



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

**Consultation Conclusions on Proposed Enhancements
to the Position Limit Regime and Associated
Amendments to the Securities and Futures (Contracts
Limits and Reportable Positions) Rules and the
Guidance Note on Position Limits and Large Open
Position Reporting Requirements**

21 March 2017

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Executive Summary

1. On 20 September 2016, the Securities and Futures Commission (SFC) issued a public consultation proposing a number of enhancements to the position limit regime (Consultation Paper). The SFC sought comments on these policy proposals and modifications to the Securities and Futures (Contracts Limits and Reportable Positions) Rules (CLRP Rules) to reflect the proposed enhancements.
2. During the consultation period, which ended on 21 November 2016, the SFC received 10 written submissions from various market participants and professional bodies. The list of respondents is set out in Appendix A, and their comments (unless requested to be withheld from publication) can be viewed on the SFC's website.
3. This paper sets out the SFC's conclusions and responses to the comments received as well as the way forward after taking the public feedback into account. This conclusions paper should be read in conjunction with the corresponding Consultation Paper.
4. In general, most respondents were supportive of the proposals to enhance the position limit regime, although a number of them suggested that the SFC should consider relaxing some requirements and criteria for the proposed excess position limits.
5. After carefully considering the comments received, the SFC is of the view that the proposals in the Consultation Paper are appropriate for the Hong Kong market and will proceed accordingly. However, in response to market feedback, the SFC has decided to lower the assets under management (AUM) requirement applicable to the proposed Asset Manager Excess Position Limit from \$100 billion to \$80 billion.
6. There were no substantive comments on the amendments to the CLRP Rules as proposed in the Consultation Paper. The SFC will make corresponding changes to the CLRP Rules to reflect the lower AUM requirement. The SFC will also take the opportunity to add statutory position limits and large open position reporting requirements for a number of new futures contracts to Schedule 1 to the CLRP Rules. These amendments are routine amendments to the CLRP Rules related to new futures and options contracts launched by Hong Kong Exchanges and Clearing Limited (HKEX).
7. The SFC is planning to submit the proposed amendments to the Legislative Council for negative vetting before the end of March 2017. Subject to the legislative process, we expect the amended CLRP Rules to become effective on 1 June 2017.

Comments Received and Our Responses

I. Client Facilitation Excess Position Limit

8. In the Consultation Paper, the SFC proposed to raise the cap on the excess position limit that may be granted under the existing Client Facilitation Excess Position Limit from 50% to 300% and to tighten the adequate financial capability requirement by increasing the net asset value (NAV) requirement from \$2 billion to \$5 billion. The majority of the respondents supported the proposal to increase the cap to 300% and considered that the proposed increase in the NAV requirement is consistent with market growth.

Cap on the Excess Position Limit

Public comments

9. One respondent commented that the SFC should consider granting an excess limit of 300% to all successful applicants rather than treating it as an upper limit. The respondent was also of the view that the proposed 300% cap is still very conservative compared to other markets. Another respondent commented that setting a constant upper cap on the excess position limit makes it too rigid to cater for future changes and the SFC should consider future needs in determining the cap.

The SFC's response

10. We would like to reiterate that our purpose in raising the cap on the excess position limit is to facilitate the use of exchange-traded contracts by market participants to meet their business needs, but we are also mindful of potential risks associated with increased positions. Rather than authorizing the use of the upper limit by all successful applicants, it is important to consider the actual need of each applicant on a case-by-case basis and to determine the level of excess position after taking relevant factors into account, including prevailing market conditions. Furthermore, it is worth noting that, as mentioned in our Consultation Paper, our analysis of Hang Seng Index (HSI) and Hang Seng China Enterprises Index (HHI) futures and options markets showed that the existing position limit should be sufficient to meet the business needs of the majority of market participants. Thus, we believe the six-fold increment to 300% should be sufficient. Furthermore, the SFC will conduct ongoing reviews in the future to consider if there is a need for any further changes.

Tightening the "Adequate Financial Capability" Requirement

Public comments

11. We received support from respondents to tighten the "adequate financial capability" requirement, but views varied on how it should be tightened. One respondent suggested setting a lower minimum financial requirement and increasing it on a case-by-case basis. Some respondents commented that a scaled financial requirement should be implemented in accordance with the actual excess position limits granted by the SFC.

The SFC's response

12. As explained in the Consultation Paper, we are of the view that the "adequate financial capability" requirement should be kept simple to minimise any compliance burden. Thus, we believe the minimum NAV requirement of \$5 billion is appropriate. It is also important

for us to ensure that all applicants have reached a sufficient business scale and have sufficient resources to manage the risks of the excess positions granted.

Transitional arrangements for the “Adequate Financial Capability” Requirement

Public comments

13. One respondent enquired about the transitional arrangements for existing applicants in relation to the tightening of the “adequate financial capability” requirement.

The SFC’s response

14. In formulating the proposed requirement, we reviewed its potential impact on all existing applicants. Based on available information, our assessment indicated that the proposal should not have any adverse impact on existing applicants as they all are able to meet the new “adequate financial capability” requirement. Prior to the implementation of the proposal, the SFC will continue to monitor the situation and hold discussions with existing applicants if needed.

Further clarification of client facilitation and the assessment criteria

Public comments

15. One respondent commented that the SFC should provide more clarity on the definition of client facilitation as well as the application process, whilst another respondent considered that the application assessment criteria and process are not sufficiently clear and transparent.

The SFC’s response

16. The term “client facilitation” is broadly defined as catering for different business needs and arrangements that require an Exchange Participant (or its affiliate) to engage in hedging activities to facilitate the provision of services to its clients. This is set out in section 3 of the existing Guidance Note on Position Limits and Large Open Position Reporting Requirements (Guidance Note) which includes an example to explain client facilitation. We revised the Guidance Note to set out the application process and required documents for each type of excess position limit. As is our current practice, the SFC encourages potential applicants to contact us should they have any questions about the application process or requirements.

Introduction of Hedging Exemptions

Public comments

17. There was a comment that the SFC should consider introducing hedging exemptions similar to those offered in overseas markets to encourage and promote bona fide risk management activities.

The SFC’s response

18. We would like to explain that the existing Client Facilitation Excess Limit and the new proposed excess limits are intended to provide a mechanism for market participants to use exchange-traded futures and options to hedge their relevant business activities. Based on our previous engagement with market participants, we consider that the proposed excess limits will be able to meet their hedging needs. At this stage, we do not consider it necessary to introduce a blanket hedging exemption.

II. ETF Market Maker Excess Position Limit

Public comments

19. Respondents were supportive of the proposed exchange traded fund (ETF) Market Maker Excess Position Limit, where an ETF market maker or liquidity provider may be authorized by the relevant recognized exchange company to hold or control futures or stock options contracts in excess of the statutory prescribed limit for hedging purposes.
20. One respondent commented that there should be some requirements or guidance on the eligibility of ETF market makers and liquidity providers so as to avoid abuse or misuse. The respondent noted that while some ETF market makers make a market for more than 100 ETFs, others may make a market for only one ETF. Therefore not all ETF market makers have the same needs and capabilities for handling excess positions.

The SFC's response

21. We would like to clarify that the proposed ETF Market Maker Excess Position Limit will be applicable mainly to market makers for ETFs tracking the HSI or HHI. Other ETF market makers will not be eligible for the proposed excess position limit. In addition, similar to existing provisions for other market makers or liquidity providers, the relevant recognized exchange company will have appropriate rules and guidelines in place to monitor potential abuse or misuse by ETF market makers.

III. Index Arbitrage Activity Excess Position Limit

Public comments

22. Respondents generally supported the proposed Index Arbitrage Activity Excess Position Limit and agreed to the proposed definition of "index arbitrage". Two respondents who requested anonymity suggested some changes to the proposed definition. We reviewed their suggestions but consider that the definition need not be revised.
23. Respondents were mostly supportive of the proposed eligibility criteria for the Index Arbitrage Excess Position Limit applicable to an Exchange Participant or its affiliate. However, one respondent was concerned about potential abuse by applicants, as monitoring of index arbitrage activities might be difficult, and suggested that the SFC should issue further guidance to ensure that the excess position limit granted will be used solely for index arbitrage activities. The respondent was also of the view that a segregated account should be established solely for index arbitrage activities in order to facilitate the monitoring of positions by regulators and Exchange Participants.

The SFC's response

24. We agree that both the SFC and the applicant should have the ability to distinguish and monitor the use of excess position limits for index arbitrage activities. We therefore propose that as part of the SFC's assessment of the applicant's internal control procedures, we would expect the applicant to have a standalone trading desk/book to conduct its index arbitrage activities.
25. In light of the comments received, we studied a number of index arbitrage manipulation cases, including in overseas markets. We noted that in some cases, the firms

established additional proprietary positions to take advantage of the price movements caused by the unwinding of index arbitrage positions. To further address the risk of misuse or abuse, the SFC will take into consideration whether the applicant has in place a Chinese wall (or equivalent internal control measures) between its index arbitrage trading desk and other trading desks. To detect and prevent potential misuse or abuse, we will also ask the applicant to demonstrate, to the satisfaction of the SFC, the effectiveness of its internal controls and compliance monitoring process.

26. Accordingly, we amended paragraph 3.25 of the Guidance Note to reflect the additional requirements proposed above.

IV. Asset Manager Excess Position Limit

Public comments

27. All respondents agreed with the proposal to introduce an Asset Manager Excess Position Limit, and one respondent was of the view that the proposal will promote Hong Kong as an asset management centre.
28. Most respondents were supportive of the proposed eligibility requirements for the Asset Manager Excess Limit. However, a number of respondents raised concerns about the proposed AUM requirement of \$100 billion. These concerns largely fall into two areas: i) the rationale for setting this requirement; and ii) that the requirement is much higher than the AUM size of many asset managers, particularly hedge fund managers. We also received a comment suggesting the eligibility criteria be expanded to allow not only entities licensed or registered for Type 9 regulated activity but also all equivalent regulated entities in overseas jurisdictions.

The SFC's response

29. We would like to further explain the rationale for setting the AUM requirement. We estimated that on average, the aggregate notional value of statutory position limits for HSI futures and options as well as HHI futures and options contracts amounted to \$16 billion from 1 July 2015 to 30 June 2016. As mentioned in the Consultation Paper, the proposed Asset Manager Excess Position Limit is intended to facilitate portfolio management. We therefore expected that asset managers who sought to apply for excess position limits would invest only a part of their funds in futures and options contracts. Based on various estimates, we made the assumption that the majority of large asset managers would invest 10% to 20% of their portfolio value in derivatives products. Therefore, an asset manager with an AUM ranging from \$80 to \$160 billion could reach the statutory position limits and need to seek an excess position limit. It is on this basis that we proposed to set the AUM requirement at the lower end of the range, ie, \$100 billion. In view of respondents' requests to lower the AUM requirement, the SFC is agreeable to lowering the proposed AUM requirement to \$80 billion.
30. As to the comments that many smaller-sized asset managers (as measured by AUM) would be excluded from the proposed excess position limit, we noted that according to the SFC's Fund Management Activities Survey, the fund size of asset managers in Hong Kong averaged \$17 billion in 2014 and \$15 billion in 2015. Given the small average fund size relative to the notional value of the statutory position limits, the SFC is of the view that the current position limits should be sufficient to cater for the needs of smaller-sized asset managers.

31. It is important for the SFC to have a direct regulatory handle on the utilisation of excess position limits. We are therefore of the view that it would not be appropriate to expand the eligibility criteria for the proposed excess position limit to cover equivalent regulated entities in overseas jurisdictions.

V. Stock Options Contracts Position Limit

Public comments

32. All respondents were supportive of the proposed increase in the statutory position limit for stock options to facilitate market development. Most respondents also supported the proposal to increase the statutory position limit from 50,000 to 150,000 contracts. However, one respondent expressed the view that the single limit of 150,000 contracts is inconsistent with HKEX's proposed three-tier position limits (ie, 50,000, 100,000 and 150,000 contracts), and that this might create unnecessary confusion as well as administrative burdens for exchange participants and market makers.

The SFC's response

33. As we explained in the Consultation Paper, the proposal to increase the statutory position limit to 150,000 contracts is intended to facilitate the implementation of HKEX's proposed three-tier position limit model, which will re-assign the position limit tier levels for stock option contracts based on a pre-determined formula on a regular or an ad-hoc basis. If the statutory position limit for stock options were to be set at three tiers, corresponding to those proposed by HKEX, then future new tier levels assigned by HKEX as a result of its regular or ad-hoc reviews could not be implemented until after the completion of legislative amendments to the CLRP Rules. For this reason, the SFC considers it appropriate to maintain the proposed increase in the statutory position limit of stock options contracts to 150,000. The proposal is also consistent with the existing approach for the statutory position limit for stock options.

VI. Proposed Amendments to the CLRP Rules and the Guidance Note

34. No substantive comments were received on the proposed amendments to the CLRP Rules. Apart from a change to reflect the revised AUM requirement and a few editorial changes, we will adopt the amendments to the CLRP Rules as proposed. Also, a few minor changes will be made to existing definitions of some terms used in the CLRP Rules for the purpose of clarity; these changes do not affect the substantive content of the definitions¹. Moreover, the SFC is taking this opportunity to add the statutory position limits and large open position reporting requirements for a number of new futures contracts into Schedule 1 to the CLRP Rules. For details, please refer to items 5, 13, 18, 19 and 20 in Schedule 1. The SFC is also making a few minor drafting amendments to the descriptions of futures contracts referred to in items 4, 5 and 9 in Schedule 1 so that the descriptions in Schedule 1 are consistent. These amendments are not related to the consultation but are part of the regular amendments to the CLRP Rules made by the

¹ The definitions of "adequate financial capability" and "specified contract" in Section 2(1) are amended.

SFC in relation to new futures and options contracts launched by HKEX and for housekeeping purposes.

35. Similarly, we also did not receive any substantive comments on proposed changes to the Guidance Note. Therefore, we will adopt the changes as proposed along with the additional provisions for assessing an applicant's internal control procedures for the Index Arbitrage Activity Excess Position Limit as discussed above.

Conclusions and Way Forward

36. After considering all comments and suggestions, the SFC concludes that the proposals as set out in the Consultation Paper will be adopted, with the exception of the AUM requirement applicable to the Asset Manager Excess Position Limit, which will be lowered from \$100 billion to \$80 billion.
37. The SFC is planning to submit the proposed amendments to the CLRP Rules to the Legislative Council for negative vetting before the end of March 2017. Subject to the legislative process, we expect the amended CLRP Rules to become effective on 1 June 2017.

List of Respondents

(in alphabetical order)

1. CompliancePlus Consulting Limited
2. Futures Industry Association
3. Hong Kong Investment Funds Association
4. I-Access Investors Limited
5. Simmons & Simmons on behalf of itself and Samsung Asset Management (Hong Kong) Limited
6. The Law Society of Hong Kong
7. Anonymous – two respondents requested not to publish their identities
8. Anonymous – two respondents requested not to publish their identities and contents of their submissions

Revised Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap 571Y)

Revised Guidance Note on Position Limits and Large Open Position Reporting Requirements