

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 2021 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 / system migration, 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 some other cases, the same client was being treated as different persons when different types of identity documents were used for account opening.
- (ii) Misinterpretation of rules resulted in assignment of different BCANs to
 - an entity with different branches;
 - an intermediary’s proprietary and agency accounts for which only the intermediary’s Client Identification Data (“**CID**”) was provided;
 - a segregated portfolio company which is a single legal entity; and
 - clients with multiple accounts such as cash and margin accounts, master and sub-accounts, fund and fund manager accounts, segregated accounts set up for different strategies or purposes (e.g. a standalone account for Capital Investment Entrant Scheme related trading) etc.

- ***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 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) Due to misunderstanding of the BCAN-CID mapping data submission requirements, some CCEPs failed to provide the exact CID as shown on clients' official identity documents.
 - (iv) 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 BCANs are kept confidential***
 - (i) ***BCAN bears obvious link to client's identity.*** Some CCEPs assigned client with a BCAN, part of which is 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 as required.
 - (ii) ***BCAN access not granted on a need-to-know basis.*** Some CCEPs displayed the BCANs in their internal systems and failed 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 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.

- ***Change of BCAN***
 - (i) BCANs assigned to clients beyond the non-affiliated intermediary level should not be changed back to intermediary level once assigned, notwithstanding that the original assignment was made on a voluntary basis beyond the minimum rule requirement.
 - (ii) BCAN changed from fund to fund manager level (or vice versa), subsequent to account opening may also amount to unauthorized change of BCAN.

- ***Incorrect BCAN assignment for TTEP / client-facing affiliates***
 - (i) **TTEP** - A single BCAN was assigned to a TTEP instead of a BCAN range for the TTEP's agency trading. 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.
 - (ii) **Affiliate clients** - BCAN was only assigned to the affiliate (for agency trading), contrary to the Rules and the FAQ which stated that the BCAN should be assigned at the next level or further levels down until the client is not an affiliate.

- ***BCAN assignment for CCEP/TTEP's affiliate with dual capacity***
 - (i) For affiliates with dual capacity, only a single BCAN designated with client type "4" was assigned by a CCEP/TTEP to its affiliates for the affiliates to carry out both brokerage business and asset management business. However, a BCAN range should be assigned for its proprietary trading and each of its clients for which it conducts agency trading.

- ***BCAN consent***
 - (i) Some CCEPs created BCAN without first obtaining clients' consent and some failed to follow up with the client who refused to provide the BCAN consent.

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 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 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 the recently published 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*

- (i) On the one hand, some EPs failed to submit a declaration to the Exchange before conducting trading in China Connect Securities for the account of their clients.
- (ii) On the other hand, some CCEPs failed to ensure that their EP clients that wishes to conduct trading through the China Connect Service for the account of its clients have been registered as a TTEP.

▪ *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](#), 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. Odd Lot Transactions

- ***Trading algorithms in use not in compliance with the odd lot trading requirements***

Some CCEPs use trading algorithms that would slice a client's board lot sell orders into multiple odd lot child orders, in breach of the requirement that all odd lots must be sold in one single order.

Under SEHK Rules 14A06(3) and 14B06(4), CCEPs and TTEPs shall put in place reasonable and necessary system and controls to ensure that the sale of odd lot relates to the sale of all, and not part, of the odd lots held in respect of a China Connect Security for a CCEP or TTEP or for a client (as the case may be).

EPs are also reminded to observe the order size of SSE and SZSE Securities, which are subject to the board lot size of 100 shares (except for STAR shares whose board lot size is 1 share with minimum order size of 200 shares) as stipulated in paragraph 3.39.1 of the [Information Book for Market Participants in Stock Connect](#).

4. Trading of ChiNext and STAR Shares

- ***Inadequate controls to ensure only Institutional Professional Investors ("IPIs") are allowed to trade ChiNext and STAR shares***
 - (i) Some CCEPs failed to have proper pre-trade controls in place to require the intermediaries to ensure that their underlying clients are IPIs prior to accepting their orders for trading ChiNext and STAR shares.
- ***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.

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 requirements for trading in ChiNext and STAR shares respectively under SEHK Rules 14A06(13) to (15) and 14B06(16) to (18).

EPs are encouraged to make reference to the recently published 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.

5. 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.

6. 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.