SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

Consultation Conclusions on Proposed Risk Management Guidelines for Licensed Persons Dealing in Futures Contracts

August 2023

Contents

Executive summary

1. On 25 November 2022, the Securities and Futures Commission (SFC) launched a two-month public consultation on Proposed Risk Management Guidelines for Licensed Persons Dealing in Futures Contracts (the Guidelines) which aim to provide guidance to licensed corporations licensed for Type 2 regulated activity[1] (futures brokers) to better manage the risks relating to their futures business.

2. The SFC received a total of 21 written submissions from industry associations, futures brokers, professional bodies, consultancy firms and individuals. A list of respondents (other than those who requested anonymity) is set out in Appendix A.

3. The key comments received and the SFC's responses are discussed in this conclusions paper.

Key comments

4. The Guidelines set out guidance for a comprehensive risk management framework for futures brokers which covers market risk management, commodity futures trading, client credit risk management, concessionary margining, risk management over executing or clearing agents, funding liquidity risk management, safeguarding client assets, trading in futures markets outside Hong Kong and stress testing.

5. In general, the respondents appreciated the SFC's intention to provide guidance on the risk management practices expected of futures brokers. Major comments were related to the practical implications of some prescriptive and quantitative requirements, such as restrictions on granting waivers of margin calls and forced liquidation after two margin call failures, the threshold for identifying client concentration in stress testing and the controls and thresholds for applying concessionary margining. Respondents generally worried that the proposed requirements may restrict business flexibility or stifle business development for smaller firms.

6. To alleviate futures brokers' concerns, we replaced some prescriptive rules and quantitative thresholds with more principles-based risk management guidance. A few comments stemmed from misunderstanding some of the proposed requirements, and these have been presented more clearly in the final Guidelines.

Coordination between Responsible Officers (ROs) and Managers-In-Charge (MICs) in the risk management of futures business

7. Some respondents supported the proposal to designate a RO or an MIC to manage each material risk relating to futures business. Others disagreed, maintaining that futures brokers would incur additional costs or have to employ or appoint additional ROs and MICs to comply with the proposed requirement, which is actually not our intention. The proposal does not require futures brokers

[1] Dealing in futures contracts

to employ or appoint additional ROs or MICs to manage the risks of futures business.

8. The policy intent is to ensure proper coordination among senior management with risk management responsibilities to ensure that there is no gap among these responsibilities. The Guidelines have been modified to emphasise this policy intent.

Specific requirements relating to commodity futures business

9. The proposal set out the factors relating to underlying commodity markets which futures brokers should consider when determining risk limits on commodity futures contracts. Some respondents supported the proposal, while a number indicated that it is not necessary for futures brokers to have a deep understanding of the underlying commodity markets because the clearing houses have already taken care of the risks of commodity futures by imposing appropriate margin requirements. In addition, futures brokers usually do not handle physical settlement for commodity futures.

10. The Guidelines have been modified to require only futures brokers handling physical settlement of commodity futures to have sufficient knowledge about the underlying commodity markets for this purpose, for example, knowledge of the roles of the parties involved in the physical settlement of the commodity futures and the storage and delivery arrangements for the underlying commodities. The Guidelines also require futures brokers to maintain a list of commodity futures in which they can deal and monitor the risks of the commodity futures on the list.

Restrictions on granting waivers of margin calls or forced liquidation

11. Many respondents commented that the decision to grant waivers of margin calls or forced liquidation should not be solely based on the number of past margin call failures and delays in margin call settlement could be due to circumstances beyond the client's control, eg, time zone differences, bank remittance delays and compliance checks. Some respondents opined that voluntary closing-out actions by clients would be a more effective risk mitigation than collecting outstanding margins. In addition, a respondent worried that the requirement may result in mandatory immediate forced-liquidation.

12. The SFC clarifies that the proposed requirement is not a forced liquidation requirement and does not specify a particular timeline for carrying out forced liquidation. Futures brokers can still follow their internal policies to decide when to carry out forced liquidations on a client who has triggered the internal policy's threshold for forced liquidation. The policy intent is to ensure that senior management properly exercises its approval power.

13. The SFC noted the respondents' call for greater flexibility in granting waivers and has modified the Guidelines to focus more on the propriety of waivers granted. Specifically, an approval for deviation from or waiver of a futures broker's margin and forced liquidation policies should not be granted unless senior management has proper justification, including that they are satisfied that the deviation or waiver would not affect the futures broker's financial stability. In addition, these

approvals should be subject to regular independent reviews to ensure that senior management has properly exercised its approval power.

Controls and thresholds for applying concessionary margining to clients

14. Some respondents disagreed about the need for a limit for exposure to concessionary margining while others considered the 10% limit proposed in the consultation too stringent and the requirement to rectify any breaches on the next trading day may adversely affect clients' trading activities.

15. We maintain the view that a futures broker should only take on risks which are commensurate with its financial position. A quantitative benchmark is crucial for preventing a futures broker from applying concessionary margining beyond its financial capability. After careful consideration of the comments received, we raised the limit for concessionary margining to 50% of the higher of a futures broker's excess liquid capital (ELC) and its available funding. Furthermore, it will not be mandatory for futures brokers which exceed the limit to rectify the situation on the next trading day, but they are still required to make a timely report to the SFC. The Guidelines have been modified to reflect these changes.

Controls relating to trading in futures markets outside Hong Kong and handling client assets outside Hong Kong

16. The majority of respondents expressed concerns that the proposed limit on client margin excess may affect the competitiveness of smaller brokers. Some respondents were concerned that limiting client margin excess held with a single overseas executing or clearing agent may constrain the futures broker's ability to open positions and execute trading strategies for clients, even though the clients have sufficient margins. They explained that client margin excess is kept for meeting overseas executing or clearing agent's margin calls and upfront margin requirements for clients' transactions, which are difficult to predict. Some respondents also noted that time zone differences, local and overseas public holidays and varying bank cut-off times would make it difficult to comply with the requirement. Some respondents noted that it may be difficult, especially for smaller brokers, to open and operate segregated or trust accounts with overseas banks or custodians for holding client margin excess.

17. In view of the practical issues identified with the proposed limit on client margin excess and the segregation requirements, we replaced them with a requirement for futures brokers to prudently manage their exposure to each overseas executing or clearing agent in respect of the client margin excess held by the agent and disclose to clients in writing the key risks of conducting transactions in overseas markets.

Stress testing

18. A number of respondents expressed concerns about the proposed daily stress testing for futures brokers applying concessionary margining. Some commented that this proposal would impose an unnecessary operational burden on futures brokers which only have very small exposure to clients who are subject to concessionary margining arrangements.

19. Having carefully considered these comments, the SFC has removed the daily stress test requirement. Nonetheless, we maintain the view that stress testing is a very important tool for futures brokers to properly manage their risk exposures. All futures brokers are required to perform stress testing at least weekly and during a volatile market, regardless of whether concessionary margining is applied.

20. Some respondents considered the single stress scenario for projecting losses for futures brokers' proprietary and client positions[2] too stringent. They counter proposed using a smaller amount of projected loss, which ranged between 80% and 150% of the margin requirements set by counterparties. On the other hand, some respondents questioned the need for an alternative approach because futures brokers should tailor-make their own stress scenarios according to the circumstances of their portfolios.

21. Given that the adoption of this stress scenario is purely optional and the counterproposals are mild compared to the projected losses generated by using the stress parameters[3] set by Hong Kong Exchanges and Clearing Limited (HKEX), the single stress scenario has been removed from the Guidelines. Futures brokers should follow the stress testing requirements set by the exchange or clearing house or design appropriate stress scenarios for stress testing their proprietary and client positions.

22. Some respondents fully supported the proposed threshold for identifying clients with significant exposure in stress tests for ad hoc credit assessments and the proposed requirement to assess futures brokers' ability to absorb the aggregate impact on their ELC or available funding of the two largest projected client overlosses and projected proprietary trading losses. Some respondents were concerned that the proposals would limit their business flexibility. Some respondents considered that the clients' and brokers' circumstances should also be taken into account.

23. We clarify that the proposed requirements are not concentration limits. They aim to help futures brokers identify potential risks and take action to ensure their resilience under market stress. This includes conducting credit risk assessments of the clients triggering those thresholds. In assessing the potential impact on the futures brokers, they may take into account their financial resources and risk controls. If there is a significant risk, the futures broker should take prompt and effective pre-emptive measures and prepare contingency plans.

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2 The Guidelines require a futures broker to conduct stress tests to estimate the projected loss in each client account and proprietary account. The projected loss should be estimated based on assumptions of extreme but plausible price movements or volatility shifts or, as an alternative, assumed to be equal to 200% of the margin requirement set by its counterparty.

3 Stress parameters specified for mainstream futures products for clearing participants by HKEX currently represent more than two times of the price movements that clearing house margin requirement can cover.

24. We have modified the Guidelines to spell out more clearly the above expectations. To enable futures brokers to focus on those clients with lower creditworthiness, we have also modified the Guidelines to exempt futures brokers from assessing clients who have a record of consistently meeting margin requirements or maintain sound financial positions relative to the size of their portfolios and trades.

Transitional period

25. A majority of respondents suggested extending the transitional period to between six and 27 months to give futures brokers sufficient time to revise their policies and upgrade computer systems to prepare for compliance.

26. It is imperative for futures brokers to comply with the requirements in the Guidelines as soon as practicable. Taking into account the feedback and the relevant modifications made to the Guidelines, we conclude that the Guidelines shall become effective six months following the gazettal of the Guidelines, except that futures brokers will be given a total of 18 months following the gazettal of the Guidelines for implementing system development for:

– incorporating client risk limits into risk management systems, order management systems or trading platforms; and

– carrying out stress tests using an assumed stress scenario designed in accordance with the Guidelines with reference to past futures market stress events and assessments of emerging risks of futures products.

After the effective date of the Guidelines, futures brokers that have not completed system development for implementing these requirements should put in place interim compensating measures to meet the risk management objective of the requirements. These measures may include monitoring compliance with risk limits manually and conducting stress tests using prudent simplified stress scenarios.

Implementation timeline

27. We carefully considered the comments received and revised the Guidelines where appropriate. The marked-up texts of the final form of the Guidelines are set out in Appendix B.

28. The SFC would like to thank all respondents for their time and effort in reviewing the proposals and for their detailed and thoughtful comments.

29. The consultation paper, the submissions received (other than those the respondents requested us to withhold from publication) and this paper are posted on the SFC's website.

Summary of comments received and the SFC's responses

Coordination between ROs and MICs in the risk management of futures business

Question 1

Do you agree that a RO or an MIC should be designated to manage each material risk relating to futures business?

Major comments

30. Some respondents supported the proposal to designate a RO or an MIC to manage each material risk relating to futures business, whereas others did not find the requirement necessary as the current RO and MIC regimes are sufficient to ensure proper risk management of licensed corporations. Accountability and operational issues which might arise under the designation approach were also raised. Some respondents worried that futures brokers would incur additional costs or have to employ or appoint additional ROs and MICs to comply with the proposed requirement.

The SFC's response

31. We clarify that the proposed requirement does not require futures brokers to employ or appoint additional ROs or MICs to manage their risks. Under the RO and MIC regimes, the ROs and MICs of a licensed corporation are responsible for the management of the firm, which already includes risk management. The proposed requirement aims to ensure proper coordination among senior management with risk management responsibilities to ensure that there is no gap among these responsibilities. Moreover, futures brokers can designate capable management staff with sufficient experience and expertise to manage more than one type of risk.

32. Considering the respondents' feedback, we have modified the requirement to better reflect this policy intent by requiring futures brokers to ensure proper coordination among the different persons who manage risks and that there are no material gaps among their responsibilities.

Specific requirements relating to commodity futures business

Question 2
Do you agree that the factors set out in paragraph 19 of the consultation paper should be taken into account by futures brokers in understanding the nature and risks of the underlying commodity market of commodity futures products? If not, please explain.

Major comments

33. Some respondents supported the proposal. A few acknowledged that a good understanding of the underlying commodity markets may promote futures brokers' professionalism and improve client services, though they viewed that it may be costly or impracticable to make this a core requirement.

34. A number of respondents commented that futures brokers do not need a deep understanding of the commodity spot market mainly because a majority of futures brokers do not handle the physical settlement of commodity futures. They also noted that the risks of commodity futures are different from those of the underlying commodities and they believed that the exchanges and clearing houses have taken the relevant risks into account in their margin and clearing requirements.

35. Separately, some respondents suggested that approving the list of commodity futures in which the futures brokers can deal can be handled by a committee, ROs or MICs instead of the board of directors.

The SFC's response

36. Having considered respondents' concerns and that most futures brokers only deal with the cash settlement of commodity futures, we have modified the Guidelines to require futures brokers handling the physical settlement of commodity futures to have sufficient knowledge about the underlying commodity markets for handling the physical settlement, for example, the roles of the parties involved in the physical settlement of the commodity futures and the storage and delivery arrangements for the underlying commodities.

37. The Guidelines have also been modified to require that the list of commodity futures in which a futures broker can deal be approved by its senior management and that futures brokers should monitor the risks of the commodity futures on the list.

System controls relating to client risk limits

Question 3
Do you agree that incorporating client risk limits into a futures broker's risk management system, order management system or trading platform will enable the futures broker to better manage its exposure to clients' trading?

Major comments

38. Respondents generally supported incorporating client risk limits into a futures broker's risk management system, order management system or trading platform. A few respondents advised that a distinction should be made between soft limits and hard limits, and that it may not be feasible to incorporate all risk limits into a risk management system, order management system or trading platform due to system limitations.

The SFC's response

39. The SFC appreciates that respondents generally agreed with the proposed requirement. In view of the comments received, the Guidelines have been modified so that a client risk limit can also be incorporated into these systems as a soft limit to facilitate futures brokers' compliance monitoring. Since it may take time to make the necessary system changes, a transitional period for this is included in the final Guidelines. Please refer to paragraphs 98 and 99 for details.

40. In addition, we consider that setting a risk limit for a group of connected clients may not always be appropriate given that different clients within a group may conduct futures trading in different markets or products or for different purposes, such as proprietary trades or client trades. Accordingly, the Guidelines have been modified so that futures brokers will only be required to set risk limits for a group of connected clients on an aggregate basis where appropriate.

Question 4
Do you agree that the alternative requirements for a futures broker's affiliate clients (clients which are group entities regulated or supervised by a financial regulator in Hong Kong or a prescribed country) will enable the futures broker to manage its exposure to their trading activities? If not, please provide the rationale and any alternative suggestions.

Major comments

41. Respondents generally welcomed the proposed alternative arrangements relating to client risk limit controls which provide greater flexibility to futures brokers with affiliate clients. One respondent requested that the SFC provide further guidance on relevant compensating measures while one proposed extending the alternative arrangements to non-affiliate clients which are brokers licensed for Type 1 (dealing in securities) or Type 2 (dealing in futures contracts) regulated activity.

The SFC's response

42. The compensating measures set out in paragraphs 22(a) to (f) of the Guidelines provide clear, specific guidance on managing a futures broker's credit risk exposure to affiliate clients. The alternative arrangements under consultation were proposed in light of the specific circumstances of futures brokers which act as an execution arm of their client-facing group entities with the corresponding risk management performed on a group-level basis. Considering that a futures broker may not have the necessary information for adopting the prescribed compensating measures for intermediary clients which do not share a common control with the futures broker, we will not extend the alternative arrangements to intermediary clients which are not affiliated with the futures broker.

Restrictions on granting waivers of margin calls or forced liquidation

Question 5

Do you agree that no waivers of margin calls or forced liquidation should be allowed for clients who have failed to meet two margin calls by the settlement deadlines without reasonable excuse in the preceding 30 calendar days? If not, what different threshold would you suggest?

Major comments

43. A few respondents agreed with the proposed requirement. One also suggested lowering the triggering threshold to one margin call failure.

44. Some respondents expressed concerns about the implementation cost and administrative burden, with one suggesting only applying the requirement to margin calls exceeding $100,000. A respondent also suggested modifying the triggering point to two forced liquidations instead of two margin call failures in the preceding 30 calendar days.

45. Many respondents commented that the decision to grant margin call or forced liquidation waivers should not be solely based on the number of margin call failures. Delays in margin call settlement could be due to circumstances beyond the client's control[4], making it difficult to fix a reasonable deadline for settlement. One respondent thought that the proposed requirement, once triggered, would require the futures broker to immediately force-liquidate the client's positions, which would significantly undermine the broker's flexibility.

46. In addition, some viewed that voluntary closing-out actions by clients would be more effective risk mitigation than collecting outstanding margins and these actions should not be viewed as margin call waivers. They added that futures brokers should have flexibility to execute their own margin and forced liquidation policies and take into consideration relevant factors, including clients' financial positions and market conditions.

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4 For example, time zone differences, bank remittance delays and compliance checks.

The SFC's response

47. We clarify that the proposed requirement is not a forced liquidation requirement and does not specify a particular timeline for carrying out forced liquidation. The proposed requirement only set out the circumstances under which a futures broker should refrain from waiving a margin call or forced liquidation requirement under its internal policies. Futures brokers can still decide when to execute forced liquidation on a client account should that be required by its internal policy.

48. We also clarify that reasonable excuses for a delay in settling margin calls can cover causes which are beyond the client's control.

49. Taking these views into account, we have revised the proposed requirement focusing on the propriety of waivers granted. Specifically, an approval for any deviation from or waiver of a futures broker's margin and forced liquidation policies should not be granted unless senior management has proper justification, including that they are satisfied that the deviation or waiver would not affect the futures broker's financial stability. In addition, these approvals should be subject to regular independent reviews to ensure that senior management has properly exercised its approval power.

Controls and thresholds for applying concessionary margining to clients

Question 6

Do you agree that 10% of the higher of ELC or available funding is an appropriate limit for a futures broker's exposure to concessionary margining? If not, what limits would you suggest? Please provide reasons.

Major comments

50. Some respondents agreed that excessive exposure to client positions with concessionary margining poses additional risks to futures brokers and expressed support for the proposals.

51. Some other respondents, however, disagreed with the proposal, maintaining that the eligibility criteria prescribed by the relevant exchanges or clearing houses have effectively restricted concessionary margining to investors with sound financial positions and good settlement records and in some cases also asserting that the margin requirements for futures positions have already been accounted for under the Securities and Futures (Financial Resources) Rules (FRR).

52. A number of respondents did not object to a limit but believed that the limit of 10% of a futures broker's ELC or available funding was too stringent and it might impede futures brokers' business and undermine the competitiveness of the futures market in Hong Kong. There were also comments that the requirement to rectify any breaches of limits on the next trading day may adversely affect clients' trading activities. Some respondents sought other concessions, including carving out certain types of client accounts (eg, omnibus accounts, client accounts opened by professional investors, licensed corporations and registered

institutions) from the calculation of the day-end aggregate uncovered client margin amount.

53. Some respondents commented that the timely calculation of the day-end aggregate uncovered client margin amount would be operationally challenging. In particular, it would be difficult for a futures broker to reasonably and in a timely manner estimate the amount of margin required to be deposited by it with its counterparties for a client's ledger account which is subject to concessionary margining and has trading activities in overseas markets.

54. Other suggestions from respondents included counting credit facilities provided by a futures broker's shareholders or affiliates towards "available funding". They also proposed using the ELC as reported in a futures broker's latest financial returns submitted to the SFC in the relevant calculation rather than the latest available ELC, as the former would more accurately reflect the broker's financial capability after month-end adjustments and accruals.

The SFC's response

55. The SFC maintains the view that a futures broker should only take on risks that are commensurate with its financial positions and a quantitative benchmark is crucial for preventing a futures broker from applying concessionary margining beyond its financial capability. Having considered the business needs of futures brokers and the practical difficulties raised by respondents, the 10% limit has been raised to 50% in the final form of the Guidelines. We note that most of the futures brokers we enquired were well below the original and the revised limits.

56. In addition, it will not be mandatory for a futures broker which exceeds the 50% limit to rectify the deviation on the next trading day. Instead, the futures broker is expected to assess its credit risk exposure to client positions with concessionary margining and take timely and appropriate action to reduce any excessive exposure and ensure its financial integrity. In its notification to the SFC, the futures broker shall set out its assessment results and the details of any risk mitigating measures it has taken or will take. Paragraphs 40 to 41 and 65(a) of the Guidelines have been modified to reflect these changes.

57. For the proposed quantitative benchmark, we clarify that a client's ledger account with trading activities only in futures markets without an upfront margin requirement prescribed in the rules of the relevant exchanges or clearing houses is not expected to be considered in the calculation of the day-end aggregate uncovered client margin amount[5].

58. We have also considered the respondents' concerns about the availability of timely data for estimating margin requirements imposed by counterparties on clients' ledger accounts with trading activities in overseas markets. To address this, we will accept a futures broker making reference to the total amount of margin required to be deposited with it by a client[6] in calculating the total amount

[5] See paragraph 25 (Note 3) of the Guidelines for the meaning of "concessionary margining".

[6] Under paragraph 26 of the Guidelines, a futures broker should impose on a client a margin requirement which is not lower than the amount set by its counterparty.

of margin required for trading of futures contracts in the client's ledger account. Paragraph 39(a) of the Guidelines has been modified accordingly.

59. In paragraph 42 of the final form of the Guidelines, we also allow a futures broker to refer to either (i) its latest amount of ELC or available funding; or (ii) the amount of ELC or available funding based on its latest financial returns submitted to the SFC when comparing its day-end aggregate uncovered client margin amount with the quantitative benchmark for concessionary margining.

60. The above modifications and clarifications provide further flexibility and address respondents' major concerns and we do not consider other concessions (eg, excluding certain types of client accounts from the day-end aggregate uncovered client margin amount and expanding the scope of available funding) necessary.

61. We also wish to clarify that the outstanding margins relating to client positions with concessionary margining are not currently subject to any specific capital charges under the FRR[7]. In any case, the FRR set out the minimum capital requirements of licensed corporations but they by no means could replace any risk management controls of licensed corporations.

62. In paragraph 37(b) of the final form of the Guidelines, the definition of "consistently meeting margin requirements" has been slightly modified to better reflect our policy intent that for a client whose account has been opened for less than one year, "consistently meeting margin requirements" shall mean no records of failure to meet margin requirements, forced liquidation or returned cheques for the period since account opening, and of at least three months.

Question 7

Do you agree to exclude from the calculation of the aggregate uncovered client margin amount the trading of futures contracts in a trading session of a futures market which extends beyond midnight? If not, please provide reasons.

Major comments

63. Respondents generally agreed with the proposal and welcomed the flexibility to allow futures brokers to determine their own cut-off time for calculating the day-end aggregate uncovered client margin amount.

The SFC's response

64. We will proceed with the proposal. The clarification in paragraph 57 above and the added flexibility provided in paragraph 39(a) of the Guidelines will better enable futures brokers to calculate the uncovered client margin amount of an account which trades in overseas futures markets.

[7] Under section 40(1) of the FRR, a futures broker must include margin shortfall amounts of clients' futures positions in its ranking liabilities but any such amounts relating to concessionary margining are exempted by virtue of section 40(2) of the FRR.

Due diligence reviews of executing or clearing agents

Question 8 Do you agree that futures brokers should conduct due diligence reviews of executing or clearing agents and have a back-up agent? If not, please provide reasons.

Major comments

65. A majority of respondents agreed that futures brokers should conduct due diligence reviews on executing or clearing agents and have a back-up agent. A few respondents suggested that this is not necessary for executing or clearing agents which are participants of Hong Kong Futures Exchange Limited (HKFE) or affiliates of futures brokers. A few respondents noted that it could be commercially challenging to conduct these due diligence reviews and maintain a back-up agent. In particular, they commented that it may not be possible for a futures broker to obtain commercially sensitive information from its executing or clearing agent and it might not be necessary to appoint back-up agents if futures brokers have put in place sufficient contingency measures.

The SFC's response

66. Having considered the market feedback, we have modified the Guidelines by focusing the due diligence reviews on overseas executing or clearing agents and excluding from them any executing or clearing agent which is a licensed corporation, registered institution, exchange participant of a recognized exchange company or clearing participant of a recognized clearing house.

67. We do not agree that the requirement should not apply to affiliate agents because group relationship cannot guarantee the futures broker has sufficient understanding of the affiliate's financials, regulatory conduct and business practices.

68. We appreciate respondents' concern that it may not always be possible for a futures broker to obtain commercially sensitive information from its executing or clearing agent. In the consultation paper, we suggested that futures brokers may consult the regulations of the jurisdiction in which the agent is licensed or authorised for relevant information. We have modified the due diligence requirement to express the policy intent that public or other available information relevant to the agent can be taken into account.

69. We also clarify that futures brokers should identify at least one candidate of back-up agent. The proposal did not require futures brokers to enter into a formal agreement or maintain an account with the back-up agent. Establishing and maintaining a mutual understanding with the candidate on the back-up arrangement would suffice. To allow futures brokers greater flexibility in designing their business continuity measures, the Guidelines have been modified to require futures brokers to implement appropriate arrangements and measures to avoid, mitigate and manage the impact of the unavailability of an executing or clearing agent, such as identifying at least one candidate of back-up executing or

clearing agent and where possible, establishing and maintaining a mutual understanding or formal agreement with the candidate on the back-up arrangement.

Safeguarding client assets

Question 9

Do you agree that a futures broker should deposit its own funds into an omnibus account with an executing or clearing agent or clearing house or a designated trust bank account to remedy a shortfall in client assets caused by set-off of clients' overlosses with other clients' assets?

Major comments

70. A majority of the respondents agreed with the proposed requirement. Some respondents suggested that the client asset shortfall caused by a set-off should be calculated at day end and remedied within the next day if the client incurring the overloss has not settled his or her margin call.

The SFC's response

71. In view of the support received, we will proceed with the proposal.

72. We envisage that the aforesaid client asset shortfall would most likely be identified during the client asset segregation process, which is usually carried out daily with reference to the end of day balances of client, bank and counterparty accounts. It is very important that any client asset shortfall should be remedied as soon as possible to protect the interests of clients. To minimise the compliance burden, futures brokers may follow their own schedule for client asset segregation in calculating and addressing a client asset shortfall.

73. To cater for a situation where clients incurring overlosses have fully or partly settled margin calls by the time the futures broker remedies the client asset shortfall, the Guidelines have been modified to require futures brokers to remedy the shortfall in other clients' assets caused by the set-off by depositing, as soon as reasonably practicable, into omnibus accounts or designated trust bank accounts or segregated accounts any assets they receive for settling the margin calls and an amount of their own cash which equals the amount of any unsettled margin calls.

Controls relating to trading in futures markets outside Hong Kong and handling client assets outside Hong Kong

Question 10 Do you agree that the amount of client margin excess held by an overseas executing or clearing agent should not exceed the futures broker's ELC reported in its latest monthly financial returns? If not, what limit would you suggest?

Major comments

74. A majority of respondents expressed concerns that the proposed requirement may affect the competitiveness of smaller brokers. Some respondents advised that client margin excess is kept for meeting overseas executing or clearing agent's margin calls and upfront margin requirements on clients' transactions, which are difficult to predict. If the client margin excess is limited or spread over different agents, it may constrain the futures broker's ability to open positions and execute trading strategies for clients, even though the clients have sufficient margins. As a result, customer complaints and margin calls or forced liquidation by overseas executing or clearing agents may increase. Some respondents also noted that time zone differences, local and overseas public holidays and varying bank cut-off times would make it difficult to comply with the requirement.

75. Some respondents suggested linking the amount of client margin excess with the exposure of the positions held with the agent. One respondent proposed to exempt affiliated executing or clearing agents from the proposed requirement.

76. Also, some respondents noted that it may be difficult, especially for smaller brokers, to open segregated or trust accounts with overseas banks or custodians for holding client margin excess. They also noted that some overseas clearing firms maintain trust accounts in Hong Kong and this reduces the need for futures brokers to open trust accounts overseas. Moreover, it would not be practical to require the finance department to work on the night shift to make overseas fund transfers.

77. Regarding the proposal for futures brokers to disclose the name of the overseas executing or clearing agent who may hold their clients' assets in omnibus account with the agent's counterparty, some respondents were concerned that this may lead to clients opening accounts directly with the agent or concentrating in those futures brokers who use well-known agents. There were also concerns about the cost of providing clients with information about the regulation of overseas executing or clearing agents, the status of client assets held outside Hong Kong and the status of a single client's assets under an omnibus account arrangement.

The SFC's response

78. In view of the practical issues identified with the proposed limit on client margin excess and the segregation requirements, we have revised the proposal by requiring futures brokers to prudently manage their exposure to each overseas

executing or clearing agent in respect of client margin excess held by the agent. Notwithstanding that no specific limit is set in the Guidelines, futures brokers are nonetheless accountable to clients in respect of client assets held overseas. They must monitor material changes in the regulation of their overseas counterparties and markets which may affect the interests or assets of their clients and diligently assess and manage the default risk of their overseas executing and clearing agents.

79. Taking into account the cost and competition concerns, we will not proceed with the proposals relating to disclosing the names of overseas executing or clearing agents and the status of single client's assets held outside Hong Kong. However, we maintain our view that clients have a right to know about the regulation of the overseas counterparties or markets through or on which their trades are executed or cleared. We have revised the Guidelines by requiring a futures broker, in response to a client's request, to disclose the latest licensing or authorisation status of its overseas counterparties or markets.

Stress testing

Question 11

Do you agree with the proposed requirement to conduct stress tests at least daily if concessionary margining is applied to any client, and at least weekly in other cases, and that stress testing should also be conducted during a volatile market?

Major comments

80. There were diverse views on how often a futures broker should perform stress tests. Some respondents proposed that stress testing (irrespective of whether the broker applies concessionary margining) should be done at most biweekly, while others suggested leaving this to the futures brokers' judgement. A number of respondents held the view that the specific requirement for futures brokers applying concessionary margining to conduct stress tests at least daily is too stringent and burdensome, particularly if a futures broker's exposure to clients who are subject to concessionary margining is small.

The SFC's response

81. We maintain the view that stress testing is a very important tool for futures brokers to properly manage their risk exposures. The Guidelines have been modified to require all futures brokers, regardless of whether concessionary margining is applied by them, to perform stress tests at least weekly and during a volatile market. In view of futures trading being mainly concentrated in current month contracts, weekly stress testing will enable futures brokers to promptly detect potential risks and take action before the contract expiry date. This expectation is also in line with HKEX's weekly stress testing requirement for clearing participants with significant activities in non-linear products (such as options).

Question 12

Do you agree with the alternative approach suggested in paragraph 65 of the consultation paper to estimate the projected losses of client and house accounts? If not, please provide the rationale and any alternative suggestions.

Major comments

82. Paragraph 65 of the consultation paper proposed an alternative approach to estimating trading losses of client and house accounts in a stressed market, whereby futures brokers can choose to assume the projected losses to be equal to 200% of the margin requirements for the positions subject to the stress test. Some respondents supported the proposal. Some respondents counter proposed a smaller amount of projected loss, which ranged between 80% and 150% of the margin requirements set by counterparties, on the basis that margin call and forced liquidation measures would help to curtail trading losses in times of market stress. On the other hand, some respondents questioned the need for an alternative approach because futures brokers should tailor-make their own stress scenarios according to the circumstances of their portfolios.

The SFC's response

83. We emphasise that the adoption of the proposed alternative approach is purely optional. Moreover, given the vast number of products in the futures market, using a single multiple of margin requirement as an approximation of projected loss is more practicable than specifying a different approximation basis for each futures contract. Since there is a lack of consensus on what that multiple should be and the counterproposals from the respondents are mild compared to the projected losses generated by using HKEX's stress parameters[8], we have removed the proposed alternative approach from the Guidelines. In other words, futures brokers should follow the guidance of paragraph 56 of the final Guidelines to design appropriate stress scenarios for the products traded by them and their clients and apply the same in their stress tests.

84. If a futures broker is a member or participant of an exchange or a clearing house, it should ensure that the assumed stress scenarios used for stress testing positions in futures contract traded or cleared by the exchange or clearing house are at least as stringent as those specified or suggested by the exchange or clearing house for its members or participants.

85. Since it may take time to make system changes to carry out stress tests using an assumed stress scenario designed in accordance with the Guidelines, a transitional period for this is included in the final Guidelines. Please refer to paragraphs 98 and 99 for details.

8 Stress parameters specified for mainstream futures products for clearing participants by HKEX currently represent more than two times of the price movements that clearing house margin requirement can cover.

Question 13

Do you agree with the threshold for excessive exposure to individual clients or groups of connected clients set out in paragraph 68(b) of the consultation paper? If not, please provide the rationale and any alternative suggestions.

Major comments

86. Paragraph 68(b) of the consultation paper proposed a threshold for identifying significant client exposures for ad hoc credit risk assessments. The threshold was defined as the amount of projected overloss of a client or a group of connected clients exceeding 30% of the futures broker's ELC or available funding. Some respondents fully supported the proposal while some viewed the requirement as a client concentration limit which may restrict business flexibility or stifle smaller firms' business development.

The SFC's response

87. We clarify that the proposal is not a client concentration limit. It aims to help futures brokers identify clients whose positions can potentially pose significant credit or liquidity risk to the futures brokers and in a timely manner assess the clients' ability to settle the projected overlosses under market stress. If significant risk is noted in the assessment, futures brokers should take prompt and effective pre-emptive measures and prepare contingency plans in accordance with the Guidelines.

88. We maintain our view that the proposed threshold is necessary to help futures brokers manage client concentration and liquidity risks.

89. Nonetheless, we have modified the Guidelines to exempt futures brokers from conducting assessments of those clients who have a record of consistently meeting margin requirements[9] or maintain sound financial positions relative to the size of their portfolios and trades. With this exemption, futures brokers can focus their attention on clients with lower creditworthiness.

[9] See paragraph 37 of the Guidelines for criterion of determining when a client would be treated as having a record of consistently meeting margin requirements.

Question 14

Do you agree with the stress scenario set out in paragraph 68(c) of the consultation paper for assessing a futures broker's ability to absorb the projected overlosses of client accounts and the projected losses of house trading? If not, please provide the rationale and any alternative suggestions.

Major comments

90. Paragraph 68(c) of the consultation paper proposed to require futures brokers to assess their ability to absorb the aggregate impact on its ELC or available funding of the two largest projected client overlosses and projected proprietary trading losses. Some respondents fully supported the proposal while some considered that the underlying assumption might be too prudent and the proposal may restrict business flexibility or stifle smaller firms' business development.

The SFC's response

91. Client default is a real possibility during market stress. Defaults by the largest clients can be devastating. The proposed stress scenario has in these circumstances struck an appropriate balance and can promote good risk management. Therefore, we maintain our view that the requirement can effectively assist futures brokers to identify the potential threats to their financial stability. If there is a significant risk, the futures broker should take prompt and effective pre-emptive measures and prepare contingency plans in accordance with the Guidelines to ensure their resilience under market stress.

92. To enable futures brokers to focus on clients with lower creditworthiness, we have modified the Guidelines to exempt futures brokers from assessing clients who have a record of consistently meeting margin requirements or maintain sound financial positions relative to the size of their portfolios and trades.

Question 15

Do you foresee any challenges for futures brokers relying on the group-level stress tests to comply with paragraphs 60 and 61 of the Appendix of the consultation paper, including the submission of stress test reports to the SFC upon request? If so, please explain the challenges and provide alternative suggestions.

Major comments

93. Most respondents welcomed the proposal to allow futures brokers to rely on group-level stress tests in complying with the stress testing requirement under paragraph 54 of the Guidelines.

The SFC's response

94. The SFC will proceed with the proposal. The relevant requirements for brokers relying on group-level stress tests are set out in paragraphs 58 to 59 of the final form of the Guidelines.

Implementation timeline

Question 16

Do you think that a nine-month transition period is appropriate for the requirements set out in paragraphs 70(a) and (b) of the consultation paper? If not, what would be an appropriate transition period? Please give your reasons.

Question 17

Do you think that a three-month transition period is appropriate for all other requirements in the Appendix of the consultation paper? If not, what would be an appropriate transition period? Please give your reasons.

Major comments

95. On the proposed nine-month transitional period for incorporating client risk limits into the futures broker's systems and conducting due diligence reviews of, and establishing back-up arrangement with, executing or clearing agents, respondents generally counter proposed longer periods ranging from 12 to 27 months to allow time for system changes, with one respondent noting that system development and testing may take at least 18 months.

96. On the proposed three-month transitional period for all other requirements in the Guidelines, some respondents counter proposed longer periods ranging from six to 27 months, mainly for making substantial changes to infrastructure and internal policies and procedures, agreeing with clients on risk limits and seeking regulatory or internal approval for IT budgets and capital injections.

97. Some respondents indicated that a longer transitional period (one-and-a-half to two years) would be necessary for Mainland-based futures brokers which need to obtain approval from Mainland authorities for capital injections.

The SFC's response

98. It is imperative for futures brokers to comply with the requirements in the Guidelines as soon as practicable. Taking into account the feedback and the relevant modifications made to the Guidelines, the Guidelines shall become effective six months following the gazettal of the Guidelines, except that futures brokers will be given a total of 18 months following the gazettal of the Guidelines for implementing system development for:

- incorporating client risk limits into risk management systems, order management systems or trading platforms; and

- carrying out stress tests using an assumed stress scenario designed in accordance with the Guidelines with reference to past futures market stress events and assessments of emerging risks of futures products.

99. After the effective date of the Guidelines, futures brokers that have not completed system development for implementing these requirements should put in place interim compensating measures to meet the risk management objective of these requirements. These measures may include monitoring compliance with risk limits manually and conducting stress tests using prudent simplified stress scenarios.

100. We will take a pragmatic and holistic approach to handle any non-compliance by futures brokers whose system development for implementing the requirements is still in progress after the end of the transitional periods.

Other major comments

101. Some respondents viewed that the Guidelines should not be applied to licensed corporations which execute futures orders for their overseas affiliates' clients as they may not be exposed to such clients' credit risk or liquidity risk.

The SFC's response

102. We do not agree. Licensed corporations executing futures orders for their overseas affiliates' clients can also be exposed to credit and liquidity risks when their affiliates fail to collect sufficient margin from their clients and default on their obligations to the licensed corporations.

Conclusions and the way forward

103. We will proceed to implement the Guidelines with the revisions set out in Appendix B of this paper. The Guidelines will become effective six months from the gazettal date subject to the transitional arrangements set out in paragraph 66 of the Guidelines.

104. The SFC would like to take this opportunity to thank all respondents for their contributions.

Appendix A – List of respondents

(in alphabetical order)

1. Chinese Futures Association of Hong Kong
2. CompliancePlus Consulting Limited
3. FIA
4. Hon Robert LEE Wai-wang
5. Hong Kong Association of Online Brokers
6. Hong Kong Securities & Futures Professionals Association
7. Hong Kong Securities Association
8. Interactive Brokers Hong Kong Limited
9. Ms. WAN
10. Nomura International (Hong Kong) Limited
11. The Law Society of Hong Kong
12. Submissions of eight respondents are published on a “no-name” basis upon request
13. Submissions of two respondents are withheld from publication upon request

Appendix B – Final form of the Risk Management Guidelines for Licensed Persons Dealing in Futures Contracts

The highlighted parts indicate revisions made to the Guidelines since the consulted draft

Introduction

1. These Guidelines are published by the Securities and Futures Commission (SFC) under section 399 of the Securities and Futures Ordinance (SFO) for the purposes of supplementing the existing control requirements for licensed persons dealing in futures contracts.

2. These Guidelines apply to persons licensed for Type 2 regulated activity (dealing in futures contracts) (futures brokers)[1].

3. These Guidelines should be read in conjunction with, and apply without prejudice to, all relevant laws, legislation, codes, regulations or guidelines that are applicable to futures brokers[~~1~~2].

4. A failure by any futures broker to comply with any applicable provision of these Guidelines:

   (a) shall not by itself render it liable to any judicial or other proceedings, but in any proceedings under the SFO before any court, these Guidelines shall be admissible in evidence, and if any provision set out in these Guidelines appears to the court to be relevant to any question arising in the proceedings, it may be taken into account in determining the question; and

   (b) may cause the SFC to consider whether such failure adversely reflects on the futures broker's fitness and properness and the need for regulatory action.

5. These Guidelines consist of qualitative guidance for risk management policies and controls on futures dealing activities, supplemented by quantitative benchmarks. The ~~requirements~~ control measures specified in these Guidelines are the minimum standards ~~the SFC expects~~ expected of futures brokers and are not meant to be exhaustive. Any deviation from these Guidelines must be properly justified by equivalent or compensating controls which are at least as prudent and effective as those set out in these Guidelines. In determining an appropriate regulatory

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1 These Guidelines do not apply to any dealing activity in futures contracts carried out by a person licensed for both Type 2 and Type 9 regulated activities solely for the purposes of carrying on its Type 9 regulated activity.

~~1~~2 Including but not limited to the SFO, the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct), the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission, and the Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules.

response to a futures broker's deviation from these Guidelines, ~~The~~ the SFC will adopt a pragmatic and holistic approach taking into account ~~each futures broker's particular~~ all the circumstances ~~when assessing its compliance with these Guidelines and determining the regulatory response to any non-compliance.~~, including but not limited to the cause, seriousness, duration and frequency of the deviation, the level of risks, the potential impact on investors, and any remedial measure taken by the futures broker.

6. Unless specified otherwise, terms used in these Guidelines bear the same meaning as defined in the SFO[~~2~~3]. Any definition provided in these Guidelines applies to the whole Guidelines unless otherwise ~~stated~~ specified.

Risk management framework

7. A futures broker should identify and prudently manage the risks arising from its proprietary trading[4] and clients' trading in futures contracts. A futures broker should ensure its risk appetites and risk limits are consistent with its strategic objectives ~~as well as~~ and commensurate with its financial and management capabilities. ~~It should establish an effective risk governance framework to manage the risks to which it and its clients are exposed.~~

8. A futures broker should establish an effective risk governance framework to manage the risks to which it and its clients are exposed. The risk management responsibilities should be delegated to senior management who has the experience and expertise and sufficient authority to implement policies and procedures to monitor and manage these risks in a timely and effective manner. Where these risks are being managed by different persons within the senior management team of a futures broker, it should ensure proper coordination among them to ensure that there is no gap among these responsibilities.

~~8. A futures broker should, for each material risk relating to futures business, designate either a Responsible Officer (RO) or a Manager-In-Charge (MIC) to manage the risk[3]. Such designated ROs and/or MICs should report directly to the board of directors or MIC of Overall Management Oversight (MIC OMO).~~

~~9. Where a futures broker designates more than one individuals to oversee the risk management function, the board of directors or MIC OMO should ensure that:~~

~~(a) there is clear documentation of and proper coordination between the risk management roles of each designated ROs and/or MICs; and~~

~~(b) there is no material gap between the respective areas of responsibility of the designated ROs and MICs.~~

[~~2~~3] For example, "futures contract" includes a contract or an option on a contract made under the rules or conventions of a futures market.

~~[3] For example, funding liquidity risk may be managed by the MIC of Finance and Accounting and trading risk may be managed by a RO.~~

[4] Including position-taking, arbitrage trading and market-making activities.

~~109.~~ ~~The board of directors or MIC OMO should delegate the designated RO and/or MIC with sufficient authority to implement policies and procedures to monitor and manage all material risks arising from the futures broker's house trading[4] and client trading in futures contracts in a timely and effective manner.~~ The risk management policies and procedures should cover the following areas:

(a) identification and assessment of material risks and determination of risk appetites and risk limits;

(b) ongoing risk monitoring, controlling and reporting;

(c) escalation and resolution procedures for ~~potential~~ breaches of risk limits and deviations from the policies and procedures; and

(d) stress testing and contingency planning.

~~11~~10. The risk management policies and procedures should be subject to regular reviews, particularly before introducing any new services or products or when there are significant changes to ~~the~~ existing products~~,~~ or services~~,~~ or relevant legislation, rules or regulations which may affect the futures broker's risk exposure.

Market risk management[5]

~~12~~11. In these Guidelines, "market risk" means the risk of loss due to adverse movements in the level or volatility of market prices of products or the underlying exposures[6] of products held by a futures broker for its own account.

~~13~~12. A futures broker~~'s~~ ~~senior management~~ should ensure that all market risk~~s~~ exposures arising from ~~house~~ proprietary trading are properly quantified, monitored and controlled.

~~Note 1~~

~~In these Guidelines, "senior management" includes the ROs and MICs designated to oversee the risk management function.~~

~~14~~13. A futures broker should ensure that ~~all~~ proprietary positions in futures contracts are marked-to-market on a real time basis. ~~Also, day~~ Day-end revaluation of proprietary positions[7] should be carried out by an independent risk control unit or back office staff who are independent of the front office, and the prices used for revaluation purposes are obtained from a source independent of the front office or are independently verified.

~~4 Including position-taking, arbitrage trading and market-making activities.~~
5 Applicable only to a futures broker engaging in ~~house~~ proprietary trading in futures contracts.
6 For example, an index or a securities underlying a futures contract.
7 Unless otherwise specified, any reference to "proprietary positions" in these Guidelines includes a reference to positions in futures contracts and positions in other products.

~~15~~14. A futures broker should establish a market risk measurement system to ~~evaluate~~ estimate the probable impact on its proprietary positions of adverse changes in market conditions over a holding period suitable for the positions to quantify its market risk exposures. A futures broker which is exposed to significant market risks or deploys complex trading strategies should use an appropriate risk model or other quantitative ~~model~~ methods (eg, value-at-risk model~~)~~, scenario analysis, sensitivity analysis or stress testing) to ~~measure~~ quantify its market ~~risks~~ risk exposures.

~~16~~15. A futures broker should regularly compare the estimated market risk exposures with the actual ~~performance~~ and hypothetical returns of its ~~house trading~~ proprietary positions. If the actual or hypothetical losses of the positions exceed the estimated ~~and actual performances differ significantly~~ market risk exposures, the difference should be investigated and, where necessary, the market risk measurement system ~~or model~~ should be ~~thoroughly reviewed and improved as appropriate~~ adjusted.

~~17~~16. A futures broker should ~~also~~ establish prudent market risk limits which are commensurate with its financial and management capabilities. The limits must be properly approved by its senior management and board of directors. Any breach of the limits should be promptly escalated to senior management and remedial action should be taken in a timely manner.

Commodity futures trading

~~18~~17. A futures broker dealing in a futures contract on commodity (commodity futures) should maintain a list of commodity futures ~~products that they~~ in which it can deal,~~.~~ ~~Such list~~ which should be approved by ~~the board of directors~~ its senior management. It should ~~understand~~ monitor the risks of the commodity futures on the list. ~~nature and risks of the products and the underlying commodity markets. When determining the risk limits for house trading and client trading in the products, it should take into account the following factors:~~

~~(a) physical properties of the commodity;~~

~~(b) factors which may affect the supply and demand of the commodity, such as its production or extraction infrastructure and life cycle, environmental and climate factors, supply and price volatility of raw materials for manufacturing the commodity, and supply and price volatility of storage and delivery facilities;~~

~~(c) the structure, organisation and operation of the commodity market, including:~~

~~(i) the composition and role of participants in the commodity market, including providers of specific services which enable the commodity market to function (such as production, extraction, delivery, storage and settlement services); and~~

~~(ii) storage and delivery arrangements, such as whether the commodity can be delivered only to specific delivery points and related administrative requirements, and the capacity constraints of specific delivery points; and~~

~~(d) political, macroeconomic and other related factors which may affect the operation of the commodity market.~~

18. A futures broker which handles physical settlement of commodity futures should have sufficient knowledge about the underlying commodity markets for this purpose. For example, it should understand:

(a) the roles of the parties involved in the physical settlement of the commodity futures; and

(b) the storage and delivery arrangements relating to the physical settlement of the commodity futures, such as whether the commodity can be delivered only to a specific delivery point or storage facility and their capacity constraints, and related administrative requirements.

Client credit risk management

19. In these Guidelines,

– "client credit risk" means the risk of a futures broker suffering loss~~es~~ due to a client defaulting on his or her obligations under a futures contract. A futures broker may suffer a loss if a client defaults on his or her obligation to it or it is required to meet the obligation of a defaulting client to a counterparty~~.~~;

~~Note 2~~

– ~~In these Guidelines, a~~ "counterparty" includes any executing agent~~s~~, clearing agent~~s~~ ~~or the~~, exchange~~s~~ or clearing house~~s~~ executing or clearing ~~the~~ a futures contract~~s~~.

Client risk limits

20. A futures broker should:

(a) put in place prudent risk limits, including trading and position limits, for each client ~~or each group of connected clients~~ to mitigate client credit risk. ~~Client risk limits for a group of connected clients should holistically take into account the circumstances of all the clients in the group.~~ The risk limits should be based on appropriate risk factors, eg, the client's total or net position in a single futures contract or related futures contracts, or total or net margin requirements. Where appropriate, a futures broker should put in place prudent risk limits for a group of connected clients on an aggregate basis which should holistically take into account the circumstances of all the clients in the group; and

(b) set position limits for each client (where applicable, each group of connected clients) for preventing any breach of any applicable statutory or regulatory position limits ~~for each client or each group of connected clients, where applicable~~.

Note ~~3~~1

In these Guidelines, a "group of connected clients" means:

(a) a group of two clients when one is the spouse of the other;

(b) any two or more clients who are natural persons (other than spouses) and act on behalf of the same third party, who is not a client of the futures broker but is the beneficial owner of these clients' accounts or stands to gain the commercial or economic benefit or bear the commercial or economic risk of the transactions in those accounts;

(c) any two or more clients who are natural persons (other than spouses) where one acts through the others and is the beneficial owner of the others' accounts, or stands to gain the commercial or economic benefit or bear the commercial or economic risk of the transactions in those accounts;

(d) any two or more clients which are corporations of which a natural person, either alone or with his or her spouse, controls 35% or more of their voting rights;

(e) any two or more clients which are members of the same group of companies; or

(f) any two or more clients who are financially connected by guarantee arrangements under which the financial liabilities of one or more of these clients are guaranteed by one or more of the others, or the financial liabilities of these clients are guaranteed by the same guarantor who is not a client of the futures broker.

To ascertain whether two or more clients who are natural persons (other than spouses) are part of a group of connected clients, a futures broker is not required to conduct proactive searches for the beneficial owners of their accounts but it should make appropriate enquiries where there is indication that a client is not acting on his or her own behalf.

21. A risk limit of a client or a group of connected clients should:

(a) in the case of a position limit for preventing any breach of a statutory or regulatory position limit~~s~~, be determined having regard to the relevant law or regulation and not exceed the statutory or regulatory position limit;

(b) not exceed ~~the statutory or regulatory position limit and~~ the corresponding ~~position~~ risk limit set by the relevant counterparty;

(c) not be excessive taking into account the following:

(i) the financial and management capabilities of the futures broker;

(ii) the financial situation of the client or group of connected clients demonstrated by appropriate objective proof, such as tax returns, salary advices, bank or broker statements ~~and~~ or audited financial statements;

(iii) any internal and external credit reference information or credit history of the client or group of connected clients;

(iv) the investment objective, risk appetite, trading pattern~~s~~ or strategy of the client or group of connected clients;

(v) any known event which reflects adversely on the financial situation or default risk of the client or group of connected clients;

(vi) the historical volatilities of the price or level of the underlying exposure of the futures contracts ~~or contracts and other products traded~~ covered by the ~~client or group of connected clients~~ limit in past market stress events;

(vii) in relation to a client who will physically settle~~d~~ ~~futures contracts on a~~ commodity futures, the readiness of the client ~~or group of connected clients~~ to deliver or take delivery of the underlying ~~commodity~~ commodities~~,~~ ~~given the characteristics of the underlying commodity market~~;

(viii) the potential financial impact on the futures broker of client default and market shocks (for example, a significant increase ~~of~~ in a counterparty's margin requirement~~s~~ ~~by counterparties on~~ for the client's positions ~~of~~ when the ~~client or group of connected clients~~ market is under stress); and

(ix) prevailing market conditions;

(d) be incorporated into the futures broker's risk management system, order management system or trading platform ~~to prevent~~ for detecting or preventing any breach; and

(e) be subject to regular reviews (at least annually) and whenever there is a significant change in any determining factors, including those set out in ~~paragraphs 21~~ subparagraphs (a), (b) and (c).

22. For an affiliate client of a futures broker which is regulated or supervised by a financial regulator in Hong Kong or a prescribed country[8] ~~(as defined in section 2(1) of the Securities and Futures (Financial Resources) Rules (FRR))~~, the futures broker will be regarded as having complied with paragraphs 20 and 21 if it has put in place:

(a) measures to prevent any breaches of statutory or regulatory position limits for the affiliate client, and the corresponding ~~position~~ risk limits set by the relevant counterparty;

(b) policies and procedures to ensure timely settlement of its obligations to the relevant counterparty, taking into account any sudden surges in the margin requirement for ~~the trading of futures contracts by~~ the affiliate ~~client~~ client's positions and its settlement obligations to the relevant counterparty;

(c) regular reviews on the affiliate client's ability to timely meet settlement obligations to the futures broker taking into account ~~its~~ the affiliate client's business and financial circumstances, including the affiliate client's:

(i) trading pattern or strategy;

(ii) investment objective and risk appetite;

(iii) financial situation and credit history;

(iv) funding resources allocated for the purpose of dealing in futures contracts;

(v) margin and risk management policies applied to ~~its~~ the affiliate client's underlying clients; and

(vi) licensing or authorisation status and any regulatory actions taken by the relevant authority or regulatory organization in the jurisdiction in which the affiliate client is licensed or authorised;

(d) regular assessments to ensure the level of trading activities of the affiliate client is commensurate with the funding resources in (c)(iv) above;

(e) ad-hoc reviews on its exposure to the affiliate client's trading activities with reference to the factors set out in (c) upon significant market events or market volatility to ensure that ~~the futures broker's~~ its client credit risk is not excessive taking into account its own financial and management capabilities; and

(f) a contingency funding plan to ensure ~~the futures broker~~ it has adequate sources of liquidity in place to fulfil its settlement obligations to the relevant counterparty and comply with the minimum liquid capital requirements

8 "Prescribed country" has the meaning assigned to it by section 2(1) of the Securities and Futures (Financial Resources) Rules (FRR).

under the FRR under a scenario of settlement delay or failure by the affiliate client.

Note ~~4~~2

In these Guidelines, an “affiliate client” of a futures broker means any company within the same group of companies as the futures broker.

23. A futures broker should clearly document in its risk management policy and procedures the methodology adopted and factors considered in determining client risk limits.

24. Any waiver~~s~~ or increase of a client risk limit should be properly justified by a written risk assessment and endorsed by senior management.

Collection of margins from clients

25. A futures broker should not trade futures contracts for a client unless the client has provided sufficient collateral[~~7~~9] to ~~cover the minimum~~ meet its margin requirement[~~8~~]. This paragraph does not apply to concessionary margining granted by a futures broker to clients pursuant to paragraph 36.

Note 3

In these Guidelines, “concessionary margining” means an arrangement between a futures broker and a client in respect of margining a futures contract whereby the client is not required to comply with an upfront collateral requirement prescribed in the rules of the exchange or clearing house executing or clearing the futures contract if the client meets the eligibility criteria prescribed in those rules.

26. A futures broker should impose on a client~~s~~ a margin requirement (~~both~~ which may include an initial margin requirement and a maintenance margin requirement) ~~for futures contracts~~ which is not lower than the amount set by its counterparty.

Note ~~5~~4

~~The amount to be collected from a client should take into account the circumstances of the client and the futures broker, the risk of the product and prevailing market conditions. A futures broker may demand a higher level of margin from clients than the margin requirements set by its counterparties as it deems appropriate.~~

A futures broker may impose a margin requirement on a client which is higher than the amount set by its counterparty taking into account the circumstances of the client and the futures broker, the risk of the futures contracts and prevailing market conditions.

[~~7~~9] For example, a cheque received by a futures broker in good faith which it has no reason for suspecting that it will be dishonoured may be treated as cash.

~~[8] Except for any client meeting the eligibility criteria prescribed in paragraph 36 for concessionary margining.~~

27. A futures broker should not grant any credit facilities or loans to any clients or make any other arrangements[~~9~~10] to enable any clients to meet ~~their~~ margin requirements ~~for futures contracts~~. This ~~requirement~~ paragraph does not apply to concessionary margining granted by ~~the~~ a futures broker to clients pursuant to paragraph 36.

~~Note 6~~

~~In these Guidelines, "concessionary margining" means an arrangement between a futures broker and a client in respect of margining a futures contract whereby the client is not required to comply with an upfront collateral requirement prescribed in the rules of the exchange or clearing house executing or clearing the futures contract if he meets the eligibility criteria prescribed in those rules.~~

28. A futures broker should put in place special margining arrangements to mitigate the client credit ~~risk caused by~~ and funding liquidity risks that may arise due to:

(a) volatile market conditions; or

(b) market movements ~~of a market which opens~~ during ~~the~~ public holidays ~~of~~ in the place where a client is based[~~10~~11].

Note 5

In these Guidelines, "funding liquidity risk" means the risk of a futures broker failing to meet its financial obligation under a futures contract when it falls due[12].

29. A futures broker should determine its special margining arrangement based on a reasonable assessment of its exposure ~~for~~ during the period between the last margin call issued on its clients and the next margin call. The assessment should take into consideration all material risks and operational factors[~~11~~13] and the implications ~~of client default~~ to its financial position and compliance with the relevant laws and regulations in case its clients fail to settle margin calls on time. Special margining arrangement may include temporarily raising margin requirements or collecting additional margins before public holidays.

[~~9~~10] For example, a futures broker should not provide financial support to an affiliated company to facilitate the latter to grant a credit facility or loan to the broker's client to help the client meet the margin requirements for the client's position in ~~on~~ futures contracts.

[~~10~~11] For example, a Hong Kong client trading in an European futures market may not be able to ~~transfer funds to the futures broker~~ meet margin calls during ~~the Chinese New Year~~ Hong Kong public holidays. Similarly, an overseas client trading in the Hong Kong futures market may not be able to transfer funds to the futures broker during ~~his~~ the client's local public holidays.

[12] For example, a futures broker fails to meet a margin call issued by its counterparty on a futures contract by the deadline, which may be due to the failure of the underlying client in meeting its margin call timely and the futures broker does not have adequate funds to settle the margin call on behalf of the client.

[~~11~~13] Including but not limited to the latest market condition and historical volatilities of the market, its ability to meet ad-hoc margin calls or settle margin calls issued by counterparties during Hong Kong public holidays ~~from counterparties~~ within the required timeframe.

30. A futures broker should set prudent thresholds for issuing margin calls, for stopping clients from opening further positions and for forced-liquidating clients' positions. It should document in its risk management policies and procedures the ~~methodology adopted and~~ factors considered in determining the thresholds and the procedures of notifying the clients of the actions triggered.

31. A futures broker should:

(a) regularly and upon receiving an ad-hoc margin call from its counterparty determine whether margin shortfalls have arisen in client accounts; ~~determine whether the net equity balance of each client account is lower than the margin requirement set by it for the open positions in the account;~~

Note 6

For the purposes of these Guidelines,

– "margin shortfall" arises when the net equity balance of a client account is lower than the margin requirement set by the futures broker for the open positions in the account;

– "net equity balance" of a client account means the sum of collateral[14] held in the account, floating profits of open positions in the account and income credited to the account, minus floating losses of open positions in the account and fees, commissions, levies and other charges debited from the account.

(b) issue a margin call to a client whose account has margin shortfall that exceeds the threshold for issuing margin calls as soon as reasonably practicable; ~~if the net equity balance in the client account is lower than the margin requirement. Upon receiving an ad-hoc margin call from its counterparty in respect of a client's futures positions, the futures broker must also calculate the total amount of margin call outstanding in the client account and issue a margin call to the client as soon as practicable;~~

~~Note 7~~

~~In these Guidelines, "net equity balance" of a client account means the sum of collateral[12] held in the account and the floating profits or losses of all open positions in the account, after adjusting for any amount of interest and levy or commission due from the client.~~

(c) collect promptly from clients any amounts due as margin. The deadline for settling a margin call should be prudent and reasonable in the circumstances. In ~~this regard~~ the case of clients based in Hong Kong, futures brokers are generally expected to collect ~~the~~ from the clients any amounts due as margin within one business day of issuing the margin call;

~~[12] Including cash collateral and non-cash collateral subject to prudent haircuts.~~
[14] Including cash collateral and market value of non-cash collateral after applying prudent haircuts.

(d) prevent a client whose account has margin shortfall from opening any new positions in futures contracts ~~when the client has an unsettled margin call or the net equity balance of his account is lower than~~ that would increase the margin ~~requirement set by the futures broker for the open positions in the account~~ shortfall amount; and

(e) maintain detailed records of margin calls ~~for~~ issued to each client, including the amount and time of issuance of each margin call, the client's response and settlement ~~history~~ details, and any follow-up action taken on outstanding margin calls.

32. If a client fails to meet a margin call before the deadline set by the futures broker, the futures broker may close out any ~~of~~ position in the client's ~~positions in the client~~ account ~~to ensure the net equity balance can meet~~ for reducing the margin shortfall ~~requirements set by it for the remaining open positions~~ in the account.

33. A futures broker should strictly enforce its margin and forced liquidation policies and procedures. It should obtain senior management's approval for:

(a) any deviation from ~~its~~ the policies; or

(b) any margin call or forced liquidation waiver.

34. Such approvals should not be granted unless the senior management has proper justification for granting the approvals, including the approver has been reasonably satisfied that the deviation or waiver would not affect the futures broker's financial stability. A futures broker should document the basis of each approval, including: ~~A futures broker should maintain detailed records for an approval of deviation or waiver which document:~~

(a) the reason ~~of~~ for granting the approval;

(b) in the case of ~~an approval of~~ a waiver approval, the approver's assessment of the ~~creditworthiness of the clients~~ client's ability to settle his or her obligations to the futures broker based on ~~their~~ the client's financial positions and ~~past records in meeting margin requirements~~ settlement history;

(c) the approver's assessment of the impact of the approval on ~~its~~ the futures broker's liquidity and ability to comply with the liquid capital requirements under the FRR; and

(d) ~~the~~ any step~~s~~ it has taken, is taking or will take to address the risks resulting from the approval.

35. ~~In any cases, a futures broker should not waive any margin calls or forced liquidation for a client who has failed to meet two margin calls by the settlement deadlines without reasonable excuse in the preceding 30 calendar days. For this purpose, reminders issued to the client on the day of the settlement deadline of an outstanding margin call would not be treated as new margin calls. All subsequent reminders must be treated as new margin calls.~~ A futures broker should subject such approvals to regular independent reviews to ensure that its senior management properly exercises the approval power.

Concessionary margining

36. A futures broker may apply concessionary margining to a client in respect of his or her trading in a futures market if:

(a) the client has a record of consistently meeting margin requirements, maintains ~~a~~ sound financial positions relative to the size of his or her portfolio and trades, and meets the eligibility criteria set out in the rules of the relevant exchange or clearing house for concessionary margining;

(b) it strictly follows all the requirements relating to concessionary margining in the rules of the exchange or clearing house; and

(c) it has sufficient liquidity and financial capability to settle its counterparties' margin requirements on the trading of futures contracts of all clients which are subject to concessionary margining.

37. For the purpose of ~~paragraph 36(a)~~ these Guidelines, "consistently meeting margin requirements" means the client has no records of failure to meet the margin requirements, forced liquidation or returned cheques:

(a) if the account has been opened for one year or more, within an immediately preceding period of at least one year; or

(b) if the account has been opened for less than one year, ~~within an immediately preceding~~ for the period since account opening, and of at least three months.

38. A futures broker should assign a prudent trading limit to each client which is subject to concessionary margining. The trading limit should not be excessive taking into account the futures broker's financial capabilities and the client's specific circumstances, including his or her financial situation, ~~credit~~ settlement history, investment objective, risk appetite and trading pattern or strategy.

39. In these Guidelines –

(a) "Uncovered client margin amount" of a client's ledger account[15] means the total amount of margin required ~~to be deposited by a futures broker with its counterparties~~ for trading of futures contracts in the account which is not covered by the account's net equity balance. In calculating the "uncovered client margin amount", a futures broker may refer to either:

(i) the total amount of margin required to be deposited by it with its counterparties; or

(ii) the total amount of margin required to be deposited by the client with it.

(b) For the purpose of calculating the "uncovered client margin amount" ~~of a client's ledger account as at the close of a trading day~~ in (a), a futures broker is not expected to take into account the trading of futures contracts in a trading session of a futures market if the trading hours of the trading session extend beyond mid-night of the trading day.

(c) "Excess liquid capital" (ELC) of a futures broker means its liquid capital less required liquid capital under the FRR.

(d) "Available funding" of a futures broker means the sum of unencumbered cash beneficially owned by it and the amount of its undrawn bank lines allocated by it for the purposes of dealing in futures contracts.

40. For the purpose of paragraph 36(c), a futures broker should ~~ensure that~~ calculate the sum of uncovered client margin amounts of all clients' ledger accounts~~[13]~~ which are subject to concessionary margining as at the close of ~~any~~ every trading day, and compare this amount with a quantitative benchmark which is set at ~~does not exceed 10%~~ 50% of the higher of ~~its~~ the futures broker's ELC and available funding ~~(concessionary margining limit). A futures broker should use its latest available ELC or available funding for the above calculation~~.

41. ~~A futures broker should strictly enforce and monitor daily its compliance with the concessionary margining limit set out in paragraph 40. Any breach of the limit should be reported to the senior management immediately and rectified on the next trading day (eg, by closing out client positions, increasing the futures broker's liquid capital or available funding).~~ A futures broker which exceeds the quantitative benchmark should:

~~13 Please refer to paragraphs 17 and 19 of Schedule 4 to the Code of Conduct applicable to exchange participants of Hong Kong Futures Exchange Limited (HKFE) for the requirement to maintain separate ledger accounts in respect of HKFE Trade and Non-HKFE Trade. The term "HKFE Trade" is defined under the Rules of HKFE.~~

15 Please refer to paragraphs 17 and 19 of Schedule 4 to the Code of Conduct applicable to exchange participants of Hong Kong Futures Exchange Limited (HKFE) for the requirement to maintain separate ledger accounts in respect of HKFE Trade and Non-HKFE Trade. The terms "HKFE Trade" and "Non-HKFE Trade" are defined under the Rules of HKFE.

(a) assess its credit risk exposure to client positions with concessionary margining to ensure the exposure is not excessive taking into account its own financial and management capabilities; and

(b) take timely and appropriate actions to reduce any excessive exposure and ensure its financial integrity.

42. A futures broker may use either (i) its latest amount of ELC or available funding; or (ii) the amount of ELC or available funding based on its latest financial returns submitted to the SFC for the comparison in paragraph 40.

~~Counterparty risk management~~ Risk management over executing or clearing agents

~~42. If a counterparty defaults, the futures broker may be required to bear the losses caused by the default if it guarantees the counterparty's performance in favour of its clients.~~

43. When a futures broker engages an executing or clearing agent to execute or clear futures contracts for clients, it should:

(a) establish written policies and procedures to ensure proper management of exposure of the firm and its clients to the agent;

(b) regularly conduct due diligence reviews of the agent if the agent is not a licensed corporation, registered institution, exchange participant of a recognized exchange company, or clearing participant of a recognized clearing house, and assess the agent's capability taking into account ~~material~~ public or other available information that is relevant to its dealings with the agent, including the agent's:

(i) licensing or authorisation status and the regulations of the jurisdiction in which the agent is licensed or authorised, including the regulations of the exchange or clearing house of which the agent is a member or participant;

(ii) financial background;

(iii) client margin and risk management policies;

(iv) execution or clearing capacity;

(v) disaster recovery procedures; and

(vi) client assets segregation policies;

(c) implement appropriate arrangements and measures to avoid ~~relying on a single~~, mitigate and manage the impact of unavailability of the executing or clearing agent~~.~~ ~~A futures broker should~~, such as identifying at least one candidate of back-up executing or clearing agent ~~(back-up agent)~~ and, where possible, establishing and maintaining a mutual understanding or formal agreement with the ~~back-up agent~~ candidate on the back-up arrangement; and

(d) monitor the impact on the capability of the agent to provide services of changes in market conditions and other circumstances~~[14]~~[16].

Funding liquidity risk management

~~44. In these Guidelines, “funding liquidity risk” means the risk of a futures broker failing to meet its financial obligation under a futures contract when it falls due[15].~~

~~45~~44. A futures broker should employ prudent cash flow management and ensure that client money or collateral held by it is sufficiently liquid for settling its counterparties’ margin requirements for trading of futures contracts on behalf of clients.

~~46~~45. A futures broker should regularly evaluate its liquidity needs to weather market-wide or idiosyncratic stresses and develop appropriate emergency funding plans. To ensure that adequate new funds are available in an emergency, it should ~~refrain from~~ avoid relying on a single funding source.

Safeguarding client assets

~~47~~46. The following requirements apply to futures brokers without prejudice to the requirements under the Securities and Futures (Client Money) Rules ~~(CMR)~~ and the Securities and Futures (Client Securities) Rules ~~(CSR)~~.

~~48~~47. A futures broker should ensure that client positions in futures contracts and their related margins are booked separately from its proprietary positions and their related margins in its accounts with ~~its~~ counterparties.

~~49~~48. A futures broker should not use assets belonging to one client to secure or settle transactions of another client.

~~50~~49. Where client positions and assets are held in an omnibus account with a counterparty, a futures broker should take reasonable steps to prevent assets belonging to one client account from being used to set off or settle another client account’s overloss (ie, any amount of trading loss~~es~~ of a client account which exceeds the account’s net equity balance).

~~51~~50. Where a client account’s overloss and other client accounts’ assets in a futures broker’s omnibus account are set off by a counterparty, the futures broker should as soon as reasonably practicable deposit into the omnibus account or a designated trust bank account or segregated account any asset received by it for settling the margin call on the client account incurring the overloss and an amount

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~~[14]~~[16] For example, regulatory actions taken against the executing or clearing agent and changes in regulations of the exchange or clearing house of which the executing or clearing agent is a member or participant.

~~[15] For example, a futures broker fails to meet a margin call issued by its counterparty on a futures contract by the deadline, which may be due to the failure of the underlying client in meeting its margin call timely and inadequate funds to settle the margin call on behalf of the client.~~

of its own cash which ~~is~~ equals ~~to~~ the amount of the ~~overloss~~ aforesaid margin call which remains unsettled ~~by the client~~ to remedy the shortfall ~~arising~~ in ~~client~~ other client accounts' assets caused by the set-off.

~~52~~51. A futures broker should disclose in the client agreement:

(a) the extent of its liability to the client in respect of client assets held by its executing or clearing agent when the latter defaults; ~~and~~

(b) the client's rights to assets held by it in its omnibus account with a clearing house may be subject to it fulfilling its obligations to the clearing house, which may be further subject to its other clients fulfilling their obligations to it, despite the fact that the client did not default on his or her obligations to it; and

~~(b)~~(c) ~~the risk of~~ the client's rights to assets held by it in ~~an~~ its omnibus account with ~~a clearing house or~~ an executing or clearing agent may be subject to it, its other clients, the executing or clearing agent or their agents, and other clients of the executing or clearing agent ~~(as the case may be)~~ or their agents fulfilling their obligations to their counterparties, despite the fact that the client did not default on his or her obligations to it.

Trading in futures markets outside Hong Kong

~~53~~52. ~~Where a~~ A futures broker which provides dealing or clearing services to clients in a futures market outside Hong Kong~~, it~~ should:

(a) prudently manage its exposure to each overseas executing or clearing agent in respect of client assets held by the agent but not required for meeting the obligations to the agent on its client transactions; ~~carry out the following measures as far as practicable to safeguard client interest and client assets:~~

~~(i) open and maintain a segregated or trust account with a bank or custodian regulated by the authority of the jurisdiction in which the futures market is located;~~

~~(ii) deposit client assets received in or transferred to that jurisdiction which are not required for meeting clients' settlement or margin obligations (ie, client margin excess) into that segregated or trust account as soon as reasonably practicable;~~

~~(iii) handle client assets in that segregated or trust account in a similar manner as the CMR or CSR (where applicable) prescribe for client assets held in Hong Kong; and~~

~~Note 8~~

~~A futures broker is exempt from the requirements in paragraphs 53(a)(i), (ii) and (iii) in respect of client margin excess held by an~~

~~overseas executing or clearing agent who imposes upfront margin requirements on clients.~~

~~(iv) refrain from holding an amount of client margin excess with a single overseas executing or clearing agent which exceeds the futures broker's ELC reported in its latest monthly financial returns. The futures broker is expected to address the concentration risk as far as practicable, such as using different agents for different futures markets or products;~~

(b) disclose in writing to clients the key risks of conducting transactions in a futures market outside Hong Kong, including but not limited to the fact that its overseas counterparties and that futures market are not subject to the regulation of the SFC and may be subject to laws and regulations which may be different from the SFO and the rules and regulations made thereunder and consequently, the client may not enjoy the same protection as that conferred on trading in a Hong Kong futures market; ~~disclose, preferably on its website, the names of all overseas executing or clearing agents who may hold the futures broker's client assets in an omnibus account with the agent's counterparty;~~

~~(c) disclose in the client agreement the key risks of conducting transactions in a futures market outside Hong Kong, including but not limited to:~~

~~(i) the risks of client assets received or held outside Hong Kong, as set out in the Risk Disclosure Statement in Schedule 1 to the Code of Conduct;~~

~~(ii) the return or transfer of a client's assets may be subject to restrictions imposed by the regulation of that futures market or law or regulation of the jurisdiction in which the futures market is located;~~

~~(iii) its overseas counterparties and that futures market are outside the jurisdiction of the SFC and may be subject to regulation which is different from the SFO; and~~

~~(iv) other material risks of conducting transactions in that futures market;~~

~~(d)~~(c) deal with client enquiries in a timely manner, in particular~~ly~~, on request by any client, disclose the latest licensing or authorisation status of its overseas counterparties or that futures market (as the case may be); ~~those relating to regulation of its overseas counterparties or that futures market and the status of client assets held outside Hong Kong;~~ and

~~(e)~~(d) monitor material changes in the regulation of its overseas counterparties and that futures market that may affect the interests or assets of its clients ~~and provide timely updates to the clients~~.

Stress testing

~~54~~53. A futures broker should establish proper stress testing policies and procedures which clearly set out the stress testing methodology and frequency, and the review and ~~escalation~~ reporting mechanisms. The policies and procedures should be approved by senior management.

~~55~~54. A futures broker should conduct stress tests ~~regularly (at least daily if concessionary margining is applied to any client and~~ at least weekly ~~in other cases)~~ and during a volatile market to identify any potential financial vulnerability. It should use appropriate stress testing methodologies ~~and tools~~ which are commensurate with the risk characteristics of products traded by it or its clients ~~to identify its financial vulnerability and any excessive exposure to individual clients or groups of connected clients~~. It should also observe the stress testing requirements set by any exchange or clearing house of which it is a member or participant.

~~56~~55. A stress test should be capable of:

(a) projecting the amount of loss (projected loss) ~~which~~ that might arise in each client account under ~~a particular~~ the stress scenario assumed in the stress test (assumed stress scenario) and estimating the impact of material projected overlosses in client accounts[17] on the futures broker's ELC~~[16]~~ and available funding;

Note ~~9~~7

In these Guidelines, "~~P~~projected overloss", in relation to a client account, means the amount by which any projected loss ~~arising from positions in futures contracts in the account under an assumed stress scenario~~ exceeds the net equity balance of the account.

Note ~~10~~8

~~Paragraph 56(a) is not applicable to the~~ A futures broker may exclude from the coverage of the stress test carried out under these Guidelines any positions in the accounts of ~~any~~ clients which ~~is~~ are:

(i) ~~a~~ licensed corporations;

(ii) ~~a~~ registered institutions; or

[17] The impact of a projected overloss on the futures broker's ELC and available funding is equal to the amount of the projected overloss on the assumption that all the positions in the client account would be closed out when the overloss arises and the futures broker would be required to settle the overloss for the client with its counterparties using its own funds.

~~[16] The impact should be calculated in accordance with sections 40(1) and (2) of the FRR on the assumption that the client fails to meet the margin call by the settlement deadline.~~

(iii) ~~a~~ futures dealers (as defined in section 2(1) of the FRR) outside Hong Kong,

if those positions are carried by such financial institutions on behalf of ~~its~~ their clients~~;~~.

(b) projecting the amounts of trading losses and margin calls ~~which~~ that might arise ~~on~~ from the futures broker's proprietary positions under ~~a particular~~ the assumed stress scenario and estimating the impact of the total amount of projected trading losses and margin calls on its ELC and available funding; and

(c) appropriately estimating the potential losses of products with non-linear payoffs (eg, options).

~~57~~56. Subject to paragraph~~s~~ ~~58 and 59~~ 57, the assumed stress scenarios to be applied by a futures broker in its stress tests should include ~~design its stress~~ scenarios of extreme but plausible price movements or volatility shifts[18] of the futures contracts traded by it or its clients which should be determined with reference to or ~~for stress testing positions in futures contracts~~ based on ~~the following~~:

~~(a) assumptions of extreme but plausible price movements or volatility shifts[17];~~

~~(b)~~(a) past futures market stress events ~~which are relevant to the futures contracts traded by it or its clients~~[~~18~~19]; and

~~(c)~~(b) its assessment of emerging risks which might have a significant impact on the price or volatility of the futures contracts[20] ~~hypothetical events based on emerging risks[19]~~.

~~58. Alternatively, subject to paragraph 59, a futures broker may choose to conduct a simplified stress test by making the following assumptions:~~

~~(a) the projected loss of a client account under a stress scenario equals 200% of the margin requirement set by its counterparty on the positions in the account; and~~

~~(b) the projected loss of a house account under a stress scenario equals 200% of the margin requirement set by its counterparty on the positions in the account.~~

~~17 For options contracts only.~~

18 A futures broker which holds options contracts for client or proprietary accounts should conduct stress tests for volatility shifts.

~~18~~19 For example, the 2008 global financial crisis and 2020 volatility in WTI crude oil price.

20 For example, an event which might significantly increase or decrease the supply or demand of the underlying commodity of a commodity futures.

~~19 For example, a significant rise or fall in commodity price due to the outbreak of a new disease.~~

~~59~~57. ~~Where~~ A futures broker which is a member or participant of an exchange or a clearing house ~~specifies or suggests minimum parameters for a futures broker's stress testing on a futures contract[20], the futures broker~~ should ensure that ~~its parameters~~ the assumed stress scenarios used for stress testing positions in ~~such~~ a futures contract traded or cleared by the exchange or clearing house are at least as stringent as those specified or suggested by the exchange or clearing house for its members or participants[21].

~~60~~58. ~~Where a~~ A futures broker which is part of a group and relies on stress tests conducted centrally at the group level~~,~~ ~~the futures broker~~ will be regarded as having complied with paragraph ~~55~~54 only if:

(a) the group-wide stress tests have taken into account the futures broker's risk exposure and financial position, and appropriately project the impact on its ELC and available funding under stress~~ed~~ scenarios; and

(b) the approach adopted by those stress tests is substantially consistent with or more stringent than the requirements set out in paragraphs ~~55~~54 to ~~59~~57.

~~61~~59. ~~Where a~~ A futures broker which relies on the stress tests prescribed in paragraph ~~60~~58 for compliance with paragraph ~~55~~54~~, it~~ should submit the group-level stress test reports to the SFC upon request. A designated senior management staff ~~RO or MIC~~ should be responsible for explaining to the SFC the stress test results relating to the broker's exposure and respond to other related enquiries from the SFC in a timely manner.

Note 9

For the avoidance of doubt, paragraphs 58 to 59 do not apply to futures brokers which conduct their own stress tests in accordance with paragraphs 54 to 57.

~~62~~60. A futures broker should promptly and diligently ~~review all the~~ assess stress test results~~,~~ with a view to identifying ~~and assess~~ any potential ~~risks~~ threat to its financial stability, and take prompt follow-up action. In ~~particular~~ conducting the assessment, it should at least:

(a) compare the total projected losses in client accounts and total projected trading losses in ~~house~~ proprietary accounts with the results of the previous stress tests ~~to identify any significant trends~~;

(b) ~~assess the credit risk of~~ identify

(i) any client or group of connected clients who has a projected overloss (total projected overlosses in the case of a group of connected clients) exceeding 30% of its ELC or available funding (Note 10); and

~~20~~21 For example, the underlying price movements to be assumed for index options traded on HKFE are ±20% when these Guidelines were prepared.

(ii) any other clients or groups of connected clients to whom its exposure is considered excessive by it (Note 10);

(c) assess ~~its ability~~ the adequacy of its ELC and available funding to absorb the aggregate impact ~~on its ELC or available funding~~ of:

(i) the projected overlosses (total projected overlosses in the case of a group of connected clients) of the two clients or groups of connected clients who have the largest projected overlosses in their accounts (Note 10); and

(ii) the projected trading losses in its ~~house trading~~ proprietary accounts; and

(d) ~~take follow-up action to ensure its financial integrity~~ assess the ability of those clients or groups of connected clients identified under subparagraph (b) or (c)(i)[22] to settle the projected overlosses (total projected overlosses in the case of a group of connected clients) should those losses arise.

<u>Note 10</u>

Clients or groups of connected clients who have a record of consistently meeting margin requirements or maintain sound financial positions relative to the size of their portfolios and trades may be excluded.

~~63~~61. Where ~~the stress test results suggest that the~~ a futures broker assesses that its financial stability might be ~~exposed to significant risks~~ under threat under an assumed ~~a~~ stress scenario, it should take prompt and effective follow-up actions, such as adjusting its risk ~~mitigating~~ management measures and ~~prepare~~ preparing a detailed contingency plan to prevent settlement failure, insolvency or non-compliance with the minimum liquid capital requirements under the FRR ~~in an emergency~~ under market stress. It should ensure that the assumptions ~~used~~ applied in the contingency plan are realistic (eg, whether contingent ~~funds will~~ funding would be ~~made~~ available ~~by affiliated companies~~ when the group ~~is~~ and its lending banks are also under stress and whether ~~the~~ concurrent funding needs of other business lines[~~21~~23] of the futures broker ~~are duly considered~~ would arise).

~~64~~62. A futures broker should document:

(a) the details of each stress test~~s~~ performed, including the methodology, data sources, data history, assumptions and assumed stress scenario applied in ~~each~~ the stress test; ~~and the findings of each test, including but not limited to:~~

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[22] An assessment of clients or groups of connected clients identified under subparagraph (c)(i) is only required if the futures broker's ELC or available funding is inadequate to absorb the aggregate impact of the amounts referred to in subparagraph (c)(i) and (ii).

[~~21~~23] For example, a futures broker may conduct other regulated activities, eg, securities margin financing and dealing in stock options. These business lines may also have funding needs under ~~a stress scenario~~ market stress.

~~(i) the amount of projected loss and overloss of each client account; and~~

~~(ii) the aggregate impact on its ELC or available funding of:~~

~~(A) the projected overlosses of the two clients or groups of connected clients who have the largest projected overlosses in their accounts; and~~

~~(B) the projected loss in its house trading;~~

(b) the results of each stress test, including but not limited to the amount of projected loss and projected overloss of each client account, and the projected trading loss in each of its proprietary account;

~~(b)~~(c) ~~major risks identified by the stress tests and its~~ the results of its assessments of ~~the impact on it~~ stress test results; and

~~(c)~~(d) any follow-up actions ~~it has~~ taken~~,~~ ~~is taking or will take~~ on the assessment results.

~~65~~63. Stress test, assessment results and follow-up actions should be promptly reviewed and approved by the futures broker's senior management and ~~made available to~~ provided to the SFC upon request.

Notification requirements

~~66~~64. A futures broker must notify the SFC in writing within one business day of becoming aware of any of the following matters:

(a) ~~any of its failure to comply with~~ it exceeds the quantitative benchmark in paragraph 40 ~~of these Guidelines~~;

(b) ~~any result of any stress test conducted by it in accordance with paragraphs 54 to 65 of these Guidelines which indicates~~ it assesses that:

(i) any client or group of connected clients identified under paragraph 60(b) might not be able to settle the projected overloss (total projected overlosses in the case of a group of connected clients) of ~~any~~ the client or the group of connected clients ~~exceeds 30% of its ELC or available funding~~; or

(ii) its ELC or available funding would not be ~~able~~ adequate to absorb the aggregate impact of the amounts referred to in paragraph ~~62(c)~~ 60(c)(i) and (ii); or

(c) ~~any of its failure or potential failure~~ it fails or will fail to meet any margin call~~s~~ from any counterparty~~ies~~.

~~67~~65. A futures broker must include in the notification to the SFC filed under paragraph ~~66~~64 full details of the matter, including:

(a) in case of a notification filed under paragraph ~~66(a)~~64(a), ~~the reasons for the failure and any measures it has taken, is taking or will take to rectify the situation and ensure future compliance;~~

(i) the reasons for exceeding the benchmark and any significant trend in the exposure to client positions with concessionary margining;

(ii) any risk mitigating measures it has taken, is taking or will take to reduce any excessive exposure to client positions with concessionary margining; and

(iii) any follow-up action it has taken, is taking or will take to prevent settlement failure or non-compliance with the minimum liquid capital requirements under the FRR;

(b) in case of a notification filed under paragraph ~~66(b)~~64(b),

(i) the relevant stress test results referred to in paragraph ~~66(b)(i)~~60(b)[24] or ~~(ii) (as the case may be);~~ (c)[25] and the results of the related assessment performed under paragraph 60(d); and

~~(ii) any risk mitigating measures to reduce any excessive exposure to any client or group of connected clients or proprietary positions; and~~

~~(iii)~~(ii) any follow-up action it has taken, is taking or will take, including its contingency plan to prevent settlement failure, insolvency or non-compliance with the minimum liquid capital requirements under the FRR and any risk mitigating measures to reduce any excessive exposure to the client or group of connected clients or proprietary positions concerned; and

(c) in the case of a notification filed under paragraph ~~66(c)~~64(c), the reasons for the failure or potential failure, and any measures it has taken, is taking or will take to rectify or prevent the failure ~~or prevent settlement failure~~.

Transitional arrangements

66. During the 12-month period from the commencement date of these Guidelines, a futures broker which does not:

(a) incorporate client risk limits into its risk management system, order management system or trading platform in accordance with paragraph 21(d); or

(b) carry out stress tests using an assumed stress scenario designed in accordance with paragraph 56,

[24] In the case of notification under paragraph 64(b)(i).
[25] In the case of notification under paragraph 64(b)(ii).

due to the incomplete development of the related system should adopt interim compensating measures to meet the risk management objective of the requirement referred to in subparagraph (a)[26] or (b)[27] (as the case may be).

[26] For example, monitoring compliance with client risk limits manually.
[27] For example, conducting stress tests using prudent simplified stress scenarios.