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Hong Kong Exchanges and Clearing Limited is a recognized exchange controller under the Securities and Futures Ordinance which is the controller of The Stock Exchange of Hong Kong Limited, Hong Kong Futures Exchange Limited, Hong Kong Securities Clearing Company Limited, The SEHK Options Clearing House Limited, HKFE Clearing Corporation Limited and OTC Clearing Hong Kong Limited.

通告 CIRCULAR

Subject: Closing of 2020 Annual Attestation and Inspection Programme

Enquiry: surveillance@hkex.com.hk

With reference to the circular (Ref. No.: MSM/002/2020) dated 28 February 2020, the Hong Kong Exchanges and Clearing Limited (“HKEX”) is pleased to announce that it has successfully completed the 2020 Annual Attestation and Inspection Programme (the “2020 Programme”).

Under the 2020 Programme, HKEX inspected 26 Exchange Participants¹ and Clearing Participants² (collectively, the “Participants”). HKEX also received 100% response on self-attestation questionnaires from 782 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 47 Participants with recommendations for improvement in a number of areas, including:

- Lack of position / trading limit set for clients, including established Clients, for exposure monitoring purpose;
- Inadequate controls / arrangements for fulfilling certain BCAN requirements;
- Inadequate stress testing in terms of frequency and stressed scenarios on proprietary / client exposures;
- Inadequate controls / arrangements to ensure fulfillment of the Clearing Houses’ settlement obligations under contingent situation.

With a view to raising the awareness of Participants’ compliance in the Priority Areas, we set out our key findings and elaborate on 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

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 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.

Felix Wang
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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”). EPs are also advised to establish and maintain proper policies and procedures, as well as robust systems and controls, to ensure on-going compliance to these rules and other applicable regulatory requirements.

In the 2020 Annual Attestation and Inspection Programme, some EPs were found deficient in the following areas:-

1. Assessment of Established Clients / Exclusive Day Trader

- ***Failure to conduct the established Clients assessment properly for its Clients as set out in the circular “[Margin Requirements under Rule 617](#)” dated 22 June 2017 (Ref No. MO/DT/089/17).*** Some EPs did not conduct any assessment on certain Clients (including affiliates, shareholders and day traders) while allowing them to create new positions without sufficient collateral. We also noted instances where no on-going review was conducted on the established Clients.

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

- (i) All Clients must be subject to proper assessment before they can be qualified as established Clients.
 - (ii) 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.
- ***Requirements of Exclusive Day Trader assessment were not properly interpreted or implemented, particularly on Scenario 2 outlined in the circular dated 22 June 2017 (Ref No. MO/DT/089/17).*** We note that some EPs did not conduct any Exclusive Day Trader assessment, while others only conducted the required assessment once during the initial established Client assessment, instead of on an on-going basis.

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

- (i) For the purpose of Scenario 2 Condition A, the assessment is required to be conducted on an on-going basis. The Exchange is of the view that EPs would have satisfied this requirement if the assessment is conducted at least once a month.

- (ii) For the purpose of Scenario 2 Condition B, EPs need to ensure 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). 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 having adequate collateral on the types of F/O Contracts that has a lower or the same minimum margin requirement as a mini-HSI futures; nevertheless, the number of contracts that can be executed would not be limited by those positions previously held overnight. However, EPs are required to collect sufficient upfront margin prior to the transaction if the relevant trade is a HSI futures or a contract which requires higher margin than a mini-HSI futures.
 - (iii) EPs must put in place appropriate arrangements in a timely manner 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.
- ***Failure to maintain proper documentation on the assessment***
- (i) ***Established Client Assessment.*** 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 justifications for approving or rejecting certain Clients. For example, the documentation omitted to reflect whether and why it may be satisfied that a Client has maintained a consistently sound financial position. For the avoidance of doubt, when assessing the soundness of the Client's financial position, an EP should not 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.).

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 the approval for established Clients should also be maintained.

- (ii) ***Exclusive Day Trader Assessment.*** In some instances, the assessment forms did not make adequate reference to support their respective outcome. For example, details such as the relevant overnight trade(s) being considered and the corresponding minimum margin requirement(s) (per contract) were omitted.

Information and records in use should allow EPs to conduct the assessment in accordance with the requirements set out in the circular dated 22 June 2017 (Ref No. MO/DT/089/17). The assessment and the outcome should be properly documented and supported by documentary evidence.

- ***Inadequate 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 regulatory requirements. We also noted instances where the policies and procedures do not accurately or fully reflect the actual practice.

As set out in the circular dated 22 June 2017 (Ref No. MO/DT/089/17), EPs are expected to have implemented appropriate measures to fully comply with the requirements under HKFE Rule 617. 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 and able to track the eligibility status of established Clients.

2. Trading Limits for Established Clients

- ***Failure to set trading limits for established Clients.*** We noted that some EPs did not set any trading limits for their established Clients, while others implemented some form of risk measures limiting the overall exposure to a certain extent. For example, some EPs required their established Clients to have collateral to cover a portion of the minimum margin requirement before transacting F.O. Business for their established Clients. It is important to note that those risk measures may not be sufficient to limit the exposure under a volatile market situation.

As set out in the circular dated 22 June 2017 (Ref No. MO/DT/089/17), EPs are expected to set trading limits for their established Clients based on the EP's assessment on the Client's financial position.

3. Initial Margin Call for Established Clients

- **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 for new positions established in T Session but subsequently closed out in T+1 session.

Under HKFE Rule 617(b), in respect of a new position established on behalf of the established Client on T-day, EPs must issue a call for the amount of minimum margin within T-day, and advise that the minimum margin is due as soon as practicable after the call but in no event later than the next Business Day. The issued initial margin call would not be considered as being settled by closing out the relevant positions subsequently. Moreover, if an established Client did not settle an initial margin call by cash, the relevant position should not be counted as an overnight position for satisfying Scenario 2 Condition A in the Exclusive Day Trader assessment.

4. Client's Minimum Margin

- **Failure to timely apply Client's minimum margin rates.** In some instances, some EPs did not ensure that latest minimum margin rates are applied before the commencement of trading³ as stated in the margin rate circulars issued by the Exchange from time to time.

Pursuant to HKFE Rule 617(d), the Exchange shall from time to time stipulate the minimum amount of margin required to be collected by EPs in respect of Exchange Contracts executed for Clients. EPs are reminded to put in place appropriate arrangements to ensure the timeliness, completeness and accuracy of margin rates being applied. Separately, 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 F/O Contracts. EPs are reminded that the minimum margin rates determined by HKEX are for their financially strongest clients.

- **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 inappropriately considered the Client's assets held in his/her non-HKFE accounts maintained with group affiliates as collateral received from the Clients.

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.

³ The earliest trading session commences at 8:30am Hong Kong time. For details of the trading hours for different contracts, please refer to [HKEX website](#).

- ***Failure to maintain appropriate measures on manual override of system controls.***
In some instances, manual override of system controls was permitted to cater for need(s) of specific business model. This practice may be acceptable, provided that (i) the manual override would not result in any regulatory breach and (ii) regular independent review of the manual overrides is conducted to ensure the controls remain effective.

Adequate and effective systems and controls should be put in place to ensure compliance with the requirements applicable to Client's minimum margin. Proper written policies and procedures as well as documentary evidence should be maintained for the assessment of margin sufficiency and justification of special approvals for manual override in cases of insufficient margin. Independent post-trade review on such special approvals should also be conducted on a regular basis to ensure that the manual overrides had not violated any of the applicable client margin requirements.

5. 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.***

Proper arrangements and adequate guidelines should be in place to ensure effective monitoring and control, and 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 for the monitoring and reporting obligation pursuant to the requirements under HKFE Rule 619, as well as proper maintenance of margin call records.

With regard to the end of day client margin calculation, EPs are advised to make reference to the Early and Final risk parameter files ("RPF") which are published by HKEX for calculating Clearing Houses' day-end margin, instead of the intra-day RPFs.

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 dated 3 March 1997](#)" (Ref. No. AUD/9703001), which stipulates that calls for margin can be met by cash deposits, while maintenance margin call can be met by a subsequent increase in the equity balance of the account up to the corresponding initial margin requirement.

6. Staff Training

- ***Inadequate staff training.*** Some EPs 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 EPs that they should provide staff with adequate and appropriate training both initially and on an on-going basis.

7. Policies and Procedures

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

Non-comprehensive policies and procedures may pose the risk of inconsistent handling the client margin requirements. The Exchange wishes to remind EPs that adequate policies and procedures should be established to ensure on-going 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 Participants⁴ 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 inadequacy) at all times.

In the 2020 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 market conditions. 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.

As a benchmark, the underlying movement adopted by Clearing Houses under extreme but plausible market conditions is $\pm 20\%$ for index options and $\pm 22\%$ for stock options.

Further information on stress testing can be found in the [Annex](#).

⁴ (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

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, trading limit and/or limits granted to DvP clients in stock trading to settle on T+2) 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, they 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. It was also noted that client limits, once granted, were not subject to regular review.

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 responsibilities set out under CCASS Rule 1703(iii), HKCC Rule 214(n) or SEOCH Rule 403(17) and with reference to the admission material (Note 2 of Attachment 2 of the "[Explanatory Notes for applications for Participantship and Trading Right](#)"), CPs are required to submit to the Clearing Houses 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 (i) proprietary trading; (ii) stock lending and borrowing; (iii) China Connect market; and (iv) margin financing. CPs are advised to notify and provide the following information to the Clearing Houses (by email to clearingcreditrisk@hkex.com.hk) when you engage in new business activities:-

- (i) Background of new business (including the commencement timeline, business strategic plan and target client sector)
- (ii) Financial projection (including the projected size⁵, revenue and profit for the first year of operation)
- (iii) Capital injection / funding plan
- (iv) Associated risks and corresponding risk measures

⁵ Examples of parameters to consider for each type of new businesses are set out below:

- (a) for proprietary trading, asset value and value-at-risk
- (b) for stock lending and borrowing, value and type of securities on loan
- (c) for China Connect market, transaction volume
- (d) for margin financing, list of acceptable stocks and loan book value

4. 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 relevant money and stock 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. For each key settlement task, sufficient buffer time should be allocated between the internal completion timeline and the Clearing Houses' settlement timelines, in order to allow exception handling process (e.g. additional transfer of funds) to be completed before the Clearing Houses' settlement timelines.

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 Clearing Houses. By relying on internal position data (instead of Clearing Houses' date/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/SEOC. This would lead to an incorrect forecast of the settlement amount and may result in payment failure.

CPs are also advised to regularly review its operational and funding backup arrangements to ensure their effectiveness. The review should include but not limited to (i) holiday backup arrangement of settlement and accounting officers; (ii) enabling money transfer through e-banking between house / client accounts and CPs' designated account for settlement and (iii) setting up overdraft facilities to provide contingency funding (including non-HKD settlement currency, e.g. CNY for China Connect Participants).

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 staffs (including their backup and holiday cover) have 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 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 7 February 2020 (Ref. No. [CD/CDCRM/034/2020](#), [CD/CDCRM/035/2020](#) and [CD/CDCRM/036/2020](#)) to enhance the staff's awareness on payment obligations of the Clearing Houses.

5. Risk Governance, Operational Capability and Risk Culture

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

A proper risk governance framework usually involves establishment of a risk 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 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.

CPs should also establish detailed policies and procedures to effectively manage the key risks. In this connection, the Appendix 2 of the [“*Explanatory Notes for Application for Participants and Trading Right*”](#) can serve as a reference of the Clearing House's latest expectation on a CP's risk management practices.

6. Third party service management

▪ ***Inadequate control in relation to system changes***

CPs should establish proper review and testing procedures in relation to any system changes. In some instances, CPs failed to spot the logic error during critical system enhancement (e.g. system changes on margin offset claim logic) made by third party system providers.

CPs are advised to strengthen its control on critical system changes, for example, system changes that has impact on settlement and margin calculation. Such controls should include (i) thorough user acceptance testing and (ii) parallel run to ensure a smooth transition.

7. Business Continuity Plan and Contingency Funding Arrangement

▪ ***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. In view of the latest COVID pandemic situation, CP should review its business continuity plan to consider whether it has granted sufficient authorization to the relevant colleagues during split team arrangement and whether the plan covering the contingency handling of the forthcoming trades (e.g. routing to a peer broker or timely stop the client orders) in case the operation capability is heavily impacted (e.g. due to quarantine of a large number of operational staff). CP should also enhance its capability to enable staff to remote access trading/clearing system.

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.