HKEX
香港交易所

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通告 CIRCULAR

Subject: **Closing of 2018 Annual Attestation and Inspection Programme**

Enquiry: **surveillance@hkex.com.hk**

With reference to the circular (Ref. No.: MSM/003/2018) dated 28 February 2018, the Hong Kong Exchanges and Clearing Limited ("HKEX") is pleased to announce that it has successfully completed the Annual Attestation and Inspection Programme 2018 (the "2018 Programme").

Under the 2018 Programme, HKEX inspected 22 Exchange Participants [1] and Clearing Participants[2] (collectively, the "Participants") and received self-attestation questionnaires from 744 Participants on compliance with the relevant rules and requirements on client margin, risk management and China Connect trading activities (collectively, the "Priority Areas").

HKEX noted that in general, most Participants 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 the Participants. Compliance advice letters have been issued to 81 Participants with recommendations for improvement in the following areas, including:

- Insufficient controls to ensure compliance with client margin requirements under HKFE Rule 617, including the assessment of established Client and Exclusive Day Trader;
- Lack of stress testing on proprietary / client exposures;
- Inadequate controls for fulfilling the settlement obligations of clearing houses;
- Inadequate or lack of controls in trade monitoring and foreign investor shareholding monitoring in China Connect trading activities

With a view to raising the awareness of Participants' 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. Participants are expected to keep abreast of all the relevant rules and regulations applicable to them.

[1] Exchange Participants of The Stock Exchange of Hong Kong Limited and Hong Kong Futures Exchange Limited
[2] (i) Clearing Participants and General Clearing Participants of HKFE Clearing Corporation Limited, and (ii) Direct Clearing Participants and General Clearing Participants of Hong Kong Securities Clearing Company Limited and The SEHK Options Clearing House Limited

香港交易及結算所有限公司
香港中環康樂廣場8號交易廣場2期8樓
Hong Kong Exchanges and Clearing Limited
8/F, Two Exchange Square, 8 Connaught Place, Central, Hong Kong

info@hkex.com.hk
(t) +852 2522 1122 (f) +852 2295 3106
hkexgroup.com | hkex.com.hk

Participants 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. Any breaches or deficiencies will be taken seriously and may result in disciplinary actions against the Participants, including but not limited to summary fines and the issuance of warning letter. HKEX will issue a separate circular to provide further details in this regard.

HKEX will continue its efforts in enhancing the industry's understanding and compliance with the relevant rules and requirements through compliance reminders, guidance notes and frequently asked questions.

Participants are encouraged to contact the Market Surveillance and Monitoring Department (email: 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 Client Margin Requirements
(Applicable to HKFE Participants only)

HKFE Participants ("EPs") are required to comply with client margin requirements, as set out under Rules 617 and 619 of the Rules, Regulations and Procedures of the Futures Exchange ("HKFE Rules"). HKFE Participants are advised to establish and maintain proper policies and procedures, as well as robust systems and controls, to ensure ongoing compliance to these rules and other applicable regulatory requirements.

In the 2018 Annual Attestation and Inspection Programme, some EPs were found deficient in the following areas:-

1. Established Clients Assessment

(i) ***Failure to conduct full review by 1 January 2018 to ensure those classified as established Clients meet the criterion set out in the circular "Margin Requirements under Rule 617" dated 22 June 2017 (Ref No. MO/DT/089/17).*** Some EPs misinterpreted the "established Client" requirement in HKFE Rule 617 to be applicable to retail clients only, while some failed to observe the prescribed deadline.

(ii) ***Failure to use adequate and appropriate records when assessing the eligibility of established Clients.*** When assessing whether an established Client has met margin obligations consistently, some EPs only considered the transaction records pertaining to his/her HKFE account, or those accounts with credit limit granted to transact before adequate collateral is received. Separately, when assessing the soundness of the Client's financial position, some EPs solely relied on the Client's self-declaration of assets in the account opening documents, or a snapshot of their account balances (e.g. net asset value, investment portfolio, cash etc.)

(iii) ***Failure to maintain proper documentation on the assessment of and approval for established Clients.*** In some instances, justifications stated on the assessment forms did not make adequate reference to documents that were used to support the assessment. The records also failed to properly demonstrate the qualifications of established Clients, or to show the EP's justifications for approving or rejecting certain clients.

The Exchange wishes to draw EPs' attention to the following:-

- The Exchange is of the view that in order to qualify as an established Client, the Client should show no record of failure to meet margin obligations arising from but not limited to HKFE transactions.

- With respect to the re-application of previously disqualified established Clients, the Client must demonstrate he/she has no record of failure to meet margin obligations within an immediately preceding record period of at least one year.

- While various forms of records for assessments are acceptable, EPs should assess the validity of the types of information and documents used in assessing the Client's financial position. Such information and records should be recent, sufficient and with documentary evidence to demonstrate that the Client would be able to immediately transmit the necessary funds to fully meet his/her initial margin obligations should such requirements apply. Proper documentation on the assessment of and approval for established Clients should also be maintained.

- The annual review of the eligibility of established Clients is only a minimum requirement. If any event arises and gives reasonable doubt that the Client might fail to demonstrate a record of consistently meeting margin obligations and/or maintaining a sound financial position, EPs should immediately re-assess if such Client still qualifies as an established Client.

(iv) ***Failure to issue initial margin call to established Clients on T-day.*** We noted that some EPs failed to issue a call for the amount of minimum margin to established Clients on T-day when new position is established, including those with day-end net equity balance above the maintenance margin but below the initial margin requirement.

Under HKFE Rule 617(b), in respect of a new position established on behalf of the established Client on T-day, EPs **<u>must</u>** issue a call for the amount of minimum margin within T-day, and that the minimum margin is due as soon as practicable after the call but in no event later than the next Business Day. EPs should not permit any Client to establish new positions if the Client has calls for minimum margin which are overdue for settlement.

Exclusive Day Trader Assessment

(v) ***Requirements of Exclusive Day Trader assessment were not properly interpreted or implemented, particularly on Scenario 2 in the circular dated 22 June 2017.*** Some EPs used calendar day instead of Business Day in counting the number of days for which overnight positions were held (Condition A). Some failed to ensure that the minimum margin requirements (per contract) applicable to F/O Contract in respect of each of the overnight positions are the same or higher than that of the relevant Day Trade (per contract) (Condition B), as they simply aggregated the number of days with overnight positions across all F/O Contracts. Some EPs only conducted the required assessment once during the initial established Client assessment, instead of on an on-going basis. We also noted that, the trading records used to assess the number of days for which overnight positions were held did not fall within the prescribed timeframe in the said circular.

(vi) ***Inadequate or outdated policies and procedures governing the assessment of and controls relating to established Clients and Exclusive Day Trader.*** In some cases, the application and/or re-application policy for established Clients did not comply with current regulatory requirements. There was also a lack of proper arrangement for maintaining/keeping track of the status of established Clients.

The Exchange wishes to draw EPs' attention to the specific requirements for assessing whether an established Client is an Exclusive Day Trader, as set out in the said circular:-

- On assessing the transaction record in order to conclude that an established Client is not an Exclusive Day Trader under Scenario 1, the Exchange is of the view that EPs would have satisfied the relevant requirements if such Client did not transact any trade during the preceding one month's period before the proposed trade is executed.

- On counting the number of days for which overnight positions were held under Scenario 2 Condition A, the Exchange is of the view that EPs would have satisfied the relevant requirements if the assessment is conducted on a monthly basis.

- To illustrate the requirement under Scenario 2 Condition B, if an established Client has held overnight positions on HSI futures for 7 Business Days and mini-HSI futures for 3 Business Days (consecutively or otherwise) during the preceding one year period, the Client can trade without receiving adequate collateral on the types of F/O Contracts that has a lower or the same minimum margin requirement as a mini-HSI future; nevertheless, the number of contracts to be executed would not be limited by those previously held overnight. However, the EP is required to collect sufficient upfront margin prior to the transaction if the relevant trade is a HSI future or a contract which requires higher margin than a mini-HSI future.

- While Exclusive Day Trader assessment should be conducted on an on-going basis, EPs must have in place timely and appropriate arrangements to ensure adequate collateral is received prior to transacting F.O. Business for those concluded to be an Exclusive Day Trader, or when the contract type of the relevant trade has higher minimum margin requirement than that of the overnight positions held.

As set out in the circular dated 22 June 2017, EPs were expected to implement appropriate measures to fully comply with the requirements under HKFE Rule 617 as provided therein, by 1 January 2018. These measures include but are not limited to maintaining proper documentation to demonstrate qualifications of established Clients, putting in place appropriate internal control policies and procedures, and ensuring the record keeping systems are up to standard.

2. Client's Minimum Margin

(i) ***Failure to apply accurate Client's minimum margin rates.*** Some EPs miscalculated clients' minimum margin due to misinterpretation of the client margining methodology or operational shortfalls.

As stipulated in the circular "*System Readiness in relation to the Revised Client Margining Methodology for Derivatives Products*" dated 28 September 2016 (Ref. No. DCRM/HKEX/198/2016), the client margin is set at 1.33 times of the clearing house margin, which is the minimum amount of margin required from a client in respect of trading in HKFE Futures and Options contracts. EPs are reminded that the minimum margin rates determined by HKEX are for their financially strongest clients. Appropriate arrangements should also be put in place to ensure the completeness and accuracy of margin rates applied.

(ii) ***Inadequate controls to ensure gross margining on Omnibus Accounts.*** Some EPs inadvertently netted the positions of underlying clients of Omnibus Account, resulting in the understatement of Client's minimum margin amount.

The Exchange wishes to draw EPs' attention to the circular "*Omnibus Accounts – Margin Requirements*" dated 7 December 1993 (Ref. No. MEM/CIR/9312050/017), which stipulates that all omnibus accounts must be maintained and margined on a gross position basis.

(iii) ***Allow Client whose account does not have sufficient collateral to establish new positions.*** In some instances, Clients only verbally committed to make fund transfer, or that the EPs had considered the Client's assets held in his/her non-HKFE accounts maintained with group affiliates as if the EP had received the collateral.

Pursuant to HKFE Rule 617(a), except for those who qualify as an established Client or for the purpose of closing out a Client's open positions, EPs shall not transact F.O. Business for any Client until and unless the EP has received from that Client collateral adequate to cover that Client's minimum margin requirement. EP should also ensure compliance with HKFE Rule 617(c) which stipulates the types of collateral acceptable for settling margin requirements.

Adequate and effective systems and controls should be put in place to ensure compliance with the requirements applicable to Client's minimum margin, especially when multiple trading systems with different controls are involved. Proper documentary evidence should be maintained for the assessment of margin sufficiency and justification of special approvals for manual override on cases of insufficient margin.

With regard to EPs who do not collect any margin from its clients under "execution-only" model, the Exchange is of the view that, if such EP is a Non-clearing Participant, it is not required to collect initial margin from the clients as it has appointed a General Clearing Participant to handle the clearing of all its trades. EP who is a Clearing Participant may also not be required to collect initial margin from the clients, provided that the risk of the trade is not assumed by the EP itself, but by the client's specified Clearing Participant. This may be achieved via a tripartite agreement among EP, Client, and Client's designated clearing broker; such agreement must clearly set out that the EP (as the execution broker) must give up the trade to the clearing broker as soon as possible and that the EP has the right to close out the Client's positions if there is failure, for any reason, in the give-up procedure.

3. Margin Call Policies & Procedures

- ***Failure to fulfil the monitoring and reporting obligations on margin calls and demands for variation adjustment in a consistent, effective and timely manner due to non-comprehensive procedures in handling margin calls.***

EPs are obliged to monitor continuously their Clients' ability to meet any margin calls and demands for variation adjustment, and notify HKFE in the event any Client has failed to meet two or more successive calls which in aggregate exceed HK$ 150,000. Such monitoring and reporting should continue on each Business Day subsequent to the initial notification until the aggregate amount of default falls below the said amount. In case the positions to which the margin call settlement failure relates to have been liquidated, EPs are still required to make the relevant notification to HKFE.

Proper arrangements and adequate guidelines should be in place to ensure effective monitoring and control in this regard, including but not limited to specifying the timeframe for margin call issuance and settlement deadlines in the policies and procedures, clear designation of responsible personnel and proper maintenance of margin call records.

With regard to the settlement of a margin call, EPs should note the requirements laid down in the circular "*Guidelines on Margin Procedures for the Purpose of Minimum Requirement pursuant to Rule 617 (March 3, 1997)*" (Ref. No. AUD/9703001). A maintenance margin call can be met by a subsequent increase in the equity balance of the account up to the corresponding initial margin requirement; whereas an initial margin call for established Clients may be cancelled if the positions, to which the initial margin relates, are opened and closed out within the same T Session or within the same T+1 Session (i.e. day trades).

4. 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.

5. Policies and Procedures

- ***Inadequate and lack of regular review on written policies and procedures.*** Some EPs did not establish proper written policies and procedures governing the business activity in the Priority Areas while some EPs did not conduct regular review even though such policies and procedures were in place.

The Exchange wishes to remind EPs that adequate policies and procedures should be established to ensure ongoing compliance with the relevant rules and requirements. Regular review and revision should also be conducted to ensure they are consistent, effective and up-to-date.

Appendix 2

Compliance Reminder on Risk Management

(Applicable to Clearing Participants[2] only)

Risk management is one of the key responsibilities of Clearing Participants ("CPs") of HKSCC, HKCC and SEOCH (collectively, the "Clearing Houses"), as set out under the admission materials and relevant rules and procedures of the Clearing Houses.

CPs should set up robust risk management frameworks and controls, so as to ensure the proper assessment, monitoring and mitigation of key risks (including but not limited to, credit risk, liquidity risk, operational risk, market risk and capital) at all times.

In the 2018 Annual Attestation and Inspection Programme, control weaknesses were found in the following risk management areas:-

1. Stress Testing

- ***Absence of proper stress testing for its own or clients' exposure on HKEX's products, particularly on non-linear products such as options.***

Stress testing of non-linear products (e.g. options) is crucial to CPs since the losses of non-linear products increase exponentially under extreme scenarios. CPs with significant activities in non-linear products are expected to implement and conduct stress testing regularly and at least on a weekly basis, to evaluate the potential loss of its portfolio under extreme but plausible market conditions. Proper stress testing policies and procedures should also be established to clearly set out the stress testing methodology, frequency and the review and escalation mechanism.

Further information on stress testing can be found in the Annex.

2. Credit Exposure Management - Monitoring of Position Limit and Late Payment Management

- ***Lack of sufficient and effective monitoring and control on credit exposures***

Client limits (e.g. position limit, credit limit and/or trading limit) are imposed by CPs on their clients for controlling their credit exposure. It was noted that while CPs had set up limits for their clients, had not implemented any system to monitor their clients' positions against limits assigned to such clients and/or had allowed clients to transact based on their clients' available funds instead. Policies and procedures in relation to the treatment of outstanding loan payments were also found to be inadequate where follow-up, escalation and provisioning / write-off of such loans were not clearly set out.

CPs are reminded to implement appropriate and adequate monitoring arrangements in this regard, including but not limited to inputting the limits assigned to clients into the system for continuous monitoring. Failure to implement appropriate and adequate monitoring arrangements may result in regulatory breaches, which could be grounds for disciplinary actions.

3. Notification of Change in Operations and Risk Control Plan

- ***Failure to notify the Clearing Houses when there is a change in operations and risk control, including but not limited to changes arising from engaging in new business activities***

According to the admission material (Note 2 of Attachment 2 of the "*Explanatory Notes for applications for Participantship and Trading Right*") and the responsibilities set out under CCASS Rule 1703(iii), HKCC Rule 214(n) or SEOCH Rule 403(17), CPs are required to notify the Clearing Houses of any change in the details supplied to the respective Clearing Houses at the time of admission and thereafter including, among other things, updated risk and control documents when engaging in new business activities such as proprietary trading and margin financing.

4. Controls on Managing Defective Securities Risk associated with Deposit of Physical Certificates

- ***Absence of proper control measures that can effectively limit the risks or losses arising from defective securities***

CPs are responsible for defective securities they deposited into the CCASS Depository and their responsibilities are set out under Section 7.2.2 of CCASS Operational Procedures. Proper measures should be implemented on managing defective securities risk, which may include the following:

(i) procedures in place to put on hold the shares from utilization (e.g. for settlement of short positions) until re-registration into the name of HKSCC Nominees Limited is completed (i.e. when the share registrar has confirmed the validity and good title of the participant's physical certificates);

(ii) withhold the sales proceeds from its selling clients until completion of re-registration of the physical certificates; or

(iii) other measure(s) to manage the risk involved in utilizing shares with immediate credit given before physical certificates are confirmed to be good and valid.

5. Control, Monitoring and Staff Training in relation to the Fulfillment of Settlement Obligations

- ***Inadequate monitoring and controls over Settlement Operations for ensuring the timely completion of steps essential to fulfill the settlement obligation of the Clearing Houses***

CPs should put in place adequate and comprehensive internal controls and procedures governing the settlement process; and all relevant officers should strictly follow the prescribed timeline to facilitate smooth operation, especially for backup or holiday covers. Examples of effective tools for settlement controls include: a checklist with maker-checker signoff over key settlement steps (with timelines clearly set out for each step); or a system dashboard to monitor the timeliness in completing each key settlement steps with automatic escalation/alerts.

CPs are advised that the review of funding sufficiency at market close should be based on the actual position data or settlement reports disseminated by the Clearing Houses. By relying on internal position data (instead of Clearing Houses' data / report) during the funding forecast/arrangement process, CPs may fail to capture errors caused by internal system or manual process e.g. incorrect/incomplete positions net-down in HKCC / SEOCH. This would lead to an incorrect forecast of the settlement amount and may result in payment failure.

CPs should keep abreast of circulars issued by the Clearing Houses and conduct regular reviews on their operation procedures to ensure compliance with the relevant rules and requirements at all times. Among other things, CPs should ensure that their settlement arrangements (including arrangements during holiday periods) comply with the latest requirements stipulated by the Clearing Houses.

CPs should ensure that their staff has adequate and up-to-date knowledge on operational risk and control, payment obligations and the consequences of failure in meeting the obligations of the Clearing Houses. CPs should arrange for their staff to attend training courses, such as the one mentioned in the circular *"Training course jointly organized by HKEX and HKSI Institute"* issued by the Clearing Houses on 31 December 2018 (Ref. No. CD/CDCRM/243/2018) and make reference to circulars such as *"Reminder on Payment Obligations of Clearing Participants"* issued by the Clearing Houses on 26 January 2018 (Ref. No. CD/CDCRM/021/2018, CD/CDCRM/022/2018 and CD/CDCRM/023/2018) to enhance the staff's awareness on payment obligations of the Clearing Houses.

6. Risk Governance and Operational Capability

- ***Inadequate control in relation to risk management governance***

A proper risk governance framework usually involves establishment of a risk management committee for exercising senior management oversight over key risk areas. In some instances, CPs did not keep proper meeting records/reports to show that a committee meeting has been conducted or the focus items discussed by senior management at the meeting.

CPs should establish a proper risk governance framework (e.g. by setting up a risk management committee with regular meetings) and maintain documentation to demonstrate senior management's oversight of issues and to keep track of their discussion and monitoring over key risk areas, in particular, on the treatment of credit risk, concentration risk and monitoring of sufficiency of liquid capital.

7. Business Continuity Plan

- ***Inadequate arrangement in place to ensure its fulfillment of the Clearing Houses' settlement obligations under contingent situation***

To cope with disruptions that may impair CPs' ability to meet settlement obligations with the Clearing Houses, CPs should develop and maintain a business continuity plan, which should clearly set out the actions that the firm would take during contingent scenarios.

Annex

31 Oct 2018

STRESS TESTING ON OPTIONS

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Clearing Risk Management

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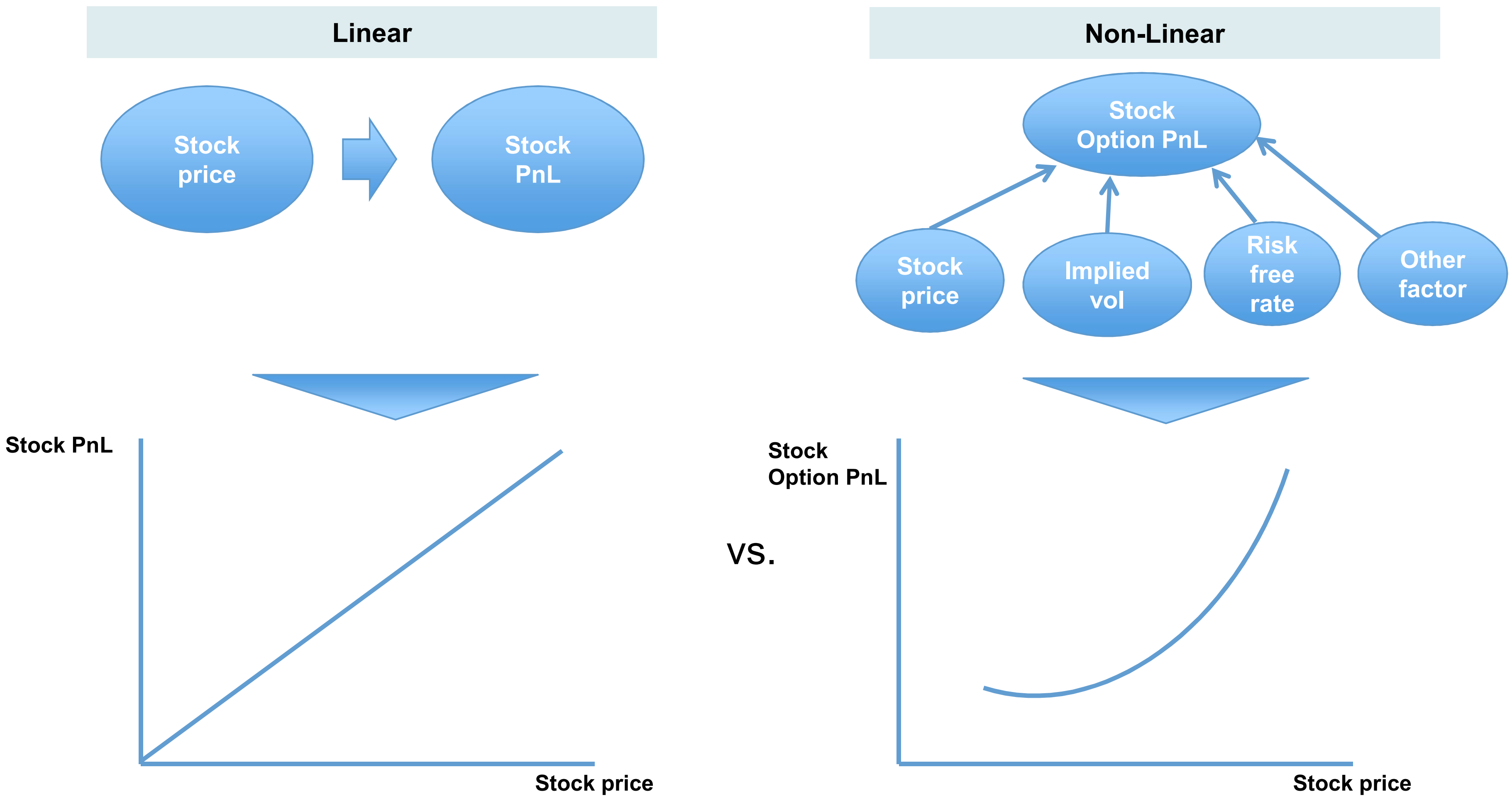
AGENDA

1. Background
2. Linear Products vs Non-Linear Products
3. Stress Testing Calculation

Overview

- Stress testing is the analysis / simulation technique widely used by institutions to evaluate the potential portfolio loss under extreme but plausible market condition.
- Most financial institutions use stress testing as a daily risk management tool e.g. set operational limits, allocate resources to ensure liquidity and capital adequacy for the aforesaid loss.
- Stress testing of non-linear products is crucial to Clearing Participants (CPs) as it tells CPs how the loss of non-linear products increases exponentially under extreme scenarios.
- CPs are strongly recommended to have proper stress testing in place for it's own or clients' exposure on HKEX's products, particularly on non-linear products such as option.

Linear vs. Non-Linear Products



- ***The change in risk exposure of option is exponential and subject to multiple risk factors, which is different from stock.***

Stress Testing Calculation - SEOCH

Example 1: Bullish view on China Life (2628) on 25 Oct 2018

- Short 1 China Life Oct18 put option at HK$15.5 strike price (x1000 shares)
- China Life closed at HK$ 17.1
- Margin Requirement is HK$ 316

	Profit and Loss in HK$	
Stock price movement assumption	**Short 1 put options at HK$15.5 strike price**	**Margin deficit per contract**
-9%	HK$ -320	HK$ -4
-15%	HK$ -1,010	HK$ -694
-22%	HK$ -2,140	HK$ -1,824

- Additional loss incurred during the positions close-out (3%* or more in normal condition, see below)
- Bid-ask spread will further widen in the stress condition

Bid Orders						Ask Orders	
	Type	BQty	Bid	Ask	AQty	Type	
	LMT	50	0.55	0.58	106	LMT	HKGS
	LMT	200	0.55	0.58	200	LMT	HKOF
	LMT	200	0.55	0.59	50	LMT	HKIM
	LMT	115	0.54	0.59	101	LMT	HKCT
	LMT	1	0.53	0.59	40	LMT	HKYK
	LMT	30	0.53	0.60	200	LMT	HKNH
	LMT	68	0.53	0.60	30	LMT	HKBN
	LMT	25	0.51	0.60	68	LMT	HKIB
	LMT	25	0.41				

- ***Stress loss of short option is massively understated if treated like stock in stress calculation (Leverage effect)***

* [(0.58-0.55)/2]/0.55=3%

Stress Testing Calculation - HKCC

Example 2: Bullish view on Hang Seng Index

- Short 1 Hang Seng Index Mar19 put option at 26,400 strike price
- Hang Seng Index closed at 26,227.7
- Margin Requirement is HK$ 132,210

	Profit and Loss in HK$	
Stock price movement assumption	**Short 1 put options at 26,400 strike price**	**Margin deficit per contract**
-5%	HK$ -37,350	HK$ 0
-10%	HK$ -84,800	HK$ 0
-20%	HK$ -201,800	HK$ -69,590

- Additional loss incurred during the positions close-out (0.7%* or more in normal condition, see below)
- Bid-ask spread will further widen in the stress condition

Bid Orders							Ask Orders
	Type	BQty	Bid	Ask	AQty	Type	
	LMT	8	735	745	8	LMT	HKOPT
	LMT	7	732	745	7	LMT	HKNHT
	LMT	5	732	751	7	LMT	HKYKI
	LMT	7	731	759	7	LMT	HKMPF
	LMT	7	729	763	5	LMT	HKLQC
	LMT	5	723	773	5	LMT	HKJPM
	LMT	5	720	774	5	LMT	HKMV
	LMT	5	704	775	5	LMT	HKSG
	LMT	5	703	780	5	LMT	HKSG
				792	5	LMT	HKBG

- ***Stress loss of short option is massively understated if treated like stock in stress calculation (Leverage effect)***

* [(745-735)/2]/735=0.7%

Compliance Reminder on China Connect Rules

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

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 ("SEHK Rules"), including without limitation to Chapters 5, 14, 14A and 14B at all times, regarding to the trading of China Connect Securities.

In the 2018 Annual Attestation and Inspection Programme, some CCEPs and TTEPs were found deficient in the following areas:-

1. 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.***

Pursuant to SEHK Rule 590 and as stated in paragraph 1.43 of the Stock Connect Frequently Asked Questions ("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 as referred to in SEHK Rule 590(2). 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 SEHK Rules 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 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.***

- ***Failure to communicate clearly the scope of services provided to the clients*. We noted that some CCEPs included in the client agreement certain provisions and clauses related to services which they did not provide to the clients in the client agreement.**

To comply with the requirements under and without limitation to SEHK 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, and clearly communicate the scope of services provided to the clients.

3. 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 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.

4. 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 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. 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 SEHK Rules 14A08, 14B08, 14A09 and 14B09, 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.

6. 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 SEHK Rules 14B06(16) to (18).

7. Off-exchange Trades or Transfers

- ***Inadequate policies, procedures and controls to ensure that off-exchange trades or transfers are prohibited.*** In particular, we noted that some CCEPs failed to establish written policies and procedures in relation to handling of off-exchange trades or transfers for the purposes prescribed under SEHK Rules 14A12 and 14B12.

To comply with the requirements under SEHK Rules 14A12 and 14B12, CCEPs and TTEPs shall put in place adequate controls to prevent or detect non-trade transfers or to handle those permitted under SEHK Rules 14A12(2) and 14B12(2).

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.

9. Policies and Procedures

- ***Inadequate and lack of regular review on policies and procedures.*** Some EPs did not establish proper written policies and procedures governing the business activity in the Priority Areas while some EPs did not conduct regular review even though such policies and procedures were in place.

The Exchange wishes to remind EPs that adequate policies and procedures should be established to ensure ongoing compliance with the relevant rules and requirements. Regular review and revision should also be conducted to ensure they are consistent, effective and up-to-date.