通告 CIRCULAR

Subject: **Compliance Bulletin (Issue No. 9) – (1) Hong Kong Investor Identification Regime ("HKIDR"), (2) Reporting Requirements for Non-Automatch Trades, (3) Pre-trade and Post-trade Controls for Detecting Significant Price Deviation, and (4) Investor Eligibility Requirements**

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As part of our continuous efforts to promote transparency and a culture of compliance in our marketplace, the Exchange has prepared this Compliance Bulletin to offer the industry a better understanding of our enforcement work and regulatory expectations. It includes some common deficiencies identified from Exchange Participants ("**EPs**") in relation to (1) HKIDR, (2) reporting requirements for Non-Automatch Trades[1] and (3) pre-trade and post-trade controls for detecting significant price deviation, and also serves as a reminder on (4) Investor Eligibility Requirements under the Rules of the Exchange ("**SEHK Rules**").

[1] Refers to transactions which are not concluded by automatic order matching in the System as defined in the SEHK Rules.

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(1) HKIDR

Relevant requirements
i. SEHK Rules ○ Chapter 5 Trading ▪ Rules 538A – Investor Identification **ii. Frequent Ask Questions ("FAQ")** ○ FAQ on HKIDR File Submission and Order Tagging ○ FAQ on HKIDR Requirements (Issued by SFC) **iii. Information Paper** ○ HKIDR-Information-Paper_e.pdf (hkex.com.hk) **iv. Reporting Forms** ○ Explanatory Notes of Reporting forms under HKIDR ○ Reporting Form Templates ▪ Aggregated Transaction Report ▪ BCAN Change Report ▪ BCAN Change for LP Quote Report ▪ BCAN Error Report ▪ Off-Exchange Trade BCAN (Buy-Side) Report

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Common deficiencies and instances of non-compliance

1. Trading with unregistered BCAN

- Failure to register the BCANs of existing clients on the previous trading day ("**T-1 day**") due to system or process issues.

Relevant requirement	
Rule 538A(4)	Relevant Regulated Intermediary ("**RRI**") shall submit the BCAN-CID Mapping File on or before the T-1 day, unless the client is a new client who has opened the trading account on T day or a client whose trading account has been inactive (irrespective of account balance or money movement) for at least 24 months since the last trade, in which case BCAN-CID Mapping File shall be submitted on T day.

2. Failure to report BCAN Change

- Some RRIs changed the BCAN of a client in the BCAN-CID Mapping File but failed to submit the BCAN Change Report to the Exchange.
- RRI shall ensure that the BCANs assigned to its clients will not be changed for a client unless such modification is necessary due to system upgrades or in other exceptional cases.

Relevant requirement	
Rule 538A(5)	RRI shall ensure that the BCANs assigned to its clients will not be changed for a client unless such modification is necessary due to system upgrades or in other exceptional cases, and in such case the RRI shall report any amendment of the BCAN assignment and the reasons for such amendment to the Exchange in such manner and at such time as the Exchange may prescribe from time to time.

3. Failure to report the off-exchange Trade BCAN (Buy side) within the prescribed timeframe

- EPs on the buy side of the off-exchange transactions did not provide the BCAN of the buy side clients within the prescribed timeframe.
- In addition, the EPs did not submit the Off-exchange Trade BCAN (Buy-side) Report to SEHK via ECP.

Relevant requirement	
Rule 538A(6)(c)	Within 15 minutes after the selling EP input the details of a sale transaction into the System or within 30 minutes after the conclusion of the transaction, whichever is later, and in any event before market close, the buying EP shall input the CE number of the RRI which assigned the BCAN and the BCAN for the buy side in such manner as the Exchange may prescribe from time to time. If the buying EP fails to input the CE number or the relevant BCAN before market close, it shall report the CE number and the BCAN to the Exchange in such manner and by such deadline as the Exchange may prescribe from time to time.

4. Failure to report the underlying BCANs of the Aggregated Transactions by the prescribed timeframe

- Some RRIs tagged the aggregated orders with the reserved value "2" but failed to report the underlying BCANs of the aggregated orders on or before market close on the third trading day after the execution of the aggregated order ("**T+3 day**") via the Aggregated Transaction Report.

Relevant requirement	
Rule 538A(6)(d)	If an on-exchange order or off-exchange order is an aggregated order, unless otherwise prescribed by the Exchange, the RRI which aggregated the order shall tag a specific reserved BCAN value (as the Exchange may prescribe from time to time) to the order to be submitted to the Exchange.

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	The RRI shall report each order underlying an executed aggregated order in such form the Exchange may prescribe from time to time on or before market close on T+3 day after the execution of the aggregated order. In the event that an aggregated order is partially executed, a RRI is only required to report the portion of the order that has been executed.

5. Inaccurate and incomplete information in the HKIDR BCAN-CID Mapping File

- Some RRIs failed to upload a complete and accurate BCAN-CID Mapping File on or before T-1 day for existing clients with consent provided.

- Multiple incidents have been reported to the Exchange in relation to the bulk deletion of BCAN records in the mapping file due to internal technical issues or processing errors and missed the submission deadline.

Relevant requirement	
Rule 538A(5)	A RRI which is responsible for assigning BCANs and preparing the BCAN-CID Mapping File shall ensure that all information relating to the BCANs and CID in the BCAN-CID Mapping File which it submits to the Exchange is accurate and up-to-date.

6. Incorrect tagging of orders and trades for agency trading routed through a chain of RRI

- Incorrect order tagging was reported to the Exchange when the orders were routed through multiple RRIs. The EP incorrectly tagged the BCAN of the intermediary RRI instead of passing on the BCAN tagged by the intermediary RRI for the client.

Relevant requirement	
Rule 538A(6)(f)	A RRI shall put in place appropriate measures to ensure that clients' BCANs or the specific reserved BCAN values (as the Exchange may prescribe from time to time) which are tagged to on-exchange orders or off-exchange trades are correct and valid.

(2) Key Reporting Requirements for Non-Automatch Trades

Relevant SEHK Rules and Circulars
i. SEHK Rules ○ Chapter 5 Trading ▪ Rules 501E(2) and 520(1) to (3) – Reporting of Non-Direct Business Transaction ▪ Rules 501F(1) to (2) and 526(1) to (2) – Reporting of Direct Business Transaction ▪ Rule 538A – Investor Identification* **In particular Rule 538A(6) which sets out certain trade reporting requirements in relation to HKIDR. Failure of a RRI, which is an EP, to comply with those requirements may be subject to standard penalties as prescribed in the circular issued by SEHK dated 3 March 2023 (Ref. No. LSD/016/2023).* **ii. Circulars** ○ 2021 Annual Attestation and Inspection Programme ("**Annual Programme**") – Compliance Reminder on Manual Trade (PDF) ○ Extension of the Wavier on Trading Fee and Relaxation of Trade Reporting time Limit for Non-Automatch Trades in Listed Debt Securities (Ref.: CT/015/20) ○ 2017 Annual Programme – Compliance Reminder on Reporting of Manual Trades (PDF)

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Common misunderstandings concerning the applicable reporting requirements for Non-Automatch Trades
Below are some of the common misunderstandings on the applicable reporting requirements: (1) Direct business transaction EPs conducting direct business transaction should input <u>both sale and purchase</u> details of the transaction into the System. However, it was noted on some occasions where the direct business transaction is conducted between an EP (as principal) and its client, some EPs split the sale or purchase details and reported them separately into the System, resulting in multiple reporting of the same transaction. (2) Non-direct business transaction For non-direct business transaction conducted with a counterpart which is not an EP, some EPs misunderstood that such transaction is not subject to the reporting requirements under the SEHK Rules. **As a reminder**, even though the buyer and/or the seller of a transaction may not be an EP, the EP that executes the transaction may still be required to comply with the applicable reporting requirements under the SEHK Rules if such EP is itself a party of that transaction.
Scenarios and Illustrative Examples
The Exchange sets out below some illustrative examples to demonstrate the expected reporting of Non-Automatch Trades executed by EP(s). EP should note that these examples are intended for illustrative purposes only and are not exhaustive, and should assess the applicability of the scenarios set out below in other markets where appropriate.

Scenarios and Illustrative Examples (continued)

Scenario 1

<u>EP X enters into agency transactions</u>:

EP X conducts a direct business trade for its client (i.e. Client A) and Counterpart B (who is another client of EP X).

Transaction			EP X's reporting	
Client A	**EP X**	**Counterpart B (another client of EP X)**	**Buy Firm Name**	**Sell Firm Name**
Buyer		Seller	EP X	EP X

<u>Note</u>
Since EP X is the party that executes the transaction between Client A and Counterpart B, EP X is responsible to input both sale and purchase details into the System.

Scenarios and Illustrative Examples (continued)

Scenario 2

EP X enters into agency transactions:

After receiving a purchase order from Client A, EP X purchases securities from another EP (i.e. Counterpart C), on behalf of Client A.

Transaction			Counterpart C’s reporting	
Client A	**EP X**	**Counterpart C (another EP)**	**Buy Firm Name**	**Sell Firm Name**
Buyer		Seller	EP X	Counterpart C

Note
EP X conducts non-direct business transaction with Counterpart C. As the selling EP, Counterpart C is responsible to input the transaction details into the System.

Scenario 3

EP X enters into agency transactions:

After receiving a purchase order from Client A, EP X purchases securities from a non-EP (i.e. Counterpart D), on behalf of Client A.

Transaction			EP X's reporting	
Client A	**EP X**	**Counterpart D (non-EP)**	**Buy Firm Name**	**Sell Firm Name**
Buyer		Seller	EP X	

Note
EP X conducts non-direct business transaction with Counterpart D. If EP X as the buying EP is aware that the seller i.e. Counterpart D is not an EP, EP X is expected to report the transaction details into the System.

Scenarios and Illustrative Examples (continued)

Scenario 4

EP X enters into back-to-back principal transactions:

After receiving a purchase order from Client A, EP X (as principle) purchases securities from Counterpart E. who is another client of EP X, and EP X (as principle) then sells the same securities to Client A.

Transaction				EP X's reporting	
	Client A	**EP X**	**Counterpart E (another client of EP X)**	**Buy Firm Name**	**Sell Firm Name**
Leg 1		Buyer	Seller	EP X	EP X
Leg 2	Buyer	Seller		EP X	EP X

Leg 1:

EP X conducts direct business transaction by purchasing the same securities from another client i.e. Counterpart E. If EP X as the buying EP is aware that Counterpart E is not an EP, EP X is expected to input both sale and purchase details into the System.

Leg 2:

EP X conducts direct business transaction by selling securities to Client A. EP X is expected to report both sale and purchase details into the System.

Scenarios and Illustrative Examples (continued)

Scenario 5

EP X enters into back-to-back principal transactions:

After receiving a purchase order from Client A, EP X (as principal) purchases securities from a third party (i.e. Counterpart F) who is another EP, and then sells the same securities to Client A.

Transaction				EP X's reporting		Counterpart F's reporting	
	Client A	EP X	Counterpart F (another EP)	Buy Firm Name	Sell Firm Name	Buy Firm Name	Sell Firm Name
Leg 1		Buyer	Seller			EP X	Counterpart F
Leg 2	Buyer	Seller		EP X	EP X		

Leg 1:

EP X conducts non-direct business transaction with Counterpart F. As Counterpart F is the selling EP, it is responsible to input the transaction details into the System.

Leg 2:

EP X conducts direct business transaction by selling securities to Client A. EP X is expected to report both sale and purchase details into the System.

Scenarios and Illustrative Examples (continued)

Scenario 6

EP X enters into back-to-back principal transactions:

After receiving a purchase order from Client A, EP X (as principal) purchases securities from a third party (i.e. Counterpart G), who is neither EP X's client nor another EP, and then sells the same securities to Client A.

Transaction				EP X's reporting	
	Client A	**EP X**	**Counterpart G (non-EP)**	**Buy Firm Name**	**Sell Firm Name**
Leg 1		Buyer	Seller	EP X	
Leg 2	Buyer	Seller		EP X	EP X

Leg 1:

EP X conducts non-direct business transaction with Counterpart G. If EP X as the buying EP is aware that the seller is not an EP, EP X is expected to report the transaction details into the System.

Leg 2:

EP X conducts direct business transaction by selling securities to Client A. EP X is expected to report both sale and purchase details into the System.

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(3) Common deficiencies in pre-trade and post-trade controls for detecting significant price deviation

Relevant requirements
i. HKFE Rules **522B.** In accordance with paragraph 4.3 of the SFC Code of Conduct, each EP should have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its Clients and other EPs from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions. **ii. SEHK Rules** **612.** A Participant shall put in place adequate and effective internal policies, guidelines and/or control procedures to protect its operations, its clients, and other Participants from any loss (financially or otherwise) arising from theft, fraud, and other dishonest acts, professional misconduct or omissions and to ensure its compliance with the CCASS Rules, the Clearing Rules, the Options Trading Rules, the Ordinance and these Rules. **iii. SFC Code of Conduct** **18.7 Risk management: internet trading and DMA** In providing internet trading or DMA services, a licensed or registered person must ensure that all the client orders are transmitted to the infrastructure used by the licensed or registered person and are subject to: (a) appropriate automated pre-trade risk management controls; and (b) regular post-trade monitoring. **18.11 Risk management: algorithmic trading** A licensed or registered person should have controls that are reasonably designed to ensure: (a) the integrity of its algorithmic trading system and trading algorithms; and (b) its algorithmic trading system and trading algorithms operate in the interest of the integrity of the market.

Common deficiencies noted from different markets

HKFE market

The pre-trade controls for detecting orders with materially deviated prices of some HKFE EPs were inadequate under certain market situations. For instance, in situations of an illiquid futures instrument where there is no trade and the order book reflects only a very low bid price, the pre-trade control would adopt that low bid as a reference price to evaluate the reasonableness of the price of inputting orders, without taking into account the value of the underlying index. As a consequence, the pre-trade control would allow these inputting orders to be sent to the market, which could result in trades being executed at unreasonable or materially deviated prices. Below is an example for illustration:

<u>Illustrative example 1</u>

Equity index future A					
Previous closing price	**Underlying index value**	**Last traded price**	**Best bid of the order book**	**Ask order with deviated price sends through the EP's trading system**	**Deficient price control logic**
2950	3000	No trade over the day	2000	1980	Allows the order to go to market because it takes best bid (2000) as a reference price and determines that 1980 is not a deviated price (while underlying index value is 3000)
As a result, a trade is executed at 2000, which is obviously a deviated price for the futures instrument where the value of the underlying index stands at around 3000.					

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Common deficiencies noted from different markets

SEHK market

Some EPs failed to put in place any price controls for client orders, but simply rely on the validation of the Exchange's trading system, believing that any order submitted to the trading system without rejection would constitute a reasonable order. This is an **incorrect** understanding of the validation logic of the Exchange's trading system.

Some EPs implemented soft-block mechanism and show a pop-up screen for clients to reconfirm order with significant deviated price. However, the reconfirmation pop-up screen does not explicitly mention that the order price is deviated from a reasonable value, hence failing to alert clients of the unreasonableness of the order price. Some EPs allow clients to disable such soft-block mechanism for convenience in their order placing process, defeating the purpose of putting in place such mechanism in the first place.

Some EPs do not have appropriate post-trade review and follow up action with clients who have executed trades with highly deviated prices.

Please see below another example for illustration:

Illustrative example 2

Security B				
Previous closing price	**Last traded price**	**Best bid and Best ask**	**Bid order with deviated price**	**Deficient price control logic**
0.5	No trade over the day	No bid order and no ask order	4	Fails to detect the bid order is deviated from previous closing price by 8 times and still allows the order to send through to the market without any warning with clear descriptions to the clients

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Good practices observed
With reference to illustrative example 1, some EPs have put in place effective price controls on derivatives products capable of taking into consideration the underlying price when determining whether a price is deviated from a reasonable or fair value. With reference to illustrative example 2 above, some EPs have implemented prudent price control measures on their clients' orders to prevent any orders with unreasonable prices from entering the market. Where a soft-block mechanism is adopted, clients who place order through such trading system would be explicitly alerted of the situation where price deviation when comparing to the previous close was noted. EPs have also refrained from offering their clients the option to disable the soft-block mechanism, unless there is a valid reason acceptable to them, which are also properly documented. EPs should note that it is crucial to ensure that orders sent to the trading system are not erroneous inputs or orders with significantly deviated prices, as such inputs may lead to trades executed at materially deviated prices, compromising market integrity. EPs should conduct regular reviews of the sufficiency of price control and detection in their order placement systems. Additionally, EPs are strongly encouraged to consider enhancing their systems or working with vendors to improve the logic to better protect clients from placing orders that may result in financial losses or preventing ill-intended orders, with the effect of taking advantage of others such as bid orders with materially low prices or ask orders with materially high prices, to be submitted. By implementing recommended good practices and enhancing their systems, EPs can better protect their clients from potential financial losses, help prevent potential market manipulation, and uphold market integrity.

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(4) Investor Eligibility Requirements

Relevant requirements
i. SEHK Rules ○ Chapter 5 Trading ▪ Rules 525A – Trading of Debt Securities under Chapter 37 of the Main Board Listing Rules ▪ Rules 592 and 593 – Trading of SPAC Shares and SPAC Warrants ○ Chapter 14A China Connect Service - Shanghai ▪ Rules 14A06(13) to (15) Trading of STAR Shares ○ Chapter 14B China Connect Service - Shenzhen ▪ Rules 14B06(16) to (18) Trading of ChiNext Shares **In particular SEHK Rules 525A(2), 14A06(15), 14B06(18) and 593(6) which set out the investor eligibility requirements for trading the above-mentioned securities in SEHK market.* **ii. Circulars** ○ Compliance Bulletin (Issue No. 3) – (i) Investor Eligibility Requirements and (ii) BCAN Requirements (Ref. No.: MSM/002/2022) ○ Guidance on Investor Eligibility Requirements (Ref. No.: MSM/001/2022) ○ Special Purpose Acquisition Companies (SPAC) - Web Corner and Frequently Asked Questions (FAQ) (Ref. No.: CT/016/2022) ○ Shenzhen Connect - Reminder on Investor Eligibility Requirement for Trading of ChiNext Shares (Ref. No. MSM/009/2021) ○ Shanghai Connect – Reminder on Investor Eligibility Requirement for Trading of STAR Shares (Ref. No.: MSM/003/2021) ○ Shenzhen Connect – Reminder on Investor Eligibility Requirement for Trading of ChiNext Shares (Ref. No.: MSM/002/2016) **iii. FAQ** ○ Special Purpose Acquisition Companies (SPAC Web Corner) ○ Stock Connect Another Milestone (Stock Connect Web Corner)

Possible Disciplinary Actions
Failure of an EP to comply with the investor eligibility requirements within a 12 month rolling period will be considered as Summary Fine Offences. EPs should be aware of the amendments to SEHK Rules and the SEHK Disciplinary Procedures set out in the circular published in December 2021 (Ref. No.: LSD/091/2021), in particular on the following sections in relation to the possible disciplinary actions to be taken against non-compliant Participants: **i. SEHK Rules** o Chapter 7 Disciplinary **ii. Disciplinary Procedures** o Part II: ▪ 1 – Offences to be Dealt with under the Standard Penalty Procedures *"Failure of an EP, a China Connect EP or a SPAC EP to comply with the requirements under SEHK Rules 525A(2), Rule 14A06(15), Rule 14B06(18) or Rule 593(6), as the case may be, within a 12 month rolling period"* ▪ 9 – Schedule of Penalties ➢ *for the first offence, issuance of a Warning Letter;* ➢ *for the second offence, an imposition of a fine of $25,000;* ➢ *for the third offence, an imposition of a fine of $50,000; and* ➢ *any subsequent offence to be treated as an offence to be dealt with by hearings in accordance with the Procedures For Offences To Be Dealt With By Hearings*

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Deficiencies and instances of non-compliance

We have identified several areas of control deficiencies and non-compliance instances with regard to the relevant Investor Eligibility Requirements, including but not limited to:

Client onboarding

(i) Misclassification of a client's Professional Investor ("**PI**") type;

(ii) Insufficient communication about the investor eligibility requirements for relevant products with direct clients and intermediaries; and

(iii) Inadequate arrangements with direct clients and intermediaries to ensure compliance with unwinding ineligible position(s) within a specific timeframe and to require intermediaries to adhere to investor eligibility requirements.

Pre-trade

(i) Inadequate understanding of system functionality, leading to system control deployment failure;

(ii) Misinterpretation or insufficient understanding of rules and requirements;

(iii) Failure to keep up with regulatory changes and implement corresponding controls in a timely manner;

(iv) Pre-trade controls applied on direct clients / affiliates' clients not capable of being extended to non-affiliated intermediaries due to lack of visibility of underlying investors' identity;

(v) Inadequate user acceptance test ("**UAT**") before deploying new or modified system control; and

(vi) Lack of routine effectiveness checks on system controls.

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Deficiencies and instances of non-compliance (continued)
Post-trade (i) Absence of post-trade review exercise to timely identify non-compliance incidents caused by staff oversight or system control deployment failure; (ii) Lack of a post-trade review framework encompassing all products subject to investor eligibility requirements; (iii) Inadequate coverage where the post-trade review only covers trades conducted by direct clients but not underlying clients of the intermediaries; (iv) Negligence in carrying out post-trade review exercises, leading to undetected non-compliance incidents over extended periods.

The Exchange would like to point out that the requirements and examples set out in this circular are by no means exhaustive. They are intended for general reference only and should not be construed as legal advice. All liability with respect to actions taken or not taken based on the contents of this circular are hereby expressly disclaimed. EPs should always take into consideration their own circumstances to ensure full compliance with the relevant rules and requirements and seek their own professional advice on their specific situation where appropriate.

EPs are strongly advised to review their current set up and implement appropriate measures to strengthen their controls, and where necessary, take appropriate actions to address any potential rule breaches or deficiencies.

EPs are also encouraged to contact the Market Surveillance and Monitoring Department (email: surveillance@hkex.com.hk) should they have any questions on the above.

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This circular has been issued in English together with Chinese translation of the same. If there is any discrepancy between the Chinese translation and the English version, the English version shall prevail.