10 October 2017

Circular to Licensed Corporations providing securities margin financing

Call for prudent risk management

In view of recent volatility in small cap stocks, the Securities and Futures Commission (SFC) is increasingly concerned that licensed corporations have failed to put in place appropriate risk management policies and internal controls for securities margin financing, creating undue risks and in some cases resulting in financial losses.

In particular, some licensed corporations were found to have excessive exposure to securities collateral which was highly concentrated, correlated (e.g. stocks with significant cross shareholdings), volatile or illiquid (i.e. holding a large portion of a stock in terms of its turnover or market capitalisation, making it difficult to liquidate).

Code of Conduct requirements

The Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) requires that a licensed corporation establishes a clear margin lending policy to provide a basis for protecting its capital and ensure that a consistent risk management policy and adequate procedures are in place to identify risks, carry out effective monitoring and take corrective action.

Licensed corporations are expected to, among other things:

- Develop, document, communicate to all relevant staff and strictly enforce a clear and prudent margin lending policy
- Identify, monitor and avoid excessive or concentrated exposure to stocks which have high correlation risk
- Avoid excessive exposure to individual securities relative to their market liquidity or market capitalisation
- Maintain a list of acceptable securities collateral and assign appropriate haircuts for each collateral based on its liquidity and volatility
- Identify and avoid concentration of lending to related margin clients
- Prevent clients with outstanding margin calls from trading on margin
- Promptly collect amounts due as margin

The SFC has noticed that some firms have fallen short of the standards expected of them under the Code of Conduct. The SFC has informed these firms of its concerns and requested that they take immediate rectification measures to comply with the relevant regulatory requirements. In response, the firms agreed to improve their internal control systems and commission independent reviews of their margin lending policies and procedures. They have also undertaken to put in place appropriate interim measures (such as to stop providing new credit to clients and refrain from repledging client securities collateral) in advance of adopting appropriate controls.

Other regulatory requirements

Licensed corporations are required to comply with **all** regulatory requirements applicable to securities margin financing. In more serious cases, even in the absence of an immediate breach of the minimum capital requirements, the SFC may take regulatory action against licensed corporations for failing to comply with any of these requirements.

The comprehensive regulatory framework for securities margin financing is mainly made up of:

- the Code of Conduct, including the dedicated schedule of requirements for securities margin financing activities (i.e. Schedule 5);

- the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (e.g. the requirements to establish and follow appropriate and effective risk management policies to ensure the firm's risks of suffering loss as a consequence of client defaults or changing market conditions are maintained at acceptable and appropriate levels; to make appropriate haircuts to the market values of collateral to establish that clients have adequate equity; to aggregate the credit risk posed by all clients belonging to the same group of companies when measuring the firm's credit exposures);

- the Securities and Futures (Financial Resources) Rules, which set out minimum capital requirements and the treatment of margin loans and related risks in liquid capital calculations; and

- the specific requirements for handling client securities collateral under the Securities and Futures (Client Securities) Rules (e.g. the need to obtain written authorisations from clients for repledging their securities collateral and the 140% repledging limit).

Prepare for the unexpected

Market conditions may reverse and share prices may plunge abruptly. In the past, a number of securities margin financing providers suffered significant financial losses and in some cases encountered financial difficulties due to unforeseeable market shocks, share price volatility, trading suspensions or client defaults. Licensed corporations should vigilantly identify, monitor and manage the potential risks of their margin lending business. They should also adopt a prudent margin lending and risk management policy which includes pre-emptive measures to protect their capital from different types of risk, for example by performing regular stress tests and avoiding over-concentration in specific stocks being used as collateral.

Senior management's responsibility

The SFC also reminds senior management of licensed corporations that they bear the primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by their firms. They should diligently supervise their margin lending business by instituting and enforcing prudent policies and rigorous controls to safeguard their business operations and clients' interests.

Tel: (852) 2231 1222 Fax: (852) 2523 4598 Website: www.sfc.hk

Should you have any queries regarding the contents of this circular, please contact Ms Perla Yau on 2231 2115.

Intermediaries Supervision Department
Intermediaries Division
Securities and Futures Commission

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