

Oversight

SFC Consultation on the Position Limit Regime

June 2022

Introduction

On 26 April 2022, the Securities and Futures Commission of Hong Kong (SFC) published a Consultation Paper on the proposed changes to the Securities and Futures (Contracts Limits and Reportable Positions) Rules and the Guidance Note on Position Limits and Large Open Position Reporting Requirements (Consultation Paper). In the Consultation Paper, the SFC proposes to amend the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Rules) and the SFC's Guidance Note on Position Limits and Large Open Position Reporting Requirements (Guidance Note). These revisions are intended to help reduce systemic risks in the securities and futures industry and safeguard market stability.

Under section 35(1) of the Securities and Futures Ordinance (SFO), the SFC may prescribe limits on the number of futures and options contracts a person may, directly or indirectly, hold or control and require a person holding or controlling a reportable position to lodge a notice of that reportable position with a recognised exchange company or the SFC. The statutory prescribed limits and reportable positions of futures and options contracts are set out in the Rules. The position limit regime in Hong Kong was last updated in 2017 where both the cap on the excess position limit which may be authorised by the SFC and the prescribed limit for stock options contracts were increased, and new excess position limits regimes for index arbitrage activities, asset managers and market makers of exchange-traded funds were introduced. Regarding the currently proposed changes, a draft of the SFC's intended revised Rules and Guidance Note are appended to the Consultation Paper.

This **Oversight** provides an overview of the amendments proposed to be introduced by the SFC in regards to the position limit regime. It first discusses the proposed amendments and compares them against the relevant current requirements. It then looks at the practical implications of the proposed changes.

Position limit regime

The SFC has proposed various amendments to the position limit regime: (i) to provide for the application of prescribed position limits and reportable positions in relation to a person holding or controlling futures and options contracts of unit trusts and sub-funds of umbrella funds; (ii) to expand the list of futures and options contracts that are covered in the Rules; (iii) to prescribe reportable positions for futures and options contracts traded during holidays; (iv) to clarify that a clearing participant (CP) of HKFE Clearing Corporation Limited (HKCC) or the SEHK Options Clearing House Limited (SECH) in exercising its right to dispose of its client's positions upon a default is not regarded as having the type of discretion described in section 7(3) of the Rules; and (v) to provide for a CP which clears excess positions of persons who have been authorised by the SFC or under the rules of the Hong Kong Futures Exchange (HKFE) or The Stock Exchange of Hong Kong Limited (SEHK) to hold or control excess positions to be eligible to apply for authorisation from the SFC or the recognised exchange company concerned to hold or control excess positions for its clients.

Each of these is discussed in more detail below.

Prescribed position limits and reportable positions of unit trusts and sub-funds

Unit trusts

Currently, the restriction on the number of contracts held or controlled set out in section 4(1) of the Rules, and the lodging of a written notice of a reportable position under section 6(1) of the Rules, applies to a “person”, which is defined in the Interpretation and General Clauses Ordinance as “[including] any public body and any body of persons, corporate or unincorporate”. The SFC notes in the Consultation Paper that whilst the trustee of a unit trust falls within such definition of a “person”, a trust may not (on the basis that a trust of itself has no legal personality) and this may therefore give the incorrect impression that a fund which is established as a unit trust is not subject to the prescribed limits and reporting of reportable positions.

In order to clarify its views regarding the above, the SFC proposes in the Consultation Paper to amend the Rules such that any person, except where a person has discretion over the positions pursuant to the Rules, shall apply the prescribed limits and reportable positions separately to (i) his or her own positions and the positions of a unit trust which he or she holds or controls; and (ii) the positions in each unit trust where there is more than one unit trust. The SFC states that such prescribed limits apply to every fund including sub-funds regardless of whether it is in the form of a unit trust, corporate fund or other structure. The SFC considers that the trustee of a unit trust is responsible for reporting on behalf of the trust. Where the same trustee acts as trustee for multiple unit trusts it should report for each separately.

In addition, the SFC proposes in the Consultation Paper to state expressly that the name of the unit trust shall be provided in a notice of a reportable position of the unit trust. The SFC states that such proposed requirement is similar to the relevant requirement under the existing Rules where a notice of a reportable position held or controlled for another person must be accompanied by information which provides the identity of the person and the number of contracts for the reportable position held or controlled for that person in each contract month.

To help achieve the above, the SFC proposes to introduce (i) new sections 6(3) and 6(4) to the Rules which set out the information which must be provided in a notice of reportable positions of a unit trust or a sub-fund; and (ii) a new section 7A to the Rules with the heading “Compliance by persons with respect to a unit trust or a corporate fund” which provides for the application of prescribed limits and reportable positions in relation to unit trusts and sub-funds of an umbrella fund. In addition, the SFC proposes to amend the Guidance Note to remind trustees of unit trusts of their existing obligations under the Rules, such as the trustee’s obligation to report the unit trust’s reportable positions where the trustee holds or controls futures or options contracts on behalf of a unit trust. In this regard, if a trustee is engaging an agent to report reportable positions on its behalf, the SFC states in the Consultation Paper that it expects the trustee to maintain proper internal records to reflect the arrangement.

Sub-funds of an umbrella fund

Currently, the Rules do not provide for how the prescribed limits and reportable positions apply to sub-funds of umbrella funds. The SFC notes in the Consultation Paper that given that each sub-fund should be managed independently according to its investment mandate or strategy, the prescribed limits and reportable positions should be applied to each sub-fund individually and separately as if each sub-fund is a stand-alone fund. Whilst the SFC notes in the Consultation Paper that some market participants already report the reportable positions for each individual sub-fund separately, this is not addressed expressly in the current Rules as a requirement. The SFC therefore proposes to specify in the Rules that a person that holds or controls positions of the sub-funds of an umbrella fund must apply the prescribed limits and the reportable positions separately to each sub-fund as if each one were a stand-alone fund. However, the SFC proposes to specify an exception to the foregoing proposed requirement where a person has discretion over the positions of a sub-fund such as where a fund manager manages the positions of all the sub-funds in question which would likely be the case in a typical umbrella fund structure. Such exception is addressed in the new section 7A(3) of the Rules. In other words, where such exception is applicable, it is proposed that the relevant prescribed limits and reportable positions do not apply separately to the relevant futures contracts or stock options contracts.

The SFC is of the view that it is not possible to cover all the legal structures of umbrella funds in the current update. Since umbrella funds are usually constituted as unit trusts or corporate funds, the SFC proposes to address these two legal structures in the proposed updates to the Rules.

Furthermore, the SFC proposes that the notice of a reportable position in respect of a sub-fund must be accompanied by information which provides the name of the sub-fund and the number of contracts held or controlled in respect of the sub-fund for the reportable position in each contract month or option series.

The SFC is of the view that the above proposed amendments to the Rules regarding unit trusts and sub-funds would ensure the following: (i) unit trusts and sub-funds observe prescribed limits and report reportable positions in a manner which is consistent with how those positions are managed and monitored in practice; (ii) trustees and other relevant entities which hold or control positions in unit trusts or sub-funds are aware of their legal obligations under the Rules; and (iii) accordingly, the data for reportable positions available to the SFC for market monitoring purposes would be more comprehensive and more accurately reflect trading activities.

List of futures and options contracts in the Rules

Currently, market participants may seek authorisation from the SFC to hold or control excess positions with respect to certain futures and options contracts pursuant to sections 4C, 4D and 4E of the Rules in order to facilitate the provision of services to clients, index arbitrage activity and asset management activity. The scope of such futures and options contracts includes “specified contracts” set out in section 2 of the Rules, which are currently limited only to (i) HSI futures and options contracts and (ii) HSCEI futures and options contracts.

Further to the recent launch of the Weekly HSI options contracts, Weekly HSCEI options contracts, HSI Futures options contracts, HSCEI Futures options contracts and Hang Seng TECH Index futures and options contracts (New Contracts), the SFC proposes to add the New Contracts to the list of “specified contracts” under the Rules and prescribe position limits for the New Contracts. Moreover, the SFC proposes to expand Schedule 1 of the Rules to include the following new contracts such that they will be subject to the same prescribed limits and reporting levels as those stipulated in the rules of HKFE: (i) Weekly Hang Seng Index options contracts; (ii) Weekly Hang Seng China Enterprises Index options contracts; (iii) Hang Seng Index Futures options contracts; (iv) Hang Seng China Enterprises Index Futures options contract; (v) Hang Seng Index (Gross Total Return Index) futures contracts; (vi) Hang Seng China Enterprises Index (Gross Total Return Index) futures contracts; (vii) Hang Seng Index (Net Total Return Index) futures contracts; (viii) Hang Seng China Enterprises Index (Net Total Return Index) futures contracts; (ix) Mini US Dollar vs Renminbi (Hong Kong) futures contracts; (x) Hang Seng TECH Index futures contract; (xi) Hang Seng TECH Index options contracts; and (xii) MSCI China A 50 Connect (USD) Index futures contracts.

Futures and options contracts traded during holidays

Currently, the Rules only require reporting of reportable positions on Hong Kong business days. However, the introduction of the derivatives holiday trading (Holiday Trading) program by Hong Kong Exchanges and Clearing Limited (HKEX) means that the HKFE will be able to determine, from amongst its suite of non-HKD denominated futures and options contracts, which contracts (Holiday Contracts) can be traded on HKFE or through its facilities on a Hong Kong public holiday falling on a weekday (Holiday Trading Day). Therefore, market participants will only be required to report their reportable positions established during Holiday Trading Days on the next business day.

In order to help ensure that the SFC’s capability to monitor build-ups of large positions during Holiday Trading Days remains unaffected, the SFC proposes in the Consultation Paper to introduce new sections 6(1A) and 6(1B) to the Rules to prescribe reportable positions for the Holiday Contracts and provide for the reporting of these positions during Holiday Trading Days.

Discretion of CPs in relation to clearing clients' positions

Section 7 of the Rules sets out how the prescribed limits and reportable positions apply to a person holding or controlling futures or options contracts for another person. The SFC notes in the Consultation Paper that despite paragraph 5.2 of the Guidance Note, there is uncertainty about the application of section 7(3) to a CP's right to dispose of a client's position in the event of a payment default.

In view of the above, the SFC proposes to introduce a new section 7(4) to the Rules to clarify that a CP of HKCC or SEOCH is not to be regarded as having the type of "discretion" as described in the Rules if the CP's power to acquire or dispose of positions may only be exercised in the event of a default on payment.

Excess position limit for CPs

According to section 4 of the Rules, no person, unless authorised under the Rules, may hold or control contracts in excess of the prescribed limit. The SFC notes in the Consultation Paper that whilst many of the persons who applied for excess position limits were both exchange participants (EPs) and CPs in the past, more EPs are clearing through the services of a General Clearing Participant (GCP). If those EPs were granted an authorisation by the SFC to hold or control contracts in excess of the prescribed limit, the GCP providing clearing services would also need to be authorised to hold the excess positions. In addition, regarding persons who have been granted authorisation under the rules of the HKFE or SEHK to hold or control contracts in excess of the prescribed limit for the purpose of market making or as an issuer (or its related corporation) of securities listed under Chapter 15A of the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited as set out in Section 4A of the Rules, the CP or GCP which provides clearing services to these persons will also need to be authorised to hold or control the same excess positions.

In view of the above, the SFC proposes to introduce a new section 4A(e) to the Rules, which will expand the list of persons who may be authorised under the exchange rules to hold excess positions to include a CP of HKCC or SEOCH which clears positions for persons authorised by a recognised exchange company to hold or control excess positions. In addition, a new section 4F to the Rules is proposed, under which the SFC may authorise a CP of HKCC to hold the excess positions in a specified contract it clears for persons that have been authorised to hold or control the excess positions under sections 4C, 4D or 4E of the Rules.

Guidance note on position limits and large open position reporting requirements

In order to achieve consistency with the revised Rules should the SFC's proposals regarding the position limit regime be implemented, the SFC also proposes in the Consultation Paper to introduce consequential amendments to the Guidance Note. The proposed revisions to the Guidance Note are set out in Appendix B to the Consultation Paper.

In addition, the SFC proposes in the Consultation Paper to amend paragraphs 3.26 and 3.35 of the Guidance Note to clarify that a fund may not hold or control excess positions notwithstanding that the fund's asset manager is authorised to hold excess positions.

Implementation timeline

The public consultation period will end on 27 June 2022. The SFC has not mentioned in the Consultation Paper any proposed timeline regarding implementation of the proposed changes. However, the SFC states in the Consultation Paper that it will provide sufficient time for the necessary adjustments and arrangements to be made.

Practical implications

The amendments proposed in the Consultation Paper reflect an effort on the part of the SFC to clarify the intended regulatory objectives of the position limit regime and bring the current position limit regime up to date in view of developments in the Hong Kong securities and futures markets in recent years. In particular, the express inclusion of unit trust and sub-funds and their related proposed requirements in the revised draft Rules and Guidance Note reflect the growth of exchange traded funds (ETFs) utilising futures and options, in particular Leveraged and Inverse Products. The changes provide some clarity on the SFC's expectation regarding related operational requirements.

The proposed amendments are likely to affect not only unit trusts and funds with sub-funds but also related stakeholders including trustees, custodians and fund managers. In addition the SFC notes in the Consultation Paper that the use of HSI and HSCEI for hedging may be restricted by its approach. Also Leveraged and Inverse Products using HSI and HSCEI futures contracts are constrained by the prescribed limits. This will not change and means not only are the positions held or controlled by a fund (such as a Leveraged and Inverse Product) subject to the prescribed position limit, the positions held or controlled by the manager, including the positions held for the manager's own account or for other funds under its management (the Leveraged and Inverse Product) but controlled by the manager, may also not in aggregate exceed the relevant maximum. Accordingly, the Leveraged and Inverse Product's ability to acquire further HSCEI futures may be affected by other futures/option contracts held or controlled by the manager. Further, the proposed changes to the Rules are not expected to affect unitholders of the relevant funds since unitholders will not themselves hold the relevant futures and/or options contracts or control the relevant funds. The SFC clarifies this point.

From a practical viewpoint, whilst it is not anticipated that the updated position limit regime will have any immediate effect on the relevant funds, if the position held or controlled by a fund manager reaches the relevant position limit or if the net asset value of a relevant fund grows significantly the restrictions under the Rules may prevent creations of units of such fund. This may cause a divergence between the trading price of a unit of the relevant fund on the SEHK and the net asset value per unit. The investment exposure could also deviate from the target exposure which adds tracking error to the relevant fund. In this regard, although it is noted that index swaps in the over-the-counter market could be used as substitutes for futures contracts, the higher cost of index swaps would affect performance of funds and reduce the return for investors.

Conclusion

The proposed updates to the position limit regime in the form of amendments to the Rules and the Guidance Note are a clarification of certain requirements and provide an indication of the SFC's intended regulatory changes. Whilst the proposed requirements are subject to finalisation, relevant parties such as fund managers and trustees of unit trusts and umbrella funds may wish to take heed of the proposed requirements and commence any necessary preparation or adjustments as appropriate.

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