

香港聯合交易所有限公司

(香港交易及結算所有限公司全資附屬公司)

THE STOCK EXCHANGE OF HONG KONG LIMITED

(A wholly-owned subsidiary of Hong Kong Exchanges and Clearing Limited)

## 通告 CIRCULAR

**Subject: Closing of 2017 Annual Attestation and Inspection Programme**

**Enquiry: [surveillance@hkex.com.hk](mailto:surveillance@hkex.com.hk)**

With reference to the Exchange circular (Ref. No.: MSM/003/2017) dated 24 February 2017, the Exchange is pleased to announce that it has successfully completed the Annual Attestation and Inspection Programme 2017 (the “2017 Programme”).

Under the 2017 Programme, the Exchange inspected 20 Exchange Participants (“EPs”) and received self-attestation questionnaires from 375 EPs on compliance with the relevant Rules of the Exchange on Manual Trade, Short Selling and China Connect trading activities (collectively, the “Priority Areas”).

The Exchange noted that in general, most EPs had put in place systems and controls for compliance with the relevant rules and requirements in the Priority Areas. However, we have identified certain deficiencies and shortcomings which are common across EPs. Compliance advice letters have been issued to 46 EPs with recommendations for improvement in the following areas, including:

- Inadequate or lack of controls and monitoring in ensuring:
  - timely and accurate reporting of manual trades;
  - accurate flagging of short sell orders and timely reporting of flagging errors; and
  - compliance with China Connect Rules; and
- Inadequate training for staff responsible for business activities in the Priority Areas.

With a view to raising the awareness of EPs’ compliance in the Priority Areas, we set out our key findings and elaborate our compliance reminders in the Appendices (“Compliance Reminders”). The provisions highlighted in the Compliance Reminders are not exhaustive and may be subject to change from time to time. EPs are expected to keep abreast of all the relevant rules and regulations applicable to them.

EPs should review their practices and procedures against our Compliance Reminders, adopt appropriate measures to strengthen their controls, and where necessary, take immediate actions to rectify any similar breaches or deficiencies.

The Exchange will continue its efforts in enhancing the industry’s understanding and compliance with the Rules of the Exchange through compliance reminders, guidance notes and frequently asked questions.

EPs are encouraged to contact the Market Surveillance and Monitoring Department (email: [surveillance@hkex.com.hk](mailto:surveillance@hkex.com.hk)), should they have any feedback or questions regarding this circular.

**Garbo Cheung**  
**Head**  
**Market Surveillance and Monitoring**  
**Markets Division**

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

**Appendix 1**

**Compliance Reminder on Reporting of Manual Trades**

Under Chapter 5 of the Rules of the Exchange, EPs should observe the general principles of the relevant rules and establish effective controls and processes to ensure that manual trades are reported accurately and timely to the Exchange.

In the 2017 Annual Attestation and Inspection Programme, some EPs were found deficient in the following areas:-

**1. Reporting of Manual Trades**

- *Failure to report manual trades to the Exchange within the prescribed timeframe due to ineffective or inappropriate operation and system controls.* We noted that some EPs, due to the default setting of their reporting systems, would report manual trades concluded during the Closing Auction Session on the following trading day (before 9:45am).

Under Rules 501E(2), 501F, 520(1), and 526(1) of the Rules of the Exchange, EPs are required to report manual trades to the Exchange within the prescribed timeframe:

- Within 15 minutes after the conclusion of the transactions in respect of direct and non-direct business transactions; and
- Immediately, and in any case, within 1 minute after the conclusion of the transactions in respect of direct business transactions which are ATS transactions,

and in any event not later than the timeframe as stipulated in the relevant rules.

In the case of manual trades concluded during the Closing Auction Session, details of the transaction should be inputted no later than the end of the Closing Auction Session.

**2. Post-trade Review of Reported Manual Trades**

- *Inadequate policies and procedures in respect of post-trade review on reported manual trades and handling of error trade.*

Under Rule 528(1) of the Rules of the Exchange, EPs are required to review both sales and purchases journals at the end of each trading session, and to report any discrepancy, erroneous transaction or compliant to the Exchange not later than 15 minutes after commencement of the Morning Session of the next trading day.

**3. Staff Training**

- *Inadequate staff training.* Some EPs did not provide mandatory and product-specific training for staff involved in the business activity in the Priority Areas, and 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 EPs that they should provide staff with adequate and appropriate training both initially and on an ongoing basis.

**Compliance Reminder on Flagging of Short Selling Orders**

Pursuant to the 11<sup>th</sup>, 14<sup>th</sup>, 15<sup>th</sup> and 18<sup>th</sup> schedule of the Rules of the Exchange, EPs engaged in short selling should put in place proper system controls and procedures to ensure compliance with all applicable regulatory requirements on short selling order flagging.

In the 2017 Annual Attestation and Inspection Programme, some EPs were found deficient in the following areas:-

**1. Short Sale Indicator**

- *Failure to apply the specific short sale indicator for short selling orders in relation to market making and hedging activities.*

As stipulated in Regulation (24) of the 14<sup>th</sup> Schedule, Regulation (16), (29), (40) and (50) of the 15<sup>th</sup> Schedule and Regulation (16) of the 18<sup>th</sup> Schedule, EPs engaged in market making or hedging short selling are required to input short selling orders with a specific short sale indicator and in such manner as the Exchange shall from time to time determine.

**2. Post-trade Review**

- *Failure to report short sell flagging errors to the Exchange in a timely manner.* In some instances, we noted the failure was attributed to the fact that staffs were not provided with adequate and up-to-date written policies and procedures on handling and reporting of misflagging error.
- *Insufficient post trade monitoring on short selling activities.* Some EPs conducted post-trade review on executed short sell orders only, but ignored the unfilled short sell orders.

As stipulated in Rule 528(1), Regulation (20), (32) and (52) of the 15<sup>th</sup> Schedule of the Rules of the Exchange, EPs are required to review all trading activities and report any errors to the Exchange in a timely manner.

**3. Staff Training**

- *Inadequate staff training.* Some EPs did not provide mandatory and product-specific training for staff involved in the business activity in the Priority Areas, and 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 EPs that they should provide staff with adequate and appropriate training both initially and on an ongoing basis.

**Compliance Reminder on Compliance with China Connect Rules**

EPs registered as China Connect Exchange Participants (CCEPs) and Trade-through Exchange Participants (TTEPs) are required to comply with the relevant rules and regulations as stipulated in the Rules of the Exchange (including without limitation to Chapters 5, 14, 14A and 14B) at all times, regarding to the trading of China Connect Securities.

In the 2017 Annual Attestation and Inspection Programme, some CCEPs and TTEPs were found deficient in the following areas:-

**1. Trade-through Exchange Participants (TTEPs)**

- *Failure to submit a declaration to the Exchange before conducting trading in China Connect Securities for the account of their clients.*

Pursuant to Rule 590 of the Rules of the Exchange and as stated in paragraph 1.43 of the Stock Connect Frequently Asked Questions (FAQs<sup>1</sup>), EPs who are not registered as CCEPs but who 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 as referred to in Rule 590(2) of the Rules of the Exchange. TTEPs are required to provide a declaration to the Exchange confirming such matters as the Exchange may require, including the EPs' awareness of and ability and undertaking to comply with applicable laws in respect of the trading of China Connect Securities. Among other things, their back office 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 Rules of the Exchange as if they were CCEPs. The Exchange has published the names of such TTEPs on the HKEX website.

**2. Client Agreement and Risk Disclosure**

- *Insufficient provisions in client agreements or other account opening documents to ensure clients (including EP's affiliate(s)) acknowledged and are aware of the differences in the restrictions, requirements, conditions and risk associated with Northbound trading of China Connect Securities, as well as the scope of services available to clients.*

To comply with the requirements under the Rules of the Exchange (including without limitation Rules 14A10, 14B10 and 14B06(16) to (18)) and 1.26 and 1.53 of the FAQ, CCEPs and TTEPs should include in the client agreement sufficient provisions covering Northbound trading of China Connect Securities including the risks involved.

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<sup>1</sup> [http://www.hkex.com.hk/eng/market/sec\\_tradinfra/chinaconnect/Documents/FAQ\\_En.pdf](http://www.hkex.com.hk/eng/market/sec_tradinfra/chinaconnect/Documents/FAQ_En.pdf)

### 3. Special Segregated Account (“SPSA”) Order

- *Ineffective system controls and procedures to ensure accuracy of SPSA investor identification number.* In some instances, SPSA client’s sell order was wrongly treated as a non-SPSA order which adversely affected the pre-trade checking mechanism.

CCEPs and TTEPs should note the requirements laid down in Rules 14A06(2A)(a), 14A06(2A)(b), 14A06(10), 14B06(3)(a)(iii), 14B06(3)(b) and 14B06(12) of the Rules of the Exchange and put in place adequate and effective systems and controls relating to pre-trade checking process for SPSA and/or non-SPSA orders.

### 4. Pre-trade Controls and Post-trade Monitoring

- *Lack of effective and sufficient pre-trade controls and post-trade monitoring on their Northbound trading activities.*

CCEPs and TTEPs are reminded to observe and comply with Rules 14A06(4), 14B06(5), 14A17, 14B17, 1428(1), 1432 and 1433 of the Rules of the Exchange in particular. To these ends, CCEPs and TTEPs should put in place reasonable and necessary controls that can effectively prevent day trading, misflagging of short selling orders and mischievous behavior towards the use of the Northbound quota and ensure compliance with all applicable laws with regard to the Northbound trading of China Connect Securities including but not limited to laws and regulations prohibiting insider dealing, market manipulation, price rigging, false trading or the creation of a false or misleading appearance of active trading on any China Connect Securities.

### 5. Margin Trading

- *Providing funds or securities margin financing arrangement to their clients on a portfolio basis.* We noted that some CCEPs provided securities margin financing arrangement to their clients, by reference to the aggregated collateral values of all securities held in their portfolio, to purchase securities including China Connect Securities which may **not** be confined to those included in the List of Eligible SSE/SZSE Securities for Margin Trading.

Under Rules 14A15 and 14B15 of the Rules of the Exchange, CCEPs and TTEPs shall ensure that Margin Trading is confined to those China Connect Securities that are included in the List of Eligible SSE/SZSE Securities for Margin Trading published by the Exchange from time to time.

### 6. Foreign Investor Shareholding Monitoring

- *Failure to put in place monitoring arrangements to ensure clients’ compliance with foreign investors’ shareholding restrictions and disclosure obligations for China Connect Securities.* Various CCEPs held the mistaken belief that they were not obliged to monitor their client’s holding in China Connect Securities as they may not be the client’s sole custodian.

The Exchange wishes to draw CCEPs’ and TTEPs’ attention to Rules 14A08, 14B08, 14A09 and 14B09 of the Rules of the Exchange, which require CCEPs and TTEPs to put appropriate monitoring arrangements in place to comply with these Rules and alert their clients to comply

with the 5% shareholding disclosure requirements and the 10% individual shareholding limit for China Connect Securities.

## **7. Trading of ChiNext Shares**

- *Failure to put in place adequate controls to ensure that only Institutional Professional Investors (“IPIs”) are allowed to buy ChiNext shares.* In particular, we noted that some CCEPs failed to conduct (i) regular review on the IPI status of their clients, and/or (ii) regular and appropriate post trade review which covers all clients including the underlying clients of intermediary clients.

The Exchange is of the view that effective controls on pre-trade and post-trade level are essential to ensure compliance with the investor eligibility requirement for trading in ChiNext shares under Rules 14B06(16) to (18) of the Rules of the Exchange.

## **8. Staff Training**

- *Inadequate staff training.* Some EPs did not provide mandatory and product-specific training for staff involved in the business activity in the Priority Areas, and 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 EPs that they should provide staff with adequate and appropriate training both initially and on an ongoing basis.