

## TOPIC 7 - OVERVIEW

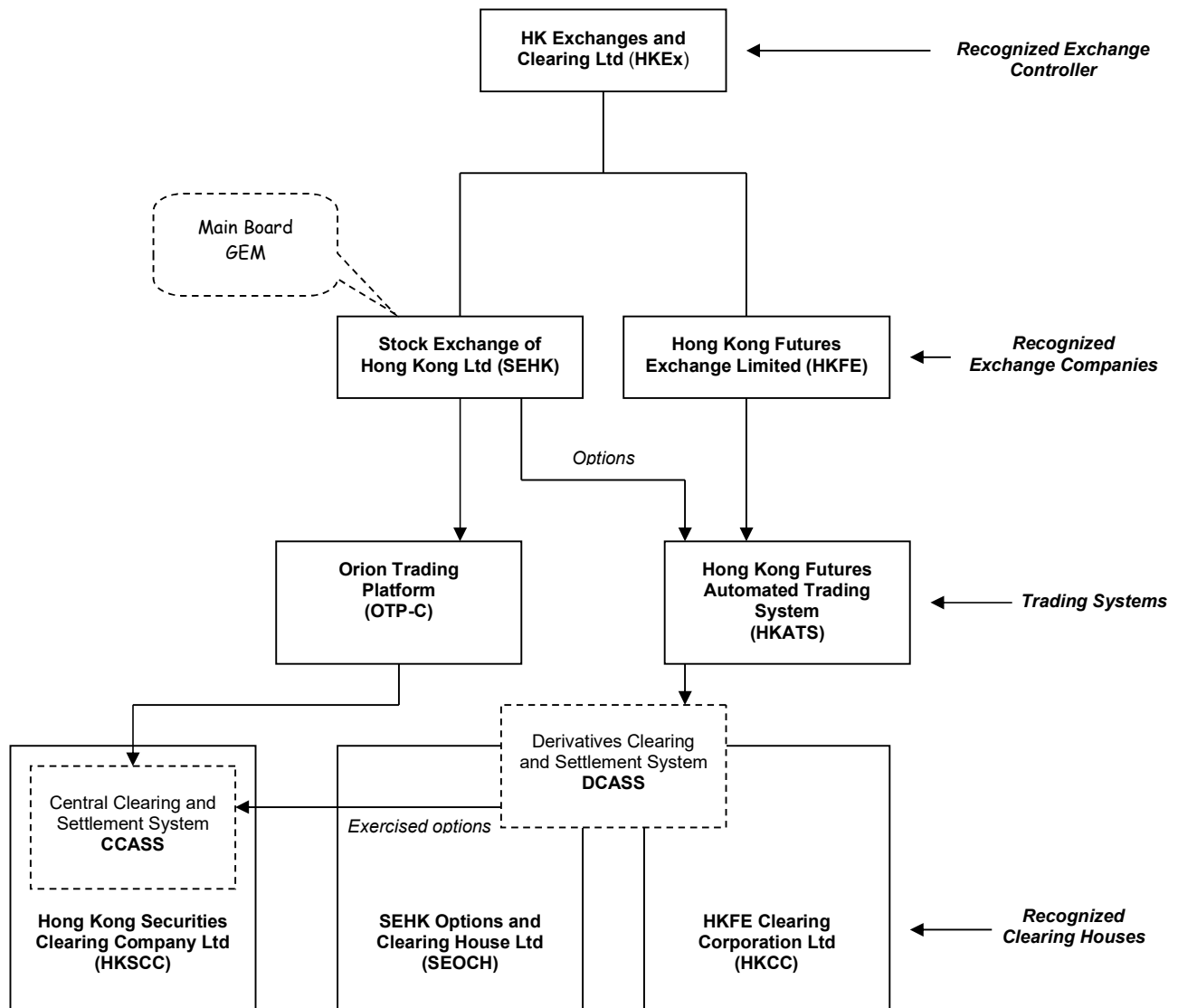
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## 1. INTRODUCTION

- This topic looks at the rules covering regulated activities in the context of the HKEx markets. Specifically:
  - Dealing in **listed securities** (Type 1 regulated activity)
  - Dealing in **traded options** (Type 1 regulated activity)
  - Dealing in **futures contracts** (Type 2 regulated activity)

## 2. HONG KONG EXCHANGES AND CLEARING LIMITED



- In November 2013, OTC Clearing Hong Kong Limited (“OTC Clear”) started operations providing clearing services for over-the-counter derivatives. OTC Clear is 75% owned by HKEx
- On 31 August 2016, the SFC designated OTC Clear as a central counterparty for certain specified OTC derivative transactions subject to the mandatory clearing obligation under the OTC Derivative Clearing Rules (see Topic 4)

## 2.1 Participants

- Those who wish to trade through the SEHK or HKFE, must hold trading rights
- Only exchange participants can hold trading rights
- Therefore, before applying for a trading right, an intermediary must register as an exchange participant
- *Exchange Participants* are participants of the SEHK; *HKFE Participants* are participants of HKFE
- Those wishing to clear trades must become clearing participants of the respective clearing houses
- From a regulatory point of view, participants must:
  - Be licensed by the SFC for Type 1 or Type 2 regulated activity, as necessary
  - Hold the necessary participantship (SEHK and/or HKFE) for the trading activities they wish to perform

## 2.2 Mutual Market Access Programmes

- The mutual market access scheme establishes trading links between the Mainland China and Hong Kong exchanges through the Shanghai-Hong Kong Stock connect (launched in November 2014) and the Shenzhen-Hong Kong Stock connect (launched in December 2016)
- The Stock Connects allows eligible investors in Mainland China to trade shares listed on the SEHK, known as the **Southbound link**, and investors in Hong Kong to trade A shares listed on the Shanghai Stock Exchange (“SSE”), known as the **Northbound link**.
- These links are an important step in the internationalization of Mainland China’s capital markets and currency.
- **Home market rules apply to all trades.** Orders are placed through local securities firms, however trading and clearing is subject to the rules and procedures of the exchange where the securities are listed.
- Trading and clearing participants are regulated by the rules and laws of the markets where they operate

### 2.2.1 Eligible Securities

- **All Hong Kong persons and overseas investors** able to trade on the SEHK can participate in the Northbound link.
- Mainland China persons who are able to participate in the Southbound link include institutional investors and individuals with Rmb500,000 in cash and securities
- Only eligible shares may be traded through Stock Connect.
- **Northbound eligible** shares are
  - SSE 180 Index constituents
  - SSE 380 Index constituents
  - SSE listed A shares with dual listing of H shares on the SEHK

- **Northbound shares that are excluded:**
  - Shares trading in a currency other than the Rmb
  - Shares listed on the SSE's risk alert board
- **Southbound eligible shares are:**
  - Hang Seng Composite Large Cap Index constituents
  - Hang Seng Composite Mid Cap Index constituents
  - Shares of all companies listed on both the SEHK and the SSE
- **Southbound shares that are excluded:**
  - Shares trading in a currency other than the Hong Kong dollar
  - H shares which have a corresponding listing on any Mainland exchanges besides the SSE; and
  - H share issuers which have a corresponding A share on the SSE's risk alert board

### 2.2.2 Trade Quota

- There are daily quotas for the value of shares traded on both the Northbound and Southbound links of both Stock Connects. The quotas are expected to be expanded as the program evolves.
- The current Northbound trading link daily quota is Rmb52 billion
- The current Southbound trading link daily quota is Rmb42 billion
- The daily quotas are calculated on a "net buy" basis
- Sell trades increase the available quota. Investors are always allowed to sell their cross-border securities. The daily quota is reset to zero at the beginning of each trading day
- Buy trades are subject to there being available daily quota

### 2.2.3 Trading, Clearing and Settlement

- Exchange participants/members of the SEHK, SSE and SZSE and clearing participants/members of the HKSCC and China Securities Depository and Clearing Corporation Limited (ChinaClear) may participate in Stock Connect subject to specific eligibility criteria for information technology, risk management, client documentation and other requirements
- SEHK exchange participants that participate in stock Connect are called **China Connect Exchange Participants** ("CCEPs"). Clearing participants are **China Connect Clearing Participants** ("CCCPs")
- Trading under both Northbound and Southbound links is through local securities firms who are exchange participants/members or have arrangements with participants to execute orders

- For **Northbound orders received in Hong Kong**:
  - The SEHK exchange participant must be registered as a CCEP to execute via Stock Connect
  - The CCEP must be a CCCP or have at least one clearing arrangement with a CCEP
  - CCCPs may use Stock Connect clearing and exchange facilities to clear the trades
  - HKSCC, through its Mainland subsidiary, acts as a participant of ChinaClear; and
  - Settlement obligations of CCCPs are undertaken by HKSCC
- For **Southbound orders received in Mainland China**:
  - ChinaClear's Hong Kong based subsidiary acts as a Special Participant of HKSCC and undertakes the same obligations and risk management provisions as other HKSCC participants
  - HKSCC remains the central clearing party
- Investors can only trade through Stock Connect on days when both markets are open and banking services are available on the corresponding settlement days
- Southbound trades are settled on a T+2 basis. **Northbound** trades are settled on the **same day for the securities** and on **T+1 for money settlement**

## 2.2.4 Pre-trade Checking for Northbound Trading Link Eligible Shares

### Standard Pre-Trade Check

- Northbound trading eligible shares can only be sold via Stock Connect if they have been deposited with a relevant exchange participant by the end of the trading day prior to the intended date of sale
- If shares are held by exchange participants or custodians who are not the intended selling brokers, they must be transferred prior to the date of sale
- Eligible A shares acquired via Stock Connect will be held in HKSCC's omnibus account maintained with ChinaClear

### Enhanced Pre-Trade Check

- Optionally, an investor whose shares are held by a Custodian or General Clearing Participant of HKSCC, which is not an exchange participant, can open a special segregated account (SPSA) with CCASS that is given a unique investor ID number
- The investor can place orders by providing this ID number to the selling broker who can make sure that the shares are available
- The shares only need to be transferred to the exchange participant after the sell order is executed

## 2.2.5 Additional Restrictions on Northbound Trading

- **Margin trading** is permitted:
  - Only on shares specified by the SSE/SZSE; and
  - Only for CCEPs and EPs who are registered with the SEHK to conduct Northbound trading through CCEPs for the account of their clients
  - SSE/SZSE may suspend margin trading in shares where volume exceeds certain thresholds
- **Stock borrowing and lending** is only permitted:
  - for covered short selling; or
  - for meeting pre-trade checking requirements
- No stock borrowing and lending agreement may be for more than one month. All stock borrowing activities must be reported to the SEHK
- Day trading is not permitted – shares bought cannot be sold before settlement, so cannot be sold on the same trading day
- No single foreign person can own more than 10% of a listed company's shares and total foreign ownership cannot exceed 30% of its total issued shares
- Mainland China has disclosure rules for holdings over 5% that may affect a person's ability to trade during specified periods

## 2.2.6 Short Selling via the Northbound Trading Links

### Northbound Short Selling

- Covered short selling is permitted on stocks that have been specified by the SSE/SZSE – they are published on the HKEx website – and are subject to:
  - Pre-trade checking to ensure that the borrowed stock is in the participants clearing account with CCASS
  - The stock is not subject to quantity restrictions
  - Reporting requirements to the SEHK
- Number of shares sold short on a given trading day should not exceed 1% of the number of those securities held by all investors through CCASS
- Number of shares sold short should not grow beyond 5% in any period of ten consecutive trading days
- The sell price should not be lower than the most recent execution price or previous closing price

- SSE/SZSE may suspend short selling activities in certain A shares when total open short positions reach 25% of the stocks listed. Short selling may resume when the A share's total open short position drops below 20%
- As with Southbound trading, naked short selling is not permitted
- The exchange participant (EP) will need to inform the buying EP that the transaction is a short sale
- An EP acting for the client should ensure that the client has borrowed sufficient stock to settle the order, if executed

### **2.2.7 Updates to Mutual Market Access Programmes**

- SFC and CSRC have reached an agreement for ETFs to become eligible securities under the mutual market access scheme in due course
- On 3 July 2017, Northbound trading of the Bond Connect started to operate. This allows investors from Hong Kong and other territories to invest in the Mainland bond market



### 3. DEALING IN SECURITIES ON SEHK (TYPE 1 ACTIVITY)

#### 3.1 Trading on the SEHK

##### 3.1.1 Closing Price Calculation

- Calculated by taking the median of 5 nominal prices in the last minute of the continuous trading session

##### 3.1.2 Direct Business

- An exchange participant acting for both the buyer and seller
- Business entered through an automated trading service must be input within 1 minute of concluding the transactions
- Details of other direct business transactions must be input to the trading system within 15 minutes of the transaction

##### 3.1.3 Transaction Costs

###### Brokerage

- No minimum
- 1% of application money for IPOs

###### Transaction Levy and Investor Compensation Levy

- Two levies charged by the SEHK on each purchase/sale of securities on behalf of SFC
- Transaction levy of 0.0027%
- Investor compensation levy of 0.002% - suspended since 19 December 2005

###### Trading Fee

- 0.005% charged to both buyer and seller and paid to SEHK

###### Trading Tariff

- HK\$0.50 charged on each purchase/sale payable to SEHK

###### Ad Valorem Stamp Duty

- 0.1% on each purchase/sale

###### Transfer Deed Stamp Duty

- HK\$5 charged to seller, irrespective of quantity traded

###### Transfer Fee

- Registrar of each listed company charges HK\$2.50 per share certificate on buyers

## 3.2 Short Selling

### 3.2.1 General Rule

- Under the SFO:

A person shall not sell securities **through a recognized stock market** unless, at the time he sells them, he or his principal has (or he believes he or his principal has) **a presently exercisable and unconditional right to vest the securities in the buyer**

- Securities charged or pledged to secure a loan may still give a person an unconditional right to vest the securities, depending upon details of the charge/pledge
- **Covered short sale:** a short sale which satisfies the above general rule
- **Naked short sale:** a short sale which does not satisfy the above general rule. Considered an offence
- Can you get hold of the securities?

### 3.2.2 Exclusions from the Prohibition

- The following are permitted short sellers or short sales:
  - A person acting in good faith who believes (and has reasonable grounds to believe) that he or the intermediary has the right to pass on the securities
  - Odd lot brokers
  - A sale of underlying securities relating to an options contract traded on a recognized stock market

### 3.2.3 Examples of Permitted Covered Short Sales

The seller has:

- Entered into a securities borrowing and lending agreement
- A title to another security which is convertible into or exchangeable for the security being sold
- An option to acquire the security
- Rights or warrants to subscribe for and receive the security

### 3.2.4 Practical Points of Short Selling on SEHK

- It may only be undertaken in securities designated by SEHK, of which there are a large number
- Exchange Participants must indicate short sell orders when inputting the orders to the trading system
- Exchange participants must make stock borrowing arrangements for settlement **before** the short sale
- A short sale cannot be made below the best current ask price (the tick rule)

### 3.3 Securities Borrowing and Lending (SBL)

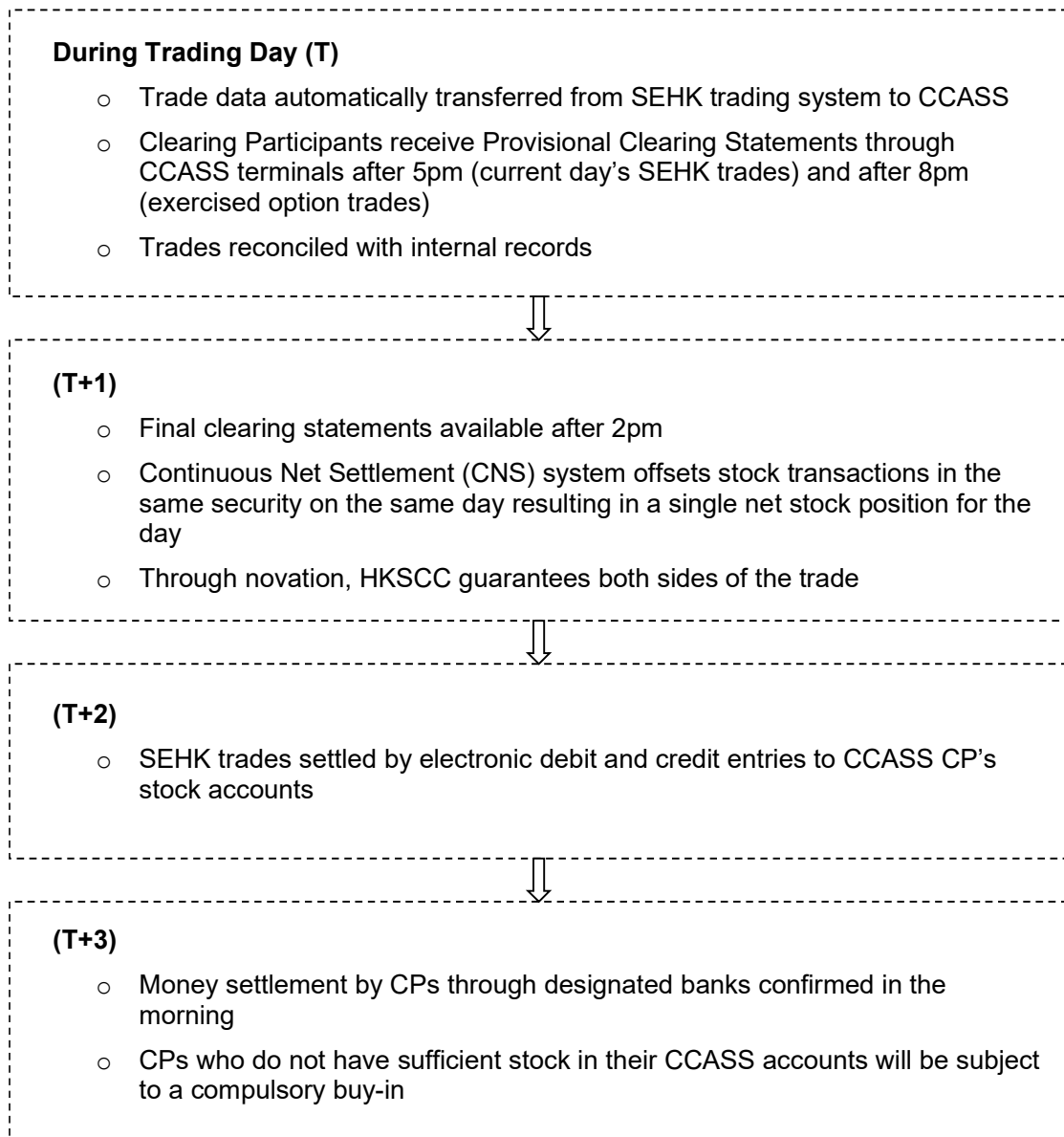
- A person borrows or lends securities on the condition that the borrower undertakes to return securities of the same description on a future date or pay the equivalent in cash by that date
- Regulated short selling is usually supported by SBL arrangements. Custodian institutions often make securities available to generate profits
- An Exchange Participant engaged in SBL must:
  - Collect collateral of at least 100% of the value of securities loaned or 105% if the borrowing is for short selling
  - Mark to market all securities borrowings at least daily against previous day's closing price
- Borrowing/lending of HK stocks is exempted from stamp duty – EPs are required to maintain ledgers recording stock borrowing/lending for inspection by IRD to justify exemption

### 3.4 Short Position Reporting

- Effective from 18 June 2012, the Securities and Futures (Short Position Reporting) Rules require market participants to report short positions at the close of trading on a reporting day.
- A reportable short position is a net short position value equal to or more than the lower of:
  - HK\$30 million; and
  - 0.02% of the value of the total number of the specified shares issued by the company concerned
- The short position report must be made to the SFC within 2 business days after the reporting day
- If circumstances threaten Hong Kong's financial stability, the SFC can insist on daily reporting of short positions, in which case submissions must be made within 1 business day of the reporting day

### 3.5 Clearing and Settlement Services

- The Central Clearing and Settlement System (CCASS) is operated by HKSCC for clearing and settlement of securities transactions on the SEHK
- HKSCC's Investor Account Service allows individual and corporate investors to open direct stock accounts in CCASS
- CCASS stock accounts:
  - **No. 01 account:** clearing account where a CCASS Clearing Participant maintains stocks for settlement
  - **No. 02 account:** for the handling of stock dividends
  - **No. 03 onwards:** safe custody stocks, house investments and securities collateral
- The clearing and settlement system is as follows:



### 3.6 Discipline – Exchange Participants

- The SEHK will hold Exchange Participants responsible for the acts of its responsible officers, directors, partners, authorized persons, representatives, officers and employees
- The front-line regulator of Exchange participants is the SFC
- The SEHK disciplinary responsibilities are limited to trading, clearing and settlement, and breaching of the Listing Rules

## 4. TRADED OPTIONS ON SEHK (TYPE 1 ACTIVITY)

- Two types of options are traded on the SEHK:
  - **Call options:** gives the holder the right, but not the obligation, to buy a fixed number of shares of a specified stock at a fixed price (exercise price) on or before a specified date
  - **Put options:** gives the holder the right, but not the obligation, to sell a fixed number of shares of a specified stock at a fixed price (exercise price) on or before a specified date
- **American-style** options are exercisable at any time up to and including the expiry date; **European-style** options are only exercisable on the expiry date
- Traded options are written on actively traded stocks which are listed on the SEHK

### 4.1 Trading

- Licensed/registered persons providing Traded Options services to clients must enter into an options client agreement before engaging in Traded Options business for the clients
- Only SFC licensed/registered persons may access the trading systems and facilities of the traded market for options in Hong Kong
- To conduct Traded Options business for clients, an Exchange Participant must register with the SEHK as an Options Exchange Participant (OEP) under one of two categories:
  - **Options Trading Exchange Participant (OTEP)**
    - must hold system access rights
    - entitled to access the options system
  - **Options Broker Exchange Participant (OBEP)**
    - not permitted to have system access rights
    - entitled to conduct Traded Options business for the accounts of clients
    - enters into broking client contracts with an OTEP and corresponding client contracts, acting as principal in both cases
- OTEPs input orders/quotes through the HKATS of HKFE – matched trades are passed to DCASS for processing

### 4.1.1 Market Makers

- SEHK operates a market-maker mechanism in Traded Options to promote liquidity
- An OTEP may apply to be a primary market maker or a regular market maker. Before permission is granted, the SEHK may consider the OTEP's:
  - Financial standing
  - Trading record
  - Personnel
  - Computer equipment
  - Internal security procedures

## 4.2 Clearing Participants

- Only OTEPs may become clearing participants of the SEOCH

### Direct Clearing Participants

- Can clear options trades for its own and clients' accounts

### General Clearing Participants

- Can clear options trades for its own, its clients' accounts and on behalf of non-clearing participants (OTEPS who are not SEOCH clearing participants)

## 4.3 Clearing and Margin

### 4.3.1 Clearing of Options

- Option trades are cleared in DCASS
- SEOCH is responsible for clearing options

### 4.3.2 Exercise of Options – Clearing of Underlying

- SEOCH Clearing Participants enter exercise instructions using DCASS terminals
- SEOCH performs assignment and novation
- Resultant stock transactions are passed to CCASS for settlement

### 4.3.3 Client Margin Calculations – Selling Traded Options

- If option exercised, client will lose, therefore an OEP:
  - Must ensure each client is promptly notified of margin and SEOCH collateral demanded as well as prompt delivery of collateral
  - May treat client as being in default if collateral not delivered promptly
  - May insist on the client delivering collateral in advance of accepting instruction

### 4.3.4 Collection of Premiums – Buying Traded Options

- Maximum loss is the premium, therefore an OEP:
  - Must ensure that any premium payable by a client is notified to the client on the same day on which the related options contract is made
  - Must ensure that all such amounts are settled in cash promptly
  - May treat a client as being in default if premium is not paid promptly
  - May insist on the client paying the premium in advance of accepting instruction

### 4.3.5 Daily Mark-to-Market Margin

- At the close of each trading day, the SEOCH marks marginable positions to market with the fixed price of each option series
- Variation margin is collected where appropriate

### 4.3.6 Intra-day Margin Call

- During periods of market volatility, the SEOCH conducts intra-day margin calls on real-time open positions using prevailing market prices
- All intra-day margin calls should be met by SEOCH Clearing Participants within one hour of notification
- An intra-day margin call will be triggered on 50% erosion in the margin interval

## 4.4 Default

- If a SEOCH participant fails to meet its financial obligations to the SEOCH, the SEOCH would take protective steps, including:
  - Closing positions
  - Transferring positions and liquidating collateral
  - Use of reserve funds and insurance cover



## 5. DEALING IN FUTURES CONTRACTS (TYPE 2 ACTIVITY)

### 5.1 Trading

- Only licensed/registered persons may have access to HKFE trading systems (directly or indirectly) to carry out the Type 2 activity of dealing in futures contracts
- There are four categories of HKFE Participant:
  - **Trader** entitled to trade in futures contracts and/or options contracts **on his own account only**
  - **Broker** entitled to trade in futures contracts and/or options contracts **on his own account** and as **agent of an HKFE Participant** for the sole purpose of concluding trades on HKFE markets
  - **Futures Commission Merchant** entitled to trade in futures contracts and/or options contracts **on his own account**, for the **account of other HKFE Participants** and for the **account of any other persons**
  - **Merchant Trader** entitled to trade in futures contracts and/or options contracts only on its own account and only ancillary to its principal business or that of its holding company

### 5.2 Clearing Participants

- Only HKFE Participants may become participants of HKCC. HKFE Participants which are not HKCC participants are **non-clearing participants**
- Two types of HKCC clearing participant:
  - **General Clearing Participant:** entitled to record, register and clear contracts on behalf of non-clearing participants and also clearing participants
  - **Clearing Participant:** entitled to record, register and clear contracts for other clearing participants
- **A non-clearing participant** is not entitled to record, register and clear contracts but must arrange that all contracts entered into are dealt with, on its behalf, by a General Clearing Participant:

### 5.3 Trading Rules

- No HKFE Participant shall knowingly take the **opposite side of a client order**, unless the following requirements are met:
  - The client has given consent in writing
  - The trade has been bid, offered and reported as laid down in the Board of HKFE procedures

### 5.4 Clearing and Margin

#### 5.4.1 Settlement Counterparties

- Although each HKATS transaction is executed between two HKFE Participants, the HKCC, on accepting the trade for clearing, takes over the role as counterparty to each transaction (novation)
- Participants are able to effect a close-out transaction through a DCASS terminal

#### 5.4.2 Initial Margin Requirements

- **Initial margin** is the minimum required levels set by the HKFE. Firms may set higher margin levels for their clients
- Margin cash or collateral must be deposited by the HKCC participant for each open position held at the end of each day's trading (**gross basis**)
- HKCC participants trading for their own accounts must post margin on a **net basis**
- **Maintenance margin** represents the minimum amount of protection against potential losses at which the HKFE participant will allow its customers to carry a position or a portfolio. If the margin falls below the maintenance level, the account must be **re-margined back** to the initial margin level

#### 5.4.3 Variation Adjustments

- Variation adjustments are the daily gain/loss for an account after marking to market

#### 5.4.4 Intra-day Calls

- In times of extreme price volatility, HKCC can perform additional intra-day mark-to-market calculations and to call for immediate payment of variation adjustment
- Losses are not allowed to accumulate beyond one business day

### 5.5 Settlement

- Settlement can be either by cash or physical delivery of the underlying instrument

## 6. TRADING AND MARKETING

- Further SFC requirements related to HKEx activities cover trading position limits and reporting requirements

### 6.1 Trading Position Limits

- No person, unless otherwise authorized by the SFC, may hold or control futures contracts or stock options (traded through HKFE and SEHK) in excess of the prescribed limits
- The key prescribed limits include:
  - **SEHK stock futures contracts**  
5,000 per contract month
  - **Hang Seng Index and Mini-Hang Seng Index futures contracts and options**  
10,000 for all contract months combined
  - **Hang Seng China Enterprise Index futures and options contracts**  
12,000 for all contract months combined
  - **Mini-Hang Seng China Enterprise Index futures contracts**  
12,000 for all contract months combined
  - **Hang Seng China H-Financials Index futures contracts**  
10,000 for all contract months combined
  - **Stock and Tracker Fund Options**  
50,000 contracts per option class in any one market direction for all expiry months combined
- It is an offence to violate either the holding or reporting provisions (potential fine and/or imprisonment)

### 6.2 Reporting Requirements

- Reportable positions must be notified in writing to the relevant exchange company within one reporting day following the day on which first holding/control occurs. Reportable positions include:
  - **SEHK stock futures contracts**  
1,000 for any one contract month
  - **Hang Seng Index futures contracts**  
500 for any one contract month
  - **Mini-Hang Seng Index futures contracts and options**  
2,500 for any one contract month or series

- **Hang Seng China Enterprise Index futures and options contracts**  
500 for any one contract month or series
- **Mini-Hang Seng China Enterprise Index futures contracts**  
25000 for any one contract month or series
- **Hang Seng China H-Financials Index futures contracts**  
500 for any one contract month
- **Stock and Tracker Fund Options**  
1,000 contracts per option class per expiry month

### 6.3 Marketing Listed Structured Products

- The SFC has established specific guidelines for the marketing of listed structured products, such as warrants
- The guidelines give direction on:
  - Contents of marketing materials
  - Explanation of risks of underlying investment and of the structured products themselves
  - Presentation of a balanced view of the structured product, including potential gains and losses
  - Legibility and prominence of required information