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Hong Kong leads in regulating short selling
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The mere mention of "short selling" often brings to mind many negative connotations, particularly in the current financial environment as problems arising from the sub-prime mortgage market in the United States continue to plague credit markets and affect the stock markets worldwide.

Short selling is a legitimate activity by itself. It plays an important role in the price discovery process and fosters development of market-neutral activities such as hedging, which are essential to a mature market. As regulators, it is abusive short selling that we want to prevent.

The short-selling regulations in Hong Kong have evolved over time since short selling was launched in a pilot scheme in 1994. When the Asian Financial Crisis in 1997-1998 exposed the regulatory deficiencies, strengthening the regulatory framework became the highest priority. The gaps in the short selling regulations were patched and reinforced. The system that we have today is more stringent than those in most major markets.

What is happening in some major markets now is not dissimilar to the Hong Kong's experience in the Asian Financial Crisis. Tumultuous market conditions have forced securities watchdogs to review and tighten their short-selling regulations. In particular, the Securities and Exchange Commission of the United States issued a temporary order in July this year prohibiting "naked" short selling of the securities of 19 financial institutions that it deemed to be systemically vulnerable.

It is important to note that "naked" short selling is not allowed in Hong Kong. Prohibition against "naked" short selling is very much entrenched in the regulatory regime. It is a criminal offence under the Securities and Futures Ordinance to conduct "naked" short selling, a share disposal transaction involving a seller who neither owns nor has arranged to borrow the stock at the time of sale.

From 2007 to 2008, the Securities and Futures Commission laid 67 charges against six people for breaching the rule against naked short selling.

Hong Kong permits only "covered" short selling, which requires the seller to have borrowed the stock or to have obtained a confirmation that the lender has the stock available to lend out at the time of sale.

But not all stocks listed on the Stock Exchange of Hong Kong Limited are eligible for short selling. Only liquid stocks are permitted by the SEHK for short selling because the prices of less liquid stocks are more vulnerable to manipulation. This prudent selection process of short-sellable stocks is not a common practice. In other major markets, short selling is generally allowed for all stocks listed.

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Further restricting short selling locally is the uptick rule which requires that a short sale cannot be made on the SEHK below the best current asking price. This rule was removed briefly from 1996 to 1998 for the development of the then fledgling short-selling market, but promptly reinstated following the Asian Financial Crisis.

Under the new arrangements put in place after the crisis, the seller and his broker were also required to confirm that the short-selling orders were “covered” before executing the order. At the same time, the SEHK implemented a strict policy of compulsory buy-in for failed trades, that is, if the seller fails to deliver the stock for settlement, the SEHK would purchase the stock from the open market on his behalf and charge the seller the associated cost as well as a penalty fee. These measures are still effective today.

Although our current regime has proven itself to be fairly effective, that is not to say that there is no room for refinement. Nothing in life stays stagnant. As the market evolves, responsible regulators must keep up by updating the rules.

In the case of the uptick rule, the Focus Group on Financial Services recommended a review at the Economic Summit on China’s 11th Five Year Plan and the Development of Hong Kong in early 2007. The general view was that the uptick rule may have been introduced for good reasons 10 years ago as a deterrent to abusive short selling in extreme market conditions. However, markets evolve and today’s market has a much wider range of trading strategies employed and the continued presence of the uptick rule interferes with the price discovery process in normal business situations. The focus group suggested a mechanism be introduced that would allow for the uptick rule to be suspended unless extreme market conditions set in or a financial crisis strikes.

Both the SFC and the Hong Kong Exchanges and Clearing Limited have been working on this proposal. The latter will soon release a consultation paper to invite public opinion.

Effective regulation is a dynamic process and is very much a function of responding to the market needs and developments. In this light, the SFC will continue to keep a vigilant eye on global developments related to short selling while remaining attuned to the needs of the Hong Kong market.

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