19 January 2023

To: The Securities and Futures Commission
54/F One Island East
18 Westlands Road
Quarry Bay, Hong Kong
Email: 2022_FuturesConsultation@sfc.hk

Dear Sirs/Madams

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

FIA[1] appreciates the opportunity to respond to the proposals set out in the "Consultation Paper on Proposed Risk Management Guidelines for Licensed Persons Dealing in Futures Contracts" consultation paper (the **Consultation**) issued by the Securities and Futures Commission (**SFC**) in November 2022.

We wish to highlight some specific comments for the consideration by the SFC. These follow the numbering set out in the Consultation. Unless otherwise defined, capitalised terms used in this letter will bear the same meanings ascribed to them in the Consultation.

Question 1

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

We are supportive of having a RO/MIC oversee the risk management function as currently required by the SFC. Such holistic oversight is crucial for timely decision making and effective management supervision.

---

[1] FIA is the leading global trade organization for the futures, options and centrally cleared derivatives markets, with offices in London, Singapore and Washington, D.C. FIA's membership includes clearing firms, exchanges, clearinghouses, trading firms and commodities specialists from more than 48 countries as well as technology vendors, lawyers and other professionals serving the industry. FIA's mission is to support open, transparent and competitive markets, protect and enhance the integrity of the financial system, and promote high standards of professional conduct. As the principal members of derivatives clearinghouses worldwide, FIA's member firms play a critical role in the reduction of systemic risk in global financial markets. Further information is available at www.fia.org.

However, firms should retain the flexibility to appoint the appropriate ROs/MICs to manage risks in accordance with their risk management frameworks and processes instead of being required to designate a RO/ MIC to manage each material risk.

Firms in Hong Kong that are regulated under the SFC already manage material risks via designated ROs and MICs (for example, there are ROs for Type 2/5 activities and MIC designations in place for an organisation's key functions). With such well-defined requirements currently in place, the creation of this additional requirement specific to futures could result in duplicative requirements that add little value to the effectiveness of risk management on a firm-wide basis.

It would also be impracticable for firms that have a cross-asset business model to designate a RO/MIC for each risk related solely to its futures business. Additionally, it would add complexity to their business operations as any changes to the RO/MIC would require reassigning risk ownership.

There could also be inconsistencies in application as each futures broker could have different interpretations of when a RO/MIC should be designated. In this regard, we seek clarity on what constitutes "material risk relating to futures business" (for example, whether this includes only market risk, client credit risk, counterparty risk and funding liquidity risk as mentioned in the Consultation).

Question 2

Do you agree that the aforesaid factors 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.

We agree that considering various key factors are important and should form part of the review for products supported by futures brokers. As futures brokers often have different business models and serve various client segments, the specific factors that each broker considers when conducting its own risk assessment may vary. We therefore suggest that futures brokers be allowed a certain level of flexibility in terms of the specific factors to be taken into consideration as long as they can demonstrate proper governance and risk management of these products.

We do not agree with the proposed requirement for futures brokers to maintain a list of commodity futures products that must be approved by their board of directors. This will increase the administrative burden on their business and add to the responsibilities of the board of directors without providing any foreseeable benefit or risk mitigation. We suggest instead that the authority to approve any product should be given to a committee or the relevant ROs/MICs responsible for risk management.

We also seek clarity from the SFC on following:

a. How are "commodity futures products" defined? For example, would crypto futures fall within the scope of these requirements?

b. There are instances where a futures broker only deals in Hong Kong listed futures contracts, while individuals licensed under that futures broker deal with non-HK listed commodity futures products for clients who have contracted with the broker's overseas affiliates. Can the SFE confirm that the requirements will apply only to Hong Kong listed futures contracts and not overseas commodity future products in such instances?

<u>**Question 3**</u>

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?

We agree that applying appropriate risk limits to clients' trading activity is a crucial component of an effective control framework. It is also important to supplement these trading limits with a broader examination of risk at the client and exchange levels, to ensure that all flow types are properly monitored.

We seek clarification from SFC on whether "client risk limits" refer to pre-trade execution risk limits (such as contract/lot size) or Delta/IM limits. The implementation of Delta/IM limits on an exchange level would be extremely complex for global international futures brokers as their underlying clients often trade in multiple exchanges, with an overall risk exposure across all asset classes, markets, and products they trade into.

The futures industry has a mature give-up system where end investors can trade with Broker A and give up the trade with Broker B so the risk resides with Broker B. Implementing only risk limits into an order management system does not effectively control the ultimate risk exposure as Broker A may offer a higher risk limit, though Broker B is still responsible and obligated to clear all trades for the end client as their designated clearing broker.

We would also highlight that futures brokers adopt a wide variety of risk limits, not all of which can or should be incorporated into systems as "hard limits" (i.e. limits beyond which clients are prevented from further trading). Some risk limits are set in the systems to prevent relevant breaches, while others like initial margin caps are monitored in real-time by futures brokers and serve as a trigger point for further risk-related actions such as issuing margin calls rather than to prevent further trading by clients.

We also welcome the proposed alternative arrangements for futures brokers that serve as the execution arm of affiliate clients and seek clarification on the "compensating measures" the SFC may consider appropriate. For example, would it be sufficient if a futures broker can demonstrate the compensating review process over its affiliate via the presentation of information to the board or business forums in the presence of MICs/ROs?

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.

We generally agree with this proposal which provides greater flexibility to futures brokers with affiliate client models.

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?

We agree with the intent of the proposals. However, we suggest allowing futures brokers to consider margin call waivers on a case-by-case basis as long as the appropriate internal approvals and reporting processes to the SFC/HKEX are in place. This would enable the broker to consider the credit profile of each client and any risk mitigation actions already taken before determining the most appropriate course of action. It would also reduce the operational burden of keeping track of whether the thresholds have been breached.

Furthermore, where counterparty risks have been mitigated because clients have reduced their positions, the waiving of a margin call in these cases should not be considered a waiver for the purposes of the threshold. For futures brokers that deal only with institutional or corporate professional investor clients or regulated entities, forced liquidation would generally be a last resort so that normal trading and hedging activities.

We also seek clarity on paragraph 28 of the Proposed Guidelines. Margin rates are published by HKEX in daily SPAN files. Futures brokers also review circulars published by HKEX regarding arrangements on public holidays or in event of volatile market conditions. Can the SFC confirm if a futures brokers would be considered compliant with paragraph 28 if they calculate margin requirements for clients based on the rates in the daily SPAN files and apply the client margin multiplier specified by HKEX (i.e. 1.33x)?

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.

No, there shouldn't be a limit for a futures broker's exposure to concessionary margining. A one size fits all approach is not suitable as larger futures brokers will have significantly greater funding capabilities and liquid capital than smaller futures brokers. Futures brokers also have different business models (for example, some futures brokers only have a single affiliate client). Moreover, limits should not be imposed where futures brokers deal with Established Clients as such clients are already recognized by under the HKEX rules as being financially sound and having strong credit histories. Some members have also suggested that futures brokers who deal only with professional investors should be exempt.

While we understand the SFC's policy objective in imposing a limit, the Proposed Guidelines could have the effect of impeding the scale of business that international firms can conduct in Hong Kong and decreasing their overall capital efficiency without meeting such objective.

We therefore suggest that, as futures brokers have been given discretion to decide which clients are eligible for concessionary margins, this discretion be extended to allow them to evaluate and determine the suitable limit for their exposure to concessionary margining. This is especially since they report financial resources daily.

We also seek further clarification from SFC on following:

a. Should (i) the ELC as reported to the SFC in the monthly financial returns or (ii) daily estimated ELCs apply? It is suggested that (i) should apply as the reported number is usually more accurate after accounting for various month end adjustments and accruals.

b. With reference to the uncovered margin amounts, we seek the SFC's confirmation that it defers to the broker to calculate this based on their post trade margining framework and an appropriate cut off time (e.g. on a T+1 basis). Illustrations and examples will be helpful for participants to understand the SFC's expectations for this 10% threshold monitoring, including timeframe for any rectifications required.

c. When calculating the futures broker to concessionary margining where a futures broker only has one affiliate client, does the exposure cover the overall omnibus level of the affiliate and does it exclude futures broker's exposure to house accounts(s) (e.g. title transfer accounts and house market making accounts)?

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

Most members agree with the proposal.

We also seek the SFC's clarification that all trading sessions that extend beyond HKEX normal trading hours (i.e. Day Session as shown in HKEx's website - https://www.hkex.com.hk/Services/Trading-hours-and-Severe-Weather-Arrangements/Trading-Hours/Derivatives-Market?sc_lang=en) are excluded from the calculation.

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.

We agree that futures brokers should conduct due diligence reviews of any executing or clearing agents.

However, it should not be mandatory to have a back-up agent as this would be commercially impractical. It would be costly and require significant infrastructure and maintenance effort to ensure that such contingency arrangements are effective. It would also be challenging find a back-up agent to work on onboarding and maintaining the accounts without any revenue.

It is also unnecessary to appoint a back-up agent if futures brokers have their own executing and clearing capabilities, and the relevant business contingency plans in place. There is also added risk contagion as the clearing house (i.e. HKEX) has exchange level contingency measures for clearing. Moreover, institutional clients would likely have their own backup agent to trade or clear if their primary futures broker is unable to do so.

We are also not aware of any other markets that have this requirement.

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?

We generally agree, though this should be subject to certain conditions such as a specific timelines to ensure the proper segregation of client funds is maintained. We would also highlight that futures brokers should have safeguards and controls in place to ensure that clients' assets will not be used to cover the overlosses of other clients. Even if a futures broker immediately deposits its own funds into an omnibus account, it would not fully mitigate the risk to the clients whose assets are being employed, as the liquidity of the futures broker would also be tied up in the arrangement.

More clarity on this rule is also needed in order to prevent confusion. Unless exchanges or clearing houses can settle all trades intra-day or even in real-time, all overlosses would have to be calculated based on end of day settlement results. If the "overlosses" referred to in the Proposed Guidelines includes those intraday ones, it would not be practical nor possible for futures brokers to remedy a shortfall in this scenario due to real-time price and position movements.

Accordingly, we suggest that clear wording be provided to stipulate that this requirement should only apply to end-of-day overlosses. Futures brokers should only deposit their own funds if the overlosses are irrecoverable (for example, if a client is in default and unable to meet margin obligations on T+1 day).

We also seek the SFC's confirmation that, with regards to disclosure requirements to clients, futures brokers can read the Proposed Guidelines together with Paragraph 15 of the SFC Code of Conduct. This means that any applicable exemptions for clients that are Professional Investors can still apply if the required conditions are met.

Finally, as the Proposed Guidelines require futures brokers to include certain risk disclosures in their client agreements, it would be helpful if the SFC could provide standard form language to ensure consistency across the market.

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?

No. The amount of client margin excess held by executing or clearing agents, whether they are based overseas or not, should not be dependent on the futures broker's ELC. Rather, it should be related to the exposure of the positions held with the agent. Moreover, due to time difference, futures brokers may not be able to meet intraday margin calls from agents located in other jurisdictions which may lead to forced liquidation outside of the Hong Kong time zone.

We would also highlight that Paragraph 56(d) of the Proposed Guidelines could severely penalise futures brokers with smaller balance sheets (i.e. limited ELC or available funding) should they be required to split business unnecessarily with more brokers for diversification purposes. Positions may be liquidated by their executing or clearing agents if the excess or buffer margin is not sufficient to cover their VM losses or they are not able to meet intraday margin calls due to different time zones or banking cut off times.

Finally, we seek the SFC's confirmation that, with regards to disclosure requirements to clients, futures brokers can read the Proposed Guidelines together with Paragraph 15 of the SFC Code of Conduct. This means that any applicable exemptions for clients that are Professional Investors can still apply if the required conditions are met.

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?

It is prudent to conduct regular stress tests regardless of whether concessionary margining is applied or not, and that these should take place more frequently during a volatile market.

However, it should not be mandatory to conduct daily testing when concessionary margining is applied to clients, particularly if these clients are also affiliate clients as the risks originate from their end clients and stress testing is conducted at that level.

We also seek clarity on what the SFC considers as "having taken into account the futures broker's risk exposure" as set out in paragraph 60(a) of the Proposed Guidelines.

Question 12

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

We agree that alternative approaches should be considered and that a margin uplift can be a reasonable simplified stress-test for businesses that are unable to produce or design their own stress testing. However, determining the appropriate stress scenario will require more research.

FIA.org

<u>Question 13</u>

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

No. A one-size-fits-all approach is not appropriate as there are significant differences amongst futures brokers (for example, corporate background, size, business model etc). Each futures broker will also have its own global policies in place regarding limits, procedures and necessary rectification actions, and imposing a threshold specific to Hong Kong does not take into account these established policies. It would also be impractical to retrieve excess liquid capital information from end/individual investors/clients.

Furthermore, assessing counterparty credit risk at the level of "groups of connected clients" may not be effective as the financial condition, credit history, and risk profile of each client may vary independently of whether they are connected or not.

Should the SFC want to prescribe a stress test framework, one suggestion is to adopt a common practical way to measure stress gap using VaR (Stress Gap = VAR - IM) or Stress Gap against NAV.

<u>Question 14</u>

Do you agree with the stress scenario set out in paragraph 68(c) 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.

No, as the existing ELC may not accurately reflect the ability of the futures broker to pay in case of loss, particularly for those who may not be as well capitalized but have access to a global funding pool.

In addition, the projected overlosses of client accounts are a worst-case scenario and do not reflect actual losses. Accordingly, they should not be considered as "breaches" that the SFC should be notified of under paragraph 66(b) of the Proposed Guidelines. Instead, they should be considered as part of routine risk management process where the futures broker may take the appropriate actions (e.g. requesting clients to top up funds or reduce positions) to mitigate the risks where necessary.

<u>Question 15</u>

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

No, although the level of complexity and frequency of requests for such reports from the SFC could impact the ease of conducting stress tests.

We also seek clarity from the SFC on the stress tests requirements. The Proposed Guidelines require a stress test to project potential losses in each client account and estimate the impact of projected overlosses in those accounts on a futures broker's ELC. Where participants conduct both futures and cash equities business under one single entity, the ELC would cover both businesses. Can the SFC confirm whether setting stress assumptions based on the risk drivers identified for the futures business would be sufficient to meet this requirement?

<u>Question 16</u>

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

No, as members' work plans and budgets for 2023 have already been set and they have limited resources available due to previously planned mandatory changes for 2023 and 2024.

A minimum transition period of 18 months would be more appropriate, though this should be subject to the complexity of developing a systems-based solution to implement the requirements.

<u>Question 17</u>

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

No, please see the response to Question 16 above.

A minimum transition period of 18 months would be more appropriate as implementing the requirements in the Proposed Guidelines will involve changes to systems, procedures, and policies.

FIA.org

Other Requests for Clarification

We seek the SFC's confirmation that the Proposed Guidelines apply only to licensed corporations and not Registered Institutions.

We welcome the opportunity to work with the SFC to address these comments.

Please feel free to contact me at bherder@fia.org, or TzeMin Yeo, Head of Legal & Policy, Asia Pacific at tmyeo@fia.org should you wish to further discuss.

Yours faithfully

Bill Herder
Head of Asia-Pacific