to ~~50%~~ **the specified percentage**.

~~(7) The Commission shall not authorize more than one member of a group of companies to hold or control a specified contract in excess of the prescribed limit if such authorization would result in the excess positions, in aggregate, of all members of that group of companies exceeding the prescribed limit by more than 50%.~~

(87) The Commission shall not authorize an exchange participant or an affiliate of an exchange participant to hold or control a specified contract in excess of the prescribed limit unless the exchange participant satisfies the Commission that –

- (a) the exchange participant or the affiliate (as the case may be) has a relevant business need for the excess for which authorization is sought;
- (b) **either** the exchange participant or ~~if the Commission considers appropriate,~~ the affiliate has adequate financial capability to cover the potential risks arising from such excess; and
- (c) the exchange participant has effective internal control procedures and risk management systems to manage the potential risks arising from such excess.

(98) The Commission shall not grant an authorization under subsection (6) if the excess for which authorization is sought may be authorized under the rules of the recognized exchange company concerned as referred to in subsection (2).

(109) An authorization granted under subsection (5) or (6) –

- (a) subject to paragraph (b), shall be valid for such period as the Commission may specify in the notice given under subsection (4)(c);
- (b) may be withdrawn by the Commission, at any time, by at least ~~7 days'~~ **5 business days'** notice in writing to the person authorized and, where the person authorized is an affiliate of an exchange participant, also to the exchange participant; and
- (c) shall be subject to such reasonable conditions as the Commission may specify in the notice given under subsection (4)(c) and the Commission may, at any time, by **at least 5 business days'** notice in writing to the person authorized and,

where the person authorized is an affiliate of an exchange participant, also to the exchange participant, amend or revoke any such condition or impose new conditions as may be reasonable in the circumstances.

(110) In this section –

“adequate financial capability” (), in relation to an exchange participant or an affiliate of an exchange participant, means such exchange participant or affiliate or his holding company having –

- (a) a net asset value of not less than \$2 billion as set out in his or its latest audited financial statements; or
- (b) a qualifying credit rating;

“affiliate” (), in relation to an exchange participant, means any corporation belonging to the same group of companies as the exchange participant;

“relevant business need” (), in relation to an exchange participant or an affiliate of an exchange participant, means a business need that requires such exchange participant or affiliate to engage in hedging or ~~arbitrage~~ activities to facilitate the provision of services to his clients;

“specified contract” () means any futures contract or stock options contract that is specified by the Commission by notice published in the Gazette for the purposes of the ~~these Rules definition~~;

“specified percentage” () means the percentage specified by the Commission by notice published in the Gazette for the purposes of ~~thisese Rules definition~~.

(112) A notice referred to in the definition of “specified contract” or “specified percentage” in subsection (101) is not subsidiary legislation.”.

Martin WHEATLEY
Chief Executive Officer,
Securities and Futures Commission

2007

Explanatory Note

Section 4 of the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap. 571 sub. leg. Y) (the “principal Rules”) prohibits a person (except an authorized person) from holding or controlling a futures contract or stock options contract in excess of the prescribed limit.

2. The purpose of these Rules is to amend section 4 of the principal Rules to provide that the Securities and Futures Commission (the “Commission”) may authorize an exchange participant or ~~his~~ affiliate to hold or control a specified contract in excess of the prescribed limit up to ~~a 50% ceiling~~ the specified percentage if the Commission is satisfied that there is a business need for the excess and that the exchange participant or the affiliate has adequate financial capability and effective internal control procedures and risk management systems to manage the potential risks arising from such excess.

ANNEX 3

GUIDANCE NOTE ON POSITION LIMITS AND LARGE OPEN POSITION REPORTING REQUIREMENTS

1. Introduction

- 1.1. Section 35(1) of the Securities and Futures Ordinance (Cap. 571) (“SFO”) empowers the SFC to make rules to (i) prescribe limits on the number of futures contracts¹ or options contracts² that may be held or controlled by a person; and (ii) require a person holding or controlling a reportable position to notify the recognized exchange company or the SFC³.
- 1.2. The Securities and Futures (Contracts Limits and Reportable Positions) Rules (“the Rules”) were made by the SFC under Section 35(1) of the SFO to prescribe limits and reportable positions applicable to futures contracts and stock options contracts traded on the recognized exchange company.
- 1.3. This Guidance Note is issued to help market participants better understand how the Rules are intended to operate in practice and explain compliance requirements of the Rules.
- 1.4. The Guidance Note is intended to clarify the SFC’s policy intent and positions on issues raised by the industry and does not have the force of law. The SFC will revise the Guidance Note to clarify its position in response to market developments and to reflect legislative changes in the future.

2. Prescribed Limits on Futures and Stock Options Contracts

Prescribed limits

- 2.1. Section 4(1) of the Rules imposes restrictions on the maximum number of futures contracts or stock options contracts that may be held or controlled by a person. The prescribed limits on futures contracts⁴ and stock options contracts are specified respectively in Schedule 1 and Schedule 2 of the Rules.
- 2.2. Except for ~~the Hang Seng Index (“HSI”) futures contract, HSI options contract, Mini-HSI futures contract and Mini-HSI index futures and index options contracts~~, Schedule 1 of the Rules specifies the maximum number of futures contracts for any one contract month or series that may be held or controlled by a person. In other words, the prescribed limits in this Schedule apply to individual contract months or options series. *For example, the prescribed limit on ~~a particular~~ any stock futures contract is 5,000 contracts for any one*

¹ Section 35(1)(a)

² Section 35(1)(b)

³ Section 35(1)(c)

⁴ In accordance with Schedule 1 of the SFO, the definition of “futures contract” includes not only a futures contract but also an option on a contract made under the rules or conventions of a futures market. In other words, futures and options contracts traded on the Hong Kong Futures Exchange are referred to as “futures contracts” in the Rules.

contract month. If a person longs 3,000 contracts of the September futures contract and longs 2,000 contracts of the October futures contract, he will not reach the prescribed limit on this contract.

- 2.3. The prescribed limit on ~~the HSI index~~ futures and ~~index~~ options contracts ~~as well as the Mini-HSI futures and options contracts~~ are calculated on a net basis for all contract months combined⁵. The futures-equivalent positions in options contracts are added to the positions in futures contracts for purposes of determining compliance with the prescribed limit. The futures-equivalent position in an options contract is the delta value⁶ of the options contract determined by the Hong Kong Futures Exchange (“HKFE”) at the close of market on each trading day multiplied by the number of contracts held or controlled.

Example:

A person holds the following positions:

- Long 8,000 September HSI futures contracts
- Short 1,000 October HSI futures contracts
- Long 2,500 November Mini-HSI futures contracts
- Long 5,000 September HSI calls with a delta value of 0.5

Since the contract value of the Mini-HSI futures contract is one-fifth of that of the HSI futures contract, 2,500 Mini-HSI futures contracts are equivalent to 500 HSI futures contracts. The futures-equivalent positions in September HSI calls are 2,500 contracts which are obtained by multiplying the delta value (0.5) by the number of contracts held (5,000 contracts). In deciding whether the person has reached the prescribed limit of 10,000 contracts, positions in all contracts are netted, i.e. 8,000 contracts (long September HSI futures contract) minus 1,000 contracts (short October HSI futures contract) plus 500 contracts (long November Mini-HSI futures contract) plus 2,500 contracts (long September HSI calls). That means the person holds a net position of 10,000 contracts and has reached the prescribed limit.

- 2.4. Schedule 2 of the Rules specifies the maximum number of stock options contracts in any one market direction⁷ for all expiry months combined that may be held or controlled by a person. ~~In determining whether the prescribed limit is exceeded, all options contracts expiring in the same month including all option types (i.e., calls and puts), strike prices, long and short positions are taken into consideration.~~ For example, the prescribed limit on any stock options contract is 50,000 contracts in any one expiry month market direction. If a person holds 30,000 long calls ~~with strike price in month A~~, 10,000 short

⁵ ~~Prescribed limits are also imposed separately on the Mini-HSI futures contracts and Mini-HSI options contracts for all contract months combined.~~

⁶ Delta is the amount by which the price of an option will change for a corresponding change in price of the underlying market. Delta can be used to equate the directional risk of an option position with a position of similar size in the underlying market. For example, if a person holds 1,000 HSI options contracts (delta value of the contract is +0.6), he is long 600 deltas or in equivalent terms, 600 HSI futures contracts.

⁷ Long calls and short puts are in the same market direction; and short calls and long puts are in the same market direction.

~~calls with strike price in month B and 40,000 long puts with strike price in month C (all these calls and puts are in the same expiry month), he will reach the prescribed limit on this contract for the short market direction, but will still be able to hold 20,000 more contracts for the long market direction. (The position in the long market direction is 30,000 contracts (i.e. 30,000 long calls) and the position in the short market direction is 50,000 contracts (i.e. 10,000 short calls plus 40,000 long puts).)~~

- 2.5. The prescribed limits in Schedule 1 and Schedule 2 are also reflected in rules of the HKFE and the Stock Exchange of Hong Kong (“SEHK”). Market participants should note that in addition to the prescribed limits, the HKFE and SEHK may impose other position limits on a particular contract, Exchange Participant or client where situations warrant such action.

Aggregation requirements

(This section should be read in conjunction with paragraph 5 below on Compliance by Agents.)

- 2.6. The prescribed limits apply to all positions held or controlled by any person including positions held by the person for his own account and positions belonging to other persons but under the control of such person. While the word “control” is not defined in the SFO or the Rules, there are circumstances where the SFC takes the view that a person is regarded as having control of positions as for example where a person is allowed to exercise discretion⁸ to trade or dispose of the positions independently without the day-to-day direction of the owner of the positions.
- 2.7. Notwithstanding the foregoing, the SFC accepts that the prescribed limits do not apply to a person who controls positions merely by virtue of its corporate relationship (e.g. a parent company in relation to positions held by its affiliates/subsidiaries) provided that such person does not give its affiliates/subsidiaries any day-to-day direction with respect to trading.

Penalties

- 2.8. Except as otherwise authorized by the SFC, HKFE or SEHK (please refer to paragraphs ~~3 below~~3.1 to 3.17), a person who contravenes Section 4(1) of the Rules without reasonable excuse is liable (i) on conviction on indictment to a fine of HK\$100,000 and to imprisonment for 2 years; or (ii) on summary conviction to a fine of HK\$10,000 and to imprisonment for 6 months.
- 2.9. In addition to any other powers and sanctions contained in the SFO or the Rules, the HKFE and SEHK may require an Exchange Participant carrying an account in which a position is in excess of the prescribed limit to take immediate steps to reduce the position below the prescribed limit pursuant to their rules. Where the HKFE or SEHK becomes aware that any person ~~maintains~~holds or controls positions in accounts with more than one Exchange Participant such that the aggregate position in all accounts exceeds

⁸ Section 7(3) of the Rules explains the situations in which a person is considered to have discretion to trade or dispose of positions independently.

the prescribed limit, the HKFE or SEHK may require any of the Exchange Participants carrying such accounts to reduce positions in the relevant accounts so that the aggregate position in all accounts will comply with the prescribed limit.

3. ~~Application~~Authorization to Exceed Prescribed Limits

3.1. No person may hold or control futures contracts or stock options contracts in excess of the prescribed limits except as otherwise authorized by the ~~SFC~~, HKFE or SEHK (as the case may be) in accordance with Sections 4(2) ~~of the Rules, or by the SFC in accordance with and~~Section 4(4) of the Rules.

Authorization for excess positions by the HKFE/SEHK

3.2. Section 4(2) of the Rules provides that the HKFE or SEHK may authorize a person to hold or control futures contracts or stock options contracts in excess of the prescribed limits ~~under the situations set out~~if the person is one of those described in Section 4(3) of the Rules.

3.3. In accordance with Section 4(3), the following persons may be authorized ~~for holding or controlling excess positions~~ by the HKFE or SEHK to hold or control excess positions:

~~(i)~~(1) a person registered with the SEHK for the purpose of performing market making or liquidity providing activities in respect of stock options contracts in accordance with its rules (*e.g. an Options Trading Exchange Participant holds excess positions in stock options contracts for which it is registered with the SEHK to make a market*);

~~(ii)~~(2) a person registered with the HKFE for the purpose of performing market making or liquidity providing activities in respect of futures contracts in accordance with its rules (*e.g. an HKFE Participant holds excess positions in futures contracts for which it is registered with the HKFE to make a market*);

~~(iii)~~(3) an issuer of securities listed under Chapter 15A of the Listing Rules who holds or controls futures contracts or stock options contracts in the course of hedging the risks of positions previously acquired in such listed securities for the purpose of performing liquidity providing activities in respect of such listed securities (*e.g. an issuer of structured products like derivative warrants and equity-linked instruments holds excess positions in futures contracts or stock options contracts to hedge the risks of positions in the structured products issued by it*); or

~~(iv)~~(4) a related corporation⁹ of an issuer of securities listed under Chapter 15A of the Listing Rules, where the related corporation holds or controls futures contracts or stock options contracts in the course of hedging the risks of positions previously acquired in such listed

⁹ The term “related corporation” is defined in ~~s~~Section 3 of Schedule 1 of the SFO.

securities for the purpose of performing liquidity providing activities in respect of such listed securities (*e.g. an associate of an issuer of structured products like derivative warrants and equity-linked instruments holds excess positions in futures contracts or stock options contracts to hedge the risks of its positions in the structured products issued by the issuer*).

- 3.4. A person who has the need to exceed the prescribed limits pursuant to Section 4(2) should make an application to the HKFE or SEHK (as the case may be) in accordance with its rules. The approval from the HKFE or SEHK must be received prior to entering into positions which exceed the limits.

Authorization for excess positions by the SFC

- 3.5. Section 4(4) of the Rules empowers the SFC to authorize a person to hold or control futures contracts or stock options contracts in excess of the prescribed limits ~~in~~ if special circumstances exist, or if the person has a relevant business need. Section 4(4) is however only applicable to situations falling outside Section 4(3). That is, the SFC will not accept applications which will may be dealt with by the HKFE ~~and or~~ SEHK in accordance with Section 4(3)¹⁰.

- 3.6. Pursuant to ~~this s~~Section 4(4), a person may hold or control futures contracts or stock options contracts in excess of the prescribed limits if:

~~(i)(1) the person is able to satisfy the SFC that special circumstances exist which warrant the person holding or controlling excess positions (Section 4(4)(a))~~ the person is authorized to do so pursuant to either under Section 4(5) or 4(6) (Section 4(4)(a));

~~(ii)(2)~~ the SFC is satisfied that the excess positions would not be prejudicial to the interest of the investing public having regard to the prescribed limits and the liquidity of the futures contracts or the stock options contracts in question (Section 4(4)(b)); and

~~(iii)(3)~~ the SFC has given the person notice in writing that it is satisfied of the matters referred to in Sections 4(4)(a) ~~and~~ (b) and either 4(5) or 4(87) (Section 4(4)(c)).

Authorization under Section 4(5) – in “special circumstances”

- 3.7. An authorization under Section 4(5) may only be granted:

(1) to a person who is not one of those described in Section 4(3); and

(2) where such person can show that there are special circumstances which warrant his holding or controlling the excess positions in question.

- 3.8. The phrase “special circumstances” is not defined in the SFO. However, the SFC considers that the reference to “special” implies that the circumstances should normally be unique or unusual (i.e. out of the ordinary) in some way.

¹⁰ This is embodied in Sections 4(5) and 4(98).

So, for example, requiring excess positions to serve a regular business need would not be regarded as constituting special circumstances.

Authorization under Section 4(6) – for a “relevant business need”

3.9. An authorization under Section 4(6) may only be granted:

- (1) to an Exchange Participant or an affiliate of an Exchange Participant; and
- (2) where such person has a relevant business need for the excess positions in question.

3.10. The phrase “relevant business need” is defined in Section 4(10~~1~~) and essentially means a need to engage in hedging ~~and/or arbitrage~~ activities as a result of providing client facilitation services (i.e. services to facilitate client transactions – whether conducted on exchange or off, and in futures or options contracts or other products). The definition is designed to ensure that excess positions are sought and authorized only for the purposes of helping Exchange Participants and their affiliates to better serve their clients, and not for purely proprietary trading. For instance, a client wants to buy a large number of futures contracts, but is concerned that the purchase will push up market prices materially and thus increase his execution prices. The Exchange Participant can facilitate this client to buy the futures contracts by selling the contracts to the client as principal over-the-counter (OTC) and then buying the futures contracts in the exchange market throughout the day to minimize the impact on market prices and to cover the OTC position established for the client. In this case, the futures contracts traded on the exchange are the proprietary positions of the Exchange Participant resulting from client facilitation activities.

3.11. The SFC’s power to grant authorizations under Section 4(6) is restricted in a number of ways. In particular:

- (1) The authorization may only be granted to persons who belong to a group of companies that includes an Exchange Participant (including the Exchange Participant) (Sections ~~4(4)(a)(ii) and~~ 4(6) and 4(10)). This is because Exchange Participants and their affiliates generally have a greater need for holding excess positions to provide client facilitation services. In addition, Exchange Participants are licensed corporations under the SFO and therefore the SFC can better assess whether they would have the capabilities to hold excess positions and manage the resultant risks.
- (2) The authorization may only be granted in respect of futures contracts or stock options contracts that have been specified by the SFC by notice in the Gazette (Sections 4(6) and 4(10~~1~~)). Such notice is not subsidiary legislation (Section 4(11~~2~~)). The SFC will, from time to time, review the list of specified contracts based on market demand.

(3) The SFC will only be able to authorize excesses of up to the specified percentage, ie that percent 50% of the prescribed limit as has been specified by the SFC by notice in the Gazette (Section 4(6) and 4(10)). Moreover, this upper limit is a per group limit, i.e. it applies to the aggregate excess positions of all companies within the same group (Section 4(7)). The notice in the Gazette is not subsidiary legislation (Section 4(11)). The SFC will, from time to time, review the specified percentage based on market need.

Example:

There are 3 members in a particular group of companies and the prescribed limit for a particular futures contract is 10,000. Assuming the specified percentage is 50% and that they each group member holds and controls contracts independently of each other (i.e. no issue of aggregation – as discussed in paragraph 2.6 above – arises because none of the group members controls contracts held by any of the others, nor holds contracts controlled by any of the others):

- *The maximum that the any members in the group may in aggregate be authorized to hold or control is 315,000 calculated as follows:
 $(3 \times 10,000) + (50\% \times 10,000) - 5,000 = 315,000$*
- *The maximum that the group would in aggregate be authorized to hold or control is 45,000 calculated as follows:
 $15,000 \times 3 = 45,000$*

It should be noted however that although the upper limit set by the specified percentage is a per applicant upper limit, the SFC will also take into account any excess positions already authorized to other members within the same group as the applicant when considering whether the requirements of Section 4(4)(b) have been satisfied.

Subject to the above, the maximum that any one member in the group may be authorized to hold or control is 15,000 calculated as follows:

$$10,000 + 5,000$$

However, once this 15,000 maximum is held or controlled, no other member in the same group may hold or control any excess positions.

It follows therefore that:

The maximum possible excess position per group (i.e. 5,000 in the above example) does not change no matter how many members there are within the group.

The maximum possible excess position of a single person does not change no matter how many members there are within the group but once a person holds this maximum possible excess, no other

person in the same group may hold or control any excess positions in the same contract.

3.12. Additionally, the SFC may only authorize excess positions under Section 4(6) if ~~the Exchange Participant in question has~~

- (1) ~~the Exchange Participant or affiliate in question has~~ adequate financial capability to cover the potential risks arising from any authorized excess position (Section ~~4(87)(b)~~); and
- (2) ~~the Exchange Participant in question has~~ effective internal control procedures and risk management systems to manage such risks (Section ~~4(87)(c)~~).

This is irrespective of whether the person authorized is the Exchange Participant or one of its affiliates.

3.13. The SFC will normally look to the Exchange Participant to ensure that excess positions are properly used and any resultant risks properly managed, as that is the regulated entity within the group. Consequently, the SFC will expect a single entity within the group (normally the Exchange Participant, as that is the regulated entity) to carry the relevant positions. In other words, if any member within a group (including the Exchange Participant) is authorized to hold excess positions in a particular futures or options contract, the SFC will normally expect all of such person's holdings in that contract (i.e. not just the excess positions) to be ~~acquired and disposed of~~ held through an account carried by the Exchange Participant. Additionally, if the group Exchange Participant is not a clearing participant (of a recognized clearing house), positions must be carried through both the group Exchange Participant and a general clearing participant (of a recognized clearing house) appointed by the group Exchange Participant. The following further points should be noted also –

- (1) Positions can be carried through any affiliate, but must be carried through the group Exchange Participant at the Exchange level. Hence, if an affiliate is not an Exchange Participant but the group wants the positions to be carried through that affiliate, then the positions must be carried through both the group Exchange Participant (at the Exchange level) and that affiliate.
- (2) It is not necessary for execution (ie acquisitions and disposals) to be conducted through the group Exchange Participant. Accordingly, any execution broker may be used (including the group Exchange Participant).

3.14. These above requirements, together with those described in paragraph 3.12(1) above will facilitate the SFC monitoring compliance with the prescribed limits and any authorized excesses.

Application process for authorizations by the SFC

~~3.7.3.15.~~ An application for authorization from the SFC to hold excess positions ~~under Section 4(4)~~ may be submitted by the following persons:

(1) where authorization is sought under Section 4(5), either:

~~(i)(a)~~ the person acting as principal for the account(s) for which the authorization is sought; or

~~(ii)(b)~~ a person who acts as an agent for the principal; and

(2) where authorization is sought under Section 4(6), the Exchange Participant concerned.

3.16. In the case of an authorization under Section 4(6), although the application must be submitted by the Exchange Participant concerned, the SFC will not dictate which members of its group should take the excess positions and hence need authorization. However, where any member of a group is authorized to hold or control excess positions in respect of a particular contract, the SFC will normally expect all of its holdings in that contract (ie not just the excess positions) to be carried through the Exchange Participant. It follows therefore that the Exchange Participant will in any event need to be authorized under section 4(6) of the Rules.

~~3.8.3.17.~~ The application should be made in writing to the Enforcement Supervision of Markets Division of the SFC ~~in writing~~. Applications may be made on the basis of an immediate client request, or in advance in anticipation of clients' prospective needs based on past experience.

3.18. There is no prescribed format for the application. It can be a letter or any written document supported by reasons and/or supporting documents for the application. The application must be approved by the SFC before positions in the relevant futures contracts or stock options contracts may be increased above the prescribed limit.

~~3.9.3.19.~~ ~~To meet the conditions as described in Sections 4(4)(a) and (b), t~~The SFC will normally require the applicant to provide at least the following information ~~to in~~ support of the application:

~~(i)(1)~~ A description of the nature of positions held or controlled (including transactions in other related markets which are an integral part of the entire portfolio);

~~(ii)(2)~~ A full and complete explanation of the business needs for holding or controlling excess positions and (in the case of an application for authorization under Section 4(6)) how the excess positions will be used to support the business of the relevant Exchange Participant and (if applicable) the affiliate; and such explanation to include;

(a) the nature and size of the positions established, or to be established, in connection with the excess position for which

authorization is sought (“related positions”), and on which market (e.g. OTC market, overseas exchange markets) such positions have been, or will be, executed;

~~(iii)~~(b) An estimate of the maximum level of the excess positions intended to be established; and

~~(iv)~~(c) The estimated duration of holding or controlling the excess positions;

(3) in the case of an application for authorization under Section 4(6), details of:

(a) the relevant Exchange Participant’s and (if applicable) the affiliate’s financial position, such information to be sufficient to demonstrate that the Exchange Participant or affiliate has adequate financial capability to cover the potential risks arising from the excess position¹¹, and should normally include at least its latest annual audited accounts and information on its credit rating (if any);

(b) the relevant Exchange Participant’s internal control procedures and risk management systems, such information to be sufficient to demonstrate that the Exchange Participant has effective internal control procedures and risk management systems to manage the potential risks arising from the excess position¹², and should normally include at least the following:

(i) a brief summary of the risk management policies and procedures that will be adopted to monitor and address the key risks connected with the excess position (such as market risk, concentration risk, etc), including:

- the counterparty due diligence process that the Exchange Participant or its affiliate (as the case may be) will use when assessing the counterparty risk of clients who are, or will be, provided client facilitation services by the Exchange Participant or its affiliate in relation to the excess position held or controlled by it
- the contingency measures that will be applied to minimize the impact of a default by the

¹¹ This is required by Section 4(87)(b). The term “adequate financial capability” is defined in Section 4(104), i.e. the person or its holding company should have a net asset value of not less than HK\$2 billion as set out in its latest audited financial statements or a qualifying credit rating (defined in Part 5 of Schedule 1 of the SFO).

¹² This is required by Section 4(78)(c).

counterparties, including the procedures for dealing with the excess position in the event of such default

- the techniques that will be used to measure, monitor, control and reduce various types of risks arising as a result of the excess position and the related position

- (ii) a brief summary of the internal control procedures that will be put in place to ensure implementation of the risk management policies and procedures mentioned in the preceding sub-paragraph (i).

Depending on the facts and circumstances of each individual case, the SFC may also request other information as it considers necessary. The SFC may also have regard to any information or material in its possession which it considers relevant.

3.12.3.20. The SFC will determine ~~whether the applicant shall be approved an application~~ to hold or control excess positions on the basis of the information supplied, the relevant prescribed limits, the liquidity of the futures contracts or stock options contracts for which the authorization is sought and such other factors as the SFC deems appropriate ~~to ensure that the circumstances in Sections 4(4)(a) and (b) are satisfied.~~

3.13.3.21. As a guiding principle, the SFC will not grant an authorization for any excess if the ~~circumstances in Sections 4(4)(a) and (b)~~ relevant preconditions¹³ are not satisfied, or if the authorization is inconsistent with the SFC's regulatory objectives in Section 4 of the SFO, in particular:

~~(i)~~ (1) to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;

~~(ii)~~ (2) to reduce systemic risks in the securities and futures industry; or

~~(iii)~~ (3) to assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

3.14.3.22. The SFC may decide to approve or deny the application or impose conditions on the authorization. Conditions imposed on an authorization may be varied or revoked subsequently on at least five business days' notice. New conditions may also be imposed (Section 4(9)(c)). A notice of decision will be provided to the applicant in writing (Section 4(4)(c)).

3.24.3.23. The SFC will endeavour to notify the applicant of its decision within ~~ten business days~~ four weeks after all information as requested by the SFC to

¹³ Relevant preconditions here refers to (in relation to an application under Section 4(5)), the limitations and other matters described in Sections 4(4)(b) and 4(5); and (in relation to an application under Section 4(6)), the limitations and other matters described in Sections 4(4)(b), 4(6), ~~4(7)~~ and ~~4(78)~~.

support the application is provided to its full satisfaction. However, since authorizations that may be granted by the SFC under Section 4(45) are special cases, it may take more time for the SFC to consider and review some particular cases. A person who has the need to exceed the prescribed limits is advised to submit an application accompanied by the supporting information to the SFC as soon as practicable.

Use and evidencing use of excess positions

3.24. Excess positions must be used to hold positions that facilitate client transactions. However, the SFC will not require that they be used in relation to a particular client transaction, or a particular client. Similarly, the SFC will not impose any limitation on the order in which excess positions are used. Appendix 1 further illustrates how excess positions may be used.

3.25. The SFC will expect Exchange Participants/their affiliates to evidence the use of their excess positions. To this end, the SFC will expect authorized Exchange Participants/affiliates to submit regular reports confirming the amount of excess used, the type of clients involved, and a general description of the nature of the client transactions including their notional and market values. Exchange participants/affiliates will need to provide an overall description of the positions they have taken, but not details in relation to each client on an individual basis. The SFC will normally require reports to be submitted quarterly within two weeks of the end of the relevant quarter. However, more frequent or additional reporting requirements may be required in individual cases as necessary.

Validity and renewal of authorizations by the SFC

~~3.14.~~**3.26.** A person who has ~~received the authorization from~~ been authorized by the SFC ~~to hold or control an excess position within a certain period of time under Section 4(5) or 4(6)~~ should submit a new application to the SFC if he wishes to continue to hold or control the excess position after the expiration date of the initial authorization. The new application should be submitted to the SFC no later than ~~five~~ **ten** business days prior to the expiration date of the initial authorization. If the SFC does not grant any further authorization for the excess position, the person will be required to close out the position in excess of the prescribed limit upon the expiration date of the initial authorization.

~~3.14.~~After an authorization is granted by the SFC, if there are any material changes in the information previously provided to the SFC, the applicant must immediately submit the updated information to the SFC. The SFC will decide if the authorization granted is still valid. Should the applicant fail to submit such information, he may not continue to rely upon the authorization granted. That is, he may be requested to close out the excess positions.

Withdrawal of authorizations by the SFC

3.27. The SFC may at any time withdraw an authorization granted under Section 4(5) or 4(6) by giving at least ~~seven~~ **five business** days' notice to the person (Section ~~4(910)~~ **4(b)**). Upon a withdrawal coming into effect, the authorization will cease to apply.

3.28. In determining the effective date of a withdrawal, the SFC will consider:

- (1) whether any excess positions are already held or controlled and if so, whether they are within the limits of the authorization previously granted;
- (2) when the relevant contracts are due to expire;
- (3) whether the withdrawal may be delayed until the time of such expiry taking into account the reasons for the withdrawal.

3.29. As a guiding principle, the SFC will not normally consider withdrawing an authorization unless it believes:

- (1) one or more of the relevant preconditions¹⁴ cease to exist;
- (2) the authorization ceases to be consistent with the SFC's regulatory objectives in Section 4 of the SFO; or
- (3) one or more of the conditions attached to the authorization have failed to be met and adequate steps have not been taken, or cannot be taken, to rectify the failure and avoid similar failures in future.

Appeals

3.16.3.30. A person may appeal against a decision of the SFC to refuse to authorize an excess position under Section 4(45) or 4(6) of the Rules to the Securities and Futures Appeals ~~Panel~~-Tribunal ("**Tribunal**") pursuant to Section 216 of the SFO¹⁵ (Section 4(4)(c) and item 78 under Division 1 of Part 2 of Schedule 8 of the SFO). An application for review of the decision must be made to the Tribunal by the person against whom the decision is made within 21 days of notice of the decision. Upon review of the decision under appeal, the Tribunal may confirm, vary or set aside the decision or substitute any other decision which the Tribunal considers more appropriate or it may remit the matter to the SFC with directions to revisit the decision. For the avoidance of doubt, before the Tribunal determines otherwise, the decision of the SFC shall remain valid and the person is required to act ~~on~~ in accordance with the decision of the SFC.

Positions held or controlled indirectly by virtue of corporate relationship

3.17.3.31. As discussed in paragraph 2.72.7 above, the SFC considers that the prescribed limits do not apply to a person who controls positions merely by virtue of its corporate relationship. In view of this, if a person is permitted by the SFC to hold or control excess positions, its affiliates (including any ~~or~~ holding company), which indirectly controls the same positions by virtue only

¹⁴ See footnote 13 above.

¹⁵ As set out in Part 2 of Schedule 8 of the SFO, the Tribunal has jurisdiction over the decision made by the SFC under Section 4(4) of the Rules.

of the corporate relationship, will not be required to seek ~~the~~ approval from the SFC separately to control the positions.

4. Notice of Reportable Positions

Reportable positions

- 4.1. In order to facilitate the HKFE and SEHK in monitoring market activities, Section 6(1) of the Rules requires a person holding or controlling a reportable position to notify the recognized exchange company of that reportable position in writing.
- 4.2. Reportable positions for futures contracts and stock options contracts are specified in Schedule 1 and Schedule 2 of the Rules respectively. Similar to the prescribed limits, the reportable positions for futures contracts are calculated based on the number of contracts held or controlled for a contract month¹⁶ or series while the reportable positions for stock options contracts are calculated based on the number of contracts held or controlled in an expiry month.
- 4.3. The aggregation requirements as mentioned in paragraphs ~~2.6~~ 2.6 and ~~2.7~~ 2.7 above equally apply to the reportable positions for futures contracts and stock options contracts.

Responsibilities of reporting

- 4.4. The notice of a reportable position specified in Section 6(1) may be submitted by:
 - ~~(i)~~ (1) a person (e.g. the Exchange Participant) acting as an agent for the principal to carry the account of the reportable position; or
 - ~~(ii)~~ (2) the person acting as principal for the reportable position.

If one of the above parties has submitted the notice of the reportable position to the Exchange, the SFC accepts that the other parties will not be required to notify the Exchange of the same reportable position under Section 6(1).

- 4.5. In other words, a person holding or controlling a reportable position can choose to submit the notice of the reportable position to the Exchange directly or through an Exchange Participant or its agent where the latter agrees to make the report on the person's behalf. However, no matter which party is chosen by the person to submit the notice to the Exchange, it is the responsibility of each person holding or controlling the reportable position to fulfill its obligations under Section 6(1).
- 4.6. In the event that a person holds or controls a reportable position in accounts at more than one agent, the person should have the sole responsibility to notify the Exchange of the reportable position. If the person decides to submit the

¹⁶ The reportable positions for HSI futures contract, HSI options contract, Mini-HSI futures contract or Mini-HSI options contract are also based on the number of contracts held or controlled.

notice of the reportable position to the Exchange through the agents, it should provide to one agent its total positions held at other agents so that the agent can submit the notice of the reportable position to the Exchange on its behalf. Alternatively, the person can ask all agents to separately report positions in each of the accounts to the Exchange even though positions in the individual accounts may not exceed the reportable level.

- 4.7. Similar to the prescribed limits, the SFC agrees that a person controlling a reportable position merely by virtue of its corporate relationship is not required to submit the notice of the reportable position to the Exchange.

Reporting requirements

- 4.8. In accordance with Sections 6(1)(a) and (b), the notice of reportable positions should be made within one reporting day following:

(i)(1) the day on which the person first holds or controls the reportable positions; and

(ii)(2) each succeeding day on which the person continues to hold or control the reportable positions.

For the avoidance of doubt, once a person has held or controlled a reportable position, it will be required to file the notice of the reportable position to the HKFE or SEHK (as the case may be) on each reporting day even though his position remains unchanged.

- 4.9. Section 6(2) of the Rules further requires that the notice of a reportable position shall be accompanied by the following information:

(i)(1) the number of futures contracts or stock options contracts held or controlled by the person in respect of the reportable position in each relevant contract month; and

(ii)(2) where the reportable position is held or controlled for another person (e.g. a client), the identity of that person and the number of futures contracts or stock options contracts held or controlled for such person in respect of the reportable position in each relevant contract month.

In respect of the information about the identity of a client, the requirements are set out in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission and the Client Identity Rule Policy.

- 4.10. In the stock options market, positions held by a market maker are recorded by the SEHK Options Clearing House in a segregated clearing account. Under SEHK rules, positions held by market makers in segregated clearing accounts are treated as having been reported to the SEHK. The SFC accepts that if the segregated clearing account is used exclusively to keep positions of a single market maker, the market maker will be deemed to have fulfilled the reporting requirements as stated in Sections 6(1) and 6(2) of the Rules.

- 4.11. Appendix 42 provides examples to illustrate the application of the prescribed limits and reportable positions.

Other reporting requirements specified by the HKFE/SEHK

- 4.12. The HKFE and SEHK have developed more detailed reporting requirements to facilitate their monitoring of reportable positions as required under Section 6 of the Rules. These requirements include the use of a prescribed form for reporting and the specific deadline for submission of the notice of reportable positions¹⁷.
- 4.13. The HKFE and SEHK also request Exchange Participants to provide additional information other than those specified in Section 6(2) such as (i) the account number, account name and identity of the transaction originator of a reportable position; (ii) the nature of a reportable position (i.e. for hedging, arbitrage or trading purposes); and (iii) the account type (i.e. house account, client account or market maker account). Exchange Participants should refer to the relevant position reporting procedures prescribed by the HKFE or SEHK for details.
- 4.14. In order to assess the systemic impact of large reportable positions on the market and monitor concentration risk more effectively, the HKFE and SEHK may make enquiries into transactions/positions in other markets (e.g. OTC market) underlying the reportable positions held by Exchange Participants. For this reason, Exchange Participants may be requested by the HKFE or SEHK to obtain details of such transactions/positions from the clients or their counterparties. Failure to provide such information to the HKFE or SEHK could lead to the imposition of position limits other than the prescribed limits according to the HKFE or SEHK rules.

Penalties

- 4.15. A person who contravenes Section 6 of the Rules without reasonable excuse is liable (i) on conviction on indictment to a fine of HK\$100,000 and to imprisonment for 2 years; or (ii) on summary conviction to a fine of HK\$10,000 and to imprisonment for 6 months.

5. Compliance by Agents

- 5.1. Section 7 of the Rules enables a person who holds or controls futures contracts or stock options contracts for other persons to apply the prescribed limits and reportable positions separately to his own position and to each of the positions he holds or controls for other persons except where the person has discretion over the positions held or controlled by him for the other persons. In other words, a person can disaggregate his own position and the positions he holds or controls for each of the other persons in the application of prescribed limits and reportable positions provided that he does not have discretion over the positions held or controlled for the other persons. A typical example of such

¹⁷ HKFE requires Exchange Participants to submit the notice of reportable positions by 12:00 noon on the reporting day (T+1).

person is an Exchange Participant or a person providing intermediary services to its clients.

- 5.2. In accordance with Sections 7(2) and (3) of the Rules, a person will be considered to have discretion in relation to a position he holds or controls for another person if:

(i) he may originate orders to acquire or dispose of any position in futures contracts or stock options contracts under a general authorization from the other person, whether the authorization is pursuant to a written agreement, power of attorney or otherwise; and

(ii) such authorization enables him to make specific acquisitions or disposals without requiring further consent or instruction from the other person.

and in such case, he will not be regarded as holding or controlling the position for the other person for the purpose of applying the disaggregation provision to this position.

Examples of such person include a fund manager controlling positions for his funds and a trader managing discretionary accounts. However, it does not include a trader with a short-term discretion from his client to manage an order (e.g. if a client leaves an order to buy or sell futures contracts at any price within a specified range, the agent will not be regarded as having discretion) or a firm initiating orders to close out a position held for its client for risk control purposes (e.g. the client has defaulted on his payment to the firm).

- 5.3. If a person has discretion over positions held with him for other persons, all these positions should be aggregated with his own position in the application of the prescribed limits and reportable positions.

- 5.4. *For example, an agent holds 400, 3,000, and 8,000 futures contracts for Clients A, B and C respectively. Client A is a discretionary account operated by the agent. The agent also holds 200 futures contracts for his own account. Since the agent has discretion over the position held for Client A, the agent's own position and Client A's position should be aggregated in the application of the prescribed limits and reportable positions. Assume that the reportable level is 500 contracts and the prescribed limit is 10,000 contracts. The agent should notify the Exchange of each of the reportable positions held with him (i.e. 600 contracts held by its own account and Client A, 3,000 contracts held by Client B and 8,000 contracts held by Client C) and identities of the persons. Since these reportable positions are within the prescribed limit, the agent fully complies with the Rules.*

- 5.5. If a person is aware that a number of its client accounts are held for the same person, all positions in these accounts should not be treated separately. They should be aggregated for purposes of determining compliance with the Rules.

- 5.6. There are situations where a person holds or controls positions for the other person who is acting as agent. In accordance with the Client Identity Rule Policy, a person holding or controlling positions for an agent should find out who are the ultimate clients and obtain the client identity information from the agent. As an agent is allowed to disaggregate positions held for his clients, his total positions may exceed the prescribed limits even though each of the client positions is within the limits. The SFC accepts that a person is in compliance with the prescribed limits in respect of the positions held for an agent provided that he has obtained the client identity information to determine that the agent is allowed to hold excess positions in accordance with the Rules. If the person is not able to obtain the client identity information to decide whether the agent complies with the prescribed limits (e.g., the agent does not want to disclose the information for commercial reasons), the person should not apply the disaggregation provision to this agent account (i.e., all positions held by the agent should be aggregated in applying the prescribed limits).

6. Application of the Rules to Different Entities

Persons holding or controlling positions at multiple firms

- 6.1. If a person holds or controls positions in accounts at more than one firm, the person should have the obligation to aggregate positions for purposes of applying the prescribed limits and reportable position requirements.
- 6.2. If a person holding or controlling positions at multiple firms chooses to submit the notice of reportable positions to the Exchange through one of the firms (e.g. an Exchange Participant) where the firm agrees to submit the notice on the person's behalf, it should provide to the firm its total positions held at other firms.
- 6.3. For the avoidance of doubt, if a person holds a reportable position but only part of the position (which has not exceeded the reportable level) is held by a firm, the firm will not need to report that position to the Exchange unless it knows that the total position held by the person in other firms has exceeded the reportable level.

Transaction originators

- 6.4. A transaction originator is a person who is ultimately responsible for originating instructions for transactions on behalf of the other person. The most common type of transaction originator is a fund manager who manages assets of a fund at his own discretion according to the investment policy of the fund. As explained in paragraph [5-25.2 above](#), since the transaction originator has discretion in relation to positions he holds or controls for his principals, he is not allowed to disaggregate the positions held or controlled for each of the principals for the purpose of applying the Rules.
- 6.5. If the total positions controlled by a transaction originator (including positions belonging to different principals, e.g., different funds, but under his control) have exceeded the reportable level, the transaction originator will be required to notify the HKFE or SEHK (as the case may be) of such positions. As required in Section 6(2) of the Rules, the transaction originator should also

provide the information about identities of each of his principals whose positions have exceeded the reportable level. *For example, a fund manager is in charge of the investment of three funds, namely, Fund A, Fund B and Fund C. Currently, there are 1,000, 800 and 200 futures contracts held by Fund A, Fund B and Fund C respectively. If the reportable level for the futures contract is 500 contracts, the fund manager should notify the Exchange of the total positions under his control (i.e., 2,000 contracts), names of the funds in which position has exceeded the reportable level (i.e., Fund A and Fund B) and the positions held in these funds.*

- 6.6. A transaction originator can choose to notify the HKFE or SEHK (as the case may be) of the reportable positions by himself or through its agent (e.g. an Exchange Participant) which agrees to make the report on his behalf.
- 6.7. The prescribed limits apply to the total positions controlled by a transaction originator even if the positions are held for different principals.

Omnibus accounts

- 6.8. In the case of an omnibus account, the Rules apply separately to the positions held by each of the underlying clients of the omnibus account except where the omnibus account operator has discretion over the positions. For this reason, positions held by different underlying clients should not be netted off for purposes of calculating and reporting reportable positions or determining compliance with the prescribed limits.
- 6.9. -If an underlying client of the omnibus account holds or controls a reportable position, the omnibus account operator should inform the HKFE or SEHK (as the case may be) of such reportable position. An omnibus account operator can notify the Exchange of the reportable positions by itself or ask its agent (e.g. an Exchange Participant) carrying the account to submit the notice of reportable positions. The notice of reportable positions should be accompanied by the information about identities of the underlying clients whose positions have exceeded the reportable level.
- 6.10. There are situations where an underlying client of the omnibus account is also an omnibus account, i.e., there are more than one layer of omnibus account. If the omnibus account operator in one layer has notified the Exchange of the reportable positions held by the ultimate clients including identities of each of them (either by itself or through its agent), the SFC accepts that the other omnibus account operators below this layer will not be required to notify the Exchange of any reportable positions held in their accounts.

Example:

Suppose that Exchange Participant A has an omnibus account B holding 1,000 long futures contracts. One of the underlying clients of omnibus account B is also an omnibus account (account C) which holds 900 long futures contracts. Positions in omnibus account C are owned by Company D (800 long futures contracts) and other small investors (a total of 100 long futures contracts).

Assume that the reportable level is 500 contracts. Exchange Participant A should inform the Exchange of the position held by the omnibus account B (i.e. 1,000 contracts). If the operator of omnibus account B has obtained the information about the ultimate client from the operator of omnibus account C and notified the Exchange of the reportable position held by Company D including its identity (the reportable position can be reported to the Exchange by the operator B itself or through the Exchange Participant A), the operator of omnibus account C will not be required to submit any notice of reportable positions to the Exchange.

- 6.11. Where the omnibus account operator has discretion over positions held with it, it should aggregate such positions with its own position in the application of the prescribed limits.

Appendix 1

Examples illustrating the use of excess positions

Example 1:

Assume a firm already holds 5,000 HSI futures contracts for proprietary trading purposes and 5,000 HSI futures contracts for clients. Assume also that the specified percentage for HSI futures contracts is 50%. Can the firm apply for excess?

- Yes, it can apply for excess of up to 5,000 contracts. *(See also the Note below.)*

Example 2:

Assume a firm holds 10,000 HSI futures contracts for hedging client-driven transactions. Assume also that the specified percentage for HSI futures contracts is 50%. Can the firm can still apply for excess?

- Yes, it can apply for excess of up to 5,000 contracts. *(See also the Note below.)*

Example 3:

Assume a firm's existing client facilitation business has used a position delta equivalent to 9,000 HSI futures contracts, and that its proprietary trading desk wishes to trade 6,000 HSI futures contracts. Assume also that the specified percentage is 50%. Can the firm apply for excess?

- Yes, it can apply for excess of up to 5,000 contracts. *(See also the Note below.)*

Note: In each of the above 3 examples, if an excess of 5,000 contracts is authorized, the firm's limit will increase to 15,000 contracts. In each case –

- The firm can use up to 10,000 contracts for proprietary trading purposes and any remaining balance for client facilitation purposes. The firm may therefore also use the entire 15,000 limit for client facilitation purposes if it holds no proprietary trading position.
- The SFC is not concerned as to the order in which the limit is consumed (ie whether the limit is first used to acquire contracts for client facilitation purposes and then for proprietary trading purposes or vice versa). It is however concerned to ensure that any holdings over 10,000 contracts are held only for client facilitation purposes – ie that holdings for proprietary trading purposes do not exceed the statutorily prescribed limit (ie 10,000 contracts in the above examples).

Example 4:

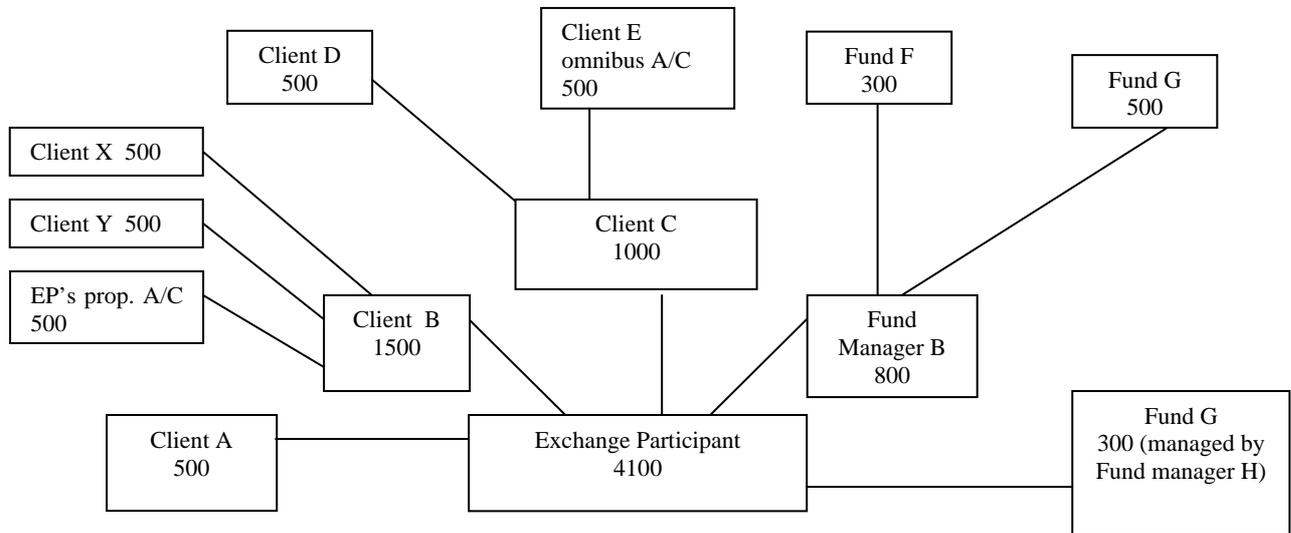
Assume the facts as stated in Example 3, and that the SFC has authorized an excess of 5,000 contracts. Assume also that the firm's client facilitation position then fluctuates, from time to time, between 3,000 and 12,000 position delta. Will the authorized excess be automatically withdrawn or otherwise affected simply because of the fluctuation?

- No, the authorized excess will not be automatically withdrawn or invalidated just because the client facilitation position falls below 3,000 (or any other amount).

- Authorizations for excess will usually be granted for a specified period of time and the excess authorized may be used at any time during that period unless withdrawn. The SFC will normally only consider withdrawing an authorization in the circumstances listed in paragraph 3.29 of this Guidance Note. It will not consider withdrawing an authorization simply because of fluctuations in use.

Appendix 12

For example: Reportable Position is 450 contracts



Client A has an account with the Exchange Participant which contains 500 contracts.

The Exchange Participant has a client account under the name of **Client B** which it uses for booking transactions for his **proprietary trading** and for the trading of **Clients X and Y**. Client X and Client Y each hold 500 contracts. The Exchange Participant's proprietary position booked into the Client B account is also 500 contracts. The Client B account therefore has a total of 1500. Provided that the Exchange Participant does not have discretion over Client X's and Client Y's positions, Client X, Client Y and the Exchange Participant's proprietary position can each be treated separately (i.e., disaggregated) by virtue of [Section 7](#) of the Rules.

Client C is a non-exchange participant agent. He holds positions for Clients D and E who have 500 contracts each. Client E is an omnibus account. Provided that Client C does not have discretion over Client D's and Client E's positions, positions held for Clients D and E can be treated separately. In respect of the omnibus account itself, if the operator of Client E does not have discretion over positions in the account, it can apply disaggregation to the positions held for each of the underlying clients.

Fund Manager B has an account with the Exchange Participant. He manages **Funds F and G** which hold 300 and 500 contracts respectively. Separately, Fund G has an account with the Exchange Participant. This account is managed by Fund Manager H. Fund G, through this account, holds 300 contracts. Funds F and G's trades held by Fund Manager B are executed by him. The positions held for Funds F and G cannot be treated separately as Fund Manager B has discretion over these positions.

Notices of Reportable Positions to be filed –

(a) the Exchange Participant should notify the Exchange of –

- 500 contracts each for its proprietary position and Client A, 1500 contracts held by Client B, 1000 contracts held by Client C, and 800 contracts held by Fund Manager B.

- (b) Client B should notify the Exchange of 500 contracts each held by the EP's proprietary account, Client X and Y.
- (c) Client A, Client X, Client Y, Client D, Client E, should each notify the Exchange of their own positions of 500 contracts.
- (d) Client C should notify the Exchange of 500 contracts each held by Client D and Client E.
- (e) Fund Manager B should notify the Exchange of the 800 contracts he controls and that 500 contracts are for Fund G.
- (f) Fund G should notify the Exchange of its 800 contracts, 500 of which are held by Fund Manager B and 300 held by Fund Manager H.

Notwithstanding the above filing requirements, the notice of a reportable position may be submitted by the agent or the person acting as principal (see paragraph 4.4). As long as there is an arrangement in place for reporting such positions, the SFC accepts that if one of the parties has submitted the notice of reportable position, the other parties will not be required to notify the Exchange of the same reportable positions.