

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”). EPs are also advised to establish and maintain proper policies and procedures, as well as robust systems and controls, to ensure on-going compliance to these rules and other applicable regulatory requirements.

In the 2020 Annual Attestation and Inspection Programme, some EPs were found deficient in the following areas:-

1. Assessment of Established Clients / Exclusive Day Trader

- ***Failure to conduct the established Clients assessment properly for its Clients as set out in the circular “[Margin Requirements under Rule 617](#)” dated 22 June 2017 (Ref No. MO/DT/089/17).*** Some EPs did not conduct any assessment on certain Clients (including affiliates, shareholders and day traders) while allowing them to create new positions without sufficient collateral. We also noted instances where no on-going review was conducted on the established Clients.

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

- (i) All Clients must be subject to proper assessment before they can be qualified as established Clients.
 - (ii) 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.
- ***Requirements of Exclusive Day Trader assessment were not properly interpreted or implemented, particularly on Scenario 2 outlined in the circular dated 22 June 2017 (Ref No. MO/DT/089/17).*** We note that some EPs did not conduct any Exclusive Day Trader assessment, while others only conducted the required assessment once during the initial established Client assessment, instead of on an on-going basis.

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

- (i) For the purpose of Scenario 2 Condition A, the assessment is required to be conducted on an on-going basis. The Exchange is of the view that EPs would have satisfied this requirement if the assessment is conducted at least once a month.

- (ii) For the purpose of Scenario 2 Condition B, EPs need to ensure 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). 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 having adequate collateral on the types of F/O Contracts that has a lower or the same minimum margin requirement as a mini-HSI futures; nevertheless, the number of contracts that can be executed would not be limited by those positions previously held overnight. However, EPs are required to collect sufficient upfront margin prior to the transaction if the relevant trade is a HSI futures or a contract which requires higher margin than a mini-HSI futures.
 - (iii) EPs must put in place appropriate arrangements in a timely manner 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.
- ***Failure to maintain proper documentation on the assessment***
- (i) ***Established Client Assessment.*** 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 justifications for approving or rejecting certain Clients. For example, the documentation omitted to reflect whether and why it may be satisfied that a Client has maintained a consistently sound financial position. For the avoidance of doubt, when assessing the soundness of the Client's financial position, an EP should not 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.).

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 the approval for established Clients should also be maintained.

- (ii) ***Exclusive Day Trader Assessment.*** In some instances, the assessment forms did not make adequate reference to support their respective outcome. For example, details such as the relevant overnight trade(s) being considered and the corresponding minimum margin requirement(s) (per contract) were omitted.

Information and records in use should allow EPs to conduct the assessment in accordance with the requirements set out in the circular dated 22 June 2017 (Ref No. MO/DT/089/17). The assessment and the outcome should be properly documented and supported by documentary evidence.

- ***Inadequate 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 regulatory requirements. We also noted instances where the policies and procedures do not accurately or fully reflect the actual practice.

As set out in the circular dated 22 June 2017 (Ref No. MO/DT/089/17), EPs are expected to have implemented appropriate measures to fully comply with the requirements under HKFE Rule 617. 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 and able to track the eligibility status of established Clients.

2. Trading Limits for Established Clients

- ***Failure to set trading limits for established Clients.*** We noted that some EPs did not set any trading limits for their established Clients, while others implemented some form of risk measures limiting the overall exposure to a certain extent. For example, some EPs required their established Clients to have collateral to cover a portion of the minimum margin requirement before transacting F.O. Business for their established Clients. It is important to note that those risk measures may not be sufficient to limit the exposure under a volatile market situation.

As set out in the circular dated 22 June 2017 (Ref No. MO/DT/089/17), EPs are expected to set trading limits for their established Clients based on the EP's assessment on the Client's financial position.

3. Initial Margin Call for Established Clients

- **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 for new positions established in T Session but subsequently closed out in T+1 session.

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 advise that the minimum margin is due as soon as practicable after the call but in no event later than the next Business Day. The issued initial margin call would not be considered as being settled by closing out the relevant positions subsequently. Moreover, if an established Client did not settle an initial margin call by cash, the relevant position should not be counted as an overnight position for satisfying Scenario 2 Condition A in the Exclusive Day Trader assessment.

4. Client's Minimum Margin

- **Failure to timely apply Client's minimum margin rates.** In some instances, some EPs did not ensure that latest minimum margin rates are applied before the commencement of trading¹ as stated in the margin rate circulars issued by the Exchange from time to time.

Pursuant to HKFE Rule 617(d), the Exchange shall from time to time stipulate the minimum amount of margin required to be collected by EPs in respect of Exchange Contracts executed for Clients. EPs are reminded to put in place appropriate arrangements to ensure the timeliness, completeness and accuracy of margin rates being applied. Separately, 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 F/O Contracts. EPs are reminded that the minimum margin rates determined by HKEX are for their financially strongest clients.

- **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 inappropriately considered the Client's assets held in his/her non-HKFE accounts maintained with group affiliates as collateral received from the Clients.

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.

¹ The earliest trading session commences at 8:30am Hong Kong time. For details of the trading hours for different contracts, please refer to [HKEX website](#).

- ***Failure to maintain appropriate measures on manual override of system controls.***
In some instances, manual override of system controls was permitted to cater for need(s) of specific business model. This practice may be acceptable, provided that (i) the manual override would not result in any regulatory breach and (ii) regular independent review of the manual overrides is conducted to ensure the controls remain effective.

Adequate and effective systems and controls should be put in place to ensure compliance with the requirements applicable to Client's minimum margin. Proper written policies and procedures as well as documentary evidence should be maintained for the assessment of margin sufficiency and justification of special approvals for manual override in cases of insufficient margin. Independent post-trade review on such special approvals should also be conducted on a regular basis to ensure that the manual overrides had not violated any of the applicable client margin requirements.

5. 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.***

Proper arrangements and adequate guidelines should be in place to ensure effective monitoring and control, and 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 for the monitoring and reporting obligation pursuant to the requirements under HKFE Rule 619, as well as proper maintenance of margin call records.

With regard to the end of day client margin calculation, EPs are advised to make reference to the Early and Final risk parameter files ("RPF") which are published by HKEX for calculating Clearing Houses' day-end margin, instead of the intra-day RPFs.

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 dated 3 March 1997](#)" (Ref. No. AUD/9703001), which stipulates that calls for margin can be met by cash deposits, while maintenance margin call can be met by a subsequent increase in the equity balance of the account up to the corresponding initial margin requirement.

6. Staff Training

- ***Inadequate staff training.*** Some EPs did not provide adequate and product-specific training for staff involved in the business activities 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 on-going basis.

7. Policies and Procedures

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

Non-comprehensive policies and procedures may pose the risk of inconsistent handling the client margin requirements. The Exchange wishes to remind EPs that adequate policies and procedures should be established to ensure on-going 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.