



**SECURITIES AND FUTURES COMMISSION**  
證券及期貨事務監察委員會

**Code of Conduct for Persons Licensed by or  
Registered with the Securities and Futures Commission**

證券及期貨事務監察委員會持牌人或註冊人操守準則



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證券及期貨事務監察委員會

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Commission**

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## Explanatory notes

The Commission will be guided by this Code of Conduct (“the Code”) in considering whether a licensed or registered person satisfies the requirement that it is fit and proper to remain licensed or registered, and in that context, will have regard to the general principles, as well as the letter, of the Code. For the purposes of the Code, a registered person includes a “relevant individual” as defined in section 20(10) of the Banking Ordinance (Cap.155), and “registered” shall be construed accordingly. The Code has been published in the Gazette.

Where the Commission has information which suggests that a licensed or registered person is not a fit and proper person to remain licensed or registered, it may conduct an investigation under section 182(1)(e) of the Securities and Futures Ordinance (Cap. 571) (“the SFO”). This information may refer to how the licensed or registered person conducts the business for which the person is licensed or registered or, in the case of an individual who is licensed or registered how he carries on the activity for which he is licensed or registered, or it may refer to other matters. The Commission places great importance on licensed or registered persons being fit and proper.

Licensed or registered persons should note the various Schedules to the Code. These are part of the Code and provide, among other things, supplemental materials such as risk disclosure statements. There are also specific Schedules of provisions that apply to licensed or registered persons which deal in securities and/or futures contracts listed or traded on The Stock Exchange of Hong Kong Limited or Hong Kong Futures Exchange Limited or trade in leveraged foreign exchange contracts. These are derived primarily from former rules of the Exchanges and the repealed Leveraged Foreign Exchange Trading Ordinance. Licensed or registered persons are expected under paragraph 12.1 of the Code to comply with the rules of exchanges and clearing houses of which they are members or participants.

To reflect the realities of today’s markets, the Commission recognizes that conduct of business principles should be flexible enough to differentiate between professional and non-professional investors and some provisions of the Code need not be observed in the case of professionals.



Unless otherwise specified or the context otherwise requires, words and phrases in the Code shall be interpreted by reference to any definition of such word or phrase in Part 1 of Schedule 1 to the SFO.

This Code does not have the force of law and should not be interpreted in a way that would override the provision of any law.





## **General principles**

The Commission has modelled the Code on principles developed and recognized by the International Organization of Securities Commissions and other principles the Commission believes to be fundamental to the undertaking of a licensed or registered person's business.

### **GP1. Honesty and fairness**

In conducting its business activities, a licensed or registered person should act honestly, fairly, and in the best interests of its clients and the integrity of the market.

### **GP2. Diligence**

In conducting its business activities, a licensed or registered person should act with due skill, care and diligence, in the best interests of its clients and the integrity of the market.

### **GP3. Capabilities**

A licensed or registered person should have and employ effectively the resources and procedures which are needed for the proper performance of its business activities.

### **GP4. Information about clients**

A licensed or registered person should seek from its clients information about their financial situation, investment experience and investment objectives relevant to the services to be provided.

### **GP5. Information for clients**

A licensed or registered person should make adequate disclosure of relevant material information in its dealings with its clients.

### **GP6. Conflicts of interest**

A licensed or registered person should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that its clients are fairly treated.



## **GP7. Compliance**

A licensed or registered person should comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of clients and the integrity of the market.

## **GP8. Client assets**

A licensed or registered person should ensure that client assets are promptly and properly accounted for and adequately safeguarded.

## **GP9. Responsibility of senior management**

The senior management of a licensed or registered person should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the firm. In determining where responsibility lies, and the degree of responsibility of a particular individual, regard shall be had to that individual's apparent or actual authority in relation to the particular business operations, and the factors referred to in paragraph 1.3 below.



# Code of conduct

## Interpretation and application

### 1.1 Definition: representative, registered person, person

- (a) A reference in the Code to a “representative” has the same meaning as under section 167 of the SFO.
- (b) A reference in the Code to a “registered person” means a “registered institution” and, except where the context otherwise requires, includes a “relevant individual” as defined in section 20(10) of the Banking Ordinance (Cap.155), and “registered” shall be construed accordingly.
- (c) A reference in the Code to a “person” includes any public body and any body of persons, corporate or unincorporate.

### 1.2 Interpretation

A reference in the Code to “it” or “its” in relation to a licensed or registered person shall, except where the context otherwise requires, be construed as including a reference to “him” or “his” (as the case may be).

### 1.3 Persons to which the Code applies

Although the Code applies to all licensed or registered persons in carrying on the regulated activities for which the persons are licensed or registered, the Commission recognizes that some aspects of compliance with the Code may not be within the control of a representative. In considering the conduct of representatives under the Code, the Commission will consider their levels of responsibility within the firm, any supervisory duties they may perform, and the levels of control or knowledge they may have concerning any failure by their firms or persons under their supervision to follow the Code.



#### **1.4 Effect of breach of the Code**

A failure by any person to comply with any provision of the Code that applies to it –

- (a) shall not by itself render it liable to any judicial or other proceedings, but in any proceedings under the SFO before any court the Code shall be admissible in evidence, and if any provision set out in the Code appears to the court to be relevant to any question arising in the proceedings it shall be taken into account in determining the question; and
- (b) the Commission shall consider whether such failure tends to reflect adversely on the person's fitness and properness.



## **Honesty and fairness**

### **2.1 Accurate representations**

Where a licensed or registered person advises or acts on behalf of a client, it should ensure that any representations made and information provided to the client are accurate and not misleading.

### **2.2 Fair and reasonable charges**

The general course of dealing or advising concerning a client, the provision of margin lending, and the charges, mark-ups, or fees affecting a client should be fair and reasonable in the circumstances, and be characterized by good faith.

### **2.3 Advertising**

A licensed or registered person should ensure that invitations and advertisements do not contain information that is false, disparaging, misleading or deceptive.

### **2.4 Anti-bribery guidelines**

A licensed or registered person should be familiar with the Prevention of Bribery Ordinance (Cap. 201) ("PBO") and follow related guidance issued by the Independent Commission Against Corruption. The PBO may prohibit an agent (normally an employee) from soliciting or accepting an advantage without the permission of the principal (normally the employer) when conducting the principal's business. A person who offers the advantage may also commit an offence.



## **Diligence**

### **3.1 Prompt execution**

A licensed or registered person should take all reasonable steps to execute promptly client orders in accordance with clients' instructions.

### **3.2 Best execution**

A licensed or registered person when acting for or with clients should execute client orders on the best available terms.

### **3.3 Prompt and fair allocation**

A licensed or registered person should ensure that transactions executed on behalf of clients are promptly and fairly allocated to the accounts of the clients on whose behalf the transactions were executed.

### **3.4 Advice to clients: due skill, care and diligence**

When providing advice to a client a licensed or registered person should act diligently and carefully in providing the advice and ensure that its advice and recommendations are based on thorough analysis and take into account available alternatives.

### **3.5 No withholding of orders for convenience**

A licensed or registered person should not withdraw or withhold client orders for its own convenience or for the convenience of any other person. For the avoidance of doubt, this only applies in respect of market orders and limit orders that can be executed in the market at the relevant price.

### **3.6 Collection of margins**

In dealing or trading for its clients in securities, futures contracts or leveraged foreign exchange contracts that require the provision of margin (including collateral), a licensed or registered person should collect promptly from clients any amounts due as margin.



### **3.7 Separate accounts**

A licensed or registered person should keep separate accounts for each client for dealings in securities, futures contracts or trading in leveraged foreign exchange contracts, and where relevant, for transactions concluded on a cash basis or a margin basis.

### **3.8 Derivative position and reporting limits**

A licensed or registered person should inform clients of applicable derivative position and reporting limits and, in relation to positions maintained with the licensed or registered person, monitor compliance with those limits.

### **3.9 Order recording**

- (a) Except as otherwise provided in Schedule 3 and Schedule 6 to the Code, a licensed or registered person should record and immediately time stamp records of the particulars of the instructions for agency orders and internally generated orders (such as proprietary accounts and staff accounts).
- (b) Where order instructions are received from clients through the telephone, a licensed or registered person should use a telephone recording system to record the instructions and maintain telephone recordings as part of its records for at least six months.
- (c) A licensed or registered person should prohibit its staff members from receiving client order instructions through mobile phones when they are on the trading floor, in the trading room, usual place of business where order is received or usual place where business is conducted, and should have a written policy in place to explain and enforce this prohibition.

#### **Notes**

The Commission notes that mobile telephones are widely used in Hong Kong. The use of mobile phones for receiving client order instructions is strongly discouraged. However, where orders are accepted by mobile

*The revisions to paragraph 3.9 will take effect on 1 Dec 2012.*



phones outside the trading floor, trading room, usual place of business where order is received or usual place where business is conducted, staff members should immediately call back to their licensed or registered person's telephone recording system and record the time of receipt and the order details. The use of other formats (e.g. in writing by hand) to record details of clients' order instructions and time of receipt should only be used if the licensed or registered person's telephone recording system cannot be accessed.

### **3.10 Best interests of clients**

A licensed or registered person should act in the best interests of its clients in providing services or recommending the services of an affiliated person to its clients.

### **3.11 Use of gifts by distributors in promoting a specific investment product**

In promoting a specific investment product to a client, a licensed or registered person should not offer any gift other than a discount of fees or charges.



## **Capabilities**

### **4.1 Fit and proper staff**

A licensed or registered person should ensure that any person it employs or appoints to conduct business is fit and proper and otherwise qualified to act in the capacity so employed or appointed (including having relevant professional training or experience).

### **4.2 Staff supervision**

A licensed or registered person should ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it to conduct business on its behalf.

### **4.3 Internal control, financial and operational resources**

A licensed or registered person should have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients and other licensed or registered persons from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.

#### **4.3A Risk mitigation requirements and margin requirements in relation to non-centrally cleared OTC derivative transactions**

A licensed person which enters into non-centrally cleared OTC derivative transactions should implement the risk mitigation requirements and margin requirements set out in Part I and Part III of Schedule 10 respectively.

## Information about clients

### 5.1 Know your client: in general

A licensed or registered person should take all reasonable steps to establish the true and full identity of each of its clients<sup>1</sup>, and of each client's financial situation, investment experience, and investment objectives. Where an account opening procedure other than a face-to-face approach is used, it should be one that satisfactorily ensures the identity of the client.

#### 5.1 A Know your client: investor characterization

- (a) A licensed or registered person should, as part of the know your client procedures, assess the client's knowledge of derivatives and characterize the client based on his knowledge of derivatives.
- (b) Where a client without knowledge of derivatives wishes to purchase a derivative product (hereafter refer to as a "transaction" in this paragraph) which is:
  - (i) traded on an exchange and the licensed or registered person has not solicited the client or made a recommendation to the client in relation to the proposed transaction, the licensed or registered person should explain the relevant risks associated with the product to the client;
  - (ii) not traded on an exchange and the licensed or registered person has not solicited the client or made a recommendation to the client in relation to the proposed transaction, the licensed or registered person should warn the client about the transaction and, having regard to the information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence, particularly the fact that he is a client without knowledge of derivatives, the licensed or registered person should provide appropriate advice to the client as to whether or not the transaction is

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<sup>1</sup> Please refer to the Commission's website regarding account opening approaches that the Commission would consider to be acceptable for the purposes of this paragraph.

suitable for the client in all the circumstances. Records of the warning and other communications with the client should be kept. If the transaction is assessed to be unsuitable for the client, the licensed or registered person may only proceed to effect the transaction if to do so would be acting in the best interests of the client in accordance with the general principles of the Code.

## **5.2 Know your client: reasonable advice**

Having regard to information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence, the licensed or registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances.

## **5.3 Know your client: derivative products**

A licensed or registered person providing services to a client in derivative products, including futures contracts or options, or any leveraged transaction should assure itself that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products.

## **5.4 Client identity: origination of instructions and beneficiaries**

- (a) Subject to paragraph 5.4(e), a licensed or registered person should be satisfied on reasonable grounds about:
  - (i) the identity, address and contact details of :
    - (A) the person or entity (legal or otherwise) ultimately responsible for originating the instruction in relation to a transaction; and
    - (B) except in the case of paragraph 5.4(d) below, the person or entity (legal or otherwise) that stands to gain the commercial or economic benefit of the transaction and/or bear its commercial or economic risk; and

- (ii) the instruction given by the person or entity referred to in paragraph 5.4(a)(i)(A).
- (b) A licensed or registered person should keep in Hong Kong a record of the details referred to in paragraph 5.4(a) and give the Commission access to that record upon request.
- (c) A licensed or registered person should not do anything to effect a transaction unless it has first complied with paragraphs 5.4(a) and (b).
- (d) In relation to a collective investment scheme or discretionary account, the "entity" referred to in paragraph 5.4(a) is the collective investment scheme or account, and the manager of that collective investment scheme or account, not those who hold a beneficial interest in that collective investment scheme or account (e.g., the unitholders of a unit trust).
- (e) Paragraph 5.4(a) applies only where the transaction involves securities or futures contracts that are listed or traded on a recognized stock market or a recognized futures market or a derivative, including an over-the-counter derivative, written over such securities or futures contracts.

## **5.5 Know your client: complex products**

- (a) Subject to paragraph 5.5(b), a licensed or registered person providing services to a client in complex products should ensure that –
  - (i) a transaction in a complex product is suitable for the client in all the circumstances;
  - (ii) sufficient information on the key nature, features and risks of a complex product is provided so as to enable the client to understand the complex product before making an investment decision; and
  - (iii) warning statements in relation to the distribution of a complex product are provided to the client in a clear and prominent manner.

- (b) For complex products which are also derivative products traded on an exchange in Hong Kong or in a specified jurisdiction, where there has been no solicitation or recommendation, a licensed or registered person is not required to comply with paragraph 5.5(a) but must still comply with paragraphs 5.1A and 5.3. For derivative products traded on an exchange which is not in a specified jurisdiction, a licensed or registered person should comply with paragraph 5.5(a) unless such product could reasonably be treated on the same basis as derivative products traded on an exchange in Hong Kong or in a specified jurisdiction.

#### Notes

“Complex product” refers to an investment product whose terms, features and risks are not reasonably likely to be understood by a retail investor because of its complex structure.

Set out below are factors to determine whether an investment product is complex or not:

- (i) whether the investment product is a derivative product;
- (ii) whether a secondary market is available for the investment product at publicly available prices;
- (iii) whether there is adequate and transparent information about the investment product available to retail investors;
- (iv) whether there is a risk of losing more than the amount invested;
- (v) whether any features or terms of the investment product could fundamentally alter the nature or risk of the investment or pay-out profile or include multiple variables or complicated formulas to determine the return; and

Note: This would include, for example, investments that incorporate a right for the investment product issuer to convert the instrument into a different investment.

- (vi) whether any features or terms of the investment product might render the investment illiquid and/or difficult to value.

A licensed or registered person should refer to the guidance (eg, guidelines and FAQs) issued by the Commission from time to time for examples of

complex products, lists of specified jurisdictions, information on the key nature, features and risks of a complex product and warning statements in relation to the distribution of a complex product that should be provided to its clients.

## **5.6 Investor identification — on-exchange orders and off-exchange trades reportable to SEHK**

- (a) This paragraph applies to a relevant licensed or registered person. The obligations set out in this paragraph do not apply to an order or trade of odd lots of listed securities traded on the odd lot/special lot market of SEHK (save for underlying orders in an executed aggregated order) and transaction(s) reported via SEHK's trade amendment system.
- (b) For the purposes of this paragraph:
  - (i) “aggregated order” means an order which comprises two or more buy orders and/or sell orders for the same listed security placed by different clients, which may be executed as an on-exchange order or off-exchange order;
  - (ii) “BCAN” means a “Broker-to-Client Assigned Number”, being a unique identification code in the format prescribed by SEHK, generated by a relevant licensed or registered person in accordance with SEHK's requirements;
  - (iii) “BCAN-CID Mapping File” means the data file containing the BCAN and CID of all clients of a relevant licensed or registered person in the format prescribed by SEHK from time to time;
  - (iv) “CID” means the client identification data as described in paragraph 5.6(n);
  - (v) “direct client” means the most immediate client of a relevant licensed or registered person which has placed or proposes to place an on-exchange order or off-exchange order through a securities trading account with that person;

- (vi) “client” has the meaning as set out in paragraph 5.6(m);
- (vii) “listed security” means any security listed or traded on SEHK’s trading system;
- (viii) “odd lot” means the number of shares of a corporation which is less than one board lot as shown on SEHK’s website;
- (ix) “odd lot/special lot market” means a market established for the trading of odd lots as described in and pursuant to SEHK’s requirements;
- (x) “OE Trade Reporting” refers to the reporting of an off-exchange trade directly by an exchange participant to SEHK according to its rules;
- (xi) “on-exchange order” means a buy or sell order for a listed security which is to be executed on the automatic order matching system operated by SEHK;
- (xii) “off-exchange order” means a buy or sell order for a listed security which is to be executed outside SEHK’s automatic order matching system and the consummation of which would result in an off-exchange trade;
- (xiii) “off-exchange trade” means a trade of a listed security which takes place outside SEHK’s automatic order matching system but is reportable by exchange participants to SEHK pursuant to its rules;
- (xiv) “relevant licensed or registered person” means a licensed or registered person which:
  - (1) submits (or arranges to submit) for execution an on-exchange order;
  - (2) carries out an off-exchange order; or
  - (3) conducts OE Trade Reporting,

in connection with its carrying out any of the specified activities;

- (xv) “SEHK” means The Stock Exchange of Hong Kong Limited; and
  - (xvi) “specified activities” means (i) proprietary trading and (ii) the provision of securities brokerage services for a person in respect of orders placed through an account opened and maintained for that person.
- (c) Subject to paragraphs 5.6(d) and 5.6(e), a relevant licensed or registered person is required to:
- (i) assign a BCAN to each of its clients, the BCAN to be linked permanently and exclusively to that client; and
  - (ii) collect CID of each client to whom it has assigned a BCAN pursuant to paragraph 5.6(c)(i) and prepare a BCAN-CID Mapping File for submission to SEHK’s data repository.

Where a client holds more than one securities trading account with a relevant licensed or registered person, a relevant licensed or registered person may assign more than one BCAN to the client to distinguish between orders placed through different accounts. However, orders placed through the same securities trading account must be tagged with the same BCAN.

- (d) Where an on-exchange order or off-exchange order is carried out through an intermediating chain of brokers, the last relevant licensed or registered person in the chain (starting with the exchange participant executing the order and working backwards), whose direct client is not a relevant licensed or registered person, shall be the party responsible for assigning the BCAN, collecting CID, preparing the BCAN-CID Mapping File, and submitting the BCAN-CID Mapping File to SEHK either directly or indirectly through another relevant licensed or registered person.



- (e) Where an on-exchange order or off-exchange order is placed from a securities trading account held jointly by two or more persons, a relevant licensed or registered person is required to assign a BCAN to the account and not to the account holders. This BCAN should be distinct from any BCAN assigned to any joint account holder who holds a securities account with the relevant licensed or registered person in his sole name. The BCAN-CID Mapping File containing the CID of all holders of that joint account should be submitted by the relevant licensed or registered person to SEHK under the BCAN assigned to the joint account.
- (f) A relevant licensed or registered person should ensure that the order information for each (i) on-exchange order which it submits (or arranges to submit) to SEHK, (ii) off-exchange order it carries out either directly or indirectly through another relevant licensed or registered person, and (iii) trade when it conducts OE Trade Reporting, includes the CE number of the licensed or registered person (being the unique identifier assigned by the SFC) as well as (1) a BCAN assigned to the relevant client or joint account or (2) a specific code as prescribed by SEHK in the case of an aggregated order as the case may be.
- (g) Where a relevant licensed or registered person transmits an on-exchange or off-exchange order to another person who is not a licensed or registered person in an intermediating chain of brokers for execution, the relevant licensed or registered person should take reasonable steps (including putting in place arrangements with the receiving person) to ensure that the BCAN (and, in the case of an aggregated order, the specific code prescribed by SEHK) assigned and tagged to the order by the relevant licensed or registered person would be transmitted by the receiving person to the next relevant licensed or registered person in the intermediating chain.
- (h) In the case of an executed aggregated order, a relevant licensed or registered person which submits (or arranges to submit) the order to SEHK or carries out the order should also ensure that the BCAN of each client or joint

account to which the underlying orders relate is subsequently submitted to SEHK in accordance with SEHK's requirements either directly or through another relevant licensed or registered person.

- (i) A relevant licensed or registered person should have automated order management systems in place to ensure that clients' BCANs and the specific codes prescribed by SEHK (in the case of an aggregated order) which are tagged to on-exchange orders or off-exchange orders and included in OE Trade Reporting are correct and valid.
- (j) A relevant licensed or registered person which is responsible for collecting CID and preparing the BCAN-CID Mapping File of its clients under paragraph 5.6 should ensure that it submits the BCAN-CID Mapping File to SEHK by the prescribed time and in accordance with SEHK's requirements either directly or through another relevant licensed or registered person.
- (k) A relevant licensed or registered person which is responsible for assigning a BCAN and preparing the BCAN-CID Mapping File should take all reasonable steps to establish that the BCAN and CID which it submits to SEHK are accurate and kept up-to-date. It should notify SEHK in accordance with SEHK's requirements when it becomes aware that any such information has changed, is inaccurate or should otherwise be updated, including where there is a closure of a client account, addition of a new client account, or a change in CID. A relevant licensed or registered person should put in place measures to require clients to notify the relevant licensed or registered person of any updates to their CID.
- (l) A relevant licensed or registered person should comply with all applicable Rules of the Exchange and other requirements prescribed by SEHK in relation to the assignment of BCANs and the submission of BCAN-CID Mapping Files to SEHK, including the notification of any changes, errors or omissions.

- (m) For the purpose of the obligations to be carried out by a relevant licensed or registered person under paragraph 5.6, a “client” means the direct client of the relevant licensed or registered person, save that:
  - (i) in the case of proprietary trading by a relevant licensed or registered person, a client refers to the relevant licensed or registered person itself;
  - (ii) in the situation mentioned in paragraph 5.6(d), a client shall be a person to whom a BCAN is assigned for the on-exchange order or off-exchange order;
  - (iii) in the situation mentioned in paragraph 5.6(e), a client refers to each of the holders of the joint securities account; and
  - (iv) in the case of a collective investment scheme or discretionary account, a client refers to a collective investment scheme, discretionary account holder or asset management company, as the case may be, which has opened a trading account with the relevant licensed or registered person, through whose account an on-exchange order or off-exchange order is placed or proposed to be placed.
- (n) For the purpose of paragraph 5.6, CID shall mean the following information in relation to a client to whom a BCAN is assigned:
  - (i) the full name of the client as shown in the client’s identity document;
  - (ii) the issuing country or jurisdiction of the identity document;
  - (iii) the identity document type; and
  - (iv) the identity document number.

- (o) For the purpose of paragraph 5.6(n), CID of a client should be collected from the identity document which is first mentioned in the list below save that where the client does not hold such document, the next mentioned document should be used and so forth:
  - (i) in the case of a natural person, his or her (1) HKID card; or (2) national identification document; or (3) passport;
  - (ii) in the case of a corporation, its (1) legal entity identifier (LEI) registration document; or (2) certificate of incorporation; or (3) certificate of business registration; or (4) other equivalent identity document; and
  - (iii) in the case of a trust, the trustee's information as in paragraph 5.6(o)(i) or (ii) (as the case may be). However in the case of a trust which is an investment fund, CID of the asset management company or the individual fund, as appropriate, which has opened a trading account with the relevant licensed or registered person should be obtained.
- (p) On or before the submission of the BCAN-CID Mapping File in respect of an individual client, a relevant licensed or registered person should have obtained from the client written or other express consent in a form and manner in compliance with the SFC's requirements. A record of consent must be kept by the relevant licensed or registered person for as long as the client remains its client and up to at least two years after the client relationship ceases.
- (q) If the consent referred to in paragraph 5.6(p) cannot be obtained from any client who is a natural person, the relevant licensed or registered person should not submit any BCAN or CID of that client to SEHK and should only effect sell orders or trades in respect of existing holdings of a listed security (but not buy orders or trades) for that client.

## **5.7 Reporting of OTC securities transactions**

- (a) Expressions appearing in paragraph 5.7 bear the same meanings as defined in paragraph 5.6(b), save that, for purposes of paragraph 5.7:
  - (i) the definition of “client” does not include paragraph 5.6(m)(ii);
  - (ii) IRD means the Inland Revenue Department of Hong Kong;
  - (iii) “OTC Securities Transaction” means a transaction involving shares which is not conducted by an on-exchange order or reportable as an off-exchange trade within the scope of paragraph 5.6 in respect of which stamp duty is chargeable in Hong Kong and the transaction is not granted stamp duty relief (whether in full or in part) from the IRD;
  - (iv) “relevant licensed or registered person” means a licensed or registered person who carries out any of the “specified activities” as defined in paragraph 5.6(b);
  - (v) “relevant transfer” means a transfer of shares in connection with an OTC Securities Transaction; and
  - (vi) “shares” means the ordinary shares of a company, or units of a REIT, listed on SEHK.
- (b) Subject to paragraphs 5.7(c) and 5.7(d), when a relevant licensed or registered person, whether as principal or agent for a client, makes a relevant transfer, it is required to report the following information to the SFC within three Hong Kong trading days after the day (in Hong Kong time) of the transfer:
  - (i) the CE number and role of the relevant licensed or registered person making the transfer, for example, whether it is the transferee, transferor, or acting as agent for the transferee or transferor (or both);

- (ii) a description of the transfer (including the stock name and stock code of the share(s) transferred, quantity of share(s) transferred by the relevant licensed or registered person, quantity of share(s) of the transaction, share transfer date, transaction price per share and transaction date);
  - (iii) where the transferee is a client of the relevant licensed or registered person, CID of the transferee;
  - (iv) where the transferor is a client of the relevant licensed or registered person, CID of the transferor; and
  - (v) where the counterparty corporation to the relevant licensed or registered person in the transfer is also a licensed or registered person, the CE number of that counterparty corporation.
- (c) A relevant licensed or registered person is not required to comply with the reporting obligations under paragraph 5.7(b) where a transfer of share(s) is made in accordance with the terms of a structured product or a derivative, or for the conversion of a depository receipt into shares or vice versa.
- (d) Where an application for a stamp duty relief has been or will be submitted to the IRD but the relief has not yet been granted, a relevant licensed or registered person would not be required to report the transfer of shares pending the IRD's determination. However, if the IRD subsequently determines that no stamp duty relief (whether in full or in part) would be granted, the relevant licensed or registered person should report the share transfer as soon as practicable after being notified of the IRD's determination.
- (e) When a relevant licensed or registered person, whether as principal or agent for a client, deposits or withdraws a physical share certificate, the relevant licensed or registered person is required to report the following information to the SFC within three Hong Kong trading days after the day (in Hong Kong time) of the deposit or withdrawal:

- (i) the CE number of the relevant licensed or registered person, whether it is a deposit or withdrawal of a physical share certificate, and whether it is acting as principal or agent;
  - (ii) a description of the deposit or withdrawal of share certificate (including the stock name and code, quantity of share(s) and deposit or withdrawal date); and
  - (iii) CID of the client of the relevant licensed or registered person.
- (f) Regardless of whether a relevant licensed or registered person has already submitted CID for the client (in the form of a BCAN-CID Mapping File) pursuant to paragraph 5.6, the relevant licensed or registered person needs to provide the client's CID in the reporting made under paragraph 5.7(b) or 5.7(e).
- (g) A relevant licensed or registered person should ensure that all information including CID it submits to the SFC is accurate and kept up-to-date. It should notify the SFC if it becomes aware that any such information is inaccurate or should otherwise be updated. It should also put in place measures to require clients to notify it of any updates to their CID.
- (h) On or before reporting information to the SFC in accordance with paragraph 5.7(b) or 5.7(e), and where the information relates to a client who is an individual, the relevant licensed or registered person shall have obtained from the client written or other express consent in form and manner in compliance with the SFC's requirements. A record of consent must be kept by the relevant licensed or registered person for as long as the client remains its client and up to at least two years after the client relationship ceases.
- (i) If the consent under paragraph 5.7(h) cannot be obtained from a client, the relevant licensed or registered person should not submit any CID of that client to the SFC. It



should only effect transfers of shares out of and withdrawals of physical share certificates from that client's account, but not transfers of shares or deposits of physical share certificates into that client's account.



## **Client agreement**

### **6.1 Client agreement in writing**

Licensed or registered persons should enter into a written agreement (“Client Agreement”) with each client before services are provided to the client. The Client Agreement should be in Chinese or English according to the language preference of the client, as should any other agreement, authority, risk disclosure, or supporting document. Licensed or registered persons should provide a copy of these documents to the client and draw to the client’s attention the relevant risks. Where an account opening procedure other than a face-to-face approach is used, the covering correspondence should specifically direct the client’s attention to the appropriate risk disclosure statements. As explained below, the type of Client Agreement may vary depending on the services provided.

### **6.2 Minimum content of client agreement**

Subject to paragraph 6.4 and Schedules 1, 3, 4 and 6 to the Code, a Client Agreement should contain at least provisions to the following effect:

- (a) the full name and address of the client as verified by a retained copy of the identity card, relevant sections of the passport, business registration certificate, corporation documents, or any other official document which uniquely identifies the client;
- (b) the full name and address of the licensed or registered person's business including the licensed or registered person's licensing or registration status with the Commission and the CE number (being the unique identifier assigned by the Commission);
- (c) undertakings by the licensed or registered person and the client to notify the other in the event of any material change to the information (as specified in paragraphs 6.2(a), (b), (d), (e) and (f)) provided in the Client Agreement;

- (d) a description of the nature of services to be provided to or available to the client, such as securities cash account, securities margin account, discretionary account, portfolio management, investment advice, unit trusts, futures/options account, or leveraged foreign exchange trading account;
- (e) a description of any remuneration (and the basis for payment) that is to be paid by the client to the licensed or registered person, such as commission, brokerage, and any other fees and charges;
- (f) if margin or short selling facilities are to be provided to the client, details of margin requirements, interest charges, margin calls, and the circumstances under which a client's positions may be closed without the client's consent;
- (g) if services are to be provided to the client in relation to derivative products, including futures contracts or options, (1) a statement that the licensed or registered person shall provide to the client upon request product specifications and any prospectus or other offering document covering such products and (2) a full explanation of margin procedures and the circumstances under which a client's positions may be closed without the client's consent;
- (h) the risk disclosure statements as specified in Schedule 1 to the Code; and
- (i) the following clause: "If we [the intermediary] solicit the sale of or recommend any financial product to you [the client], the financial product must be reasonably suitable for you having regard to your financial situation, investment experience and investment objectives. No other provision of this agreement or any other document we may ask you to sign and no statement we may ask you to make derogates from this clause."

*Note: "Financial product" means any securities, futures contracts or leveraged foreign exchange contracts as defined under the SFO. Regarding "leveraged foreign exchange contracts", it is only applicable to those traded by persons licensed for Type 3 regulated activity.*

### **6.3 No circumvention of legal requirements**

A licensed or registered person should ensure that it complies with its obligations under a Client Agreement and that a Client Agreement does not operate to remove, exclude or restrict any rights of a client or obligations of the licensed or registered person under the law.

### **6.4 Limited provision of services**

A Client Agreement should properly reflect the services to be provided. Where the services to be provided are limited in nature, the Client Agreement may be limited accordingly. For example, where the services to be provided by a licensed or registered person to a client are limited to effecting one-off disposals of securities in connection with initial public offerings, the Client Agreement would only need to contain the provisions set out in paragraphs 6.2(a), (b), (d) and (e).

### **6.5 No inclusion of clauses which are inconsistent with the Code or which misdescribe the actual services provided to clients**

A licensed or registered person should not incorporate any clause, provision or term in the Client Agreement or in any other document signed or statement made by the client at the request of the licensed or registered person which is inconsistent with its obligations under the Code.

*Note: This paragraph precludes the incorporation in the client agreement (or in any other document signed or statement made by the client) of any clause, provision or term by which a client purports to acknowledge that no reliance is placed on any recommendation made or advice given by the licensed or registered person.*

No clause, provision, term or statement should be included in any Client Agreement (or any other document signed or statement made by the client at the request of a licensed or registered person) which misdescribes the actual services to be provided to the client.

## Discretionary accounts

### 7.1 Authorization and operation of a discretionary account

- (a) A licensed or registered person should not effect a transaction for a client unless before the transaction is effected (i) the client, or a person designated in writing by the client, has specifically authorized the transaction; or (ii) the client has authorized in writing the licensed or registered person or any person employed by the licensed or registered person (who must in turn be a licensed or registered person) to effect transactions for the client without the client's specific authorization.
- (b) Where a client wishes to grant an authority described under paragraph 7.1(a) (ii), the licensed or registered person or a person employed by it should explain the terms of the authority to the client. If an authority is granted to an employee or agent of the licensed or registered person, the authority should state that the person is an employee or agent of the licensed or registered person. The licensed or registered person should also confirm with the client at least on an annual basis whether that client wishes to revoke such authority. For the avoidance of doubt, it will be acceptable for the licensed or registered person to send a notification to the client before the expiry date of its discretionary authority and inform the client that such authority is automatically renewed unless the client specifically revokes it in writing before the expiry date.
- (c) If a licensed or registered person has obtained an authority described under paragraph 7.1(a)(ii), the Client Agreement and the licensed or registered person's records should designate such accounts as "discretionary accounts".
- (d) Senior management should approve the opening of discretionary accounts.

*The revisions to paragraph 7.1 will take effect on 1 Dec 2012.*

- (e) A licensed or registered person should implement internal control procedures to ensure proper supervision of the operation of discretionary accounts.

## **7.2 Disclosure of benefits**

- (a) Specific disclosure - monetary benefits under explicit remuneration arrangement and trading profit made from a transaction
  - (i) Where a licensed or registered person and/or any of its associates explicitly receives monetary benefits (whether quantifiable or not prior to or at the point of sale) from a product issuer (directly or indirectly) for effecting a transaction in an investment product for a client, the licensed or registered person should disclose the maximum percentage of the monetary benefits receivable by it and/or any of its associates by the type of investment product.

For monetary benefits that are not quantifiable, the licensed or registered person should also disclose the existence and nature of such benefits.

- (ii) Where a licensed or registered person takes no market risk and makes a trading profit for effecting (A) a purchase of an investment product from a third party for a client; or (B) a sale of an investment product to a third party for a client, the licensed or registered person should disclose the maximum percentage of the trading profit to be made by the type of investment product.
- (b) Generic disclosure - monetary benefits under non-explicit remuneration arrangement and non-monetary benefits
  - (i) Where a licensed or registered person effects a transaction in an investment product which is issued by it or any of its associates and it will not explicitly receive monetary benefits when effecting such transaction for a client, the licensed or registered person should disclose that it or any of its associates will benefit from effecting such transaction.

- (ii) Where a licensed or registered person and/or any of its associates receives from a product issuer non-monetary benefits for effecting a transaction for a client, the licensed or registered person should disclose the existence and nature of such non-monetary benefits.

The licensed or registered person should make the above disclosure to clients at the account opening stage or prior to entering into a discretionary client agreement with a client for discretionary management services. The disclosure must be in writing, communicated to clients through electronic or other means. The information disclosed in written form should be in Chinese or English according to the language preference of the client.

The licensed or registered person should ensure that the disclosure in writing is prominent, is presented in a clear and concise manner and is easy for average clients to understand.

In respect of the disclosure to be made under this paragraph, a one-off disclosure is acceptable. Where there are changes, an update must be provided to the client as soon as reasonably practicable.

#### Notes

Examples of changes to the one-off disclosure include additional investment product types and an increase in the maximum percentage of the monetary benefits receivable.

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## **Information for clients**

### **8.1 Information about the firm: in general**

- (a) A licensed or registered person should provide clients with adequate and appropriate information about its business, including contact details, services available to clients, and the identity and status of employees and others acting on its behalf with whom the client may have contact.
- (b) Where employees act for more than one company within a financial services group, a licensed or registered person should ensure that there is no reasonable basis for confusion on the part of the client as to the company for which these employees are acting.

### **8.2 Prompt confirmation**

- (a) Unless specifically agreed otherwise in writing by the client, after a licensed or registered person has effected a transaction for a client, it should endeavour to confirm promptly with the client the essential features of the transaction. This does not apply in relation to a discretionary account.
- (b) Where a licensed or registered person trades in options contracts for its clients, it should provide each client with a trade confirmation promptly after effecting such trading that includes:
  - (i) the number of contracts purchased or sold, the underlying asset, expiry month, strike price, option type (put or call), version number (if not 0) and whether they were closing contracts or opening contracts; and
  - (ii) the price and the unit of the asset comprised in each lot the subject of such contract.





## 8.3 Disclosure of monetary and non-monetary benefits

### Part A

#### Disclosure of monetary benefits

*Where the monetary benefits received or receivable are quantifiable prior to or at the point of entering into a transaction*

##### (a) Specific disclosure

###### *Explicit remuneration arrangement*

- (i) Where a licensed or registered person and/or any of its associates explicitly receives monetary benefits from a product issuer (directly or indirectly) for distributing an investment product, the licensed or registered person should disclose the monetary benefits that are receivable by it and/or any of its associates as a percentage ceiling of the investment amount or the dollar equivalent.

###### *Trading profit made from a back-to-back transaction*

- (ii) Where a licensed or registered person enters into a back-to-back transaction concerning an investment product, the licensed or registered person should disclose to the client the trading profit to be made. The trading profit should be disclosed as a percentage ceiling of the investment amount or the dollar equivalent.

#### Notes

For the avoidance of doubt, the specific disclosure should be made on a transaction basis.

As a minimum, a licensed or registered person should disclose the monetary benefits that are receivable by it and/or any of its associates or the trading profit in the form of a percentage ceiling of the investment amount rounded up to the nearest whole percentage point or the dollar equivalent. However, having regard to its own circumstances, the licensed or registered person may disclose a specific percentage or the dollar equivalent instead.



Back-to-back transactions refer to those transactions where a licensed or registered person, after receiving –

- (a) a purchase order from an investor, purchases an investment product from a third party and then sells the same investment product to the investor; or
- (b) a sell order from an investor, purchases an investment product from the investor and then sells the same investment product to a third party,

and no market risk is taken by the licensed or registered person.

**(b) Generic and other disclosure**

*Non-explicit remuneration arrangement*

- (i) Where a licensed or registered person does not explicitly receive monetary benefits for distributing an investment product which is issued by it or any of its associates, the licensed or registered person should disclose that it or any of its associates will benefit from the origination and distribution of this product.

*Where the monetary benefits received or receivable are not quantifiable prior to or at the point of entering into a transaction*

- (ii) Where the monetary benefits received or receivable by a licensed or registered person and/or any of its associates from a product issuer (directly or indirectly) for distributing an investment product are not quantifiable prior to or at the point of entering into a transaction, the licensed or registered person should disclose the existence and nature of such monetary benefits, and the maximum percentage of such monetary benefits receivable per year.

**Notes**

For the avoidance of doubt, the disclosure in respect of this paragraph 8.3(b)(ii) of the Code should be made on a transaction basis.



## Part B

### Disclosure of non-monetary benefits

- (a) Where a licensed or registered person and/or any of its associates receives from a product issuer non-monetary benefits for distributing an investment product, the licensed or registered person should disclose the existence and nature of such non-monetary benefits.

#### 8.3 A Disclosure of transaction related information

- (a) Where a licensed or registered person distributes an investment product to a client (including where it sells an investment product to or buys such product from the client), the licensed or registered person should deliver the following information to the client prior to or at the point of entering into the transaction:
  - (i) The capacity (principal or agent) in which a licensed or registered person is acting;
  - (ii) Affiliation of the licensed or registered person with the product issuer;
  - (iii) Whether or not the licensed or registered person is independent (with reference to the requirements set out in paragraph 10.2 of the Code) and the bases for such determination;
  - (iv) Disclosure of monetary and non-monetary benefits (*please refer to paragraph 8.3 of the Code*); and
  - (v) Terms and conditions in generic terms under which client may receive a discount of fees and charges from a licensed or registered person.
- (b) The disclosure must be made in writing, electronically or otherwise. In respect of the disclosure to be made under paragraph 8.3A(a)(iii), the disclosure should be made in the form of a statement as specified in Schedule 9 to the Code. The licensed or registered person should have adequate measures in place to ensure that the above information is



provided to the client prior to or at the point of entering into the transaction. In respect of the disclosure to be made under paragraph 8.3A(a)(i), (ii), (iii), and (v) above, a one-off disclosure (“One-off Disclosure”) is acceptable. Where there are changes to the One-off Disclosure, either (1) an updated One-off Disclosure, or (2) individual disclosure for each transaction where the information for which deviates from the information in the One-off Disclosure, must be provided to the client prior to or at the point of entering into a transaction.

- (c) In circumstances where provision of information in written form is not possible before a transaction is concluded, the licensed or registered person should make a verbal disclosure and provide such information in writing to the client as soon as practicable after the conclusion of the transaction.
- (d) The information disclosed in written form should be in Chinese or English according to the language preference of the client.

#### Notes

The licensed or registered person should ensure that the disclosure in writing is prominent, is presented in a clear and concise manner and is easy for average clients to understand.

### **8.4 Information about the firm: financials**

A licensed or registered person should, upon request, disclose the financial condition of its business to a client by providing a copy of the latest audited balance sheet and profit and loss account required to be filed with the Commission and disclose any material changes which adversely affect the licensed or registered person's financial condition after the date of the accounts.

### **8.5 Information on corporate actions**

A licensed or registered person that has control of a client's assets should respond promptly to the client's requests for information on corporate actions in relation to those assets.



## **Client priority**

### **9.1 Priority for client orders: order handling and recording**

A licensed or registered person should handle orders of clients fairly and in the order in which they are received. Orders of clients or transactions to be undertaken on behalf of clients should have priority over orders for the account of the licensed or registered person, or any account in which the licensed or registered person has an interest or the account of any employee or agent of the licensed or registered person.

### **9.2 Priority for client orders: order allocation**

A licensed or registered person should, where it has aggregated an order for a client with an order for another client, or with an order for its own account, give priority to satisfying orders of clients, in any subsequent allocation if all orders cannot be filled.

### **9.3 Non-public, material information**

A licensed or registered person should have procedures in place to ensure that its employees do not deal (for the benefit of the licensed or registered person, the employee or a client) in securities or futures contracts where the employee concerned effects the dealing in order to “front-run” pending transactions for or with clients, or on the basis of other non-public information which would be expected to materially affect prices of those securities or futures contracts and which is to be released to the market.

### **9.4 Withdrawal from business**

A licensed or registered person that withdraws in whole or in part from providing any investment or related services should ensure that affected clients are promptly notified of the action and that any business which remains outstanding is promptly completed or transferred to another licensed or registered person in accordance with any instructions of the affected clients.



## **Conflicts of interest**

### **10.1 Disclosure and fair treatment**

Where a licensed or registered person has a material interest in a transaction with or for a client or a relationship which gives rise to an actual or potential conflict of interest in relation to the transaction, it should neither advise, nor deal in relation to the transaction unless it has disclosed that material interest or conflict to the client and has taken all reasonable steps to ensure fair treatment of the client.

### **10.2 Independence**

Where a licensed or registered person represents itself as being independent, or uses any other term(s) with similar inference, when distributing an investment product:

- (a) it should not receive fees, commissions, or any monetary benefits, paid or provided (whether directly or indirectly) by any party in relation to such distribution of investment product to clients; and
- (b) it should not have any close links or other legal or economic relationships with product issuers, or receive any non-monetary benefits from any party, which are likely to impair its independence to favour a particular investment product, a class of investment products or a product issuer.

#### **Notes**

“Close links” which may impair independence include where a licensed or registered person has a parent company and subsidiary relationship with a product issuer, or is in a controlling entity relationship (as defined in the SFO) with the product issuer.



## **Client assets**

### **11.1 Handling of client assets**

- (a) A licensed or registered person should, in the handling of client transactions and client assets, act to ensure that client assets are accounted for properly and promptly. Where the licensed or registered person or a third party on behalf of the licensed or registered person is in possession or control of client positions or assets, the licensed or registered person should ensure that client positions or assets are adequately safeguarded.
- (b) Where a client's assets are received or held overseas, additional risk disclosures should be provided to the client, as such assets may not enjoy the same protection as that conferred under the SFO, the Securities and Futures (Client Money) Rules and the Securities and Futures (Client Securities) Rules.



## **Compliance**

### **12.1 Compliance: in general**

A licensed or registered person should comply with, and implement and maintain measures appropriate to ensuring compliance with the law, rules, regulations and codes administered or issued by the Commission, the rules of any exchange or clearing house of which it is a member or participant, and the requirements of any regulatory authority which apply to the licensed or registered person.

### **12.2 Employee dealings**

- (a) A licensed or registered person should have a policy which has been communicated to employees in writing on whether employees are permitted to deal or trade for their own accounts in securities, futures contracts or leveraged foreign exchange contracts. For purposes of paragraph 12.2, the term “employees” includes directors (other than non-executive directors) of a licensed or registered person.
- (b) In the event that employees of a licensed or registered person are permitted to deal or trade for their own accounts in securities, futures contracts or leveraged foreign exchange contracts:
  - (i) the written policy should specify the conditions on which employees may deal for their own accounts;
  - (ii) employees should be required to identify all related accounts and report them to senior management. For purposes of paragraph 12.2, the term “related accounts” includes accounts of their minor children and accounts in which the employees hold beneficial interests;
  - (iii) employees should generally be required to deal through the licensed or registered person or its affiliates;
  - (iv) if the licensed or registered person provides services in securities or futures contracts listed or traded on a recognized stock market or a recognized futures market





or in derivatives, including over-the-counter derivatives written over such securities or futures contracts, and its employees are permitted to deal through another dealer, in those securities or futures contracts, the licensed or registered person and employee should arrange for duplicate trade confirmations and statements of account to be provided to senior management of the licensed or registered person;

- (v) any transactions for employees' accounts and related accounts should be separately recorded and clearly identified in the records of the licensed or registered person; and
  - (vi) transactions of employees' accounts and related accounts should be reported to and actively monitored by senior management of the licensed or registered person who should not have any beneficial or other interest in the transactions and who should maintain procedures to detect irregularities and ensure that the handling by the licensed or registered person of these transactions or orders is not prejudicial to the interests of the licensed or registered person's other clients.
- (c) A licensed or registered person should not knowingly deal in securities or futures contracts for another licensed or registered person's employee unless it has received written consent from that licensed or registered person.

## **12A Obligations under the FDRS**

A licensed or registered person should comply with the Financial Dispute Resolution Scheme ("FDRS") for managing and resolving disputes administered by the Financial Dispute Resolution Centre Ltd ("FDRC") in full and be bound by the dispute resolution processes provided for under the FDRS. The FDRS will apply to licensed or registered persons other than firms which carry on Type 10 regulated activity under the SFO i.e. provision of credit rating services.



### **12.3 Complaints**

A licensed or registered person should ensure that:

- (a) complaints from clients relating to its business are handled in a timely and appropriate manner;
- (b) steps are taken to investigate and respond promptly to the complaints;
- (c) where a complaint is not remedied promptly, the client is advised of any further steps which may be available to the client under the regulatory system including the right to refer a dispute to the FDRC; and
- (d) where a complaint has been received, the subject matter of the complaint is properly reviewed. If the subject matter of the complaint relates to other clients, or raises issues of broader concern, a licensed or registered person should take steps to investigate and remedy such issues, notwithstanding that the other clients may not have filed complaints with the licensed or registered person and/or the FDRC.

### **12.4 Responsibility for acts of employees**

A licensed or registered person should be responsible for the acts or omissions of its employees and agents in respect to the conduct of its business.

### **12.5 Notifications to the Commission**

A licensed or registered person, as a firm, should report to the Commission immediately upon the happening of any one or more of the following:

- (a) any material breach, infringement of or non-compliance with any law, rules, regulations, and codes administered or issued by the Commission, the rules of any exchange or clearing house of which it is a member or participant, and the requirements of any regulatory authority which apply to the



licensed or registered person, or where it suspects any such breach, infringement or non-compliance whether by:

- (i) itself; or
- (ii) persons it employs or appoints to conduct business with clients or other licensed or registered persons,

giving particulars of the breach, infringement or non-compliance, or suspected breach, infringement or non-compliance, and relevant information and documents;

- (b) the passing of any resolutions, the initiation of any proceedings, or the making of any order which may result in the appointment of a receiver, provisional liquidator, liquidator or administrator or the winding-up, re-organisation, reconstruction, amalgamation, dissolution or bankruptcy of the licensed or registered person or any of its substantial shareholders or the making of any receiving order or arrangement or composition with creditors;
- (c) the bankruptcy of any of its directors;
- (d) the exercise of any disciplinary measure against it by any regulatory or other professional or trade body or the refusal, suspension or revocation of any regulatory licence, consent or approval required in connection with its business;
- (e) any material failure, error or defect in the operation or functioning of its trading, accounting, clearing or settlement systems or equipment;
- (f) any material breach, infringement or non-compliance of market misconduct provisions set out in Part XIII or Part XIV of the Securities and Futures Ordinance that it reasonably suspects may have been committed by its client, giving particulars of the suspected breach, infringement or non-compliance and relevant information and documents; and

*Paragraph 12.5(f) will take effect on 1 Dec 2012.*



- (g) any determination or settlement of a complaint in connection with the FDRS (including the details of the determination or settlement), if so requested by the Commission.

## **12.6 Co-operation under the FDRS**

A licensed or registered person should:

- (a) make honest and diligent disclosure before mediators and/or arbitrators in connection with the FDRS; and
- (b) render all reasonable assistance to the FDRS.

## **12.7 Expert witness**

A licensed or registered person, as a firm, should not, without reasonable excuse, prohibit persons it employs from performing expert witness services for the Commission and the Hong Kong Monetary Authority.

*.Paragraph 12.7 will take effect on 1 Dec 2012.*



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## **Rebates, soft dollars, and connected transactions**

### **Retention of rebates, soft dollars and connected transactions**

- 13.1 A licensed or registered person that acts for a client in the exercise of investment discretion may receive goods or services (i.e. soft dollars) from a broker in consideration of directing transaction business on behalf of the client to the broker only if:
- (a) the goods or services are of demonstrable benefit to the licensed or registered person's clients;
  - (b) transaction execution is consistent with best execution standards and brokerage rates are not in excess of customary full-service brokerage rates;
  - (c) the client has consented in writing to the receipt of the goods and services; and
  - (d) disclosure is made of the licensed or registered person's practices for receiving the goods and services, including a description of the goods and services received.

#### **Notes**

Goods and services may include: research and advisory services; economic and political analysis; portfolio analysis, including valuation and performance measurement; market analysis, data and quotation services; computer hardware and software incidental to the above goods and services; clearing and custodian services and investment-related publications. The goods and services may not include travel, accommodation, entertainment, general administrative goods or services, general office equipment or premises, membership fees, employee salaries, or direct money payments. This note is not exhaustive and may be amended from time to time.

Disclosure and consent may be made or given in the Client Agreement or other investment management agreement (or an addendum thereto). Whichever form of document is used, it must include a specific statement describing the licensed or registered person's soft dollar practices. In addition, at least annually the client must be given a statement describing the licensed or registered person's soft dollar practices, including a description of the goods and services received by the manager.



- 13.2 A licensed or registered person described in paragraph 13.1 that intends to receive and retain cash or money rebates in relation to client transactions may retain those rebates only if :
- (a) the client has consented in writing to the retention of rebates;
  - (b) brokerage rates are not in excess of customary full-service brokerage rates; and
  - (c) disclosure of the rebates and their approximate value is made to the client.

#### Notes

Disclosure and consent may be made or given in the Client Agreement or other investment management agreement (or an addendum thereto). Whichever form of document is used it must include a specific statement that the manager may receive and retain brokerage commission rebates and describe the licensed or registered person's practices in regard to the rebates. In addition, at least twice annually the client must be provided with a quantification of the value of rebates received in relation to the client's account. Alternatively, this may be done in each contract note provided to the client. Quantification of rebates may involve estimates taken from aggregate commission and rebate data provided the estimates are reasonably accurate in relation to the client's account.

- 13.3 A licensed or registered person described in paragraph 13.1 should ensure and be able to demonstrate that any transactions undertaken or services acquired in relation to a client's account that involve payments from client assets directly or indirectly to a person connected with the licensed or registered person are undertaken at arm's length terms and in the best interests of the client. Essentially, this requires that such terms not be less favourable than those generally available in the market.
- 13.4 A licensed or registered person that provides a portfolio manager with goods, services, or cash rebates has a responsibility to satisfy itself that the portfolio manager is mindful of the requirements of this section. In addition, the licensed or registered person should make further enquiries if the type of goods and services listed in the invoices presented for payment by the portfolio manager appear not to be of the type described in paragraph 13.1. This is in addition to any legal duties that the licensed or registered person



and the portfolio manager may have, including those imposed by the Prevention of Bribery Ordinance (Cap. 201).

### **13.5 Refund obligation**

Where a cooling-off mechanism is incorporated in an investment product and a client exercises his right under such mechanism to cancel the order, sell the product back to the issuer or its agent, or otherwise unwind the transaction in relation to that product, the licensed or registered person should promptly execute the client's instruction and pass on to the client the full amount of refund (including the sales commission<sup>1</sup>) received from the product issuer less a reasonable administrative charge<sup>2</sup>.

#### **Notes**

<sup>1</sup>This includes any sales commission retained by the licensed or registered person in relation to that transaction.

<sup>2</sup>The administrative charge should be disclosed to the client at or prior to point of sale and should not contain any profit margin.





## **Responsibility of senior management**

### **14.1 Responsibility of senior management**

Senior management of a licensed or registered person should properly manage the risks associated with the business of the licensed or registered person, including performing periodic evaluation of its risk management processes. Senior management should understand the nature of the business of the licensed or registered person, its internal control procedures and its policies on the assumption of risk. They should clearly understand the extent of their own authority and responsibilities. In respect of that authority and those responsibilities:

- (a) they should have access to all relevant information about the business on a timely basis; and
- (b) they should have available to them and seek where appropriate all necessary advice on that business and on their own responsibilities.

In determining the responsibility of particular individuals, regard should be had to the factors referred to in GP9.

## Professional investors

### 15.1 Professional Investors: in general

- (a) “Professional Investor” is defined in section 1 of Part 1 of Schedule 1 to the SFO. It includes specified entities set out in paragraphs (a) to (i) of the definition (e.g., banks and insurance companies) and persons belonging to a class which is prescribed under the Securities and Futures (Professional Investor) Rules (“Professional Investor Rules”) (paragraph (j) of the definition).
- (b) Notwithstanding that some legal restrictions imposed by the SFO (e.g., the issuance of advertisements, the making of unsolicited calls and the communication of an offer in relation to securities) do not apply to licensed or registered persons in dealing with Professional Investors, all the requirements in the Code (including the general principles such as acting honestly and fairly and in the best interests of clients and the requirement to ensure the suitability of a recommendation or solicitation for a client is reasonable in all the circumstances) must still be strictly observed subject to exemptions.
- (c) For the purposes of setting out exemptions and for ease of reference under the Code, Professional Investors are referred to in the Code in specific terms as set out in paragraph 15.2.

### 15.2 Overview and terminology

Professional Investors are referred to in the Code in the following terms:

**Institutional Professional Investors**- persons falling under paragraphs (a) to (i) of the definition of “professional investor” in section 1 of Part 1 of Schedule 1 to the SFO.

Licensed or registered persons dealing with Institutional Professional Investors are automatically exempt from the provisions set out in paragraphs 15.4 and 15.5 hereunder.

**Corporate Professional Investors-** trust corporations, corporations or partnerships falling under sections 4, 6 and 7 of the Professional Investor Rules.

Should licensed or registered persons wish to be exempt from the provisions set out in paragraph 15.4, they should observe the assessment requirements set out in paragraph 15.3A and comply with paragraph 15.3B. Should licensed or registered persons wish to be exempt from the provisions set out in paragraph 15.5 only, they should just comply with paragraph 15.3B.

Where a Corporate Professional Investor cannot meet the requirements under paragraph 15.3A in any aspect, the licensed or registered person cannot be exempt from the provisions set out in paragraph 15.4 when dealing with this Corporate Professional Investor. If paragraph 15.3B is not complied with in any aspect, all regulatory obligations should be observed by the licensed or registered persons without any exemption unless stated otherwise.

**Individual Professional Investors-** individuals falling under section 5 of the Professional Investor Rules.

Should licensed or registered persons wish to be exempt from the provisions set out in paragraph 15.5, they should comply with paragraph 15.3B.

If paragraph 15.3B is not complied with in any aspect, all regulatory obligations should be observed by the licensed or registered persons without any exemption unless stated otherwise.

### **15.3A Assessment requirements for Corporate Professional Investors**

- (a) If a licensed or registered person has complied with paragraph 15.3B, it is exempt from the provisions set out in paragraph 15.5 and may also be exempt from the provisions set out in paragraph 15.4 if it is reasonably satisfied that the Corporate Professional Investor meets the three criteria set out in paragraph 15.3A(b) in relation to the relevant products and markets.



- (b) In making the assessment on a Corporate Professional Investor in relation to the relevant products and/or markets, the licensed or registered person should assess whether or not the Corporate Professional Investor satisfies all of the following three criteria:
  - (i) the Corporate Professional Investor has the appropriate corporate structure and investment process and controls (i.e., how investment decisions are made, including whether the corporation has a specialised treasury or other function responsible for making investment decisions);
  - (ii) the person(s) responsible for making investment decisions on behalf of the Corporate Professional Investor has(have) sufficient investment background (including the investment experience of such person(s)); and
  - (iii) the Corporate Professional Investor is aware of the risks involved which is considered in terms of the person(s) responsible for making investment decisions.
- (c) The above assessment should be in writing. Records of all relevant information and documents obtained in the assessment should be kept by the licensed or registered person so as to demonstrate the basis of the assessment.
- (d) A licensed or registered person should undertake a separate assessment for different product types or markets.
- (e) A licensed or registered person should undertake a new assessment where a Corporate Professional Investor has ceased to trade in the relevant product or market for more than 2 years.

### **15.3 B Procedures for dis-applying provisions under paragraphs 15.4 and 15.5**

- (a) Prior to dis-applying the provisions set out in paragraph 15.4 (when dealing with Corporate Professional Investors only) and/or the provisions set out in paragraph 15.5 (when dealing



with Corporate Professional Investors and Individual Professional Investors), a licensed or registered person should also:

- (i) obtain a written and signed declaration from the client that the client has given consent;
  - (ii) fully explain to the client the consequences (i.e., all relevant regulatory exemptions that the licensed or registered person is entitled to) of being treated as a Professional Investor and that the client has the right to withdraw from being treated as such at any time; and
  - (iii) specify that the client is treated as a Professional Investor in a particular product and market and inform the client that he has a right to withdraw from being treated as a Professional Investor whether in respect of all products or markets or any part thereof.
- (b) A licensed or registered person should carry out a confirmation exercise annually to ensure that the client continues to fulfill the requisite requirements under the Professional Investor Rules. In carrying out the annual confirmation exercise, a licensed or registered person should remind the client in writing of:
  - (i) the risks and consequences (i.e., all relevant regulatory exemptions that the licensed or registered person is entitled to) of being treated as a Professional Investor, in particular, the licensed or registered person is not required to comply with the regulatory requirements set out in paragraphs 15.4 and/or 15.5 of the Code (as the case may be); and
  - (ii) the right for the client to withdraw from being treated as a Professional Investor whether in respect of all products or markets or any part thereof.

**15.4 Exempt provisions for Corporate Professional Investors where licensed or registered persons have complied with paragraphs 15.3A and 15.3B and Institutional Professional Investors**

- (a) Information about clients
  - (i) the need to establish a client's financial situation, investment experience and investment objectives (paragraph 5.1 and paragraphs 2(d) and 2(e) of Schedule 6 to the Code), except where the licensed or registered person is providing advice on corporate finance work;
  - (ii) the need to ensure the suitability of a recommendation or solicitation (paragraph 5.2 and paragraph 49 of Schedule 6 to the Code); and
  - (iii) the need to assess the client's knowledge of derivatives and characterize the client based on his knowledge of derivatives (paragraph 5.1A of the Code);
- (b) Client agreement
  - (i) the need to enter into a written agreement and the provision of relevant risk disclosure statements (paragraph 6.1, paragraph 20.2(c), paragraph 2 of Schedule 3, paragraph 2 of Schedule 4 and paragraph 1 of Schedule 6 to the Code);
- (c) Information for clients
  - (i) the need to disclose transaction related information (paragraph 8.3A of the Code);
- (d) Discretionary accounts
  - (i) the need for a licensed or registered person to obtain from the client an authority in a written form prior to effecting transactions for the client without his specific authority (paragraph 7.1(a)(ii) of the Code);

- (ii) the need to explain the authority described under paragraph 7.1(a)(ii) of the Code and the need to confirm it on an annual basis (paragraph 7.1(b) of the Code); and
- (iii) the need for a licensed or registered person to disclose benefits receivable for effecting transactions for a client under a discretionary account (paragraph 7.2 of the Code).

(For the avoidance of doubt, a licensed or registered person should still obtain an authorization from a client in order to effect transactions on the client's behalf, however where Professional Investors are concerned the procedures for obtaining such authorizations as described in (i) and (ii) above are relaxed.)

- (e) the need to ensure the suitability of a transaction in a complex product, to provide sufficient information about a complex product and to provide warning statements (paragraph 5.5(a) of the Code).

#### **15.5 Exempt provisions for Corporate Professional Investors and Individual Professional Investors where licensed or registered persons have complied with paragraph 15.3B and Institutional Professional Investors**

- (a) Information for clients
  - (i) the need to inform the client about the licensed or registered person and the identity and status of its employees and others acting on its behalf (paragraph 8.1 of the Code);
  - (ii) the need to confirm promptly with the client the essential features of a transaction after effecting a transaction for a client (paragraph 8.2, paragraph 4 of Schedule 3 and paragraph 18 of Schedule 6 to the Code); and
  - (iii) the need to provide the client with documentation on the Nasdaq-Amex Pilot Program (paragraph 1 of Schedule 3 to the Code).



## **Analysts**

Note: In respect of the provisions relating to preparation of investment research on new listing applicants, the provisions relate to listing of securities where the application for listing to the Stock Exchange of Hong Kong Limited is submitted on or after 31 October 2011.

### **16.1 Application**

- (a) This paragraph applies to:
  - (i) an analyst;
  - (ii) a firm that employs any analyst; and
  - (iii) a firm that issues any investment research.
- (b) This paragraph covers:
  - (i) investment research on securities that are traded in Hong Kong; and
  - (ii) investment research on securities that are issued or to be issued by a new listing applicant which are to be traded in Hong Kong,

and investment research that has an influence on such securities.

### **16.2 Interpretation**

- (a) “Analyst” for the purposes of this paragraph means any individual within a firm who prepares and/or publishes investment research or the substance of investment research. The term does not include an individual:
  - (i) giving investment advice or comments wholly incidental to his dealing or broking function;
  - (ii) conducting research solely for the firm’s internal consumption and not for distribution to clients; or
  - (iii) giving personal (one-to-one) investment advice.





In respect of paragraph 16.2(a)(ii), the firm's internal consumption includes consumption by all companies in the group and not just those specified in paragraph 16.2(d).

- (b) "Associate" for the purposes of this paragraph means:
- (i) the spouse, or any minor child (natural or adopted) or minor step-child, of the analyst;
  - (ii) the trustee of a trust of which the analyst, his spouse, minor child (natural or adopted) or minor step-child, is a beneficiary or a discretionary object; or
  - (iii) another person accustomed or obliged to act in accordance with the directions or instructions of the analyst.
- (c) "Financial interest" for the purposes of this paragraph means any commonly known financial interest, such as investment in the securities in respect of an issuer or a new listing applicant, or financial accommodation arrangement between the issuer or the new listing applicant and the firm or analyst.

This term does not include commercial lending conducted at arm's length, or investments in any collective investment scheme other than an issuer or new listing applicant notwithstanding the fact that the scheme has investments in securities in respect of an issuer or a new listing applicant.

- (d) "Firm" for the purposes of this paragraph means any intermediary and its group of companies. A company will only be regarded as a group company if it carries on a business in Hong Kong in:
- (i) investment banking;
  - (ii) proprietary trading or market making; or
  - (iii) agency broking,
- in relation to securities.



- (e) “Individual employed by or associated with...the firm” for the purposes of paragraph 16.5(c) means any individual:
  - (i) employed by the firm in accordance with whose directions or instructions the analyst is accustomed or obliged to act;
  - (ii) employed by the firm who has influence on the subject matter or content, or the timing of distribution, of investment research; or
  - (iii) who is responsible for determining the remuneration of the analyst.
- (f) “Investment research” for the purposes of this paragraph includes documentation containing any one of the following:
  - (i) result of investment analysis of securities;
  - (ii) investment analysis of factors likely to influence the future performance of securities, not including any analysis on macro economic or strategic issue; or
  - (iii) advice or recommendation based on any of the foregoing result or investment analysis,and an investment/research report shall be construed accordingly.
- (g) “Issuer” for the purposes of this paragraph means:
  - (iv) a corporation;
  - (v) a REIT; and
  - (vi) an entity that is established to conduct business operations and constituted in a form other than that of a corporation or REIT,

the securities of which are listed on The Stock Exchange of Hong Kong Limited.



- (h) “New listing applicant” for the purposes of this paragraph means:
- (i) a corporation;
  - (ii) a REIT; and
  - (iii) an entity that is established to conduct business operations and constituted in a form other than that of a corporation or REIT

applying for listing of and permission to deal in securities on The Stock Exchange of Hong Kong Limited, none of whose securities, are already listed on The Stock Exchange of Hong Kong Limited.

- (i) “Prospectus” for the purposes of this paragraph means a prospectus, listing document, offering circular or similar document issued by a new listing applicant.
- (j) “REIT” for the purposes of this paragraph means a real estate investment trust which is authorized or applying for authorization by the Commission under section 104 of the SFO.
- (k) “Securities” for the purposes of this paragraph means:
  - (i) shares, depositary receipts, interests or units issued by an issuer and any warrants or options on these shares, depositary receipts, interests or units which are listed or traded on The Stock Exchange of Hong Kong Limited; and
  - (ii) shares, depositary receipts, interests or units issued or to be issued by a new listing applicant and any warrants or options on these shares, depositary receipts, interests or units which are to be listed or traded on The Stock Exchange of Hong Kong Limited.



## 16.3 Principles

The Commission believes the following principles<sup>2</sup> are of fundamental importance to the business undertaken by all analysts and firms to which this Paragraph applies.

### (a) Analyst trading and financial interests

Mechanisms should exist so that analysts' trading activities or financial interests do not prejudice their investment research and recommendations.

### (b) Firm financial interests and business relationships

Mechanisms should exist so that analysts' investment research and recommendations are not prejudiced by the trading activities, financial interests or business relationships of the firms that employ them.

### (c) Analyst reporting lines and compensation

Reporting lines for analysts and their compensation arrangements should be structured to eliminate or severely limit actual and potential conflicts of interest.

### (d) Firm compliance systems

Firms that employ analysts should establish written internal procedures or controls to identify and eliminate, avoid, manage or disclose actual and potential analyst conflicts of interest.

### (e) Outside influence

The undue influence of securities issuers, institutional investors and other outside parties upon analysts should be eliminated or managed.

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<sup>2</sup> These principles generally replicate those published by the International Organisation of Securities Commissions ("IOSCO") on 25 September 2003 in the Statement of Principles for Addressing Sellside Securities Analyst Conflicts of Interest ("Statement of Principles"). Aside from these principles, analysts and firms are encouraged to adopt the measures specified in the Statement of Principles as best practices. The Statement of Principles is available at the IOSCO website at [www.iosco.org](http://www.iosco.org).



**(f) Clarity, specificity and prominence of disclosure**

Disclosures of actual and potential conflicts of interest should be complete, timely, clear, concise, specific and prominent.

**(g) Integrity and ethical behaviour**

Analysts should be held to high integrity standards.

**16.4 Analyst trading and financial interests**

**(a) Firms to establish dealing policies for analysts**

A firm that employs any analyst should establish and maintain written policies and control procedures governing the dealings and tradings by any such analyst with a view to eliminating, avoiding, managing or disclosing actual or potential conflicts of interest arising from such dealings or tradings.

**(b) Limitations on dealing by analysts**

An analyst or his associate should not deal in or trade any securities in respect of an issuer that the analyst reviews:

- (i) in a manner contrary to his outstanding recommendation ; or
- (ii) within 30 days prior to and 3 business days after the issue of investment research on the issuer,

except in special circumstances outlined in the firm's policy and pre-approved by the relevant legal or compliance function.

In respect of paragraph 16.4(b)(ii), an analyst should not issue any investment research on an issuer if he or his associate had dealt in or traded the securities in respect of the issuer within the previous 30 days, except on occurrences of major events that would affect the price of the securities and the events are known to the public.



**(c) Disclosure of relevant relationships**

If an analyst or his associate serves as an officer of the issuer or the new listing applicant (which includes in the case of a REIT, an officer of the management company of such REIT; and in the case of any other entity, an officer or its equivalent counterpart of the entity who is responsible for the management of the issuer or the new listing applicant) that the analyst reviews, the analyst should disclose that fact in the research report.

**(d) Disclosure of relevant financial interests**

If an analyst or his associate has any financial interests in relation to an issuer or a new listing applicant that the analyst reviews, he should disclose that fact in the research report.

**16.5 Firm financial interests and business relationships**

**(a) Disclosure by firms of relevant financial interests**

Where a firm has any financial interests in relation to an issuer or a new listing applicant the securities in respect of which are reviewed in a research report, and such interests aggregate to an amount equal to or more than:

- (i) in the case of an issuer, 1% of the issuer's market capitalization;
- (ii) in the case of a new listing applicant, an amount equal to or more than 1% of the new listing applicant's issued share capital, or issued units, as applicable,

the firm should disclose that fact in the research report.

**(b) Disclosure by firms of relevant market making activities**

A firm that makes, or will make, a market in the securities in respect of the issuer or the new listing applicant should disclose that fact in the research report.



**(c) Disclosure by firms of relevant relationships**

A firm having an individual employed by or associated with the firm serving as an officer of the issuer or the new listing applicant should disclose that fact in the research report.

**(d) Disclosure by firms of relevant business relationships**

A firm that has an investment banking relationship with the issuer or the new listing applicant should disclose that fact in the research report. Any compensation or mandate for investment banking services received within the preceding 12 months would constitute an investment banking relationship.

**(e) Improper dealing by firms ahead of issue of investment research**

A firm should not improperly deal or trade ahead in the securities in respect of the issuer which its investment research covers.

**(f) Firms not to provide certain assurances to issuers or new listing applicants**

A firm should not, with a view to commencing or influencing a business relationship with an issuer or a new listing applicant, provide any promise or assurance of favourable review or change of coverage or rating in its investment research.

**(g) Quiet periods**

A firm that acts as a manager, sponsor, listing agent or underwriter of a public offering should not issue any investment research covering the issuer or the new listing applicant at any time falling within a period of:

- (i) 40 days immediately following the day on which the securities are priced if the offering is an initial public offering; or
- (ii) 10 days immediately following the day on which the securities are priced if the offering is a secondary public offering,



unless the firm has been issuing investment research on the an issuer or the new listing applicant with reasonable regularity in its normal course of business, or on occurrences of major events that would affect the price of the securities and the events are known to the public.

The day on which the securities are priced refers to the day when the specific price of the offering is determined.

## **16.6 Analyst reporting lines, compensation and participation in other functions**

### **(a) Analyst reporting lines and compensation**

A firm that has an investment banking function should not:

- (i) arrange for its analysts to report to such function; or
- (ii) directly link its analysts' compensation to any specific investment banking transaction.

### **(b) Pre-approval of investment research by investment banking function**

A firm that has an investment banking function should not allow such function to pre-approve analyst reports or recommendations, except in circumstances subject to oversight by compliance or legal function where investment banking function reviews a research report for factual accuracy prior to publication.

### **(c) Analysts not to solicit investment banking business**

An analyst should not participate in business activities designed to solicit investment banking business, such as sales pitches and deal road shows.

## **16.7 Firm compliance systems**

- (a) A firm should establish, maintain and enforce a set of written policies and control procedures to eliminate, avoid or manage actual and potential analyst conflicts of interest. These policies and procedures should be appropriately formulated





having regard to the firm's particular structure and business model and the experience and investment profile of its clients.

- (b) A firm should establish, maintain and enforce a set of written policies and control procedures to ensure that analysts responsible for preparing a research report on a new listing applicant are not provided by the firm with any material information, including forward looking information (whether qualitative or quantitative) concerning the new listing applicant that is not:
  - (i) reasonably expected to be included in the prospectus; or
  - (ii) publicly available.

## **16.8 Outside influence**

An analyst or his firm should disclose in the research report the fact where the issuer, the new listing applicant or other third party has provided or agreed to provide any compensation or other benefits in connection with the investment research.

## **16.9 Making commentaries or recommendations through the mass media**

When an analyst makes commentaries or recommendations through the mass media, all provisions in paragraph 16, as modified (where applicable) under paragraph 16.9(a) and (b) below, should apply.

### **(a) Analysts appearing in personal capacity in the mass media**

When an analyst provides analyses or comments on securities in respect of an issuer or new listing applicant in the mass media in his personal capacity, including appearing in person, he should disclose the following at the time the analyses or comments are provided:

- (i) his name;
- (ii) his licence status; and



- (iii) where he and/or his associate has a financial interest in the issuer or new listing applicant, the fact of having such an interest.

**(b) Analysts responding in personal capacity to queries from audiences and journalists**

When an analyst is asked by members of an audience, or otherwise by a journalist, for analyses or comments on specific securities, he may offer such analyses or comments, provided that he makes the disclosures set out in paragraph 16.9(a)(i) to (iii) notwithstanding the fact that he and/or his associates have traded in the relevant securities during the 30 days prior to giving such analyses or comments.

**(c) Firms communicating their investment research through the mass media**

For avoidance of doubt, when a firm communicates its investment research through the mass media, such as disseminating its research reports in whole or in part in a sponsored programme, all relevant provisions in paragraph 16 should apply.

**16.10 Clarity, specificity and prominence of disclosure**

**(a) Quality of disclosure**

Where any matter is required to be disclosed under this Paragraph, the disclosure should be:

- (i) clear;
- (ii) concise;
- (iii) specific;
- (iv) given adequate prominence; and
- (v) released in a timely and fair manner.



**(b) Methods of disclosure**

Any disclosure required under this Paragraph should be made in a method that is commensurate with the medium through which the investment research, or analyst's advice or comments, is being delivered. The required disclosures are limited to the fact of the matter. Details such as the amount or its nature are not required.

**(c) Disclosure responsibility**

Where relevant disclosures have been made by analysts and/or firms, they will not be held responsible if their investment research, or recommendation is published or otherwise reproduced in whole or in part by the mass media without the relevant disclosures.

**16.11 Integrity and ethical behaviour**

- (a) An analyst should have a reasonable basis for his analyses and recommendations.
- (b) An analyst should define the terms used in making recommendations, and utilize such definitions consistently.
- (c) An analyst should not seek to obtain from the new listing applicant or its advisers any material information, including forward looking information (whether qualitative or quantitative) concerning the new listing applicant that is not:
  - (i) reasonably expected to be included in the prospectus;  
or
  - (ii) publicly available.

**Note**

The expectation that an analyst only uses information that is reasonably expected to be included in the prospectus or that is publicly available does not preclude an analyst from conducting his own due diligence such as undertaking site visits.

## Sponsors

### 17.1 Introduction

- (a) This paragraph applies to a licensed corporation or registered institution, licensed or registered under the SFO for Type 6 regulated activity and permitted under its licence or certificate of registration to undertake work as a sponsor and which is appointed as a sponsor by an applicant seeking a listing of its securities on the Stock Exchange under the Listing Rules<sup>3</sup>.
- (b) A sponsor's primary role is to provide assurance to the Stock Exchange and the market generally that the listing applicant complies with the Listing Rules and other relevant legal and regulatory requirements and that the listing document provides sufficient particulars and information for investors to form a valid and justifiable opinion of the listing applicant's shares<sup>4</sup>, financial condition and profitability. A sponsor also advises and guides the listing applicant as to the Listing Rules and other relevant regulatory requirements.
- (c) The Commission attaches a great deal of importance to maintaining the integrity of the market and the transparency in fund raising and other listing exercises. This paragraph sets out the responsibilities and obligations which a sponsor should fulfil when discharging its functions as a sponsor. This paragraph also contains standards and provides guidance on due diligence procedures in respect of a listing application. In assessing whether a sponsor is fit and proper to remain licensed or registered and permitted to carry out its sponsor work, the Commission will have regard to the provisions of this paragraph.

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<sup>3</sup> Under Listing Rule 3A.02, an applicant seeking a listing of its securities on the Stock Exchange must appoint a sponsor to assist it with its application for listing. References to the Main Board Listing Rules in this paragraph should be taken to cover the equivalent GEM Listing Rules.

<sup>4</sup> In some cases a listing will involve other securities such as debentures or equity interests other than shares, for example units in a REIT. Where a listing agent is appointed for a listing of units in a REIT, the provisions under this paragraph will equally apply to the listing agent.

- (d) Sponsors are reminded of their other obligations under the Listing Rules, the Sponsor Guidelines and the CFA Code. In case of any conflicts amongst the Listing Rules, the Sponsor Guidelines, the CFA Code and this paragraph, the provisions of this paragraph shall prevail.
- (e) If a listing applicant appoints more than one sponsor in relation to a listing application:
  - (i) the joint appointments do not relieve any of the sponsors of any of their responsibilities and obligations under this paragraph; and
  - (ii) each of the sponsors is responsible for ensuring that the requirements set out in this paragraph in relation to the listing application are fully discharged.

### **17.1 A Appointment**

Before accepting an appointment by a listing applicant as a sponsor in relation to a listing application on the Main Board of the Stock Exchange, a sponsor should either:

- (a) be independent<sup>5</sup> of the listing applicant and ensure that it or one of the companies within its group of companies<sup>6</sup> is appointed at the same time as an overall coordinator (“OC”) (as defined under paragraph 21.2.3 of the Code) in connection with that listing application; or
- (b) obtain written confirmation from the listing applicant that at least one sponsor, which is independent of the listing applicant, or one of the companies within the group of companies of that sponsor, has been appointed as an OC in connection with that listing application.

### **17.2 Key requirements**

A sponsor should comply with the following key requirements in order to discharge its role satisfactorily.

<sup>5</sup> The circumstances under which a sponsor is considered not to be independent of the listing applicant are set out under the Listing Rules.

<sup>6</sup> For the purposes of this paragraph, “group of companies” has the same meaning as in section 1 of Part 1 of Schedule 1 to the SFO.

(a) Advising a listing applicant

A sponsor should advise and guide a listing applicant in preparation for a listing.

(b) Reasonable due diligence

A sponsor should take reasonable due diligence steps in respect of a listing application; before submitting a listing application a sponsor should complete all reasonable due diligence on a listing applicant except in relation to matters that by their nature can only be dealt with at a later date.

(c) Disclosure to the market

A sponsor should take reasonable steps to ensure that true, accurate and complete disclosure about a listing applicant is made to the public.

(d) Communication with the regulators

A sponsor should deal with the regulators in a truthful, cooperative and prompt manner.

(e) Proper records

A sponsor should maintain proper books and records that are sufficient to demonstrate its compliance with the Code.

(f) Resources, systems and controls

A sponsor should maintain sufficient resources and effective systems and controls for proper implementation and adequate management oversight of the sponsor work.

(g) Overall management of a public offer

A sponsor should act as the overall manager of a public offer to ensure that the public offer is conducted in a fair and orderly manner.

(h) Information provided to analysts in new listings

A sponsor should take reasonable steps to ensure analysts do not receive material information not disclosed in the listing document.

### **17.3 Advising a listing applicant**

#### **(a) Understanding a listing applicant**

Based on reasonable due diligence, a sponsor should have a sound understanding of:

- (i) a listing applicant, including its history and background, business and performance, financial condition and prospects, operations and structure, procedures and systems; and
- (ii) the personal and business backgrounds of the directors, key senior managers and (where applicable) controlling shareholders of the listing applicant.

#### **(b) Advice and guidance**

- (i) A sponsor should advise and guide a listing applicant and its directors as to their responsibilities under the Listing Rules and other relevant regulatory requirements which apply to a Hong Kong listed company and its directors and take reasonable steps to ensure that during the listing application process they understand and meet these responsibilities.
- (ii) Where material deficiencies are identified in relation to the operations and structure, procedures and systems, or directors and key senior managers of a listing applicant, a sponsor should provide adequate advice and recommendations to assist the listing applicant to remedy these material deficiencies.
- (iii) Where these material deficiencies cannot be remedied prior to the submission of a listing application, a sponsor should make adequate disclosure as part of its submission of the listing application, including the

nature of these deficiencies, reasons for non-rectification and remedial actions taken or to be taken.

#### **17.4 Work required before submitting a listing application**

(a) Reasonable due diligence

Before submitting an application on behalf of a listing applicant to the Stock Exchange a sponsor should have (i) performed all reasonable due diligence on the listing applicant except in relation to matters that by their nature can only be dealt with at a later date, and (ii) ensure that all material information as a result of this due diligence has been included in the Application Proof.

(b) Completeness of information in an Application Proof

Before submitting an application on behalf of a listing applicant to the Stock Exchange a sponsor should come to a reasonable opinion that the information in the Application Proof is substantially complete except in relation to matters that by their nature can only be dealt with at a later date.

(c) Resolving fundamental compliance issues

Before submitting an application on behalf of a listing applicant to the Stock Exchange a sponsor should come to a reasonable opinion that:

- (i) the listing applicant is in compliance with all relevant listing qualifications under Chapter 8 of the Listing Rules (except to the extent that waivers from compliance with those requirements have been applied for to the Stock Exchange in writing);
- (ii) the listing applicant has established procedures, systems and controls (including accounting and management systems) which enable the listing applicant and its directors to comply with the Listing Rules and other relevant legal and regulatory requirements on an ongoing basis;



- (iii) the listing applicant has established procedures, systems and controls (including accounting and management systems) which provide a reasonable basis for the directors to make a proper assessment of the financial position and prospects of the listing applicant on an ongoing basis; and
- (iv) the directors of the listing applicant collectively have the experience, qualifications and competence to manage the listing applicant's business and comply with the Listing Rules, and individually have the experience, qualifications and competence to perform their individual roles, including an understanding of their obligations and those of the listing applicant as an issuer under the Listing Rules and other legal and regulatory requirements relevant to their role.

(d) Identifying material issues

When submitting an application on behalf of a listing applicant to the Stock Exchange, a sponsor should ensure that all material issues known to it which, in its reasonable opinion, are necessary for the consideration of:

- (i) whether the listing applicant is suitable for listing; and
- (ii) whether the listing of the applicant's securities is contrary to the interest of the investing public or to the public interest;

are disclosed in writing to the Stock Exchange.

## **17.5 Disclosure to the market**

(a) Overall disclosure

At the time of issue of a listing document, a sponsor, after reasonable due diligence, should have reasonable grounds to believe and should believe that the listing document contains sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares and the financial condition and profitability of the listing applicant.

(b) Disclosure: non-expert sections

At the time of issue of a listing document, a sponsor, after reasonable due diligence, should have reasonable grounds to believe and should believe that:

- (i) the information in the non-expert sections of the listing document is true, accurate and complete in all material respects and not misleading or deceptive in any material respect; and
- (ii) there are no matters or facts the omission of which would make any information in the non-expert sections of a listing document or any other part of the listing document misleading in a material respect.

(c) Disclosure: expert reports

At the time of issue of a listing document, a sponsor as a non-expert, after performing the due diligence set out in paragraph 17.7, should have no reasonable grounds to believe and should not believe that the information in the expert reports is untrue, misleading or contains any material omissions.

## **17.6 Due diligence**

(a) Reasonable judgement

A sponsor should conduct due diligence in order to have a thorough knowledge and understanding of a listing applicant and to satisfy itself in relation to the disclosure in the listing document. A sponsor should exercise reasonable judgement on the nature and extent of due diligence work needed in relation to a listing applicant having regard to all relevant facts and circumstances. A sponsor should recognise that the nature and extent of due diligence varies from case to case depending on the facts and circumstances and there is no exhaustive list of due diligence steps that would apply in all circumstances.

(b) Professional scepticism

In undertaking its role a sponsor should examine with professional scepticism the accuracy and completeness of statements and representations made, or other information given, to it by a listing applicant or its directors. An attitude of professional scepticism means making a critical assessment with a questioning mind and being alert to information, including information from experts, that contradicts or brings into question the reliability of such statements, representations and information.

(c) Appropriate verification

A sponsor should not merely accept statements and representations made and documents produced by a listing applicant or its directors at face value. Depending on the nature and source of the information and the context in which the information is given, the sponsor should perform verification procedures that are appropriate in the circumstances, such as reviewing source documents, inquiring of knowledgeable persons or obtaining independently sourced information. Where the sponsor becomes aware of circumstances that may cast doubt on information provided to it or otherwise indicate a potential problem or risk, the sponsor should undertake additional due diligence to ascertain the truth and completeness of the matter and information concerned. Over reliance on management's representations or confirmations for the purposes of verifying information received from a listing applicant cannot be regarded as reasonable due diligence.

(d) Preparation of a listing document

Regarding the preparation of a listing document, a sponsor should perform, without limitation, each of the following:

- (i) oversee, and be closely involved in, the preparation of the listing document;
- (ii) achieve a thorough understanding of the listing applicant, including its business, history, background, structure and systems;

- (iii) gain a sufficient understanding of the industry in which the listing applicant operates, including reviewing key characteristics of the industry and data about competitors;
  - (iv) examine and consider the integrity, qualifications and competence of the directors, including reviewing internal records, board minutes and public filings;
  - (v) examine and consider the accuracy and reliability of the financial information, including reviewing the financial statements of major subsidiaries, internal financial records, tax certificates, regulatory filings and public records;
  - (vi) assess the business performance, financial condition, development, prospects and any financial projection or profit forecast;
  - (vii) assess the legality and compliance of the business operations and whether the listing applicant is subject to any material legal proceedings or disputes;
  - (viii) assess whether there has been any material change since the date of the last audited balance sheet, including any matter that might impact upon the listing applicant's business model, performance, prospects or financial condition; and
  - (ix) undertake independent verification of all material information, including documents provided, and statements and representations made, by the listing applicant and its directors.
- (e) Independent due diligence steps

A sponsor should conduct the following independent due diligence steps:

- (i) inquire directly of knowledgeable persons within or outside the listing applicant e.g. directors, key management staff, consultants and controlling shareholder(s);
- (ii) conduct inspection of key physical assets including where appropriate production facilities;

- (iii) interview major business stakeholders such as the listing applicant's customers, suppliers, creditors and bankers;
  - (iv) in relation to material matters, review relevant underlying records and supporting documents of the listing applicant; and
  - (v) in relation to material matters, independently obtain information from sources outside the listing applicant, such as searches of public filings and databases, external confirmations, third-party data about competitors and the engagement of external agents to perform relevant checks.
- (f) Interview practices

Where a sponsor interviews major business stakeholders (e.g. customers, suppliers, creditors and bankers), the sponsor should adopt effective and adequate measures to ensure that the records of the interviews are reasonably accurate, complete and reliable in all material respects. In conducting interviews, the sponsor should:

- (i) select independently those to be interviewed based on objective and proportionate criteria, e.g. those with whom the listing applicant has entered into high value transactions or entities with special or unusual characteristics;
- (ii) carry out the interview directly with the person or entity selected for interview with minimal involvement of the listing applicant;
- (iii) confirm the bona fides of the interviewee (including establishing the identity of the interviewee and other relevant information) to satisfy itself that the interviewee has the appropriate authority and knowledge for the interview;
- (iv) hold an in-depth discussion with a view to obtaining adequate and satisfactory responses to all questions

raised and follow up on any incomplete or unsatisfactory responses or outstanding matters; and

- (v) identify any irregularities noted during the interview (e.g. interview not taking place at the registered or business address of the person or entity selected for interview, reluctance on the part of the interviewee to cooperate) and ensure any irregularities are adequately explained and resolved.

(g) Seeking assistance from third parties

A sponsor cannot abrogate responsibility for due diligence. Where a sponsor engages a third party to assist it to undertake specific due diligence tasks (e.g. engaging lawyers to undertake verification of title to properties, accountants to review internal controls, consultancy firms to undertake market research, agencies to perform investigative work), the sponsor remains responsible in respect of the matters to which the specific tasks relate. A third party's work<sup>7</sup>, in itself, would not be sufficient evidence that a sponsor has discharged its obligation to conduct reasonable due diligence. The degree to which a third party's work can be relied on may depend on the professional qualifications of the third party to conduct the work. As a minimum the sponsor should:

- (i) assess whether the third party is appropriately qualified and competent for the tasks assigned to it;
- (ii) consider the scope and extent of the tasks to be performed by the third party;
- (iii) assess the results of the work performed by the third party and arrive at its own opinion whether the work provides a sufficient basis to determine that reasonable

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It should be noted that for a particular listing application an entity may be assisting in connection with due diligence tasks as well as being responsible for an expert report. For instance an accounting firm may be tasked with reviewing the internal controls as well as being the reporting accountant; in this case the guidance for sponsors in paragraph 17.6(g) applies to the review of internal controls and the guidance in paragraph 17.7 to the work as the reporting accountant.

due diligence has been conducted and whether further due diligence is required;

- (iv) assess whether the results of the work are consistent with other information known to the sponsor including that derived from its other due diligence work; and
- (v) assess whether the results of the work should be incorporated in the listing document and whether they should be brought to the attention of the regulators.

(h) **Stock Exchange Listing Rules**

The Stock Exchange sets out its expectations of due diligence sponsors would typically perform in PN21. PN21 explains that it is not in any way intended to set out the actual steps that may be appropriate in any particular case. Each listing applicant is unique and so will be the due diligence appropriate for the purpose of its listing application. The scope and extent of appropriate due diligence by a sponsor may be different from (and considerably more extensive than) the more typical examples in PN21. The sponsor should exercise its judgement as to what investigations are appropriate for a particular case and the extent of due diligence. Sponsors are reminded of their obligations to comply with the Listing Rules and the relevant practice notes and guidelines on due diligence standards.

## **17.7 Due diligence on expert reports**

For the purposes of paragraph 17.5(c), the sponsor should:

- (a) satisfy itself that:
  - (i) the expert is appropriately qualified, experienced and competent to give the opinion;
  - (ii) the expert is sufficiently resourced; and
  - (iii) the expert is independent from the listing applicant and its directors and controlling shareholder(s);

- (b) assess whether the scope of the expert's work:
  - (i) is appropriate to the opinion given by the expert; and
  - (ii) adequately covers the reliability of information provided to the expert, if not, the sponsor should:
    - (A) request that the scope of the expert's work be expanded;
    - (B) seek the assistance of a third party; or
    - (C) extend its due diligence having regard to the procedures set out in paragraph 17.6,

to cover the information provided to the expert;

*Note 1: As a reporting accountant performs audit procedures on information received from a listing applicant under applicable professional standards, a sponsor is not expected to carry out any further due diligence on this information. Nevertheless if a sponsor is aware of any matters which raise concerns relating to the information underlying the accountant's report, the sponsor should conduct further enquiries necessary to satisfy itself that these concerns are addressed; these enquiries may involve obtaining relevant supporting information and documents.*

*Note 2: If an expert relies on information prepared by a third party, for example where a legal adviser is engaged to confirm the title of properties, the sponsor should follow the procedures set out in paragraph 17.6(g). If an expert who relies on information prepared by a third party also follows standards which are at least equivalent to those required under paragraph 17.6(g), the sponsor may rely on the work performed by the expert in that respect.*

- (c) assess whether material bases and assumptions (in the case of financial information, critical accounting policies and estimates) on which the expert report is founded are fair, reasonable and complete; and



- (d) as regards the expert's opinion and the rest of the information contained in the report, the sponsor should:
  - (i) critically review the expert's opinion and the rest of the information in the report against the totality of all other information known to the sponsor about the listing applicant (including the business model, track record, operations, forecasts, sector performance and any relevant information publicly available) through due diligence and the sponsor's knowledge and experience of the listing applicant, the market in which the listing applicant operates and of comparable companies;
  - (ii) corroborate the information in the expert report with the information disclosed in non-expert sections and the sponsor's knowledge and experience of the listing applicant to ascertain whether the information throughout is consistent and coherent; and
  - (iii) conduct follow up work to resolve any material discrepancies, irregularities or inconsistencies.
- (e) The performance of each of the procedures in paragraph 17.7(a) to (d) above should be to the standard expected of a sponsor which is not itself expert in the matters dealt with in the relevant expert report.

## **17.8 Management Discussion and Analysis of Financial Information and Condition (MD&A)**

A sponsor should in conjunction with the management of a listing applicant and its other advisers prepare relevant, adequate and comprehensible MD&A that should:

- (a) avoid excessive or irrelevant disclosure that may overwhelm investors and act as an obstacle to identifying and understanding material matters and critical information;
- (b) focus on matters that materially impacted upon historical financial performance or condition;
- (c) analyse and explain material fluctuations in the financial items and amounts with specific and substantive reasons;

- (d) discuss material factors or events that are likely to impact future financial performance or condition; and
- (e) identify and discuss from an investor's perspective any exceptional items or unusual accounting treatments that require further enquiry or disclosure by, amongst other things, making reference to disclosure or treatments adopted by comparable companies.

## **17.9 Communications with the regulators**

- (a) A sponsor should reasonably satisfy itself that all information provided to the Stock Exchange and the SFC during the listing application process is accurate and complete in all material respects and not misleading in any material respect and, if it becomes aware that the information provided does not meet this requirement, the sponsor should inform the Stock Exchange and the SFC (as the case may be) promptly.
- (b) A sponsor should deal with all enquiries raised by, and provide all relevant information and documents requested by the Stock Exchange and the SFC (as the case may be) promptly, including answering any questions addressed to the sponsor in a cooperative and truthful manner.
- (c) Where a sponsor becomes aware of any material information relating to a listing applicant or listing application which concerns non-compliance with the Listing Rules or other legal or regulatory requirements relevant to the listing (except as otherwise disclosed pursuant to paragraph 17.4(d)), it should report the matter to the Stock Exchange in a timely manner. Such duty continues after the sponsor ceases to be the sponsor of the listing applicant, if the material information came to the knowledge of the sponsor whilst it was acting as the sponsor.
- (d) Where a sponsor ceases to act for a listing applicant before completion of the listing, the sponsor should inform the Stock Exchange in a timely manner of the reasons for ceasing to act.

## **17.10 Proper records**

- (a) A sponsor should maintain adequate records so as to demonstrate to the SFC its compliance with the Code and in particular compliance with this paragraph. A sponsor should document its systems and controls governing sponsor work and the annual assessment required under paragraph 17.12.
- (b) A sponsor should keep a record of all sponsor work. On request by the SFC a sponsor should be able to provide an up-to-date list of sponsor work undertaken setting out the names of client companies, the composition of Transaction Teams (including any variations) and the names, titles and roles of staff assigned to each listing.
- (c) In respect of each listing assignment, a sponsor should keep records, including relevant supporting documents and correspondence, within its control relating to:
  - (i) the Transaction Team under paragraph 17.11(c) and any subsequent variations within the Transaction Team;
  - (ii) due diligence
    - (A) a due diligence plan identifying the required time and skill sets of persons needed to implement the plan;
    - (B) changes to the due diligence plan and reasons;
    - (C) the nature, timing and extent of due diligence procedures; and
    - (D) the results of due diligence performed together with its assessment of these results;
  - (iii) for due diligence procedures conducted by third parties, information relating to the matters in paragraph 17.6(g);
  - (iv) the bases for the opinions, assurances and conclusions required under paragraphs 17.3, 17.4, 17.5 and 17.7, including internal discussions and any actions taken prior to these opinions and assurances being given or conclusions being reached;

- (v) all significant matters arising in the course of the listing process, including internal discussions and actions taken, regardless of whether or not the relevant matters are disclosed in the final listing document; and
  - (vi) the involvement of Management in considering critical matters as referred to in paragraph 17.11(d).
- (d) A complete set of a sponsor's records in connection with a listing assignment should be retained in Hong Kong for at least seven years after completion or termination of the relevant transaction.

#### **17.11 Resources, systems and controls**

A sponsor should maintain sufficient resources and effective systems and controls to ensure that the sponsor is able to meet and does meet all its obligations and responsibilities under the Code and in particular this paragraph and the Listing Rules. In respect of each listing assignment:

- (a) before accepting any appointment as a sponsor of an assignment, taking account of other commitments, the sponsor should ensure that it has sufficient staff with appropriate levels of knowledge, skills and experience to devote to the assignment throughout the period of the assignment;
- (b) a sponsor should ensure that it is appointed to act for a listing applicant sufficiently in advance of the expected date of a listing application. Taking account of the nature, scale and complexity of the assignment and any other factors that may affect the standard of work, the sponsor should ensure that it has adequate time to undertake the work necessary to meet its obligations and responsibilities under the Code and the Listing Rules. The appointment should clearly:
  - (i) specify the listing applicant's responsibilities to facilitate the sponsor to perform its duties and to meet its obligations under the Code and the Listing Rules. In particular provisions should be set out to the effect that the listing applicant should:

- (A) fully assist the sponsor to perform due diligence;
  - (B) procure all relevant parties engaged by the listing applicant in connection with the listing application (including financial advisers, experts and other third parties) to cooperate fully with the sponsor to facilitate the sponsor's performance of its duties;
  - (C) acknowledge that the sponsor is required, and should be given every assistance, to meet its obligations and responsibilities under the Code and the Listing Rules to provide information to the regulators including without limitation, notifying the regulators of reasons when the sponsor ceases to act under paragraph 17.9(d); and
  - (D) enable the sponsor to gain access to all relevant records in connection with the listing application.
- (ii) specify the terms of the sponsor's fees, including the basis on which the fees are determined, the payment structure and timing and any other factors that would affect the fees. No provisions should be made for any "no deal; no fee" arrangements (or arrangements to that effect).

All terms of an appointment should be agreed as early as possible and in sufficient time for the sponsor to meet its obligations and responsibilities under the Code and the Listing Rules. It is for a sponsor to determine whether its appointment is made in sufficient time to meet its client's expected timetable. If insufficient time is made available to complete the work required a sponsor should not accept appointment as a sponsor. A sponsor should not submit a listing application less than 2 months after all the terms of its appointment as a sponsor are agreed. When a sponsor is appointed, it should advise the Stock Exchange as soon as practicable.

- (c) taking account of the nature, scale and complexity of the assignment and any other factors that may affect the standard of work, the sponsor should appoint a Transaction Team which:

- (i) comprises staff with appropriate levels of knowledge, skills and experience; and
- (ii) includes at least one Principal who acts as the supervisor of the Transaction Team

to carry out the assignment throughout the period of the assignment.

*Note 1: A Transaction Team should have sufficient knowledge and experience of Hong Kong regulatory requirements.*

*Note 2: Members in one Transaction Team may work in other Transaction Teams of the sponsor provided that:*

- (A) *Management and the Principals of the respective Transaction Teams are satisfied that the sponsor can properly discharge its responsibilities in all the sponsor work that it undertakes;*
  - (B) *If a Principal is assigned to supervise more than one Transaction Team, Management is satisfied that each team is properly and adequately supervised by at least one Principal who has the necessary capacity, capability and competence to supervise; and*
  - (C) *The sponsor complies with General Principle 6 and paragraph 10.1 of the Code in respect of conflicts of interest.*
- (d) there must be clear and effective reporting lines and channels so that decisions on critical matters are not made by the Transaction Team but by Management or a committee designated by Management for this purpose. Members of such designated committee should be independent of the Transaction Team and should have appropriate seniority and expertise necessary to consider the following matters as a minimum:
- (i) acceptance of a mandate to act as a sponsor;
  - (ii) appointment of the Transaction Team and any significant variation to such appointment; and

- (iii) resolution of suspicious circumstances, difficult or sensitive issues, conflicting information and material non-compliance by a listing applicant.
- (e) Management is ultimately responsible for the supervision of the sponsor work and for compliance with all relevant legal and regulatory requirements, it may delegate operational functions to its staff but cannot abrogate its responsibilities. Accordingly, Management must put in place appropriate systems, controls and procedures to govern sponsor work, which include:
  - (i) formulation of an appropriate due diligence plan, amended or updated as necessary;
  - (ii) allocation of sufficient persons with appropriate levels of knowledge, skills and experience to each assignment over the period of the assignment;
  - (iii) implementation of the due diligence plan, with any outstanding steps or steps which deviate from the original plan identified, explained and followed up;
  - (iv) adequate supervision and management of the staff who carry out the work; and that the staff do not act beyond their proper authority;
  - (v) reviews of the standard and extent of due diligence work, and the performance of the Principals and the Transaction Team; and
  - (vi) escalation of critical matters including but not limited to those set out in paragraph 17.11(d) to Management or its designated committee for decision.
- (f) Upon completion of a listing transaction, a sponsor should submit to the SFC, within 2 weeks after the first day of dealings, its team structure chart in respect of that listing transaction countersigned by a Principal who supervised the transaction. The chart should show the reporting line of each of the licensed or registered staff within the team together with their respective names, business titles and responsibilities, including in advising the listing applicant on

compliance with the Code and the Listing Rules and the performance of due diligence. The SFC may seek further details from firms and individuals to substantiate their submissions.

#### **17.12 Annual assessment of systems and controls**

A sponsor should carry out an assessment annually in order to ensure that its systems and controls remain effective. Any material non-compliance issue should be reported to the SFC promptly.

*Note: The annual assessment may take the form of an internal and/or external audit. A sponsor should devise its own programme based on its assessment of risks related to its operations, the firm's business structures, its own internal systems and the track record of compliance including, but not limited to, any complaints received either from within or from third parties and any regulatory concerns raised by the regulators in the period under review.*

#### **17.13 Overall management of a public offer**

##### **(a) Overall management**

Where a listing application involves a public offer, a sponsor should act as the overall manager of the public offer. In doing so, the sponsor should:

- (i) assess the likely interest in, or the reception of, the offer by the public; and
- (ii) put in place sufficient arrangements and resources to ensure that the public offer and all matters ancillary thereto are conducted in a fair, timely and orderly manner.

##### **(b) Sufficient arrangements and resources**

In discharging its obligations under paragraph 17.13(a) above, the sponsor should have regard to at least the following matters:

- (i) whether there are sufficient arrangements to ensure that listing documents (in both electronic and printed



form) and application forms (in printed form) are made readily available to the public during the public offer period;

- (ii) without derogating from the sponsor's obligation to act as the overall manager of the public offer, whether specific responsibilities in relation to the public offer should be delegated to other parties; and if so, whether these parties are competent and have sufficient capacity and resources to handle the relevant responsibilities;
- (iii) whether sufficient measures have been put in place to ensure that:
  - (A) the distribution of prospectuses and application forms to the public;
  - (B) the collection of completed application forms from the public; and
  - (C) the despatch of unsuccessful applications, refund cheques and share certificates after the public offer period closes,can be made in a timely and orderly fashion;
- (iv) the need to avoid events of disorder or failure which may arise during the public offer period and before the trading of securities commences or otherwise in connection with the public offer, and ensure that appropriate contingency plans have been drawn up to deal with any such events; and
- (v) where balloting is required to determine the successful applications under a public offer, whether appropriate arrangements have been put in place to ensure that balloting would be conducted fairly and independently of the listing applicant and parties associated with it.

#### **17.14 Information provided to analysts in new listings**

A sponsor should take reasonable steps to ensure that all material

information, including forward-looking information (whether quantitative or qualitative) concerning a listing applicant or listing application disclosed or provided to analysts is contained in the relevant listing document.

## **17.15 Glossary**

For the purpose of this paragraph,

- (a) “Application Proof” means an advanced proof of the listing document submitted with the listing application under the Listing Rules
- (b) “CFA Code” means Corporate Finance Adviser Code of Conduct
- (c) “expert” includes accountant, engineer, appraiser and any other person whose profession gives authority to a statement made by him
- (d) “expert report” means, in relation to a listing document, any part of the listing document purporting to be made on the authority of an expert or purporting to be a copy of or extract from a report, opinion, statement or valuation of an expert where the expert gives consent for the inclusion in the listing document of the copy or extract and the listing document includes a statement that he has given and has not withdrawn such consent
- (e) “listing applicant” means an applicant applying for a listing of its securities on the Stock Exchange
- (f) “listing application” means an application submitted by a listing applicant in connection with the listing of its securities and all documents in support of or in connection with the application, including any replacement of, and amendment and supplement to, the application
- (g) “listing document” means a prospectus, a circular and any equivalent document (including a scheme of arrangement and introduction document) issued in connection with a listing application
- (h) “Listing Rules” means the Rules Governing the Listing of Securities on the Stock Exchange (“Main Board Listing

Rules”); references to the Main Board Listing Rules in this paragraph should be taken also to refer to the equivalent GEM Listing Rules

- (i) “Management” includes a sponsor’s Board of Directors, Managing Director, Chief Executive Officer, Responsible Officers, Executive Officers and other senior management personnel
- (j) “non-expert sections” means, in relation to a listing document, any part of the listing document that is not part of any expert report
- (k) “PN21” means Practice Note 21 of the Listing Rules
- (l) “Principal” means an individual that meets the criteria stipulated under the Sponsor Guidelines appointed by a sponsor to act as a Principal; in respect of a listing assignment, a Principal means an individual appointed by a sponsor to supervise the Transaction Team
- (m) “public offer” means, in relation to a listing application, an offer for subscription or an offer for sale of securities to the public
- (n) “Regulators” means the SFC and/or the Stock Exchange as appropriate
- (o) “REIT” means Real Estate Investment Trust
- (p) “SFC” means Securities and Futures Commission
- (q) “Sponsor Guidelines” means Additional Fit and Proper Guidelines for Corporations and Authorized Financial Institutions applying or continuing to act as Sponsors and Compliance Advisers
- (r) “Stock Exchange” means The Stock Exchange of Hong Kong Limited
- (s) “Transaction Team” means the staff appointed by a sponsor to carry out a listing assignment



## **Electronic Trading**

### **18.1 Application**

This paragraph applies to a licensed or registered person which conducts electronic trading of securities and futures contracts that are listed or traded on an exchange or internet trading of securities that are not listed or traded on an exchange.

### **18.2 Interpretation**

- (a) “Algorithmic trading” for the purposes of this paragraph means computer generated trading activities created by a predetermined set of rules aimed at delivering specific execution outcomes.
- (b) “Algorithmic trading system” for the purposes of this paragraph means the system through which algorithmic trading is conducted. It includes a system designed and developed in-house or by a third party service provider.
- (c) “Direct market access” (hereafter referred to as “DMA” in this paragraph) for the purposes of this paragraph means the access to a market provided to a client by a licensed or registered person through which the client transmits orders, directly or indirectly, to the market’s trade matching system for execution under the licensed or registered person’s identifier other than those initiated by way of internet trading.
- (d) “Electronic trading” for the purposes of this paragraph means the trading of securities and futures contracts electronically and includes internet trading, DMA and algorithmic trading.
- (e) “Electronic trading system” for the purposes of this paragraph means the system through which electronic trading is conducted. It includes a system designed and developed in-house or by a third party service provider.
- (f) “Internet trading” for the purposes of this paragraph means an arrangement where order instructions are sent to a licensed or registered person through its internet-based trading facility.



An internet-based trading facility may be accessed through a computer, mobile device or other electronic device.

### **18.3 Responsibility for orders**

A licensed or registered person is responsible for the settlement and financial obligations of orders sent to the market through its electronic trading system and for implementing policies, procedures and controls to supervise the orders in accordance with applicable regulatory requirements.

### **18.4 Management and supervision**

A licensed or registered person should effectively manage and adequately supervise the design, development, deployment and operation of the electronic trading system it uses or provides to clients for use, as may be appropriate in the circumstances.

### **18.5 Adequacy of system**

A licensed or registered person should ensure the integrity of the electronic trading system it uses or provides to clients for use, as may be appropriate in the circumstances, including the system's reliability, security and capacity, and have appropriate contingency measures in place.

### **18.6 Record keeping**

A licensed or registered person should keep, or cause to be kept, proper records on the design, development, deployment and operation of its electronic trading system.

### **18.7 Risk management: internet trading and DMA**

In providing internet trading or DMA services, a licensed or registered person must ensure that all the client orders are transmitted to the infrastructure used by the licensed or registered person and are subject to:

- (a) appropriate automated pre-trade risk management controls;  
and
- (b) regular post-trade monitoring.



### **18.8 Minimum client requirements: DMA**

A licensed or registered person should establish minimum client requirements for its DMA services and assess whether each client meets the requirements before granting DMA services to a client.

### **18.9 Qualification: algorithmic trading**

A licensed or registered person should establish and implement effective policies and procedures to ensure that persons

- (a) involved in the design and development of; or
- (b) approved to use

its algorithmic trading system and trading algorithms are suitably qualified.

### **18.10 Testing: algorithmic trading**

A licensed or registered person should ensure that the algorithmic trading system and trading algorithms it uses or provides to clients for use are adequately tested to ensure that they operate as designed.

### **18.11 Risk management: algorithmic trading**

A licensed or registered person should have controls that are reasonably designed to ensure:

- (a) the integrity of its algorithmic trading system and trading algorithms; and
- (b) its algorithmic trading system and trading algorithms operate in the interest of the integrity of the market.



## **Alternative liquidity pools**

### **19.1 Application**

This paragraph applies to a licensed or registered person who:

- (a) operates an alternative liquidity pool; or
- (b) routes client orders to an alternative liquidity pool for execution.

### **19.2 Interpretation**

For the purposes of this paragraph:

- (a) “ALP Guidelines” means the guidelines that are required to be prepared by a licensed or registered person operating an alternative liquidity pool, for the purpose of providing guidance to the users of the alternative liquidity pool concerning its operation.
- (b) “alternative liquidity pool” (hereafter referred to as ALP) means an electronic system operated by a licensed or registered person through which the crossing / matching of orders involving listed or exchange traded securities is conducted with no pre-trade transparency. It includes a system designed and developed in-house or by a third party service provider.
- (c) “authorized trader” means an individual who is authorized by a user to place orders into an ALP. For the avoidance of doubt, a licensed or registered person operating an ALP is not an authorized trader in relation to orders placed into its ALP.
- (d) “group of companies” has the same meaning as in Part 1 of Schedule 1 to the SFO.
- (e) “proprietary order” means an order which is for:
  - (i) the account of a licensed or registered person operating an ALP, trading as principal;
  - (ii) the account of any user, which is a company within the same group of companies as the licensed or registered person operating an ALP, trading as principal;

- (iii) any account in which a licensed or registered person operating an ALP, or any user which is a company within the same group of companies as the licensed or registered person, has an interest; or
- (iv) the account of any employee or agent of a licensed or registered person operating an ALP or of any user which is a company within the same group of companies as the licensed or registered person.

For the avoidance of doubt, client facilitation orders are to be treated as proprietary orders.

- (f) “qualified investor” means:
  - (i) a person falling under paragraphs (a) to (i) of the definition of “professional investor” in section 1 of Part 1 of Schedule 1 to the SFO; or
  - (ii) a person within the meaning of sections 4, 6 (other than a person referred to in section 6 (b)(ii)) or 7 of the Securities and Futures (Professional Investor) Rules.
- (g) “user” means a qualified investor whose orders are placed into or whose transactions are conducted in an ALP, and includes any qualified investor who/which is ultimately responsible for originating the instruction in relation to an order placed into, or a transaction conducted in, an ALP.

### **19.3 Management and supervision**

A licensed or registered person operating an ALP should effectively manage and adequately supervise the design, development, deployment and operation of its ALP, as may be appropriate in the circumstances.

### **19.4 Access to ALPs**

- (a) All licensed or registered persons should establish and implement measures to ensure that only qualified investors are permitted to be users of an ALP.
- (b) A licensed or registered person should only route orders to an ALP on behalf of clients where such orders are placed or originated by a person who is a qualified investor.



## **19.5 Operation of ALPs**

A licensed or registered person operating an ALP may allow transactions to be placed into, and transacted in, its ALP at such times as it considers appropriate.

## **19.6 Order priority**

Irrespective of the time when orders are placed, a licensed or registered person operating an ALP should ensure that the orders of users which are not proprietary orders have priority over proprietary orders when such orders are being transacted at the same price.

## **19.7 Information for users**

- (a) A licensed or registered person operating an ALP should, by means of ALP Guidelines, provide sufficiently comprehensive information to the users of the ALP to ensure that they are fully informed as to the manner in which the ALP operates.
- (b) Prior to routing any order to an ALP on behalf of a client for the first time, a licensed or registered person should ensure that the ALP Guidelines have been brought to the attention of the person placing or originating the order.

## **19.8 Opting out of ALP**

A licensed or registered person operating an ALP should permit the users to opt out of matching or crossing their orders in its ALP.

## **19.9 Adequacy of system**

A licensed or registered person operating an ALP should ensure the integrity of the ALP as may be appropriate in the circumstances, including the controls, reliability, security and capacity of the ALP, and have appropriate contingency measures in place in case of any failure.

## **19.10 Record keeping**

A licensed or registered person operating an ALP should keep, or cause to be kept, proper records concerning the design, development, deployment and operation of its ALP.

### **19.11 Risk management**

A licensed or registered person operating an ALP should have controls that are reasonably designed to ensure:

- (a) the integrity of its trading methodology; and
- (b) that its trading methodology operates in the interest of preserving the integrity of the market.

### **19.12 Reporting and notification obligations**

- (a) A licensed or registered person operating an ALP should have procedures in place to ensure that information concerning transactions conducted on its ALP is appropriately reported or made available to its users, exchanges, the Commission and other regulators.
- (b) A licensed or registered person operating an ALP should keep the Commission informed of any change in relation to the operation of its ALP and any breach arising out of its operation.

## **Dealing with group affiliates and other connected persons**

### **Financial exposures to group affiliates and other connected persons**

- 20.1 A licensed corporation should manage financial exposures to group affiliates and other connected persons, namely its shareholders, directors and employees, according to the same risk management standards it would apply in respect of financial exposures to independent third parties undertaken by it on an arm's length basis, except where doing so would have the effect of overriding an applicable requirement or exemption under any law, rule or regulation administered or issued by the Commission or the regulators (if any) of the group affiliates or other connected persons in respect of the exposure or transaction giving rise to the exposure.

### **Soliciting or recommending clients to enter into OTC derivative transactions with a group affiliate, or arranging for OTC derivative transactions to be entered into between a group affiliate and clients**

- 20.2 A licensed person, when soliciting or recommending its clients who are not group affiliates to enter into OTC derivative transactions with a group affiliate, or arranging for OTC derivative transactions to be entered into between a group affiliate and its clients who are not group affiliates, should:
- (a) act in the best interests of the clients;
  - (b) make such solicitation, recommendation or arrangement only if the group affiliate is a licensed corporation, an authorized financial institution, or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable OTCD jurisdiction (Notes 1 and 2); and
  - (c) if the group affiliate is not a licensed corporation, provide to the clients an appropriate risk disclosure statement in the client agreements which should, at a minimum, contain the risk disclosure in respect of the risk of entering into OTC derivative transactions with an unlicensed person as specified in Schedule 1 to the Code.

Note 1: A licensed person is exempt from the provision set out in paragraph 20.2(b) if the client is a licensed corporation, an authorized financial institution, or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable OTCD jurisdiction.

Note 2: Transitional period in respect of *existing client facing affiliates* which fall outside the range of regulated persons set out in paragraph 20.2(b) (“**Transitional Period**”): The provision set out in paragraph 20.2(b) does not apply to solicitation, recommendation or arrangement related to an *existing client facing affiliate* which falls outside the range of regulated persons set out in that paragraph until the date immediately after the end of the transitional period for Type 11 regulated activity (as defined in section 1 of Part 1 of Schedule 11 to the Securities and Futures Ordinance as amended by section 55 of the Securities and Futures (Amendment) Ordinance 2014). An *existing client facing affiliate* means a group affiliate which has an ongoing introduction agreement with a licensed corporation within the same group that was established and in effect before 12 December 2018 whereby the licensed corporation agrees to introduce clients to enter into OTC derivative transactions with it. During the Transitional Period, licensed corporations should implement reasonable measures to protect clients from conduct and prudential risks of existing client facing affiliates which fall outside the range of regulated persons set out in paragraph 20.2(b).

### **Booking OTC derivative transactions in group affiliates**

- 20.3 A licensed corporation should comply with paragraph 20.4 if it arranges a group affiliate which is not a licensed corporation, an authorized financial institution, or a corporation similarly regulated as an OTC derivative dealer or a bank in a comparable OTCD jurisdiction, to:
- (a) enter into OTC derivative transactions with its clients;
  - (b) enter into OTC derivative transactions with it on a back-to-back basis against OTC derivative transactions entered into by it with clients; or
  - (c) enter into OTC derivative transactions with another group affiliate on a back-to-back basis against OTC derivative transactions entered into by that other group affiliate with its clients under its solicitation, recommendation or arrangement.
- 20.4 The licensed corporation referred to in paragraph 20.3 should, in respect of the risks undertaken by the first-mentioned group affiliate in the OTC derivative transactions arranged by it for that group affiliate,

- (a) in the case where the licensed corporation has responsibility for or oversight of the management of such risks, ensure the risks are properly managed; or
- (b) in any other case, take reasonable steps to ensure that the risks are covered by a risk management programme whose standards are not less stringent than the risk management standards set by the Commission for licensed corporations, by the Hong Kong Monetary Authority for authorized financial institutions, or by a securities, futures, or banking regulator in a comparable OTCD jurisdiction for OTC derivative dealers or banks entering into similar transactions.

20.5 The comparable OTCD jurisdictions referred in paragraphs 20.2 to 20.4 are jurisdictions set out in the list of comparable OTCD jurisdictions published on the Commission's website for the purposes of those paragraphs.

## **Bookbuilding and placing activities in equity capital market and debt capital market transactions**

### **21.1 Introduction**

21.1.1 Paragraph 21 applies to a licensed or registered person that engages in providing services to issuers, investors or both in respect of an offering of shares or debt securities and involves the following activities conducted in Hong Kong:

- (a) collating investors' orders (including indications of interest) in an offering in order to facilitate:
  - (i) the price determination and the allocation of shares or debt securities to investors; or
  - (ii) the process of assessing demand and making allocations("bookbuilding activities");
- (b) marketing or distributing shares or debt securities to investors pursuant to those bookbuilding activities ("placing activities"); or
- (c) advising, guiding and assisting the issuer client<sup>8</sup> in those bookbuilding and placing activities.

A licensed or registered person engaged in any of the above-mentioned capital market activities is referred to as a "capital market intermediary" ("CMI").

21.1.2 Paragraph 21 covers only the following types of offerings that involve bookbuilding activities:

- (a) an offering of shares<sup>9</sup> listed<sup>10</sup> or to be listed<sup>11</sup> on The Stock Exchange of Hong Kong Limited ("SEHK") ("share offering"); or

<sup>8</sup> In the case of an initial public offering of shares (including a public offer conducted in connection with a secondary listing in Hong Kong) ("IPO"), "issuer client" includes "listing applicant".

<sup>9</sup> References to "shares" in paragraph 21 also include depositary receipts and units or interests in SFC-authorized real estate investment trusts ("REITs") listed or to be listed in Hong Kong.

<sup>10</sup> This only covers the placing of listed shares to third-party investors by an existing shareholder if it is accompanied by a top-up subscription by the existing shareholder for new shares in the issuer.

<sup>11</sup> This covers (i) IPOs, which include share offerings in connection with a secondary listing and offer of existing shares by way of IPO; (ii) offerings of a class new to listing; and (iii) offerings of new shares of a class already listed under a general or special mandate.

- (b) an offering of debt securities listed or unlisted, and offered in Hong Kong or otherwise (“debt offering”).

21.1.3 Paragraph 21 sets out the standards of conduct expected of a CMI in a share or debt offering. CMIs are also reminded to fulfil their obligations under applicable laws, rules and regulations, including properly addressing actual and potential conflicts of interest, ensuring the fair treatment of both their issuer client and investor clients, and upholding the integrity of the market at all times. In the case of a share offering, these include the Listing Rules<sup>12</sup> and other regulatory requirements or guidance issued by SEHK from time to time (“SEHK Requirements”). In the case of a debt offering where the debt securities are listed on SEHK, CMIs are also reminded to ensure compliance with the applicable rules and regulations issued by SEHK.

21.1.4 There are many types of share and debt offerings, which vary in nature and complexity, and a CMI may play different roles in different offerings. It is the responsibility of the senior management of a CMI to establish and implement adequate and effective policies, procedures and controls to ensure compliance with the rules and regulations which are applicable to the roles they play in an offering.

## **21.2 Types of CMIs**

21.2.1 A CMI which is engaged by the issuer of a share or debt offering is referred to as a syndicate CMI.

21.2.2 A CMI which is not engaged by the issuer<sup>13</sup> of a share or debt offering is referred to as a non-syndicate CMI.

21.2.3 In the case of a share offering, an “Overall Coordinator” (“OC”) of the offering is a syndicate CMI which, solely or jointly, conducts any of the following activities:

- (a) overall management of the offering, coordinating the bookbuilding or placing activities conducted by other CMIs, exercising control over bookbuilding activities and making allocation recommendations to the issuer client;

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<sup>12</sup> The Rules Governing the Listing of Securities on SEHK and Rules Governing the Listing of Securities on GEM of SEHK.

<sup>13</sup> Given that a non-syndicate CMI is not engaged by the issuer, the issuer is not its client and hence not an “issuer client”. The above notwithstanding, references to “issuer client” in this paragraph include references to “issuer” in the case of a non-syndicate CMI.

- (b) advising the issuer client of the offer price and being a party to the price determination agreement with the issuer client; or
- (c) exercising the discretion to reallocate shares between the placing tranche and public subscription tranche, reduce the number of offer shares, or exercise an upside option or over-allotment option.

21.2.4 In the case of a debt offering, an OC of the offering is a syndicate CMI which, solely or jointly, conducts the overall management of the offering, coordinates the bookbuilding or placing activities conducted by other CMIs, exercises control over bookbuilding activities and makes pricing or allocation recommendations to the issuer client.

21.2.5 For the avoidance of doubt, irrespective of whether or not a CMI has been formally appointed by, or has entered into a written agreement with, the issuer client, a CMI which conducts any of the activities in paragraphs 21.2.3 or 21.2.4 will be an OC and is required to comply with this paragraph.

### **21.3 CMI - Obligations and expected standards of conduct<sup>14</sup>**

A CMI should uphold market integrity and ensure compliance with all applicable legal and regulatory requirements.

#### **21.3.1 Assessment of issuer client and offering**

A CMI should conduct an adequate assessment of an issuer client before engaging in a share or debt offering for that issuer client. This includes:

- (a) taking reasonable steps to obtain an accurate understanding of the history and background, business and performance, financial condition and prospects, operations and structure of the issuer client, except for a repeated issuer of debt offerings where a CMI acted as the CMI for previous offerings made by the same issuer. In this case, the CMI should ascertain whether there have been any material changes in the circumstances of the issuer client of relevance to its role as CMI; and

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<sup>14</sup> For the purpose of this paragraph, a non-syndicate CMI which is not appointed by a syndicate CMI (hence does not receive remuneration directly or indirectly from the issuer client) and is only responsible for relaying investor clients' orders to CMI for placing into the order book is only required to comply with paragraphs 21.3.3, 21.3.5 and 21.3.7.



- (b) establishing a formal governance process to review and assess the share or debt offering, including any actual or potential conflicts of interest between the CMI and the issuer client as well as the associated risks.

### 21.3.2 Appointment of CMI

Subject to paragraph 21.4.1 of the Code, before a CMI conducts any bookbuilding or placing activities, it should ensure that it has been formally appointed under a written agreement to conduct such activities by an issuer client in the case of a syndicate CMI or another CMI in the case of a non-syndicate CMI. The written agreement should clearly specify the roles and responsibilities of a CMI, the fee arrangements (including fixed fees as a percentage of the total fees to be paid to all syndicate CMIs participating in the offering<sup>15</sup>) and the fee payment schedule.

### 21.3.3 Assessment of investor clients

- (a) A CMI should take reasonable steps to assess whether its investor clients, based on their profiles, fall within the types of investors targeted in a marketing and investor targeting strategy (“targeted investors”) as referred to under paragraph 21.4.3.
- (b) In the case of a share offering, a CMI should take all reasonable steps to identify investor clients to whom the allocation of shares will be subject to restrictions or require prior consent from SEHK under the SEHK Requirements (“Restricted Investors”) and inform the OC (whether directly or indirectly) before placing an order on behalf of such clients.
- (c) In the case of a debt offering, a CMI should take all reasonable steps to identify whether its investor clients may have any associations<sup>16</sup> with the issuer client, the CMI or a company in the same group of companies<sup>17</sup> as the CMI

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<sup>15</sup> This includes fees for providing advice to the issuer, marketing, bookbuilding, making pricing and allocation recommendations and placing these securities with investor clients. This is also commonly referred to as “underwriting fees” by the industry.

<sup>16</sup> Investor clients who are the directors, employees or major shareholders of the issuer client, the CMIs or their group companies would be considered as having an association with the issuer client, the CMIs or their group companies.

<sup>17</sup> For the purposes of this paragraph, “group of companies” has the same meaning as in section 1 of Part 1 of Schedule 1 to the SFO.

(“group company”) and provide sufficient information to an OC to enable it to assess whether orders placed by these investor clients may negatively impact the price discovery process.

#### 21.3.4 Marketing

- (a) A CMI should only market the shares or debt securities to its investor clients which are targeted investors. In the case of a share offering, where the shares are only marketed to selected investor clients, the CMI should be satisfied that the shares have been marketed to a sufficient number of clients and the likelihood of undue concentration of holdings is reasonably low.
- (b) A CMI should allow all of its investor clients which are targeted investors and have indicated an interest in an offering to participate in that offering.

#### 21.3.5 Order book

- (a) A CMI should take reasonable steps to ensure that all orders (including indications of interest) placed in an order book represent bona fide demand of its investor clients, itself and its group companies. A CMI should also make enquiries with its investor clients about orders which appear unusual, for example, an order which is not commensurate with the investor client’s financial profile, before placing the order.
- (b) A CMI should ensure transparency in the bookbuilding process. It should disclose (whether directly or indirectly) the identities of all investor clients in an order book, except for orders placed on an omnibus basis. For orders placed on an omnibus basis, a CMI should provide, whether directly or indirectly, information about the underlying investor clients (ie, the investor client’s name and unique identification number) to the OC and the issuer when placing the orders.
- (c) A CMI (including the OC) which receives information about the investor clients for orders placed on an omnibus basis as mentioned under subparagraph (b) should only use this information for placing orders in that specific share or debt offering transaction.

### 21.3.6 Allocation

A CMI should establish and implement an allocation policy to ensure a fair allocation of shares or debt securities to its investor clients. This policy should:

- (a) address or take into account the principles and requirements under paragraph 21.3.10 and the following factors:
  - (i) the marketing and investor targeting strategy;
  - (ii) the order size and circumstances of the investor client;
  - (iii) the price limits for the investor client's orders;
  - (iv) any minimum allocation amounts indicated by investor clients;
  - (v) any applicable legal and regulatory requirements; and
- (b) prevent any practices which may result in the unfair treatment of investor clients or knowingly distort the demand for other share or debt offerings.

### 21.3.7 Rebates and preferential treatment offered

- (a) A CMI should not offer any rebates to an investor client or pass on any rebates provided by the issuer client to an investor client. In addition:
  - (i) in the case of an IPO, a CMI should not enable any of its investor clients to pay, for each of the shares allocated, less than the total consideration as disclosed in the listing documents; and
  - (ii) in the case of a debt offering, a CMI should not enter into any arrangements which may result in investor clients paying different prices for the debt securities allocated.
- (b) A CMI should disclose (whether directly or indirectly) to the issuer client, OC, all of its targeted investors and the non-syndicate CMIs it appoints:

- (i) any rebates offered (such as those offered by the issuer client of a debt offering) to CMIs. The disclosure should specify, for example:
  - the targeted recipients of the rebates;
  - the terms and conditions under which the targeted recipients may receive the rebates; and
  - the timing for the payment of the rebates; and
- (ii) any other preferential treatment of any CMIs or targeted investors (such as guaranteed allocations).

In the case of a share offering, a CMI should make the above disclosure upon becoming aware of any such rebates or preferential treatment. In the case of a debt offering, the disclosure should be made no later than the time of the dissemination of the deal “launch message” to targeted investors.

#### 21.3.8 Disclosure of information to OC, non-syndicate CMIs and targeted investors

A CMI should disclose complete and accurate information in a timely manner on the status of the order book and other relevant information it received to:

- (a) the OC (whether directly or indirectly) and non-syndicate CMIs it appoints for them to carry out their duties; and
- (b) its targeted investors for them to make an informed decision<sup>18</sup>.

#### 21.3.9 Record keeping

A CMI should maintain books and records which are sufficient to demonstrate its compliance with all applicable requirements in this paragraph. In particular, a CMI should document:

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<sup>18</sup> Where a CMI is a non-syndicate CMI (such as a sub-placing agent), it should disclose information received from syndicate CMIs or non-syndicate CMIs (such as a distributor).

- (a) assessments of the issuer client, share or debt offering and investor clients;
- (b) audit trails from the receipt of orders (i.e. including indications of interest), the placing of orders in the order book (whether directly or indirectly) through to the final order allocation (including changes in the orders received, details of the rejected orders and the reasons thereof, order confirmations with each investor client or CMI prior to the final allocation decisions and records of the allocation decisions made with a special focus on large or unusual allocations);
- (c) all key communications with, and information provided to, the OC, other CMIs or investor clients, including information about the status of the order book (such as the launch term sheet and book messages);
- (d) where a CMI's order is placed on an omnibus basis, the intended basis of allocation for all orders with justifications as well as any material deviations from its allocation policy as referred to in paragraph 21.3.6;
- (e) all key communications with the issuer client, such as disclosures made to the issuer client in relation to actual or potential conflicts of interest;
- (f) rebates offered by the issuer client and the payment details;
- (g) any other preferential treatment offered to itself, non-syndicate CMIs it appoints or its investor clients; and
- (h) information forming the basis of all submissions made to SEHK and the SFC.

Except for records mentioned in subparagraph (b), which should be kept for a period of not less than two years, a CMI should maintain the above records for a period of not less than seven years.

#### 21.3.10 Conflicts of interest

- (a) A CMI should establish, implement and maintain policies and procedures to:

- (i) identify, manage and disclose actual and potential conflicts of interest which may, for example, arise when a CMI:
    - serves both the interests of its issuer client and investor clients;
    - serves the interests of its investor clients when having a proprietary interest (including a proprietary interest of its group companies) in an offering; or
    - has full discretion over allocations to investor clients or a proprietary order; and
  - (ii) govern the process for generating proprietary orders as well as making allocations to such orders.
- (b) A CMI should:
- (i) always give priority to satisfying investor clients' orders over its own proprietary orders<sup>19</sup> and those of its group companies;
  - (ii) only be the price taker in relation to its proprietary orders and those of its group companies and ensure that these orders would not negatively impact the price discovery process; and
  - (iii) segregate and clearly identify its own proprietary orders and those of its group companies (whether directly or indirectly) in the order book and book messages.

*Note: For the purposes of this paragraph, proprietary orders of a group company exclude orders placed by the group company on behalf of its investor clients or funds and portfolios under its management, but include orders placed on behalf of funds and portfolios in which a CMI or its group company has a substantial interest.*

<sup>19</sup> For share offering, proprietary orders are subject to the SEHK Requirements.

- (c) In relation to a debt offering, a CMI should take reasonable steps to disclose (whether directly or indirectly) to the issuer client how any risk management transactions it intends to carry out for itself, the issuer client or its investor clients will not affect the pricing of the debt securities.

#### 21.3.11 Resources, systems and controls

A CMI should maintain sufficient resources and effective systems and controls to ensure that it can discharge its obligations and responsibilities.

##### Chinese walls

- (a) Where a CMI is a company or is part of a group of companies undertaking multiple activities in relation to an offering, for example, it or its group company is involved in the preparation and issuance of research reports, sponsor work, bookbuilding activities, placing activities and other related business activities, the CMI should take adequate measures to prevent the flow of information which may be confidential or price sensitive between staff performing different activities and to prevent and manage any conflicts of interest which may arise. In particular, the CMI should establish and maintain:
- (i) an effective system of functional barriers (Chinese walls) which should include having physical separation between, and different staff employed for, the various business activities; and
  - (ii) appropriate policies and procedures which cover:
    - the procedures (including approval procedures) for bringing staff over the wall;
    - the standards of conduct expected of staff brought over the wall; and
    - the records to be kept on wall-crossing activities.

### Review and approval of orders and allocations

- (b) The placing of orders for, or the allocation of shares or debt securities to, any of the following types of accounts by a CMI should be subject to appropriate risk assessments (taking into consideration, for instance, a CMI's financial capability and exposure to associated risks) and management review and approval:
  - (i) proprietary orders for the CMI and any of its group companies;
  - (ii) orders from its investor clients which may appear unusual, for example, orders which might appear to be related to the issuer client; and
  - (iii) in the case of a share offering, allocations which are subject to restrictions or require the prior consent of SEHK under the SEHK Requirements.

### Appointment of non-syndicate CMIs

- (c) Where a CMI appoints a non-syndicate CMI to assist it in distributing shares or debt securities, it should exercise due skill, care and diligence in the selection and appointment.

### Surveillance and monitoring

- (d) A CMI should conduct independent surveillance and monitoring on a regular basis to detect irregularities, conflicts of interest, leakage of price sensitive or confidential information about the issuer client and the offering, and potential non-compliance with applicable regulatory requirements or its own policies and procedures. For example, a CMI should:
  - (i) review the book messages it prepares and disseminates to ensure that there are no misleading messages;
  - (ii) perform surveillance of electronic communications; and
  - (iii) select debt or share offerings for post-deal reviews to ensure that the pricing or allocation is adequately justified.



This should be supplemented by an effective incident management and reporting mechanism to ensure that any issues identified are reported to independent control functions for follow-up action and escalated to senior management as appropriate.

#### 21.3.12 Communication with the SFC and SEHK

A CMI should deal with the SFC and SEHK in an open and cooperative manner and promptly provide all relevant information and explanations in accordance with applicable legal or regulatory requirements or upon request.

### 21.4 OC - Obligations and expected standards of conduct

In addition to the requirements specified in paragraph 21.3, an OC should comply with the following requirements.

#### 21.4.1 Terms of appointment

- (a) Before an OC conducts any activities specified in paragraph 21.2.3 for a share offering or participates in any bookbuilding or placing activities for a debt offering, it should ensure that:
  - (i) it has been formally appointed by the issuer under a written agreement to conduct such activities; and
  - (ii) the written agreement should clearly specify its roles and responsibilities, fee arrangements (including fixed fees as a percentage of the total fees to be paid to all syndicate CMIs participating in the offering) and the fee payment schedule.
- (b) In the case of an IPO on the Main Board of SEHK, an OC should, before accepting an appointment, either:
  - (i) ensure that it (or one of its group companies) is also appointed as a sponsor<sup>20</sup>, which is independent<sup>21</sup> of the

<sup>20</sup> Reference to “sponsor” in this paragraph 21 shall include the listing agent in the context of a REIT seeking the SFC’s authorisation.

<sup>21</sup> The circumstances under which a sponsor is considered not to be independent of the issuer client are set out under the Listing Rules.

issuer client, and that both appointments are made at the same time and at least two months before the submission of the listing application to SEHK by or on behalf of the issuer client; or

- (ii) obtain a written confirmation from the issuer client that for that IPO at least one sponsor, which is independent of the issuer client, or a group company of that sponsor, has been appointed as an OC, in which case its appointment as an OC should be made no later than two weeks after the submission of the listing application to SEHK by or on behalf of the issuer client.
- (c) In the case of an IPO on GEM of SEHK, an OC should ensure that it is appointed as an OC no later than two weeks after the submission of the listing application to SEHK by or on behalf of the issuer client.

#### 21.4.2 Advice to issuer client

- (a) An OC should act with due skill, care and diligence when providing advice, recommendations and guidance to the issuer client. In particular, an OC should:
  - (i) ensure that its advice and recommendations are balanced and based on thorough analysis and are compliant with all applicable legal and regulatory requirements;
  - (ii) engage the issuer client at various stages during the offering process to understand the issuer client's preferences and objectives with respect to pricing and the desired shareholder or investor base so that the OC is in a position to advise, develop or revise a marketing and investor targeting strategy with a view to achieving these objectives given prevailing market conditions and sentiment;
  - (iii) explain the basis of its advice and recommendations to the issuer client, including any advantages and disadvantages. For example, it should communicate its allocation policy to the issuer client to ensure that the

issuer client understands the factors underlying the allocation recommendations;

- (iv) advise the issuer client in a timely manner, throughout the period of engagement, of key factors for consideration and how these could influence the pricing outcome, allocation and future shareholder or investor base; and
  - (v) advise the issuer client on the information that should be provided to syndicate CMLs to enable them to meet their obligations and responsibilities under the Code. This includes information about the issuer client to facilitate a reasonable assessment of the issuer client required under paragraph 21.3.1.
- (b) An OC which participates in a share offering should:
- (i) provide guidance to the issuer client on the market's practice on the ratio of fixed and discretionary fees<sup>22</sup> to be paid to syndicate CMLs participating in an IPO; and
  - (ii) advise and guide the issuer client and its directors as to their responsibilities under the SEHK Requirements which apply to placing activities and take reasonable steps to ensure that they understand and meet these responsibilities.
- (c) Where the issuer client decides not to adopt an OC's advice or recommendations in relation to pricing or allocation of shares or debt securities or, in the case of a share offering, its decisions may lead to a lack of open market, an inadequate spread of investors or may negatively affect the orderly and fair trading of such shares in the secondary market, the OC should explain the potential concerns and advise the issuer clients against making these decisions.

<sup>22</sup> Discretionary fees refer to the portion of the total fees to be paid to all syndicate CMLs at the absolute discretion of the issuer client.

### 21.4.3 Marketing, rebates and preferential treatment offered

- (a) An OC should, in consultation with the issuer client, devise a marketing and investor targeting strategy for order generation, taking into account the objectives and preferences of the issuer client. This may include specifying the types of investors targeted<sup>23</sup> and the portion of an offering to be allocated to each type of investors to establish the desired shareholder or investor base. In the case of an IPO, the strategy should include which types of investors who may be appropriate to be cornerstone investors and aim to achieve an open market and an adequate spread of investors and promote the orderly and fair trading of the shares in the secondary market in accordance with the SEHK Requirements.
- (b) An OC should keep in view prevailing market conditions and sentiment and advise the issuer client to adjust the strategy as appropriate.
- (c) An OC should advise the issuer of the disclosure of any rebates and preferential treatment.

### 21.4.4 Bookbuilding

An OC should take all reasonable steps to ensure that the price discovery process is credible and transparent, the order book has been properly managed and the allocation recommendations made to the issuer client as well as the final allocation have a proper basis. An OC should use its best endeavours, when advising the issuer client or when making pricing and allocation decisions as delegated by the issuer client, to strike a balance between the interests of the issuer client and investor clients and to act in the best interests of the integrity of the market.

- (a) Order generation and consolidation of an order book

An OC should take reasonable steps to properly manage an order book and ensure the transparency of the order book.

<sup>23</sup> These include institutional clients, sovereign wealth funds, pension funds, hedge funds, family offices, high net worth individuals and retail investors.

(i) In particular, an OC should:

- ensure that the identities of all investor clients are disclosed in the order book, except for orders placed on an omnibus basis;
- properly consolidate orders in the order book by taking reasonable steps to identify and eliminate duplicated orders, inconsistencies or errors;
- segregate and clearly identify in the order book and book messages any proprietary orders of CMI and their group companies; and
- make enquiries with CMI which have placed orders on behalf of their investor clients, themselves or their group companies which appear unusual or irregular, for example, orders which appear to be related to the issuer client.

(b) Pricing

An OC should:

- (i) advise the issuer client on the pricing with reference to, for instance, the results of the bookbuilding activities, the characteristics of the issuer client, prevailing market conditions and sentiment and the requirements of the relevant authorities;
- (ii) advise the issuer client against providing any arrangements whereby:
  - in the case of an IPO, the investor clients would pay, for each of the shares allocated, less than the total consideration as specified in the listing documents; and
  - in the case of a debt offering, the investor clients would pay different prices for the debt securities allocated.

- (iii) ensure that the proprietary orders of CMLs or their group companies and, for debt offering, the orders placed by investor clients which have associations with the issuer client, CMLs or their group companies, will not negatively impact the price discovery process.

(c) Allocation

- (i) An OC should develop and maintain an allocation policy which sets out the criteria for making allocation recommendations to the issuer client. The allocation policy should address or take into account the following factors:
  - the issuer client's objectives, preferences and recommendations;
  - the prevailing market conditions and sentiment;
  - the types and characteristics as well as the circumstances of targeted investors;
  - the spread of investors (for example, the sizes and number of large holdings); and
  - the overall subscription rate for the offer.
- (ii) An OC should make allocation recommendations in accordance with an allocation policy as referred to in subparagraph (i) above. In addition:
  - recommendations regarding the allocation of shares or debt securities to the investor clients of the OC should take into account the policy specified in paragraph 21.3.6; and
  - in the case of an IPO, allocation recommendations should also ensure that allocations to Restricted Investors comply with the SEHK Requirements and be made with a view to achieving an open market, an adequate spread of shareholders and the orderly and fair trading of the shares in the secondary market.

Should the allocation recommendations materially deviate from the allocation policy or the policy specified in paragraph 21.3.6, the OC should explain to the issuer client the reasons for the deviation.

#### 21.4.5 Assessment of investors

- (a) In the case of an IPO, an OC should:
  - (i) advise the issuer client to provide to all syndicate CMIs a list of its directors, existing shareholders, their close associates and nominees engaged by any of the above for the subscription or purchase of shares offered in the IPO; and
  - (ii) take all reasonable steps to identify investors which are on the list mentioned under subparagraph (i) and ensure that they will only be allocated shares in accordance with applicable SEHK Requirements.
- (b) In the case of a debt offering, an OC should:
  - (i) advise the issuer client to provide sufficient information to all syndicate CMIs to enable them to reasonably identify whether investor clients have any associations with the issuer client; and
  - (ii) take all reasonable steps to identify whether investor clients have any associations with the issuer client, CMIs or their group companies.

#### 21.4.6 Disclosures to syndicate CMIs and targeted investors

An OC should:

- (a) inform other syndicate CMIs of the issuer client's marketing and investor targeting strategy; and
- (b) disseminate material information related to the offering (for example, information which may affect the prices, orders received per investor type, proprietary orders of CMIs and their group companies, and known preferential treatments and rebates) as included in, for example, the launch term

sheet and book messages, in a timely manner to all syndicate CMLs and ensure that such information is complete, accurate and has a proper basis.

#### 21.4.7 Record keeping

An OC should document:

- (a) all changes in the order book throughout the bookbuilding process;
- (b) all key discussions with the issuer client on, for instance, the ratio of fixed and discretionary fees to be paid to all syndicate CMLs participating in the IPO, marketing and investor targeting strategy, pricing, allocation policy and disclosures of any actual or potential conflicts of interest;
- (c) key advice or recommendations provided to the issuer client (including the allocation rationale, advantages and disadvantages, and any material deviations from the allocation policy);
- (d) the final decisions of the issuer client which deviate materially from the advice or recommendations provided by the OC, including the OC's explanation to the issuer client on any potential concerns associated with these decisions and the advice provided; and
- (e) the rationale for any decisions delegated to it by the issuer client (such as pricing and allocation of shares).

An OC should maintain records of the above for a period of not less than seven years.

#### 21.4.8 Communication with the SFC

- (a) An OC should report and provide the following information to the SFC in a timely manner:
  - (i) any instances of material non-compliance with the SEHK Requirements related to, for example, the placing activities conducted by itself or the issuer client;



- (ii) any material changes to the information it previously provided to the SFC and SEHK;
  - (iii) the reasons for ceasing to act as an OC in a share offering transaction;
  - (iv) other information as the SFC may require from time to time.
- (b) In the case of an IPO, an OC<sup>24</sup> should provide the following information to the SFC by no later than four clear business days prior to the Listing Committee Hearing<sup>25</sup>:
  - (i) the name of each OC participating in the offering;
  - (ii) the allocation of the fixed portion of the fees paid by the issuer to each OC; and
  - (iii) the total fees (as a percentage of the gross amount of funds raised) of both the public offer and the international tranche to be paid to all syndicate CMIs participating in the offering and the ratio between the fixed and discretionary portions of the total fees to be paid to all syndicate CMIs participating in the offering (in percentage terms).

If there are any material changes to any of the above, the OC should notify the SFC as soon as practicable.

*Note: If more than one intermediary is appointed as an OC for an IPO, arrangements should be made for one of them to provide the information specified in this subparagraph to the SFC.*

*Notwithstanding this, each OC is jointly and severally liable for ensuring that such information is accurate and complete and has been provided to the SFC within the timeframe stipulated above.*

<sup>24</sup> In the case of an IPO on the Main Board of the SEHK, this requirement is only applicable to an OC which is also appointed as a sponsor for that IPO as referred to in paragraph 21.4.1(b).

<sup>25</sup> Reference to “Listing Committee Hearing” shall refer to the expected date of the issue of the approval-in-principle letter by the SFC in the context of a REIT seeking the SFC’s authorisation.





## **Schedule 1      Risk disclosure statements**

### **Explanation**

A Client Agreement under paragraph 6 of the Code should include applicable risk disclosures, declaration by staff and acknowledgement by client in substantially the following form and should be in print at least as large as other text in the Client Agreement.

The substance contained in the following risk disclosure statements is considered to be the minimum required. A licensed or registered person may elect to provide additional risk disclosure information as appropriate.

Where any of the following risk disclosure statements are applicable, a declaration by staff and acknowledgement by client should be executed. The substance contained in the following declaration by staff and acknowledgement by client is considered to be the minimum required.

#### **Declaration by staff**

A member of staff, who should be a licensed or registered person, should sign and date a declaration confirming that the licensed or registered person has:

- provided the risk disclosure statement in a language of the client's choice (English or Chinese); and
- invited the client to read the risk disclosure statement, ask questions and take independent advice if the client wishes.

The name and CE number of that staff member should be stated in block letters in the risk disclosure statement.

#### **Acknowledgement by client**

The client shall sign and date an acknowledgement confirming that:

- the risk disclosure statement was provided in a language of the client's choice (English or Chinese); and
- the client was invited to read the risk disclosure statement, to ask questions and take independent advice if the client wishes.



#### Notes for licensed or registered persons

The declaration by staff and acknowledgement by client are needed when the client signs the first authority and not for any later renewal. The staff member should explain to the client the purposes for which the authority is to be used.



## **Risk disclosure statements**

The following risk disclosures should be given where they apply to the expected or actual activity of the client.

### **Risk of securities trading**

*The prices of securities fluctuate, sometimes dramatically. The price of a security may move up or down, and may become valueless. It is as likely that losses will be incurred rather than profit made as a result of buying and selling securities.*

### **Risk of trading futures and options**

*The risk of loss in trading futures contracts or options is substantial. In some circumstances, you may sustain losses in excess of your initial margin funds. Placing contingent orders, such as "stop-loss" or "stop-limit" orders, will not necessarily avoid loss. Market conditions may make it impossible to execute such orders. You may be called upon at short notice to deposit additional margin funds. If the required funds are not provided within the prescribed time, your position may be liquidated. You will remain liable for any resulting deficit in your account. You should therefore study and understand futures contracts and options before you trade and carefully consider whether such trading is suitable in the light of your own financial position and investment objectives. If you trade options you should inform yourself of exercise and expiration procedures and your rights and obligations upon exercise or expiry.*

### **Risk of trading in leveraged foreign exchange contracts**

*The risk of loss in leveraged foreign exchange trading can be substantial. You may sustain losses in excess of your initial margin funds. Placing contingent orders, such as "stop-loss" or "stop-limit" orders, will not necessarily limit losses to the intended amounts. Market conditions may make it impossible to execute such orders. You may be called upon at short notice to deposit additional margin funds. If the required funds are not provided within the prescribed time, your position may be liquidated. You will remain liable for any resulting deficit in your account. You should therefore carefully consider whether such trading is suitable in light of your own financial position and investment objectives.*



## **Risk of trading Growth Enterprise Market stocks**

*Growth Enterprise Market (GEM) stocks involve a high investment risk. In particular, companies may list on GEM with neither a track record of profitability nor any obligation to forecast future profitability. GEM stocks may be very volatile and illiquid.*

*You should make the decision to invest only after due and careful consideration. The greater risk profile and other characteristics of GEM mean that it is a market more suited to professional and other sophisticated investors.*

*Current information on GEM stocks may only be found on the internet website operated by The Stock Exchange of Hong Kong Limited. GEM Companies are usually not required to issue paid announcements in gazetted newspapers.*

*You should seek independent professional advice if you are uncertain of or have not understood any aspect of this risk disclosure statement or the nature and risks involved in trading of GEM stocks.*

## **Risks of client assets received or held outside Hong Kong**

*Client assets received or held by the licensed or registered person outside Hong Kong are subject to the applicable laws and regulations of the relevant overseas jurisdiction which may be different from the Securities and Futures Ordinance (Cap.571) and the rules made thereunder. Consequently, such client assets may not enjoy the same protection as that conferred on client assets received or held in Hong Kong.*

## **Risk of providing an authority to repledge your securities collateral etc.**

*There is risk if you provide the licensed or registered person with an authority that allows it to apply your securities or securities collateral pursuant to a securities borrowing and lending agreement, repledge your securities collateral for financial accommodation or deposit your securities collateral as collateral for the discharge and satisfaction of its settlement obligations and liabilities.*



*If your securities or securities collateral are received or held by the licensed or registered person in Hong Kong, the above arrangement is allowed only if you consent in writing. Moreover, unless you are a professional investor, your authority must specify the period for which it is current and be limited to not more than 12 months. If you are a professional investor, these restrictions do not apply.*

*Additionally, your authority may be deemed to be renewed (i.e. without your written consent) if the licensed or registered person issues you a reminder at least 14 days prior to the expiry of the authority, and you do not object to such deemed renewal before the expiry date of your then existing authority.*

*You are not required by any law to sign these authorities. But an authority may be required by licensed or registered persons, for example, to facilitate margin lending to you or to allow your securities or securities collateral to be lent to or deposited as collateral with third parties. The licensed or registered person should explain to you the purposes for which one of these authorities is to be used.*

*If you sign one of these authorities and your securities or securities collateral are lent to or deposited with third parties, those third parties will have a lien or charge on your securities or securities collateral. Although the licensed or registered person is responsible to you for securities or securities collateral lent or deposited under your authority, a default by it could result in the loss of your securities or securities collateral.*

*A cash account not involving securities borrowing and lending is available from most licensed or registered persons. If you do not require margin facilities or do not wish your securities or securities collateral to be lent or pledged, do not sign the above authorities and ask to open this type of cash account.*

### **Risk of providing an authority to hold mail or to direct mail to third parties**

*If you provide the licensed or registered person with an authority to hold mail or to direct mail to third parties, it is important for you to promptly collect in person all contract notes and statements of your*



*account and review them in detail to ensure that any anomalies or mistakes can be detected in a timely fashion.*

Notes for licensed or registered persons

The licensed or registered person should confirm with the client at least on an annual basis whether that client wishes to revoke the authority. For the avoidance of doubt, it will be acceptable for the licensed or registered person to send a notification to the client before the expiry date of the authority and inform the client that it is automatically renewed unless the client specifically revokes it in writing before the expiry date.

### **Risk of margin trading**

*The risk of loss in financing a transaction by deposit of collateral is significant. You may sustain losses in excess of your cash and any other assets deposited as collateral with the licensed or registered person. Market conditions may make it impossible to execute contingent orders, such as "stop-loss" or "stop-limit" orders. You may be called upon at short notice to make additional margin deposits or interest payments. If the required margin deposits or interest payments are not made within the prescribed time, your collateral may be liquidated without your consent. Moreover, you will remain liable for any resulting deficit in your account and interest charged on your account. You should therefore carefully consider whether such a financing arrangement is suitable in light of your own financial position and investment objectives.*

### **Risk of trading Nasdaq-Amex securities at The Stock Exchange of Hong Kong Limited**

*The securities under the Nasdaq-Amex Pilot Program ("PP") are aimed at sophisticated investors. You should consult the licensed or registered person and become familiarised with the PP before trading in the PP securities. You should be aware that the PP securities are not regulated as a primary or secondary listing on the Main Board or the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited.*



The following risk disclosure should be given to clients where a licensed person (i) solicits or recommends its clients who are not group affiliates to enter into OTC derivative transactions with a group affiliate which is not a licensed person; or (ii) arranges for OTC derivative transactions to be entered into between a group affiliate which is not a licensed person and its clients who are not group affiliates.

**Risk of entering into over-the-counter derivative transactions with an unlicensed person**

*If you enter into over-the-counter derivative transactions with [name of the group affiliate] (**Your Counterparty**), it is important for you to note that Your Counterparty is not licensed by the Securities and Futures Commission (SFC) and hence is not subject to the conduct and prudential supervision by the SFC.*

**[Notes for licensed persons:** Where the group affiliate is regulated by a financial regulator, describe the regulated status of the group affiliate, state the name of the regulator and the jurisdiction where the regulator is located, and include also the following risk disclosure statement:

*“Although Your Counterparty is regulated by another regulatory body, the regulation of such regulatory body may be different from the regulation of the SFC, and the protection that you may receive under the regulation of that regulatory body might not be the same as the protection that you would receive if Your Counterparty were licensed by the SFC.”]*

**[Notes for licensed persons:** Where the group affiliate is also not regulated by any other financial regulator, include also the following risk disclosure statement:

*“You should also note that Your Counterparty is not regulated by any other financial regulator and as such, you may not receive any regulatory protection at all.”]*

*You should cautiously consider whether it would be in your best interest to enter into over-the-counter derivative transactions with Your Counterparty instead of a licensed corporation and seek independent professional advice when in doubt.*

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**The following additional risk disclosure concerning futures and options trading may be provided to clients if licensed or registered persons so desire.**

## **Additional risk disclosure for futures and options trading**

This brief statement does not disclose all of the risks and other significant aspects of trading in futures and options. In light of the risks, you should undertake such transactions only if you understand the nature of the contracts (and contractual relationships) into which you are entering and the extent of your exposure to risk. Trading in futures and options is not suitable for many members of the public. You should carefully consider whether trading is appropriate for you in light of your experience, objectives, financial resources and other relevant circumstances.

### **Futures**

#### **1. Effect of “Leverage” or “Gearing”**

Transactions in futures carry a high degree of risk. The amount of initial margin is small relative to the value of the futures contract so that transactions are “leveraged” or “geared”. A relatively small market movement will have a proportionately larger impact on the funds you have deposited or will have to deposit: this may work against you as well as for you. You may sustain a total loss of initial margin funds and any additional funds deposited with the firm to maintain your position. If the market moves against your position or margin levels are increased, you may be called upon to pay substantial additional funds on short notice to maintain your position. If you fail to comply with a request for additional funds within the time prescribed, your position may be liquidated at a loss and you will be liable for any resulting deficit.

#### **2. Risk-reducing orders or strategies**

The placing of certain orders (e.g. “stop-loss” orders, or “stop-limit” orders) which are intended to limit losses to certain amounts may not be effective because market conditions may make it impossible to execute such orders. Strategies using combinations of positions, such as “spread” and



“straddle” positions may be as risky as taking simple “long” or “short” positions.

3. *[Repealed]*

## Options

4. Variable degree of risk

Transactions in options carry a high degree of risk. Purchasers and sellers of options should familiarise themselves with the type of option (i.e. put or call) which they contemplate trading and the associated risks. You should calculate the extent to which the value of the options must increase for your position to become profitable, taking into account the premium and all transaction costs.

The purchaser of options may offset or exercise the options or allow the options to expire. The exercise of an option results either in a cash settlement or in the purchaser acquiring or delivering the underlying interest. If the option is on a futures contract, the purchaser will acquire a futures position with associated liabilities for margin (see the section on Futures above). If the purchased options expire worthless, you will suffer a total loss of your investment which will consist of the option premium plus transaction costs. If you are contemplating purchasing deep-out-of-the-money options, you should be aware that the chance of such options becoming profitable ordinarily is remote.

Selling (“writing” or “granting”) an option generally entails considerably greater risk than purchasing options. Although the premium received by the seller is fixed, the seller may sustain a loss well in excess of that amount. The seller will be liable for additional margin to maintain the position if the market moves unfavourably. The seller will also be exposed to the risk of the purchaser exercising the option and the seller will be obligated to either settle the option in cash or to acquire or deliver the underlying interest. If the option is on a futures contract, the seller will acquire a position in a futures contract with associated liabilities for margin (see the section on Futures above). If the option is “covered” by the seller



holding a corresponding position in the underlying interest or a futures contract or another option, the risk may be reduced. If the option is not covered, the risk of loss can be unlimited.

Certain exchanges in some jurisdictions permit deferred payment of the option premium, exposing the purchaser to liability for margin payments not exceeding the amount of the premium. The purchaser is still subject to the risk of losing the premium and transaction costs. When the option is exercised or expires, the purchaser is responsible for any unpaid premium outstanding at that time.

### **Additional risks common to futures and options**

#### **5. Terms and conditions of contracts**

You should ask the firm with which you deal about the terms and conditions of the specific futures or options which you are trading and associated obligations (e.g. the circumstances under which you may become obliged to make or take delivery of the underlying interest of a futures contract and, in respect of options, expiration dates and restrictions on the time for exercise). Under certain circumstances the specifications of outstanding contracts (including the exercise price of an option) may be modified by the exchange or clearing house to reflect changes in the underlying interest.

#### **6. Suspension or restriction of trading and pricing relationships**

Market conditions (e.g. illiquidity) and/or the operation of the rules of certain markets (e.g. the suspension of trading in any contract or contract month because of price limits or “circuit breakers”) may increase the risk of loss by making it difficult or impossible to effect transactions or liquidate/offset positions. If you have sold options, this may increase the risk of loss.

Further, normal pricing relationships between the underlying interest and the futures, and the underlying interest and the option may not exist. This can occur when, for example, the futures contract underlying the option is subject to price limits



while the option is not. The absence of an underlying reference price may make it difficult to judge “fair value”.

7. Deposited cash and property

You should familiarise yourself with the protections given to money or other property you deposit for domestic and foreign transactions, particularly in the event of a firm insolvency or bankruptcy. The extent to which you may recover your money or property may be governed by specific legislation or local rules. In some jurisdictions, property which had been specifically identifiable as your own will be pro-rated in the same manner as cash for purposes of distribution in the event of a shortfall.

8. Commission and other charges

Before you begin to trade, you should obtain a clear explanation of all commission, fees and other charges for which you will be liable. These charges will affect your net profit (if any) or increase your loss.

9. Transactions in other jurisdictions

Transactions on markets in other jurisdictions, including markets formally linked to a domestic market, may expose you to additional risk. Such markets may be subject to regulation which may offer different or diminished investor protection. Before you trade you should enquire about any rules relevant to your particular transactions. Your local regulatory authority will be unable to compel the enforcement of the rules of regulatory authorities or markets in other jurisdictions where your transactions have been effected. You should ask the firm with which you deal for details about the types of redress available in both your home jurisdiction and other relevant jurisdictions before you start to trade.

10. Currency risks

The profit or loss in transactions in foreign currency-denominated contracts (whether they are traded in your own or another jurisdiction) will be affected by fluctuations in



currency rates where there is a need to convert from the currency denomination of the contract to another currency.

#### 11. Trading facilities

Electronic trading facilities are supported by computer-based component systems for the order-routing, execution, matching, registration or clearing of trades. As with all facilities and systems, they are vulnerable to temporary disruption or failure. Your ability to recover certain losses may be subject to limits on liability imposed by the system provider, the market, the clearing house and/or participant firms. Such limits may vary: you should ask the firm with which you deal for details in this respect.

#### 12. Electronic trading

Trading on an electronic trading system may differ from trading on other electronic trading systems. If you undertake transactions on an electronic trading system, you will be exposed to risks associated with the system including the failure of hardware and software. The result of any system failure may be that your order is either not executed according to your instructions or is not executed at all.

#### 13. Off-exchange transactions

In some jurisdictions, and only then in restricted circumstances, firms are permitted to effect off-exchange transactions. The firm with which you deal may be acting as your counterparty to the transaction. It may be difficult or impossible to liquidate an existing position, to assess the value, to determine a fair price or to assess the exposure to risk. For these reasons, these transactions may involve increased risks. Off-exchange transactions may be less regulated or subject to a separate regulatory regime. Before you undertake such transactions, you should familiarise yourself with applicable rules and attendant risks.



## Schedule 2      Client identity guidance note

Paragraph 5.4 of the Code requires that licensed or registered persons:

- satisfy themselves about information that identifies those who are ultimately responsible for originating instructions about a transaction and those who will ultimately benefit from a transaction or bear its risk and
- record that information in Hong Kong,

*before* doing anything to effect such a transaction.

Paragraph 5.4 of the Code supplements the existing "know your client" in paragraph 5.1 of the Code.

Paragraph 5.4 of the Code is intended to improve the transparency of trading in securities or futures contracts listed or traded on a recognized stock market or a recognized futures market or in derivatives, including over-the-counter derivatives, written over such securities or futures contracts, wherever such trading occurs, by improving the information that is available to the Commission about the identity of those interested in transactions on those markets.

Like the rest of the Code, paragraph 5.4 of the Code uses simple language. Licensed or registered persons should interpret paragraph 5.4 sensibly in accordance with its spirit and not interpret paragraph 5.4 technically or literally. Licensed or registered persons must satisfy themselves about and record information that identifies those who are really behind a transaction: those who *ultimately* originate instructions in relation to a transaction and those who *ultimately* benefit from, or bear the risk of, that transaction. The Commission is concerned about the substance of what is going on with a transaction and not the technicalities.

For example, if a licensed or registered person's client was a company incorporated in the British Virgin Islands, the licensed or registered person would have to satisfy itself whether or not a shareholder or director of that company had originated the instructions in relation to the transaction and would receive the ultimate benefit from, or bear the risk of, the transaction. The licensed or registered person would also have to satisfy itself whether or not the company was being used as a nominee to conceal that person's identity. If it was the shareholder who turned out to be relevant and not the





company, and the relevant shares turned out to be held on trust, the licensed or registered person would have to be satisfied about who was giving instructions in relation to the trust and who would benefit from, or bear the risk of, the transaction.

In relation to a collective investment scheme or discretionary account, the Commission does not intend that licensed or registered persons concern themselves with those who have a beneficial interest in that collective investment scheme or discretionary account, unless they are ultimately responsible for originating instructions in relation to a specific transaction.

For example, in relation to a collective investment scheme or discretionary account, licensed or registered persons must only satisfy themselves about and record information about the scheme or account and the manager of that scheme or account if they are the person giving instructions. However, licensed or registered persons must record information about a beneficiary of the scheme or account rather than the investment manager if that beneficiary has overridden the manager's discretion and originated the instructions in relation to a transaction.



## **Schedule 3      Additional requirements for licensed or registered persons dealing in securities listed or traded on The Stock Exchange of Hong Kong Limited**

The provisions in this Schedule apply to all licensed or registered persons in the course of their dealing in securities listed or traded on The Stock Exchange of Hong Kong Limited (“SEHK”), except as otherwise specified in certain paragraphs which do not apply to licensed or registered persons which are not exchange participants of SEHK.

For the purposes of this Schedule, the defined terms and expressions set out below have the meanings assigned to them under the rules (including the Options Trading Rules of The Stock Exchange of Hong Kong Limited (“Options Trading Rules”) and Operational Trading Procedures for Options Trading Exchange Participants of The Stock Exchange of Hong Kong Limited (“Operational Trading Procedures”) for Options Trading Exchange Participants) of SEHK. Where such defined terms and expressions are applied to exchange participants of SEHK, they are deemed to apply with the same meaning to licensed or registered persons which are not exchange participants wherever the context so permits.

### **Nasdaq-Amex pilot program**

1. Before accepting or operating a securities trading account for any person in relation to securities admitted to trading under the Nasdaq-Amex Pilot Program, a licensed or registered person which is an exchange participant of SEHK should provide the person with documentation on the Nasdaq-Amex Pilot Program as prescribed by SEHK in either the Chinese or English language according to the language preference of the person.

### **Options client agreement**

2. Without prejudice to paragraphs 6.1 to 6.3 of the Code, before any services are provided to a person (the client) in relation to the Options Contracts, a licensed or registered person which is an Options Exchange Participant or engages in Exchange Traded Options Business should ensure that the Client Agreement



(“Options Client Agreement”) contains at least statements to the effect that:

- (a) the licensed or registered person will keep information relating to the client’s options account confidential, but may provide any such information to the Commission and, where the licensed or registered person is an Options Exchange Participant, also to the SEHK and Hong Kong Exchanges and Clearing Limited to comply with their requirements or requests for information;
- (b) the client will confirm that:
  - (i) the options account is operated solely for the client’s account and benefit, and not for the benefit of any other person; or
  - (ii) the client has disclosed to the licensed or registered person in writing the name of the person(s) for whose benefit the options account is being operated; or
  - (iii) the client has requested the licensed or registered person to operate the options account as an Omnibus Account, and will immediately notify the licensed or registered person, on request, of the identity of any person(s) ultimately beneficially interested in Client Contracts;
- (c) where the licensed or registered person is an Options Exchange Participant, all Exchange Traded Options Business shall be effected in accordance with all laws, rules and regulatory directions (the “Rules”) applying to the licensed or registered person, which include the Options Trading Rules of SEHK, the Clearing Rules of The SEHK Options Clearing House Limited (“SEOCH”) and the rules of the Hong Kong Securities Clearing Company Limited (“HKSCC”); and in particular, SEOCH has authority under the Rules to make adjustments to the terms of Contracts, the licensed or registered person should notify the client of any such adjustments which affect Client Contracts to which the client is a party, and all actions taken by the licensed or registered



person, by SEHK, by SEOCH or by HKSCC in accordance with such Rules shall be binding on the client;

- (d) where the licensed or registered person is not an Options Exchange Participant, the licensed or registered person will collect margin requirements and premium in accordance with the Rules;
- (e) the client agrees that the terms of the Standard Contract for the relevant options series shall apply to each Client Contract between the licensed or registered person and the client, and that all Client Contracts shall be created, exercised, settled and discharged in accordance with the Rules;
- (f) the client agrees to provide the licensed or registered person with cash and/or securities and/or other assets ("Margin") as may be agreed from time to time, as security for the client's obligations to the licensed or registered person under the Options Client Agreement; such Margin should be paid or delivered as demanded by the licensed or registered person from time to time; and the amounts required by way of Margin should not be less than, but may exceed, the amounts as may be required by the Rules in respect of the client's open positions and delivery obligations, and further Margin may be required to reflect changes in market value;
- (g) if the licensed or registered person accepts securities by way of Margin, the client will on request provide the licensed or registered person with such authority as the licensed or registered person may require under the Rules to authorize the licensed or registered person to deliver such securities, directly or through an Options Exchange Participant, to SEOCH as SEOCH Collateral in respect of Exchange Traded Options Business resulting from the client's instructions to the licensed or registered person; and the licensed or registered person does not have any further authority from the client to borrow or lend the client's securities or otherwise part with possession (except to the client or on the client's instructions) of any of the client's securities for any other purpose;
- (h) the client agrees to indemnify the licensed or registered person, and the licensed or registered person's employees



and agents, against all losses and expenses resulting from breach of the client's obligation under the Options Client Agreement, including costs reasonably incurred in collecting debts from the client, and in closing the options account;

- (i) if the client fails to comply with any of the client's obligations and/or to meet the client's liabilities under the Options Client Agreement, including failure to provide Margin, the licensed or registered person may:
  - (i) decline to accept further instructions from the client in respect of Exchange Traded Options Business;
  - (ii) close out some or all of the client's Client Contracts with the licensed or registered person;
  - (iii) enter into Contracts, or into transactions in securities, futures or commodities, in order to settle obligations arising or to hedge the risks to which the licensed or registered person is exposed in relation to the client's failure;
  - (iv) dispose of Margin, and apply the proceeds thereof to discharge the client's liabilities to the licensed or registered person,

and any proceeds remaining after discharge of all the client's liabilities to the licensed or registered person should be paid to the client;

- (j) the client agrees to pay interest on all overdue balances (including interest arising after a judgement debt is obtained against the client) at such rates and on such other terms as the licensed or registered person has notified to the client from time to time;
- (k) in respect of all Contracts effected on the client's instructions, the client will pay the licensed or registered person, within the time period notified by the licensed or registered person, Premium, the licensed or registered person's commission and any other charges, and applicable levies imposed by SEHK, as have been notified to the client; and the licensed or



registered person may deduct such Premium, commissions, charges and levies from the options account;

- (l) the licensed or registered person may place limits on the open positions or delivery obligations that the client may have at any time;
- (m) where the licensed or registered person is an Options Exchange Participant, an acknowledgement by the client that:
  - (i) the licensed or registered person may be required to close out Client Contracts to comply with position limits imposed by SEHK; and
  - (ii) if the licensed or registered person goes into default, the default procedures of SEHK may result in Client Contracts being closed out, or replaced by Client Contracts between the client and another Options Exchange Participant;
- (n) where the licensed or registered person is an Options Exchange Participant, at the client's request, it may agree to the Client Contracts between itself and the client being replaced, in accordance with the Rules, by Client Contracts between the client and another Options Exchange Participant;
- (o) on exercise of a Client Contract by or against the client, the client will perform the client's delivery obligations under the relevant contract, in accordance with the Standard Contract and as the client has been notified by the licensed or registered person;
- (p) where the licensed or registered person is an Options Exchange Participant, the client acknowledges that, although all Options Contracts are to be executed on SEHK, the client and the licensed or registered person shall contract as principals under Client Contracts;
- (q) the licensed or registered person agrees to provide the client, upon request, with the product specifications for Options Contracts;



- (r) where the licensed or registered person is an Options Exchange Participant, if the licensed or registered person fails to meet its obligations to the client pursuant to the Options Client Agreement, the client shall have a right to claim under the Investor Compensation Fund established under the SFO, subject to the terms of the Investor Compensation Fund from time to time;
- (s) the licensed or registered person will notify the client of material changes in respect of the licensed or registered person's business which may affect the services the licensed or registered person provide to the client;
- (t) the client confirms that the client has read and agrees to the terms of the Options Client Agreement, which have been explained to the client in a language that the client prefers;
- (u) the Options Client Agreement is governed by, and may be enforced in accordance with, the laws of the Special Administrative Region of Hong Kong;
- (v) where the licensed or registered person is an Options Exchange Participant, the category of Options Exchange participation under which it is registered and the full name and contact details of the Options Officer or Options Representative who will be primarily responsible for the client's affairs should also be provided. A licensed or registered person which is subject to the Long-Only Restriction in accordance with Options Trading Rule 207 should also deliver to such client a written statement to the effect that: (i) the licensed or registered person is registered by SEHK as an Options Broker Exchange Participant, and not as an Options Trading Exchange Participant; (ii) as a condition of such registration, the only Exchange Traded Options Business which the licensed or registered person may conduct for clients is the purchase, closing, exercise, settlement and discharge of long options transactions; and (iii) therefore a client cannot write options through the client's options account with the licensed or registered person, or otherwise create any short open position;



- (w) where the licensed or registered person is an Options Exchange Participant, on the expiry day but only on the expiry day, the Options System will automatically generate exercise instructions in respect of all open long positions which are in-the-money by or above the percentage prescribed by SEOCH from time to time;
- (x) where the licensed or registered person is an Options Exchange Participant, the client may instruct the licensed or registered person to override an “automatically generated exercise instruction” referred to in subparagraph (w) above before the System Closure on the expiry day in accordance with the Operational Clearing Procedures of SEOCH; and
- (y) risk disclosure statements as specified in Schedule 1 to the Code will be attached.

## **Time stamping**

3. Without prejudice to paragraph 3.9 of the Code:

- (a) a licensed or registered person should maintain a record of the date and time at which it receives each instruction from a client in respect of the purchase, sale or exercise of Client Contracts. It must also maintain a record of the date and time at which it originates a purchase or sale of the Options Contracts for its House Account. A licensed or registered person should immediately time stamp the records of instructions received from clients and the origination of orders for its House Account;
- (b) notwithstanding paragraph 3(a) of this Schedule, a licensed or registered person which is a Market Maker, when fulfilling its Market Maker obligations, may choose not to time stamp the records of its quotes entered into the Options System, but it should continue to abide by all other conditions of paragraph 3(a) of this Schedule; and
- (c) notwithstanding paragraph 3(b) of this Schedule, where an Authorized User, in the course of the same day, enters orders in respect of both market making activity and client business, all orders, including quotes, so entered that day by that





Authorized User should be time stamped in the manner described above.

## Options trade confirmations

4. Where the licensed or registered person is an Options Exchange Participant, it should provide an Options Trade Confirmation that includes:
  - (a) the number of Client Contracts or Options Broker Client Contracts purchased or sold, the underlying security, expiry month, strike price, option type (put or call), version number (if not 0) and whether they were closing contracts or opening contracts;
  - (b) the price and the number of securities comprised in each lot the subject of the Client Contract or Options Broker Client Contract;
  - (c) a risk disclosure statement to the following effect: “Options can involve a high degree of risk and may not be suitable for every investor. Investors should ensure they understand those risks before participating in the options market”;
  - (d) a statement that one or more Options Contracts on the same terms as the Client Contracts or Options Broker Client Contracts were executed by the licensed or registered person which is an Options Exchange Participant (or, if applicable, by an Options Trading Exchange Participant on its behalf) on SEHK;
  - (e) a statement that, in the event of a default committed by the licensed or registered person resulting in the client suffering pecuniary loss, the client shall have a right to claim under the Investor Compensation Fund established under the SFO, subject to the terms of the Investor Compensation Fund from time to time; and
  - (f) a statement that all Exchange Traded Options Business made for or on behalf of a client shall be subject to the relevant provisions of the constitution, Rules of The Stock Exchange of Hong Kong Limited (“SEHK Rules”), regulations,



the Articles, customs and usages of SEHK, the Options Trading Rules, the Clearing Rules of SEOCH, the CCASS Rules and of the laws of Hong Kong, which shall be binding on both the licensed or registered person and the client.

## **Exercise of Client Contracts**

5.
  - (a) Following notification of exercise pursuant to Clearing Rule 505 of SEOCH in respect of an OCH Contract or an NCP Contract comprised in a short open position of a licensed or registered person which is an Options Trading Exchange Participant allocated to its Client Account, that licensed or registered person should, by a random selection process, select a Client Contract from among all Client Contracts comprised in short open positions of clients in the same option series as that Contract. The Client Contract so selected should, by operation of the Options Client Agreement and Options Trading Rule 416, for all purposes be treated as having been validly exercised at the time of the selection. The licensed or registered person should notify its client of the details of such exercise as soon as possible.
  - (b) Where a licensed or registered person which is an Options Broker Exchange Participant receives notification pursuant to Options Trading Rule 416A in respect of the exercise of an Options Broker Client Contract, the licensed or registered person should, by a random selection process, select a Client Contract from among all Client Contracts comprised in short open positions of clients in the same option series as that Options Broker Client Contract. The Client Contract so selected shall also be treated for all purposes as having been validly exercised. The licensed or registered person should notify its client of the details of the exercise as soon as possible.
6. Where a licensed or registered person which is not an Options Exchange Participant receives notification from another licensed or registered person for the exercise of a Client Contract, the first-mentioned licensed or registered person should, by a random selection process, select a Client Contract from among all Client Contracts comprised in short open positions of clients in the same option series as that Client Contract. The Client Contract so



selected shall also be treated for all purposes as having been validly exercised. The first-mentioned licensed or registered person should notify its client of the details of the exercise as soon as possible.

## **Adjustments to contracts (“capital adjustments”)**

7. Where SEOCH makes adjustments to the terms of the Contracts of an option series in accordance with the Clearing Rules, a licensed or registered person which is an Options Exchange Participant, should:
  - (a) by no later than the next Business Day after such adjustments have been announced, notify all its clients affected by such adjustments of the details of the adjustments; and
  - (b) as soon as possible but in any event no later than 1 Business Day after the adjustment takes effect, notify all its clients of any changes to the terms of any Contracts in the client’s account resulting from such adjustments.
8. Where a licensed or registered person which is not an Options Exchange Participant receives a notification about capital adjustments from an Options Exchange Participant, it should promptly inform its clients of the same.

## **Omnibus Accounts**

9. Where a licensed or registered person which is an Options Exchange Participant accepts as a client a person whom the licensed or registered person knows to be engaging in Exchange Traded Options Business on behalf of other persons, the licensed or registered person should open one or more Omnibus Account(s) in the name of the client and should ensure that the client, to the fullest extent possible, calculates and collects appropriate amounts of Margin and Premium from such other persons.



## **Client's Money in relation to Exchange Traded Options Business**

10. *[Repealed]*
11. Without prejudice to paragraph 3.7 of the Code, each licensed or registered person should maintain a separate ledger account for each of its clients into which should be entered sufficient particulars to identify uniquely and unambiguously all Exchange Traded Options Business in relation to each client. Each such ledger account must contain information which is sufficient, at any given time, to enable all collateral and money received from each client to be separately identified and allocated to each aspect of Exchange Traded Options Business conducted on behalf of that client.

## **Securities borrowing and lending**

12. *[Repealed]*
13. *[Repealed]*

## **Short selling**

14. *[Repealed]*

## **Other requirements**

15. A licensed or registered person which is an exchange participant of SEHK should also comply with the following rules (including the rules, regulations, guidelines, procedures and circulars updated from time to time) of the SEHK where applicable:
  - (a) *[Repealed]*
  - (b) *[Repealed]*
  - (c) Options Trading Rules 424 to 426A and Operational Trading Procedures paragraphs 5.4 to 5.6 and Appendix H on client margin requirements; and
  - (d) Options Trading Rules 435 to 441 and Operational Trading Procedures paragraphs 5.9 to 5.12 of SEHK on position limits.



**Schedule 3A *[Repealed]***

**Schedule 3B *[Repealed]***



## **Schedule 4      Additional requirements for licensed or registered persons dealing in futures contracts and/or options contracts traded on Hong Kong Futures Exchange Limited**

The provisions in this Schedule apply to all licensed or registered persons in the course of their dealing in Futures Contracts and/or Options Contracts traded on Hong Kong Futures Exchange Limited (“HKFE”) except as otherwise specified in certain paragraphs which do not apply to licensed or registered persons which are not exchange participants of HKFE.

For the purposes of this Schedule, the defined terms and expressions set out below have the meanings assigned to them under the rules of HKFE. Where such defined terms and expressions are applied to exchange participants of HKFE, they are deemed to apply with the same meaning to licensed or registered persons which are not exchange participants wherever the context so permits.

### **Books and accounts**

1. A licensed or registered person which is an exchange participant of HKFE should maintain proper books and records which, inter alia, correctly and clearly record:
  - (a) the financial position of each client's trading account;
  - (b) the time, date and complete particulars of instructions received from and trades executed for clients;
  - (c) the time, date and complete particulars of the licensed or registered person's own orders and trades;
  - (d) particulars of all the open positions of the licensed or registered person and of each of its clients (that is, not simply the net open positions);
  - (e) the amount of margin deposited from time to time by the licensed or registered person with
    - (i) the Clearing House (where applicable); and



- (ii) executing agents,  
identifying each such agent and the amount of margin deposited with each;
  - (f) the amount of variation adjustment paid by the licensed or registered person to
    - (i) the Clearing House (where applicable); and
    - (ii) executing agents,  
identifying each such agent and the amount of variation adjustment paid to each;
  - (g) the amount of margin deposited or required to be deposited by each client;
  - (h) the amount of variation adjustment collected or required to be collected from clients;
  - (i) all payments and assets received or held by the licensed or registered person to satisfy margin requirements;
  - (j) particulars of all margin calls and demands for variation adjustment made; and
  - (k) any other particulars from time to time required by HKFE to be kept in the books and records of the licensed or registered person.
- 1A. Where confirmations of executed trades are made to clients through the telephone, a licensed or registered person should use a telephone recording system to record such confirmations and maintain telephone recordings as part of its records for at least six months.
- 1B. A licensed or registered person should prohibit its staff from confirming executed trades through mobile phones when on the trading floor, in the trading room, usual place of business where order is received or usual place where business is conducted, and

*The revisions to paragraphs 1A and 1B will take effect on 1 Dec 2012.*



should have a written policy in place to explain and enforce this prohibition.

#### Notes

The Commission notes that mobile telephones are widely used in Hong Kong. The use of mobile phones for confirming executed trades is strongly discouraged. However, where executed trades are confirmed by mobile phones outside the trading floor, trading room, usual place of business where order is received or usual place where business is conducted, staff members should immediately call back to their licensed or registered person's telephone recording system and record the time of confirmation and the details of executed trades. The use of other formats (e.g. in writing by hand) to record details of executed trades and time of confirmation should only be used if the licensed or registered person's telephone recording system cannot be accessed

## Client Agreement

2. Without prejudice to paragraphs 6.1 to 6.3 of the Code, before any services are provided to a client in relation to the transaction of any Futures Contracts and/or Options Contracts, a licensed or registered person should ensure that the Client Agreement contains at least provisions to the following effect that:
  - (a) (where a licensed or registered person is an exchange participant of HKFE) the category of exchange participant under which the licensed or registered person is registered. The particulars of every licence or registration (including the CE number) maintained by the licensed or registered person (for both exchange participants and non-exchange participants) pursuant to the SFO or any other regulatory provisions, and the full name of the employee primarily responsible for the client's affairs and particulars of the licence or registration maintained by that employee (including the CE number) pursuant to the SFO or any other regulatory provisions;
  - (b) (where a licensed or registered person is an exchange participant of HKFE) every Exchange Contract shall be subject to the charge of a Investor Compensation Fund levy and a levy pursuant to the SFO, the cost of both of which shall be borne by the client;





- (c) (where a licensed or registered person is an exchange participant of HKFE) if the client suffers pecuniary loss by reason of the licensed or registered person's default, the liability of the Investor Compensation Fund will be restricted to valid claims as provided for in the SFO and the relevant subsidiary legislation and will be subject to the monetary limits specified in the Securities and Futures (Investor Compensation – Compensation Limits) Rules and accordingly there can be no assurance that any pecuniary loss sustained by reason of such a default will necessarily be recouped from the Investor Compensation Fund in full, in part or at all;



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- (d) transactions related to exchange traded futures and options contracts shall be subject to the rules of the relevant markets and exchanges. A statement that the licensed or registered person is required, upon the request of HKFE (in the case where the licensed or registered person is an exchange participant of HKFE) or the Commission, to disclose the name, beneficial identity and such other information concerning the client as the Exchange or the Commission may require and that the client agrees to provide such information concerning the client as the licensed or registered person may require in order for the licensed or registered person to comply with this requirement;
- (e) the client may have varying level and type of protection in relation to transactions on different markets and exchanges;
- (f) (if appropriate, then prominently displayed and in bold type) the licensed or registered person may, subject to the provisions of the SFO and any applicable law, take the opposite position to the client's order in relation to any exchange traded futures and options contracts, whether on the licensed or registered person's own account or for the account of its associated company or other clients of the licensed or registered person, provided that such trade is executed competitively on or through the facilities of HKFE in accordance with its rules or the facilities of any other commodity, futures or options exchange in accordance with the rules and regulations of such other exchange;
- (g) (where a licensed or registered person is an exchange participant of HKFE) the client acknowledges that the Clearing House may do all things necessary to transfer any open positions held by the licensed or registered person on the client's behalf and any money and security standing to the credit of its account with the licensed or registered person to another exchange participant of HKFE in the event the rights of the licensed or registered person as an exchange participant of HKFE are suspended or revoked;
- (h) all monies, securities and other property received by the licensed or registered person from the client or from any other person (including a clearing house) for the account of the



client shall be held by the licensed or registered person as trustee and segregated from the licensed or registered person's own assets. These assets so held by the licensed or registered person shall not form part of the assets of the licensed or registered person for insolvency or winding up purposes but shall be returned to the client promptly upon the appointment of a provisional liquidator, liquidator or similar officer over all or any part of the licensed or registered person's business or assets;

- (i) (where a licensed or registered person is an exchange participant of HKFE) any monies, approved debt securities or approved securities received by the licensed or registered person from the client or from any other person (including the Clearing House) are held in the manner specified under paragraphs 7 to 12 of this Schedule and the client authorises the licensed or registered person to apply any such monies, approved debt securities or approved securities in the manner specified under paragraphs 14 to 15. In particular, the licensed or registered person may apply such monies, approved debt securities or approved securities in or towards meeting the licensed or registered person's obligations to any party insofar as such obligations arise in connection with or incidental to F.O. Business transacted on that client's behalf;
- (j) (where a licensed or registered person is an exchange participant of HKFE) the client acknowledges that in respect of any account of the licensed or registered person maintained with the Clearing House, whether or not such account is maintained wholly or partly in respect of F.O. Business transacted on behalf of that client and whether or not monies, approved debt securities or approved securities paid or deposited by that client has been paid to or deposited with the Clearing House, as between the licensed or registered person and the Clearing House, the licensed or registered person deals as principal and accordingly no such account is impressed with any trust or other equitable interest in favour of the client and monies, approved debt securities and approved securities paid to or deposited with the Clearing House are thereby freed from the trust referred to in paragraph 2(h) of this Schedule;



- (k) (where a licensed or registered person is an exchange participant of HKFE) the period within which margin calls and demands for variation adjustments must be met, the licensed or registered person may be required to report to HKFE and the Commission particulars of all open positions in respect of which two successive margin calls and demands for variation adjustments are not met within the period specified by the licensed or registered person and the licensed or registered person may require more margin or variation adjustments than that specified by the Exchange and/or the Clearing House and may close out open positions in respect of which any margin calls and demands for variation adjustments are not met within the period specified by the licensed or registered person or at the time of making such call(s) or demand(s);
- (l) (where a licensed or registered person is an exchange participant of HKFE) the client acknowledges that the licensed or registered person is bound by Rules of Hong Kong Futures Exchange Ltd (“HKFE Rules”) which permit HKFE to take steps to limit the positions or require the closing out of contracts on behalf of such clients who in the opinion of the Exchange are accumulating positions which are or may be detrimental to any particular Market or Markets, or which are or may be capable of adversely affecting the fair and orderly operation of any Market or Markets as the case may be; and
- (m) risk disclosure statements as specified in Schedule 1 to the Code will be attached.

## **Discretionary accounts**

- 3. (a) In the event that the net equity in a discretionary account falls below such sum as is specified by the client in writing to the licensed or registered person from time to time or if, in any period of three or fewer consecutive trading days, it falls by more than 50 per cent from the level at which it stood at the beginning of that period, a licensed or registered person should forthwith notify the client in writing of the level of net equity and, except with the prior written consent of the client to every subsequent transaction, should not initiate any new trades in respect of that discretionary account (except in



order to close out existing open positions) until such time as the net equity in the discretionary account exceeds the specified amount or (as the case may be) is restored to the level at which it stood at the beginning of the period.

- (b) For the purpose of paragraph 3(a) of this Schedule, "net equity" at any time means the balance at that time shown in the ledger account relating to the discretionary account plus any floating profit or less any floating loss in respect of the discretionary account, and after adjusting for any levies or commission due from the client.

4. (a) A licensed or registered person should not:

- (i) accept, carry or initiate on behalf of a discretionary account more than two day trades in any Market; or
- (ii) open short options positions in a discretionary account,

unless it has obtained from the client on whose instructions the discretionary account was opened prior written approval specifically authorising such transactions.

- (b) For the purpose of paragraph 4(a) of this Schedule, a "day trade" is a transaction whereby a licensed or registered person executes in the same day an order to buy and an order to sell Exchange Contracts on the same Market in the same futures contract month, option series, or Currency Contract Type for the same client.

## **Omnibus Accounts**

5. A licensed or registered person which is an exchange participant of HKFE should maintain the following information of all omnibus accounts carried by it:

- (a) the name of the client on whose instructions the account is operated and an indication as to whether or not it is an exchange participant of HKFE;
- (b) the title of the account in the books of the licensed or registered person;



- (c) the address of the client;
  - (d) whether the business transacted in respect of the account is HKFE Trade or Non-HKFE Trade; and
  - (e) whether the client is authorised under the Ordinances or the laws of its jurisdiction to operate an omnibus account and whether the client is a dealer registered under the Ordinances or under the laws of its relevant jurisdiction.
6. (a) A licensed or registered person which is an exchange participant of HKFE should ensure that a client who operates an omnibus account and who is not an exchange participant of HKFE should:
- (i) in the client's dealings with the person(s) from whom it receives instructions with respect to the omnibus account, comply with and enforce the margin and variation adjustment requirements and procedures as stipulated in the rules as though the client were an exchange participant of HKFE and as though the person(s) for whose account or benefit such instructions are given were clients;
  - (ii) cause Exchange Contracts to be entered into in fulfillment of such instructions, so that there shall in no circumstances be any dealing with the instructions in a manner which constitutes unlawful dealing in differences in market quotations of commodities under the laws of Hong Kong or any other applicable jurisdiction or in a manner which constitutes or involves betting, wagering, gaming or gambling with respect to such items in contravention of Hong Kong laws or any other applicable laws; and
  - (iii) ensure that the persons from whom the client receives instructions comply with the margin and variation adjustment requirements as stipulated in the rules, with the result that, as between HKFE and the licensed or registered person, the licensed or registered person should be responsible for ensuring that such requirements are complied with by all persons through



whom instructions pass with respect to the omnibus account as if each in turn was the client for whom such omnibus account was operated.

- (b) A licensed or registered person should not operate an omnibus account unless it is able, whether by virtue of the contractual terms applying between it and its client or otherwise, to comply strictly with paragraph 6(a) of this Schedule.

## **Client's monies, approved debt securities and approved securities of clients**

7. (a) *[Repealed]*

- (b) Every licensed or registered person which is an exchange participant of HKFE and which transacts on behalf of its clients both HKFE Trade and Non-HKFE Trade should maintain at least two segregated bank accounts and should ensure that client's money relating to HKFE Trade is paid into one segregated bank account designated as an "HKFE Trade" account whilst client's money relating to Non-HKFE Trade is paid into another segregated bank account designated as a "Non-HKFE Trade" account, and should procure that client's money received and paid by the licensed or registered person in respect of HKFE Trade and Non-HKFE Trade is always kept separately and accounted for separately.

8. (a) Every licensed or registered person which is an exchange participant of HKFE and which receives from clients collateral for margin requirements in the form of approved debt securities should establish and keep with a recognized dealer registered with the Hong Kong Monetary Authority (in the case of Exchange Fund Bills or Notes) or any bank, depository or institution approved by the Clearing House from time to time (in the case of other approved debt securities) at least one debt securities account in the name of the licensed or registered person and in the title of which the word "client", "segregated", "Non-House" or other similar word or phrase appears and which constitutes a segregated debt securities account.

- (b) Every licensed or registered person which is an exchange participant of HKFE and which receives from clients collateral





for margin requirements in the form of approved debt securities and which transacts on behalf of clients both HKFE Trade and Non-HKFE Trade should maintain at least two segregated debt securities accounts and should ensure that clients' approved debt securities relating to HKFE Trade are deposited into one segregated debt securities account designated as an "HKFE Trade" account whilst clients' approved debt securities relating to Non-HKFE Trade are deposited into another segregated debt securities account designated as a "Non-HKFE Trade" account, and should procure that clients' approved debt securities received and deposited by the licensed or registered person in respect of HKFE Trade and Non-HKFE Trade are always kept separately and accounted for separately.

9. (a) Every licensed or registered person which is an exchange participant of HKFE and which receives from clients collateral for margin requirements in the form of approved securities should establish and keep with a registered participant of the Central Clearing and Settlement System operated by Hong Kong Securities Clearing Company Limited ("HKSCC") or any other depository, institution or clearing house approved by the Clearing House from time to time at least one securities account in the name of the licensed or registered person and in the title of which the word "client", "segregated", "Non-House" or other similar word or phrase appears and which constitutes a segregated securities account.
- (b) Every licensed or registered person which is an exchange participant of HKFE and which receives from clients collateral for margin requirements in the form of approved securities and which transacts on behalf of clients both HKFE Trade and Non-HKFE Trade should maintain at least two segregated securities accounts and should ensure that clients' approved securities relating to HKFE Trade are deposited into one segregated securities account designated as an "HKFE Trade" account whilst clients' approved securities relating to Non-HKFE Trade are deposited into another segregated securities account designated as a "Non-HKFE Trade" account, and should procure that clients' approved securities received and deposited by the licensed or registered person in respect of



HKFE Trade and Non-HKFE Trade are always kept separately and accounted for separately.

10. (a) to (d) *[Repealed]*
  - (e) Each licensed or registered person, whether an exchange participant of HKFE or not, should ensure that client's money maintained in segregated bank accounts is at all times sufficiently liquid to satisfy readily all margin requirements or other trading related liabilities in respect of F.O. Business conducted on behalf of clients. In this connection, each licensed or registered person should ensure that prudent cash flow management procedures are employed.
11. (a) All approved debt securities received by a licensed or registered person which is an exchange participant of HKFE from a client or from any other person (including the Clearing House) for the account of the client should be held by the licensed or registered person as trustee, segregated from the licensed or registered person's own assets and deposited into a segregated debt securities account of the licensed or registered person.
  - (b) Unless clients' approved debt securities are deposited directly into the licensed or registered person's segregated debt securities account, every licensed or registered person which is an exchange participant of HKFE holds or receives clients' approved debt securities should as soon as practicable and in any event within the next business day after its receipt deposit clients' approved debt securities into the licensed or registered person's segregated debt securities account.
  - (c) No clients' approved debt securities may be deposited by a licensed or registered person which is an exchange participant of HKFE into any account other than a segregated debt securities account maintained by that licensed or registered person.
  - (d) No approved debt securities or other debt securities other than clients' approved debt securities may be deposited by a licensed or registered person which is an exchange participant of HKFE into a segregated debt securities account.



12.
  - (a) All approved securities received by a licensed or registered person which is an exchange participant of HKFE from a client or from any other person (including the Clearing House and HKSCC) for the account of the client should be held by the licensed or registered person as trustee, segregated from the licensed or registered person's own assets and deposited into a segregated securities account of the licensed or registered person.
  - (b) Unless clients' approved securities are deposited directly into the licensed or registered person's segregated securities account, every licensed or registered person which is an exchange participant of HKFE holds or receives clients' approved securities should as soon as practicable and in any event within the next business day after its receipt deposit clients' approved securities into the licensed or registered person's segregated securities account.
  - (c) No clients' approved securities may be deposited by a licensed or registered person which is an exchange participant of HKFE into any account other than a segregated securities account maintained by that licensed or registered person.
  - (d) No approved securities or other securities other than clients' approved securities may be deposited by a licensed or registered person which is an exchange participant of HKFE into a segregated securities account.
13. *[Repealed]*
14. Where a licensed or registered person is an exchange participant of HKFE, there may be withdrawn from a segregated debt securities account:
  - (a) approved debt securities required to meet obligations of the licensed or registered person to the Clearing House or an executing agent arising in connection with F.O. Business transacted by the licensed or registered person on the instructions of one or more clients provided that no withdrawal may be made which would have the effect that Clearing House margin, variation adjustment requirements or other trading related liabilities in respect of F.O. Business



conducted on behalf of any client are thereby financed by other clients' approved debt securities;

- (b) approved debt securities which are transferred to another segregated debt securities account; and
- (c) approved debt securities returned to or in accordance with the directions of a client, but in such a case notwithstanding the client's directions, no approved debt securities may be deposited into another account of the licensed or registered person unless that account is a segregated debt securities account.

15. Subject to a licensed or registered person which is an exchange participant of HKFE having obtained from its clients specific written authority and such other consent(s) as may be required under applicable laws, rules and regulations, the following may be withdrawn from a segregated securities account:

- (a) approved securities required to meet the obligations of the licensed or registered person to the Clearing House or an executing agent arising in connection with F.O. Business transacted by the licensed or registered person on the instructions of one or more clients provided that no withdrawal may be made which would have the effect that Clearing House margin, variation adjustment requirements or other trading related liabilities in respect of F.O. Business conducted on behalf of any client are thereby financed by other clients' approved securities;
- (b) approved securities which are transferred to another segregated securities account; and
- (c) approved securities returned to or in accordance with the directions of a client, but in such a case notwithstanding the client's directions, no approved securities may be deposited into another account of the licensed or registered person unless that account is a segregated securities account.



## **No set-off between licensed or registered person's accounts and client's accounts**

16.
  - (a) No licensed or registered person should apply, permit or suffer any monies, securities or any other forms of collateral standing to the credit of any client's ledger account to be applied for the benefit of its own trading accounts, accounts of its directors or employees or for the benefit of trading accounts of any other clients.
  - (b) No licensed or registered person should apply, permit or suffer any monies, securities or any other forms of collateral received from clients to be applied against debts of its own trading account or accounts of its directors or employees.

## **Client's ledgers**

17. Every licensed or registered person which is an exchange participant of HKFE should maintain in its books and records separate ledger accounts for every client in respect of:
  - (a) all HKFE Trade;
  - (b) all Non-HKFE Trade;
  - (c) all trade which is neither HKFE Trade nor Non-HKFE Trade and is consequently not F.O. Business, of that client.
18.
  - (a) Every licensed or registered person which is an exchange participant of HKFE and which receives from clients collateral for margin requirements in the form of approved debt securities or approved securities (or which arranges for approved debt securities or approved securities of clients to be deposited directly with the Clearing House) should maintain proper books and records which correctly and clearly record, inter alia, the following details of all approved debt securities and approved securities received from each client:
    - (i) a complete description of each type of approved debt securities and approved securities; and



- (ii) the quantity and face value of approved debt securities and approved securities deposited with or withdrawn from the Clearing House or each depository, institution or other clearing house with which the segregated debt securities account or segregated securities account is maintained and the date of any such deposit or withdrawal.
  - (b) Every licensed or registered person which is an exchange participant of HKFE should ensure that all regular statements of account to clients contain the details listed in subparagraph (a) above.
19. Every licensed or registered person which is an exchange participant of HKFE should segregate its clients' HKFE Trade ledger accounts and Non-HKFE Trade ledger accounts and any other ledger accounts so that, except by actual cash payments or approved debt securities transfers, credit balances on any given type of trade account may not be used to offset debit balances, or to meet margin requirements or demands for variation adjustment on any other type of trade account.

## **Other requirements**

20. A licensed or registered person which is an exchange participant of HKFE should also comply with the following rules (including the rules, regulations, guidelines, procedures and circulars of HKFE updated from time to time) of HKFE where applicable:
- (a) Circular dated 31/7/1998 (Ref. No. CIR/LEGAL/980274) on disclaimer and Circular dated 8/5/1998 (Ref. No. CIR/LEGAL/980141) on HKFE disclaimer;
  - (b) HKFE Rule 617 on minimum margin requirements, including Circular dated 7/12/1993 (Ref. No. MEM/CIR/9312050/017) on the requirements governing omnibus accounts; Circular dated 27/8/1998 (Ref. No. CIR/CMP/980310) on day trade margin requirements; and Circular dated 3/3/1997 (Ref. No. AUD/9703001) on Guidelines on Margin Procedures;
  - (c) Circular dated 30/1/1997 (Ref. No. CMP/CIR/9701010) and 13/6/1997 (Ref. No. MEM/CIR/9706036) on large open



position (reporting) procedures (including HSI Futures, HSI Options and NYMEX contracts), including prescribed forms, and Circular dated 14/7/1999 (Ref. No. CIR/CMP/990271) on delta position limits; and

- (d) Circular dated 10/3/1995 (Ref. No. MEM/CIR/9503029/023) on stock futures (client margining, large open positions and position limits, client account documentation and general).



## **Schedule 5      Additional requirements for licensed persons providing margin lending**

### **General**

1.      The provisions in this Schedule apply to persons licensed for :
    - (a)    Type 8 regulated activity, namely securities margin financing;  
and
    - (b)    Type 1 regulated activity, namely dealing in securities, that  
provide financial accommodation to any of their clients in  
order to facilitate acquisitions or holdings of listed securities  
by the persons for their clients,
- except as otherwise specified.

### **Margin lending policy**

2.      A licensed person should have a prudent margin lending and  
margin call policy set out in writing and properly communicated to  
its staff.
3.      A licensed person should assure itself that the margin client has  
the financial capacity to meet obligations arising from instructions  
the margin client gives and in the absence of such assurance, it  
shall not accept instructions from such margin client.

### **Differentiation between cash and margin accounts**

4.      Where a client operates both a cash and a margin account, the  
licensed person should have adequate systems and resources to  
ensure that transactions and assets booked under one account are  
not commingled with those booked under the other.

### **Prudent bank borrowing**

5.      (a)    To avoid potential over-borrowing, a licensed person should  
ensure that the aggregate of all outstanding bank borrowings,  
overdrafts, advances etc. secured by the pledging or deposit





of securities collateral belonging to margin clients remains prudent when compared to the aggregate of all outstanding margin loans made to margin clients. As a general guide, the amount of such bank borrowings, overdrafts and advances should not exceed 120% of the value of outstanding margin loans.

- (b) A licensed person that repledges securities collateral should notify the Commission in writing within one business day whenever for a continuous period of 2 weeks the aggregate outstanding balance of borrowings drawn under its bank credit facilities equals or exceeds 80% of the total credit limit of the bank credit facilities calculated at the sum of:
  - (i) the credit limit of each unsecured bank credit facility; and
  - (ii) the lower of
    - (I) the aggregate credit limit of its secured bank credit facilities; and
    - (II) the aggregate amount that the banks are willing to lend against the security pledged to the banks.

Notes:

The licensed person may include as part of the total credit limit the amount that the banks are willing to lend against the listed securities that belong to the licensed person and have not been pledged to the banks, plus the amount the banks are willing to lend against any clients' securities collateral that has not been repledged but may be so repledged as permitted by the repledging limit under the Securities and Futures (Client Securities) Rules.

## **Client agreement**

- 6. A licensed person should ensure that a written Margin Client Agreement is entered into with a client before margin lending is provided to that client. The Margin Client Agreement shall specify that the account is a "margin account".



7. In the case of a person licensed for Type 8 regulated activity, the Margin Client Agreement should, in addition to the requirements set out in paragraph 6 of the Code, contain a statement that:
- (a) the licensed person is subject to the sole business requirement and it can only provide financial accommodation to facilitate the acquisition of listed securities and, where applicable, for the continued holding of those securities. The client will not be able to withdraw funds under the facility unless they are for such purposes; and
  - (b) the licensed person cannot effect dealing in securities for or on behalf of clients, except for the liquidation of their securities collateral in order to collect margin calls or outstanding debts.

## **Information for clients**

8. A licensed person should clearly inform margin clients in writing of its margin lending and margin call policy as it affects them.
9.
  - (a) A licensed person that repledges securities collateral should inform a client that it has this practice upon opening a margin account for the client.
  - (b) A licensed person that changes its repledging status from non-repledging to repledging should inform all its existing margin clients as soon as practicable.
  - (c) A licensed person that repledges securities collateral should ensure that a risk disclosure statement in relation to the provision of an authority to repledge securities collateral as specified in Schedule 1 to the Code is included in a prominent position in the written notice given by it to any client to renew the standing authority in which the client authorizes it to deposit the client's securities collateral as collateral for financial accommodation provided to it.



## Internal controls

10. A licensed person should, where possible, assign the responsibility for margin lending to a senior officer or committee that is independent of the sales or trading function. A clear margin lending policy should be developed, documented and communicated to all relevant staff for strict enforcement. Such policy should include at least the following objectives:
  - (a) to provide a basis for protecting the capital of the licensed person;
  - (b) to ensure adequate procedures are in place for identification of risks, effective monitoring and corrective action; and
  - (c) to ensure there is a consistent risk management policy.
11. In particular, this policy should:
  - (a) ensure exposure to individual margin clients or “groups of related margin clients” (as defined in the Securities and Futures (Financial Resources) Rules) (“FRR”) is adequately secured;
  - (b) avoid building up excessive exposure to individual margin clients or groups of related margin clients; and
  - (c) avoid building up excessive exposure to individual item of securities deposited as collateral.
12. The margin lending policy framework should address, among other things, the following:
  - (a) the form of objective proof of net income or net worth such as: tax returns, salaries advice and bank statements. This should be used as a reference for setting credit limits and should be subject to strict enforcement and regular review;
  - (b) the list of securities acceptable as collateral, and the different haircuts applicable to collateral, bearing in mind their liquidity and volatility in prevailing market conditions;
  - (c) the procedures to identify groups of related margin clients;



- (d) the monitoring of changes in concentrated collateral positions, and consider the need to amend the list of securities acceptable as collateral for additional advances;
- (e) the monitoring of changes in concentrated securities margin loans and consider whether additional advances would be prudent where there is such concentration;
- (f) the triggering level for making the first and successive margin calls, including intra-day calls;
- (g) the giving of warnings to clients with outstanding margin calls specifying the steps the firm plans to take and when;
- (h) the maintenance of appropriate detailed records to ensure that the case history of margin calls for each individual client can be readily established;
- (i) the triggering level for stopping further advances to clients, for example where there are outstanding margin calls yet to be met;
- (j) the triggering level for forced liquidation of a client's collateral;
- (k) a procedure in the case of a forced liquidation of a client's collateral to ensure the best available terms to the client and reduction of the firm's exposure to that client to an acceptable level;
- (l) the circumstances in which deviation from the policy, supported by written explanations, may be approved by management, specifying the limits applicable to each level of the management; and where such deviation has an adverse effect on the firm's liquid capital position, the steps taken to ensure that the firm will not, as a result, be in breach of the FRR; and
- (m) the management reports (especially exception reports) necessary to ensure efficient monitoring over margin lending on an ongoing basis, readily showing
  - (i) outstanding margin loan balance per account;



- (ii) margin call status of each margin client;
- (iii) analysis of collateral received;
- (iv) margin ratios for different collateral items; and
- (v) concentration of exposure to securities collateral or clients.

13. In the case of a person licensed for Type 8 regulated activity, the licensed person should make appropriate enquiries of a margin client when that margin client wishes to draw against the client's account. Generally, any advance in excess of the realisable value of the securities collateral would indicate lending outside the scope of providing financial accommodation for facilitating the acquisition or any continued holding of listed securities.



## **Schedule 6      Additional requirements for licensed persons engaging in leveraged foreign exchange trading**

The provisions in this Schedule apply to the carrying on of Type 3 regulated activity, namely leveraged foreign exchange trading, by persons licensed to conduct such activity.

### **Part I**

#### **General conduct of business requirements**

##### **Client Agreement**

1. Without prejudice to paragraphs 6.1 to 6.3 of the Code, before entering into a leveraged foreign exchange contract (“contract”) with or on behalf of a client, the licensed person should ensure that the Client Agreement contains at least the followings-
  - (a) a statement by the client-
    - (i) that the client is trading on his own behalf; or
    - (ii) if the client is not trading on his own behalf, of the name of the ultimate beneficiary on whose behalf the client is trading;
  - (b) a statement by the client as to whether he is to operate his account by giving orders himself or by appointing another person to give orders on his behalf, and in the latter case, the name and address of the person appointed, to be accompanied by an appointment in writing;
  - (c) a statement by the licensed person that none of its employees or representatives should accept appointment by the client as agent to operate the client's account for the purposes of paragraph (b) unless a separate agreement is entered into in accordance with paragraph 6 of this Schedule;



- (d) a statement by the licensed person as to whether it may take the opposite position to a client's order;
- (e) a statement as to whether or not any employee or representative of the licensed person may be allowed to trade contracts on his own account pursuant to the policy established under paragraph 12.2(a) of the Code;
- (f) a statement that all telephone conversations between the licensed person and the client made in the course of business will be recorded on a centralized tape recording system operated by the licensed person;
- (g) specification of all services and contracts which the licensed person may provide to, transact with, or undertake on behalf of, the client and of all terms and conditions attached to those services and to the trading of contracts;
- (h) where the terms of its licence so requires, a statement that in relation to any dispute between the licensed person and the client, the licensed person should, if the client so requires, agree to refer the dispute to arbitration in accordance with the Securities and Futures (Leveraged Foreign Exchange Trading - Arbitration) Rules;
- (i) details of margin requirements and the time within which any initial margin or other margin deposits must be paid;
- (j) the circumstances in which contracts transacted with or undertaken on behalf of the client may be closed out without the client's consent;
- (k) a description of the methods or procedures adopted by the licensed person in choosing the prices or interest rates for the purposes of marking to market the client's open positions and in calculating the client's interest income and expenses;
- (l) a statement that the client may be affected by any curtailment of, or restriction on, the capacity of the licensed person to trade in respect of open positions as a result of action taken by the Commission under applicable rules and regulations or for any other reason, and that in such circumstances, the



client may be required to reduce or close out his open positions with the licensed person; and

- (m) a statement to the effect that the Client Agreement and all rights, obligations and liabilities under it should be governed by and construed in accordance with the laws of the Hong Kong SAR.

## **Statement of client information**

- 2. A licensed person should obtain from each of its clients a written statement which contains the following information about that client-
  - (a) the name, address, telephone number and facsimile number, if any, of the client;
  - (b)
    - (i) in the case of an individual, details of that individual's Hong Kong identity card or, if the client is not the holder of an identity card, details of his passport, travel or other document issued by a competent government agency providing proof of identity;
    - (ii) in the case of a corporation, details of its certificate of incorporation or similar document issued by the relevant authority of the country of incorporation;
    - (iii) in the case of a partnership, details of its business registration certificate or similar document issued by the relevant authority of the country where the partnership was formed or, where not available, the partnership agreement or other document constituting the partnership;
  - (c)
    - (i) in the case of an individual, his occupation, position and years spent in that occupation;
    - (ii) in the case of a corporation, the type of business and the number of years in the business;
    - (iii) in the case of a partnership, the type of business and the number of years in that business;





- (d) details of the financial position of the client; and
  - (e) details of the client's investment objectives and strategy.
3. Where a client has appointed another person to trade on his behalf, the licensed person should obtain the information required in paragraph 2(a), (b) and (c) above in relation to that person and a statement of his relationship with the client.
  4. A licensed person should obtain from each of its clients, and from any person who is authorized by the client to trade on his behalf, a written declaration to the effect that-
    - (a) the statement provided under paragraph 2 above is true, complete and correct; and
    - (b) the client and the authorized person will notify the licensed person of any material changes to that information.
  5. A client who is a sole proprietor should, notwithstanding that he is trading in the name of his firm, be deemed to be trading as an individual for the purposes of paragraphs 2 to 4 of this Schedule.

## **Discretionary accounts**

6. A licensed person who wishes to offer discretionary account services to its clients should enter into a separate written discretionary account agreement (Discretionary Account Agreement) with the client which, together with the Client Agreement required by paragraph 6.1 of the Code, will govern the relationship between the licensed person and the client.
7. A licensed person should, before entering into any contract with or on behalf of a client under a discretionary account-
  - (a) inform the client that a Discretionary Account Agreement is required to be entered into between them in writing in either English or Chinese;
  - (b) explain to the client the contents of the Discretionary Account Agreement; and
  - (c) enter into a Discretionary Account Agreement with the client.



8. The Discretionary Account Agreement should include-
- (a) a description by the licensed person as to the way in which the discretionary account will be managed by it, including information required pursuant to paragraph 10 of this Schedule;
  - (b) a statement that the client appoints the licensed person to manage his account;
  - (c) a statement by the licensed person of-
    - (i) the name of the representative managing the account;
    - (ii) the name of the supervisor of that representative; and
    - (iii) whether that representative is permitted to trade for his own account pursuant to the policy established under paragraph 12.2(a) of the Code;
  - (d) details of the terms and conditions specified by the client for management of the account, which should include-
    - (i) the amount deposited by the client;
    - (ii) the terms and conditions of any stop-loss or stop-limit order by the client; and
    - (iii) any specifications imposed by the client concerning his investment objectives and strategy including the size of transactions, frequency of trading and the currencies to be traded in;
  - (e) details of all charges, commission, brokerage or remuneration payable by the client in addition to the charges, commission, brokerage or remuneration payable under the Client Agreement;
  - (f) a statement that any modifications to the Discretionary Account Agreement must be in writing and accepted by both parties in writing except for the terms and conditions specified in paragraph (d), which may be amended unilaterally at any time by the client;



- (g) a statement that either party may suspend or terminate the Discretionary Account Agreement at any time by giving notice of suspension or termination to the other by telephone or in writing, such suspension or termination to take effect upon receipt of the notice;
  - (h) a statement by the client that he understands that he is not obliged to enter into a Discretionary Account Agreement before he can retain other non-discretionary services of the licensed person, that he understands the contents of the Discretionary Account Agreement and that he accepts the terms and conditions contained therein;
  - (i) the risk disclosure statement prescribed by Schedule 1 to the Code; and
  - (j) an explanation of the additional risks of giving discretionary powers to a licensed person to manage an account on his behalf, including the total dependence by the client on the integrity and skill of the licensed person and the inherent risk of conflict of interest in that a licensed person may take the opposite position to a client's order while acting for the client.
9. A licensed person should not accept or carry a discretionary account unless it-
- (a) has obtained, in addition to a duly signed Discretionary Account Agreement under paragraph 6 of this Schedule, a signed copy of a power of attorney or other document by which trading authority is given or restricted; and
  - (b) has designated such an account in its books and records as a discretionary account.
10. A licensed person should comply with the following procedures in managing a discretionary account-
- (a) whenever the net equity in a discretionary account falls during any one calendar month by more than 30% from the level at which it stood at the beginning of that month, the licensed person-



- (i) should immediately notify the client of the level of net equity, the amount of trading loss and the amount of income generated to the licensed person from the account during that month;
  - (ii) should not, except in order to close out existing open positions, initiate any new contracts in respect of the discretionary account unless the client consents and subject to such conditions as may be imposed by the client;
- (b) in the case of any discretionary account to which paragraph (a)(ii) applies-
  - (i) the licensed person should assign a member of its senior management to review and approve every contract executed for the discretionary account before the consent of the client has been received; and
  - (ii) where the consent of the client to continue trading is duly given, the licensed person should continue to comply with the requirements of paragraph (a), by using the net equity standing at the beginning of the day on which his consent is given as a new starting point.
- 11. For the purposes of paragraph 10 of this Schedule, the net equity standing at the beginning of any calendar month should be treated as including any cash deposits made to, and as excluding any cash withdrawal made from, the account by the client during that month.
- 12. For the purposes of paragraphs 6 to 15 of this Schedule, the consent of the client is duly given only if it is given in writing or is recorded on the centralized tape recording system of the licensed person.
- 13. A licensed person should not maintain a trading position for a client where the client holds an equal outstanding long and short position of the same foreign currency at the same time, unless such position is specifically requested by the client in each instance.
- 14. All attempts to telephone the client should be recorded on the centralized tape recording system.



15. Each discretionary account should be reviewed by a member of the senior management of the licensed person at least once every 3 business days to ensure that it is being operated in conformity with the specific instructions of the client, if any, the Client Agreement, the Discretionary Account Agreement and relevant requirements governing discretionary accounts.

## **Client orders**

16. Without prejudice to paragraph 3.9 of the Code, a licensed person should-
  - (a) ensure that all telephone orders from a client are recorded on the centralized tape recording system operated by it; and
  - (b) record in writing each order, whether made by telephone or otherwise, immediately after it is received.
17. The record required to be made under paragraph 16 of this Schedule should include-
  - (a) the name of the client and, if applicable, the person who is authorized by the client to give the order and the account number of the client;
  - (b) the time and date at which the order was received;
  - (c) the method by which the order was given;
  - (d) the type, price and quantity of the contracts ordered;
  - (e) the name of the representative or employee of the licensed person who received the order; and
  - (f) detailed particulars of the instructions in respect of the order.
18. A licensed person should confirm the details of each order executed as soon as possible with that client or his agent, as the case may be, through a telephone connected to the centralized tape recording system.
19. Where the voice of a client cannot be recorded on the centralized tape recording system for any reason, the licensed person should-



- (a) in the absence of any written instructions given by the client in respect of the order, require the client to sign an order form; and
  - (b) confirm details of the contract with the client once an order has been executed.
- 20. Where a licensed person does not have the client's confirmation on tape or on an order form as required by paragraph 19(a) above and the client disputes the order within 10 business days of its execution, it should be voidable at the option of the client.
- 21. Where a client gives any instructions involving closing positions or closing an entire account, a licensed person should ensure that all necessary contracts that may be required in order to implement those instructions are executed promptly and that the price and terms and conditions of such contracts do not differ in any material respect from contracts entered into with or on behalf of other clients.

## **Payment to clients**

- 22. A licensed person should ensure that any instructions given by a client relating to payment to the client of any net equity, floating profit or margin excess are complied with within 1 business day.

## **Client's margin**

- 23. A licensed person should set the initial margin and maintenance margin level for its clients at not less than 5% and 3% respectively of the gross principal value of the contract offered by the licensed person. For cross currency trades and locked positions (i.e. situation where a client simultaneously holds an equal long and short position of the same currency), only one set of margin is required.
- 24. Except as provided in paragraph 25 of this Schedule, no licensed person should execute any contract for a client until and unless the licensed person has received from the client a margin deposit adequate to cover the initial margin required.



25. A licensed person may execute a contract for a client, other than a discretionary account client, without first having received the initial margin from that client if it is reasonably satisfied that, given the investment objectives, investment strategy and financial position of that client, the full amount of the initial margin will be deposited by the client within the next business day or such shorter period as may be specified by the licensed person.
26. Paragraph 25 above does not apply to a client-
- (a) who has never entered into a contract through or with the licensed person;
  - (b) who has never paid, or been asked to pay, any initial margin to the licensed person; or
  - (c) who has failed to satisfy the initial margin requirement as specified in paragraph 25 above on at least 2 occasions during the period of 1 year immediately preceding the transaction for which the deferral of the deposit of initial margin is requested by the client.
27. For the purposes of calculating the amount of any margin deposit required, the basis and method of valuation applicable to margins as provided in section 41 of the Securities and Futures (Financial Resources) Rules should be adopted.

## **No credit on margin**

28. Except as expressly provided in paragraph 25 of this Schedule, a licensed person should not extend any credit or give any rebate of any kind to a client which has the effect of circumventing or evading the margin requirements specified herein.

## **Restricted use of margin collateral**

29. A licensed person should ensure that margin deposits and other assets of its clients and recognized counterparties are properly safeguarded and are held separately from the assets of the licensed person.



## **Personal trading by staff**

- 30. No representative or employee of a licensed person should be a client of another licensed person for trading in leveraged foreign exchange contracts.
- 31. A licensed person must make reasonable enquiries to ensure that none of its representatives or employees contravenes paragraph 30 above.
- 32. Without prejudice to paragraph 30 of this Schedule and paragraph 12.2 of the Code, a licensed person who permits its representatives or employees to trade for their own account in leveraged foreign exchange contracts should ensure that contracts undertaken for the account of a representative or employee must be reported to and reviewed on a daily basis by senior management of the licensed person.

## **Advertisements**

- 33. Without prejudice to paragraph 2.3 of the Code, where a licensed person issues an advertisement in relation to its business, it should ensure that the advertisement contains a risk disclosure statement as prescribed by Schedule 1 to the Code.
- 34. Any material issued by the licensed person which is intended to promote, or which has the effect of promoting, interest in the business of the licensed person should be deemed to be an advertisement for the purposes of paragraph 33 above.

## **Taping**

- 35. Without prejudice to paragraph 3.9 of the Code, a licensed person should install at its place of business a centralized tape recording system to record all telephone conversations conducted by it or its representatives with prospective clients, clients and recognized counterparties.
- 36. All telephone lines used by employees or representatives of the licensed person responsible for making calls, confirming orders, executing contracts, transferring funds, or carrying out instructions





incidental thereto, should be routed through the centralized tape recording system.

37. Tapes from the centralized tape recording system should be kept for at least six months.
38. A licensed person should ensure that access to tapes of the centralized tape recording system, whether in use or in storage, is strictly controlled.
39. A licensed person should-
  - (a) use its best endeavours to ensure that the centralized tape recording system functions properly at all times; and
  - (b) carry out random checks at intervals of not less than once every week to ensure that all applicable laws, rules and regulations have been complied with.

## **Trading practices**

40. A licensed person should-
  - (a) disclose its trading hours to its clients, specifying the beginning and ending hours of a business day; and
  - (b) display at each of its places of business a prominent notice which shows the information specified in paragraph (a).
41. A licensed person should quote both the bid and offer prices at the request of a client.
42. A licensed person should not quote a price for a contract without specifying whether the price is, for a given quantity of contracts, a firm one or merely indicative.
43. A licensed person quoting a price for a contract to any person should inform that person that the price given by it is available only for a limited period of time and, where practicable, specify the time period in question.
44. A licensed person quoting a firm price should trade at that price.

*The revisions to paragraph 37 will take effect on 1 Dec 2012.*



45. All contracts should be recorded in trading slips which are time stamped.

## **Record of client's complaints**

46. Without prejudice to paragraph 12.3 of the Code, a licensed person should-
- (a) maintain a written record of any complaints from clients; and
  - (b) establish and implement proper procedures for handling and investigating such complaints.
47. A licensed person should ensure that client complaints are dealt with promptly and remedial action is taken as soon as possible.
48. A licensed person should inform a client of the results of any complaints made by him as soon as practicable and in any event within 3 business days of determining the results of that complaint.

## **Part II**

### **Specific guidelines**

#### **Client relations**

49. Client orders

A licensed person should ensure that it has adequately considered the client's investment objectives, investment strategy and financial position when making recommendations to a client.

50. Trading limits of clients

- (a) A licensed person should set limits on the size of the positions which each client may establish in the light of the financial position and investment objectives, and strategy of the client.
- (b) The limits set under paragraph (a) and any changes thereafter should be notified forthwith to the client in writing.



51. Adequate communication

A licensed person should ensure that there are adequate lines of communication with clients.

52. Confidentiality

A licensed person should maintain confidentiality in respect of information relating to their clients. Except as required by law, a licensed person should not disclose to a third party any information relating to their clients without their explicit permission.

53. Cessation

Where a licensed person decides to withdraw from providing services to its clients, it should notify the clients concerned and the Commission immediately. It should take reasonable steps to protect its clients' outstanding positions.

## **Trading procedures**

54. Quotation

Prices quoted and interest rates applied by a licensed person should be fair and reasonable having regard to all relevant circumstances.

55. Concluding a trade

Oral agreements are considered binding, and subsequent written confirmation is regarded as evidence of the trade and should not override terms agreed orally.

## **Staff Trading and other activities**

56. Trading limits of staff

Where representatives or employees of a licensed person are allowed to trade, the licensed person should apply the same procedures, specified in paragraph 50 of this Schedule, in respect of any trading by its staff as are applied to other persons.



57. Staff trading not to be prejudicial to the interest of clients

A licensed person should maintain and enforce proper and effective procedures to ensure that trading by its representatives and employees for their own account, if permitted under the policy on trading by staff of a licensed person as disclosed in the Client Agreement, are not prejudicial to the interests of clients of the licensed person.

58. Outside business activities

A licensed person should formulate policies on whether its employees and representatives are allowed to engage in outside employment or business activities, and ensure that if such activities are allowed, they do not compromise the position of the employees or representatives concerned, or that of the licensed person or its clients.

## **Management control**

59. Supervision

A licensed person should take all reasonable steps to ensure that:-

- (a) its representatives and employees are suitably qualified and properly trained to a level commensurate with their responsibilities; and
- (b) its representatives and employees are aware of their responsibility to act professionally at all times.

60. Internal management system

- (a) A licensed person should have an appropriate internal management system which can capture, monitor and control risks in relation to the business and which can reasonably be expected to protect its business from financial loss arising from theft, fraud and other dishonest acts or omissions.
- (b) A licensed person should formulate operating procedures for the business, including contingency plans to cater for disasters and emergencies, in a comprehensive operations



manual and should regularly conduct reviews of such operating procedures based on it.

61. Responsibility for trading activities

A licensed person should clearly set out in writing the policies and practices which trading and support staff should follow. These should include-

- (a) general trading policy including reporting procedures;
- (b) persons authorized to trade;
- (c) instruments and contracts to be dealt in;
- (d) limits on open positions, mismatch positions, recognized counterparties, stop-loss limits;
- (e) confirmation and settlement procedures;
- (f) trading relationships with banks, brokers, clients or other licensed persons; and
- (g) other relevant guidance as considered appropriate.

62. Position limits

A licensed person should establish a comprehensive framework of limits to control the overall foreign exchange exposure of the business. These should include limits on gross and net open positions in individual currencies and on the aggregate of all currencies, both during the day and overnight, with clients and recognized counterparties.



63. Trading and back office monitoring

A licensed person should ensure that-

- (a) senior managerial staff are located in the trading room to ensure the efficient and proper functioning of the trading room;
- (b) access to the trading room is restricted to authorized personnel only;
- (c) all open positions of the licensed person, of all clients and of all recognized counterparties are monitored and revalued continuously;
- (d) daily reports comparing actual positions against internal limits are routinely prepared for, and reviewed by, its management, and that excesses and irregularities are promptly reported to senior management;
- (e) trades are processed promptly; and
- (f) all positions generated by the trading room are regularly reconciled with back office records.

64. Internal audit

Each licensed person should have staff performing internal audit functions, including periodic review of the systems and procedures in place to ensure-

- (a) accuracy and completeness of recording of all trading transactions;
- (b) effective segregation of duties between trading, settlement and accounting staff; and
- (c) effectiveness and accuracy of reporting of excesses, irregularities and potential exposures.



## **Market integrity**

### **65. Market terminology**

A licensed person should ensure that when its representatives communicate with its clients and prospective clients-

- (a) the terminology used is clear and unambiguous; and
- (b) any explanation given is understood by the clients or prospective clients.

## **Electronic trading**

66. For the purpose of this Schedule, “electronic trading” means the trading of leveraged foreign exchange contracts electronically by means of internet trading. Paragraph 18 of and Schedule 7 to the Code should be interpreted accordingly.

67. A licensed person should comply with the following principles and requirements when conducting electronic trading:

- Paragraphs 18.4 to 18.7 of the Code; and
- Paragraphs 1.1, 1.2.2 to 1.2.8, 1.3 and 2.1 of Schedule 7 to the Code.



## **Schedule 7      Additional requirements for licensed or registered persons conducting electronic trading**

### **Introduction**

Paragraph 18 of the Code stipulates the general principles that apply to a licensed or registered person which conducts electronic trading of securities and futures contracts that are listed or traded on an exchange or internet trading of securities that are not listed or traded on an exchange. This Schedule sets out the specific requirements in this regard.

Paragraph 1 of this Schedule provides general requirements on electronic trading. Paragraph 2 provides specific requirements on internet trading and DMA. Paragraph 3 provides specific requirements on algorithmic trading.

Where an electronic trading system is provided by a third party service provider, a licensed or registered person should perform appropriate due diligence to ensure the licensed or registered person meets the requirements set out in paragraph 18 of the Code of Conduct and this Schedule in its use of the system.

Unless otherwise stated, the terms used in this Schedule are as defined in paragraph 18 of the Code.

### **1)      Requirements on Electronic Trading**

#### **1.1      Management and Supervision**

*A licensed or registered person should effectively manage and adequately supervise the design, development, deployment and operation of the electronic trading system it uses or provides to clients for use, as may be appropriate in the circumstances.*

- 1.1.1 A licensed or registered person should establish and implement written internal policies and procedures on the operation of the electronic trading system it uses or provides to clients for use, to ensure that:





- (a) there is at least one responsible officer or executive officer responsible for the overall management and supervision of the electronic trading system;
- (b) there is a formalised governance process with input from the dealing, risk and compliance functions;
- (c) there are clearly identified reporting lines with supervisory and reporting responsibilities assigned to appropriate staff members; and
- (d) there are managerial and supervisory controls that are designed to manage the risks associated with the use of the electronic trading system by itself or by its clients.

1.1.2 A licensed or registered person which provides an electronic trading system for use by its clients should comply with the requirements set out in paragraph 1.1.1 in respect of the design, development and deployment of the system.

1.1.3 A licensed or registered person should conduct regular reviews to ensure that these internal policies and procedures are in line with changing market conditions and regulatory developments and promptly remedy any deficiencies identified.

1.1.4 A licensed or registered person should assign adequately qualified staff, expertise, technology and financial resources to the design, development, deployment and operation of the electronic trading system.

## 1.2 Adequacy of System

*A licensed or registered person should ensure the integrity of the electronic trading system it uses or provides to clients for use, as may be appropriate in the circumstances, including the system's reliability, security and capacity, and have appropriate contingency measures in place.*

### *System Controls*

1.2.1 A licensed or registered person should ensure that the electronic trading system it uses or provides to clients for use has effective controls to enable it, where necessary, to:



- (a) immediately prevent the system from generating and sending orders to the market; and
- (b) cancel any unexecuted orders that are in the market.

### *System Reliability*

- 1.2.2 A licensed or registered person should ensure that the electronic trading system it uses or provides to clients for use and all modifications to the system are tested before deployment and are regularly reviewed to ensure that the system and modifications are reliable.
- 1.2.3 A licensed or registered person should promptly report to the Commission any material service interruption or other significant issues related to the electronic trading system it provides to clients for use.

### *System Security*

- 1.2.4 A licensed or registered person should employ adequate and appropriate security controls to protect the electronic trading system it uses or provides to clients for use from being abused. The security controls should at least include:
  - (a) reliable techniques to authenticate or validate the identity and authority of the system users to ensure that the access or the use of the system is restricted to persons approved to use the system on a need-to-have basis;
  - (b) effective techniques to protect the confidentiality and integrity of information stored in the system and passed between internal and external networks;
  - (c) appropriate operating controls to prevent and detect unauthorised intrusion, security breach and security attack; and
  - (d) appropriate steps to raise the awareness of system users on the importance of security precautions they need to take in using the system.



### *System Capacity*

1.2.5 A licensed or registered person which provides an electronic trading system for use by its clients should ensure that:

- (a) the capacity usage of the electronic trading system is regularly monitored and appropriate capacity planning is developed. As part of the capacity planning, a licensed or registered person should determine and keep a record of the required level of spare capacity;
- (b) the capacity of the electronic trading system is regularly stress tested to establish the system behavior under different simulated market conditions, and the results of the stress tests and any actions taken to address the findings of the stress tests are documented;
- (c) the electronic trading system has sufficient capacity to handle any foreseeable increase in the business volume and market turnover;
- (d) the electronic trading system has contingency arrangements to:
  - (i) handle client order instructions exceeding the capacity of which the system can handle; and
  - (ii) inform clients about the arrangements and ensure alternative means of order execution are available and offered to them.

### *Contingencies*

1.2.6 A licensed or registered person which provides an electronic trading system for use by its clients should establish a written contingency plan to cope with emergencies and disruptions related to the electronic trading system. The contingency plan should at least include:

- (a) a suitable backup facility which will enable the licensed or registered person to provide electronic trading services or alternative arrangements for order execution in the event of an emergency;



- (b) arrangements to ensure business records, client and transaction databases, servers and supporting documentation are backed up in an off-line medium. Off-site storage is generally expected to be subject to proper security measures; and
- (c) a plan for dealing with client and regulatory enquiries by trained staff.

1.2.7 A licensed or registered person should ensure that the contingency plan to deal with potential emergencies and disruptions is periodically tested and the plan is viable and adequate.

1.2.8 In the event of material system delay or failure, a licensed or registered person which provides an electronic trading system for use by its clients, should, in a timely manner:

- (a) ensure the material system delay or failure is rectified; and
- (b) inform clients the causes or possible causes of the material system delay or failure and how client orders will be handled.

### 1.3 Record Keeping

*A licensed or registered person should keep, or cause to be kept, proper records on the design, development, deployment and operation of its electronic trading system.*

1.3.1 With respect to the electronic trading system, a licensed or registered person should keep or cause to be kept:

- (a) comprehensive documentation of the design and development, including any testings, reviews, modifications, upgrades or rectifications of its system;
- (b) comprehensive documentation of the risk management controls of its system;
- (c) audit logs on the activities of its system;



- (d) incident reports for all material system delays or failures of its system.

**Note**

Details of the requirements for the recording of audit logs and incident reports referred to in paragraphs 1.3.1 (c) and (d) are set out in the Annex to this Schedule.

1.3.2 A licensed or registered person should retain or cause to be retained:

- (a) documentation referred to in paragraphs 1.3.1 (a) and (b) for a period of not less than 2 years after the electronic trading system ceased to be used; and
- (b) audit logs and incident reports referred to in paragraphs 1.3.1 (c) and (d) for a period of not less than 2 years.

**Note**

Where an electronic trading system is provided to a licensed or registered person by a third party service provider, the licensed or registered person should make arrangements with the service provider to ensure that the records described in paragraph 1.3.1 are kept and are retained for the periods described in paragraph 1.3.2. In response to a request for information made by the Commission, information in the possession of a third party service provider that is proprietary in nature may be provided to the Commission directly from the service provider.

## **2) Specific Requirements on Internet Trading and DMA**

### **2.1 Risk Management**

*In providing internet trading or DMA services, a licensed or registered person must ensure that all the client orders are transmitted to the infrastructure used by the licensed or registered person and are subject to:*

- (a) *appropriate automated pre-trade risk management controls; and*



(b) *regular post-trade monitoring.*

2.1.1 A licensed or registered person should put in place risk management and supervisory controls for the operation of its internet trading or DMA services that are directly controlled by the licensed or registered person. The risk management and supervisory controls should include:

- (a) automated pre-trade controls that are reasonably designed to:
  - (i) prevent the entry of any orders that would result in exceeding appropriate trading and credit thresholds prescribed for each client or proprietary account;
  - (ii) limit the financial exposure of the licensed or registered person;
  - (iii) alert the user to the entry of potential erroneous orders and prevent the entry of erroneous orders;
  - (iv) prevent the entry of orders that are not in compliance with the regulatory requirements; and
- (b) post-trade monitoring to reasonably identify any order instructions and transactions which may be manipulative or abusive in nature.

2.1.2 A licensed or registered person should, upon identification of any suspected manipulative or abusive trading activities, take immediate steps to prevent such activities from continuing.

2.2 Minimum client requirements for DMA services

*A licensed or registered person should establish minimum client requirements for its DMA services and assess whether each client meets the requirements before granting DMA services to a client.*

2.2.1 A licensed or registered person should ensure that the client using its DMA services meets the minimum requirements established by the licensed or registered person, which should include:



- (a) the client has appropriate arrangements in place to ensure that its users are proficient and competent in using the system for the DMA services;
- (b) the client understands and has the ability to comply with applicable regulatory requirements; and
- (c) the client has in place adequate arrangements to monitor the orders entered through the DMA services.

2.2.2 A licensed or registered person should from time to time evaluate the minimum client requirements in light of current market conditions.

2.2.3 A licensed or registered person should regularly assess whether the client using its DMA services continues to meet the minimum client requirements.

2.2.4 Where a licensed or registered person permits its client to sub-delegate the DMA services to another person, the client should be a licensed or registered person or an overseas securities or futures dealer or an overseas bank subject to regulatory supervision. The licensed or registered person and its clients should have in place an arrangement to ensure that:

- (a) the orders of such person will flow through the systems of the client and will be subject to appropriate risk management and supervisory controls; and
- (b) such person meets the minimum client requirements established by the licensed or registered person and a written agreement is in place between the client and such person that sets out the terms of the DMA services being sub-delegated.

### **3) Specific Requirements on Algorithmic Trading**

#### **3.1 Qualification**

*A licensed or registered person should establish and implement effective policies and procedures to ensure that persons:*



- (a) *involved in the design and development of, or*
- (b) *approved to use*

*its algorithmic trading system and trading algorithms are suitably qualified.*

- 3.1.1 A licensed or registered person which uses internally developed algorithmic trading system or trading algorithms, or provides its algorithmic trading system or trading algorithms for use by its clients, should ensure that the design and development of its algorithmic trading system and trading algorithms are supported by persons adequately qualified and trained to understand the compliance and regulatory issues which may arise from the use of the algorithmic trading system and the trading algorithms.
- 3.1.2 A licensed or registered person should ensure that a person who is approved to use its algorithmic trading system has a good understanding of:
  - (a) the operation of the algorithmic trading system and trading algorithms; and
  - (b) the compliance and regulatory issues which may arise from the use of the algorithmic trading system and trading algorithms.
- 3.1.3 Where necessary, a licensed or registered person should provide training to the person on:
  - (a) the use and operation of the algorithmic trading system;
  - (b) each of the trading algorithms contained in the algorithmic trading system including:
    - (i) its trading characteristics and execution behavior;
    - (ii) the potential market impact and risks to market integrity; and





- (iii) whether it is appropriate to use a particular trading algorithm under certain market conditions in the execution of certain orders in light of the regulatory requirements.

3.1.4 A licensed or registered person should ensure that the person who is approved to use its algorithmic trading system is timely informed and, where necessary, is provided with the training in respect of any changes to the design and development of its algorithmic trading system and trading algorithms.

3.1.5 A licensed or registered person should provide the person who is approved to use its algorithmic trading system with up-to-date documentation for operating its algorithmic trading system. The documentation should contain an explanation of the operation of its algorithmic trading system and trading algorithms, as well as the risk, supervisory and compliance controls.

## 3.2 Testing

*A licensed or registered person should ensure that the algorithmic trading system and trading algorithms it uses or provides to clients for use are adequately tested to ensure that they operate as designed.*

3.2.1 A licensed or registered person should ensure that the algorithmic trading system and trading algorithms it uses or provides to clients for use, and any subsequent developments and modifications are adequately tested before deployment in such a way so as to be satisfied that:

- (a) the algorithmic trading system and trading algorithms will operate as designed;
- (b) the design and development of the algorithmic trading system and trading algorithms have taken into account:
  - (i) foreseeable extreme market circumstances; and



- (ii) the characteristics of different trading sessions, such as auction sessions and continuous trading sessions; and
- (c) the deployment of the algorithmic trading system and trading algorithms would not interfere with the operation of a fair and orderly market.

3.2.2 A licensed or registered person should ensure that the algorithmic trading system as well as trading algorithms are regularly, and no less than annually, reviewed and tested for the algorithmic trading system's ability to handle sizable trading volume and for the trading algorithms' ability to execute orders without interfering with the operation of a fair and orderly market.

#### Note

Where an algorithmic trading system or a trading algorithm is provided to a licensed or registered person by a third party service provider, a licensed or registered person should perform appropriate due diligence to ensure that the testing conducted on the algorithmic trading system or the trading algorithm meets the requirements described in paragraph 3.2.

### 3.3 Risk Management

*A licensed or registered person should have controls that are reasonably designed to ensure:*

- (a) *the integrity of its algorithmic trading system and trading algorithms; and*
- (b) *its algorithmic trading system and trading algorithms operate in the interest of the integrity of the market.*

3.3.1 A licensed or registered person should have controls that are reasonably designed to:

- (a) monitor and prevent the generation of or passing to the market for execution order instructions from its algorithmic trading system which may:



- (i) be erroneous; or
  - (ii) interfere with the operation of a fair and orderly market; and
- (b) protect the licensed or registered person and its clients from being exposed to excessive financial risk.

3.3.2 A licensed or registered person should regularly conduct post-trade reviews of trading activities conducted through its algorithmic trading system, including the relevant order instructions, to identify any:

- (a) suspicious market manipulative or abusive activities; and
- (b) market events or system deficiencies such as unintended impact on the market which call for further risk control measures.

3.3.3 A licensed or registered person should, upon identification of any suspected market manipulative or abusive trading activities, take immediate steps to prevent these activities from continuing.

### 3.4 Record Keeping

*A licensed or registered person should keep, or cause to be kept, proper records on the design, development, deployment and operation of its electronic trading system.*

3.4.1 A licensed or registered person should ensure that the design and development, including any modifications, of its algorithmic trading system and trading algorithms are documented and recorded in writing. The documentation should show the rationale for the design, development and modification, as well as their intended outcome. These records should be retained for a period of no less than 2 years after its system and algorithms are ceased to be used.



3.4.2 A licensed or registered person should ensure that records of all the parameters which its algorithmic trading system and trading algorithms take into account for each order is kept and is retained for a period of no less than 2 years.

3.4.3 A licensed or registered person should ensure that records of the reviews and tests conducted under paragraph 3.2.2 setting out the scope of findings of the tests are kept and are retained for a period of no less than 2 years.

#### Note

Where an algorithmic trading system and/or a trading algorithm is provided to a licensed or registered person by a third party service provider, the licensed or registered person should make arrangements with the service provider to ensure that the records described in paragraphs 3.4.1 to 3.4.3 are kept and are retained for the periods set out in those paragraphs. In response to a request for information made by the Commission, information in the possession of a third party service provider that is proprietary in nature may be provided to the Commission directly from the service provider.



## **Annex**

### **Requirements for Audit Logs and Incident Reports**

A licensed or registered person should make arrangement to keep the audit logs and incident reports referred to in paragraphs 1.3.1 (c) and (d) of Schedule 7. The logs and reports should be made available to the Commission upon request. It is important that the logs and reports be reviewed regularly for detecting potential problems and planning preventive measures.

#### **(i) Audit Logs**

Audit logs should document the order process and transaction flow through the trading system, where applicable. This will at a minimum include:

- (a) order placement / cancellation / modification / execution (with time stamping and the assignment of unique reference number);
- (b) system login attempts including login details such as user identity, date and time of the login attempts;
- (c) credit/margin validation exceptions - which for example, may include the logging of instances where the credit limit/cash limits available for trading have been exceeded thereby causing the client to have insufficient credit or cash to execute the transaction;
- (d) compliance validation exceptions - which for example may include logging exceptions where the client does not have enough stock holdings to actually sell the shares;
- (e) the assigning of hierarchical user access - where different levels of access are allocated to different job responsibilities within the firm;
- (f) details of the changes to critical system parameters and master files; and



- (g) erroneous order inputs – which for example may include order prices which materially deviated from the market, order sizes exceeding the client's trading limits, and orders in a stock which do not accord to client instructions.

## **(ii) Incident Reports**

Incident reports should document instances where the licensed or registered person's electronic trading system experiences a material delay or failure that renders it unusable by clients. At a minimum, it should include:

- (a) a clear explanation of the problem;
- (b) the time of outage or delay;
- (c) the duration of outage or delay;
- (d) the systems affected during outage or delay and subsequently;
- (e) whether this problem or a related problem has occurred before;
- (f) the number of clients affected at the time and the impact on these clients;
- (g) the steps taken to rectify the problem; and
- (h) steps taken to ensure that the problem does not occur again.



## **Schedule 8      Additional requirements for licensed or registered persons operating alternative liquidity pools**

### **Introduction**

1. Paragraph 19 of the Code stipulates the general principles that apply to licensed or registered persons operating an alternative liquidity pool (“ALP”) or routing client orders to an ALP. This Schedule stipulates, in more detail, the requirements that should be observed by a licensed or registered person operating an ALP (“ALP operator”).
2. Unless otherwise stated, the terms defined in paragraph 19.2 of the Code shall have the same meaning when used in this Schedule.

### **Management and supervision**

3. An ALP operator should establish and implement written internal policies and procedures concerning the design, development, deployment and operation of its ALP to ensure that:
  - (a) there is at least one responsible officer or executive officer responsible for the overall management and supervision of the ALP;
  - (b) there is a formalized governance process, with input from risk and compliance functions;
  - (c) there are clearly identified reporting lines, with supervisory and reporting responsibilities assigned to appropriate staff members; and
  - (d) there are managerial and supervisory controls that are designed to manage the risks associated with the operation of the ALP.
4. An ALP operator should conduct regular reviews to ensure that its internal policies and procedures are in line with changing market conditions and regulatory developments and should promptly remedy any deficiencies identified.



5. An ALP operator should assign adequately qualified staff, expertise, technology and financial resources to the design, development, deployment and operation of its ALP.
6. An ALP operator should effectively manage and adequately supervise the design, development, deployment and operation of its ALP, as may be appropriate in the circumstances.

## Access to ALPs

7. Only qualified investors are permitted to be the users of ALPs. Subject to paragraph 8 of this Schedule, an ALP operator should take all reasonable steps to ascertain that the users of its ALP are qualified investors.
8. An ALP operator should have in place measures which **ensure**:
  - (a) that all of its clients, and all of the clients of any other company within the same group of companies as the ALP operator, who/which are users of its ALP, are qualified investors; and
  - (b) that it will be able to comply with the requirements of the Commission, as revised from time to time, concerning “client identity” (including the identity, address and contact details of the users of its ALP).

## Information for users

### ALP Guidelines

9. An ALP operator should prepare and publish on its website comprehensive and accurate ALP Guidelines concerning its ALP, including (but not limited to) details relating to:
  - (a) trading and operational matters;
  - (b) user restrictions;
  - (c) opt-out arrangement;
  - (d) user priority, order routing and execution methodology;





- (e) transaction pricing;
- (f) order cancellation;
- (g) the internal control procedures that have been put in place to ensure the fair and orderly functioning of its ALP and to address potential conflict of interest issues;
- (h) the potential risks associated with transactions conducted in its ALP in respect of which the users of its ALP should reasonably be made aware;
- (i) the transaction of proprietary orders in its ALP;
- (j) whether the orders of different users of its ALP may be aggregated; and
- (k) the identity of each member of its staff (by title and department) who is permitted access to trading information concerning orders placed into, and transactions conducted in, its ALP and, in each case, the reason(s) why such access is necessary.

10. A licensed or registered person should provide a copy of its ALP Guidelines to the Commission forthwith upon their publication on its website.

#### Revision of ALP Guidelines

11. An ALP operator should revise or update its ALP Guidelines as necessary to ensure that they remain comprehensive, accurate and current, and should, as soon as reasonably practicable thereafter, publish the revised or updated ALP Guidelines on its website and circulate them to the users of its ALP, identifying the amendments that have been made and providing an explanation for the making of such amendments. An ALP operator should provide a copy of the revised or updated ALP Guidelines to the Commission, identifying the amendments that have been made and providing an explanation for the making of such amendments, forthwith upon the publication of the revised or updated ALP Guidelines on the ALP operator's website.



## Adequacy of system

### System controls

12. An ALP operator should ensure that its ALP has effective controls to enable it, where necessary, to immediately prevent transactions from being conducted in the ALP.

### System reliability

13. An ALP operator should ensure that its ALP, and all modifications to its ALP, are tested before deployment and are regularly reviewed to ensure that the ALP and its modifications are reliable.

### System security

14. An ALP operator should employ adequate and appropriate security controls to protect its ALP from any type of abuse. The security controls should at least include:
  - (a) reliable techniques to ensure that access to its ALP is restricted to persons whose access to the ALP is essential and whose access has been approved by the ALP operator;
  - (b) effective techniques to protect the confidentiality and integrity of information concerning transactions conducted in the ALP that is passed between internal and external networks;
  - (c) appropriate operating controls to prevent and detect any unauthorized intrusion, security breach and security attack; and
  - (d) appropriate measures to raise the awareness of the ALP operator's staff concerning the importance of security and the strict observance of security in connection with the ALP.

### System capacity

15. An ALP operator should ensure that:
  - (a) the usage capacity of its ALP is regularly monitored and appropriate capacity planning is conducted. As part of the



capacity planning, an ALP operator should determine, monitor and maintain the required level of spare capacity;

- (b) the capacity of its ALP is regularly stress tested to establish the system behaviour under different simulated market conditions, with the findings of the stress tests and any actions taken to address those findings being documented;
- (c) its ALP has sufficient capacity to handle any foreseeable increase in business volume and market turnover; and
- (d) its ALP has contingency arrangements, the details of which have been communicated to the users of the ALP:
  - (i) to facilitate the handling of users' orders when the capacity of the ALP is exceeded; and
  - (ii) by which alternative means of executing orders are available and offered to users.

#### Information security

16. An ALP operator should:

- (a) only permit members of its staff to have access to trading information concerning orders placed, or transactions conducted, in its ALP and only to the extent necessary to enable the ALP to operate satisfactorily and efficiently, and at all times keep the Commission informed as to:
  - (i) the identity of each such staff member (by title and department) and the information to which he/she has access;
  - (ii) the basis upon which it is necessary, in each case, for such access to be permitted; and
  - (iii) any change made in relation to the staff members to whom such access is permitted and the basis for such change;
- (b) maintain an adequate access log that records the identity and role of the staff members who have access to its ALP, the



information that has been accessed, the time of access, any approval given for such access and the basis upon which such access was permitted in each case;

- (c) have adequate and effective systems and controls in place to guard against, and detect, information leakage or abuse by members of its staff in relation to the trading information concerning orders placed and/or transactions conducted in its ALP to which they have access; and
- (d) have appropriate measures in place to ensure that any person responsible for originating the instruction in relation to a proprietary order in its ALP, does not have access, whether directly or indirectly, to any trading information or transaction data concerning orders placed, or transactions conducted, in the ALP, other than confirmation of the eventual outcome of the order.

## Contingencies

- 17. An ALP operator should establish a written contingency plan to cope with emergencies and disruptions related to the operation of its ALP. The contingency plan should at least include:
  - (a) a suitable backup facility which will enable the ALP operator to operate the ALP in the event of an emergency;
  - (b) arrangements to ensure user and transaction databases and servers are backed up in an off-line medium, with off-site storage being subject to proper security measures; and
  - (c) trained staff being available to deal with user and regulatory enquiries.
- 18. An ALP operator should ensure that the contingency plan to deal with potential emergencies and disruptions is periodically tested and that the plan is viable and adequate.
- 19. An ALP operator should, in the event of a material system delay or failure, in a timely manner:
  - (a) ensure that the delay or failure is rectified; and



- (b) inform users of its ALP of the causes, or possible causes, of the delay or failure and the manner in which their orders will be handled.

## **Record keeping**

- 20. An ALP operator should keep, or cause to be kept:
  - (a) comprehensive documentation of the design, development, deployment and operation of its ALP, including any testing, reviews, modifications, upgrades or rectifications of the ALP; and
  - (b) comprehensive documentation of the risk management controls for the ALP.
- 21. An ALP operator should retain the documentation referred to in paragraph 20(a) and (b) for a period of not less than two years after the ALP ceases to operate.
- 22. An ALP operator should keep:
  - (a) for a period of not less than seven years, the following records in respect of transactions conducted in its ALP in such manner as will enable them to be readily accessible in written form in the Chinese or English language (and, if necessary, immediately convertible into such written form), and provide any such records to the Commission upon request:
    - (i) details of the users of its ALP, including their registered names and addresses, dates of admission and cessation, authorized traders and related details, and client agreements;
    - (ii) details of any restriction, suspension or termination of the access of any user to its ALP, including the reasons for this;
    - (iii) all notices and other information, whether written or communicated through electronic means, provided by



- the ALP operator to the users of its ALP, whether individually or generally; and
- (iv) routine daily and monthly summaries of trading in its ALP, including:
    - (I) the securities in respect of which transactions have been executed; and
    - (II) the transaction volume, expressed in numbers of trades, numbers of securities traded and total settlement value; and
  - (b) for a period of not less than two years, time-sequenced records of orders and any other actions or activities conducted in its ALP, as particularized below, in such manner as will enable them to be readily accessible in written form in the Chinese or English language (and, if necessary, immediately convertible into such written form), and provide any such records to the Commission upon request:
    - (i) the date and time that any order was received, executed, modified, cancelled or expired (where applicable);
    - (ii) the identity, address and contact details of the user and authorized trader initiating an entry, modification, cancellation or execution of an order;
    - (iii) the particulars of any order and any subsequent modification and execution of the order (where applicable), including but not limited to, the securities involved, the size and side (buy or sell) of the order, the order type, and any order designation, time and price limit or other conditions specified by the user responsible for originating the order; and
    - (iv) the particulars of the allocation and re-allocation (where applicable) of an execution.



## **Risk management**

23. An ALP operator should have controls that are reasonably designed to monitor and prevent the crossing of orders in its ALP which may:
  - (a) be erroneous;
  - (b) interfere with the operation of a fair and orderly market; or
  - (c) be in breach of any legal or regulatory obligations.
24. An ALP operator should regularly conduct post-trade reviews of transactions conducted in its ALP to identify any:
  - (a) suspicious market manipulative or abusive activities;
  - (b) market events or system deficiencies, such as unintended impact on the market, which call for further risk control measures; and
  - (c) breaches, whether actual or potential, of any requirements relating to fair and orderly trading in its ALP or which might constitute market misconduct.
25. Forthwith, upon becoming aware of any breach, whether actual or potential, of any legal or regulatory obligation referred to in paragraph 23(c) or any requirement referred to in paragraph 24(c), an ALP operator should notify the Commission of such matter and provide the Commission with such additional assistance in connection therewith as it might request.
26. An ALP operator should, upon identification of any suspected market manipulative or abusive trading activities, take immediate steps to prevent these activities from continuing.



## Reporting and notification obligations

### Transaction reporting

27. An ALP operator should have appropriate arrangements in place to ensure that:
- (a) transactions conducted in its ALP that are required to be reported to The Stock Exchange of Hong Kong Limited (“SEHK”) are properly reported in the manner and within the time limit prescribed by the rules and regulations of SEHK;
  - (b) transactions conducted in its ALP that are required to be reported to any exchange or regulator outside Hong Kong are properly reported in the manner and within the time limit required by such exchange or regulator;
  - (c) regular transaction analyses are made available to the users of its ALP concerning the transactions that are conducted on their behalf in the ALP; and
  - (d) it provides the Commission with a report recording the volume of trades conducted by each of the 10 largest users of its ALP on a calendar monthly basis within 10 business days after the end of each calendar month, or as otherwise requested by the Commission.

### Notification to the Commission

28. An ALP operator should:
- (a) notify the Commission of any proposed change to the following which might affect the operation of its ALP or the users of its ALP, and provide the Commission with an explanation for the proposed change, prior to its implementation:
    - (i) corporate structure and governance arrangements;
    - (ii) business plans or operations;
    - (iii) the trading rules, trading sessions and operating hours, the system operator, hardware, software, and other





- technology of its ALP, and all system interfaces between its ALP and other ALPs or other electronic trading platforms;
- (iv) the ALP operator's contractual responsibilities in relation to the users of its ALP;
  - (v) the criteria for approval or disapproval of the users of its ALP; and
  - (vi) the contingency plan in relation to its ALP;
- (b) notify the Commission of any breach of any relevant regulatory obligations or the ALP Guidelines forthwith upon its occurrence;
  - (c) notify the Commission of the causes, or possible causes, of material delay or failure to the operation of its ALP affecting the users of its ALP forthwith upon its occurrence; and
  - (d) provide the Commission with any updated review report concerning its ALP forthwith upon it becoming available.



## **Schedule 9      Disclosure statement in respect of an intermediary's independent status**

Under paragraph 8.3A(a)(iii) of the Code, where a licensed or registered person distributes an investment product to a client (including where it sells an investment product to or buys such product from the client), the licensed or registered person should inform the client, prior to or at the point of entering into the transaction, whether or not the licensed or registered person is independent (with reference to the requirements set out in paragraph 10.2 of the Code) and the bases for such determination.

Such disclosure should be made by the licensed or registered person to the client containing the substance set out in the following disclosure statements.

### **Where the licensed or registered person is independent:**

“We are an independent intermediary because:

1. we do not receive fees, commissions, or any other monetary benefits, provided by any party in relation to our distribution of any investment product to you; and
2. we do not have any close links or other legal or economic relationships with product issuers, or receive any non-monetary benefits from any party, which are likely to impair our independence to favour any particular investment product, any class of investment products or any product issuer.”

### **Where the licensed or registered person is NOT independent:**

“We are NOT an independent intermediary because:

1. we receive fees, commissions, or other monetary benefits from other parties (which may include product issuers) in relation to our distribution of investment products to you. For details, you should refer to our disclosure on monetary benefits which we are required to deliver to you prior to or at the point of entering into any transaction in investment products;

and/or

2. we receive non-monetary benefits from other parties, or have close links or other legal or economic relationships with issuers of products that we may distribute to you.”

*Note: in addition to making the disclosure in the paragraph above, it is optional for a licensed or registered person to further provide a description of the close links or other legal or economic relationships with product issuers which are likely to impair the intermediary’s independence to favour any particular investment product, any class of investment products or any product issuer. Licensed and registered persons should also note the disclosure requirements in relation to non-monetary benefits in paragraph 8.3 of the Code.”*

## **Schedule 10      Risk mitigation requirements and margin requirements in relation to non-centrally cleared OTC derivative transactions**

### **Part I Risk mitigation requirements in relation to non-centrally cleared OTC derivative transactions**

The risk mitigation requirements set out in this Part of this Schedule apply to:

- (a) a licensed corporation (regardless of the regulated activity for which it is licensed) which is a contracting party to OTC derivative transactions that are not centrally cleared<sup>1</sup>; and
- (b) a corporation licensed for Type 9 regulated activity which provides a service of managing a portfolio of OTC derivative products for a collective investment scheme managed by it, in respect of non-centrally cleared OTC derivative transactions executed by it on behalf of the collective investment scheme managed by it, except to the extent that the risk mitigation requirements are handled by the governing body of the collective investment scheme or its delegate.

The risk mitigation requirements do not apply to registered persons.

#### *Trading relationship documentation*

1. A licensed corporation should execute written trading relationship documentation with its counterparties prior to, or contemporaneously with, executing a non-centrally cleared OTC derivative transaction. Such documentation should contain all material terms governing the trading relationship between the counterparties, including credit support arrangements where applicable.

#### *Trade confirmation*

2. A licensed corporation should establish and implement policies and procedures to ensure the material terms of all non-centrally cleared

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<sup>1</sup> An excluded currency contract as defined under Rule 2 of Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules is only subject to the requirements on Trading Relationship Documentation and Trade Confirmation.

OTC derivative transactions are confirmed in writing as soon as practicable after the execution of a transaction. Material terms confirmed should include the terms necessary to promote legal certainty for a transaction.

3. A licensed corporation may use one-way confirmation instead of two-way confirmation insofar as both parties have agreed in advance to confirm trades using this process, so that the outcome is legally binding on both parties.

### *Valuation*

4. A licensed corporation should agree with its counterparty in writing the process for determining the value of non-centrally cleared OTC derivatives in a predictable and objective manner at any time from the execution of the transaction to the termination, maturity, or expiration thereof. The valuation determinations should be based on economically similar transactions or other objective criteria. All agreements on the valuation process should be documented in the trading relationship documentation or trade confirmation.
5. If a licensed corporation values a non-centrally cleared OTC derivative transaction using a proprietary valuation model, the licensed corporation should ensure that the model:
  - (a) employs a valuation methodology with an accepted economic or sound theoretical basis which incorporates all factors that counterparties would reasonably consider in valuing the non-centrally cleared OTC derivative transaction;
  - (b) is appropriately calibrated and tested for validity;
  - (c) is subjected to independent model review, validation and approval periodically and when material changes to the methodology or the model are made; and
  - (d) outputs are subjected to regular independent review and verification.

The results of model calibration, testing, review and validation should be documented.

If a licensed corporation values a non-centrally cleared OTC

derivative transaction using a third party valuation model, the licensed corporation should exercise due skill, care and diligence to confirm that the model satisfies paragraphs (a) to (c) above, and the licensed corporation should conduct regular independent reviews and verification of the model outputs.

6. A licensed corporation with material exposures to non-centrally cleared OTC derivative transactions should perform periodic reviews of the agreed-upon valuation process to take into account any changes in market conditions.

*Note: In respect of an asset manager licensed for Type 9 regulated activities, paragraphs 4 to 6 (inclusive) of the risk mitigation requirements are only applicable to an asset manager that is responsible for the overall operation of a fund or has been delegated responsibility for fund valuation.*

#### *Portfolio reconciliation*

7. A licensed corporation should establish and implement policies and procedures to ensure that the material terms are exchanged and valuations (including variation margin) are reconciled with counterparties, at regular intervals.
8. The frequency of portfolio reconciliation with each counterparty should be commensurate with the risk exposure profile of the counterparty, taking into account the size and volatility of the non-centrally cleared OTC derivative portfolio of the licensed corporation with a particular counterparty.

#### *Portfolio compression*

9. A licensed corporation should, in respect of non-centrally cleared OTC derivative portfolios, establish and implement policies and procedures to regularly assess and, to the extent appropriate, engage in portfolio compression, proportionate to the level of exposure or activity of the licensed corporation.

#### *Dispute resolution*

10. A licensed corporation should agree in writing with its counterparties, other than counterparties who are individuals, the mechanism or process for determining when discrepancies in trade populations, material terms, valuations and margins should be considered

disputes, as well as how such disputes should be resolved as soon as practicable. Where the counterparty is not a financial counterparty, the licensed corporation may meet this requirement by establishing and implementing effective policies and procedures regarding the type of counterparties with whom such dispute resolution mechanism or process should be agreed, proportionate to the level of exposure to the counterparty.

For the purposes of the risk mitigation requirements in relation to non-centrally cleared OTC derivative transactions:

- (1) “financial counterparty” means:
- (a) an authorized institution (AI) as defined in section 2(1) of the Banking Ordinance (Cap 155);
  - (b) a licensed corporation;
  - (c) a provident fund scheme registered under the Mandatory Provident Fund Schemes Ordinance (Cap 485) or its constituent fund as defined in section 2(1) of that Ordinance;
  - (d) an occupational retirement scheme as defined in section 2(1) of the Occupational Retirement Schemes Ordinance (Cap 426);
  - (e) an insurer authorised under the Insurance Ordinance (Cap 41);
  - (f) a licensed money service operator as defined in section 1 of Part 2 of Schedule 1 to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap 615);
  - (g) a money lender licensed under the Money Lenders Ordinance (Cap 163);
  - (h) a special purpose vehicle or a securitisation vehicle, except where and to the extent that the special purpose vehicle enters into non-centrally cleared OTC derivative transactions for the sole purpose of hedging;
  - (i) a collective investment scheme as defined in section 1 of Part 1 of Schedule 1 to the SFO;
  - (j) an entity that carries on a business outside Hong Kong and is

engaged predominantly in any one or more of the following activities:

- Banking;
- Securities or derivatives business;
- Asset management;
- Insurance business;
- Operation of a remittance or money changing service;
- Lending;
- Activities that are ancillary to the conduct of these activities.



## Part III Margin requirements

The margin requirements described in Part III of this Schedule apply to all licensed persons which are contracting parties to non-centrally cleared OTC derivative transactions entered into with a covered entity, subject to the relevant thresholds as set out below.

### Terminology

#### Covered Entity

1. Covered entity means a financial counterparty, a significant non-financial counterparty or another entity designated by the SFC<sup>2</sup>, but excludes a sovereign<sup>3</sup>, public sector entity<sup>4</sup>, multilateral development bank<sup>5</sup> and the Bank for International Settlements. Any reference to “counterparty” below means covered entity, unless stated otherwise.

#### Financial Counterparty

2. Financial counterparty refers to any entity which falls within the definition of “financial counterparty” in Part I of this Schedule, with respect to a one-year period from 1 September each year to 31 August of the following year, if the entity itself or the consolidated group to which it belongs has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK\$15 billion.

#### Significant Non-financial Counterparty

3. Significant non-financial counterparty refers to any entity other than a financial counterparty, with respect to a one-year period from 1 September each year to 31 August of the following year, if the entity itself or the consolidated group to which it belongs has an average

<sup>2</sup> The SFC may designate any entity (or class of entities) as a covered entity if the SFC considers it reasonably necessary in order to ensure that the objectives of this Part are fulfilled or that its requirements are not circumvented, or the SFC is otherwise satisfied that it is appropriate to do so.

<sup>3</sup> Sovereign means (a) HKSAR; (b) the central government of a country; or (c) the central bank of a country.

<sup>4</sup> Public sector entity means any agency of HKSAR or of a central government that is incorporated or established for non-commercial purposes.

<sup>5</sup> As specified by the HKMA in the Banking (Specification of Multilateral Development Bank) Notice (Cap. 155N)

aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK\$60 billion.

#### Average Aggregate Notional Amount

4. The average aggregate notional amount:
- (a) is calculated as the average of the total gross notional amount of month-end positions of non-centrally cleared OTC derivatives for March, April and May preceding the 1 September starting date in a relevant year. Month-end positions should be converted into Hong Kong Dollars using corresponding month-end spot rates, before calculating the average position;
  - (b) includes the gross notional amount of all non-centrally cleared OTC derivatives, including non-centrally cleared OTC derivatives mentioned in paragraph 7(b), (c), (d) and (e) below;
  - (c) is calculated on a consolidated group level<sup>6</sup> by including all non-centrally cleared OTC derivatives of all entities within the consolidated group<sup>7</sup>; and
  - (d) includes all the non-centrally cleared OTC derivatives that entities within the group have entered into with each other, counting each of them once.

#### Consolidated Group

5. “Consolidated group” means a group of entities for which consolidated financial statements are prepared.

<sup>6</sup> An investment fund managed by an asset manager will be treated as an entity that is separate from the related group of funds for the purposes of applying the average aggregate notional amount as long as the fund is a distinct segregated pool of assets (i) that would be treated as such for the purposes of the fund's default or insolvency and upon the default or insolvency of the asset manager and (ii) that is not collateralised by or otherwise guaranteed or supported by any other investment fund managed by the asset manager or by the asset manager.

<sup>7</sup> To avoid doubt, non-centrally cleared OTC derivatives (i) for which a licensed person faces no counterparty risk; or (ii) that are entered into with a sovereign, public sector entity, multilateral development bank or the Bank for International Settlements should be included.

## Netting Set

6. Netting set means a group of non-centrally cleared OTC derivative transactions between two counterparties that are subject to a legally enforceable bilateral netting agreement.

## Instruments subject to the requirements

7. The margin requirements apply to all non-centrally cleared OTC derivatives except the following:
- (a) OTC derivative transactions that are cleared by a clearing member on behalf of a non-member or a non-member's client where:
    - (i) the non-member and its client (as appropriate) are subject to the margin requirements of the central counterparty; or
    - (ii) the non-member and its client (as appropriate) provide margin consistent with the relevant corresponding central counterparty's margin requirements.
  - (b) physically settled FX forwards and FX swaps, and the "FX transactions" embedded in cross-currency swaps associated with the exchange of principal<sup>8</sup>, subject to paragraph 8;
  - (c) excluded currency contracts within the meaning of section 2 of Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules;
  - (d) physically settled commodity forwards; and
  - (e) on or before 3 January 2026, non-centrally cleared single-stock options, equity basket options and equity index options.

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<sup>8</sup> To avoid doubt, all other payments or cash flows that occur during the life of the cross-currency swap must be considered in the initial margin calculation, ie, the only payments that may be excluded from the calculation of initial margin are the fixed physically settled FX transactions associated with the exchange of principal.

8. The instruments listed in paragraph 7(b) above are only subject to the variation margin requirements if:
- (a) they are entered into by a licensed person with any of the following entities:
    - (i) an authorized institution as defined in section 2(1) of the Banking Ordinance (Cap 155);
    - (ii) a licensed corporation; or
    - (iii) an entity that carries on a business outside Hong Kong and is engaged predominantly in any one or more of the following activities:
      - Banking;
      - Securities or derivatives business; and
      - Asset management<sup>9</sup>;
  - (b) In relation to both counterparties referred in (a) above, with respect to a one-year period from 1 September each year to 31 August of the following year, the entity itself or the consolidated group to which it belongs has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK\$60 billion.

## Margin requirements

### Initial margin (“IM”) requirements

9. A licensed person should exchange (ie, post and collect) IM<sup>10</sup> on a gross basis with a covered entity which is a counterparty to non-

<sup>9</sup> For the avoidance of doubt, this seeks to cover the asset manager, but not the funds managed by the manager.

<sup>10</sup> IM means the collateral that protects the parties to non-centrally cleared OTC derivatives from the potential future exposure that could arise from future changes in the mark-to-market value of the derivatives during the time it takes to close out and replace the position in the event of a counterparty default. The amount of IM reflects the size of the potential future exposure.

centrally cleared OTC derivative transactions in a one-year period according to the following implementation schedule:

- (a) from 1 September 2021 to 31 August 2022, where both the licensed person and the covered entity have an average aggregate notional amount of non-centrally cleared OTC derivatives, calculated according to paragraph 4, exceeding HK\$375 billion;
  - (b) on a permanent basis from 1 September 2022 for each subsequent 12-month period, where both the licensed person and the covered entity have an average aggregate notional amount of non-centrally cleared OTC derivatives, calculated according to paragraph 4, exceeding HK\$60 billion.
10. The methodologies for calculating IM that serve as the baseline for margin collected from a counterparty should (i) reflect the potential future exposure associated with the relevant portfolio of non-centrally cleared OTC derivatives and (ii) ensure that all counterparty risk exposures are covered fully with a high degree of confidence.
11. No IM has to be collected in relation to non-centrally cleared OTC derivatives for which a licensed person faces no (ie, zero) counterparty risk and these may be excluded from the IM calculation<sup>11</sup>.
12. The required amount of IM may be calculated by reference to either (i) a standardised margin schedule (“standardised approach”); or (ii) a quantitative portfolio margin model (“model approach”). A licensed

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<sup>11</sup> As an example, consider a European call option on a single stock. Suppose that a licensed person agrees to sell a fixed number of shares to another party, the option buyer, at a predetermined price at some specific future date (the contract's expiry) if the option buyer wishes to do so. Suppose further that the option buyer makes a payment to the licensed person at the outset of the transaction that fully compensates the licensed person for the possibility that it will have to sell shares at contract expiry at the predetermined price. In this case, the licensed person faces zero counterparty risk while the option buyer faces counterparty risk. The licensed person has received the full value of the option at the outset of the transaction. The option buyer, on the other hand, faces counterparty risk since the licensed person may not be willing or able to sell shares to the option buyer at the predetermined price at the expiry of the contract. In this case, the licensed person would not be obliged to collect any IM from the option buyer and the call option could be excluded from the IM calculation. Since the option buyer faces counterparty risk, the option buyer needs to collect IM from the licensed person in a manner consistent with the standards herein.

person may use the standardised approach to calculate IM for one asset class while using the model approach for another asset class.

13. The choice between the standardised approach and the model approach should be made consistently over time for non-centrally cleared OTC derivatives.
14. A licensed person should follow the steps set out in Annex A to calculate IM amounts under the standardised approach.
15. A licensed person should follow the steps set out in Annex B to calculate IM amounts under the model approach.
16. A licensed person may agree with its counterparty to include non-centrally cleared OTC derivatives that are otherwise out of scope (from the margin requirements to which the licensed person is subject) within the in-scope portfolio for the purpose of calculating IM, as long as this is done consistently and on an ongoing basis.
17. A licensed person may elect not to exchange IM with a significant non-financial counterparty provided that the licensed person has obtained a declaration from the significant non-financial counterparty that it predominantly uses the non-centrally cleared OTC derivatives for hedging purposes.

#### IM threshold

18. A licensed person may agree with the counterparty not to exchange IM if the amount due is equal to or lower than a threshold of HK\$375 million ("IM threshold").
19. The IM threshold is applied at the level of the consolidated groups to which the licensed person and the counterparty belong and is based on all non-centrally cleared OTC derivatives outstanding between the

two consolidated groups. A licensed person may agree with its counterparty on allocating the IM threshold at entity level.

20. If the total IM amount exceeds the IM threshold, the two consolidated groups need to exchange at least the difference between the total IM amount and the IM threshold.
21. A licensed person should have adequate and appropriate systems and controls in place to ensure that any allocated IM threshold is not exceeded.

#### Treatment of IM

22. When a licensed person is the party collecting IM, appropriate collateral arrangements, including credit support arrangements, should be in place which are legally effective in the event that the party posting IM defaults or becomes insolvent.
23. A licensed person as the party collecting IM should:
  - (a) ensure IM collected is held in such a way that it is available in a timely manner to the licensed person in case the party posting IM defaults or becomes insolvent; and
  - (b) provide the party posting IM with the option to have the IM that it posts segregated from the IM posted to the licensed person by other counterparties.
24. A licensed person as the party posting IM should ensure IM posted:
  - (a) is subject to arrangements that protect the licensed person to the extent possible under applicable law in the event that the party collecting IM defaults or becomes insolvent; and
  - (b) is segregated from the proprietary assets of the party collecting IM by either placing the IM with a third party custodian or

through other legally effective arrangements to protect the IM from the default or insolvency of the party collecting IM.

25. If a third-party custodian is used, the licensed person should ensure that:
- (a) the custodian is not a consolidated group member of the counterparty collecting or posting IM; and
  - (b) the financial condition and credit standing of the custodian is regularly monitored.
26. IM collected from a counterparty may be re-hypothecated, re-pledged or reused (henceforth “re-hypothecated”) with a third party only for the purpose of hedging the licensed person’s derivative positions arising out of transactions with the counterparty for which IM was collected and must be subject to the following conditions:
- (a) The counterparty is not an entity that regularly holds itself out as making a market in derivatives, routinely quotes bid and offer prices on derivatives contracts and routinely responds to requests for bid or offer prices on derivatives contracts;
  - (b) The licensed person has:
    - (i) disclosed to the counterparty its right not to permit re-hypothecation and the risks associated with the nature of the counterparty’s claim to the re-hypothecated collateral in the event of the default or insolvency of the licensed person or the third party; and
    - (ii) given the counterparty the option to individually segregate the collateral that it posts; and
    - (iii) the counterparty has given express consent in writing to the re-hypothecation of its collateral;



- (c) Collateral collected as IM from the counterparty should be treated as a client asset segregated from the licensed person's proprietary assets until re-hypothecated. Once re-hypothecated, the third party should treat the collateral as a client asset, and segregate it from the third party's proprietary assets. Assets returned to the licensed person after re-hypothecation should also be treated as client assets and should be segregated from the licensed person's proprietary assets;
- (d) The IM of counterparties which have consented to the re-hypothecation of their collateral should be segregated from that of counterparties which have not so consented;
- (e) Where IM has been individually segregated, the collateral should only be re-hypothecated for the purpose of hedging the licensed person's derivative positions arising out of transactions with the counterparty in relation to which the collateral was provided;
- (f) Where IM has been individually segregated and subsequently re-hypothecated, the licensed person should require the third party similarly to segregate the collateral from the assets of the third party's proprietary assets and the assets of any other person;
- (g) Protection is given to the counterparty from the risk of loss of IM in circumstances where either the licensed person or the third party defaults or becomes insolvent and where both the licensed person and the third party default or become insolvent;
- (h) Where the licensed person re-hypothecates IM, the agreement with the recipient of the collateral (ie, the third party) should prohibit the third party from further re-hypothecating the collateral;

- (i) Where collateral is re-hypothecated, the licensed person must notify the counterparty. Upon request by the counterparty and where the counterparty has opted for individual segregation, the licensed person should notify the counterparty of the amount of cash collateral and the value of non-cash collateral that has been re-hypothecated;
- (j) Collateral must only be re-hypothecated to, and held by, an entity that is regulated in a jurisdiction that meets all of the specific conditions contained in this paragraph and in which the specific conditions can be enforced by the licensed person;
- (k) The counterparty and the third party may not be within the same consolidated group; and
- (l) The licensed person and the third party should keep appropriate records to show that all the above conditions have been met.

#### Variation margin (“VM”) requirements

27. A licensed person should exchange<sup>12</sup> VM<sup>13</sup> with a covered entity for non-centrally cleared OTC derivative transactions, from 1 September 2020, for a one-year period from 1 September each year to 31 August of the following year when the licensed person itself or the consolidated group to which it belongs has an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK\$15 billion, except that an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK\$60 billion applies to the instruments listed in paragraph 7(b). The VM amount exchanged should fully collateralise the current exposure of the non-centrally cleared OTC derivative transactions.

<sup>12</sup> Exchange of margin means the posting and collecting of margin between two covered entities.

<sup>13</sup> VM means the collateral which protects the parties to non-centrally cleared OTC derivatives from the current exposure that has already been incurred by one of the parties from changes in the mark-to-market value of the derivatives after the transaction has been executed. The amount of variation margin reflects the size of this current exposure, which can change over time depending on the mark-to-market value of the derivatives at any point in time.

28. VM should be calculated and exchanged for non-centrally cleared OTC derivative transactions subject to a single, legally enforceable netting agreement.
29. A licensed person may agree with its counterparty to include non-centrally cleared OTC derivatives that are otherwise out of scope (from the margin requirements to which the licensed person is subject) within the in-scope portfolio for the purpose of calculating VM, as long as this is done consistently and on an ongoing basis.
30. A licensed person may elect not to exchange VM with a significant non-financial counterparty provided that the licensed person has obtained a declaration from the significant non-financial counterparty that it predominantly uses the non-centrally cleared OTC derivatives for hedging purposes.

#### Minimum transfer amount

31. A licensed person may agree with the counterparty not to exchange margin if the amount due (aggregate of IM and VM) since the last exchange of margin is equal to or lower than a specified minimum transfer amount not exceeding HK\$3.75 million (the “minimum transfer amount”).
32. A licensed person and the counterparty need to transfer the full amount of margin if the minimum transfer amount is exceeded, ie, without deduction of the minimum transfer amount.

#### Timing for the exchange of margin

33. IM should be called at the earliest time possible after either execution of a transaction or upon changes in measured potential future exposure. The IM amount for a given counterparty has to be recalculated at least every ten business days.

34. IM should be collected as soon as practicable within the standard settlement cycle for the relevant collateral type.
35. VM should be calculated at least on a daily basis and be called at the earliest time possible after the trade date and from time to time thereafter.
36. VM should be collected as soon as practicable within the standard settlement cycle for the relevant collateral type.

Assets eligible as margin<sup>14</sup>

37. Subject to paragraphs 38 and 40, the following collateral instruments are eligible as margin (both IM and VM):
  - (a) Cash in any currency;
  - (b) Marketable debt securities issued or fully guaranteed by a sovereign or a relevant international organisation<sup>15</sup>;
  - (c) Marketable debt securities issued or fully guaranteed by a multilateral development bank;
  - (d) Marketable debt securities issued or fully guaranteed by a public sector entity;
  - (e) Other marketable debt securities;
  - (f) Gold; or
  - (g) Listed shares which are subject to a haircut percentage of 15% under the Securities and Futures (Financial Resources) Rules ("FRR").

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<sup>14</sup> These asset eligibility requirements apply even if a licensed person elects to follow the margin requirements applicable to the counterparty under paragraph 50.

<sup>15</sup> As defined in section 2 of Banking (Capital) Rules (Cap 155L).

38. When a licensed person is the party collecting IM or VM, the following instruments are not eligible for IM or VM:
- (a) securities issued by the licensed person or an entity that is within the same consolidated group as the licensed person; and
  - (b) securities whose value exhibits a significant correlation with the creditworthiness of the counterparty or the value of the underlying non-centrally cleared OTC derivative portfolio in such a way that would undermine the effectiveness of the protection offered by the margin (“wrong way risk”).
39. A licensed person should ensure the collateral collected as IM or VM is not overly concentrated in terms of an individual issuer, issuer type and asset type.
40. Assets referred to in paragraph 37(b), (c), (d) and (e) are only eligible as margin if they are associated with a credit quality of investment grade. Notwithstanding the foregoing, the following assets are not eligible:
- (a) any special debt securities as defined under the FRR;
  - (b) any securities or any instrument acknowledging, evidencing or creating a subordinated loan or a debt due from a corporation within a group of companies of which the holder of the securities or instrument is a member;
  - (c) any structured product other than a bond that:
    - (i) has a coupon rate that has an inverse relationship to a money market or interbank reference interest rate that is widely quoted; or
    - (ii) has principal or coupon payments that are linked to an inflation rate;

- (d) any securities or instrument the terms and conditions of which provide that, upon the occurrence of one or more events specified in the terms and conditions, one or both of the following must apply in relation to the principal value:
  - (i) the principal value is to be fully or partially converted into or exchanged for shares of the issuer or a related corporation of the issuer;
  - (ii) the principal value is to be fully or partially written down; or
- (e) listed securities that have been suspended from trading for at least 3 trading days or ceased trading on any exchange on which the securities were listed, except where the securities can continue to be traded on any other exchange on which the securities are listed.

#### Haircuts<sup>16</sup>

- 41. A licensed person should apply the haircuts set out in Annex C.
- 42. For the purpose of exchanging IM, each party may designate only one currency in the trading relationship documentation (such as a master agreement or credit support arrangement).
- 43. A currency mismatch arises whenever the eligible collateral posted (as either IM or VM) is denominated in a currency other than the currencies designated by the contracting parties in the trading relationship documentation.
- 44. In the case of a currency mismatch, an additive haircut ("FX Haircut") of 8% should be applied to the market value of any IM collateral (cash and non-cash IM collateral) and non-cash VM collateral, except for CNY-CNH, where the FX Haircut should be 1.5%.

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<sup>16</sup> These haircut requirements apply even if a licensed person elects to follow the margin requirements applicable to the counterparty under paragraph 50.

45. If the trading relationship documentation does not identify relevant currencies as described in paragraphs 42 and 43 above, the FX Haircut would apply to the market value of all collateral for margin purposes, except cash VM collateral.

## **Scope of applicability**

### **Netting**

46. A licensed person need not exchange IM and VM in circumstances where there is reasonable doubt as to the enforceability of the netting agreement upon default or insolvency of the counterparty.
47. A licensed person need not exchange IM in circumstances where there is a reasonable doubt as to the enforceability of arrangements for the protection of posted collateral upon default or insolvency of a counterparty.
48. The licensed person should have a well-founded basis to justify its eligibility for exemption under paragraph 46 or 47 after undertaking an assessment of the enforceability of the netting agreement or the collateral arrangements (as the case may be). This should be supported by an external legal opinion<sup>17</sup> in writing with reference to the netting or collateral provisions in the contractual arrangements used by the licensed person. The licensed person should arrange for any such legal opinion to be updated on a regular basis as appropriate.

### **Intragroup transactions**

49. The margin provisions in this Part do not apply to non-centrally cleared OTC derivative transactions between a licensed person and a covered entity which is in the consolidated group to which the licensed person belongs (ie, an affiliate), provided that,

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<sup>17</sup> Jurisdictional opinions obtained from external independent legal counsels by an industry association of which the licensed person (or any member of the licensed person's group of companies) is a member are acceptable.

- (a) the licensed person and the affiliate are accounted for on a full basis in the consolidated financial statements of the holding company of the consolidated group to which they belong, for the purpose of and in compliance with the Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants, the International Financial Reporting Standards issued by the International Accounting Standards Board, or the standards of accounting practices applicable to the holding company in the place in which it is incorporated; and
- (b) the risk evaluation, measurement and control procedures applicable to the licensed person and the affiliate are centrally overseen and managed within the consolidated group to which they belong.

#### Substituted compliance

50. A licensed person which enters into a non-centrally cleared OTC derivative transaction that is subject to the margin requirements set out in this Part (“SFC requirements”) with a counterparty which is subject to the margin requirements of another regulator or jurisdiction (“the counterparty’s margin requirements”) may, in respect of the transaction, elect to adhere to the counterparty’s margin requirements instead of SFC requirements subject to the following being satisfied<sup>18</sup>:

- (a) the licensed person must notify the SFC of its intention to adhere to the counterparty’s margin requirements before it begins to do so;
- (b) either of the following apply:

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<sup>18</sup> The SFC may specify conditions with which a licensed person must comply in adhering to the margin requirements of a jurisdiction or regulator, regardless of whether a comparability determination has been issued by the SFC or HKMA. The SFC will publish on its website the names of the jurisdictions or regulators whose margin requirements are referred to in paragraph (b) and any specified conditions referred to in paragraph (c).



- (i) the counterparty's margin requirements are of a WGMR<sup>19</sup> member jurisdiction or a regulator in such a jurisdiction and the SFC has deemed the counterparty's margin requirements to be comparable to SFC requirements until a comparability determination in respect of the counterparty's margin requirements is issued by the SFC or HMKA; or
  - (ii) a comparability determination in respect of the counterparty's margin requirements has been issued by the SFC or HMKA; and
- (c) the licensed person must comply with all conditions specified by the SFC in respect of it adhering to the counterparty's margin requirements.

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<sup>19</sup> Working Group on Margining Requirements under the Basel Committee on Banking Supervision and the International Organization of Securities Commissions.

## **Annex A - Calculating IM amounts by reference to a standardised margin schedule**

- A.1 The total amount of IM required on a portfolio according to the standardised margin schedule should be computed by referencing the standardised margin rates in A.3 below and by adjusting the gross IM amount by an amount that relates to the net-to-gross ratio pertaining to all non-centrally cleared OTC derivatives in the legally enforceable netting set. The IM amount is calculated in two steps. First, the margin rate in the schedule set out in A.3 is multiplied by the gross notional size for each derivative contract, and then this calculation is repeated for each derivative contract to arrive at the gross IM. Second, the gross IM amount is adjusted by the ratio of the net current replacement cost to gross current replacement cost (“NGR”). This is expressed through the following formula:

$$\textbf{Net Standardised IM} = 0.4 * \textit{Gross IM} + 0.6 * \textit{NGR} * \textit{Gross IM}$$

where NGR is defined as the level of net replacement cost over the level of gross replacement cost for transactions subject to legally enforceable netting agreements. Net replacement cost is the sum of positive and negative market values of all derivative contracts in the netting set. The value is set to zero if the sum is negative. Gross replacement cost is the sum of the positive market values of derivative contracts in the netting set.

- A.2 The total amount of IM required for a portfolio according to the standardised margin schedule is the net standardised IM amount.

### A.3 Standardised IM schedule

Asset class	IM requirement (% of notional exposure)
Interest rate <sup>20</sup> :	
0-2 year duration	1
2- 5 year duration	2
5+ year duration	4
Foreign exchange	6
Commodity <sup>21</sup>	15
Equity	15
Credit:	
0-2 year duration	2
2-5 year duration	5
5+ year duration	10
Other	15

<sup>20</sup> Inflation swaps, which transfer inflation risk between counterparties, are to be considered as part of the interest rate asset class.

<sup>21</sup> This includes gold and other precious metals such as silver and platinum.

## **Annex B - Calculating IM amounts by reference to a quantitative portfolio margin model**

### **B.1 Supervisory requirements**

- B.1.1 A licensed person should obtain approval in writing from the SFC before using an internally developed or a third-party IM model<sup>22</sup>.
- B.1.2 The applicant needs to demonstrate that the relevant IM model satisfies all of the criteria set out in this Annex and any other requirement as specified by the SFC on an ongoing basis.
- B.1.3 Unless the SFC agrees otherwise, a licensed person should notify the SFC at least 60 days in advance before making any subsequent material changes to an approved model.
- B.1.4 The SFC may consider that a licensed person using a model should collect a greater amount of IM than that determined by the licensed person's model if additional collateral is appropriate due to the structure, complexity or other features of the licensed person's non-centrally cleared OTC derivatives portfolio.

### **B.2 Modelling standards and calculation**

- B.2.1 A licensed person's IM model should be conceptually sound and designed to calculate IM in an appropriately risk-sensitive manner.
- B.2.2 The level of sophistication of the modelling approach should reflect the nature, scale and complexity of the risks inherent in the derivative contracts it is applied to.
- B.2.3 The IM model should calculate a conservative estimate of the potential future exposure of non-centrally cleared OTC derivatives, reflecting a variation in value of the instrument that is based on a

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<sup>22</sup> This requirement applies even if a licensed person elects to follow the margin requirements applicable to the counterparty under paragraph 50.

one-tailed 99% confidence interval over a 10-day horizon. The maturity of a derivative contract may be used instead of the 10-day requirement if it is shorter than 10 days<sup>23</sup>.

B.2.4 The IM model should be calibrated based on historical data in the most recent continuous period prior to the calibration date for no less than 3 years and no more than 5 years.

B.2.5 At least 25% of the data used for calibration should be representative of a period of significant financial stress, identified and applied separately at least for each asset class, which is appropriate to the derivatives to which the IM model is applied. If the most recent data period does not contain at least 25% stressed data, the least recent data in the time series should be replaced by data from a period of significant financial stress, until the overall proportion of stressed data is at least 25% of the overall data set.

B.2.6 The data within each of the identified periods should be equally weighted for calibration purposes.

B.2.7 Derivatives that are not subject to the same netting set should not be considered in the same IM model calculation.

### B.3 Model elements

B.3.1 The IM model should capture all relevant risk factors which materially influence the non-centrally cleared OTC derivative contracts in a netting set. As a minimum, risk factors should include foreign exchange or interest rate risk, equity risk, credit risk and commodity risk.

B.3.2 The model should appropriately assess other material risks arising from imperfect correlations, idiosyncratic risks for credit underlying, market liquidity and non-linear dependencies.

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<sup>23</sup> If VM is exchanged at less than a daily frequency, the number of days in between VM collection should be added to the 10-day horizon. If VM is exchanged at varying frequencies between the calculation of IM amounts, the number of days to be added to the 10-day horizon should be the maximum number of days in between VM collections within this period.

B.3.3 Risk-offsetting features should only be recognised within the same asset class and not across different asset classes.

#### B.4 Model performance

B.4.1 A licensed person has to ensure that the data used in the model are subject to a process that ensures their quality.

B.4.2 The process should include recalibration, back testing and validation of the IM model.

B.4.3 The licensed person should ensure that the model:

- (a) Employs a methodology with an accepted economic or sound theoretical basis which incorporates all factors that counterparties would reasonably consider in calculating the IM;
- (b) Is appropriately calibrated and tested for validity;
- (c) Is subjected to independent model review, validation and approval periodically and when material changes are made; and
- (d) Outputs are subjected to regular independent review and verification.

The results of model calibration, testing, review and validation should be documented.

#### B.5 Documentation

B.5.1 A licensed person should maintain adequate documentation in respect of the IM model.

B.5.2 The documentation should be sufficient to ensure that any knowledgeable third-party would be able to understand the design and operational details of the IM model.

## Annex C - Standardised haircut schedule

The market value of eligible collateral (see paragraph 37) should be adjusted as follows:

*Adjusted value of collateral = value of collateral \* (1-applicable asset class haircut – applicable currency mismatch haircut)*

Asset class	Residual maturity	Haircut	Haircut credit quality grade 1	Haircut credit quality grades 2 & 3
	Year(s)	(%)		
Cash in same currency		0	-	-
Marketable debt securities associated with a credit quality of investment grade issued or fully guaranteed by: (i) A multilateral development bank; or (ii) A relevant international organization.	less than one	0.5	-	-
	between one and five	2	-	-
	greater than five	4	-	-
Marketable debt securities associated with a credit quality of investment grade issued or fully guaranteed by: (i) A sovereign; or (ii) A public sector entity.	less than one	-	0.5	1
	between one and five	-	2	3
	greater than five	-	4	6
Other marketable debt securities associated with a credit quality of investment grade that are publicly traded, subject to paragraph 38	less than one	-	1	2
	between one and five	-	4	6
	greater than five	-	8	12
Eligible equities <sup>24</sup>		15	-	-
Gold		15	-	-
Add-on FX haircut for currency mismatch, subject to paragraph 44		8	-	-

<sup>24</sup> Please refer to paragraph 37(g) for details.

Where a debt security has two external credit ratings that map onto different credit quality grades, a licensed person should use the higher of the haircuts associated with the two credit quality grades. Where a debt security has three external credit ratings which map onto two or more different credit quality grades, a licensed person should use the higher of the two lowest associated haircuts.

#### Credit Quality Grades for Long-Term Exposures

<b>Credit quality grade</b>	<b>Standard &amp; Poor's Ratings Services</b>	<b>Moody's Investors Service</b>	<b>Fitch Ratings</b>
1	AAA AA+ AA AA-	Aaa Aa1 Aa2 Aa3	AAA AA+ AA AA-
2	A+ A A-	A1 A2 A3	A+ A A-
3	BBB+ BBB BBB-	Baa1 Baa2 Baa3	BBB+ BBB BBB-

#### Credit Quality Grades for Short-Term Exposures

<b>Credit quality grade</b>	<b>Standard &amp; Poor's Ratings Services</b>	<b>Moody's Investors Service</b>	<b>Fitch Ratings</b>
1	A-1+ A-1	P-1	F1+ F1
2	A-2	P-2	F2
3	A-3	P-3	F3



## **Schedule 11      Additional requirements for licensed or registered persons conducting Type 13 regulated activity**

### **Introduction**

1. This Schedule sets out additional requirements (“Additional Requirements”) that apply to a person licensed or registered for Type 13 regulated activity, namely providing depositary services for relevant CISs (a “Depositary”).
2. A Depositary should establish and implement internal control policies and procedures to meet the Additional Requirements. The internal controls and procedures designed to meet the Additional Requirements may vary from firm to firm taking into account the size of the operation of the firm, the nature and volume of transactions undertaken and the nature of the relevant CIS property. In the case where an operation of the relevant CIS that is subject to the oversight of a Depositary is in fact carried out by the Depositary, it would be held primarily responsible for such activity or matter.

*Note: For a relevant CIS that is a PRF, subject to the provisions under the PRF Code, where no management company is appointed for the PRF or any investment portfolio thereunder, in respect of such PRF and/or the investment portfolio(s), as the case may be, the Depositary will be primarily responsible for the obligations set out under this Schedule 11 (in particular, paragraphs 9 (Subscriptions and redemptions); 10 (Valuation/price/net asset value calculation monitoring); 11 (Distribution payments); 12 (Cash flow monitoring); and 13 (Investment monitoring)).*

3. In this Schedule:
  - (a) a “relevant CIS” has the meaning assigned to such term by Part 2 of Schedule 5 to the SFO;
  - (b) “relevant CIS property” has the meaning assigned to such term by Part 2 of Schedule 5 to the SFO;

- (c) a “Product Code” means any of the following codes administered by the Commission, as may be amended and updated from time to time:
    - (i) the Code on Unit Trusts and Mutual Funds (“UT Code”);
    - (ii) the Code on Open-Ended Fund Companies (“OFC Code”)<sup>1</sup>;
    - (iii) the Code on Real Estate Investment Trusts (“REIT Code”);  
and
    - (iv) the Code on Pooled Retirement Funds (“PRF Code”);
  - (d) “REIT” means a real estate investment trust which is authorized by the Commission under section 104 of the SFO and pursuant to the REIT Code;
  - (e) a “PRF” means a pooled retirement fund (which may comprise various investment portfolio(s)) which is authorized by the Commission under section 104 of the SFO and pursuant to the PRF Code; and
  - (f) references to “relevant operator(s)” are to other parties involved in the operation of a relevant CIS, which may include a management company, the board of directors of a relevant CIS, a transfer agent, administrator, registrar and, in the case of a PRF, a product provider.
4. Unless otherwise stated, terms used in this Schedule shall have the same meaning as defined or used in the relevant Product Code(s).”

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<sup>1</sup> Open-ended fund companies offered to the public in Hong Kong (public OFCs) (i.e. those which are registered and authorized under section 104 of the SFO) are authorized pursuant to both the UT Code and the OFC Code. Also, pursuant to the OFC Code, public OFCs and their key operators (including the custodians) are required to comply with all applicable requirements under the UT Code as well as Section I of the OFC Code.

## **Part I Depositary of a relevant CIS authorized under the UT Code or the PRF Code**

### **Management and supervision**

#### **5. Communication with the management company of a relevant CIS**

A Depositary should communicate with the management company in an effective and timely manner in the course of discharging its functions and obligations with respect to a relevant CIS. A Depositary should:

- (a) promptly report to the management company (i) actual material breaches of applicable legal and regulatory requirements which may impact the Depositary's carrying on of its regulated activities; (ii) issues that may lead to material breaches of applicable legal and regulatory requirements which may impact the Depositary's carrying on of its regulated activities and (iii) matters that may affect its ability to discharge its functions or obligations under the constitutive documents with respect to the relevant CIS. The Depositary should implement rectification and remedial actions, involve and coordinate with the management company in respect of such breaches or matters reported (and ensure that such breaches or matters are reported to the Commission in accordance with the relevant Product Code(s));

*Note: Where a delegate or third party is engaged to carry out the operations and functions of the Depositary, the Depositary is expected to have an effective arrangement in place with the delegate or third party to enable the Depositary to comply with this requirement.*

- (b) notify the management company of material exceptions to its business continuity plan identified during regular tests which may have a material adverse impact on the operation of the relevant CIS or the discharge of the Depositary's obligations; and

- (c) upon the activation of its business continuity plan, promptly communicate with the management company if there is any material change to the extent of services to be provided to the relevant CIS.

*Note: For the purpose of paragraph 5, where the relevant CIS is a PRF, references to “management company” shall be replaced by “product provider”.*

## 6. Appointment and oversight of delegates or third parties

- (a) Where a delegate or third party is appointed or engaged to carry out any activity that is relevant to the Depositary, the Depositary should have established internal control policies and procedures to enable it to have proper oversight over the delegate or third party so that the Depositary can be reasonably satisfied that the delegate or third party is competent to carry out the relevant activity. Such internal control policies and procedures include those relating to:
  - (i) the selection of a delegate or third party, including an assessment of their competence, regulatory and financial status, capabilities and internal controls and systems in carrying out the relevant activity;
  - (ii) the ongoing monitoring (including a regular review) of the delegate or third party so that the Depositary is satisfied that:
    - (1) the relevant activity is performed in compliance with the relevant legal and regulatory requirements and the constitutive documents of the relevant CIS; and
    - (2) effective internal controls and systems have been established and maintained by the delegates or third parties in carrying out the relevant activity; and
  - (iii) addressing actual or potential conflicts of interests that may arise from the appointment and oversight of delegates or third parties.

- (b) A Depositary should establish an appropriate contingency plan in relation to the engagement of delegates or third parties, including actions and measures to be taken in the event of breaches and solvency matters as well as other material issues related to them.
- (c) Although a delegate may be engaged for the custody and safekeeping of relevant CIS property, the responsibilities and obligations of a Depositary in respect of such activity shall remain with the Depositary.

*Note 1: For the purposes of paragraph 6, delegates or third parties include those appointed or engaged by the Depositary, the management company, the board of directors of a relevant CIS (or in the case where the relevant CIS is a PRF, the product provider) and any delegates of these persons.*

*Note 2: For the purposes of paragraph 6, activities that are relevant to a Depositary refer to activities that a Depositary is primarily responsible for (e.g. custody and safekeeping of relevant CIS property), and operation of the relevant CIS for which the Depositary has an oversight obligation over, in each case in accordance with the provisions under the relevant Product Code(s).*

## **Operational controls and compliance**

### **7. Record keeping**

A Depositary should ensure that its record keeping policies comply with applicable legal and regulatory requirements as well as requirements under the constitutive documents of the relevant CIS and that it complies with all such record keeping requirements on an ongoing basis.

### **8. Oversight of the relevant CIS**

A Depositary should have oversight of the relevant CIS to ensure that it is operated (or in the case of a relevant CIS that is a PRF, administered) in accordance with the provisions of the constitutive documents of the relevant CIS.

## 9. Subscription and redemption

In respect of each relevant CIS, a Depositary should have oversight of the relevant operator(s) to ensure that:

- (a) subscription and redemption transactions are processed on a timely basis;
- (b) subscription and redemption orders are carried out in accordance with the provisions of the constitutive documents of the relevant CIS;
- (c) where subscription proceeds are received by the Depositary or a relevant operator but the subscription orders relating to these proceeds have not yet been accepted (or, in the case of PRFs, placed), these proceeds are deposited on a timely basis into segregated or omnibus bank account(s) designated for holding such proceeds;
- (d) when subscription orders are accepted (or in the case of PRFs, placed), the subscription proceeds relating to such orders are deposited on a timely basis into a segregated bank account designated as a trust account or client account for holding money which constitutes relevant CIS property;
- (e) redemption proceeds are transferred on a timely basis into segregated or omnibus bank account(s) designated for holding such proceeds for payment to the respective unit/shareholders, or in the case of a PRF, scheme participants, and held therein until such proceeds are paid out from such account in accordance with the constitutive documents of the relevant CIS;
- (f) unit or share certificates (where appropriate) are issued and cancelled in a timely manner;
- (g) reconciliation of subscription and redemption is performed (e.g. subscription or redemption orders are reconciled with the proceeds received or paid and the number of units issued or cancelled);

- (h) the frequency of reconciliation conducted is consistent with that of subscriptions and redemptions; and
- (i) it has maintained proper documentation and records of the reasons for (i) suspension of dealing of units or shares of the relevant CIS and (ii) any suspension of calculation of valuation, price or net asset value of the relevant CIS, including the consultation process and the communication between the Depositary and the management company.

*Note: If the segregated or omnibus bank account(s) designated for holding subscription proceeds is established and maintained by a Type 13 licensed corporation, the licensed corporation shall hold the proceeds in relation to a relevant CIS on trust for the subscribers or scheme participants until such proceeds are paid into the relevant CIS' segregated bank account designated as a trust account or client account for holding scheme money or, in the case where the proceeds are rejected or withdrawn, are returned to the potential investors. Similarly, if the segregated or omnibus bank account(s) designated for holding redemption proceeds is established and maintained by a Type 13 licensed corporation, the licensed corporation shall hold the redemption proceeds in relation to a relevant CIS on trust for the respective unit/shareholders or, in the case of a PRF, scheme participants, until the proceeds are paid out from such account in accordance with the constitutive documents of the relevant CIS.*

#### 10. Valuation/price/net asset value calculation monitoring

A Depositary should:

- (a) have oversight of the relevant operator(s) to ensure that the methodology adopted to calculate the net asset value per unit or share for each type of investments held by the relevant CIS (including illiquid assets) is in accordance with the provisions of the constitutive documents of the relevant CIS;
- (b) have oversight of the relevant operator(s) to ensure that the calculation of the net asset value of the relevant CIS, including interest income, dividend income and fee expenses, is accurate;

- (c) have oversight of the relevant operator(s) to ensure that the use of the fair value adjustments for valuing different types of properties of the relevant CIS, including the circumstances which trigger the use of fair value adjustments is in accordance with the provisions of the constitutive documents of the relevant CIS, and that the governance structure and the review process for the fair value adjustments established by the management company (in consultation with the Depositary) are appropriate;
- (d) establish a clear and comprehensive escalation mechanism for any error or exception in the pricing of the units or shares of the relevant CIS. Where there are pricing errors or exceptions, it should:
  - (i) inform the management company of the pricing errors or exceptions which have come to the attention of the Depositary;
  - (ii) report, or ensure the relevant operator(s) has reported, the pricing errors or exceptions to the Commission in a timely manner, in accordance with the relevant Product Code(s); and
  - (iii) work with the management company to ensure that the pricing errors or exceptions are dealt with in accordance with the relevant Product Code(s), including ensuring that there are appropriate compensation arrangements for the relevant CIS and/or relevant unit/shareholders or where the relevant CIS is a PRF, scheme participants; and

*Note: For the purpose of paragraph 10(d), where the relevant CIS is a PRF, the reference to “management company” shall be replaced by “management company and/or product provider”.*

- (e) have oversight of the relevant operator(s) to ensure that it maintains proper recording of interest income, dividend income and other corporate actions in relation to each relevant CIS.



## 11. Distribution payments

- (a) A Depositary should have oversight of the relevant operator(s) to ensure that:
  - (i) distribution calculations are carried out in accordance with the provisions of the constitutive documents of the relevant CIS; and
  - (ii) distribution payments are timely complete and accurate.
- (b) In respect of each relevant CIS, a Depositary should ensure that distribution proceeds are transferred on a timely basis upon instruction from the relevant operator into segregated or omnibus bank account(s) designated for holding such distribution proceeds for payment to the respective unit/shareholders, or in the case of a PRF, scheme participants, and held there until the proceeds are paid out from the account in accordance with the constitutive documents of the relevant CIS.

*Note: If the segregated or omnibus bank account(s) designated for holding distribution proceeds is established and maintained by a Type 13 licensed corporation, the licensed corporation shall hold the distribution proceeds in relation to a relevant CIS on trust for the respective unit/shareholders or, in the case of a PRF, scheme participants, until the proceeds are paid out from the account in accordance with the constitutive documents of the relevant CIS.*

## 12. Cash flow monitoring

A Depositary should:

- (a) implement proper procedures and controls in opening and maintaining any bank account for the relevant CIS; and where any bank account for the relevant CIS is opened by the management company in the name of the relevant CIS or the management company itself, the Depositary should have oversight to ensure that the relevant CIS/management company

has implemented proper procedures and controls in opening any such bank account; and

- (b) identify cash flows which are inconsistent with the operations of the relevant CIS.

### 13. Investment monitoring

A Depositary should:

- (a) carry out the instructions of the management company of the relevant CIS with post-trade verifications in relation to investment limitations and restrictions to ensure compliance with the provisions of the offering and constitutive documents of the relevant CIS and the relevant Product Code(s);
- (b) have oversight of the relevant operator(s) to ensure that it has complied with the investment and borrowing limits set out in the offering and constitutive documents of the relevant CIS and the conditions under which the CIS was authorized;
- (c) on a regular basis, provide or make available copies of the Depositary's reconciled records relating to relevant CIS property and transactions executed on behalf of the relevant CIS, to the management company or its delegate(s) for the management company to ensure that there are no discrepancies between the records maintained by the Depositary and the management company, respectively, and where any exceptions are identified, they are followed up in a timely manner;
- (d) have oversight of the relevant operator(s) to ensure that transactions are settled, and ensure that exceptions are detected and followed up, all in a timely manner;
- (e) have oversight of the relevant operator(s) to ensure that the counterparties of all transactions (e.g. brokers or financial institutions of a transaction) are on the authorized list of the relevant CIS;

- (f) have oversight of the relevant operator(s) to ensure that the margin requirement for different types of investment are complied with; and
- (g) have oversight of the relevant operator(s) to ensure that daily mark-to-market value on collateral and reconciliation of reports provided by counterparties with regard to the collateral are prepared and/or reviewed by the relevant operator(s) appropriately.

#### 14. Custody and safekeeping of relevant CIS property

In respect of each relevant CIS, a Depositary should:

- (a) assess and manage custody risk with adequate organisational arrangements to minimise the risks of loss of the relevant CIS property;
- (b) unless the relevant CIS property are held in omnibus or individual account(s) designated as a trust account or client account, with adequate safeguards in line with international standards and best practices to ensure that the relevant CIS property are properly recorded with frequent reconciliations, segregate the relevant CIS property of each relevant CIS from the property of:
  - (i) the management company, investment delegate and their respective connected persons;
  - (ii) the Depositary and any nominees, agents or delegates throughout the custody chain; and
  - (iii) other relevant CIS and clients of the Depositary and its or their nominees, agents or delegates throughout the custody chain;
- (c) properly register the relevant CIS property in the name of or to the order of the Depositary, unless prohibited by any relevant laws or regulations;

- (d) properly safekeep the relevant CIS property;
- (e) establish and maintain proper segregated bank account(s) designated as a trust account or client account for holding money which constitutes relevant CIS property whether in Hong Kong or overseas, unless prohibited by any relevant laws or regulations;
- (f) obtain sufficient and reliable information and conduct verification of ownership of relevant CIS property;
- (g) maintain comprehensive, up-to-date and accurate records of relevant CIS property, including cash and assets that cannot be held in custody;
- (h) ensure reconciliation is carried out on a daily basis for cash and on a regular basis for other relevant CIS property;
- (i) ensure any part of the relevant CIS property that is subject to any security interest to secure payment or repayment of financial accommodation under which credit is or is to be provided in respect of the relevant CIS (“scheme collateral”) is held in safe custody in segregated account(s) solely for the purpose of holding such scheme collateral or otherwise dealt with in accordance with provisions of the constitutive documents of the relevant CIS; and
- (j) ensure payments and asset transfers or other dealings of any relevant CIS property on behalf of the relevant CIS are properly authorized in accordance with the constitutive documents of the relevant CIS.

*Note: Where the relevant payments or asset transfers or other dealings of relevant CIS property need not be authorized by the Depositary under the constitutive documents of the relevant CIS, the Depositary should have proper oversight of the management company to ensure that the management company has properly authorized or has obtained the relevant authorization.*

15. Connected party transactions entered into by or on behalf of the relevant CIS

Any reference to “connected party transactions” in Part I of this Schedule refers to “Transactions with connected persons” in the relevant provisions under the UT Code and the PRF Code, respectively.

A Depositary should:

- (a) ensure that there are proper controls adopted by the relevant CIS and/or have oversight of the relevant operator(s) to ensure that it has adopted proper controls in respect of connected party transactions of the relevant CIS;
- (b) ensure that the relevant operator(s) has effective controls in place for obtaining the Depositary’s prior written consent for transaction(s) between the relevant CIS and the entities mentioned in the relevant Product Code(s), such transactions are executed at arm’s length and in the best interests of the relevant CIS, and that the consent is supported by proper documentation of the justifications for the approval of the transactions; and
- (c) where cash forming part of the relevant CIS property is deposited with any of the management company, investment delegates, directors of the relevant CIS or any of their connected persons, have oversight of the relevant operator(s) to ensure that controls are in place to address any conflicts of interests including (i) oversight of the relevant cash management policy of the management company; and (ii) the relevant operator(s) has effective controls in place for obtaining all necessary prior written consent from the Depositary for depositing the cash with these parties, in each case ensuring that the deposit is maintained in a manner that is in the best interests of the unit/shareholders (or in the case of a PRF, scheme participants) and in accordance with the provisions of the relevant Product Code(s) and constitutive documents of the relevant CIS.

16. Handling different classes of investors fairly

A Depositary should have oversight of the relevant operator(s) to ensure that where a relevant CIS has multiple classes of units/shares, investors of different classes of units/shares are treated fairly, such as the putting in place of control procedures by the management company to ensure accuracy in the calculation of the net asset value of a relevant CIS with multiple classes of units/shares in accordance with the constitutive documents of the relevant CIS and the valuation procedures established by the management company.

17. Professional indemnity insurance

A Depositary should maintain adequate professional indemnity insurance cover commensurate with its business.

## **Part II Depositary of a relevant CIS authorized under the REIT Code**

### **Introduction**

18. A Depositary of a REIT should generally observe the requirements set out under Part I of this Schedule with the modifications set out in paragraph 19 below. It should also ensure compliance with all requirements applicable to a REIT's trustee under the REIT Code.

*Note: An SFC-authorized REIT is a closed-ended fund which invests primarily in real estate. A Depositary of a REIT has a fiduciary duty to hold the assets of the REIT on trust for the benefit of the unitholders of the REIT, and to oversee the activities of the management company for compliance with the relevant constitutive documents of, and regulatory requirements applicable to, the REIT. In line with the obligations of a REIT trustee as set out in the REIT Code, the requirements set out under Part I of this Schedule should generally be applicable to a Depositary of a REIT. However, in view of the particular nature, product structures and features of REITs, some of the requirements set out in Part I of this Schedule are modified in paragraph 19 below for a Depositary of a REIT.*

### **Modifications to Part I of this Schedule for a Depositary of a REIT**

19. The following requirements in Part I of this Schedule apply to the Depositary of a REIT with modifications set out below:

(a) Pricing errors

As REITs are normally traded at prevailing trading prices on The Stock Exchange of Hong Kong Limited, the requirements relating to pricing errors in paragraph 10(d) would not typically be relevant in the context of REITs. Where there is no issue of new REIT units based on the net asset value of the relevant REIT, the requirements under paragraph 10(d) will not be triggered.

(b) Cash flow monitoring and cash reconciliation

Under the REIT Code, the management company has the obligation to manage the cash flows of a REIT. In place of the specific requirements under paragraphs 12 and 14(h) of Part I of this Schedule, the Depositary of a REIT should (i) ensure that the management company has put in place proper cash flow management policy and controls and (ii) have oversight on and regular monitoring of the implementation of such policy and controls to ensure compliance with all applicable legal and regulatory requirements as well as requirements under the constitutive documents of the REIT.

(c) Custody and safekeeping of relevant CIS property

The Depositary of a REIT should ensure that all the assets of the REIT are properly segregated and held for the benefit of the unitholders in accordance with the REIT Code and the provisions of the constitutive document of the REIT, including the safe custody of all title documents of the real estate owned by the REIT subject to the paragraph below and paragraph 14(i) of this Schedule.

Where in the reasonable opinion of the Depositary of a REIT it is in the interests of the REIT that certain assets of the REIT (e.g. title documents of real estate and bank accounts) have to be held, maintained and/or operated by its management company in the name of the REIT or any special purpose vehicle (“SPV”), the Depositary should ensure that the management company has put in place proper safeguards and controls (i) to ensure the relevant assets are properly segregated and held in safe custody in accordance with all applicable legal and regulatory requirements as well as requirements under the constitutive documents of the REIT and (ii) to enable the Depositary to monitor and have an effective oversight and control on the relevant assets on an on-going basis.

(d) Connected party transactions

The requirements under paragraph 15 of Part I of this Schedule do not apply to a Depositary of a REIT. The Depositary of a REIT should ensure compliance with all of its obligations in respect of connected party transactions under the REIT Code and the constitutive documents of the REIT.



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