SECURITIES AND FUTURES ORDINANCE (Chapter 571)

Guidance Note to clarity 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 contracts[4] and stock options contracts are specified respectively in Schedule 1 and Schedule 2 of the Rules.

2.2. Except for index futures and index options contracts, Schedule 1 of the Rules specifies the maximum number of futures contracts for any one contract month or series that may be held or controlled by a person. In other words, the prescribed limits in this Schedule apply to individual contract months or options series. *For example, the prescribed limit on any stock futures contract is 5,000 contracts for any one contract month. If a person longs 3,000 contracts of thT 15 Tm[( )]TJET EMC /P <</MCID 3,0-3(8 9.96 Tf1 0 0 1 358.15 5)3-15(he)4( )]TJETMC*

(2) The authorization may only be granted in respect of futures contracts or stock options contracts that are specified contracts (Sections 4(6) and 4(10)). The SFC will, from time to time, review the list of specified contracts based on market demand.

(3) The SFC will only be able to authorize excesses of up to the specified percentage (Section 4(6) and 4(10)). The SFC will, from time to time, review the specified percentage based on market need.

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

> *The maximum that any member in the group may be authorized to hold or control is 15,000 calculated as follows:*
> *10,000 + (50% × 10,000) = 15,000*
>
> *The maximum that the group would in aggregate be authorized to hold or control is 45,000 calculated as follows:*
> *15,000 × 3 = 45,000*

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

3.12. Additionally, the SFC may only authorize excess positions under Section 4(6) if-

(1) the Exchange Participant or affiliate in question has adequate financial capability to cover the potential risks arising from any authorized excess position (Section 4(7)(b)); and

(2) the Exchange Participant in question has effective internal control procedures and risk management systems to manage such risks (Section 4(7)(c)).

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

3.13. The SFC will normally look to the Exchange Participant to ensure that excess positions are properly used and any resultant risks properly managed, as that is the regulated entity within the group. Consequently, the SFC will expect a single entity within the

Exchange Participant. It follows therefore that the Exchange Participant will in any event its latest annual audited accounts and information on its credit rating (if any);

(b) the relevant Exchange Participant's internal control procedures and risk management systems, such information to be sufficient to demonstrate that the Exchange Participant has effective internal control procedures and risk management systems to manage the potential risks arising from the excess position[11], and should normally include at least the following:

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

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

the contingency measures that will be applied to minimize the impact of a default by the counterparties, including the procedures for dealing with the excess position in the event of such default

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

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

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

3.20. 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.

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out in its latest audited financial statements or a qualifying credit rating (defined in Part 5 of Schedule 1 of the SFO).

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Validity and renewal of authorizations by the SFC

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.

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

(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,

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

<u>Example 1:</u>

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

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

<u>Example 2:</u>

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

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

<u>Example 3:</u>

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

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

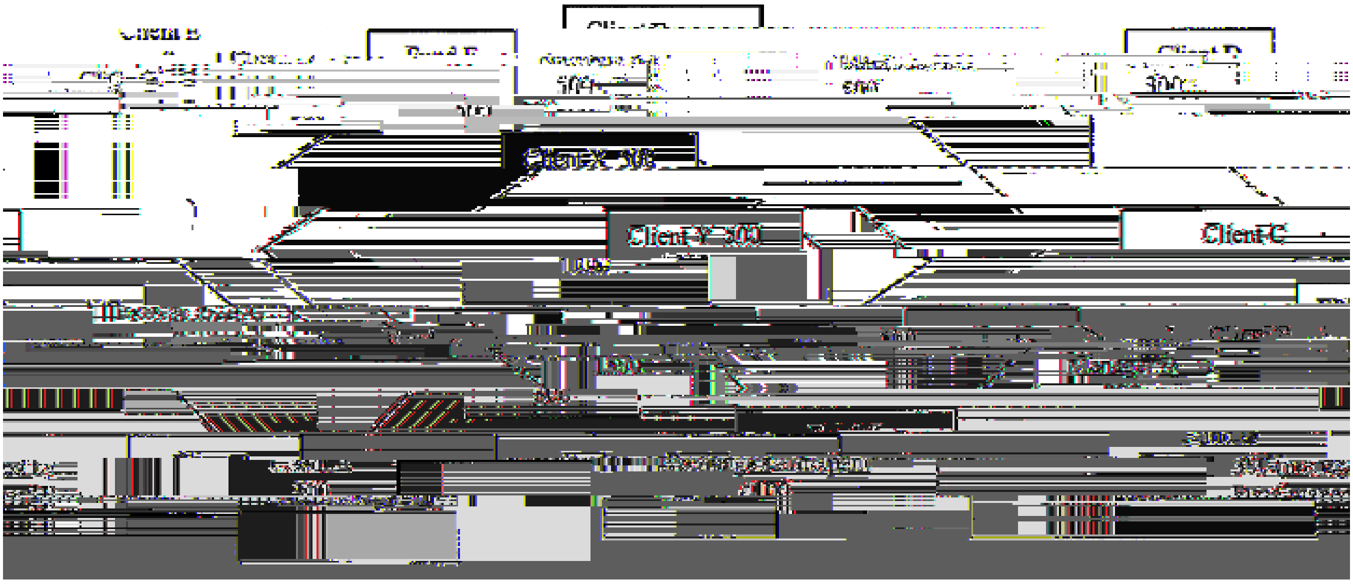
Note: In each of the above 3 examples, if an excess of 5,000 contracts is authorized, the firm's limit will increase to 15,000 contracts. In each case ð

> The firm can use up to 10,000 contracts for proprietary trading purposes and any remaining balance for client facilitation purposes. The firm may therefore also use the entire 15,000 limit for client facilitation purposes if it holds no proprietary trading position.
>
> The SFC is not concerned as to the order in which the limit is consumed (ie whether the limit is first used to acquire contracts for client facilitation purposes and then for

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

Appendix 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***

(b) Client B should notify the Exchange of 500 contracts each held by the EP's proprietary account, Client X and Y.

(c)