Appendix 3

Compliance Reminder on Risk Management
(Applicable to Clearing Participants[1] only)

Risk management is one of the key responsibilities of Clearing Participants ("**CPs**") of HKSCC, HKCC and SEOCH (collectively, the "**Clearing Houses**"), as set out in the admission materials and relevant rules and procedures of the Clearing Houses.

CPs should set up robust risk management frameworks and controls, so as to ensure performing proper assessment, monitoring and mitigation of key risks (including but not limited to, credit risk, liquidity risk, operational risk, market risk and capital inadequacy) at all times.

In the 2024 Annual Attestation and Inspection Programme, control weaknesses were found in the following risk management areas:

1. Credit Exposure and Position Management

- ***Lack of sufficient and effective monitoring and control on credit exposures and positions***

Risk limits (e.g. position limit, credit limit, trading limit, concentration limit and/or limits granted to DvP clients in stock trading to settle on T+2) are imposed by CPs on their clients or on the CP itself for controlling their clients' credit, and the CP's own trading/margin lending exposure. It was noted that while CPs had set up limits for their clients, they had not implemented any system to monitor their clients' positions against limits assigned to them and/or had allowed their clients to transact based on their available funds instead. Policies and procedures in relation to the treatment of outstanding loan payments were also found to be inadequate where follow-up, escalation and provisioning / write-off of such loans were not clearly set out. In addition, it was noted that the limits, once granted, were not subject to regular review.

Client limits should also include limits set in third party systems, including those in HKEX systems that facilitate the management of client exposures. For example, regarding General Clearing Participants' ("**GCPs**") implementation of pre-trade monitoring on its non-CP clients, it was noted that client limits (e.g. pre-trade limits) are set up but their reviews are conducted separately from other internal client limits during the GCPs' client risk assessment and risk mitigation process. Separate and lower client limits should be set for risky order types, such as manual trades involving illiquid stocks and clients with limited track records.

Apart from client limit, trading limit and concentration limit should also be set up by CP to control its proprietary trading risk and margin loan book concentration risk respectively.

[1] (i) Clearing Participants and General Clearing Participants of HKFE Clearing Corporation Limited, and (ii) Direct Clearing Participants and General Clearing Participants of Hong Kong Securities Clearing Company Limited and The SEHK Options Clearing House Limited

CPs are reminded to implement appropriate and adequate monitoring arrangements in this regard, including but not limited to (i) inputting the limits assigned to clients into the system for continuous monitoring and timely adjustments of the limits according to changes in client's credit risk and (ii) ensuring the monitoring arrangement is capable of timely identifying the heightened risk (e.g. intraday position monitoring is expected to ensure compliance with the Capital Based Position Limits (CBPL)). Failure to implement appropriate and adequate monitoring arrangements may result in regulatory breaches, which could be grounds for disciplinary actions.

2. Stress Testing

- ***Absence of proper stress testing for its own or clients' exposure on HKEX's derivatives products***

Stress testing of derivatives products (e.g. futures and options) is crucial to CPs since the losses of some derivatives products are likely to increase exponentially under extreme market conditions. CPs with activities in derivatives products are expected to implement and conduct stress testing regularly and at least on a weekly basis, to evaluate the potential loss of its portfolio under extreme but plausible market conditions. Proper stress testing policies and procedures should also be established to clearly set out the stress testing methodology, frequency, and the review and escalation mechanism.

As a benchmark, the underlying price movement and volatility parameters under extreme but plausible market conditions for common products are as follows:

	Downside Scenario	**Upside Scenario**
HSI	Price -20% | Volatility +43%	Price +20% | Volatility -24%
HHI	Price -20% | Volatility +43%	Price +20% | Volatility -24%
HTI	Price -29% | Volatility +62%	Price +29% | Volatility -35%
CUS	Price -4% | Volatility +38%	Price +4% | Volatility -22%

3. Control, Monitoring and Staff Training in relation to Fulfillment of Settlement Obligations

- ***Inadequate monitoring and controls over Settlement Operations for ensuring the timely completion of steps essential to fulfill the settlement obligation of the Clearing Houses***

CPs should put in place adequate and comprehensive internal controls and procedures governing the relevant money and stock settlement process; and all relevant staffs should strictly follow the prescribed timeline to facilitate smooth operation, especially for backup or holiday covers. Examples of effective tools for settlement controls include: a checklist with maker-checker signoff over key settlement steps (with timelines clearly set out for each step); or a system dashboard to monitor the timeliness in completing each key settlement steps with automatic escalation / alerts. For each key settlement task, sufficient buffer time should be allocated between the internal completion timeline and the Clearing Houses' settlement timelines, in order to allow exception handling process (e.g. additional transfer of funds) to be completed before the Clearing Houses' settlement timelines.

CPs should also put in place funding estimation and position management procedures for collateral requirements (e.g. marks and margins) and settlement obligations, particularly in handling exceptionally large positions. This includes processes to reduce the position for computation of collateral requirements, such as by providing Specific Cash Collateral or Specific Stock Collateral to HKSCC for its large long or short stock positions under CNS System respectively.

CPs are also advised to regularly review its operational and funding backup arrangements to ensure their effectiveness. The review should include but not limited to (i) holiday backup arrangement of settlement and accounting officers; (ii) enabling money transfer through e-banking between house / client accounts and CPs' designated account for settlement; (iii) sufficiency of liquidity buffer and overdraft facilities to provide contingency funding (including non-HKD settlement currency e.g. CNY for China Connect Participants); and (iv) regular test transfers should be conducted on rarely used designated account(s) for settlement to ensure they remain operative.

CPs should keep abreast of the circulars issued by the Clearing Houses from time to time and conduct regular reviews on their operation procedures to ensure compliance with the relevant rules and requirements at all times. Among other things, CPs should ensure that their settlement arrangements (including arrangements during holiday periods) comply with the latest requirements stipulated by the Clearing Houses.

CPs should ensure that their staff (including their backup and holiday cover) have adequate and up-to-date knowledge pertaining to operational risk and control, payment obligations and the consequences of failure in meeting the obligations of the Clearing Houses. CPs should also arrange for staff to attend training courses and make reference to circulars such as *"Reminder on Payment Obligations of Clearing Participants"* issued by the Clearing Houses in 2024 (Ref. No. CD/CDCRM/247/2024, CD/CDCRM/248/2024 and CD/CDCRM/270/2024) to enhance staff's awareness of payment obligations to the Clearing Houses.

4. Business Continuity Plan and Contingency Funding Arrangement

- ***Inadequate arrangement in place to ensure its fulfillment of the Clearing Houses' settlement obligations, and compliance with SEHK Rule 541 / HKFE Rule 522C under contingent situation***

To cope with disruptions that may impair CPs' ability to meet settlement obligations to the Clearing Houses, CPs should develop and maintain a business continuity plan, which should clearly set out the actions that they would take during contingent scenarios (Examples of contingent scenarios are (i) system disruption or vendor ceasing technical support in short notice; and (ii) operation staff who is unable to access office to execute trading/clearing procedure due to severe weather/pandemic). Drawing from the industry's experience in handling COVID pandemic situation, CPs should review their business continuity plan and consider whether they have granted sufficient authorization to the relevant colleagues during split team arrangement and whether the plan covered the contingency handling of the forthcoming trades (e.g. routing to a peer broker[2], putting timely stop to client orders and promptly notifying clients about the order handling approaches) in case the operation capability was impaired (e.g. due to quarantine of a large number of operational staff). CPs should also enhance its capability to enable staff's remote access to trading/clearing system.

On the other hand, for CP appointed as a backup broker by a client which is a SEHK and/or HKFE Exchange Participant (collectively the "**EP Client**"), the CP should put in place appropriate and effective measures, and take reasonable steps to ensure that the EP Client they deal with are not in suspension status, unless prior approval has been obtained from the relevant Exchange(s). As a reminder:

(i) The identification of the EP Client in trading suspension status should be conducted in a timely manner; and

(ii) Upon identification, the necessary waiver under SEHK Rule 541 and/or HKFE Rule 522C must be obtained from the relevant Exchange before dealing with such EP Client, including but not limited to executing any orders placed by it.

CPs should make reference to circulars on "*Dealings with suspended EPs*" (Ref. No.: MSM/005/2024, MSM/012/2021, MSM/013/2021 and MSM/014/2021) to enhance staff's awareness in this regard.

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[2] For CPs which may only have institutional or professional investor clients, who usually have several other brokers to handle their trading orders, in these cases, instead of routing client trades to peer brokers, CPs can also consider implementing alternative arrangements (e.g. a playbook to inform clients to trade with other brokers and handling client asset transfer requests). For other CPs, especially for those which are appointing a (new) peer broker, a similar playbook to readily inform all affected clients to trade with other brokers and handling client asset transfer requests should also be developed.