22 June 2017

Circular to futures brokers on compliance and control issues

Following the publication of the *Report on the fact-finding exercise*[1] *on retail futures brokers*[2] on 28 April 2017, this circular sets out key areas of regulatory concern about retail futures brokers, and the standards of conduct and internal controls the SFC expects of futures brokers.

The SFC emphasizes the importance of proper risk management. Collecting adequate margin from clients helps to ensure that clients fulfil their obligations and minimises the financial risk exposure of brokers. Futures brokers should collect all amounts due as margin promptly and ensure that margin call records are properly maintained. Where the upfront initial margin requirement might be waived for "established clients"[3], it is vital that the eligibility criteria is carefully assessed and monitored regularly.

1. Criteria for assessing "established clients" under HKFE Rule 617(b)

Futures brokers have adopted differing criteria for assessing whether a client is "established" under HKFE Rule 617(b). The risk is that clients who do not have sufficiently good financial standing or creditworthiness might still be classified as established, and therefore allowed to trade in futures contracts without depositing sufficient upfront margin, exposing futures brokers to elevated financial risk.

The SFC has worked with HKFE to provide guidance to the industry on the assessment criteria for established clients under HKFE Rule 617(b) http://www.hkex.com.hk/eng/market/partcir/hkfe/2017/Documents/MO_DT_089_17_e.pdf. Detailed guidelines on how to fulfil the following criteria in assessing if a client is eligible to be treated as an established client are set out in the guidance:

- demonstrating a record of consistently meeting margin obligations
- maintaining a sound financial position
- ongoing review of the eligibility of established clients

HKFE also provides specific guidelines on the criteria for determining whether an established client is an "exclusive day trader" for whom futures brokers should not transact day trades without collecting the minimum margin from the client.

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[1] The SFC conducted a fact finding exercise on selected local futures brokers, which are exchange participants of Hong Kong Futures Exchange Limited (HKFE) and mainly serve retail clients, regarding their business profile and risk management controls.
[2] Futures brokers refer to intermediaries licensed or registered for Type 2 regulated activity of "dealing in futures contracts", where "futures contract" means a contract or an option on a contract made under the rules or conventions of a futures market as defined in Section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance.
[3] Under Rule 617(b) of the Rules of the HKFE, if certain criteria are satisfied, exchange participants may transact for established clients even if they do not deposit sufficient upfront margin.

HKFE's guidance should ensure greater consistency as to how the financial status and creditworthiness of clients should be assessed before they are treated as established clients. This will improve overall risk controls and futures brokers' resilience to market volatility.

HKFE exchange participants should follow the guidance in assessing established clients, and maintain proper documentation of the assessment and approval of established clients.

2. Collection of margin from clients

SFC inspections have shown that some futures brokers have allowed clients who are not established to open new positions before receiving sufficient initial margin. This is inconsistent with HKFE Rules[4] and the SFC Code of Conduct[5].

3. Margin call documentation

SFC inspections also found that some futures brokers did not keep any records of margin calls or of sufficient details of margin calls.

Futures brokers should maintain records which are sufficient to show particulars of all margin calls made to every client[6]. Relevant information including the initiation of each margin call, particulars of margin calls made, the client's response to the margin call, and any follow-up actions taken (such as forced liquidation) should be properly documented.

4. Setting-off arrangement

Arrangements have been common whereby funds are transferred between client accounts which effectively set-off the debit balance of a client's futures trading account against the credit balance of the client's other trading accounts held with the futures broker or its affiliated companies[7]. However, relevant information such as the specific terms that apply to, and the risks involved in, these transfers might not be specified in a client's authorisation or otherwise provided to the client. Where funds have been transferred to cover margin shortfalls in lieu of forced liquidation, clients may not have the opportunity to decide whether to maintain open positions subject to market risk or to stop continuing losses by liquidating them.

Futures brokers are therefore reminded to disclose to their clients and bring to their attention all relevant terms and risks of any of these set-off arrangements. For example, futures brokers should communicate to clients:

- the circumstances under which transfer of funds can be effected, such as:
    - whether the client's consent will be obtained before each fund transfer;
    - how clients will be contacted and action taken if the client is uncontactable;

[4] HKFE Rule 617
[5] Paragraph 3.6 of the Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct)
[6] Section 7(2)(d)(iv) of the Securities and Futures (Keeping of Records) Rules and paragraph 1(j) of Schedule 4 to the Code of Conduct
[7] Such arrangement was usually effected when a client's futures trading account had a margin shortfall or when he wanted to open new positions without adequate margin deposits, while his other trading account maintained with the broker or its affiliated companies had an excess cash balance. Funds would be transferred to the client's futures trading account to meet the margin requirement.

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- whether only excess funds in other accounts would be transferred to the client's futures trading account;
- whether sales of collateral in the client's other accounts might be used to fund a shortfall in the futures trading account;
- whether the transfer would cover the margin shortfall only or be a higher amount to establish or replenish any buffer; and

- the market risks involved in holding open positions and any additional charges that may be borne by the clients.

Disclosure may be made in the clients' authorisation or by using other methods that ensure clear communication to clients. A proper audit trail of all communications with clients should be maintained.

SFC inspections have also shown that some futures brokers have used the credit balance in a client's non-HKFE trade ledger account to offset the debit balance, or to meet a margin requirement, in the client's HKFE trade ledger account without making of actual fund transfers, or vice versa. HKFE exchange participants must not allow credit balances in any type of trading account to be used to offset debit balances, or to meet margin requirements or demands for variation adjustment, on any other trading account unless there are actual fund transfers[8].

5. Segregation of accounts for HKFE trades and non-HKFE trades

Some futures brokers have not maintained separate segregated bank accounts for holding client money relating to HKFE trades and non-HKFE trades. Others did not designate the bank accounts used for keeping client money relating to HKFE trades and non-HKFE trades separately as "HKFE Trade" and "Non-HKFE Trade" accounts. Some did not maintain separate ledger accounts for each client in respect of HKFE trades and non-HKFE trades.

HKFE exchange participants which transact HKFE trades and non-HKFE trades should maintain at least two segregated bank accounts and should ensure that all client money relating to HKFE trades is paid into a segregated bank account designated as an "HKFE Trade" account. Client money relating to non-HKFE trades must be paid into a different segregated bank account designated as a "Non-HKFE Trade" account[9]. In addition, they should maintain separate ledger accounts for every client in respect of all HKFE trades, all non-HKFE trades and all other trades which are unrelated to the business of dealing in futures contracts[10].

6. Client money placed with overseas brokers

Some brokers, when conducting futures transactions for clients in other jurisdictions, have placed client money with overseas brokers in amounts which were substantially in excess of the margin required to be posted.

Futures brokers should establish and maintain policies and procedures to ensure proper management of risks to which they and their clients are exposed when conducting these

[8] Paragraph 19 of Schedule 4 to the Code of Conduct
[9] Paragraph 7(b) of Schedule 4 to the Code of Conduct
[10] Paragraph 17 of Schedule 4 to the Code of Conduct

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overseas transactions. They should evaluate and monitor the risks of transacting through overseas brokers, and avoid placing excessive client money with them. They should explain to clients the risks associated with such trading activities, including the risk that client assets held overseas may not be subject to the protections given to client assets held in Hong Kong[11].

Should you have any questions regarding the content of this circular, please contact Ms Jacquline Yip at 2231 1530.

Intermediaries Supervision Department
Intermediaries Division
Securities and Futures Commission

End

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[11] Paragraph 11.1(b) of the Code of Conduct. Please also refer to the circular concerning provision of services to clients for conducting transactions in other jurisdictions issued by the SFC on 23 November 2011 http://www.sfc.hk/edistributionWeb/gateway/EN/circular/openFile?refNo=H657

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