

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 comply at all times 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 2020 Annual Attestation and Inspection Programme, some CCEPs and TTEPs were found deficient in the following areas:-

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

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

Clerical mistakes during client onboarding process, human intervention in the BCAN assignment process and deficiencies in system design have led to multiple BCANs being generated and assigned to the same client. We noted that this occurred when a client opened multiple trading accounts such as cash and margin accounts, master/sub-accounts, fund and fund manager accounts etc. In some other cases, the same client was being treated as different persons when different types of identity documents were used for account opening.

▪ ***Inaccurate Client Identification Data (“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 clients under *Proprietary or Principal Trading* (Type 5), which is only intended for the house accounts of the CCEP or TTEP or that of their affiliate.
- (ii) 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)
- (iii) Some CCEPs inadvertently provided the fund manager’s CID for clients which use the fund as the legal entity for opening the trading account with the CCEPs.

▪ ***Insufficient controls / arrangements to ensure that BCANs are kept confidential.***

- (i) ***BCAN bears obvious link to client’s identity.*** We noted that some CCEPs assigned client with a BCAN that is partly formed by the client’s account number. Accordingly, the CCEPs failed to prepare the BCAN in a way that do not bear any obvious link to a client’s identity.

- (ii) **BCAN visibility in internal systems.** We noted that some CCEPs displayed the BCANs in some internal systems and failed to ensure that the use of and accessibility to BCANs are strictly restricted to a need-to-know basis.

CCEPs and TTEPs are reminded to observe and comply with SEHK Rule 1425A, paragraphs 4, 11, 19, 21 and 22 of the [Northbound Investor ID Model FAQ](#) and the examples set out in [BCAN – CID Mapping File Data Record Examples](#). In this regard, CCEPs and TTEPs should put in proper controls / arrangements, and regularly assess the effectiveness of them, to (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, and (iii) keep BCANs strictly confidential. Comprehensive guidelines should be in place to ensure that the controls are being carried out as designed and in a consistent manner. Adequate training should also be provided to staffs involved in BCAN-related process on a regular and on-going basis. Additionally, CCEPs and TTEPs are reminded that BCAN assigned to a client shall not be changed, and shall not be reused for other clients once assigned. If a CCEP or TTEP needs to change the BCAN in exceptional cases, it must obtain the approval from the Exchange in advance.

The Exchange wishes to draw EP's 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 multiple BCANs for that client, 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 the 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 or 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 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.

2. Trade-through Exchange Participants

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

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

- (i) Pursuant to SEHK Rule 590 and as stated in paragraph 1.43 of the [Stock Connect Frequently Asked Questions](#) ("Stock Connect FAQs"), 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 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. Client Agreement and Risk Disclosure

- ***Insufficient provisions in client agreements or other account opening documents to ensure clients acknowledged and are aware of the restrictions, requirements, conditions and risk associated with Northbound trading of China Connect Securities, as well as the scope of services available to clients.***
- ***Failure to communicate clearly the scope of services provided to the clients.*** We noted that some CCEPs that provide Margin Trading and Short Selling services for local securities, but not for China Connect Securities, did not clearly communicate to their clients through the client agreement or other supplementary notification that such services are not available for China Connect Securities.

To comply with the requirements under SEHK Rules 14A10, 14B10 and 14B06(16) to (18), and 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 the clients.

4. Margin Trading

- **Provision of funds for the purchase of non-Eligible Securities.** Due to a system deficiency, a CCEP has inadvertently provided funds to its client for purchasing China Connect Securities that are not included in the List of Eligible SSE/SZSE Securities for Margin Trading.

Under SEHK Rules 14A15 and 14B15, 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.

5. Pre-trade Controls and Post-trade Monitoring

- **Lack of effective and sufficient pre-trade controls and post-trade monitoring on their Northbound trading activities.** We noted that in some cases, the personnel conducting post-trade monitoring is not independent from those conducting the trades. In other cases, the independent party only review cases escalated by those conducting the trades. As such, CCEPs failed to ensure proper segregation of duties which is critical to the effectiveness of the controls.

CCEPs and TTEPs are reminded to observe and comply with SEHK Rules 14A06(4), 14B06(5), 14A06(9)-(10), 14B06(11)-(12), 14A17, 14B17, 1421(2), 1428(1), 1432 and 1433 in particular. To these ends, CCEPs and TTEPs should put in place reasonable and necessary controls that can effectively prevent day trading, overselling of sellable inventory positions, 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.

With regard to system controls where manual override is allowed, proper documentary evidence should be maintained for the justification of special approvals.

6. Policies and Procedures

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

- (i) ***ChiNext trading.*** We noted that the written policies and procedures of some CCEPs contained inadequate details and guidance relating to the (i) regular review on the Institutional Professional Investors (“IPI”) status of their clients, and/or (ii) regular and appropriate post-trade review which covers 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 shares under SEHK Rules 14B06(16) to (18).
- (ii) ***Off-exchange Trades or Transfers.*** Some CCEPs failed to establish written policies and procedures in relation to the handling of off-exchange trades or transfers for the purposes prescribed under SEHK Rules 14A12 and 14B12.
- (iii) ***Surveillance monitoring.*** The written policies and procedures of some CCEPs relating to trade monitoring and/or shareholding monitoring for the purpose of compliance with SEHK Rules 1428, 1432, 1433, 14A08 and 14B08 were found to be incomplete.

Non-comprehensive policies and procedures may pose compliance risk as well as operational risk. The Exchange wishes to remind CCEPs and TTEPs 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 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 CCEPs and TTEPs that they should provide staff with adequate and appropriate training both initially and on an on-going basis.