**CompliancePlus Consulting**

**Compliance Consulting • Funds Consulting**
**Regulatory Consulting • Compliance Training**

# Submission to Consultation Paper issued by the Securities and Futures Commission on the Proposed Enhancements to the Position Limit Regime and the Associated Amendments to the Securities and Futures (Contracts Limits and Reportable Positions) Rules and Guidance Note on Position Limits and Large Open Position Reporting Requirements ("The Proposal")

Josephine Chung
Director, CompliancePlus Consulting Limited

November 2016

**For enquiries on this submission, please contact Josephine Chung at jchung@complianceplus.hk. CompliancePlus Consulting Limited understands and agrees that our name and/ or submission may be published to the public.**

## Introduction

The Securities and Futures Commission (the "**SFC**" or the "**Commission**") issued a Consultation Paper on proposed changes to the Position Limit Regime and the Associated Amendments to the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap. 571Y of the Laws of Hong Kong) and Guidance Note on Position Limits and Large Open Position Reporting Requirements on 20 September 2016 (the "**Consultation Paper**").

This Proposal is made in response to the Consultation Paper with our comments and suggestions illustrated below. Terms defined or given a particular construction in the Consultation Paper have the same meaning in this Proposal unless a contrary indication appears.

**1a. Do you agree with the proposal to raise the cap on the excess position limit for HSI and HHI futures and options contracts from the current level of 50% to 300%?**

We agree that the position limit regime in Hong Kong is currently too restrictive in comparison to international standards, and we welcome changes to the regime in response to the continuous growth and development of the vibrant market of Hong Kong. Nevertheless, we do not support the proposal to raise the cap for excess position limit from 50% to 300%

With reference to paragraph 20 and 21 of the Consultation Paper, the rationale for raising the cap by 6 times (from 50% to 300%) is due to the increase of position delta of HHI futures and options market by 6 times from 2007 to 2015.

We find this inference and deduction to be lack of scientific reasoning and too rigid to cater future changes and demands in the ever-fluctuating market.

The Hong Kong Financial Services Development Council issued the paper "Hong Kong's Position Limits Regime for Exchange-traded Derivatives – the Need for Revision" (the "**FSDC Paper**") in February 2016. In the FSDC Paper, it was addressed that the existing position limit regime, being set as a constant number of contracts rather than derived by a scientific model based on relevant market indicators, is lack of a scientific mechanism to cater for individual characteristics across stocks.

Further, it was also suggested that the number of contracts could not adequately reflect the risk profile of the position limit holder. Rather than maintaining a simple regime with one single cap, the Commission could have taken into account additional factors in deciding on the position limit cap for different stock option contracts.

It is noticeable that, when considering the extent to which the cap shall be increased, the Commission only considered the increase of position delta from 2007 to 2015. As indicated in the Consultation paper, the position delta of HSI and HHI has been steadily increasing over the years.

In light of the steady market growth and development of Hong Kong, it is foreseeable that the demands for hedging and derivatives will continuously increase in the incoming years. Further, it is notable that, since the imposition of the position limit regime early in 1999, the Commission only undertook changes for once in 2006-2007. And as opposed to other major exchanges, the Hong Kong position limits regime is not incorporated in the rules of exchange, but rather in a subsidiary legislation.

Given the inherent complexity in initiating legislative changes and the infrequency of the Commission to make changes to the regime in response to market changes, we suggest that when considering the extent to which the cap shall be imposed, other than considering recent market figures, there shall be

a prudent consideration to the needs in the upcoming future that the Commission should explain to the industry further as to the rationale of raising the cap to 300%, for example, why beyond 300% is not recommended, what risk may cause to the market etc. if above 300%, market impact analysis etc.

Noting that some other exchanges such as Australian Securities Exchange and United States (intercontinental Exchange) do not have any cap limit and some respondents in a previous consultation back then in 2007 suggested removing the upper limit, the Commission should in future study this approach though we note that this approach may not be an option in the near future.

*Hedging Exemption*

In addition to the proposed changes, we suggest that there should be a hedging exemption to the regime. Multiple foreign exchange markets have incorporated similar exemptions.

The United States Commodity Futures Trading Commission (the "**CFTC**") grants exemptions to its position limits for bona fide hedging, which in their definition, means derivative transactions or positions that represent a substitute for transactions or positions to be taken at a later time in a physical marketing channel, with the purpose to offset price risks incidental to commercial cash or spot operations and positions to be established and liquidated in an orderly manner in accordance with sound commercial practices.

The Singapore Intercontinental Exchange (the "**ICE**") also grants exemptions from its position limits for bona fide hedge positions, which includes arbitrage, risk management or spread positions. Applicants for exemptions have to describe the size and nature of exemption. Additional information could be required where necessary before granting of exemption. Applicants have to

undertake that they will comply with any limitations imposed by the Exchange. We are of the view that the Commission should promote and encourage bona fide and market neutral hedging and risk management activities. Such exemption could be subject to the ultimate discretion of the Commission, taking into account the nature and scope of the applicant's business, as well as internal operations and policies to ensure compliance with conditions in granting exemptions.

**1b. Do you agree with the proposal relating to tightening the "adequate financial capability" requirement as set out in paragraph 25?**

We agree to tighten the "adequate financial capability" but we do not agree with the increase in the adequate financial capability requirement from $2 billion to $5 billion. We do not quite understand the scientific basis of the new requirement of $5 billion, which we hope the Commission can explain further on this point.

As mentioned in paragraph 23 of the Consultation Paper, the size of excess position authorized by the Commission to an applicant will be determined on a case-by-case basis, with 300% only being an upper limit.

Accordingly, the excess position to be granted will vary among applicants taking into account their needs and capability. It is possible that certain applicants will only be eligible for excess position of 50% or below.

Whilst the excess position limits to be granted will vary case by base, we believe that the case-by-case standard shall also apply to accessing the applicant's financial capability, with a scaling requirement to be implemented in accordance to the excess position limits granted.

With the primary objective for all changes to this regime being to enhance and promote hedging and risk management activities, a single financial capability threshold that will likely be disproportionate to the excess position limits granted will burden the actual likelihood in achieving the objectives of the proposed changes. A scaling requirement will better address the entity's capability and necessity in carrying out the corresponding hedging activities.

In addition, this may reduce the no. of market players that may cause an unintended consequence of concertation risks to the market.

Further, as opposed to only maintaining a single monetary threshold, we suggest that the Commission may take into account other factors in determining the capability of applicants to excess position limits.

The applicants could be required to demonstrate actual or foreseeable business needs in applying for such excess limits with some data analyses and scenario and sensitivity analyses to the Commission for their consideration on granting the excess position limit and the extent of excess position limit to be granted.

The applicants shall be required to demonstrate that they have effective internal control procedures, risk management systems and fit and proper personnel to manage all the potential risks.

Qualified applicants may also be subject to ongoing periodical reporting responsibilities to the Commission, reporting the usage of the excess positions and maintenance of the internal systems and procedures.

If the Commission decides to entirely shift the financial capability threshold to $5 billion, there is a need to effect a transitional period for existing entities that are eligible for excess position limits. As the shift from $2 billion to $5 billion

may lead to major and substantial adjustments for the eligible entities, a transitional period of reasonable length will be necessary for them to solicit the excess capital required, or to adjust their investments and positions if they could not meet the new requirement the moment when the it comes into effect. The Consultation Paper have not discussed about transition arrangements, which in our opinion, will be a material concern in considering the implementation of the new requirements.

**2. Do you have any comments on the proposed ETF Market Maker Excess Position Limit, i.e. an ETF market maker or liquidity provider may be authorized under the rules of the relevant recognized exchange company to hold or control futures or stock options contracts in excess of the statutory prescribed limit for hedging the risks arising from their ETF market making or liquidity providing activities?**

The ETF market has experienced a steady growth since its introduction in Hong Kong. In 2015, multiple sources have suggested Hong Kong to be the second largest market in Asia Pacific Region in terms of ETF Assets under Management ("**AUM**") and the third largest market in terms of ETF annual turnover.

We welcome the proposal to authorize ETF market makers and liquidity providers to hold or control futures or stock options contracts in excess of the statutory prescribed limit for hedging purpose.

Nonetheless, there should still be some requirement and further guidance on the eligibility of ETF market makers and liquidity providers who can apply for excess position limit.

With reference to information on the website of Hong Kong Exchange and Clearing Limited ("**HKEX**") (https://www.hkex.com.hk/eng/etfrc/SMMList/SMM_List.htm), there are currently 30 ETF market makers in the market. It is noticeable that a large discrepancy exists between the ETF traded by the market makers.

Whilst the largest ETF market maker in Hong Kong ETF market provides liquidity for 124 ETFs, the smallest ETF market maker only serves 1 ETF.

Hence, despite we acknowledge the need for certain ETF market makers in holding stock options and futures in excess of the statutory prescribed limit, it should be noted that not every ETF market maker have such need and capability in handling the position in excess to the statutory limit.

It will be necessary to set certain criteria for ETF market makers to apply for excess holding position to avoid any abuse or misuse. When considering the eligibility benchmark for ETF market makers to apply for excess holding position, as mentioned earlier in the answer 1a, we are of the opinion that the Commission should take into account the growth and development trend of the ETF market in future years, catering the anticipated continuance of rapid growth rate of market and screening the market makers with lower capability.

**3a. Do you have any comments on the proposed Index Arbitrage Activity Excess Position Limit, i.e. the SFC may authorize an EP or its affiliate to hold or control HSI and HHI futures and options contracts in excess of the prescribed limit for index arbitrage activities?**

Index arbitrage is a relatively new trend in Asia market. Index arbitrage activities allow investors to take advantage of price differentials between stock index futures and the underlying basket of constituent stocks in the index, or

the price discrepancy between the actual and theoretical price of the stock index future.

This trading strategy is relatively simple yet hard to capitalize as the market will eliminate these arbitrage opportunities within a short period of time. Therefore, index arbitrage has not been popular until recent years with the development of computer programs that closely monitor the market and calculate the fair price of the underlying stock index futures quicker than the market can response.

These programs allow firms to grasp arbitrage opportunities in a very limited time frame and capitalize from index arbitrage activities. Given that index arbitrage activities are still quite new in Hong Kong, limited data and statistics could be referenced at this stage to comment on the necessity for letting exchange participants to apply for excess position limits in carrying out such activities.

We understand the positive effects of index arbitrage activities and the intention for the Commission to promote such activities to accelerate price adjustment processes in market, yet the present market demand for excess position limits seem not very strong.

We suggest the regulators to check with the industry or market players relating to the Index Arbitrage Market to assess the demand and whether this is a priority to the industry and to the Commission.

**Do you have any comments on the definition of "Index arbitrage" set out in the proposed new section 4D(3) of the CLRP Rules?**

We have no comments.

**3b. Do you have any comments or suggestions on the proposed eligibility criteria for EP or its affiliate to hold or control excess position limits for index arbitrage activities?**

As previously answered in 1b, we do not agree with the imposition of one single threshold for applications for excess position limits. A scaling or case-by-case standard will be more flexible and could better cater the situation and circumstances of each applicant.

Further, concerning the excess position limit designated for index arbitrage activities, we are concerned that when it comes into practice, whether regulators could ensure the applicant's excess limit to be actually used for genuine index arbitrage activities.

Once the EP or its affiliate is granted with excess position holding right for index arbitrage activities, they can make use of the right and hold options and futures in excess holding position for other purpose.

It requires a much higher level of compliance to ensure the purpose of the excess holding position. We suggest the Commission to issue further guidance note to the market on the suggested procedures and mechanism on how to ensure the purpose of the excess holding position is solely for index arbitrage activities.

If the EPs and their affiliates are actively engaging in other types of investing activities, or even have applied for excess holding limit prior to the introduction of excess position limit for index arbitrage activities participants, the situation would be even more complicated.

Unless there is a segregated account for index arbitrage activities, or else it will be rather difficult and confusing for both the regulators and the EPs to ensure

the purpose of the excess position holding is solely for index arbitrage activities.

**4a. Do you have any comments on the proposed Asset Manager Excess Position Limit, i.e. the SFC may authorize an asset manager to hold or control HSI and HHI futures and options contracts in excess of the statutory prescribed limit?**

We welcome the Commission's decision to allow SFC licensed asset managers to hold or control HSI and HHI futures and options contracts in excess of the statutory prescribed limit. In January 2015, the Commission published a report in its risk-focused industry meeting series entitled Asset Management: Looking Forward.

The report highlighted the solid and substantial growth in the asset management industry in Hong Kong and Asia as well as the increasing focus on market surveillance and risk governance. It is believed that Hong Kong based asset managers mostly utilize HSI and HHI futures and options contracts to manage their funds under their control and they have genuine business need for excess position limits.

We believe that the changes could accommodate with the demands of asset managers to manage various types of products and to provide them with additional flexibility in their operations. It is also beneficial in promoting Hong Kong as an asset management centre.

**4b. Do you have any comments or suggestions on the eligibility criteria for asset managers to qualify for the Asset Manager Excess Position Limit?**

We do not support the proposed HKD $100 billion AUM threshold. Looking into the Survey on Hedge Fund Activities published by the Commission in March 2015, it is noticeable that less than 20% of the hedge funds in Hong Kong could reach the threshold of HKD 100 billion AUM (Chart 1).

If the proposed $100 million threshold is put into practice, it will only benefit the large scale hedge funds, whilst the middle-sized and small sized funds, which constitutes the majority of asset managers, will not be better off from the regime. Some large fund house with AUM over HKD$100 billion may not need to apply for excess limit while other small sized funds houses may need excess limit but will be restricted from doing so due to AUM threshold.

In addition, we believe that there is no direct correlation between AUM, demand for excess position limit and the asset manager's risk management capabilities. It is important to note that the AUM is just an aggregation of the amount of assets managed by a fund management company.

Each fund's asset is segregated from other with no correlation. Each fund's assets and liability is ring fenced. It may not have any materiality on the financial strength of a fund or a fund management company.

Despite the shortcomings of the proposed AUM threshold, we welcome the Commission's proposal to include demonstration of genuine business need, as well as showing of internal control procedures and risk management systems (items (ii) and (iii)) to be part of the eligibility requirement. With the primary objective of all proposed changes to the regime being to promote hedging and related risk management activities, we however urge the Commission to

reconsider the eligibility threshold, shedding more light on items (ii) and (iii) instead of the AUM threshold in (i), such that a wider range of fund managers could be benefited, which will be favorable for the development of Hong Kong as an asset management center.

It is noticeable that the excess position limit will be granted to the Type 9 licensed corporation, instead of to each of the funds managed. We suggest that the Commission may require such asset managers granted with excess position limit to be subject to a periodic reporting duty, which they shall report the actual usage and allocation of the excess holdings. The Commission may look into such data and statistics and possibly reserves the right to amend the excess position limit granted.

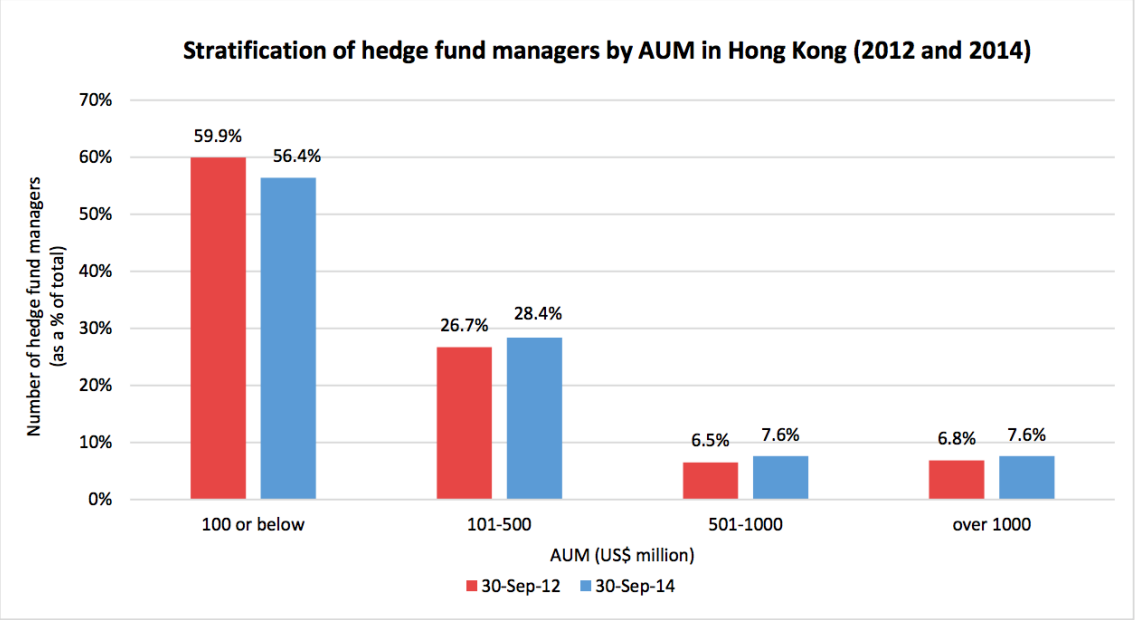


Chart 1 – Stratification of hedge fund managers by AUM in Hong Kong

(Source: Survey on Hedge Fund Activities, SFC, March 2015)

## 5. Comments on raising the statutory limit for all stock options

The current statutory limit for stock options has been in place since 2006. We believe that the current stock options position limit model is outdated and it is not in the same pace with the current market situation.

The HKEX Consultation Paper issued in April 2016 on its proposed revision of stock option position limit model received a majority of supportive responses. Respondents who supported the proposal believed that the proposed model could improve the efficiency of the derivatives market, as well as allowing better usage of options market for risk management purposes, which is in line with the objective of this Consultation Paper.

With the rise on the stock option limit, the market exposure will also increase. We suggest the Commission to strengthen the risk monitoring procedures so as to main the overall market stability.

We also noticed that in the HKEX proposal on raising the statutory limit, the HKEX has introduced a regular review mechanism. We welcome this mechanism and suggest the Commission to implement a similar mechanism on the position limit regime so as to ensure the policies are set in line with the latest market situations and trends.

## Conclusion

In general, we welcome the long waited proposed changes to the position limits regime in response to the continuous market growth and increasing variety of market activities, which promotes financial stability and facilitate market development in Hong Kong.

We appreciate the Commission's efforts on this in balancing the benefits of the market participants and the industry and managing the market risks and protecting interests of the investing public.

However, we are of the view that the proposed regime may potentially negate the flexibility to all sorts of market participants such as the implementation of clear-cut financial capability and asset-under-management requirements hinders the opportunity for middle to small-sized exchange participants and asset managers to even remotely benefit from the improved regime.

Despite the importance of financial capability, we are of the view that it should not serve as a prerequisite for excess position limit applications. Other factors including the nature of investment activities being carried out, exposure to risks as well as effectiveness of internal control policies and procedures should be of higher importance when considering individual cases.

**-END-**