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Proposed changes to position limits and large open position reporting requirements – further consultation

Pinky Siu

In April 2022, the Hong Kong Securities and Futures Commission (**SFC**) launched a consultation on proposed changes to the position limits and large open position reporting regime in Hong Kong (**First Consultation**). On 22 November 2022, the SFC published the [consultation conclusions](#) on the First Consultation and began a [further consultation](#) on the proposed changes (**Further Consultation**).

Proposals related to funds

Our earlier [article](#) discussed the SFC's key proposals in the First Consultation to clarify how the Securities and Futures (Contract Limits and Reportable Positions) Rules (**Rules**) are to be applied to unit trusts and mutual funds. In the consultation conclusions and Further Consultation, the SFC outlined some misconception and questions from the public, the industry's comments on the proposals and the SFC's response, which are summarised below:

Comments / questions on key proposals in the First Consultation	SFC's response
<p>(1) The SFC proposed to clarify that (i) limits and reportable positions are applicable to each sub-fund individually and separately, as if each sub-fund were a stand-alone fund and (ii) for a fund manager who has discretion over the positions of all the sub-funds in question, aggregation would be expected.</p> <p>The SFC noted there might have been some confusion or misconception that the proposal would result in duplicated efforts to comply with the position limits and reporting requirements.</p>	<ul style="list-style-type: none"> The SFC reiterated that the policy intention is to impose position limits and reporting requirements at the individual fund level because each fund is distinct and has its own investment mandate. <p>Hence, where a person holds or controls positions for more than one fund, the SFC will require the person to apply the position limits and reporting levels to the position of each fund. However, if the person has discretion over the funds' positions, for the purpose of compliance with the Rules, the person will have to aggregate the positions of all the funds together with his or her own position.</p> <ul style="list-style-type: none"> Similarly, for umbrella funds, the policy intention is to apply position limits and reporting requirements to positions of each of the sub-funds under an

Comments / questions on key proposals in the First Consultation	SFC's response
	<p>umbrella fund because each sub-fund is managed independently, like a standalone fund, according to its investment mandate or strategy. Therefore, applying the position limits and reporting requirements at the sub-fund level would be sensible and in line with how each sub-fund's positions and the associated risks are managed.</p> <ul style="list-style-type: none"> The concerns about duplicated efforts in reporting (ie, multiple parties having to report the same position) is a misconception because asset managers generally have discretion over the positions of their funds and hence they will need to aggregate the positions of the funds under their control to comply with the position limits and reporting requirements.
<p>(2) While it is proposed to clarify that, for a unit trust, the trustee shall have the obligation to observe the prescribed limits in relation to the positions of the unit trust, as well as to report the unit trust's reportable positions, the SFC received comments that trustees are not in a position to comply with the position limits and reporting requirements due to operational difficulties. For example, trustees do not have timely access to funds' position information, nor do they have the expertise to monitor and calculate funds' positions and reporting obligations.</p>	<ul style="list-style-type: none"> The SFC considers that it would be more appropriate for the person responsible for the day-to-day investment and operation of funds (ie, the asset manager) to have the primary responsibility for observing position limit compliance and reporting obligations at the individual fund and sub-fund level because they control trading and have first-hand information about the funds' positions. Nevertheless, as the Rules apply to any person who "holds or controls" positions, trustees are still subject to the requirements of the Rules. If a trustee can demonstrate that it has measures in place to ensure the asset manager who manages its unit trusts has observed position limit compliance and reported positions on its behalf, the SFC will consider that the trustee has discharged its obligations under the Rules.
<p>(3) A query was raised as to whether the Rules would also cover funds constituted in other legal forms or structures, apart from unit trusts.</p>	<ul style="list-style-type: none"> The SFC confirmed that the Rules are intended to cover funds of all legal forms and structures. The SFC highlighted unit trusts in the First Consultation mainly because there could be uncertainties about whether unit trusts were subject to the Rules. The proposals in the First Consultation was to clarify the application of the Rules to sub-funds of unit trusts or corporate funds, considering that the two forms are the dominant fund types in Hong Kong. The SFC proposes to further amend the Rules to clarify how they should apply to funds in general.
<p>(4) The SFC proposed that for reporting on behalf a unit trust, the unit trust's name should be specified in the notice rather than the trustee's identity.</p> <p>The SFC received comment that the disclosure of the name of a unit trust or sub-fund in a reportable notice would be sensitive.</p>	<p>The SFC considers that this information is essential for market monitoring. However, the SFC takes note of the industry's concern and will ensure that the information will not be disclosed to the public.</p>

For the proposal highlighted in (2) above, since the SFC now proposes to require (i) **asset managers to observe** position limit compliance and report positions at the individual fund or sub-fund level and (ii) **trustees to demonstrate** that they have measures in place to ensure the asset manager who manages its unit trusts has observed the requirements, the SFC is further consulting the public on this revised proposal by way of the Further Consultation.

In addition, the Hong Kong Exchanges and Clearing Limited launched a consultation in June 2022 on proposed enhancements to the exchange-level position limit regime, which will eventually trigger amendments to the Rules. Therefore, the SFC is taking this opportunity to consult the public on these additional amendments in the Further Consultation.

The deadline for submitting comments on the Further Consultation is 23 December 2022. The SFC has not indicated any proposed implementation timeline in the consultation paper.

SFC proposes to issue risk management guidelines relating to the dealing activities of futures brokers, which are intended to supplement the existing risk management requirements applicable to them

Stephen Tisdall

On 25 November 2022, the Securities and Futures Commission (**SFC**) issued its Consultation Paper on Proposed Risk Management Guidelines for Licensed Persons Dealing in Futures Contracts (**Consultation Paper**). The SFC's nineteen-page draft Risk Management Guidelines for Licensed Persons Dealing in Futures Contracts (**Guidelines**) are included as the Appendix to the Consultation Paper.

The Guidelines are intended to supplement existing risk management requirements for futures dealing activities, which are principally set out in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission; the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission; and the Suggested Control Techniques and Procedures for Enhancing a Firm's Ability to Comply with the Securities and Futures (Client Securities) Rules and the Securities and Futures (Client Money) Rules.

As these existing risk management requirements are principally concerned with financial futures, the SFC considers it necessary to prescribe regulatory standards for the risk management of commodity futures trading.

SFC concerns

The SFC attributes the need for the Guidelines as arising out of two years of extreme market volatility in the financial and commodity futures markets associated with the Covid-19 pandemic, which resulted in losses incurred by futures investors and by their brokers, and which underscored the challenges which futures brokers face during times of market volatility. In particular, the SFC noted the effects of some clients being unable to meet margin calls, resulting in losses to them and, in some cases, resulting in their futures brokers requiring emergency funding or financial assistance to prevent them from defaulting on their obligations to clearing houses, or to enable them to comply with their obligations under the Securities and Futures (Financial Resources) Rules.

Unsatisfactory risk management practices that have been observed by the SFC include futures brokers:

- Allowing clients with outstanding margin calls to establish new positions.
- Allowing clients to open futures positions with margin requirements which were lower than those set by the relevant clearing house.
- Failing to establish risk limits to control the exposure of their business and to manage concentration risk.
- Applying the same risk limit to every client without considering their individual circumstances.

- Failing to implement any controls to monitor clients' positions against the limits assigned to them.
- Failing to liquidate clients' positions after their net equity balance fell below liquidation thresholds.
- Failing to properly assess clients before they were treated as established clients and to conduct regular reviews of their eligibility.
- Failing to have proper stress testing in place to evaluate the potential losses of its option portfolios under extreme market conditions.
- Keeping some clients' excess margins in a firm's omnibus accounts with clearing brokers, resulting in the excess margins being used to offset the futures trading losses of other clients or to meet the clearing broker's margin requirements for the futures trading of other clients.

Proposed obligations under the Guidelines

The Guidelines stipulate the areas in respect of which the SFC will expect compliance from licensed futures dealers, notably in respect of their:

- Risk management framework, including the designation of a responsible officer and/or Manager-In-Charge for this purpose.
- Market risk management, including management of the risk of loss due to adverse movements in the level or volatility of market prices products, or of the underlying exposures of products, held by a firm for its own account.
- Commodity futures trading, including the maintenance of a board-approved list of commodity futures products in respect of which dealing is permitted.
- Client credit risk management, including the imposition of prudent trading, position and other limits for each client, or each group of connected clients, and the setting of position limits for each client, or group of clients, to prevent breaches of statutory or regulatory position limits.
- Concessionary margining for certain clients with sound financial positions and with records of having consistently met margin requirements.
- Counterparty risk management, including the formulation of written policies and procedures, and the conduct of due diligence to manage the exposure of a firm and its clients to executing or clearing agents.
- Funding of liquidity risk management, including prudent cashflow management and ensuring that client money or collateral is sufficiently liquid for settling margin requirements for the trading of futures contracts on behalf of clients.
- Safeguarding of client assets, including ensuring that client positions in futures contracts and their related margins are booked separately from a firm's proprietary positions and their related margins in accounts with its counterparties.
- Trading in futures markets outside Hong Kong, including the maintenance of segregated or trust accounts in the relevant foreign jurisdictions, and disclosing to clients the risks involved in the conducting of transactions in such jurisdictions.
- Stress testing involving policies and procedures, which are approved by a firm's senior management and clearly set out the firm's testing methodology and frequency and its relevant review and escalation mechanisms.
- Obligations to notify the SFC of breaches of the Guidelines.

The SFC is currently inviting interested parties to submit their comments concerning the Consultation Paper and the Guidelines on or before 31 January 2023.

Hong Kong SFC licensing and compliance hints – December 2022

Karen Lo

Understanding the nature of SFC enquires and investigations

According to the SFC's latest Quarterly Report, the SFC commenced 53 in-depth inspections of licensed corporations involving the audit of their compliance and regulatory requirements, and made 1,929 requests for trading and account records from corporations triggered by market surveillance conducted in Q3 of 2022. The SFC continues to take enforcement action against licensed corporations for regulatory breaches and seek criminal convictions. The SFC has disciplined four corporations and five individuals during the last quarter; the highest fine imposed on a licensed corporation over the past quarter was HK\$20.1 million. In addition, the licences of some ROs and individuals were suspended and individuals banned from re-entering the industry for a certain period of time for failing remain fit and proper. In the case of material failings the SFC is prepared to impose lifelong bans against the licensed individuals where warranted.

This article considers two types of SFC enquiries among a number of different options available to the SFC in seeking information and commencing an investigation. One type of SFC enquiry is a formal request pursuant to s.180 of the Securities and Futures Ordinance (**SFO**) in connection with an SFC inspection undertaken by the SFC Intermediaries Division. Such inspections mainly involve an onsite or remote review of a licensed corporation's regulated activities, or cover a thematic surveillance focused on topical issues. Section 180 empowers an SFC officer to enter premises to inspect, copy, record and make inquiries about the business conducted by the corporation or their associated entity and any transaction or activities in the course of the business conducted by the corporation or its associated entity. The SFC Intermediaries Supervision can also refer any possible wrongdoing to the SFC Enforcement Division which can invoke a full range of investigative powers under s.182.

Another type of SFC enquiry is an information request triggered by market surveillance under the s.181 of the SFO, and these preliminary enquiries are normally undertaken by the SFC Enforcement Division when requesting information and documents from a person in relation to their trading activities and /or records. This section empowers the SFC to obtain information relating to securities, future contracts, leverage foreign exchange contracts and collective investment schemes, and the SFC can investigate where it has reasonable cause to believe that an individual may have engaged in defalcation, fraud, misfeasance or other misconduct activities in connection with dealing, giving advice or investment management pursuant to s.182 and s.183, including enforcement proceedings. In such circumstances the SFC may disclose the materials which it has compelled a person to provide in Hong Kong to an overseas regulator in providing assistance with the investigation of cross-border misconduct activities pursuant to s.186 of the SFO.

It is important to understand the nature of any notice received by the SFC as well as its implications and the requirement to adhere to statutory secrecy obligations. Typically, requests for information are subject to short deadlines for responding although reasonable requests for extensions are normally entertained.

Deacons assists clients across a wide range of regulatory enquires from the SFC, some routine and others in relation to enforcement proceedings. If you would like more information as to how we can assist you prepare for a routine inspection as well as deal with potential enforcement proceedings, please contact us.

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