

Appendix 3

Compliance Reminder on China Connect Rules

(Applicable to China Connect Exchange Participants and Trade-through Exchange Participants only)

China Connect Exchange Participants (“**CCEPs**”) and Trade-through Exchange Participants (“**TTEPs**”) are required to at all times, comply with the relevant rules and regulations regarding the trading of China Connect Securities as stipulated in the Rules of the Exchange (“**SEHK Rules**”), including but not limited to Chapters 5, 14, 14A and 14B.

In the 2022 Annual Attestation and Inspection Programme, some CCEPs and TTEPs were found to be deficient in the following areas:-

1. Broker-to-Client Assigned Number (“BCAN”) Requirements

▪ ***Multiple BCANs assigned for the same client***

- (i) Clerical mistakes during client onboarding process, human intervention in the BCAN assignment process, vendor system limitation and deficiencies in system design were common reasons that led to multiple BCANs being generated and assigned to the same client. In one case, a client has been assigned with two BCANs as the system failed to remove the client’s BCAN from the BCAN-CID mapping file when the account was closed, but assigned with a new BCAN when the CCEP subsequently reopened the account of the same client. In another case, a client was assigned with multiple BCANs at the trust level with the same CID of the trustee but the client is in fact the trustee. There were also other scenarios where we noted that testing accounts were incorrectly created for the CCEP itself and/or its clients.
- (ii) Misinterpretation of rules resulted in assignment of different BCANs to
 - clients with multiple accounts such as cash and margin accounts; and
 - fund and fund manager accounts.

▪ ***Inaccurate CID and BCAN client type provided in the BCAN-CID Mapping File***

- (i) Due to misunderstanding of the classification requirement, some CCEPs mistakenly assigned the house accounts of their corporate and institutional clients under *Proprietary or Principal Trading* (Type 5), which is in fact only intended for the house accounts of the CCEP or TTEP or that of their affiliates.
- (ii) Some CCEPs mistakenly assigned their affiliates’ house account under *Legal Entity – Fund managers and others* (Type 4), which is in fact only intended for fund managers or other corporate clients.

- (iii) Due to human errors and the absence of maker-checker process for creating client profile in their internal systems, some CCEPs mistakenly assigned corporate clients/joint account holders under *Individual* (Type 1) which is in fact only intended for individual clients.
 - (iv) Some CCEPs failed to assign the corresponding client type for its fund or fund manager clients, and wrongly classified fund clients under *Legal Entity – Fund managers and others* (Type 4), or fund managers or other corporate clients under *Legal Entity – Fund* (Type 3).
 - (v) Due to misunderstanding of the BCAN-CID mapping data submission requirements, clerical mistakes, staff oversight and/or system error, some CCEPs failed to provide the exact CID as shown on clients' official identity documents, including but not limited to the client name, identity number, ID type, country/region of issuance. In addition, some CCEPs incorrectly used the Business Registration Certificate as identity documents instead of the Certificate of Incorporation or other official incorporation documents / Legal Entities Identifiers (LEI).
 - (vi) Some CCEPs inadvertently provided the fund manager's CID for clients that use the fund as the legal entity for opening the trading account with CCEPs.
- ***Insufficient controls / arrangements to ensure BCAN-CID Mapping File data accuracy***
 - (i) ***No regular review.*** Some CCEPs did not conduct any regular review of the data in the BCAN-CID Mapping File and failed to detect inaccurate client type assignments and/or incorrect CID input.
 - (ii) ***Lack of adequate control over data accuracy regarding BCAN assigned by its affiliate to underlying clients.*** Some CCEPs on-boarded their non-EP affiliates as their clients where BCANs were assigned to the affiliates' underlying clients. However, they did not put in place adequate control to ensure data accuracy on those BCANs concerned, leaving the data inaccuracy issue at the affiliates level undetected.
 - ***Insufficient controls / arrangements to ensure BCAN confidentiality and BCAN access granted on a need-to-know basis only***

Some CCEPs displayed the BCANs in their internal systems and/or unnecessarily granted BCAN access to dealers without proper or adequate justifications provided. These CCEPs are considered failing to ensure that the use of and accessibility to BCANs are strictly restricted on a need-to-know basis.

▪ ***Insufficient controls to ensure correct BCAN tagging***

- (i) Human errors in processing high-touch orders and implementing new booking flow in the order system have led to incorrect BCAN tagging. Some CCEPs selected the wrong client account when placing the client's order which resulted in wrong BCAN tagging.
- (ii) Some CCEPs mistakenly placed an order originated from one client (client A) to another client (client B) due to the miscommunication between CCEP's sales and trading departments.
- (iii) Incorrect BCAN mapping in the system also led to wrong BCAN tagging.

▪ ***Incorrect BCAN assignment for TTEP***

A single BCAN was assigned to a TTEP instead of a BCAN range. However, a CCEP executing for TTEPs should set aside BCAN ranges for each of its TTEPs for them to assign to their clients so that BCANs used by the CCEP will not overlap with its TTEPs. The BCANs of a TTEP for proprietary trading should also be within the same BCAN range designated by its executing CCEP.

CCEPs and TTEPs are reminded to observe and comply with the BCAN requirements as set out in SEHK Rule 1425A, and to refer to various guidance, including but not limited to the [Northbound Investor ID Model FAQ](#), [Guidance Notes on BCAN-CID Mapping File](#), [BCAN – CID Mapping File Data Record Examples](#) and [Northbound Trading Investor ID Model - System File Interface Specification](#).

In this regard, CCEPs and TTEPs should put in place necessary controls and arrangements, and regularly assess their effectiveness, such that they can (i) assign unique BCAN to each of their Northbound trading clients, (ii) ensure the BCAN client type and CID submitted to the Exchange is accurate and up to date, (iii) keep BCANs strictly confidential, (iv) ensure BCAN assignment is correct, and (v) ensure BCAN consent is obtained from clients before proceeding with order placing. Additionally, CCEPs and TTEPs are reminded that once a BCAN was assigned to a client, it shall not be changed and shall not be reused for other clients, unless with the prior written approval from the Exchange. Comprehensive guidelines should be in place to ensure that the controls and arrangements are being implemented as designed and in a consistent manner. In addition, adequate training should be provided to staffs involved in BCAN-related process on a regular and on-going basis.

The Exchange wishes to draw Exchange Participants' ("EP") attention to some of the good practices that we observed during the onsite inspection:-

- (i) In order to avoid treating a client with multiple accounts as different clients, and inadvertently assigning that client with multiple BCANs as a result, some EPs would request the client to declare in its account opening form that he/she has not opened

any account with the firm previously. Some EPs would also compare other client information (e.g. address, contact number) to identify any potential matches.

- (ii) To handle multiple trading accounts setup arrangement (e.g. cash and margin accounts, master/sub-accounts, fund and fund manager accounts etc.), some EPs assign BCANs based on the ID number for individual clients and business registration number for corporate clients, rather than on trading account level.
- (iii) Some EPs conduct independent review on all client information obtained during onboarding to ensure data accuracy.
- (iv) Some EPs perform regular review on all data in the BCAN-CID Mapping File, including but not limited to changes (e.g. addition/deletion/amendment) and timely reconciliation between internal system records and the BCAN-CID mapping file to ensure the CID submitted to the Exchange are complete, accurate and up-to-date.
- (v) Adopt automation and minimize manual intervention as much as possible. Where manual procedures are involved in BCAN assignment and submission process, maker-checker mechanism is implemented.

EPs are encouraged to make reference to our Compliance Bulletin ([Ref. No.: MSM/002/2022](#)) which listed out some common deficiencies and related issues identified, and also good practices observed with respect to compliance with the relevant BCAN requirements.

2. TTEP registration and CCEP executing via other CCEPs

▪ ***TTEP registration***

When onboarding clients who are also EPs, some CCEPs failed to check their trading capacity to ensure that their EP clients that wish to conduct trading through the China Connect Service for the account of their clients have been registered as TTEPs.

▪ ***CCEP executing via other CCEPs***

- (i) Some CCEPs conducted China Connect trading activities through other CCEPs for principal and/or agency trading for purposes other than contingency situation.
- (ii) Pursuant to SEHK Rule 590, only a TTEP (not CCEP) is allowed to trade through a CCEP; the only exception would be for contingency purpose.

The Exchange wishes to draw EP's attention to the following:-

- (i) Pursuant to SEHK Rule 590(2) and 590(4) and as stated in paragraph 1.43 of the [Stock Connect Frequently Asked Questions \("Stock Connect FAQ"\)](#), EPs who are not registered as CCEPs but wish to provide services to their clients to trade in China Connect Securities may do so through CCEPs for the account of their clients as TTEPs.
- (ii) TTEPs are required to provide a declaration to the Exchange confirming such matters as the Exchange may require, including the EPs' awareness of and the ability and undertaking to comply with applicable laws in respect of the trading of China Connect Securities. Among other things, their systems must have the capability of conducting pre-trade checking, client agreements must be amended to allow for Northbound trading and appropriate arrangements must be made to ensure that their clients understand the risks of investing in China Connect Securities, etc. TTEPs are required to abide by the rules governing Northbound trading under the SEHK Rules as if they were CCEPs. From time to time, the Exchange may publish on the HKEX website (or by such other means as it considers appropriate), a list of TTEPs who have submitted declarations to the Exchange. TTEPs must not provide instructions to a CCEP, whether directly or indirectly, to trade in China Connect Securities for the account of their clients before their names are included in such published list of TTEPs.
- (iii) CCEPs should put in place adequate controls to ensure that their intermediary broker clients, who are EPs and conduct trading for their clients, must be registered as TTEPs both initially and on an on-going basis.

3. Trading of ChiNext and STAR Shares

- ***Inadequate communication of regulatory requirements and prior arrangement***

Some CCEPs failed to communicate with their clients the investor eligibility requirements for trading ChiNext and STAR shares, and the unwinding arrangement upon identification of ineligible transactions in the client agreement.

- ***Inadequate controls to ensure only Institutional Professional Investors ("IPIs") are allowed to trade ChiNext and STAR shares***

Some CCEPs failed to implement pre-trade controls (e.g. identifying ChiNext and STAR shares by complete stock code ranges) to block non-IPIs from trading ChiNext and STAR shares due to a lack of procedures governing timely update of stock code range.

- ***Inadequate procedures and controls for a timely identification of non-compliance incident in relation to Investor Eligibility requirement***
 - (i) Some CCEPs relied entirely on the pre-trade system controls to block non-IPIs from trading ChiNext and STAR shares, which is considered insufficient for the purpose of timely identification of non-compliance incidents.
 - (ii) Some CCEPs only conducted post-trade review at direct client level, but failed to cover all clients including the underlying clients of the intermediaries.
 - (iii) Some CCEPs only sought negative confirmation from intermediaries which have conducted trading of ChiNext and STAR shares. In the event that the intermediaries mistakenly placed orders for ChiNext and STAR shares on behalf of their clients who are not IPIs, such breach of the investor eligibility requirement would likely be left undetected.

The Exchange is of the view that effective controls on client onboarding, pre-trade and post-trade level are essential to ensure compliance with the investor eligibility requirements for trading in ChiNext and STAR shares respectively under SEHK Rules 14A06(13) to (15) and 14B06(16) to (18).

The Exchange wishes to draw EP's attention to a good practice we observed during the onsite inspection. We noted that some EPs have adopted automation to utilize ChiNext/STAR product flagging directly from the websites¹ of Shanghai and Shenzhen Stock Exchange respectively on a daily basis to help them to ascertain whether a particular stock is listed on the ChiNext or STAR board, followed by a reconciliation conducted between the information obtained from the exchange data feeds and third party vendor on a real time basis.

EPs are also encouraged to make reference to our Compliance Bulletin ([Ref. No.: MSM/002/2022](#)), which listed out some common deficiencies and related issues identified, and good practices observed with respect to compliance with the relevant investor eligibility requirements.

4. Client Agreement and Risk Disclosure

- ***Insufficient coverage in client agreements or other account opening documents***

Some CCEPs failed to include sufficient provisions, clauses or declarations to ensure clients have acknowledged and are aware of the restrictions, requirements, conditions and risks associated with Northbound trading of China Connect Securities, as well as the scope of services available to clients.

¹ SSE: <http://www.sse.com.cn/assortment/stock/list/share/>;
SZSE: <http://www.szse.cn/market/product/stock/list/index.html>

- ***Insufficient clarity on the scope of services provided to clients***

We noted that some CCEPs, which provide Margin Trading, Stock Borrowing and Lending and Short Selling services for local securities but not for China Connect Securities, failed to clearly communicate to their clients through the client agreement or other supplementary notification specifying that such services are not available for China Connect Securities.

To comply with the requirements under SEHK Rules 14A10, 14B10, 14A06(13) to (15) and 14B06(16) to (18), and also paragraphs 1.26 and 1.53 of the Stock Connect FAQs, CCEPs and TTEPs should include in the client agreement sufficient provisions covering Northbound trading of China Connect Securities, including the risks involved, and clearly communicate the scope of services provided to clients.

5. Error trade reporting

- ***Misunderstanding of error trade reporting requirement***

Some CCEPs conducted non-trade transfers to rectify error trades but failed to submit error trade report to the Exchange.

Pursuant to SEHK Rule 14A12(3) and 14B12(3), CCEPs who carry out non-trade transfers of China Connect Securities referred to in Rule 14A12(2)(b) or 14B12(2)(b) for the purpose of rectifying an error trade shall submit to the Exchange an error trade report together with supporting documents explaining the nature of the error, how the error was made and providing details of the non-trade transfer to be processed.

6. Policies and Procedures

- ***Inadequate policies and procedures, and lack of regular reviews***

- (i) ***BCAN requirements.*** Some CCEPs only relied on the operational manual provided by the system vendor, but failed to establish their own written policies and procedures in relation to the handling of BCAN assignment for the purpose of ensuring compliance with the BCAN requirements under SEHK Rule 1425A.
- (ii) ***TTEP registration.*** The written policies and procedures of some CCEPs contained inadequate details and guidance relating to the provision of brokerage services to EPs for the purpose of ensuring compliance with the TTEP registration requirement under SEHK Rule 590.

- (iii) ***ChiNext and STAR trading.*** The written policies and procedures of some CCEPs contained inadequate details and guidance relating to the (i) regular review on the IPI status of their clients, and/or (ii) regular and appropriate post-trade review to cover all clients including the underlying clients of intermediary broker clients, for the purpose of ensuring compliance with the investor eligibility requirement for trading in ChiNext and STAR shares respectively under SEHK Rules 14A06(13) to (15) and 14B06(16) to (18).

Non-comprehensive policies and procedures may pose compliance risk as well as operational risk on the participants. The Exchange wishes to remind CCEPs and TTEPs of the need to establish and maintain comprehensive policies and procedures to ensure compliance with all relevant rules and requirements. Regular review and revision should also be conducted to ensure they are consistent, effective and up-to-date.

7. Staff Training

- ***Inadequate staff training***

Some CCEPs and TTEPs did not provide adequate and product-specific training for staff involved in the business activities of the Priority Areas, but merely relied on on-the-job training through sharing and coaching by senior staff members.

To foster a culture of compliance, the Exchange wishes to remind CCEPs and TTEPs that they should provide their staffs with adequate and appropriate training both initially and on an on-going basis.