



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

### **The Law Society's Submissions**

The Securities and Futures Commission (the “SFC”) issued a consultation paper on “Proposed Risk Management Guidelines for Licensed Persons Dealing in Futures Contract” on 25 November 2022 (“Consultation Paper”).

In response, the Law Society provides the following submissions. The same abbreviations and definitions appearing in the Consultation Paper are used in this paper.

The Law Society supports the SFC's proposal to issue risk management guidelines for the dealing activities of futures brokers. In introducing the proposal, the SFC draws attention to the extreme volatility in the financial and commodity futures markets that has occurred over the last two years or so. In addition, we note that the majority of existing risk management requirements for futures dealing activities as set out in the Management, Supervision and Internal Control Guidelines for Persons Licensed etc. with the SFC and the Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) and (Client Money) Rules were issued in April 2003. On the basis of the age of this guidance alone, the time is ripe for it to be revisited to ensure it reflects the growing sophistication of the futures market in Hong Kong over the last twenty years and the increased risks which have accompanied that growth.

We are not in a position to comment on all of the detailed proposals that the SFC makes. However, when comparing the current guidance mentioned above with what is now proposed, we note that in many respects the SFC is moving from a series of fairly high level principles to a series of more prescriptive requirements. We observe only that a sensible balance needs to be struck to ensure that the SFC achieves its objective of providing further guidance on futures brokers' risk management (including in particular for commodity futures trading) without burdening the industry with unduly prescriptive, overly detailed requirements which may cause confusion or remove flexibility in implementation. The latter is desirable given the range of different business models operated by futures brokers in Hong Kong.

### **Question 1**

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

#### **Law Society's response:**

Yes, we agree.

### **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.*

#### **Law Society's response:**

Yes, we agree. However, as mentioned in the consultation, the list of high level factors is non-exhaustive. Futures brokers should be reminded to look beyond this list of factors when understanding the risks they face and not to treat it as a checklist.

### **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?*

#### **Law Society's response:**

Yes, we agree.

### **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.*

**Law Society's response:**

Yes, we welcome the SFC's proposal to allow futures brokers to adopt alternative arrangements for clients which are group entities regulated or supervised by a regulator in Hong Kong or a prescribed country.

**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?*

**Law Society's response:**

No, we suggest that no waivers of margin calls or forced liquidation should be allowed for clients who have failed to meet one margin call (instead of two margin calls) without reasonable excuse in the preceding 30 calendar days. We do not see any logic in allowing failure to meet two margin calls. If the Hong Kong market is experiencing extreme volatility, the interests of the market and investors as a whole require rapid de-risking. Imposing a two-margin calls' requirement would likely slow down the process in relation to clients who may be major sources of risk/exposure for brokers and the market.

In our view, an individual client being given some latitude by the proposed defence of 'reasonable excuse' should be sufficient.

**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.*

**Law Society's response:**

Yes, we agree.

**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.*

**Law Society's response:**

Yes, there are already other market protection mechanisms in place.

**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.*

**Law Society's response:**

Yes, we agree.

**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?*

**Law Society's response:**

Yes, we agree.

**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?*

**Law Society's response:**

Yes, we agree.

**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?*

**Law Society's response:**

Yes, we see regular stress testing as one of the most important SFC proposals. We agree that daily testing should be mandated for clients who are the beneficiaries of concessionary margining. The risks associated with such arrangements are obvious and therefore they require constant testing.

However, for 'other cases', we query whether stress testing must be done on a weekly basis. Can future brokers be provided the flexibility to do stress test regularly without a specifying a time period? In times of extreme volatility, once a week may not be sufficient. Conversely, in benign market conditions, is it necessary for a stress test to be done every week? If a stress test is not done every week given the benign market conditions, would the SFC take action against a broker for what the industry may regard as a 'technical' non-compliance? If yes, this would seem to be excessive.

The onus should be on the broker to design a risk management program and a stress testing regime which can adapt to different market conditions and to identify excessive/dangerous exposures to clients. The broker must exercise prudent judgement as to what is required in the prevailing market conditions.

**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.*

**Law Society's response:**

No, this proposed alternative approach appears to be driven by concerns about the inability of smaller futures brokers to design stress scenarios for each product because of a lack of resources. This does not appear to us an appropriate driver when dealing with something as important as stress testing. Why shouldn't smaller brokers be required to adopt/design similar internal testing practices/systems as larger brokers? Historically, the SFC has been unsympathetic to pleas from smaller brokers which did not have sufficient resources to deal with matters such as customer due diligence to satisfy AML/CTF requirements. We think this is the correct approach by the SFC. The same principle should apply here i.e. the SFC should not provide an alternative to future brokers simply due to a perceived lack of resources to design stress scenarios for each product. Alternatively, can the SFC make the simple alternative approach available to all brokers so that all licensed corporations are treated consistently?

### **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) above? If not, please provide the rationale and any alternative suggestions.*

#### **Law Society's response:**

Yes, we agree.

### **Question 14**

*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.*

#### **Law Society's response:**

Yes, we agree.

### **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 Proposed Guidelines, including the submission of stress test reports to the SFC upon request? If so, please explain the challenges and provide alternative suggestions.*

#### **Law Society's response:**

Yes, for multi-entity, multi-jurisdiction financial groups, paragraphs 60 and 61 will add to the operational and logistical challenges they face in dealing with the regulatory requirements in different jurisdictions when conducting group level stress tests. It is unclear to us whether the standards the SFC seeks to impose in this regard are consistent with international standards or are likely to lead to difficulties for groups in practice because the SFC's approach is more stringent than in other markets.

### **Question 16**

*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.*

**Law Society's response:**

No, we regard a nine-month transition period as being too short for proposed reforms of this magnitude when the market has lived with the existing limited guidance in this area for almost twenty years. We suggest a twelve-month period would be fairer to all futures brokers, and we suggest the same time period be adopted for all other requirements in the Proposed Guidelines.

**Question 17**

*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.*

**Law Society's response:**

Please see our answer to question 16 above.

**The Law Society of Hong Kong  
31 January 2023**