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A EXCHANGE TRADED OPTIONS

1. INTRODUCTION

1.1 Definitions

- An **option** gives holder the right but not an obligation to:
  - Buy or sell a security, commodity or other underlying instrument: or
  - Otherwise exercise the right and obtain the benefits related to favorable movements in a measure (such as interest rates)

- Characteristics include:
  - Holder may or may not choose to exercise option (in contrast to future or forward)
  - Usually for specific period for specific price
  - Options may be traded on SEHK at different prices (premium)
  - The writer of the option has the obligation (which may be for unlimited amount) for life of option
  - Holder's costs limited to premium paid for option (as can choose not to exercise if price movements are unfavorable)

- **Call option** gives right to BUY fixed number of underlying stock at the exercise price on or before the expiry date

- **Put option** gives right to SELL fixed number of underlying stock at the exercise price on or before the expiry date

- SEHK traded options are American-style (can exercise at any time to expiry date) not European-style (can only exercise on expiry date)

- **Derivatives** under S245 Part XIII and S285 Part XIV SFO in relation to listed securities are defined as:
  - Rights, options or interests in or in respect of listed securities
  - Contracts to make a profit or avoid a loss by reference to price of listed securities or rights, options or interests in those securities
  - Rights, options or interests in respect of either of the above
  - Instruments or other documents creating, acknowledging or evidencing any rights, options or interests or any contracts referred to above

- Therefore options can be considered as derivatives

- Options on securities listed on SEHK are traded on SEHK and part of Type I regulated activities

- Options on future contracts are traded on HKFE and are part of Type 2 regulated activities

- Therefore although HKFE is called the "derivatives market", options are also traded on SEHK, which is often referred to as the "cash market"

1.2 Options Traded on the SEHK

- Traded options are written on actively traded stocks, which are listed on the SEHK
- The following rules cover the trading of SEHK traded options:
  - Options Trading Rules of SEHK
  - Operational Trading Procedures for Options Trading Exchange Participants of the SEHK
  - Hong Kong Futures Automated Trading System Trading Procedures
  - Options Clearing Rules of SEOCH
  - Operational Clearing Procedures for Options Trading Exchange Participants of SEOCH
  - General Rules of Central Clearing and Settlement System (CCASS Rules)

1.3 The Trading and Clearing Systems

- HKATS is a transaction-based network system
- Orders are placed electronically into the HKATS' Central Orderbook for auto-matching based on price/time priority
- During pre-market opening period, calculated opening prices are established before the open to maintain market order
- DCASS provides a common platform for clearing and settlement of SEHK Traded Options and HKFE index futures and options, single stock futures and options
- Matched trades are passed to the SEOCH for registration, clearing and settlement
- SEOCH acts as the clearing house and is responsible for monitoring risks
- SEOCH is the counterparty for all trades and the guarantor of performance in respect of money settlement and stock delivery
- SEOCH participants enter exercise instructions for house or client positions using DCASS terminals
- SEOCH performs assignment and **novation** and the resultant stock transactions are passed to CCASS for settlement
- SEOCH participants can make enquiries and carry out various types of **rectification on trades** executed during the day via DCASS. They can also **give-up trades** they have executed during the day to other SEOCH participants

2. PARTICIPANT TYPES AND ACCESS RIGHTS

2.1 Options Exchange Participants

- Only SEHK Exchange Participants may have access to the trading systems and facilities of Traded Options
- To conduct any exchange-traded options business for clients, an exchange participant must be registered with the exchange as an options exchange participant under either one of the following sub-categories:
  - Options Trading Exchange Participant (Trading Participant); or
  - Options Broker Exchange Participant (Broker Participant)
- A participant shall at all times:
  - adhere strictly to, and be bound by, the Options Trading Rules, the Operational Trading Procedures and any conditions of its approval as a participant;
  - comply in respect of all matters, such as decisions, directives and guidelines, in relation to the above rules and procedures, as well as the SEOCH Rules and the CCASS Rules which may affect it to the extent they are applicable

2.1.1 Options Trading Exchange Participant

- A Trading Participant must:
  - be an Exchange Participant and Type 1 licensed
  - be a SEOCH Clearing Participant or have entered into a clearing agreement with a SEOCH General Clearing Participant
  - have installed computer hardware and software , as specified by SEHK, to gain access to HKATS
  - have staff and operating and security procedures in place that allow constant access to HKATS to conduct its traded options business

2.1.2 Options Broker Exchange Participant

- A Broker Participant must:
  - be an Exchange Participant and Type 1 licensed
  - have an options broking agreement exclusively with one Trading Participant, which is a SEOCH Direct or General Clearing Participant
  - have staff and systems in place to enable constant access to updated price information on Traded Options

2.1.3 Register

- The SEHK maintains a register of Options Exchange Participants, containing each participant's full name, address, category of participantship and any other required information

2.1.4 Termination of Participantship

- An Options Exchange Participant may resign his participantship by giving written notice to the SEHK.
- The resignation will only be effective when:
  - No open positions of the Options Exchange Participant remain
  - All delivery obligations have been met
  - The SEHK notifies the Options Exchange Participant that the participantship is cancelled

2.2 The SEHK Options Clearing House Participant

- There are two types of SEOCH participants:
  - **Direct clearing participants (DCP):** can register and clear trades for its own and clients' accounts
  - **General clearing participants (GCP):** can register and clear trades for its own account, its clients' accounts and other Trading Participants' own and clients' accounts
- Each SEOCH participant must:
  - Be a trading participant and therefore a Type 1 licensee
  - Be in good standing and in compliance with the Options Trading Rules
  - Have appropriate procedures and back-office systems
  - Maintain minimum liquid requirements (DCP HK$5 million, GCP HK$20 million)
  - Deliver collateral to SEOCH for initial contribution to the reserve fund (DCP HK$1.5 million, GCP HK$5 million)
- SEOCH maintains clearing accounts in DCASS and CCMS (Common Collateral Management System) for each SEOCH participant
- SEOCH participants can use DCASS terminals to make on-line enquiries, rectify trades, give-up executed trades to other SEOCH participants or take-up trades from other SEOCH participants

2.3 Market Makers

- A **trading** participant can apply to SEHK to register as a market maker for a particular option class
- SEHK will check the financial standing, trading record, personnel, computer equipment and internal security before granting permission
- There are two categories of market maker: Regular Market Maker and Primary Market Maker

2.3.1 Regular Market Makers

- Regular Market Makers are:
  - Entitled to enter quotes into HKATS on receipt of quote requests or according to the obligation to provide continuous quotes
  - Permitted to enter a number of quotes simultaneously into HKATS
  - Required to be available to respond to quote requests or provide continuous quotes on all trading days
  - Obliged, upon receipt of quote requests, to offer quotes in HKATS for an option series in an option class:
    - for a minimum quantity of contracts
    - for a minimum period of time
    - not exceeding the maximum bid and offer spreads

2.3.2 Primary Market Makers

- Primary Market Makers:
  - Must enter quotes into HKATS on receipt of quote requests and provide continuous quotes in accordance with the terms and conditions of its appointment letter
  - Are required to be available to respond to quote requests and provide continuous quotes on all trading days
  - Are, upon receipt of quote requests, obliged to offer quotes in HKATS for an option series in an option class:
    - for a minimum quantity of contracts
    - for a minimum period of time
    - within a designated period after receipt of the relevant quote request
    - not exceeding the maximum bid and offer spreads
  - Must respond to no less than a certain % of quote requests and provide continuous quotes for no less than a certain % of trading hours as may be specified in its appointment letter

- Other points relevant to traded options market makers:
  - They are entitled to fee discounts for market making activities
  - They must maintain records of hedging activities and make them available for SEHK inspection
  - SEHK may suspend market making obligations on declaring unusual market conditions (eg extreme market volatility)
  - A Regular Market Maker's failure to respond to at least 50% of quote requests per option class, over two consecutive months, may lead to a loss of market maker status

2.4 Access to HKATS

- All Traded Options trading must be carried out by a Trading Participant using HKATS with the equipment and software as specified by SEHK
- Access to HKATS is controlled by the use of usernames and passwords
- A trading Participant must ensure that all persons gaining access to HKATS exercise due care and orders and give-up instructions are entered, amended or cancelled in accordance with SEHK procedures and guidelines
- A Trading Participant will be fully responsible and liable for any unstable condition, breakdown or damage to HKATS as a result of unauthorized usage or non-compliance with the Options Trading Rules

3. TRADES MONITORING, POSITION LIMITS AND REPORTING REQUIREMENTS

3.1 Trades Monitoring

3.1.1 Options Broking Agreement

- Only a Trading Participant with system access rights can access the options system
- A Broking Participant cannot access the options system, but is entitled to conduct Traded Options business on behalf of its clients by entering into an options broking agreement with a Trading Participant and corresponding client contracts, in each case acting as principal
- Points to note are:
  - A Broker Participant can only have one options broking agreement at any time
  - A Broker Participant who has entered into an agreement with a Trading Participant will be a client of the latter regarding various rules and procedures
  - Trading Participants must monitor their Broker Participants, ensuring they satisfy all demands for SEOCH collateral in respect of margin, or demands for premium, settlement amount and/or delivery obligations and that they notify the SEHK of any failures

3.1.2 Disclosure of Client's Information

- An Options Exchange Participant must be able to comply with the requirements under the Code of Conduct and Client Identity Rule Policy to disclose all information regarding the identity of clients to the SEHK, and its designated staff, upon request

3.1.3 Error Trades, Give Ups and Take Ups

- If a Trading Participant discovers that an order specification entered into HKATS is **incorrect and unmatched**, the Trading Participant must correct it in HKATS. If the order has **already been matched**, the Trading Participant must make an adjustment in DCASS
- After order matching, the client may request the Trading Participant (SEOCH participant) to give up the client contract to another Trading Participant. Through novation, a new client contract will be created between the take up Trading Participant and the client

3.2 Position Limits and Reporting Requirements

- Under the Securities and Futures (Contract Limits and Reportable Positions) Rules, no person may hold or control futures contracts and stock options traded through a recognized stock exchange in excess of the prescribed limits

- SEHK may:
  - ➢ Prescribe the maximum number or value of long or short open positions at a point in time or over a period of time that an Options Exchange Participant may hold
  - ➢ Alter position limits orally (followed by a written notice) or in writing
  - ➢ Relax position limits and amend limits while participant increases its liquid capital
  - ➢ Require notification of long or short open positions exceeding certain limits
  - ➢ Require disclosure of beneficial ownership of certain open positions
  - ➢ Impose limits on number and type of contracts relating to particular option class

- A participant must immediately notify SEHK if it exceeds any position limits.

- SEHK will require a participant to close or give-up contracts to meet the limits

4. CLEARING AND MARGIN

4.1 Client Margin Calculations

- An Options Exchange Participant (OEP):
  - ➢ Is required, after the start of the after-business period* on each trading day, to calculate margin in respect of all open positions and delivery obligations of each client
  - ➢ Is required to ensure that the margin calculated is no less than the amount calculated using the prescribed SEHK methodologies
  - ➢ Must ensure that each client is promptly notified of the margin and the SEOCH collateral demanded
  - ➢ Must ensure that each margin is promptly settled by the delivery of SEOCH collateral by each client
  - ➢ May treat a client as being in default if collateral is not promptly delivered
  - ➢ May require a client to maintain SEOCH collateral with the OEP in advance of accepting instructions from the client

    ** "After-business period" means the time period after trading but before batch processing when input of clearing functions into DCASS by SEOCH participants is no longer allowed*

- Clients can elect to have margin requirements on option positions calculated on a portfolio basis

- Operational Trading Procedures specify how margins should be calculated

- Cheques may be accepted as collateral (in good faith)
- Margin requirements may be satisfied in the form of cash or non-cash assets such as bank guarantees, securities or Exchange Fund bills/notes

4.2 Collection of Premiums and Collateral

- An Options Exchange Participant (OEP):
  - Must ensure that premium payable by a client is notified to that client on the day the options contract is made
  - Must ensure that all amounts are settled in cash promptly
  - May treat a client as being in default if the premium is not paid promptly
  - May require a client to pay premium in advance of accepting instructions from the client
  - May set off amounts due from the client against amounts due to the client in respect of margin, settlement amount, premium and surplus SEOCH collateral

4.3 Default by Clients

- If a client is in default on payment of premium or SEOCH collateral or in delivery, the participant may:
  - Not take any further orders
  - Close, give-up or exercise some or all of client contracts
  - Enter into contracts to hedge risk from default
  - Make any necessary contract to meet obligations arising as a result of default
  - Dispose of some or all of SEOCH collateral (other than cash) and use that plus cash to settle amounts due to him, with the balance being refunded to the client
  - Dispose of any or all of securities held to settle obligations
- Participants must notify the exchange if client defaults

4.4 Intra-day Calls

- When there is extreme price volatility SEOCH can call for immediate payment of a variation adjustment based on intra-day mark to market calculations on open positions
- This prevents losses accumulating over time or to allow deferral of losses
- When an intra-day margin call cannot be fully covered by the collateral provided, the SEOCH participant must satisfy the call in cash within one hour of the demand

5. SETTLEMENT

5.1 Exercise of Options

- Trading participant may exercise contract for long open position with SEOCH directly if an SECOH participant or if an NCP, by requesting designated GCP to exercise contract with SEOCH
- Each exercise must be against client ledger account of appropriate participant
- DCASS allows SEOCH participant to exercise client's right as option holder to buy or sell
- SEOCH participant must input exercise instructions in DCASS for each contract
- Contract is legally binding if entered into SEOCH even if not yet reported back to client
- On an expiry day, DCASS will automatically generate exercise instructions in respect of all open long positions in spot month contracts which meet the exercise criterion prescribed by the relevant SEOCH participant (if any) or the SEOCH
- Participant can override automatically generated exercise instructions before system closure on expiry day
- DCASS produces report of automatic exercise information after close
- For exercise of short open position, participant must select matching client contract, which is then treated as exercised when selected
- Trading participant must notify broker participant promptly of any assignment of option contracts
- Exercised stock options are settled by CNS in CCASS

5.2 Payment to Clearing House

- Intermediaries must pass cash premiums to SEOCH for onward payment to sellers
- SEHK must report to SFC any misconduct of exchange participant which might result in default of clearing and settlement
- Risk management techniques at SEOCH are designed to prevent SEOCH from defaulting on obligations
- However, if default occurs, SEOCH could close or transfer positions and liquidate collateral
- SEOCH will first use margin money then use reserve funds and could also look to insurance cover

B OTC DERIVATIVES

6. LICENSING

6.1 Introduction

- Decisions taken by the Group of 20 and the Financial Stability Board have led Hong Kong to implement a new regulatory framework for OTC derivatives transactions (new OTCD regime)
- Once amendments are made to various rules, codes and guidelines, two new Regulated Activities (RA) will be introduced:
  - Type 11 – Dealing in OTC Derivative Products or Advising on OTC Derivative Products
  - Type 12 – Providing Client Clearing Services for OTC Derivative Transactions
- Once amendments are made to various rules, codes and guidelines, two RAs will be expanded:
  - Type 7 – Providing Automated Trading Services
  - Type 9 – Asset Management
- The SFO defines an **OTC Derivative Product** as a structured product, **not** including:
  - A securities and a futures contract traded on a recognized market
  - A structured product authorized by the SFC under the SFO for sale to the public
  - A structured product that takes the form of a debt security deriving its returns from an underlying pool of assets
  - A debt or equity instrument or fund or deposits that has an embedded feature that makes it a structured product
  - A spot contract
  - A structured product sold to multiple persons on the same terms during an offer period of up to 2 weeks
- The SFO definition of "securities" does not require the instrument to be listed on an exchange
- Futures contracts are defined such that they must be traded on an exchange
- Before the new OTCD regulatory regime is fully implemented, intermediaries must inform the SFC if they wish to engage in OTC derivatives and will have to follow the guidelines that follow

6.2 Fit and Proper

- SFC follows IOSCO (International Organisation of Securities Commissions) approach requiring systems, controls and management to ensure prudential risk management
- Intermediaries must meet the basic “fit and proper” criteria as laid out by SFC for all regulated activities
- In addition, they need a specific statement of internal controls within the management and control systems and procedures to cater for OTC derivatives activities
- Can be applied with flexibility however must be as stringent as in guidelines
- Systems and procedures must be fully documented
- Must be able to demonstrate internal controls are as effective as IOSCO guidelines
- The SFC requires licensed or registered persons to have regard to the following matters:
  - **Framework of risk management**: clear policies overseen by board of directors or senior management body
  - **Independent market risk management**: monitor risk limits and approve pricing and valuation models (including mark to market mechanisms)
  - **Independent credit risk management**: set and monitor credit limits; review leverage, concentration and risk reduction arrangements
  - **In-house expertise and resources**
  - **Risk reduction techniques**: can include master agreements, netting arrangements, collateralisation of transactions, third party credit enhancements (letters of credit and guarantees) and contingency planning
  - **Valuations and exposure**: daily risk valuations; exposures may be aggregated as long as netting arrangements are acceptable and enforceable
  - **Systems**: includes accounting, risk management and information systems
  - **Liquidity, funding arrangements and financial performance**: continuous monitoring required

6.3 Risks of OTC Derivatives Trading

- IOSCO define a derivative as a financial instrument whose value is derived from and reflects changes in the prices of the underlying products. They facilitate the transfer of risk and investment. However, they can increase risks in the market place.

- IOSCO description of risks include:
  - **Credit risk**: risk counterparty will fail to perform obligation owed to intermediary
  - **Market risk**: risk movement in prices or values will result in loss for intermediary
  - **Liquidity risk**: risk lack of counterparties will leave intermediary unable to liquidate or offset of position
  - **Settlement risk**: risk that intermediary will not receive funds or instruments from counterparty at expected time
  - **Operations risk**: risk that the intermediary will suffer loss as a result of human error of deficiencies in systems
  - **Legal risk**: risk that intermediary will suffer loss as result of contracts being unenforceable or inadequately documented

- While such risks are not unique to OTC derivatives, they cause concern due to:
  - The volume, scope and variety of OTC derivatives
  - The interrelatedness of participants
  - The opacity and uncertain liquidity of the OTC markets
  - The complexity of and potential leverage in the instruments

- Need constant monitoring of exposure and dynamic hedging

- Implementation of risk management policies must be followed by all concerned

6.4 Risk Management Policies and Procedures

- Risk management policies and procedures must:
  - Be in written form
  - Be overseen by Board or equivalent senior management
  - Specifically cover derivatives activity
  - Clearly establish responsibility for implementation
  - Provide for accurate, informative and timely reports
  - Be understood by all in the business
  - Establish an independent market risk management function to monitor application of risk limit policies and to review and approve pricing models and valuation systems
  - Establish separate function to assess inputs to models
  - Ensure all models are back-tested
  - Ensure separation of back-office, accounting and compliance functions from trading, risk management
  - Monitor conflict of interests between divisions
  - Address measurement of market and credit risk, including:
    - Aggregate exposures against risk tolerant objectives

- Stress scenarios and tests (severe price movements and changes in market behaviour)
- Market risk measurement methodologies
- Acceptability criteria for counterparties, strategies and products
- Risk monitoring and exception reporting
- Personnel policies
- Establishment of risk management controls
- Checks over accounts, traders, operational staff and systems

6.5 Oversight by Senior Management

- Senior management (or at least two members) should:
  - Supervise and enforce implementation of policies
  - Understand practical activities and risks of business
  - Receive regular reports (daily) on transactions and positions
  - Be aware of possible human errors in reporting
  - Perform manual checks to make sure system is not being abused
  - Establish internal audit system on manual input to models
  - Assess regularly effect of positions on capital adequacy
  - Assess impact of exposures and potential exposures on capital adequacy
  - Ensure model stress testing and back testing
  - Assess risk/rewards for traders to ensure best use of capital, time and rate of return
  - Take action swiftly for any breaches of policies, practices and guidelines

6.6 Independent Credit Risk Management

- There must be an independent credit risk management function to set and monitor credit limits, review leverage, concentration and risk reduction arrangements

- Credit risk function should:
  - Assess each new client application
  - Ensure no trader conducts business with a client unless assessed and has a credit limit set
  - Should be considered a breach of in-house procedures if a credit limit is exceeded without senior management approval
  - Function should have similar importance to other account opening procedures with a due diligence approach to opening accounts
  - Need to assess appetite for risk, quality of credits, level of concentration, reliance on credit enhancements, measurement methodologies and separation of sales supervision from exposure supervision
  - Master agreements with standard terms should be used to ensure terms understood and clarity over jurisdiction

6.7 Adequate Resources

- Risk management controls, including back-office systems, accounting, supervision and training, require adequate resources
- This should include in-house expertise of both people and systems
- Knowledge at all levels, including traders and risk managers, needs to be adequate
- Adequate capital is required and funding risk calculations should be reviewed daily
- Intermediaries need to ensure that IOSCO guidelines are met to meet SFC's additional requirements
- Quality of policies, systems, processes and procedures are important and should operate in an effective and efficient manner

6.8 Progress of the Developing New OTCD Regime

- Mandatory reporting obligation became effective on 10 July 2015
- Mandatory clearing obligations and the expanded definition of automated trading services became effective on 1 September 2016
- Topic 2 covers mandatory reporting obligations and mandatory clearing obligations for OTC derivative transactions

7. Ongoing Requirements

- There are additional ongoing requirements to meet acceptable standards to engage in OTC derivatives activities

7.1 Systems

- Accounting, risk management and information systems should ensure adequate and timely:
  - ➢ Documenting, processing, confirming, approving and reconciling of trades and valuation systems in front and back office
  - ➢ Assessing of risk on global basis
  - ➢ Accurate reporting to management
  - ➢ External reporting by management
- The systems should be internally or externally reviewed to ensure they are operating as designed

7.2 Risk Reduction Techniques

- Risk reduction techniques should be used such as:
  - Checks that counterparty has power to enter transactions, represented by officer with actual authority, is credit worthy and has access to appropriate payment systems
  - Termination or restricting activities with participants where there is doubt on adequacy of their management controls
  - Master agreements to reduce documentation risk and to increase ability to assign or unwind transactions
  - Netting arrangements
  - Collateralisation of transactions
  - Third party credit enhancements (including letters of credit and guarantees)
  - Contingency planning to address operational risk
  - Use of SPVs which can be separately capitalized, credit rated and domiciled to isolate risks

7.3 Valuations and Exposures

- Daily accurate risk valuations using acceptable pricing methodology to mark-to-market and identify concentrations should be made
- Exposures to credit and market risk should be calculated
- Legal netting arrangements can be taken into account
- Value at risk (VAR) models and notional value assessments may be used, subject to regulatory approval and evidence of effective and adequate back-testing

7.4 Financial Performance

- Financial performance should be monitored on a continuing basis
- Revenues and adequacy of funding needs to be considered
- Liquidity planning needs to look at rebalancing portfolios, augmenting collateral and management of defaults

7.5 Conduct requirements in relation to OTCD transactions

- The Code of Conduct addresses conduct requirements intended to mitigate risk where the business of a licensed corporation, or various persons connected to it, involves **OTCD transactions**. The requirements fall into two main parts that deal with:
  - **mitigating risk** in OTCD transactions that are not centrally cleared (NCC); and
  - **managing risk** in relation to group affiliates and other connected persons

Mitigating risk in OTCD transactions that are not centrally cleared

- Licensed corporations subject to risk mitigation requirements will be:
  - a contracting counterparty to a NCC OTCD transaction; and
  - licensed for Type 9 regulated activity (asset management), managing a portfolio of non-centrally cleared OTCDs ("NCC OTCDs")
- Risk mitigation requirements **do not apply to registered institutions**
- The specific requirements revolve around **four key areas**: documentation, valuation, portfolio matters and handling of disputes

Group affiliates and other connected persons

Risk management

- Licensed corporations should apply the same risk management standards to all such parties, subject to any legal or regulatory requirement or exemption that might be applicable

Dealings

- Licensed persons that solicit, recommend, or arrange for OTCD transactions between a group affiliate and a client (other than a client that is a group affiliate) should always act in the best interests of the client

Disclosures when dealing with unlicensed persons

- Although a group affiliate may frequently be subject to regulatory oversight in Hong Kong or another jurisdiction, this is not always be the case
- In some cases, a licensed corporation may solicit, recommend or arrange for a client (other than a client that is a group affiliate) to enter into an OTCD transaction with a group affiliate that is not a person licensed by the SFC
- In such cases, additional risk disclosures should be included in the written client agreement that bring to the attention of the client that the group affiliate is not licensed by the SFC, and that the regulatory oversight protection afforded to the client might not the same as if the group affiliate were licensed and regulated by the SFC