Appendix 1

Compliance Reminder on Client Margin Requirements
(Applicable to HKFE Participants only)

HKFE Participants ("EPs") are required to comply with client margin requirements, as set out under Rules 617 and 619 of the Rules, Regulations and Procedures of the Futures Exchange ("HKFE Rules"). HKFE Participants are advised to establish and maintain proper policies and procedures, as well as robust systems and controls, to ensure ongoing compliance to these rules and other applicable regulatory requirements.

In the 2018 Annual Attestation and Inspection Programme, some EPs were found deficient in the following areas:-

1. Established Clients Assessment

(i) ***Failure to conduct full review by 1 January 2018 to ensure those classified as established Clients meet the criterion set out in the circular "Margin Requirements under Rule 617" dated 22 June 2017 (Ref No. MO/DT/089/17)***. Some EPs misinterpreted the "established Client" requirement in HKFE Rule 617 to be applicable to retail clients only, while some failed to observe the prescribed deadline.

(ii) ***Failure to use adequate and appropriate records when assessing the eligibility of established Clients.*** When assessing whether an established Client has met margin obligations consistently, some EPs only considered the transaction records pertaining to his/her HKFE account, or those accounts with credit limit granted to transact before adequate collateral is received. Separately, when assessing the soundness of the Client's financial position, some EPs solely relied on the Client's self-declaration of assets in the account opening documents, or a snapshot of their account balances (e.g. net asset value, investment portfolio, cash etc.)

(iii) ***Failure to maintain proper documentation on the assessment of and approval for established Clients*.** In some instances, justifications stated on the assessment forms did not make adequate reference to documents that were used to support the assessment. The records also failed to properly demonstrate the qualifications of established Clients, or to show the EP's justifications for approving or rejecting certain clients.

The Exchange wishes to draw EPs' attention to the following:-

- The Exchange is of the view that in order to qualify as an established Client, the Client should show no record of failure to meet margin obligations arising from but not limited to HKFE transactions.

- With respect to the re-application of previously disqualified established Clients, the Client must demonstrate he/she has no record of failure to meet margin obligations within an immediately preceding record period of at least one year.

- While various forms of records for assessments are acceptable, EPs should assess the validity of the types of information and documents used in assessing the Client's financial position. Such information and records should be recent, sufficient and with documentary evidence to demonstrate that the Client would be able to immediately transmit the necessary funds to fully meet his/her initial margin obligations should such requirements apply. Proper documentation on the assessment of and approval for established Clients should also be maintained.

- The annual review of the eligibility of established Clients is only a minimum requirement. If any event arises and gives reasonable doubt that the Client might fail to demonstrate a record of consistently meeting margin obligations and/or maintaining a sound financial position, EPs should immediately re-assess if such Client still qualifies as an established Client.

(iv) ***Failure to issue initial margin call to established Clients on T-day.*** We noted that some EPs failed to issue a call for the amount of minimum margin to established Clients on T-day when new position is established, including those with day-end net equity balance above the maintenance margin but below the initial margin requirement.

Under HKFE Rule 617(b), in respect of a new position established on behalf of the established Client on T-day, EPs **must** issue a call for the amount of minimum margin within T-day, and that the minimum margin is due as soon as practicable after the call but in no event later than the next Business Day. EPs should not permit any Client to establish new positions if the Client has calls for minimum margin which are overdue for settlement.

Exclusive Day Trader Assessment

(v) ***Requirements of Exclusive Day Trader assessment were not properly interpreted or implemented, particularly on Scenario 2 in the circular dated 22 June 2017.*** Some EPs used calendar day instead of Business Day in counting the number of days for which overnight positions were held (Condition A). Some failed to ensure that the minimum margin requirements (per contract) applicable to F/O Contract in respect of each of the overnight positions are the same or higher than that of the relevant Day Trade (per contract) (Condition B), as they simply aggregated the number of days with overnight positions across all F/O Contracts. Some EPs only conducted the required assessment once during the initial established Client assessment, instead of on an on-going basis. We also noted that, the trading records used to assess the number of days for which overnight positions were held did not fall within the prescribed timeframe in the said circular.

(vi) ***Inadequate or outdated policies and procedures governing the assessment of and controls relating to established Clients and Exclusive Day Trader.*** In some cases, the application and/or re-application policy for established Clients did not comply with current regulatory requirements. There was also a lack of proper arrangement for maintaining/keeping track of the status of established Clients.

The Exchange wishes to draw EPs' attention to the specific requirements for assessing whether an established Client is an Exclusive Day Trader, as set out in the said circular:-

- On assessing the transaction record in order to conclude that an established Client is not an Exclusive Day Trader under Scenario 1, the Exchange is of the view that EPs would have satisfied the relevant requirements if such Client did not transact any trade during the preceding one month's period before the proposed trade is executed.

- On counting the number of days for which overnight positions were held under Scenario 2 Condition A, the Exchange is of the view that EPs would have satisfied the relevant requirements if the assessment is conducted on a monthly basis.

- To illustrate the requirement under Scenario 2 Condition B, if an established Client has held overnight positions on HSI futures for 7 Business Days and mini-HSI futures for 3 Business Days (consecutively or otherwise) during the preceding one year period, the Client can trade without receiving adequate collateral on the types of F/O Contracts that has a lower or the same minimum margin requirement as a mini-HSI future; nevertheless, the number of contracts to be executed would not be limited by those previously held overnight. However, the EP is required to collect sufficient upfront margin prior to the transaction if the relevant trade is a HSI future or a contract which requires higher margin than a mini-HSI future.

- While Exclusive Day Trader assessment should be conducted on an on-going basis, EPs must have in place timely and appropriate arrangements to ensure adequate collateral is received prior to transacting F.O. Business for those concluded to be an Exclusive Day Trader, or when the contract type of the relevant trade has higher minimum margin requirement than that of the overnight positions held.

As set out in the circular dated 22 June 2017, EPs were expected to implement appropriate measures to fully comply with the requirements under HKFE Rule 617 as provided therein, by 1 January 2018. These measures include but are not limited to maintaining proper documentation to demonstrate qualifications of established Clients, putting in place appropriate internal control policies and procedures, and ensuring the record keeping systems are up to standard.

2. Client's Minimum Margin

(i) ***Failure to apply accurate Client's minimum margin rates.*** Some EPs miscalculated clients' minimum margin due to misinterpretation of the client margining methodology or operational shortfalls.

As stipulated in the circular "*System Readiness in relation to the Revised Client Margining Methodology for Derivatives Products*" dated 28 September 2016 (Ref. No. DCRM/HKEX/198/2016), the client margin is set at 1.33 times of the clearing house margin, which is the minimum amount of margin required from a client in respect of trading in HKFE Futures and Options contracts. EPs are reminded that the minimum margin rates determined by HKEX are for their financially strongest clients. Appropriate arrangements should also be put in place to ensure the completeness and accuracy of margin rates applied.

(ii) ***Inadequate controls to ensure gross margining on Omnibus Accounts.*** Some EPs inadvertently netted the positions of underlying clients of Omnibus Account, resulting in the understatement of Client's minimum margin amount.

The Exchange wishes to draw EPs' attention to the circular "*Omnibus Accounts – Margin Requirements*" dated 7 December 1993 (Ref. No. MEM/CIR/9312050/017), which stipulates that all omnibus accounts must be maintained and margined on a gross position basis.

(iii) ***Allow Client whose account does not have sufficient collateral to establish new positions.*** In some instances, Clients only verbally committed to make fund transfer, or that the EPs had considered the Client's assets held in his/her non-HKFE accounts maintained with group affiliates as if the EP had received the collateral.

Pursuant to HKFE Rule 617(a), except for those who qualify as an established Client or for the purpose of closing out a Client's open positions, EPs shall not transact F.O. Business for any Client until and unless the EP has received from that Client collateral adequate to cover that Client's minimum margin requirement. EP should also ensure compliance with HKFE Rule 617(c) which stipulates the types of collateral acceptable for settling margin requirements.

Adequate and effective systems and controls should be put in place to ensure compliance with the requirements applicable to Client's minimum margin, especially when multiple trading systems with different controls are involved. Proper documentary evidence should be maintained for the assessment of margin sufficiency and justification of special approvals for manual override on cases of insufficient margin.

With regard to EPs who do not collect any margin from its clients under "execution-only" model, the Exchange is of the view that, if such EP is a Non-clearing Participant, it is not required to collect initial margin from the clients as it has appointed a General Clearing Participant to handle the clearing of all its trades. EP who is a Clearing Participant may also not be required to collect initial margin from the clients, provided that the risk of the trade is not assumed by the EP itself, but by the client's specified Clearing Participant. This may be achieved via a tripartite agreement among EP, Client, and Client's designated clearing broker; such agreement must clearly set out that the EP (as the execution broker) must give up the trade to the clearing broker as soon as possible and that the EP has the right to close out the Client's positions if there is failure, for any reason, in the give-up procedure.

3. Margin Call Policies & Procedures

- ***Failure to fulfil the monitoring and reporting obligations on margin calls and demands for variation adjustment in a consistent, effective and timely manner due to non-comprehensive procedures in handling margin calls.***

EPs are obliged to monitor continuously their Clients' ability to meet any margin calls and demands for variation adjustment, and notify HKFE in the event any Client has failed to meet two or more successive calls which in aggregate exceed HK$ 150,000. Such monitoring and reporting should continue on each Business Day subsequent to the initial notification until the aggregate amount of default falls below the said amount. In case the positions to which the margin call settlement failure relates to have been liquidated, EPs are still required to make the relevant notification to HKFE.

Proper arrangements and adequate guidelines should be in place to ensure effective monitoring and control in this regard, including but not limited to specifying the timeframe for margin call issuance and settlement deadlines in the policies and procedures, clear designation of responsible personnel and proper maintenance of margin call records.

With regard to the settlement of a margin call, EPs should note the requirements laid down in the circular "*Guidelines on Margin Procedures for the Purpose of Minimum Requirement pursuant to Rule 617 (March 3, 1997)*" (Ref. No. AUD/9703001). A maintenance margin call can be met by a subsequent increase in the equity balance of the account up to the corresponding initial margin requirement; whereas an initial margin call for established Clients may be cancelled if the positions, to which the initial margin relates, are opened and closed out within the same T Session or within the same T+1 Session (i.e. day trades).

4. Staff Training

- ***Inadequate staff training.*** Some EPs did not provide mandatory and product-specific training for staff involved in the business activity in the Priority Areas, and merely relied on on-the-job training through sharing and coaching by senior staff members.

To foster a culture of compliance, the Exchange wishes to remind EPs that they should provide staff with adequate and appropriate training both initially and on an ongoing basis.

5. Policies and Procedures

- ***Inadequate and lack of regular review on written policies and procedures.*** Some EPs did not establish proper written policies and procedures governing the business activity in the Priority Areas while some EPs did not conduct regular review even though such policies and procedures were in place.

The Exchange wishes to remind EPs that adequate policies and procedures should be established to ensure ongoing compliance with the relevant rules and requirements. Regular review and revision should also be conducted to ensure they are consistent, effective and up-to-date.