

SFC reprimands and fines Merrill Lynch Far East Limited \$2 million for regulatory breaches

1 Apr 2015

The Securities and Futures Commission (SFC) has reprimanded and fined Merrill Lynch Far East Limited (Merrill Lynch Far East) \$2 million for regulatory breaches and internal control failings relating to position limit failures (Note 1).

The decision follows an SFC investigation into the holding of Merrill Lynch International (MLI) in 14,181 contracts in Hang Seng China Enterprises Index (HSCEI) on 30 May 2013 in breach of the prescribed position limit of 12,000 contracts. Merrill Lynch Far East controlled the trading or part of the trading for MLI and had discretion to make trading decisions for MLI for hedging at the material time (Note 2).

The SFC found that Merrill Lynch Far East failed to implement adequate internal controls to monitor MLI's positions in HSCEI futures and options contracts to ensure compliance with the prescribed position limit (Note 3).

Specifically, although Merrill Lynch Far East had a system in place to alert traders to reduce MLI's position when its aggregate position reached 80% of the prescribed position limit, the system failed to capture MLI's expiring short positions and their potential impact on the prescribed position limit. This resulted in Merrill Lynch Far East's failure to detect the expiry of a large short position in HSCEI futures contracts on 30 May 2013 and the corresponding increase in MLI's long position which contributed directly to the position limit breach.

In determining the penalty, the SFC has taken into account Merrill Lynch Far East's co-operation and that it has taken steps to strengthen its internal controls on monitoring position limits.

End

Notes:

1. Merrill Lynch Far East is a licensed corporation under the Securities and Futures Ordinance to carry on Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 6 (advising on corporate finance) and Type 7 (providing automated trading services) regulated activities.
2. Rule 4(1) of the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Rules) provides that no person, except persons authorized by the SFC or the Hong Kong Exchanges and Clearing Limited, may hold or control futures contracts or stock options contracts in excess of the prescribed limit.

Section 5(a) of the Rules provides that the limit on the number of contracts that may be held or controlled, in the case of futures contracts, is specified in Schedule 1 of the Rules.

Schedule 1 of the Rules provides that the prescribed limit for Hang Seng China Enterprises Index contracts is 12,000 long or short position delta for all contract months combined.

3. General Principle 7 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) requires a licensed person to comply with all regulatory requirements applicable to the conduct of its business activities.

Paragraph 12.1 of the Code of Conduct requires a licensed person to comply with and maintain appropriate measures to ensure compliance with all applicable regulatory law, rules, regulations and codes administered or issued by the SFC, exchanges, clearing houses and other regulatory authorities which apply to the licensed person.

[A copy of the Statement of Disciplinary Action is available on the SFC's website](#)

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STATEMENT OF DISCIPLINARY ACTION

The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has taken the following disciplinary action against Merrill Lynch Far East Limited (**Merrill Lynch Far East**) pursuant to section 194 of the Securities and Futures Ordinance (**SFO**):
 - (a) publicly reprimanded Merrill Lynch Far East pursuant to section 194(1)(b)(iii) of the SFO; and
 - (b) imposed a pecuniary penalty of HK\$2,000,000 pursuant to section 194(2) of the SFO.
2. The disciplinary action is taken for Merrill Lynch Far East's failure to implement adequate internal controls to ensure compliance with the prescribed position limit for Hang Seng China Enterprises Index (HSCEI) futures contracts and options contracts.

Summary of Facts

3. On 30 May 2013 after market close, Merrill Lynch International (**MLI**) held a net long delta position of 14,181 contracts in HSCEI futures and options contracts in breach of the prescribed position limit of 12,000 long or short position delta for all contract months combined¹²³.
4. Although MLI was the booking affiliate for the trades of Bank of America Merrill Lynch, Merrill Lynch Far East controlled the trading or at least part of the trading for MLI and had discretion to make trading decisions for MLI for hedging purposes.
5. On 31 May 2013, Merrill Lynch Far East had reduced MLI's holdings in HSCEI futures and options contracts to a level below the prescribed limit.
6. Merrill Lynch Far East submitted that there were measures in place to monitor position limits. These controls include:
 - (a) generating a daily position report which show the aggregated position of HSCEI futures and options contracts across all MLI books at the end of the previous day;
 - (b) alerting all relevant traders by email to reduce their positions when the aggregated position reaches 80% of the prescribed net delta position limit; and

¹ Section 4(1) of the Securities and Futures (Contracts Limits and Reportable Positions) Rules (Cap 571Y) (the "Rules") provides that no person, except persons authorized by the SFC or the Hong Kong Exchange (HKEx), may hold or control futures contracts or stock options contracts in excess of the prescribed limit.

² Section 5(a) of the Rules provides that the limit on the number of contracts that may be held or controlled, in the case of futures contracts, is specified in Schedule 1 of the Rules.

³ Schedule 1 of the Rules provides that the prescribed limit for HSCEI futures contracts and options contracts is 12,000 long or short position delta for all contract months combined.

- (c) implementing a buffer control of 20% of the prescribed limit to cater for the likely maximum daily movement of MLI's position irrespective of the cause of the movement.
- 7. However, the controls and monitoring report were not effective because they did not capture the expiry of MLI's short positions and their potential impact on the prescribed position limit.
- 8. As a result, Merrill Lynch Far East's failure to detect the expiry of a large short position in HSCEI futures contracts at market close on 30 May 2013 and the corresponding increase in MLI's long position contributed directly to the position limit breach on 30 May 2013.
- 9. Merrill Lynch Far East has advised it has since taken steps to strengthen its internal controls on monitoring positions in HSCEI futures and options contracts to ensure compliance with the prescribed position limit.

Conclusion

- 10. The SFC concludes that Merrill Lynch Far East failed to ensure there were adequate measures in place to monitor MLI's positions in HSCEI futures and options contracts to ensure compliance with the prescribed position limit at the material time.
- 11. Merrill Lynch Far East should regularly review its systems and controls to ensure they are adequate in monitoring MLI's position in HSCEI futures and options contracts and comply with the prescribed position limit.