SFC's Consultation Conclusion on Risk Management Guidelines for Futures Dealing Activities

Background

In light of the market volatility incidents witnessed in both the financial and commodity futures markets during 2020 to 2022, the Securities and Futures Commission (the "SFC") found it imperative to set out guidance on futures brokers' risk management practice and it initiated a consultation about a proposal for risk management guidelines in November 2022. After the 9-month consultation period, the SFC has lately published the Risk Management Guidelines for Licensed Persons dealing in Futures Contracts (the "Guideline") in August 2023 to set out their expectation to future brokers of a comprehensive risk management framework to manage the risks arisen from its proprietary trading and clients' trading in future contracts.

Timeline

The key dates and transitional arrangements for implementation of system changes to comply with the new requirements are as follow:

25 February 2024
The Guidelines will be effective

25 February 2025
End of transitional period

12–month Transitional Period

Future brokers to implement system changes related to automated controls related to client risk limits and stress testing[1]

Major Challenges

In the realm of guidance for risk management policies and controls on futures dealing activities, we foresee that future brokers will need to thoroughly assess and understand these challenges:

Client credit risk management

Incorporation of client risk limits into the risk management system, order management system or trading platform to manage clients' trading exposure.

Concessionary margining

Application of trading limit to each client which is subject to concessionary margining and follow the quantitative benchmark set by the SFC.

Notification requirement

Written notification to the SFC within one business day of becoming aware of incident related to the excess of quantitative benchmark under concessionary margining; or failure/ foreseeable failure to meet respective projected loss or margin call.

Stress testing

Establishment of proper stress testing policies and procedures (for example, testing methodology, review and escalation reporting mechanisms) and conduct of weekly stress testing at minimum.

[1] Future brokers should impose interim compensating measures such as manual monitoring and simplified stress scenarios during the transitional period.

Key Requirements

The key requirements that newly introduced in the Guideline are as follow:

Risk management framework

A risk governance framework should be established by the future brokers to ensure proper delegation of risk management responsibilities to senior management.

The risk management policies and procedures should cover the identification and assessment of risks and determination of risk appetites and risk limits; ongoing risk monitoring, controlling and reporting; escalation and resolution procedures, and stress testing and contingency planning.

Market risk management on proprietary trading

Proprietary positions are required to be monitored under real time mark-to-market basis and day-end independent revaluation.

Market risk measurement system and appropriate risk models should be established to quantify market risk exposures for estimating the potential impact of adverse market changes. Futures brokers should perform regular comparison between estimated market risk exposures and actual and hypothetical losses of the positions and investigate the difference. Prudent market risk limits should be set and promptly escalated and remedied in case of breaches.

Concessionary margining

Concessionary margining to a client should be applied only if a set of conditions are fulfilled, including, the client meets all eligibility criteria and adhere to all relevant requirements as specified in the rules of the exchange or clearing house and has sufficient liquidity to settle margin requirements for these clients. In this regard, the SFC has set out a quantitative benchmark that the margin amounts of these clients which are not covered by own account's net equity balance should not exceed 50% of the higher of its the futures broker's excess liquid capital and available funding.

Commodity futures trading

A list of commodity futures should be maintained by the futures brokers for dealing control and risk monitoring. Futures brokers should have sufficient knowledge about physical settlement of the commodity futures, including their roles, storage and delivery arrangement.

Client credit risk management

Future brokers should put in place prudent risk limits, including trading and position limits, for each client, or each group of connected clients, where applicable. In the case that the client of the future broker is an affiliate, which is regulated or supervised by a financial regulator in Hong Kong or a prescribed country, instead of setting internal risk limits, the future brokers could fulfil other requirements, for example to set out proper policies and procedures with the purpose to ensure timely settlement of its obligations to the relevant counterparty as well prevent any breaches of statutory or regulatory position limits for the affiliate client and for complying with the credit risk management on the affiliate client.

Margin and forced liquidation policies and procedures (for examples, collecting promptly from clients any amounts due as margin, setting of prudent thresholds for margin calls and stopping clients from opening further positions) should be implemented and strictly enforced by the future brokers. In case of any wavier of any margin call or forced liquidation, prior approval from senior management detailing their justification and assessment on its the futures broker's liquidity should be obtained and documented.

Risk management over executing or clearing agents

It is not uncommon that the future brokers engage executing or clearing agents to execute or clear futures contracts for clients. In this circumstance, the future brokers are required to establish written policies and procedures to ensure proper management of exposure of the firm and its clients to the agent and implement appropriate contingent measures to manage the impact of their unavailability, which includes identifying one candidate of backup agent.

Funding liquidity risk management

Future brokers should management its cash flow prudently and main sufficient liquidity for setting their client's margin requirements. Emergency funding plans and avoidance of sole funding source are suggested in the Guideline in order to fulfil their liquidity needs all the time.

Trading in futures markets outside Hong Kong

Where applicable, the future brokers should manage its exposure (in respect of client margin excess) to each overseas executing or clearing agent and disclose in writing to clients the key risks of conducting transactions in a futures market outside Hong Kong.

Notification requirements

Various matters are required to report to the SFC within one business day, including in excess of quantitative benchmark related to concessionary margining, client might not be able to settle the projected overloss, future broker might not be able to absorb the aggregated projected losses, or any failure or potential failure to meet margin calls from any counterparty.

Safeguarding client assets

Client positions and their related margins are required to book separately from its proprietary positions and their related margins. Future brokers should manage client assets in the omnibus accounts to prevent assets belonging to one client account from being used to set off or settle another client account's overloss.

Stress testing

Proper stress testing policies and procedures which clearly set out the stress testing methodology and frequency (at least weekly) should be established to project the amount of loss arise in each client account and impact on the futures brokers' excess liquid capital and available funding under assumed stress scenarios. Conditional exemptions may apply to, for examples, specific financial institutions clients or clients who have a record of consistently meeting margin requirements or maintain sound financial positions relative to the size of their portfolios and trades. Group-wide stress tests may be considered if the stress test approach is consistent with the requirement set out in the Guideline and have taken into account the futures broker's risk exposure and financial position, and appropriately project the impact on its excess liquid capital and available funding under stress scenarios.

How We Can Help

It can be complex to identify, evaluate and on-going monitoring all risks associated with proprietary trading and clients' trading under high volume trading and dynamic market environment, as well as determine appropriate risk appetites and limits that requires an overall balance between future brokers' strategic objectives, financial capabilities and risk mitigation measures. Furthermore, establishment of new policies and procedures or enhancement to the existing ones that align to the Guideline can be a challenge considering that the policies and procedures have to clearly accommodate different scenarios and requirements set out in the Guideline while ensuring overall consistency. On the other hand, the identification and implementation of appropriate robust market risk measurement system, credit risk monitoring measures and stress testing models requires sophisticated tools and methodologies to capture all relevant risk factors accurately.

Deloitte have extensive experience advising our clients in designing, assessing, and transforming the processes, controls, and infrastructure needed to address the specific regulations and regulatory risks. We provide rich industry insights in assessing clients' readiness to handle various market scenarios and the alignment of the regulatory guideline.

We offer:

Gap Analysis / Health Check	Regulatory Advisory
Assessment on identifying required compliance infrastructures	Provision of advice over regulatory requirements

Contact Us

Feel free to get in touch with our professionals to assist your firm on all matters relating to the above.

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