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

Report on the fact-finding exercise on retail futures brokers

April 2017

Executive Summary

Background

1. The Securities and Futures Commission (SFC) performed a fact-finding exercise regarding the business profiles and risk management controls and practices of 10 local futures brokers (the Reporting Firms) which mainly serve retail clients. The review period covered January to December 2015 (the Reporting Period).

2. The exercise focused on the Reporting Firms' dealing in futures and options (F&O) contracts under their Type 2 licences and did not cover dealing in stock options traded on The Stock Exchange of Hong Kong Limited under Type 1 licences.

3. The SFC sent questionnaires to the Reporting Firms to collect quantitative information including number of clients, turnover and commission income. This was followed by discussions with management to obtain a high level of understanding of the Reporting Firms' business profiles and risk management controls.

4. The exercise revealed certain regulatory issues in relation to the Reporting Firms' established clients and setting-off arrangements, on which further guidance will be provided to the industry.

5. Whilst the information gathered could assist the SFC in supervising licensed corporations, it is also useful to market participants in understanding the industry landscape and benchmarking against their peers. Our findings from the exercise are summarised below.

Key findings

A. Business profiles of the Reporting Firms

Most clients were Hong Kong individuals

6. Overall, 88% of the Reporting Firms' active clients[1] were based in Hong Kong and the majority of them were individual clients. Three Reporting Firms had mostly clients based in mainland China.

Most Reporting Firms dealt in both local and overseas F&O contracts

7. All the Reporting Firms engaged in dealing in local F&O contracts. Seven also engaged in dealing in overseas F&O contracts, and some of these had trading participantships to trade directly on overseas exchanges.

[1] Active clients are clients to whom the licensed corporations are required to prepare and deliver monthly statements of account in accordance with the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules.

Local F&O contracts represented about 70% of client turnover

8. Of the Reporting Firms' total client turnover, F&O contracts traded on the Hong Kong Futures Exchange Limited (HKFE) represented around 70%. HKFE futures represented about 55% and HKFE options 15%. The most popular contracts traded by clients included Mini-Hang Seng Index Futures, Hang Seng Index Futures and Mini H-shares Index Futures.

9. Non-HKFE trades accounted for the remaining 30% of total client turnover and nearly all of these were futures contracts. The most popular contracts were the SGX FTSE China A50 Index Futures.

HKFE trades accounted for 46% of commission income

10. HKFE trades contributed to 46% of the Reporting Firms' commission income during the Reporting Period. Non-HKFE trades accounted for the remaining 54%.

B. Risk management

11. In general, the Reporting Firms reported that they established and maintained risk management policies and procedures and disclosed to clients their margin call and forced liquidation policies in client agreements. They also had automated controls in place to stop clients from opening new positions if their accounts had insufficient margin deposits. To monitor clients' risk exposures, some Reporting Firms set limits (such as trading and credit limits) for their clients, while some conducted stress tests in addition to setting risk limits.

C. Regulatory issues

Different criteria for assessing established clients under HKFE Rule[2] 617(b)

12. The Reporting Firms adopted different criteria for assessing established clients under HKFE Rule 617(b). For example, some Reporting Firms would consider treating new clients as established clients, while some would only consider treating those existing clients who had records of trading with them for at least three months as established clients. Some Reporting Firms stated that a client would not be regarded as an "exclusive day trader" if he held at least one overnight position within a specified period. This ranged from a one month period to the entire period since the account opening date.

13. We have concerns that clients who did not have good financial standing or creditworthiness were treated as established clients and allowed to trade in F&O contracts without depositing sufficient upfront margin. This could expose futures brokers to undue credit and financial risks, especially during times of significant market volatility, if clients failed to settle a deficit or a margin shortfall in their accounts in a timely manner.

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[2] Rules of HKFE.

14. In view of the above, we are working with HKFE to issue further guidance to the industry on the assessment criteria for established clients under HKFE Rule 617(b).

Setting-off arrangements were common

15. Amongst the Reporting Firms, it was a common arrangement to set off the debit balance in clients' futures trading accounts against the credit balance(s) in the clients' other trading account(s) held with the broker or its affiliated companies. The Reporting Firms reported that cross payments were usually effected through fund transfers which were usually sourced from the excess cash balance in clients' securities trading accounts. In some cases, fund transfers were used to meet the margin requirements in the clients' futures trading accounts.

16. The above arrangements were authorised by the clients by way of client agreements, standing authorities and/or written instructions. However, relevant information such as the specific terms that apply to, and the risks involved in, cross payments might neither be specified in the clients' authorisation nor provided to the clients. In cases where funds were transferred to cover a margin shortfall in lieu of a forced liquidation, the clients might not be given an opportunity to decide whether to maintain their open positions in futures contracts which are subject to market risks or to stop loss by liquidating their positions.

17. In this regard, the SFC will issue a circular to provide guidance to the industry on the expected standard of controls for cross-payment arrangements.

Summary of findings

A. Overview

Among the 270 futures brokers (ie, corporations licensed for dealing in futures contracts in Hong Kong) as of 31 December 2015 (the Reporting Date), about two-thirds, or 178, were exchange participants of HKFE.

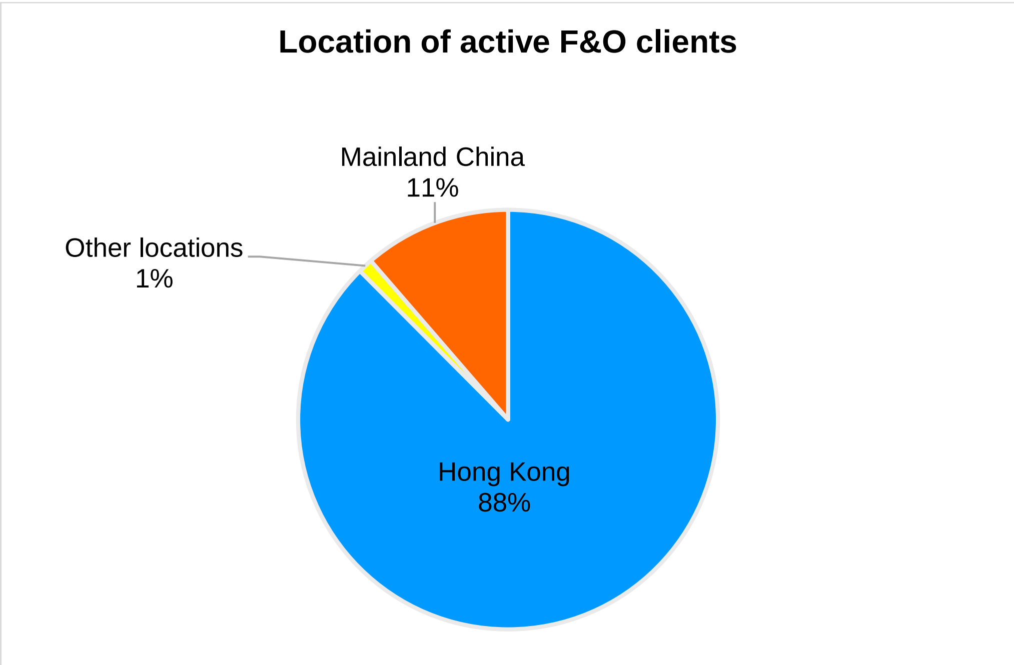
The 10 Reporting Firms accounted for about 50% of the total number of active F&O clients of all licensed corporations. Three Reporting Firms only engaged in dealing in HKFE contracts while the remainder engaged in dealing in both HKFE and non-HKFE contracts.

B. Reporting Firms' business profiles

1. Clientele

(a) Location of clients

About 24% of the Reporting Firms' total clients were active clients as of the Reporting Date. As shown in the graph below, the majority of active clients were based in Hong Kong. Three Reporting Firms had mostly clients based in mainland China.



(b) **Types of client accounts**

Individual clients accounted for over 90% of the Reporting Firms' total number of active clients. Three Reporting Firms reported that they had only individual clients. Other types of client accounts included corporate accounts and omnibus accounts.

(c) **Clients in common with affiliated companies**

More than half of the Reporting Firms' active clients were also active clients of their affiliated companies (eg, the securities arms of their group companies). For a few Reporting Firms, over 90% of active clients also maintained accounts with their affiliated companies.

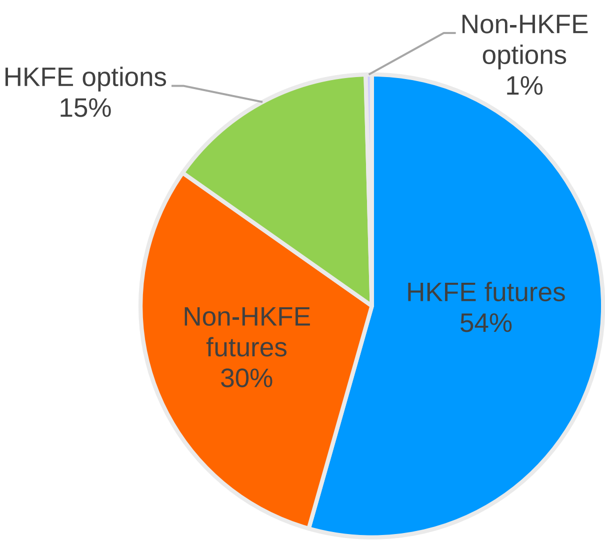
(d) **Major sources of clients**

Reporting Firms mainly sourced new clients through referrals by their account executives (AEs) and walk-ins.

2. Turnover of F&O contracts

During the Reporting Period, the Reporting Firms derived 84% of their turnover from dealing in futures contracts and 16% from dealing in options contracts. HKFE F&O contracts accounted for 69% of the Reporting Firms' total turnover, while non-HKFE F&O contracts represented the remaining 31%.

Turnover of F&O contracts#



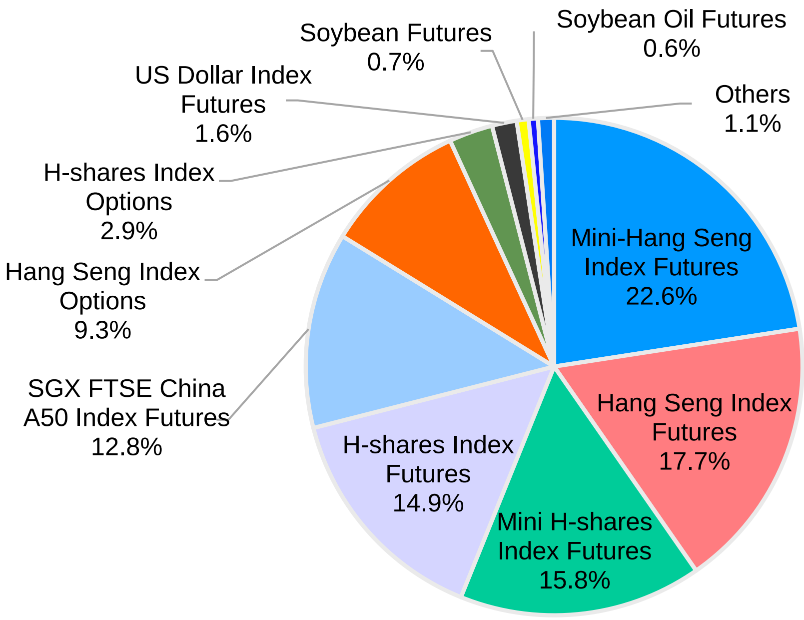
In terms of the number of contracts traded by clients.

3. Top five F&O contracts traded by clients

Reporting Firms reported the top five F&O contracts traded by their clients during the Reporting Period. Altogether, this information showed that most clients focused on trading only a few types of contracts. The top five F&O contracts accounted for a significant portion, between 44% and 100%, of the Reporting Firms' total turnover.

As shown in the graph below, the most popular contracts included Mini-Hang Seng Index Futures, Hang Seng Index Futures and Mini H-shares Index Futures.

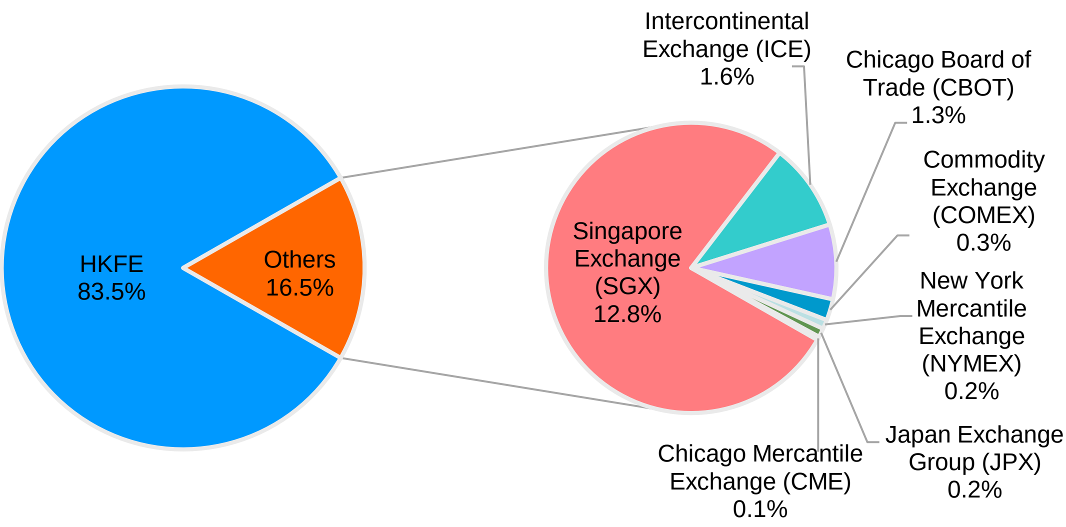
Top five F&O contracts traded by clients#



In terms of the number of contracts traded.

Most of the top five F&O contracts were traded on HKFE, which accounted for over 80% of the Reporting Firms' turnover, followed by the SGX (12.8%) and the Intercontinental Exchange (1.6%).

Major exchanges traded#



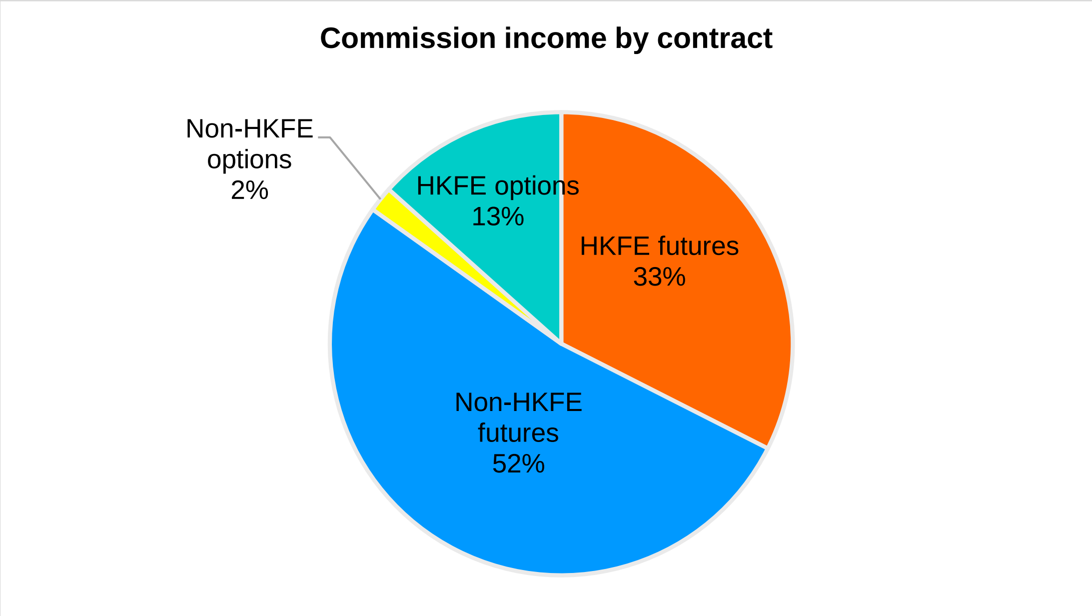
In terms of the number of top five contracts traded by clients mentioned above.

4. Overseas exchange participantships

Seven Reporting Firms engaged in dealing in overseas F&O contracts. While some had trading participantships to trade directly on overseas exchanges, nevertheless they all cleared trades on overseas exchanges through other brokers.

5. Commission income

Although HKFE trades accounted for about 70% of the Reporting Firms' total turnover, they contributed less than 50% of commission income. It was noted that the commission rates charged by the Reporting Firms on HKFE contracts were generally lower than those on non-HKFE contracts.



Commission rates charged by the Reporting Firms varied, even for the same contract. Generally, lower commissions were charged for day trading and online trading.

The majority of the Reporting Firms reported that they offered commission rebates to their AEs. Only a few Reporting Firms offered commission rebates to their clients who had larger trading volumes. Some Reporting Firms also offered commission discounts to clients during occasional promotional campaigns.

6. Major channels for placing orders

Most Reporting Firms received client orders via electronic trading platforms (eg, online or mobile trading platforms). Most reported that improving the efficiency of electronic trading platforms is one of their main focuses.

In view of increasing cybersecurity risks, some Reporting Firms reported that they would strengthen their cybersecurity controls in order to protect clients and themselves from malicious hacking and financial losses.

C. Risk management

1. Margin policy

(a) Collaterals accepted

All the Reporting Firms stated that they accepted cash collateral in the same denomination as clients' respective investments (mainly in Hong Kong dollars, US dollars and the Japanese yen). None accepted non-cash collateral.

(b) Margin requirements

For clients who had only futures positions, all the Reporting Firms adopted fixed-rate margining on a gross basis. Where clients had both futures and options positions, all the Reporting Firms adopted a Standard Portfolio Analysis of Risk (SPAN)[3] methodology for portfolio-based margining.

For HKFE contracts, all the Reporting Firms responded that they collected from clients the same margin as required by HKFE, except for some riskier contracts (eg, long-term put options and renminbi currency futures) where they collected an extra margin ranging from 5% to 20%. For non-HKFE contracts, the Reporting Firms might ask for an extra margin ranging from 5% to 50% over the amount charged by the relevant exchange.

Some Reporting Firms stated that at times of significant market volatility, an extra margin ranging from 10% to 25% would usually be collected from clients. Additional margins might also be collected from clients if the contracts traded had thin market liquidity or the clients had excessive open positions.

(c) Controls for insufficient margin deposits

All the Reporting Firms reported that they had automated controls in place to stop clients (other than established clients) from opening new positions if their accounts had insufficient margin deposits.

(d) Offsetting between HKFE and non-HKFE trading accounts

All the Reporting Firms which engaged in dealing in overseas F&O contracts reported that they allowed clients to transact in HKFE contracts if the clients had excess equity in their non-HKFE trading accounts (or to transact in non-HKFE contracts if they had excess equity in their HKFE trading accounts) and had transferred margin payments between their trading accounts.

In deciding whether to issue a margin call for a client's positions denominated in a particular currency, most Reporting Firms would also consider the client's equity positions held in other currencies.

[3] SPAN is a risk-based portfolio approach developed by the CME for calculating the daily margin requirement.

2. Margin call policy

(a) Disclosure of margin call policy

All the Reporting Firms reported that they disclosed their margin call policy in client agreements. Half of them also disclosed the policy on the company's website or a pop-up window after clients logged into the trading system.

(b) Execution and withholding of margin calls

Most Reporting Firms reported that they assigned their credit department to identify margin call targets by reviewing daily margin call reports. In general, AEs were responsible for making margin calls and documenting the details in the margin call reports. Some Reporting Firms assigned their credit department or dealing department to make the margin calls.

The Reporting Firms issued margin calls by various means, such as via phone, email and short message service (SMS). Margin call reports and records were normally reviewed by the Reporting Firms' responsible officers or the credit department. Most Reporting Firms did not exercise discretion to withhold margin calls.

(c) Types of margin calls

The Reporting Firms generally had three types of margin calls:

Initial margin (IM) calls

IM calls were generally applicable to established clients for opening new positions[4]. For details on IM calls, please refer to "Established clients under HKFE Rule 617(b)" under Section D of this report.

Intra-day margin calls

The Reporting Firms reported that they monitored clients' margin status on a real-time basis. For risk management purposes, whenever a client's net equity balance was below a certain level (usually below the maintenance margin (MM) level), the Reporting Firms would issue an intra-day margin call to the client, who was normally required to settle the margin shortfall on the same day.

Day-end margin calls

MM was required for each open position held at the end of each trading day (T day). All the Reporting Firms reported that when the net equity balance in a client's account was below the MM level at day end, they would issue a day-end margin call to notify the client to bring his net equity balance up to the IM level. Half of the Reporting Firms made day-end margin calls after market close on the T day whilst

[4] Other clients should have fulfilled the IM requirement before opening new positions, and thus IM calls were not applicable to them.

the remaining firms made margin calls in the morning of the T+1 day. Clients were usually required to settle margin shortfalls by the T+1 day.

(d) Reporting failure to meet successive margin calls

The majority of the Reporting Firms reported that it was rare for clients to fail to meet two or more successive margin calls or demands for variation adjustments (ie, mark-to-market adjustments) which in aggregate exceeded $150,000, as they would have already liquidated the clients' positions. But in such a case, they would report the matter to HKFE in accordance with HKFE Rule 619(b).

When clients incurred a margin shortfall and failed to meet margin calls, most Reporting Firms would conduct an impact analysis for liquidity management purposes.

3. After-hours trading on HKFE

All the Reporting Firms indicated that they engaged in after-hours trading on HKFE, but it only accounted for about 10% of their total turnover in F&O contracts. Some firms reported that they imposed enhanced risk management measures, including additional margin requirements and intra-day margin calls and strict forced liquidation, on top of the +/- 5% price limit imposed by HKFE.

4. Forced liquidation

(a) Disclosure of forced liquidation policy

All the Reporting Firms reported that they disclosed their forced liquidation policy in client agreements. Half of them also disclosed the policy on the company's website or a pop-up window after clients logged into the trading system.

(b) Execution of forced liquidation

In general, the Reporting Firms would liquidate clients' positions when their net equity balances were 20% to 60% below the IM requirement. Except when the market was volatile, most firms would give prior notice to clients by phone, email or SMS before liquidating their positions. Clients were generally given a few hours to cover the margin shortfall in their accounts.

Amongst the Reporting Firms, it was common for forced liquidation to be executed as market orders depending on prevailing market conditions. Forced liquidation was generally executed up to the extent that covered the margin shortfall.

5. Other risk management measures

(a) Limit setting

To monitor risk exposure, most Reporting Firms set limits on their clients, such as trading, order and credit limits[5]. Some Reporting Firms also imposed a position limit on specific contracts at a firm level or an order limit at an AE level.

When setting limits, the Reporting Firms indicated that they would take various factors into account, including the clients' financial backgrounds, trading and settlement histories, overall positions, the firm's turnover as well as the position limits set by the relevant exchanges.

(b) Stress tests

Apart from setting limits, some Reporting Firms also conducted stress tests on a client or firm portfolio basis.

D. Regulatory issues

1. Established clients under HKFE Rule 617(b)

(a) Overview

Eight Reporting Firms reported that they had established clients as of the Reporting Date. Established clients represented about 23% of the total number of active clients of these firms. Two out of the eight reported that their established clients constituted more than half of their active clients.

(b) Assessment criteria for established clients

The Reporting Firms adopted different criteria for assessing established clients under HKFE Rule 617(b). Key observations are summarised below.

<u>Acceptance of new clients as established clients</u>

Some Reporting Firms reported that they would consider treating new clients as established clients while others would only consider treating existing clients as such. In particular, some Reporting Firms required that clients have at least three months of trading records with the firms before they could be considered as established clients.

<u>Assessment of clients' financial positions and trading histories</u>

When assessing whether a client consistently met margin obligations and maintained a sound financial position, the Reporting Firms usually referred to the information in the clients' account opening documents (such as their occupation, annual income and net worth) and bank statements. The firms might also consider

[5] Credit limits were usually applicable to established clients for opening positions without sufficient upfront margin deposits.

the clients' margin call and settlement histories and the status of their securities trading accounts maintained with the firms or their affiliated companies, if any[6].

The Reporting Firms adopted different review periods to assess the clients' financial soundness and trading patterns, ranging from less than three months to over one year.

For the Reporting Firms that allowed new clients to be considered as established clients, some would review the clients' statements of accounts issued by other brokers when assessing the clients' financial positions and trading histories.

Transacting day trades exclusively

The Reporting Firms usually assessed clients' trading patterns and positions over a period of time when deciding whether they had a history of transacting day trades exclusively. Some Reporting Firms reported that they would not consider a client as an "exclusive day trader" if he held at least one overnight position within a specified period. This ranged from a one month period to the entire period since the account opening date.

Ongoing review

Most Reporting Firms reported that they performed regular reviews, ranging from monthly to annually, of clients' eligibility to be treated as established clients.

(c) Collection of IM from established clients[7]

Upfront IM

An exchange participant of HKFE may transact F&O business for an established client before receiving collateral adequate to cover the client's minimum margin requirements. Some Reporting Firms requested that established clients pay a partial upfront IM when opening new positions. These clients were required to settle the remaining IM either on the T day or the T+1 day if the relevant positions remained open at the end of the T day.

IM calls

The Reporting Firms generally issued IM calls to established clients to collect margins on their new positions by close of business on the T day if their net equity balance was below the IM requirement. Clients were normally required to settle margin shortfalls by the T+1 day.

The above findings showed that the Reporting Firms adopted different criteria for assessing established clients. We have concerns that clients who did not have good financial standing or creditworthiness were treated as established clients and allowed to trade in F&O contracts without depositing sufficient upfront margins. This could expose futures brokers to undue credit and financial risks, especially during times of significant market volatility if clients failed to settle shortfalls in their accounts in a timely manner.

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[6] The criteria used by the Reporting Firms in the assessment included having no records of bounced cheques, unfulfilled margin calls or forced liquidations.

[7] The relevant minimum margin requirement for established clients is set out in HKFE Rule 617(b).

In view of the above, we are working with HKFE to issue further guidance to the industry on the assessment criteria for established clients under HKFE Rule 617(b).

2. Setting-off arrangements

All the Reporting Firms stated that they had arrangements to set off the debit balances in clients' futures trading accounts against the credit balance(s) in their other trading account(s), such as securities trading accounts, held with the Reporting Firms or their affiliated companies. Such arrangements were authorised by clients by way of client agreements, standing authorities and/or written instructions.

Setting-off arrangements were usually effected when a client's futures trading account had a margin shortfall or when he wanted to open new positions without adequate margin deposits, while his other trading accounts maintained with the broker or its affiliated companies had an excess cash balance. Funds would be transferred to the client's futures trading account to meet the margin requirement.

Some Reporting Firms indicated that cross payments were solely initiated by the client, while others reported that they could be initiated either by the firm or the client. Firms which initiated cross payments would normally obtain the client's consent or notify the client before each fund transfer even after obtaining prior authorisation.

All the Reporting Firms reported that they would physically transfer the funds between the clients' trading accounts and would transfer at least the amount of the clients' margin shortfall. Some firms would transfer a higher amount subject to their clients' instructions.

While cross payments were arranged with the clients' authorisation, relevant information such as the specific terms that apply to, and the risks involved in, cross payments might not be specified in the clients' authorisation nor provided to the clients. In cases where funds were transferred for covering a margin shortfall in lieu of a forced liquidation, clients might not be given an opportunity to decide whether to maintain their open positions in futures contracts which are subject to market risks or to stop loss by liquidating their positions.

In this regard, the SFC will issue a circular to provide guidance to the industry on the expected standards of controls for cross-payment arrangements.