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

24 Apr 2020

Circular to commodity futures brokers

Managing financial and operational risks under extreme market conditions

In light of the unprecedented volatility in overseas crude oil futures markets and the upcoming local public holidays when these markets will remain open, the Securities and Futures Commission (SFC) reminds all commodity futures brokers to vigilantly control their risk exposures and maintain sufficient resources to deal with the challenges posed by extreme market conditions.

The SFC recently found that two commodity futures brokers committed significant, though short-term, breaches of the liquid capital requirements under the Securities and Futures (Financial Resources) Rules (FRR) due to failures to collect large amounts in margin calls amidst the volatility in overseas crude oil futures markets. Although the breaches were resolved, they illustrate the importance of taking more prudent risk management measures to protect the firm's operations and ensure compliance with regulatory requirements in extreme circumstances.

Commodity futures brokers are urged to control their exposures to clients, including by taking the following measures.

(a) Monitor and address individual clients' concentration risks in a timely manner.

(b) Prudently set clients' trading limits and position limits to ensure that they are commensurate with the client's financial strength and settlement history, as well as the firm's financial resources.

(c) Prudently set margin requirements for clients and consider:

 (i) raising margin requirements above the levels required by the clearing house or clearing agent to appropriately reflect prevailing market conditions, the client's financial strength and settlement history, and the firm's ability to meet margin calls (including intraday calls) on client positions from the clearing house or clearing agent; and

 (ii) adding a margin cushion to cover the risk of being unable to collect additional margin from clients during holidays and weekends, in particular long weekends.

(d) Only open new positions for clients after collecting sufficient margins.

(e) Promptly collect outstanding margin calls from clients.

Commodity futures brokers are also required to closely monitor changes in market conditions and margin requirements set by clearing houses or clearing agents and rigorously assess their impact on the firm's risk exposures, cash flow and liquid capital. Stress tests and liquid capital computations should be carried out regularly and at times of high market volatility. Failure to maintain sufficient liquidity to meet operating needs, including meeting payment obligations to clients, clearing houses and clearing agents, or maintain sufficient liquid capital in accordance with the FRR, may result in serious regulatory consequences. Where necessary, contingent funding and capital support from group companies or shareholders should be pre-arranged to ensure the firm can cope with emergencies.

Commodity futures brokers are also reminded to diligently supervise their operations to mitigate operational risks and safeguard client assets. Proper controls should be in place to ensure that transfers of client money to overseas clearing houses or clearing agents comply with the requirements of the Securities and Futures (Client Money) Rules. Client margin deposits held with overseas clearing houses or clearing agents should be properly safeguarded and accounted for.

Commodity futures brokers dealing through overseas counterparties should also establish and maintain policies and procedures to ensure the proper management of risks to which the firms and their clients are exposed. Reference should be made to the SFC's circular dated 23 November 2011[1].

In addition, under paragraph 5.3 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, licensed persons are required to assure themselves that clients trading futures, options or other derivative products understand the nature and risks of these products and have sufficient net worth to assume the risks and bear the potential losses. Accordingly, in light of the recent extreme price movements of crude oil futures, commodity futures brokers must reassess their clients' financial capability to bear the potential losses arising from trading in these products and should not open new positions for those clients who are unable to bear them.

The abovementioned measures are by no means exclusive or exhaustive. Senior management of commodity futures brokers are responsible for the proper management of the risks and operations of their firms, including the evaluation of the firm's risk exposures and the maintenance of appropriate risk management policies, control procedures and adequate resources. Under changing market conditions, any failure to prudently manage risks, or mistakes or omissions in operations, may result in significant adverse financial and operational consequences and affect client interests. Failure to properly carry out management duties or protect client interests may result in regulatory actions.

[1] Circular to All Licensed Corporations: Provision of services to clients for conducting transactions in other jurisdictions.

Should you have any questions regarding the contents of this circular, please contact your case officer.

Intermediaries Supervision Department
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End

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