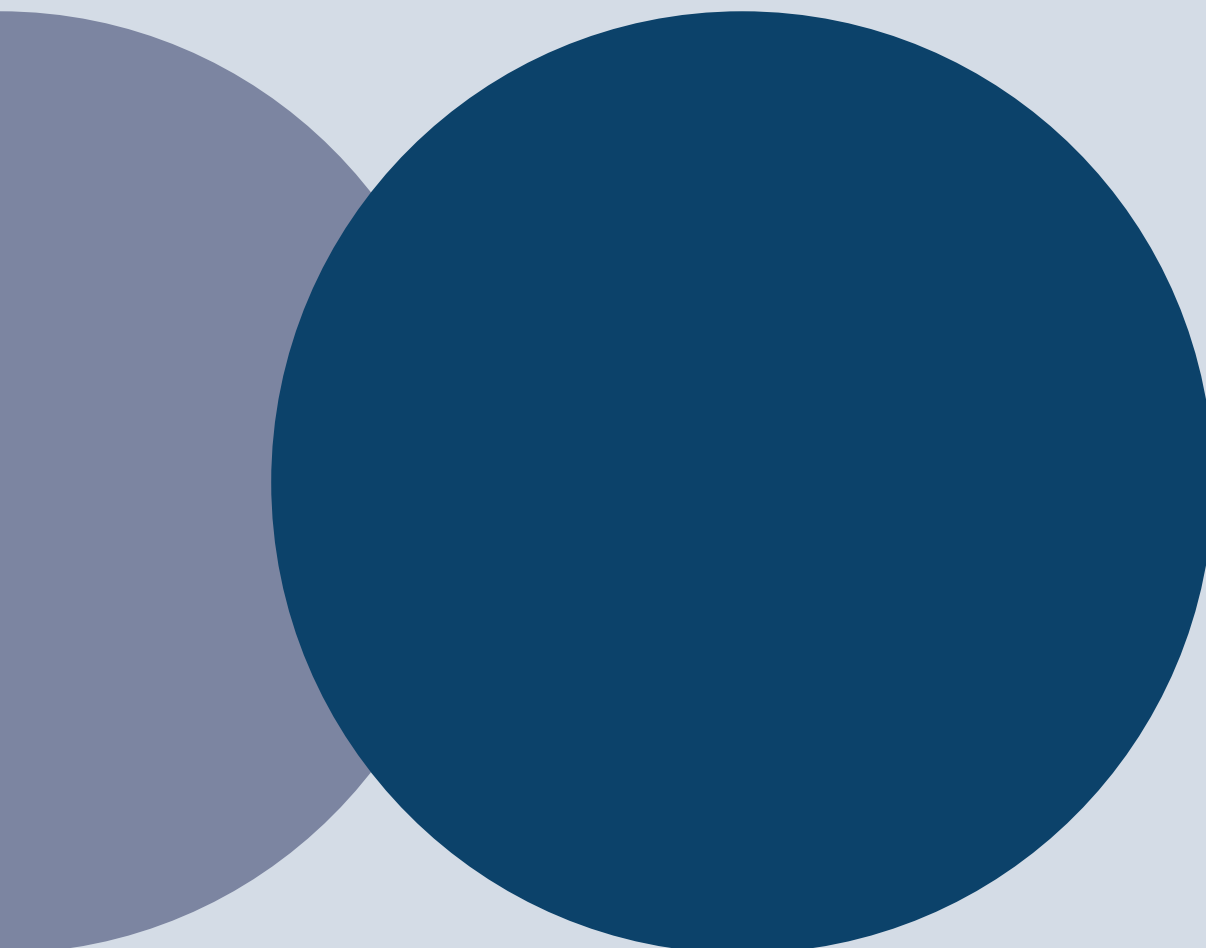


June 2016

## CONSULTATION CONCLUSIONS

### PROPOSAL FOR REVISION OF THE STOCK OPTION POSITION LIMIT MODEL



---

## **TABLE OF CONTENTS**

---

	Page No.
<b>EXECUTIVE SUMMARY</b>	2
<b>Chapter 1: Introduction</b>	4
<b>Chapter 2: Market Feedback</b>	5
<b>Chapter 3: Conclusions and Next Steps</b>	10
<b>APPENDICES</b>	
<b>Appendix I: Final Proposal</b>	12
<b>Appendix II: List of Respondents</b>	15

---

## EXECUTIVE SUMMARY

---

1. In April 2016, Hong Kong Exchanges and Clearing Limited (HKEX) issued a consultation paper (Consultation Paper) on its proposed revision of the stock option position limit model for its derivatives market. This paper presents the results of the market consultation.
2. The Consultation Paper proposed a revision of the existing model with the objective of maintaining the relevance of individual position limits in the long run, thus ensuring the city's competitiveness as an international financial centre. The proposed model is aimed at addressing the technical issues of the existing stock option position limit regime, including a de facto single position limit system and no regularly scheduled reviews to help ensure the regime reflect the market's development.
3. HKEX received a total of 36 responses from a broad spectrum of market participants which included 23 Exchange Participants, 5 asset management companies, 5 professional and industry associations, 1 listed company and 2 individuals.
4. The majority of respondents strongly supported the proposed revision of the stock option position limit model. 32 out of 34 (94 per cent) corporate respondents and 2 out of 2 (100 per cent) individual respondents supported the revision of the current model with the introduction of a three-tier system with a review mechanism to address the issues with the existing regime. 32 out of 34 (94 per cent) corporate respondents and 2 out of 2 (100 per cent) individual respondents also agreed that the implementation of the proposed model would be an important step in enhancing Hong Kong's stock options market and increasing its competitiveness. While some respondents commented that the revised limits are too small, it is generally agreed that it is a step forward in enhancing Hong Kong's stock options market and increasing its competitiveness.
5. Since the majority of respondents were supportive, HKEX will proceed with the proposal. The features of the proposed three-tier model for stock option position limit are as follows.
  - a) Three-tier system: A contract equivalent number will be calculated for each stock option class based on the underlying stock's contract size, market capitalisation and liquidity. Based on the contract equivalent number, each stock option class will be assigned to one of three tiers comprising limits of 50,000, 100,000 and 150,000 open contracts in any one market direction for all expiry months combined.
  - b) Review mechanism: The position limits for all stock option classes will be reviewed annually and adjusted when necessary to ensure they remain in line with the market's development. In addition, following a corporate action, the contract size of the affected stock option may also be adjusted to maintain the notional value of the option contract.

6. As mentioned in the Consultation Paper, the adoption of the proposed three-tier model would require changes to the Securities and Futures Ordinance (SFO) and HKEX's rules, and is subject to the approval of the Securities and Futures Commission (SFC). Moreover, the SFO changes would need to be introduced to the Legislative Council for negative vetting before the proposed model could be adopted.

---

## CHAPTER 1: INTRODUCTION

---

7. On 29 April 2016, HKEX published a consultation paper on its proposed revision of the stock option position limit model for its derivatives market (the Consultation Paper) to get market views on the proposal.
8. In the Consultation Paper, HKEX proposed among other things:
  - a three-tier framework with the position limit for each stock option class based on the underlying stocks' market capitalisation and liquidity. Each stock option class would be assigned to one of three tiers comprising stock option position limits of 50,000, 100,000 and 150,000 contracts based on the contract equivalent number.
  - annual reviews of the position limit for each stock option class to ensure the limits are in line with the market's development.
  - adjustment of the contract size for a stock option class following a corporate action that affects the underlying stock.

For details of the Consultation Paper, please refer to <http://www.hkex.com.hk/eng/newsconsul/mktconsul/Documents/cp201604.pdf>

9. The consultation period ended on 3 June 2016. HKEX received a total of 36 responses from Exchange Participants, professional and industry associations, asset management companies, listed companies and individuals, 2 responses were late submissions received and accepted in the week after the consultation closure. A list of the respondents is provided in Appendix II. Copies of their responses are available on the HKEX website at: <http://www.hkex.com.hk/eng/newsconsul/mktconsul/responses/cp201604r.htm>
10. Statistics and key responses to the Consultation Paper are summarised in Chapter 2. It also includes HKEX's responses to key comments raised. They should be read in conjunction with the Consultation Paper.
11. HKEX's conclusions and the next steps are set out in Chapter 3.
12. HKEX would like to take this opportunity to thank all those who shared their comments and views during the consultation process.

## CHAPTER 2: MARKET FEEDBACK

13. The following table summarises the 36 respondents by category:

Category	Q1. The revision of the current model with the introduction of a three-tier system with a review mechanism for HKEX's stock option position limit to address the issues with the existing regime		Q2. The implementation of the proposed model would be an important step in enhancing Hong Kong's stock options market and increasing its competitiveness	
	Support	Not Support	Support	Not Support
<b>Corporate</b>	<b>32 (94%)</b>	<b>2 (6%)</b>	<b>32 (94%)</b>	<b>2 (6%)</b>
Exchange Participants	22	1	22	1
Asset Management Companies	4	1	4	1
Professional and Industry Associations	5	0	5	0
Listed Company	1	0	1	0
<b>Individual</b>	<b>2 (100 %)</b>	<b>0 (0 %)</b>	<b>2 (100 %)</b>	<b>0 (0 %)</b>

14. Among the 36 responses received, 32 out of 34 (94 per cent) corporate respondents and 2 out of 2 (100 per cent) individual respondents supported the revision of the current model with the introduction of a three-tier system with a review mechanism to address the issues with the existing regime.

15. Among the 36 responses received, 32 out of 34 (94 per cent) corporate respondents and 2 out of 2 (100 per cent) individual respondents agreed the implementation of the proposed model would be an important step in enhancing Hong Kong's stock options market and increasing its competitiveness.

16. Summary of responses by category:

**a. Exchange Participants:** There were 23 responses from Exchange Participants. 22 (67 per cent market share<sup>1</sup>) supported the revision of the stock option position limit model while 1 (1 per cent market share) did not support it.

**b. Asset Management Companies:** There were 5 responses from asset management companies. 4 responses (80 per cent) supported the revision of the stock option position limit model while 1 (20 per cent) did not support it.

<sup>1</sup> Based on the turnover statistics of stock options market in 2015

- c. Listed Company:** There was 1 response from a listed company and it supported the revision of the stock option position limit model.
- d. Professional and Industry Associations:** There were 5 responses from professional and industry associations which broadly represent different stakeholders in the investment community. Their members include trading firms, investors and other market participants. All associations supported the revision of stock option position limit model.
- e. Individual:** Out of the 2 responses from individuals, 2 (100 per cent) supported the revision of stock option position limit model.
17. We are pleased to see the majority market support for our proposed revision of the stock option position limit model. The large majority of respondents agreed that the proposed model could address the issues of the existing regime and enhance Hong Kong's stock options market.
18. The two negative responses to questions one and two came from one Exchange Participant and one asset management company. Their reasons are as follows:
- a) One respondent from an Exchange Participant commented that there is no urgency for position limit revision due to the recent decline in market flow and volume. However, that respondent agreed that introduction of the review mechanism would enhance efficiency of the stock options market.

HKEX response: The proposed revision of the stock option position limit regime is for the long term benefit of the stock options market. The existing position limit regime has not been revised for a decade. HKEX believes implementation of the proposal would align Hong Kong's stock option position limit regime with international practices and ensure the relevance of individual position limits in the long run. In the consultation, most respondents are supportive to the proposal, and are in favour of implementing these changes as soon as reasonably practicable.

- b) One respondent from an asset management company commented that while setting higher, more sensibly-calibrated position limits are positive steps, that respondent was worried that adding a third tier may increase the risk of position limit breaches as there would be more limits that require monitoring.

HKEX response: HKEX proposed a three-tier system so that the assigned position limit would be more reflective of the characteristics of the underlying stocks. Under the three-tier system, distribution of stock options among the tiers would be more diverse and meaningful. We noted that some overseas exchanges like the Chicago Board Options Exchange (CBOE) has higher position limits but applies more tiers (five tiers for CBOE). In our proposal, HKEX proposed a three-tier system under the current market condition to strike a balance between ease of administration and catering for the diversity

of underlying stocks. Most respondents were supportive to the proposed model.

### Comments Received

19. The large majority of respondents were in favour of the proposal. Their key comments to the consultation and HKEX's responses are set forth in the following paragraphs.

### **Shortcomings of existing model**

20. Responses received: Some respondents stated that currently some stock option business is being carried out in the less transparent over-the-counter (OTC) market because the existing limits are restrictive. This reduces the liquidity in the listed option market, thus hampering the effectiveness of listed stock options as efficient hedging tools for market participants.
21. HKEX response: The proposed revision of the stock option position limit model allows stock options to be put into different position limit tiers, including tiers with larger limits than today's maximum limit. If its proposal is adopted, HKEX believes that the listed stock option market would be more efficient for market participants to manage their risk and exposure as more OTC transactions would migrate to the listed market.

### **Maximum position limit**

22. Responses received: Some respondents suggested setting a higher maximum position limit. Also, some respondents hoped that position limits would eventually be removed when there is full listed and OTC market transparency.
23. HKEX response: HKEX agrees the position limit regime should be reviewed from time to time. HKEX sees the maximum limit of 150,000 contracts in its proposal as a conservative start to avoid drastic changes to the position limit regime. A top limit of 150,000 contracts is already three times of the existing regime's maximum level of 50,000 contracts.

### **Market makers' position limits**

24. Responses received: Some respondents enquired if the existing practice of allowing market makers for stock options to apply for additional position limits would be changed.
25. HKEX response: There would not be any changes to the existing procedures for market makers to apply for additional position limits if the current regime is revised.

### **Position limits for other derivatives**

26. Responses received: Some respondents suggested the revision of the position limit model should include other derivatives such as equity index futures.



27. HKEX response: From HKEX's previous studies, stock option position limits are not in line with international standards and market participants have said the existing stock option position limits prevent the market from meeting their trading and hedging needs fully.
28. For equity index derivatives, practices in regard to position limits vary. However, in overseas markets, where position limits do exist, hedge exemption regimes are typically in place to facilitate the risk management activities of qualified users whose hedging needs exceed the prescribed limits. Feedback from a soft market consultation indicated that some market participants are strongly looking for a comprehensive hedge exemption regime for equity index derivatives. HKEX has been in discussions with regulators and market participants on this topic and plans to have further discussions.

### **Buffer time for adjustment of positions following the annual review**

29. Responses received: Some respondents suggested that buffer time should be given for adjustment of positions following the annual review, especially for the positions of longer term options which tend to have lower liquidity.
30. HKEX response: Under the proposal, annual reviews will be conducted at the end of each November, and the results will be announced in the following December. The revision will take effect on 1 April of the following year. Many respondents are supportive to the introduction of review mechanism so that the size of the limits would be more in line with market development, and they have no comment on the buffer time. HKEX believes that the buffer between the results announcement and the effective date would allow sufficient time for market participants to adjust their positions. Also, applying the same buffer time for options of different tenors could reduce administration burden, especially during the initial implementation of the proposal. Nonetheless, HKEX agreed that the position limit model shall be reviewed from time to time as market develops.

### **Measurement unit for stock option position limits**

31. Responses received: Some respondents noted the measurement unit of position limits for equity index products (in position delta) and stock options (in contracts) is inconsistent and should be reviewed.
32. HKEX response: In a soft consultation exercise, most market participants were strongly supportive of keeping number of contracts as the measurement unit for stock option position limits. Among the responses received in the consultation, a majority of the respondents had no concerns or supported using number of contracts as the measurement unit of stock option position limits. Internationally, number of contracts is the most common measurement unit for stock option position limits. The non-alignment of the measurement unit for position limits for stock options and equity index futures could be due to differences in the products' characteristics (physical delivery for stock options versus cash settlement for equity index products). Considering the above factors, HKEX believes that it is

more appropriate to keep number of contracts as the measurement unit for stock option position limits at this time.

### **Other issues in Hong Kong's stock options**

33. Responses received: Some respondents suggested the position limit regime is not the only issue in Hong Kong's stock options market, but they agreed HKEX's proposal is an important step forward. The other issues include improving cost efficiency with cross margining, expanding the stock options universe, issuing European style stock options and increasing the reporting level for Large Open Position, etc.
34. HKEX response: HKEX acknowledges there may be other areas for further improvement of its stock options market. HKEX will monitor the issues mentioned by the respondents and consider seeking broad market feedback. HKEX will also maintain its active communication with regulators, as some of the issues mentioned in the responses may require regulators' approval.

## CHAPTER 3: CONCLUSIONS AND NEXT STEPS

35. Responses to the Consultation Paper show very strong support for the proposed revision of Hong Kong's stock option position limit model. Among the 36 responses received, 32 out of 34 (94 per cent) corporate respondents and 2 out of 2 (100 per cent) individual respondents supported the proposed model. Among the 23 responses from EPs, 22 (with 67 per cent market share) supported the model.
36. Respondents who supported the proposed stock option position limit model agreed the proposal would improve the efficiency of Hong Kong's derivatives market. They also agreed the proposed three-tier framework would address the de facto single position limit issue and allow more use of HKEX's stock options market for risk management purposes. In addition, supportive respondents believed regular reviews would ensure the relevance of individual stock option position limits in the long run.
37. With the majority of the responses supportive, HKEX will proceed with its proposed stock option position limit model. The differences of existing and proposed model are summarised below.

	Existing Model	Proposed Model
Position Limit Tier (contracts)	<ul style="list-style-type: none"> <li>• 50,000</li> <li>• 30,000</li> </ul>	<ul style="list-style-type: none"> <li>• 150,000</li> <li>• 100,000</li> <li>• 50,000</li> </ul>
Methodology on contract equivalent number	Higher of (a) or (b): (a) Lower of (i) or (ii) i) 2.5% of outstanding shares ii) 10% of underlying stock's turnover over past six months (b) 7.5% of underlying stock's turnover over past six months	<ul style="list-style-type: none"> <li>• 5% of outstanding shares, provided that it is not (i) lower than 25% and (ii) higher than 33% of the underlying stock's turnover over past six months<sup>2</sup></li> <li>• Subject to an additional threshold<sup>3</sup> of 6.7% of underlying stock's turnover over past six months</li> </ul>
Regular Review Mechanism	N/A	Annual review of position limit tier of each stock option

<sup>2</sup> If 5% of outstanding shares is lower than the 25% threshold, the contract-equivalent number is set at the 25% of the stock's turnover for the past six months; or if 5% of outstanding shares is higher than the 33% threshold, the contract-equivalent number is set at the 33% of the stock's turnover for the past six months.

<sup>3</sup> The liquidity threshold could be revised from time to time as deemed appropriate by HKEX.

	<b>Existing Model</b>	<b>Proposed Model</b>
Adjustment upon Corporate Action	N/A	Contract size could be adjusted to maintain the notional value of position limit

38. Details of the final version of HKEX's proposed stock option position limit model are set forth in Appendix I for reference.
39. HKEX will discuss its proposal with the SFC with a view towards implementing the proposal. HKEX hopes to announce the next steps, detailed implementation plans and schedules in due course.

---

## APPENDIX I: FINAL PROPOSAL

---

40. Subject to further discussion with the SFC and SFC's approval, HKEX's proposed stock option position limit model to be implemented will be as follows:

### Three-tier System

41. A three-tier system will be introduced for HKEX's stock option position limit. The position limit would be set with reference to the market capitalization and liquidity of the underlying stocks. Details of the methodology are described below.
42. The position limit under the three-tier system is 50,000, 100,000 or 150,000 contracts. If the contract-equivalent number is equal to or higher than 150,000 contracts, the position limit would be set at 150,000 contracts. If the contract-equivalent number is equal to or higher than 100,000 but lower than 150,000 contracts, the position limit would be set at 100,000 contracts. If the contract-equivalent number is lower than 100,000 contracts, the position limit would be set at 50,000 contracts. The tiers are illustrated in the following table.

Tier	Contract-equivalent number (X)	Proposed position limit*
1	150,000 contracts $\leq$ X	150,000 contracts
2	100,000 $\leq$ X < 150,000 contracts	100,000 contracts
3	X < 100,000 contracts	50,000 contracts

*\* On the basis of existing practice: the number of open contracts per option class in any one market direction for all expiry months combined*

43. The contract-equivalent number<sup>4</sup> is calculated based on the number of outstanding shares and turnover of the underlying stocks. It is determined by the followings:

5 per cent of the outstanding shares, provided that it is not:

- lower than 25 per cent of the stock's turnover for the past six months;
- higher than 33 per cent of the stock's turnover for the past six months.

Otherwise, if 5 per cent of outstanding shares is lower than the 25 per cent threshold, the contract-equivalent number is set at the 25 per cent of the stock's turnover for the past six months; or if 5 per cent of outstanding shares is higher than the 33 per cent threshold, the contract-equivalent number is set at the 33 per cent of the stock's turnover for the past six months.

---

<sup>4</sup> Contract-equivalent number refers to the number of shares calculated from formula above, and then divided by the contract size. Contract size of most stock options is 1 board lot.

## Prudence Measures

44. The calculation of the contract-equivalent number is subject to an additional liquidity threshold at 6.7 per cent of the past six months' turnover of the underlying stock if the model is adopted. This is to ensure a smooth transition and prevent speculative positions concentrated in any single expiry month from having an impact on liquidity. The liquidity threshold could be revised from time to time as deemed appropriate by HKEX.
45. Examples of the calculation of the stock option position limit under the proposed model are shown in the table below.

Underlying stock (stock code)	Outstanding shares* (‘000 contracts)	6-month turnover of underlying shares* (‘000 contracts)		Projected contract equivalent number (‘000 contracts)	Position limit liquidity threshold	Projected contract equivalent number with liquidity threshold (‘000 contracts)	Proposed position limit (‘000 contracts)
		5%	33%		25%		
Bank of China (3988)	4,181	15,169	11,492	11,492	3,064	3,064	150
Agricultural Bank of China (1288)	154	722	547	547	146	146	100
Cheung Kong Property (1113)	558	480	364	480	97	97	50

Source: HKEX, as of 31 December 2015

\* The numbers of shares are expressed per contract size. The contract sizes of Bank of China (3988), Agricultural Bank of China (1288) and Cheung Kong Property (1113) are 1,000, 10,000 and 1,000 shares respectively.

## Review Mechanism

### Regular review

46. Regular review mechanism would be introduced. Reviews will be conducted at the end of each November, and the results will be announced in the following December. If revisions are necessary, they will take effect on 1 April of the following year to provide a buffer for investors to unwind any excess positions.

For corporate action

47. A mechanism for reviews in connection with corporate actions will be included. Following a corporate action, such as a share split, that affects the underlying stock, HKEX may consider adjusting the contract size of the affected stock option to maintain the notional value of the option contract. Adjustments will take effect immediately on the effective date of the corporate action.

**Position Limit under Existing Regime and Proposed Model**

48. Under the proposed model, there are three tiers of position limits. A summary of the change of position limits when applying the model is illustrated below:

Existing Regime

<b>Position limit</b>	<b>Number of option classes</b>
50,000 contracts	80
30,000 contracts	4

Proposed Model

<b>Position limit</b>	<b>Number of option classes</b>
150,000 contracts	41
100,000 contracts	16
50,000 contracts	27

\* Based on data from July to December 2015

\*\* On the basis of existing practice: the number of open contracts per option class in any one market direction for all expiry months combined

---

## **APPENDIX II: LIST OF RESPONDENTS**

---

### **Exchange Participants (23 in total)**

- 1 ABN AMRO Clearing Hong Kong Limited
- 2 BNP Paribas Securities (Asia) Limited
- 3 Credit Suisse Securities (Hong Kong) Limited
- 4 Eclipse Options (HK) Limited
- 5 HSBC Securities Brokers (Asia) Limited
- 6 Huajin Futures (International) Limited
- 7 I-Access Investors Limited
- 8 Vantage Capital Markets HK Limited
- 9-23 15 Exchange Participants requested anonymity

### **Asset Management Companies (5 in total)**

- 24 Keywise Capital Management (HK) Limited
- 25 Oasis Management Company Ltd.
- 26-28 3 asset management companies requested anonymity

### **Listed Company (1 in total)**

- 29 Korea Investment & Securities Co., Ltd.

### **Professional and Industry Associations (5 in total)**

- 30 Hong Kong Investment Funds Association
- 31 FIA
- 32 The Hong Kong Society of Financial Analysts
- 33 The Alternative Investment Management Association Limited
- 34 Asia Securities Industry & Financial Markets Association

### **Individuals (2 in total)**

- 35 Alejandro Chuy
- 36 Jin, Hyun-Tae



Hong Kong Exchanges and Clearing Limited  
12/F, One International Finance Centre  
1 Harbour View Street, Central, Hong Kong

[info@hkex.com.hk](mailto:info@hkex.com.hk)  
t: +852 2522 1122 f: +852 2295 3106  
[hkexgroup.com](http://hkexgroup.com) | [hkex.com.hk](http://hkex.com.hk)