



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 position 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. 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 any stock futures contract is 5,000 contracts for any one 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.*

¹ Section 35(1)(a)

² Section 35(1)(b)

³ Section 35(1)(c)

⁴ In accordance with Schedule 1 to 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.



- 2.3. The prescribed limits on certain futures contracts such as stock index futures and stock index options contracts, currency futures contracts and commodity futures contracts are calculated on a net basis for all contract months combined. Moreover, for stock index futures and stock index options contracts with the same underlying index, as well as currency futures and currency options contracts with the same underlying currency pair, the futures-equivalent positions in options contracts are added to the positions in futures contracts for purposes of determining compliance with the prescribed limits. The futures-equivalent position in an options contract is the delta value⁵ 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 direction⁶ for all expiry months combined that may be held or controlled by a person. *For example, the prescribed limit on any stock options contract is 150,000 contracts in any one market direction. If a person holds 30,000 long calls in month A, 100,000 short calls in month B and 50,000 long puts in month C, he will reach the prescribed limit on this contract for the short market direction, but will still be able to hold 120,000 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 150,000 contracts (i.e. 100,000 short calls plus 50,000 long puts).)*

⁵ 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.

⁶ Long calls and short puts are in the same market direction; and short calls and long puts are in the same market direction.



- 2.5. In general, 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 discretion⁷ 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 paragraph 3 below), 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 holds or controls positions in accounts with more than one Exchange Participant such that the aggregate position in all accounts exceeds 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.

⁷ 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.



3. 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 HKFE or SEHK (as the case may be) in accordance with Section 4(2) of the Rules, or by the SFC in accordance with 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 if the person is one of those described in Section 4A of the Rules.
- 3.3. In accordance with Section 4A, the following persons may be authorized by the HKFE or SEHK to hold or control excess positions:
- (1) a person registered with the SEHK for the purpose of performing market making or liquidity providing activities in accordance with its rules (i) in respect of stock options contracts (*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*) or (ii) in respect of exchange traded funds where the person holds or controls futures contracts or stock options contracts in the course of hedging the risks arising from performing market making or liquidity providing activities;
 - (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*);
 - (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
 - (4) a related corporation⁸ 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 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*

⁸ The term “related corporation” is defined in Section 3 of Schedule 1 to the SFO.



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 provides that the SFC may authorize a person to hold or control futures contracts or stock options contracts in excess of the prescribed limits if (i) special circumstances exist (Section 4B); or if the person (ii) has a relevant business need (Section 4C); (iii) carries out index arbitrage activity (Section 4D); or (iv) is an asset manager that meets the specified criteria (Section 4E). Section 4(4) is however only applicable to situations falling outside Section 4(2). That is, the SFC will not accept applications which may be dealt with by the HKFE or SEHK in accordance with Section 4(2).

- 3.6. Pursuant to Section 4(4), the SFC may authorize a person to hold or control futures contracts or stock options contracts in excess of the prescribed limits under Section 4B, 4C, 4D or 4E by giving the person a notice of authorization if:

- (1) the person is not one of those described in Section 4A; and
- (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.

Authorization under Section 4B – in “special circumstances”

- 3.7. An authorization under Section 4B may only be granted 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. So, for example, requiring excess positions to serve a regular business need would not be regarded as constituting special circumstances.

Authorization under Section 4C – for purposes of facilitating provision of services to clients

- 3.9. An authorization under Section 4C 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 4C(3) and essentially means a need to engage in hedging activities as a result of providing client facilitation services (i.e. services to facilitate client transactions – whether conducted on exchange or off exchange, 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 may facilitate this client’s purchase of 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.

Authorization under Section 4D – for purposes of index arbitrage activity

- 3.11. An authorization under Section 4D may only be granted:
- (1) to an Exchange Participant or an affiliate of an Exchange Participant; and
 - (2) where such person engages in index arbitrage activities and will hold or control the excess for the purposes of those activities.
- 3.12. The phrase “index arbitrage” is defined in Section 4D(3) to mean a trading strategy engaged in by the person-
- (a) involving (i) the purchase or sale of a stock index futures contract (***the futures contract***); or (ii) the purchase (or sale) of a stock index call options contract together with the sale (or purchase) of a stock index put options contract, where both contracts have the same underlying index, expiry date and strike price (***the options contracts***);
 - (b) in conjunction with the sale or purchase of some or all of the stocks comprised in the underlying basket of stocks (***the stocks***) used to compile the index underlying the futures contract or the options contracts; and
 - (c) with a view to securing a profit from any difference in price between the stocks and the futures contract or the options contracts.

The SFC accepts that “the stocks” do not necessarily include all the components stocks of the underlying index of the futures or options contracts, the SFC however expects the applicant to demonstrate that the tracking error of the stocks is immaterial.



- 3.13. The SFC may grant authorizations under Sections 4C and 4D to an Exchange Participant or persons who belong to a group of companies that includes an Exchange Participant. 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.
- 3.14 The SFC will determine the size of excess positions to be authorized for an applicant on a case by case basis after taking into consideration various factors including the prevailing market situation. It should be noted that although the upper limit set by the specified percentage is a per applicant upper limit, the SFC will take into account any excess positions already authorized to other members within the same group as the applicant. Under Section 4(4)(b), the SFC may authorise the excess sought only if it 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.
- 3.15 Additionally, the SFC may only authorize excess positions under Sections 4C and 4D if –
- (1) the Exchange Participant or affiliate in question has adequate financial capability to cover the potential risks arising from any authorized excess position; and
 - (2) the Exchange Participant in question has effective internal control procedures and risk management systems to manage such risks.

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

- 3.16 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 specified contract⁹, the SFC will normally expect all of such person's holdings in that contract (i.e. not just the excess positions) to be 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 –

⁹ The term “specified contract” is defined in the Rules.



- (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 (i.e. acquisitions and disposals) to be conducted through the group Exchange Participant. Accordingly, any execution broker may be used (including the group Exchange Participant).

The above requirements, will facilitate the SFC in monitoring compliance with the prescribed limits and any authorized excesses.

Authorization under Section 4E – for purposes of asset management activity

3.17. An authorization under Section 4E may only be granted:

- (1) to an intermediary that is (i) licensed or registered for Type 9 regulated activity under the SFO (asset manager); and (ii) manages assets having a total value (AUM) of not less than HK\$80 billion;
- (2) where such asset manager needs excess positions to facilitate its asset management activity; and
- (3) the asset manager has effective internal control procedures and risk management systems to manage the potential risks arising from the excess.

3.18. For the purposes of Section 4E, the AUM of an asset manager is determined as follows:

- (1) in the case that the applicant is a Licensed Corporation (LC) under the SFO, it is the “Total aggregate net value of assets under management” figure reported in its latest filing to the SFC under the Securities and Futures (Financial Resources) Rules; and
- (2) in the case that the applicant is a Registered Institution under the SFO, the applicant is to use the figure reported under its asset management activity in its latest filing to the Hong Kong Monetary Authority under Section 63 of the Banking Ordinance on securities related activities. This figure is to be used as the basis for further adjustment by the applicant to arrive at an adjusted figure equivalent to the “Total aggregate net value of assets under management” figure mentioned in sub-paragraph (1) above.

3.19. The SFC is mindful that any excess positions granted should be commensurate with the asset manager’s business need. Under Section 4(4)(b), the SFC may authorise the excess sought only if it 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. In this regard, the SFC in determining the size of the excess position to be granted to an asset manager under Section 4E will take into account the following: –

- (1) investment mandates and size of all the funds managed by the asset manager; and
- (2) the investment strategies of the asset manager.

Application process for authorizations by the SFC

3.20. An application for authorization from the SFC to hold excess positions may be submitted by the following persons:

- (1) where authorization is sought under Section 4B, either:
 - (a) the person acting as principal for the account(s) for which the authorization is sought; or
 - (b) a person who acts as an agent for the principal;
- (2) where authorization is sought under Sections 4C and 4D, the Exchange Participant concerned; and
- (3) where authorization is sought under Section 4E, the asset manager concerned.

3.21. In the case of an authorization sought under Sections 4C and 4D, 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 (i.e. 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 Sections 4C and 4D of the Rules.

3.22. All applications to the SFC should be made in writing to the Supervision of Markets Division of the SFC. Applications may be made on the basis of an immediate need, or in advance in anticipation of prospective needs based on past experience.

3.23. 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.



3.24. In the case of an application for authorization under Section 4C, the SFC will require the applicant to provide the following information:

- (a) 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);
- (b) a full and complete explanation of the needs for holding or controlling excess positions and 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:
 - the nature and size of the positions established, or to be established, in connection with the excess positions for which authorization is sought, and on which market (e.g. OTC market, overseas exchange markets) such positions have been, or will be executed;
 - an estimate of the maximum level of the excess positions intended to be established; and
 - the estimated duration of holding or controlling the excess positions.
- (c) details of the relevant Exchange Participant's and (if applicable) the affiliate's or their holding company's financial position, such information to be sufficient to demonstrate that the Exchange Participant or affiliate or their holding company meets the adequate financial capability requirement and should normally include at least its latest annual audited financial statements or information on its credit rating (if any);
- (d) details of 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 positions, 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 positions (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 with client facilitation services by the Exchange Participant or its affiliate in relation to the excess positions held or controlled by it



- *the contingency measures* that will be applied to minimize the impact of a default by the counterparties, including the procedures for dealing with the excess positions 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 positions 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).

3.25. In the case of an application for authorization under Section 4D, the SFC will require the applicant to provide the following information:

- (a) the index arbitrage trading strategy and the relevant positions, which include:
- a description of how index arbitrage activities are conducted, or will be conducted, in connection with the excess positions for which authorization is sought;
 - a description of the current nature and size of the positions related to the index arbitrage trading strategy in question (including positions in other related markets which are an integral part of the index arbitrage portfolio);
 - the methodology adopted to determine the underlying stocks involved in the index arbitrage portfolio and their relative weighting of the entire portfolio;
 - the timing of execution in the stock market and the relevant stock index derivatives market;
 - an estimate of the maximum level of the excess positions intended to be established;
 - an estimate of the duration of holding or controlling the excess positions; and
 - the circumstances under which the index arbitrage portfolio will be unwound and the detailed unwinding strategy and process.
- (b) the monitoring process to ensure that the excess positions sought are executed according to the strategy described above;
- (c) information to demonstrate that the trading desk/book for index arbitrage activities is standalone;



- (d) details of the internal control measures and compliance monitoring process to prevent and detect potential misuse or abuse of the excess positions which should include a Chinese Wall (or equivalent internal control measures) in place between the index arbitrage trading desk and other trading desks;
- (e) details of the relevant Exchange Participant's and (if applicable) the affiliate's or their holding company's financial position, such information to be sufficient to demonstrate that the Exchange Participant or affiliate or their holding company meets the adequate financial capability requirement and should normally include at least its latest annual audited financial statements or information on this credit rating (if any);
- (f) details of the relevant Exchange Participant's internal control procedures and risk management systems to demonstrate that the Exchange Participant has effective internal control procedures and risk management systems to manage the potential risks arising from the excess position, 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, tracking error etc.). The summary should cover *the techniques that will be used to measure, monitor, control and reduce various types of risks* arising as a result of the excess positions and the related position; and
 - (ii) a brief summary of the internal control procedures that will be put in place to ensure the implementation of the risk management policies and procedures mentioned in the preceding sub-paragraph (i).

3.26. In the case of an application for authorization under Section 4E, the SFC will require the applicant to provide the following information:

- (a) a summary of the investment objectives and characteristics of each of the funds under its management and a description of the nature of positions held or controlled by each of the funds (including investments in other related markets which are an integral part of the entire portfolio);
- (b) a full and complete explanation of the needs for holding or controlling excess positions and how the excess positions will be used for asset management purposes;
- (c) an estimate of the maximum level of the excess positions intended to be established for each of the funds;



- (d) the relevant asset manager's internal control procedures and risk management systems to demonstrate that the asset manager has effective internal control procedures and risk management systems to manage the potential risks arising from the excess position, 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.). The summary should cover the techniques that will be used to measure, monitor, control and reduce various types of risks arising as a result of the excess positions and the related position; and
 - (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).
- (e) information showing that the applicant's total assets under management is not less than HK\$80 billion:
 - (i) For licensed corporations, the latest filing made by the applicant to the SFC under the Securities and Futures (Financial Resources) Rules which contains a "Total aggregate net value of assets under management" figure.
 - (ii) For registered institutions, the latest filing made by the applicant to the Hong Kong Monetary Authority under Section 63 of the Banking Ordinance on securities related activities should be used as the basis for further adjustment by the applicant to arrive at a figure equivalent to the "Total aggregate net value of assets under management" figure mentioned in (i).

Other considerations for authorization

- 3.27. 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.
- 3.28. The SFC will determine 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.
- 3.29. As a guiding principle, the SFC will not grant an authorization for any excess if the relevant preconditions set out in the Rules are not satisfied, or if the



authorization is inconsistent with the SFC's regulatory objectives in Section 4 of the SFO, in particular:

- (1) to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
- (2) to reduce systemic risks in the securities and futures industry; or
- (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.

3.30. 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(5)(c)). A notice of authorization will be provided to the applicant in writing (Section 4(4)(c)).

3.31. The SFC will endeavour to notify the applicant of its decision within four weeks after all information as requested by the SFC to support the application is provided to its full satisfaction. However, since authorizations that may be granted by the SFC under Section 4B 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

3.32. Excess positions authorized under Section 4C 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. Example 1 in Appendix 1 further illustrates how excess positions may be used.

3.33. 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:

- (1) the amount of excess used;
- (2) the type of clients involved;
- (3) a general description of the nature of the client transactions including their notional and market values; and
- (4) an overall description of the positions they have taken, but not details in relation to each client on an individual basis.

3.34. Excess positions authorized under Section 4D must be used solely for index arbitrage activities. Please refer to Example 2 in Appendix 1 which illustrates how excess positions may be used for index arbitrage activities. 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:

- (1) the amount of excess used;
- (2) a general description of the size of the stock index derivatives positions used for index arbitrage activities;
- (3) details of the stock portfolio established; and
- (4) the daily risk position of the entire index arbitrage portfolio containing the stock index derivatives positions and the stock positions.

3.35. Excess positions authorized under Section 4E must be used for asset management purposes. The SFC will expect asset managers to evidence the use of excess positions. To this end, the SFC will expect the asset manager authorized to submit regular reports providing details of the following:

- The amount of excess used for each of the funds under its management;
- The total number of futures positions held by each of the funds under its management; and
- The notional value of futures positions as a percentage relative to the fund size for each of the funds under its management

3.36. The SFC will normally require reports mentioned above 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

3.37. A person who has been authorized by the SFC under Section 4B, 4C, 4D or 4E should submit a new application to the SFC if he wishes to continue to hold or control the excess positions after the expiration date of the initial authorization. The new application should be submitted to the SFC no later than two months prior to the expiration date of the initial authorization. If the SFC does not grant any further authorization for the excess positions, the person will be required to close out the position in excess of the prescribed limit upon the expiration date of the initial authorization.

Withdrawal of authorizations by the SFC

3.38. The SFC may at any time withdraw an authorization granted under Section 4B, 4C, 4D or 4E by giving at least five business days' notice to the person (Section 4(5)(b)). Upon a withdrawal coming into effect, the authorization will cease to apply.

3.39. 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; and
- (3) whether the withdrawal may be delayed until the time of such expiry taking into account the reasons for the withdrawal.

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

- (1) one or more of the relevant preconditions set out in the Rules in respect of the authorization in question 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

3.41. A person may appeal against a decision of the SFC to refuse to authorize excess positions under Section 4B, 4C, 4D or 4E of the Rules to the Securities and Futures Appeals Tribunal ("**Tribunal**") pursuant to Section 216 of the SFO (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 in accordance with the decision of the SFC.

Positions held or controlled indirectly by virtue of corporate relationship

3.42. As discussed in paragraph 2.7 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 holding company), which indirectly controls the same positions by virtue only of the corporate relationship, will not be required to seek 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 month 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 and 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:
 - (1) a person (e.g. the Exchange Participant) acting as an agent for the principal to carry the account of the reportable position; or
 - (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 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:



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

- (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
- (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 2 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 positions¹⁰.

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

¹⁰ HKFE requires Exchange Participants to submit the notice of reportable positions by 12:00 noon on the reporting day (T+1).



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 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:
- (1) 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
 - (2) 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 5.2 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's proprietary trading desk has a position of HSI futures contracts equivalent to 9,000 position delta, and that its sales desk wants to facilitate clients' trades resulting in the use of about 30,000 HSI futures contracts for hedging purpose. Assume also that the specified percentage is 300%. Can the firm apply for excess?

- Yes, it can apply for excess of up to 30,000 contracts. However, the size of excess positions authorized for an applicant will be determined on a case by case basis after taking into consideration various factors such as the prevailing market situation.

If an excess of 30,000 contracts is authorized, the firm's limit will increase to 40,000 contracts—

- 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 40,000 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 – i.e. that holdings for proprietary trading purposes do not exceed the statutorily prescribed limit.

Example 2:

Assume a firm already holds a short position in HSI futures contract equivalent to 8,000 position delta for its proprietary trading business, and that it wishes to hold another 30,000 position delta for its index arbitrage activities in the same short direction. Assume that the specified percentage is 300%. Can the firm apply for excess?

- Yes, it can apply for excess of up to 30,000 contracts. However, the size of excess positions authorized for an applicant will be determined on a case by case basis after taking into consideration various factors such as the prevailing market situation.

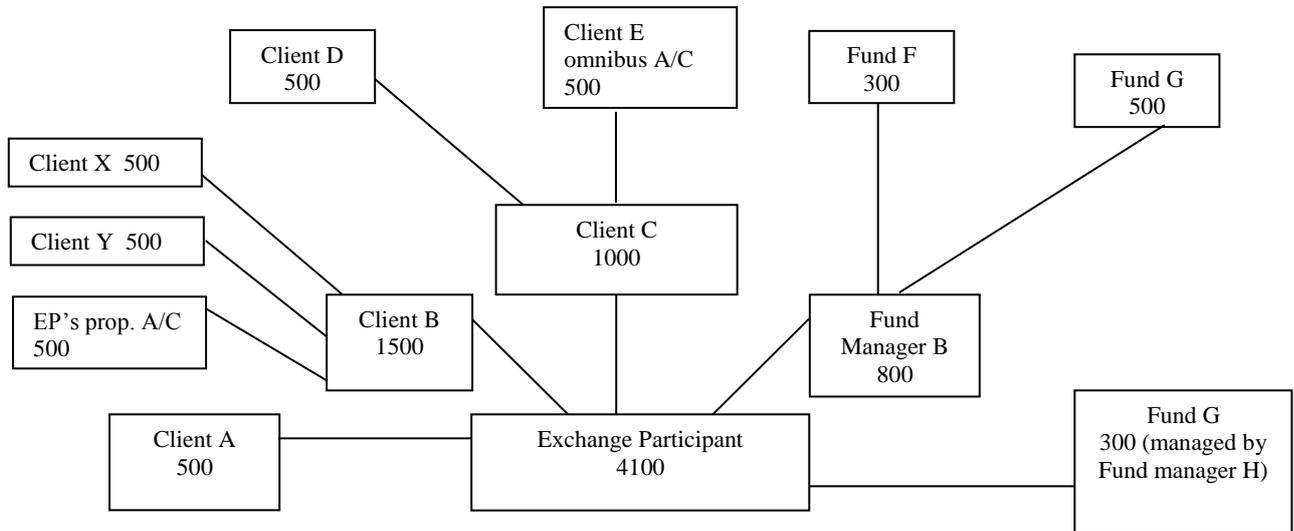
If an excess of 30,000 contracts is authorized, the firm's limit will increase to 40,000 contracts—

- The firm can use up to 10,000 contracts for its proprietary trading business (not including index arbitrage activities) and any remaining balance for its index arbitrage activities. The firm may therefore also use the entire 40,000 limit for its index arbitrage activities if it holds no other proprietary trading position.



Appendix 2

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.