Banking (Exposure Limits) Rules[1]

Item	Heading	Detailed Proposals	Remarks and Explanation of Policy Intent
<u>PART 1</u> – Preliminary			
1	Commencement	1.1 The Rules will come into operation on the day appointed for the commencement of section 9 of the BAO.	We would like to invite comment from AIs on the earliest possible time that they would be ready for implementing the new rules taking into account necessary system changes.
2	Interpretation - General	2.1 The following definitions will be included in Part 1 of the Rules: • *Capital Rules* means the Banking (Capital) Rules (Cap. 155 sub. leg. L); • The following terms will have the meaning given to them	These definitions and interpretations are expected to be used in more than one Part of the Rules.

[1] This is a provisional working title.

		in section 2(1) of the Capital Rules; - *Additional Tier 1 capital;* - *Banking book;* - *CET1 capital;* - *Collective investment scheme;* - *Fair value;* - *Forward contract;* - *Futures contract;* - *Option contract;* - *Repo-style transaction;* - *Swap contract;* - *Tier 1 capital;*	

		- *Trading book.* 2.2 The Rules will include a provision to the effect that a reference in the Rules to a table or formula followed by a number (including an alphanumeric number) is a reference to the table or formula, as the case may be, in these Rules bearing that number.	Cf section 2(2) of the Capital Rules and rule 2(4) of the Banking (Liquidity) Rules ("BLR").
		2.3 The Rules will provide that if, under a provision of the Rules, the approval or consent of the MA is required by an AI in respect of any matter, the institution must seek the approval or consent, by making an application in the specified form (if any) to the MA.	Cf section 2(3) of the Capital Rules and rule 2(5) of the BLR.
		2.4 The Rules will provide that if, under a provision of the Rules, the MA is required to give, or may give, notice of any matter to all AIs, or to a class of such institutions, it is sufficient compliance with the provision if the MA publishes the notice in the Gazette.	Cf section 2(4) of the Capital Rules and rule 2(6) of the BLR.
		2.5 If any matter specified in a provision of these Rules is qualified by the word "appropriate", "material",	Cf section 2(5) of the Capital Rules and rule 2(7)

		"prudent", "reasonable", "relevant" or "reliable", then, for the purposes of assisting in ascertaining the nature of each qualification insofar as it relates to the matter, the Rules will note that regard must be had to any guidelines or codes of practice issued under the BO that are applicable to the provision;	of the BLR. Banking (Amendment) Ordinance 201 ("BAO") s17 amends Part XVIC of the BO to include the Rules made under s81A within the "relevant provisions" for issuance of a code of practice.
3	Valuation of exposures measured at fair value	3.1 Provision will be included into the Rules such that where the exposures of an AI are measured at fair value, for the purposes of these Rules, the institution must establish and maintain valuation systems, controls and procedures that are effective to ensure that the valuation of its exposures is prudent and reliable. 3.2 For this purpose, an AI must make adjustments, where appropriate, to the valuation of its exposures that are measured at fair value to account for— (a) the limitations of the valuation model or	Cf section 4A of the Capital Rules and Rule 9 of the BLR.

		methodology and the data used by the institution in the valuation process; (b) the liquidity of the institution's exposures; and (c) other relevant factors that might reasonably be expected to affect the prudence and reliability of the valuation of the institution's exposures. 3.3 To avoid doubt, adjustments made by an AI in accordance with this section may exceed adjustments made by the institution in accordance with the financial reporting standards adopted by the institution. 3.4 If the value of an equity exposure measured according to Division 4 of Part 2 is a fair value, it must be determined in accordance with subparagraphs 3.1 to 3.3 above.	
4	MA may require provisions of these Rules to apply to certain AIs on a consolidated or unconsolidated basis	4.1 For the purposes of the application of the exposure limit under paragraph 8.1 below to an AI incorporated in Hong Kong that has one or more than one subsidiary, the Rules will provide that the MA may, by notice in writing to the institution, require the provision to apply	To specify the power to require application of the Rules on a consolidated basis pursuant to new s81A(3)(d) of the BO (as inserted by the

		to the institution – (a) on an unconsolidated basis in respect of the institution; (b) on a consolidated basis in respect of the institution and one or more of such subsidiaries; or (c) on an unconsolidated basis in respect of the institution and on a consolidated basis in respect of the institution and one or more of such subsidiaries. 4.2 The Rules will oblige an AI to comply with the requirements of a notice given to it as described under paragraph 4.1 above. 4.3 The Rules will include a provision to the effect that no duty to which a subsidiary of an AI may be subject shall be regarded as contravened by reason of the submission of information by the subsidiary to the institution for the purpose of enabling or assisting the institution to comply with a notice described under paragraph 4.1 above.	BAO), which reflects s79A of the BO and section 3C of the . It is envisaged that additional exposure limits will ultimately be covered by this consolidation provision when the Rules are amended to include other types of exposure limits in the future. Cf BO s79A(3).

5	Prescribed notification requirements - section 81C of the BO (as inserted by the BAO)	5.1 The Rules will prescribe that an AI must immediately notify the MA of an [exposure limit event] and provide the MA with any particulars of the event that the MA requests. 5.2 An [exposure limit event] means: (a) failure to comply with the limit referred to in paragraph 8.1 below; (b) failure to comply with any conditions set by the MA in giving a consent under the circumstances described in paragraph 8.2(g) below; or (c) failure to comply with a limit set out in a notice served on an institution under paragraph 9.1 below.	To specify prescribed notification requirements for the purposes of the new s81C(1) of the BO, as inserted by the BAO, making reference to the language of Rule 14 of the BLR. It is expected that [exposure limit event] will be expanded to capture breach of other exposure limits/conditions when the Rules are "expanded" in the future.
PART 2 – Limitation on equity exposures			

Division 1 General			
6	Application of Part 2	6.1 This Part will be expressed to apply to AIs incorporated in Hong Kong and a reference to an AI under this Part should be construed as an AI incorporated in Hong Kong.	
7	Interpretation of Part 2	7.1 The following definitions will be included in Part 2 of the Rules as they will only be applicable to Rules included in Part 2 : • ***CIS means*** collective investment scheme; • ***Delta*** has the meaning given by section 281 of the Capital Rules; • ***Delta-weighted position*** has the meaning given by section 281 of the Capital Rules;	
		• ***Equity exposures*** mean all of an AI's direct and indirect equity interests (whether voting or non-voting) in a company where those interests are not consolidated for the purposes of determining the institution's capital base	Cf section 145 of the Capital Rules with necessary modification tailored for the large exposure framework.

		in accordance with Part 3 of the Capital Rules, including: (i) holdings of any share issued by a company; (ii) holdings of any equity derivative contract; (iii) the equity component of holdings in any CIS which is engaged in the business of investing in equity and the acquisition and disposal of equity interests; (iv) holdings of any instrument which would satisfy the requirements for inclusion in the institution's CET1 capital or Additional Tier 1 capital if the instrument were issued by the institution; (v) holdings of any instrument: (A) which is irredeemable; (B) which does not embody an obligation on the part of the issuer except an obligation which falls within sub-paragraph (vi) below; and (C) which conveys a residual claim on the assets or income of the issuer; (vi) holdings of any instrument which embodies an obligation on the part of the issuer and in respect of which –	7.1 Equity exposures (iii): The suggested wording of "equity component of holdings in any CIS" is intentional to avoid confusion since the HKMA is going to introduce new provisions to Capital Rules later to implement the new Basel standard on equity investments in fund, and the term "equity exposure to CIS" will be used to mean all investments in CIS regardless whether the CIS invest in equities. Meanwhile, we deliberately omitted the word principally (cf Capital Rules s145)

			(A) the issuer may indefinitely defer the settlement of the obligation; (B) the obligation requires (or permits at the issuer's discretion) settlement by the issuance of a fixed number of the issuer's equity shares; (C) the obligation requires (or permits at the issuer's discretion) settlement by the issuance of a variable number of the issuer's equity shares and, other things being equal, any change in the value of the obligation is attributable to, comparable to, and in the same direction as, the change in the fair value of a fixed number of the issuer's equity shares; or (D) the institution has the option to require that the obligation be settled in equity shares unless the institution demonstrates to the satisfaction of the MA that – - in the case of a traded instrument, the instrument trades more like debt of the issuer than equity; or - in the case of a non-traded instrument, the	because we intend to capture all CISs which invest in equity interests without any qualifier.

		instrument should be treated as a debt holding; (vii) holdings of any debt obligation, share, derivative contract, investment scheme or instrument, which is structured with the intent of conveying the economic substance of equity interests;	
		(viii) any of the institution's liabilities on which the return is linked to that of equity interests, which include but are not limited to short selling position in relation to stock borrowing; and (ix) any commitment to acquire any of the holdings stated under (i) to (vii) or to acquire the liabilities stated under (viii) above.	(viii) is modified. The added clause "which include but are not limited to short selling position in relation to stock borrowing" to (viii) seeks to clarify that the term "equity exposure" would include short positions. (ix) is added to cater for the policy intent under the equity exposures framework.
		To avoid doubt, an equity exposure can be a long position or a short position;	This clause is added to clarify that the term "equity exposure" would include long/short positions.

		• ***Equity derivative contract*** means a futures contract, forward contract, swap contract, option contract or similar derivative contract the value of which is determined by reference to the value of, or any fluctuation in the value of, one or more than one underlying equity or underlying equity index (being an index calculated by reference to a basket of equities). 7.2 The weight of an equity in an equity index means the weight of that equity in the equity index as specified by the index provider in compiling the index. 7.3 The weight of an equity in a basket of equities means the ratio of the fair value of that equity to the aggregate fair value of all the equities in the basket.	This definition has combined the definitions of "equity contract" under s2(1) and "equity-related derivative contract" under s281 of the Capital Rules . 7.2 and 7.3: These references are used in paragraph 14.2 below.
Division 2 Limitation of equity exposures			
8	Limitation of AI's equity exposures	8.1 The Rules will provide that, subject to the provisions described in paragraphs 8.2 and 9 below, the aggregate equity exposures of an AI calculated pursuant to the methodology set out in paragraph 10 below shall not exceed 25 per cent of the Tier 1 capital of the institution.	

		8.2 For the purposes of the limit referred to in paragraph 8.1 above, the equity exposures of an AI do not include – (a) the holding of any share capital as security for facilities granted by the institution or any share capital acquired by the institution in the course of the satisfaction of debts due to it: Provided that all share capital acquired in the course of the satisfaction of debts due to the institution shall be disposed of at the earliest suitable opportunity, and in any event not later than 18 months after its acquisition or within such further period as the MA approves in writing in any particular case. (b) the acquisition or holding by the institution of any part of the share capital of any company or companies under an underwriting or subunderwriting contract for a period not exceeding 7 working days, or such further period as the MA approves in writing, and subject to such conditions as the MA may think proper to attach to such approval, in any particular case;	To provide similar exemptions to those under the current Section 87 of the BO. Section 81A(3)(i) of the BO, as inserted by the BAO, provides for MA to consent to incurring of exposures that need not be taken into account in calculating applicable limit. (a) Cf current s87(1) of the BO. (b) Cf current s87(2)(a) of the BO.

		(c) any commitment by the institution to acquire the share capital of any company or companies under an underwriting or subunderwriting contract that would be captured under item (ix) of the definition of equity exposure;	(c) As the definition of "equity exposure" includes a commitment to acquire any such an exposure, there is a need to exclude underwriting contracts which by their nature involve a commitment to acquire shares not otherwise subscribed/sold. Similar exemption is provided for under current s81(6)(j) of the BO.
		(d) any holding, approved in writing by the MA, of share capital in – (i) another AI; or (ii) a company carrying out nominee, executor or trustee functions, or other functions related to banking business, the business of taking deposits, insurance business, investments or other financial services;	(d) Cf current s87(2)(b) of the BO.

		(e) any holding, approved in writing by the MA, of share capital which is deducted in determining the capital base of the AI under the Capital Rules; (f) any equity exposure up to the amount incurred by the AI specifically to offset any holding in subparagraphs (a), (b), (d) or (e) above or any commitment in subparagraph (c) above. The intention here is that the exclusion in this paragraph (f) shall be capped at the amount of the holding or commitment as the case may be. In other words, an AI cannot exclude from its calculation any "excess" offsetting exposure. (g) any equity exposure: (i) specified in a consent given by the MA (which consent may be given to the AI, or a class of AIs, or generally to all AIs) where the	(e) Cf current s87(2)(c) of the BO. (f) is to avoid the anomaly that the positions under (a) to (d) are exempted but the hedges taken in respect of them are not. Section 81A(3)(i) provides for rules to empower MA to consent to exclusion of specified exposures from the large exposures limit calculation.

		MA considers that it is reasonable to allow such exposure not to be taken into account in calculating whether the AI has reached the limit referred to in paragraph 8.1, having regard to (a) the nature and risks associated with the equity exposure; (b) any risk mitigation measures taken by the AI to manage these risks; (c) the additional risks associated with any such risk mitigation measures; and (d) any other factors as the MA may consider relevant; and (ii) subject to such conditions as the MA thinks fit to impose on any such consent.	
9	MA may vary the limit on aggregate equity exposures applicable to an AI	9.1 The Rules will provide that subject to the procedure set out in paragraphs 9.2, 9.3, 9.4 and 9.5 the MA may, by notice in writing served on an AI vary the limit referred to in paragraph 8.1 above applicable to the institution if the MA is satisfied, on reasonable grounds, that it is prudent to make the variation, taking into account (a) the risks associated with the level or concentration of the AI's equity exposures; (b) any risk mitigation measures taken by the AI to manage these risks; (c) the risks associated with any such risk mitigation measures; (d) any prevailing or reasonably anticipated market	To specify the circumstances and procedures in relation to the power of the MA to vary any limit imposed under these Rules applicable to an AI pursuant to the new s81A(3)(j) of the BO. The policy intention is that the MA may increase or decrease a limit using this power.

		conditions which might affect the risks associated with the AI's equity exposures; and (e) any other factors as the MA may consider relevant. 9.2 If the MA proposes to serve such a notice on an AI, the Rules will require the MA to serve a draft of the notice (draft notice) on the institution. 9.3 A draft notice served on an AI must– (a) specify – (i) the manner in which the limit is proposed to be varied; and (ii) the circumstances pertaining to, and the grounds for, the proposed variation; and (b) include a statement that the institution may, within 14 days (or any longer period as the MA allows in any particular case) from the date of service of the draft notice, make written representations to the MA on any or all of the matters specified in the draft notice. 9.4 If representations are made by the AI concerned on the draft notice served on the AI, the Rules will provide that	Reference has been made to BO sections 97F and 97K

		the MA may, after considering the representations – (a) serve a notice on the institution in substantially the same terms as the draft notice; (b) serve a notice on the institution in terms modified to take account of any one or more of those representations that satisfies the MA that the modification concerned ought to be made; or (c) elect not to serve a notice on the institution because one or more of those representations satisfy the MA that the MA should neither take the action mentioned in sub-paragraph (a) nor take the action mentioned in sub-paragraph (b). 9.5 If no representations are made by the AI concerned on the draft notice served on the AI, the Rules will provide that the MA may serve a notice on the institution in substantially the same terms as the draft notice. 9.6 If the limit relating to aggregate equity exposures referred to in paragraph 8.1 applicable to an AI is varied by the MA under this procedure, the Rules will be expressed to apply, in relation to that institution, with all necessary modifications, to take account of the limit so	

		varied. 9.7 The Rules will provide that a decision of the MA to vary any limit imposed under these Rules is a decision to which section 101(B)(1) of the BO applies. 9.8 To avoid doubt – (a) the MA will be allowed to serve a draft notice on an AI in substitution for an earlier draft notice served on the institution; and (b) the reference to "substantially the same terms as the draft notice" used in sub-paragraphs 9.4(a) or 9.5 above should not be construed to include the statement mentioned in sub-paragraph 9.3(b) above.	Section 81A(4) of the BO, as inserted by the BAO, states that the rules may provide that a specified decision of the MA is a decision to which s101(B)(1) of the BO applies.
Division 3 Calculation of aggregate equity exposures			
10	Calculation of aggregate equity exposures	10.1 The Rules will provide that the aggregate equity exposures of an AI is the sum of its equity exposures in the banking book and trading book measured in accordance with Division 4.	

		10.2 Within each of the trading book and banking book, long and short positions in the same equity are permitted to be offset, irrespective of the instrument from which they are derived. 10.3 Offsetting of equity exposures across the trading book and banking book is not allowed. 10.4 Any net short position in an equity exposure should be treated as if it were a net long position.	 Reference: section 185(e)
Division 4: Measurement of equity exposures			
11	General	11.1 The Rules will provide that an AI's equity exposures in relation to an on-balance sheet item (other than shares of a company, repo-style transactions, an equity derivative contract, an item with an embedded equity derivative contract and CIS) should be measured at the value presented in the institution's balance sheet.	Reference made to Capital Rules section 183(3) and the definition of "principal amount" under BLR rule 54. We consider that the expression "value presented in the institution's balance sheet" can be more easily understood than "current book value" in s79 of the

		11.2 An AI's equity exposure in relation to an off-balance sheet item other than shares of a company and an equity derivative contract should be measured at the contracted amount.	BO. The term "contracted amount" is well understood by the industry and has been used in Capital Rules s51 (principal amount) and s139 (principal amount).
12	Equity exposures in the shares of a company	12.1 The Rules will provide that an AI's equity exposures in the shares of a company is the sum of the total of the value of shares presented in the institution's balance sheet and the amount for the time being remaining unpaid on the shares.	Reference made to BO s79 (see paragraph (a) of the definition "value")
13	Equity derivative contracts	13.1 The Rules will provide for an AI to convert its futures contracts, forward contracts and options contracts into exposures in the underlying equity by— (a) valuing its futures contracts and forward contracts relating to an individual equity or a basket of equities at the fair value of the underlying equity or underlying basket of equities respectively under the contracts;	Reference: Capital Rules section 292(1)(c) and (d)(i)

		(b) valuing its futures contracts relating to equity indices as— (i) the current index value multiplied by the monetary value of one index point set by the futures exchange where the futures contract is traded; or (ii) the fair value of the underlying basket of equities used to compile the index; (c) valuing its option contracts relating to an individual equity, a basket of equities or an equity index at the delta-weighted position of the option. 13.2 An AI should regard each of its equity swap contracts as long and short positions such that in the case of an equity swap contract under which the institution— (i) is receiving an amount based on the change in value of a particular equity, basket of equities or equity index; and (ii) is paying an amount based on the change in value of a different equity, basket of equities or equity index, the position in sub-subparagraph (i) is the long position, and the position in sub-subparagraph (ii) is the short position, of the equity swap contract.	13.1(c): Reference to Capital Rules section 303(c).

14	Treatment of exposures in equity derivative contracts in relation to an equity basket and equity index	14.1 The Rules will provide that an AI may break down its equity exposure in equity derivative contracts in relation to a basket of equities or an equity index into exposures in the individual underlying equities in the basket or equity index, provided that it has daily information to calculate its exposures in the individual underlying equities as described below. 14.2 For the purposes of the calculation referred to in paragraph 14.1 above, an institution's exposure in an individual underlying equity should be calculated as the weight of that equity in the basket or equity index multiplied by the value of the equity derivative contract calculated according to paragraph 13 above. 14.3 An institution's positions in the individual underlying equities derived according to paragraph 14.1 above can be offset against the institution's opposite position in the same equity according to paragraph 10.2 above for the	This treatment makes reference to the look-through approach provided in paragraph 80(ii) of the "Capital requirements for banks' equity investments in funds" published by the Basel Committee on Banking Supervision [2] in December 2013. The application of para 14 is intended to be optional. For example, an AI sells an index futures contract and the value of the contract calculated according to paragraph 13.1 is HK$1 million. Assuming that

[2] https://www.bis.org/publ/bcbs266.pdf

		purpose of calculating the institution's aggregate equity exposures.	stock A accounts for 4% of the index as disclosed by the index compiling company. The AI's short position in stock A arising through the contract is HK$1m x 4% = HK$40,000. If the AI also holds shares of stock A valued at HK$60,000, the long and short positions can be offset resulting in a net long position of HK$20,000 in stock A.
15	Repo-style transactions	15.1 The Rules will provide that in calculating its equity exposure, an AI must treat an equity underlying a repo-style transaction in accordance with the following provisions. (a) If the transaction falls within paragraph (a) or (b) of the definition of repo-style transaction as imported from section 2(1) of the Capital Rules, an AI shall treat the equity sold or lent under the transaction as	Subparagraphs (a) to (b) mirror section 75 of the Capital Rules in the calculation of risk-weighted amount of exposures in respect of assets underlying repo-style transactions.

		remaining as an on-balance sheet exposure of the institution as if the institution had never entered into the transaction and accordingly, include the equity in the calculation of the institution's aggregate equity exposures. (b) If the transaction falls within paragraph (d) of the definition of repo-style transaction as imported from section 2(1) of the Capital Rules if and to the extent an institution has provided any equity as collateral under the transaction, the institution shall treat the equity as its on-balance sheet exposure as if the institution had never entered into the transaction and accordingly, include the equity in the calculation of the institution's aggregate equity exposures.	
16	CIS	16.1 The Rules will provide that an authorized institution shall measure its on balance sheet exposure to the equity component of a CIS by any one of the following methods, provided that the institution has the necessary information required under that method –	Reference is made to paragraphs 80(ii) and 80(iii) of the "Capital requirements for banks' equity investments in funds" published by the Basel Committee on Banking

		(a) An authorized institution can measure its on balance sheet exposure to the equity component of a CIS by Formula A, provided that the following conditions are satisfied: (i) There is sufficient and frequent information provided to the institution regarding the underlying exposures of the CIS. To satisfy this condition, the frequency of financial reporting of the CIS must not be less frequent than that of the authorized institution, and the information must be sufficient to allow the institution to calculate its equity exposure to the CIS according to Formula A; and (ii) The information provided to the institution in (i) is verified by an independent third party such as the depository, the custodian or the manager of the CIS or is subscribed information provided by third party market data providers. <u>Formula A</u> $E_{CIS} = \text{Min}\ [V, V \times (CIS_{actual} / CIS_{NAV})]$, where E_{CIS} = the institution's on balance sheet exposure to the	Supervision in December 2013. Para 16 applies to both the banking and the trading book. Please see Annex for illustrations of the application of Formulae A, B and C.

		equity component of the CIS; V = value of the institution's holding in the CIS presented on the institution's balance sheet; CIS_{actual} = total amount of equity exposures held by the CIS as reported in the CIS's latest financial report (the CIS's holding of equity derivative contracts must be converted into exposures in the underlying equity for inclusion in this total amount); CIS_{NAV} = total net asset value of the CIS as reported in the CIS's latest financial report. (b) An authorized institution can measure its on balance sheet exposure to the equity component of a CIS by Formula B if the maximum extent of equity exposures permitted to be incurred by the CIS under its mandate is known to the institution. <u>Formula B</u> E_{CIS} = Min [V, V x CIS_{max}], where E_{CIS} = the institution's on balance sheet exposure to the equity component of the CIS; V = value of the institution's holding in the CIS	

		presented on the institution's balance sheet; CIS_{max} = the ratio of the maximum amount of equity exposures permitted to be incurred by the CIS under its investment mandate to the total net asset value of the CIS as reported in the CIS's latest financial report. The maximum amount of equity exposures permitted to be incurred by the CIS under its investment mandate must include equity exposures converted from the CIS's holding of equity derivatives contracts, and be determined assuming that the CIS borrows to the maximum extent permitted under its mandate. (c) An authorized institution can measure its on balance sheet exposure to the equity component of a CIS at the value of the CIS presented on its balance sheet. 16.2 The Rules will provide that an authorized institution may break down its on balance sheet exposure to the equity component of a CIS calculated according to paragraph 16.1(a) into positions in the individual underlying equities in the CIS by formula C below, provided that that total exposures held by the CIS does	The application of 16.2 and 16.3 is intended to be optional. An AI will be able to **look through** its

		not exceed the total net asset value of the CIS as reported in the CIS's latest financial report. <u>Formula C</u> $E_u = E_{CIS} \times CIS_u / CIS_{actual}$, where E_u = the institution's exposure to an underlying equity held by the CIS; E_{CIS} = the institution's on balance sheet exposure to the equity component of the CIS calculated by Formula A CIS_u = amount of exposure to an underlying equity held by the CIS as reported in the CIS's latest financial reports. It must include any exposure to that underlying equity arising from the CIS's holding of equity derivative contracts; CIS_{actual} = total amount of equity exposures held by the CIS as reported in the CIS's latest financial report (the CIS's holding of equity derivative contracts must be converted into exposures in the underlying equity for inclusion in this total amount). 16.3 For the purpose of paragraph 16.2, total exposure held by a CIS means the sum of exposures incurred by the	investment in a **CIS** using 16.2 **only if (i) it has been able to calculate** its exposure to the **equity component** of the CIS according to para 16.1(a) **and (ii)** it is **not a leveraged fund**. The latter condition is attached because an AI would not be able to precisely hedge its exposures under a leveraged CIS with its positions outside the fund.

		CIS with respect to any asset class including cash and exposures converted from the holding of derivative contracts. 16.4 An institution's positions in the individual underlying equities derived from Formula C can be offset against the institution's opposite position in the same equities according to paragraph 10.2. 16.5 The Rules will provide that if an authorised institution has any off balance sheet unfunded commitment to invest in the CIS, such unfunded commitment should be included in the institution's aggregate equity exposure at the contracted amount.	16.5 - This provision would mean that the whole contracted amount of unfunded commitment will be included in the calculation of aggregate equity exposure according to paragraph 10 without going through the calculation in paragraphs 16.1 and 16.2.
Part 3: Transitional provisions for Part 2			
17	Interpretation	17.1 The Rules will provide that for the purpose of this part, relevant day means the date of commencement of Part 2 of these Rules, i.e. [dd mm 2018].	

18	In relation to section 79A of the BO	18.1 If immediately before the relevant day section 87 of the BO applies (following the issue under s79A of the BO of a written notice by the MA) to an institution (a) on a consolidated basis instead of on an unconsolidated basis; or (b) on both a consolidated basis and an unconsolidated basis, then, on and from the relevant day, a notice as described under paragraph 4.1 above shall be deemed under the Rules to have been issued to the AI requiring it to calculate its aggregate equity exposure on the same basis.	
19	In relation to section 87 of the BO	19.1 Where, immediately before the relevant day, any period allowed under the proviso to Section 87(1) of the BO had not expired then the Rules will provide that, on and from the relevant day, the unexpired portion of that period shall be deemed to be a further period approved under, and for the purposes of, the provision referred to in paragraph 8.2(a) as if, on the relevant day, the MA had given such approval under the provision referred to in paragraph 8.2(a), and the provisions of the Rules shall apply accordingly.	To provide for the transitional arrangement in relation to Section 87 similar to that in s148A of the BO

		19.2 Where, immediately before the relevant day, any further period allowed under Section 87(2)(a) of the BO had not expired then the Rules will provide that, on and from the relevant day, the unexpired portion of that period shall be deemed to be a further period approved under, and for the purposes of, the provision referred to in paragraph 8.2(b) as if, on the relevant day, the MA had given such approval under the provision referred to in paragraph 8.2(b), and the provisions of the Rules shall apply accordingly. 19.3 Where an approval given by the MA under Section 87(2)(b) of the BO is in force immediately before the relevant day the Rules will provide that an approval shall be deemed to be given by the MA under the provision referred to in paragraph 8.2(d) on the relevant day. 19.4 Likewise, any approval given under Section 87(2)(c) of the BO which is in force immediately before the relevant day shall be deemed under the Rules an approval given by the MA under the provision referred	

		to in paragraph 8.2(e) on the relevant day.	

Annex

Illustrative examples for application of Formulae A, B and C

Formula A

Example 1:

Book value of the AI's holding in the CIS presented on its balance sheet (V): HK$100

CIS Information according to its financial report

Shares held	$250
Bonds held	$50
Equity exposures arising from derivative contracts	$100
Unitholders' equity	$200
Loans	$100
Net Asset Value	$200

Total amount of equity exposures held by the CIS as reported in the CIS's latest financial report (CIS_{actual}) = $350

AI's on balance sheet exposure to the equity component of the CIS (E_{CIS})
= Min [$100, $100 x ($350/$200)] = $100

Example 2:

Book value of the AI's holding in the CIS presented on its balance sheet (V): HK$100

CIS Information according to its financial report

Shares held	$50
Bonds held	$250
Equity exposures arising from derivative contracts	$100
Investment from unitholders	$200

Loans	\$100
Net Asset Value	\$200

Total amount of equity exposures held by the CIS as reported in the CIS's latest financial report (CIS_{actual}) = \$150
AI's equity exposure to the CIS (E_{CIS}) = Min [\$100, \$100 x (\$150/\$200)] = \$75

Formula B

Example 3

Book value of the AI's holding in the CIS presented on its balance sheet (V): HK\$100

The CIS investment objective is to invest up to 70% of its total exposure (as defined in paragraph 16.3) in equities. The fund may incur a financial leverage (defined as the ratio of total fund assets to total unitholders' equity) of up 2 times.

CIS_{NAV} = total net asset value of the CIS as reported in the CIS's latest financial report.

Total exposure that can be incurred by the CIS = 2 x CIS_{NAV},

Maximum amount of equity exposures permitted to be incurred by the CIS under its investment mandate = 70% x 2 x CIS_{NAV} = 1.4 x CIS_{NAV}

Ratio of the maximum amount of equity exposures permitted to be incurred by the CIS under its investment mandate to the total net asset value of the CIS as reported in the CIS's latest financial report (CIS_{max}) = 1.4 x CIS_{NAV} / CIS_{NAV} = 1.4

AI's on balance sheet exposure to the equity component of the CIS (E_{CIS})
= Min [V, V x CIS_{max}] ,
= Min [100, 100 x 1.4] ,
= 100

Example 4

Book value of the AI's holding in the CIS presented on its balance sheet (V): HK\$100

The CIS investment objective is to match the performance of the Hang Seng Index with a leverage factor of 1.5 on a daily basis, with leverage being obtained through the use of borrowings, futures contracts and other derivative contract in order for the CIS to obtain a daily target exposure of 150% of its net asset value.

The institution's on balance sheet exposure to the equity component of the CIS (E_{CIS}) = Min [$100, $100 x 1.5] = $100

Formula C

Example 5

Assume the CIS in Example 1 has the following exposures in Stock A and Stock B:

CIS information according to its financial report

Stock A	$150
Stock B	$100
Bonds held	$50
Exposures to Stock A arising from futures contracts	$100
Investment from unitholders	$200
Loans	$100
Net Asset Value	$200

Exposure to Stock A held by the CIS = $250
Exposure to Stock B held by the CIS = $100
Total equity exposures held by the CIS =$350

The institution's exposure to Stock A held by the CIS = $100 x ($250 / $350) = $71.4
The institution's exposure to Stock B held by the CIS = $100 x ($100 / $350) = $28.6