



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

## **The Guidance Note on Short Selling Reporting and Stock Lending Record Keeping Requirements**

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**The Guidance Note on Short Selling**

**Reporting and Stock Lending**

**Record Keeping Requirements**

**1. Introduction**

This Guidance Note is intended to clarify the SFC's policy intent and position on issues raised by the industry and does not have the force of law.

**2. Naked/uncovered short selling under section 170 of the SFO**

**Section 170**

- 2.1 Section 170(1) of the SFO prohibits "naked" or "uncovered" short selling. It creates a criminal offence for a person to sell securities at or through a recognized stock market unless at the time of the sale, he (or his client, if he is an agent) has a presently exercisable and unconditional right to vest the securities in the purchaser of them, or believes and has reasonable grounds to believe that he (or his client, as the case may be) has such a right.

**Example**

*It would be a criminal offence if a person deliberately sold short, and then went into the market to 'cover' the short by buying the securities or arranging to borrow them to settle the sale.*

For the avoidance of doubt, section 170 applies only to short sales conducted at or through a recognized stock market, i.e., at present, the Stock Exchange of Hong Kong Limited ("SEHK"). It does not apply to off-exchange short sales.

- 2.2 The maximum penalties for contravention of section 170(1) are a fine of HK\$100,000 and imprisonment for 2 years.

**Circumstances which fall outside section 170**

- 2.3 There are some circumstances where the SFC accepts that a seller has a "presently exercisable and unconditional right to vest the securities in the purchaser of them" even though the seller does

not actually have the securities at the time of placing the sale order.

Examples

- (a) *the seller has bought the securities before he places a sale order for them. Even though the securities may not have been delivered to him before he places the sale order, the sale order is an ordinary sale (i.e., conducting day trades where securities are bought first and then sold does not violate section 170(1)).*
- (b) *the seller has obtained a "hold notice" or a "blanket assurance" (see paragraph 9.6) from a stock lender to borrow the amount of securities being sold prior to placing the sale order. If (for any reason) the securities are eventually not made available for borrowing (for example, the lender withdraws the "hold" when the seller calls to confirm the borrowing because the lender needs the securities for its own use), there is no breach of section 170(1). This is because at the time of the sale, the seller believed and had reasonable grounds to believe that arrangements were in place to vest the securities in the purchaser of them.*
- (c) *the seller owns or has borrowed physically settled options or warrants, convertible bonds, depository receipts, or any other convertible or exchangeable security which gives him a "presently exercisable and unconditional right to vest the underlying securities in the purchaser of them". The sale of the underlying securities is a "covered" short sale. If the seller has placed irrevocable instructions before the sale, to convert/exercise the security to receive the underlying securities, the sale of the underlying securities is an ordinary sale.*
- (d) *the seller has lent the relevant securities but has a right of recall under the relevant securities borrowing and lending agreement. The sale of the relevant securities is an ordinary sale.*
- (e) *the seller owns the securities and conducts a long sale but in*

*anticipation of settlement difficulties on T+2 the seller either borrows or asks his agent to borrow the securities to temporarily 'cover' his settlement obligations. This sale of securities is an ordinary sale.*

- (f) *the seller has bought Hong Kong listed securities on an overseas exchange (e.g. the London Stock Exchange) and shortly afterwards sells the securities in Hong Kong. Even though the seller may not have received the securities he bought on the overseas exchange before he sold them in Hong Kong, the sale is an ordinary sale as long as the securities he bought and sold are of the same class. If the securities are of a different class but can be converted to securities of the same class, then the sale of the securities in Hong Kong is a "covered" short sale.*
- (g) **Transactions under the HKD-RMB Dual Counter Model (Dual Counter Model<sup>1</sup>)**

*Under the Dual Counter Model, when a person (including a Dual Counter Market Maker) buys a Dual Counter Security in one currency under a primary counter or a secondary counter and in conjunction with that purchase, sells the same Dual Counter Security in another currency under the other counter, the sale is an ordinary sale as the Dual Counter Security traded under the two counters are of the same class -*

- *the person buys a Dual Counter Security under the HKD counter and sells that same Dual Counter Security under the RMB counter*
- *the person buys a Dual Counter Security under the RMB counter and sells that same Dual Counter Security under the HKD counter*

*The terms "Dual Counter Security", "Dual Counter Market Maker", "primary counter" and "secondary counter" are defined in the Rules of the SEHK ("SEHK Rules").*

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<sup>1</sup> The Dual Counter Model is set up to support trading of securities in both HKD and RMB currencies that are of the same class and issued by the same issuer, trading under two separate counters, and transfer of shares between the two counters.

## **2.4 Technical breaches of section 170**

- 2.4.1 While it is an intermediary's duty to check if his clients have adequate securities available to sell pursuant to their sale orders, mistakes or errors resulting in short positions do occur from time to time, i.e., technical breaches of section 170(1).
- 2.4.2 It is not the SFC's policy to penalise genuine mistakes or errors. So long as the seller believed and had reasonable grounds to believe that he had (or in the case of an agent selling for his principal, the agent believed and had reasonable grounds to believe that his principal had) the right, title or interest to or in the securities he intended to sell, he will have a defence under section 170(3)(a).

## **2.5 Exemptions from section 170(1)**

- 2.5.1 For the purpose of section 170(3)(e) of the SFO, the SFC has made Securities and Futures (Short Selling and Securities Borrowing and Lending (Miscellaneous)) Rules "the Rules" under sections 397(1) and (2), and section 398(7) of the SFO. Section 3 of the Rules disapplies section 170(1) of the SFO to market makers appointed by the Hong Kong Monetary Authority for certain securities and market makers and liquidity providers of the SEHK and the Hong Kong Futures Exchange Limited ("HKFE") that conduct jobbing business to make it easier for them to fulfil their market making obligations.
- 2.5.2 Broadly speaking, the following categories of persons are permitted to conduct naked or uncovered short sales under section 3 of the Rules –
- (a) *Hong Kong Monetary Authority-appointed market makers, and their agents on their behalf, may sell short Exchange Fund Notes, Exchange Fund Bills and specified instruments<sup>2</sup>;*
  - (b) *Securities Market Makers, which include Dual Counter Market Makers, conducting jobbing business, and*
  - (c) *Futures Market Makers conducting jobbing business.*

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<sup>2</sup> These are defined to be notes issued by the KCR Corporation, the MTR Corporation, the Airport Authority and the Hong Kong Mortgage Corporation.

### "Jobbing Business"

- 2.5.3 For the purpose of the exemptions, "jobbing business" includes the selling of securities listed or traded on the SEHK by SEHK or HKFE market makers and liquidity providers in the course of performing market making or liquidity providing functions or for the purpose of hedging their market making or liquidity providing positions.
- 2.5.4 The guiding principles for the application of the exemptions are –
- (a) The security that is sold short must be either listed or admitted to trading on SEHK (regardless of whether it is a Designated Security for short selling purposes);
  - (b) Any person, irrespective of whether he is a participant of the SEHK or HKFE, is entitled to the exemptions provided that he is 'registered' with the relevant exchange to provide market making or liquidity providing services. This will include persons formally recognised by the relevant exchange as providing market making or liquidity providing services whether under the relevant rules, by way of registration or otherwise. Issuers (and their related companies) of structured products, like derivative warrants, which are listed on the SEHK under Chapter 15A of its Main Board Listing Rules are also eligible for the exemptions.

#### Example

*SEHK market makers currently include "Designated Specialists", "associates" of issuers of derivative warrants and, "Derivative Warrant Liquidity Providers". These terms are defined in the SEHK Rules.*

- (c) A market maker on the SEHK may sell short securities for which it provides market making or liquidity providing functions. It will have to 'cover' its short position, whether by buying back the securities, borrowing them or through any other means (e.g. by submitting a creation request in the case of an Exchange Traded Fund) by the end of the next trading day (T+1). An extra day for covering the short position will allow market makers to quote prices efficiently even near the market close.

*Example*

Under the Dual Counter Model, a Dual Counter Market Maker that carries out the following sales and purchases of a Dual Counter Security in performing market making or liquidity providing activities in compliance with the SEHK Rules is considered to be acting within the scope of section 3(2)(c) of the Rules -

- (i) *the Dual Counter Market Maker sells short a Dual Counter Security in the primary counter and either contemporaneously or thereafter (but before the end of the trading day following the day of the sale (T+1)), buys the same Dual Counter Security in the secondary counter; or*
- (ii) *the Dual Counter Market Maker sells short a Dual Counter Security in the secondary counter and either contemporaneously or thereafter (but before the end of the trading day following the day of the sale (T+1)), buys the same Dual Counter Security in the primary counter;*

and accordingly, these come within the scope of a “jobbing business” under section 3(1)(c) of the Rules.

- (d) Market makers/liquidity providers on the SEHK and HKFE are also permitted to sell short underlying securities of the securities or the futures contract<sup>3</sup> for which they provide market making/liquidity providing functions, to hedge their market making/liquidity providing positions. Short selling of securities with the same underlyings of the securities or futures contracts positions being hedged is also permitted.

Examples

- (i) *An SEHK market maker is permitted to sell short listed security "A" to hedge a market making position in respect of listed security "B" if "A" is an underlying security of "B". This will include e.g. hedging a market making position in China Tracker units ("B") by short selling the underlying stocks ("A"*

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<sup>3</sup> "Securities" and "futures contracts" are defined in Schedule 1 of the SFO.



- and other underlyings); hedging a market making/liquidity providing position in a derivatives warrant or a stock option ("B") by short selling the underlying stock ("A") etc.*
- (ii) *The market maker is also permitted to sell short listed security "X" to hedge a market making position in respect of listed security "B", if "X" has an underlying security "Y" and "Y" is also an underlying security of "B". This will include e.g. hedging a market making position in China Tracker units ("B") by short selling a derivative warrant ("X") with an underlying ("Y") whereby "Y" is also an underlying of the China Tracker; i.e. hedging the risk exposure of a security by short selling another security which has a common underlying.*
  - (iii) *A HKFE market maker of a single stock futures contract, which has listed security "C" as its underlying security is permitted to sell short "C" to hedge against its exposure in that stock futures contract. This will include e.g. hedging ABC stock futures contract by short selling stock ABC.*
  - (iv) *If the futures or options contract is in respect of an index, the HKFE market maker may sell short listed security "X" which is a component stock of the index to hedge against its exposure in that index futures or options contract. This will include e.g. hedging Hang Seng Index futures and options contract by short selling its underlying stocks ("X" and other underlyings).*
  - (v) *If the futures contract is in respect of listed security "D", the market maker may also sell short listed security "C" where both "C" and "D" have "Z" as their underlying security. This will include e.g. hedging an Exchange Traded Fund ("D") futures contract by short selling the same or another Exchange Traded Fund ("C") whereby both "D" and "C" share some common underlyings ("Z" or other underlyings).*
- (e) Where the underlyings of a security or futures contract is an index or a basket of securities, the relevant market maker or liquidity provider is permitted to sell short, for hedging purposes, any or all of those underlying securities.

- (f) Short sales by SEHK or HKFE market makers for hedging purposes should only be made to hedge against existing positions. That is to say, the exemption does not apply to pre-hedging activities.
- (g) The SEHK and HKFE will require special indicators for the input of transactions in which the exemptions are claimed. Industry participants who conduct short sales pursuant to these exemptions are expected to adhere to relevant input requirements that will be prescribed by SEHK and HKFE or to give their agents, who execute the sales for them, sufficient instructions to comply with the SEHK's input requirements.

### **3. Covered short selling — Reporting requirements under sections 171 and 172 of the SFO**

- 3.1 The requirements in sections 171 and 172 are to ensure that all short selling activities executed at or through SEHK are properly reported and supported by an adequate amount of securities at the time of the sale. These sections apply to short sales, which are "covered".
- 3.2 Under the SEHK Rules<sup>4</sup>, "covered" short sales may only be effected in certain Designated Securities<sup>5</sup> and they must be effected through SEHK's Automatic Order Matching and Execution System. Under the SEHK Rules, the "tick" rule applies to all "covered" short sales<sup>6</sup>, i.e. a short sale cannot be effected below the current best ask price.
- 3.3 Section 171 puts a duty to report short selling transactions on both the seller (as a principal, whether he is a client or an intermediary) and the intermediary (as an agent). In summary, section 171 requires the seller, at the time of placing the order, to identify it as a "short selling order" and to provide confirmation that the sale is

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<sup>4</sup> The Eleventh Schedule.

<sup>5</sup> The list of Designated Securities is usually reviewed and updated by SEHK quarterly and is posted on the HKEx website.

<sup>6</sup> Short sales of some securities have been exempted from the tick rule. These include the Tracker Fund, the China Tracker, the 2 Exchange Traded Funds trading under the Pilot Programme. Short selling for some market making transactions are also exempt. Previously, hedging transactions of stock options market makers were exempt from the tick rule for an amount of \$30 million (transactions above that amount would require justifications). This restriction has been removed.

"covered". An intermediary who receives a "short selling order", knowing it to be a "short selling order", must ensure that he obtains the confirmation from the seller prior to transmitting the order to the SEHK for execution and must retain the confirmation for at least 12 months from the date of the transaction.

3.4 Section 172 imposes a duty on an exchange participant who receives a "short selling order", knowing it to be a "short selling order" for input into SEHK's system, to mark it as "short" in such form as the SEHK may prescribe from time to time.

### 3.5 Definition of "short selling order"

3.5.1 As defined in Schedule 1 of the SFO<sup>7</sup>, a "short selling order" is an order to sell securities where the seller's "presently exercisable and unconditional right to vest the securities in the purchaser of them" arises in one of the following ways:

- (a) The seller is party to a securities borrowing and lending agreement under which he has borrowed the securities or obtained a confirmation from the lender that he has the securities available to lend to him;
- (b) The seller holds an option, a subscription right or warrant, or a convertible or exchangeable security, which confers on him the right to acquire the securities to which the sale relates.

3.5.2 In the circumstances described in paragraph 3.5.1(b), a sale order will not be treated as a "short selling order" if at the time of placing the order, the seller has issued unconditional instructions to obtain the underlying securities to which the sale order relates.

#### **Circumstances which fall outside sections 171 and 172**

3.5.3 There are other circumstances where a sale order will not be a "short selling order":

#### Examples

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<sup>7</sup> The SFC is also empowered to make rules under Schedule 2 and section 397 of the SFO to provide for additional circumstances in which a sale order would be treated as "short selling order". The purpose of this provision is to give the SFC the flexibility to include new arrangements that can provide a "cover" for short selling transactions. The SFC does not intend to make such rules currently. The SFC will consult the industry if such rules are to be made.

- (a) *The seller holds a physically-settled call option or listed warrant in respect of the securities, and has exercised the option or listed warrant;*
- (b) *The seller holds depository receipts, and has given instructions to obtain the securities underlying the depository receipts;*
- (c) *The seller holds an Exchange Traded Fund unit, and has given instructions for the redemption of the unit;*
- (d) *The seller's securities are out on loan at the time of placing the sale order and it is clear in the lending agreement between the seller and the borrower that the seller has a right to recall those securities at any time.*

3.5.4 In the above circumstances, no reporting is required. The subsequent borrowing of securities to meet settlement obligations of the sale transactions will not be regarded as falling within sections 171 and 172.

### **3.6 Definition of "securities borrowing and lending agreement"**

3.6.1 A securities borrowing and lending agreement is defined in Schedule 1 of the SFO as an agreement whereby a person borrows or lends securities pursuant to an arrangement where the borrower undertakes to return securities of the same description to the lender or pay the equivalent value of the securities. The definition expressly includes a stock borrowing within the meaning of section 19(16) of the Stamp Duty Ordinance of Hong Kong<sup>8</sup>.

3.6.2 For the purposes of sections 171 and 172, a seller will clearly be treated as a "borrower" if he has entered into an industry-standard securities lending agreement, under which he has borrowed the securities or obtained a "hold notice" or "blanket assurance" in respect of the securities being sold.

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<sup>8</sup> The definition of "stock borrowing" under the Stamp Duty Ordinance is:  
"...the obtaining by a borrower from a lender, under a stock borrowing and lending agreement, of Hong Kong stock the sale and purchase of which in Hong Kong are subject to the rules and practices of the Exchange, whether the Hong Kong stock is so obtained directly from the lender or indirectly under or through a recognised clearing house and in accordance with the rules of that recognised clearing house which constitute the stock borrowing and lending agreement."

- 3.6.3 Questions may arise when a person has acquired securities pursuant to a repurchase agreement, which involves an outright transfer of securities. Relief from payment of Hong Kong stamp duty is available, under section 19 of the Stamp Duty Ordinance, where Hong Kong stock is borrowed pursuant to a stock borrowing and lending agreement. For stamp duty relief purposes, the Hong Kong Stamp Office has been willing to register equity repurchase agreements as "stock borrowing and lending agreements". As the definition of "securities borrowing and lending agreement" in section Schedule 1 of the SFO specifically includes a stock borrowing within the meaning of the Stamp Duty Ordinance, an order to sell stock which has been acquired pursuant to an agreement registered as a "stock borrowing and lending agreement" for the purposes of the Stamp Duty Ordinance will be treated as a "short selling order".
- 3.6.4 However, if an equity repurchase agreement is registered as a "securities borrowing and lending agreement" under the Stamp Duty Ordinance, but the securities acquired thereunder are simply held as collateral, the SFC will not regard a subsequent sale of those securities (where the sale is made as a result of counterparty default) as a "short selling order" and therefore the short selling reporting requirements will not be triggered. This is because once the counterparty has defaulted, the person who originally received the collateral will have an absolute right to the securities. Therefore the selling of the securities is an ordinary sale.

### **3.7 Obligations to report "short selling orders"**

- 3.7.1 Section 171 imposes reporting obligations on short sellers, whether they are selling as principals or agents, as well as exchange participants who sell as principals or as agents.

#### **3.7.2 Selling as principal**

- (a) Section 171(1) applies where a person (other than an exchange participant) is selling as a principal. An investment manager or other person acting on behalf of clients or beneficiaries is regarded as selling as a principal if he has full discretion to sell the securities, and the sale is not being

effected in accordance with instructions received from the clients or beneficiaries (section 171(7)). Examples of such persons include fund managers trading for a fund and traders managing omnibus accounts or discretionary accounts. However, it does not include a trader with a short-term discretion from a client to manage a sale order (e.g. a client leaving an order to sell short a security above a price good-till-cancelled, will not be regarded as having full discretion).

**"Documentary assurance"**

- (b) When passing a "short selling order" to an agent for execution, the short seller must, at the same time, provide the agent with a "documentary assurance" that
- he has a presently exercisable and unconditional right to vest the securities to which the order relates in the purchaser of them; and
  - where the securities have been borrowed to cover the sale, that the lender has the securities available to lend to the seller.

In plain language, what is needed to be conveyed in the assurance is that "it is a short sale" and "it has been covered".

- (c) The documentary assurance must be provided (by no later than) at the time the "short selling order" is placed with the agent. The assurance must be in the form of a document<sup>9</sup>, which may include a written confirmation, tape recording, or electronic documents etc. Accordingly, an assurance given over the phone would be sufficient if the phone line is being taped. The assurance can also be given by e-mail or other electronic communication (e.g. orders are received through an electronic media, such as the Internet or other information services, or using checkboxes or pop-up messages to obtain the required confirmations, are considered sufficient provided

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<sup>9</sup> "document" as defined in SFO includes any register, books, record, tape recording, any form of computer input or output, and any other document or similar material (whether produced mechanically, electrically, or manually, or by any other means whatsoever).

that the information is properly recorded and retained). To comply with section 171, short sellers must ensure that they have proper arrangements with their agents so that the documentary assurance can be received and retained.

- (d) From the agent's perspective, the SFC accepts that, as long as the communication from the short seller confirms that the sale is a "short selling order" and, where the securities are obtained by way of a borrowing, that the seller has obtained confirmation from the lender that the securities are available for borrowing to settle the transaction, it is not necessary for the seller to disclose the identity of the lender, or to give further details of the borrowing.
- (e) Questions were raised whether one documentary assurance is adequate for a series of short selling orders to be executed within a period of time. The SFC considers that it is acceptable provided that the documentary assurance(s) is/are sufficient to cover all of the subsequent short selling orders as well as the period of time for the execution of those orders.

### **3.7.3 Exchange participant selling as principal**

- (a) Where an exchange participant conducts a "short selling order" as principal, and if the "cover" for the sale is a borrowing arrangement, the exchange participant must have obtained a "documentary assurance" from the lender that the lender has the securities available to lend to him (section 171(3)) by no later than at the time the order is made. An exchange participant is a "principal" if he is selling for his own account, or if exercising discretion on behalf of a client. The documentary assurance can be a "hold notice" or "blanket assurance" given over the phone if the exchange participant tapes the call. The taped record will need to be retained for at least a year.
- (b) The responsibilities under section 171(3) are solely those of the exchange participant. The lender has no obligation under the SFO to provide the "documentary assurance" when lending securities to an exchange participant.

#### **3.7.4 Selling as an agent**

- (a) Where an agent receives a "short selling order" from a seller, section 171(5) requires the agent to obtain the necessary documentary assurance mentioned in paragraph 3.7.2(b), from his principal or other person for whose benefit or on whose behalf the order is made.
- (b) This obligation applies to an intermediary who takes an order from his client and passes it on (directly or indirectly) to an exchange participant for execution on SEHK. The exchange participant, being an agent of this intermediary, is required to obtain the necessary documentary assurance from him. In practice, this obligation can be complied with by the intermediary (i) supplying a copy of the documentary assurance he has received from his principal to the exchange participant or (ii) confirming, in the form of a document to the exchange participant, that the sale is a short sale and that it is covered.

#### **3.7.5 Agents with full discretionary power to trade**

An investment manager or other person who is acting on behalf of clients or beneficiaries, but is effecting the short sale at full discretion and not pursuant to instructions from the clients or beneficiaries, is not an "agent" but "principal" for this purpose (section 171(7)). Therefore, he must comply with the requirements imposed on persons selling as principal, as outlined in 3.7.2.

#### **3.8 SFC's power to request additional information**

- 3.8.1 Sections 171(2), (4) and (6) empower the SFC to make rules under section 397 to require sellers to give or collect documentary information (other than that required in sections 171(1), (3) and (5)) to the agent about the short sale, within such time as is specified in the rules.
- 3.8.2 The SFC does not intend to make rules under these sections at present. If such rules are to be made in the future, the industry will be consulted.

#### **3.9 Breach of reporting requirements and available defences**

- 3.9.1 Section 171(10) creates a criminal offence for breaches of the



reporting requirements in sections 171(1), (3) and (5). The maximum penalty is a fine of HK\$50,000 and imprisonment for a term of 12 months.

- 3.9.2 Section 171(11) provides a defence from section 171(10) for a seller who has failed to provide or collect a documentary assurance if the seller did not know or believed and had reasonable grounds to believe that the order was not a "short selling order". This defence is available to all sellers whether selling as principal or agent.
- 3.9.3 The defence will not be available for a seller who knows that the order is a "short selling order" but fails to provide the necessary assurance to his agent, or a seller who knows the relevant facts (i.e., that the order is a short selling order and that the securities are borrowed under a securities borrowing and lending agreement) but is not aware of his legal obligation to provide the assurance.
- 3.9.4 The defence may however apply if the seller held options, depository receipts or Exchange Traded Fund units and thought that the right to obtain the underlying securities had been exercised at the time of placing the sale order when in fact it had not. If the right had not been exercised, the sale order would be a "short selling order" and the reporting requirements would apply. However, if the seller is able to show that his mistaken belief (that he had exercised the right to obtain the underlying securities) was reasonable (so that he had reasonable grounds for believing that the order was not a short selling order), he would have a defence under section 171(11).
- 3.9.5 The defence may not be available for a seller who sought to comply with section 171 but failed to do so because of an inadvertent error (for example, sending a fax or e-mail assurance to the wrong person by mistake). That said, it is not the SFC's policy to prosecute genuine mistakes or errors.
- 3.9.6 If the seller has obtained a "hold notice" or "blanket assurance" or has borrowed the relevant securities from a stock lender, but for any reason, the securities were eventually not made available for borrowing (for example, the lender withdrew the "hold" when the

seller called to confirm the borrowing because it needed the securities for its own use), no breach of section 170 or 171 would have been committed. This is because at the time of placing the sale order, the seller believed and had reasonable grounds to believe that arrangements were in place to vest the securities in the purchaser of them.

### **3.10 Retention of documentary assurances**

3.10.1 Section 171(8) requires an agent or an exchange participant who receives or collects documents required under sections 171(1) to (6) to retain them for at least 12 months from the date of their receipt and to produce them to the SFC upon request within the 12-month period.

3.10.2 A failure to comply with the retention and production requirements in section 171(8) is a criminal offence punishable by a fine of HK\$50,000 and imprisonment for a term of 12 months<sup>10</sup> under section 171(12).

3.10.3 Section 171(12) provides a defence for a failure to comply with the retention and production requirements if the agent or exchange participant has a "reasonable excuse".

## **4. Alternative modes of compliance**

4.1 Since the introduction of section 171, the SFC has had continued dialogue with industry participants to understand the operation of the section and compliance concerns in practice. Industry participants were of the view that the requirements under this section to provide or obtain a documentary assurance before placing or receiving an order delay execution of transactions and inhibit conduct of trading strategies such as arbitrage whereby timely execution is critical. The delay is usually a result of waiting for the documentary assurance from lenders or counterparts that the securities are available for lending.

4.2 The alternative methods of compliance in section 4 of the Rules

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<sup>10</sup> As no rules have been made under section 171(2), (4) and (6), section 171(12) in effect only applies to a failure to retain and/or produce to the SFC documents collected under section 171(1), (3) and (5).

are introduced for the purpose of shortening the delay caused by waiting for the documentary assurance to facilitate timely execution of transactions. These alternative methods are also intended to alleviate compliance burdens on industry participants.

4.3 Under sections 4(1), (2) and (3), alternative methods of compliance are provided separately for sellers as principals, exchange participants who sell as principals and agent sellers of "specified short selling orders". Sellers who comply with the alternative methods of compliance in section 4 of the Rules will not be required to comply with the relevant requirements in the primary legislation (i.e., the corresponding requirement in section 171). However, to comply in full with the alternative methods of compliance, they are required to retain the documents collected under these alternative methods for at least 12 months from the date of the creation of the document and produce these documents to the SFC upon request within that 12-month period.

4.4 There is no penalty for "breach" of the alternative methods of compliance. However, a seller is relieved from complying with the relevant requirements in section 171 only if he complies with an alternative method provided in section 4 of the Rules. A failure to comply with that alternative method in full, will subject the seller to the relevant requirement in section 171. Therefore, a seller who elects to use an alternative method but fails to comply in full with the requirements in section 4 may be considered to have committed an offence under section 171(10). The defences under sections 171(11) and (12) will be available to such person.

#### **4.5 "Specified short selling orders"**

The alternative methods of compliance in section 4 of the Rules are available only to "specified short selling orders"<sup>11</sup>, i.e. short sales which are "covered" by a stock borrowing and lending arrangement.

#### **4.6 Selling as principal**

4.6.1 A seller as principal may, instead of providing the agent with a

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<sup>11</sup> A "specified short selling order" is defined in section 4(6) for the purpose of the rule as a "short selling order" within the meaning of paragraph (a)(i) of the definition of "short selling order" in Schedule 1 of the SFO.

documentary assurance at the time of placing the order (as required under section 171(1)), give the assurance<sup>12</sup> orally and -

- (a) record the oral assurance in a tape recording himself;
- (b) have an arrangement with his agent whereby the agent has agreed
  - to record the assurance in a tape record; or
  - to record specified particulars relating to the order in the form of a time- stamped document; or
- (c) provide the agent with a documentary confirmation of the oral assurance by the end of the day on which the oral assurance is given.

#### **4.7 Exchange Participants selling as principal**

4.7.1 An exchange participant who is selling as principal may, instead of collecting the documentary assurance from the stock lender before he places the order (as required under section 171(3)), receive the assurance orally from the stock lender and -

- (a) record the oral assurance in a tape recording himself;
- (b) record specified particulars relating to the order in the form of a time-stamped document; or
- (c) have an arrangement with the stock lender whereby the lender has agreed to record specified particulars relating to the borrowing in the form of a document and provide the document to the exchange participant by the end of the day on which the oral assurance is given.

#### **4.8 Selling as agent**

4.8.1 An agent seller may, instead of collecting the documentary assurance from the principal at the time he receives the order (as required under section 171(5)), receive the assurance orally from his principal and -

- (a) record the oral assurance in a tape recording himself;
- (b) record specified particulars relating to the order on a time-

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<sup>12</sup> The assurance which he is to give under section 171(1)(a) and, if applicable, (b) of the SFO.

stamped document; or

- (c) have an arrangement with the principal whereby the principal has agreed to provide him a documentary confirmation of the oral assurance by the end of the day on which the oral assurance is given.

#### **4.9 Specified particulars to be recorded in time stamped records**

4.9.1 Where a seller elects to record, or arrange with his agent or stock lender to record particulars relating to the order on a "time-stamped record", the particulars which are required to be recorded are -

- (a) the securities or group of securities borrowed or available for borrowing (as the case may be); and
- (b) the quantity of each security borrowed or to be borrowed; and
- (c) whether a "blanket assurance" or a "hold" has been given or a "borrow" has been entered into and the time at which the blanket assurance or hold was given or entered into.

#### **4.10 Time-stamp records**

4.10.1 The SFC will accept time-stamped order tickets (or any standard time-stamped records used by market participants) recording the required particulars.

4.10.2 Persons electing to record the particulars on a time-stamped record should ensure that the particulars are recorded contemporaneously with the receipt of oral assurance and stamped timely. *Insofar as SFC intermediaries are concerned, the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission requires intermediaries to immediately time stamp the records of instructions received from clients and the origination of orders for its house account. The Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC provide guidelines for management to establish and maintain policies and procedures through the use of time stamping facilities.*

#### **4.11 Arrangements with agents, counterparties or lenders**

4.11.1 In general, the alternative methods of compliance allow certain

sellers to make arrangements with their agents, counterparties or lenders whereby the agent, counterparty or lender agrees to record an oral assurance or the required particulars on a time-stamped record, or provide a confirmation of an oral assurance by the day end.

- 4.11.2 As the requirements to give or collect documentary assurances under section 171 of the SFO are on these sellers, a failure on his agent, counterparty or lender's part in fulfilling the arrangement (i.e., failing to tape record the oral assurance, record the particulars on a time-stamped record or provide the confirmation) will not render the seller liable if the seller has made such an arrangement with the agent, counterparty or lender (as the case may be).
- 4.11.3 Although the arrangement between the seller and the agent, counterparty or lender could take many forms, the SFC believes that it is in the seller's interest that such arrangement is clearly documented and the obligations of each party are specified.

## **5. Obligations to input "short selling orders" into the Exchange trading system**

- 5.1 Under section 172(1) of the SFO, an exchange participant (or its representative) who knows or is informed that an order is a "short selling order" must -
- (a) if passing on the order to another person for execution, inform that person that the order is a "short selling order"; or
  - (b) if inputting the order into the SEHK trading system, mark it as a short sale in accordance with the SEHK Rules<sup>13</sup>.
- 5.2 The purpose of section 172 is to ensure that "short selling orders" are reported to SEHK without any loss of information due to communication breakdowns within the firm of an exchange participant. The importance of this section lies in the fact that the

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<sup>13</sup> Currently the input indicator for "short selling orders" is "Y". The SEHK Rules only permit short sales in respect of Designated Securities. All short sales are required to be struck through the trading system (i.e., AMS) and are subject to the tick rule. Please also refer to footnote 5.

application of the tick rule will not be triggered if a "short selling order" is not properly identified during the input process. Therefore, if an exchange participant's sales representative receives a "short selling order" from a client, he must make sure that he informs his trader (or any person who is responsible for inputting the order into the SEHK trading system) that the order is a "short selling order" so that it can be so inputted.

- 5.3 Section 172(2) creates an offence for any person (i.e., the exchange participant or its representatives) to contravene section 172(1) without reasonable excuse. Section 172(3) provides that a person shall not be regarded as committing an offence under 172(2) if he fails to comply with the requirements by reason only of his inadvertence, carelessness or negligence. Therefore, genuine oversight or inputting error will not result in criminal liability.
- 5.4 The penalties for breach of section 172(1) are a fine of HK\$50,000 and imprisonment for a term of 12 months.

## **6. Purchases to cover a "short"**

The SFC is empowered to make rules under section 397 of the SFO to require a person who buys securities at or through SEHK to close out his short positions (for example, by buying securities in order to redeliver borrowed securities to the lender), to notify the exchange participant who effects the purchase of this fact. No rules have been made under this provision. If such rules are to be made, the SFC will consult the industry.

## **7. Compliance**

### **Agent's responsibility under sections 170(1) and 171**

- 7.1 Where a person is acting as an agent for a seller, i.e., the agent receives a sell order from his principal for execution or for passing onwards for execution, the agent should know or believe and have reasonable grounds to believe that his principal has a presently exercisable and unconditional right to vest the securities in the purchaser of them.

- 7.2 An agent seller should either know that the principal has the securities or if not, he should seek a confirmation from the principal as to whether the principal owns the securities that are being sold. Where the principal confirms that he owns the securities, the agent will have complied with his obligations in section 170(1). If the principal has borrowed the securities or he has an option, warrant or other convertible or exchangeable security which confers on him the right to acquire the securities being sold and he has not yet exercised the right to acquire the underlying securities, the sale is a "short selling order" and the agent (as well as the principal) is required to comply with the requirements in section 171.
- 7.3 In practice, an assurance recorded in compliance with section 171 or the alternative methods of compliance in section 4 of the Rules which confirms that the sale is "covered" and, where relevant or applicable, that the lender has confirmed the securities are available is sufficient.

#### **Client Agreements**

- 7.4 Industry participants may adopt different approaches to comply with section 170(1) and section 171 of the SFO. Some confirm short sales by phone, or paper or electronic forms; and some by making use of pop up screens.
- 7.5 A firm which wishes to only conduct long sales for clients may also rely on a clause in client agreements stating that it does not accept "short selling orders" at all.
- 7.6 Alternatively, an intermediary may also rely on a clause in a client agreement that all of the client's sell orders will be long sales, and the client must inform the intermediary where the client places a "covered" short selling order. The SFC considers this is acceptable provided that such agreement is evidenced in writing, and the client confirms that he understands and agrees with the provision by signing the agreement/documentation. In the event that subsequent to the agreement, the intermediary has a reasonable cause to believe that the client has placed a "covered" short selling order without informing the intermediary of such, the SFC is of the view that the intermediary cannot continue to rely on the agreement to comply with section 171.



## 8. Others Issues Raised by the Industry

### Aggregation of Trading Units/Books

- 8.1 The SFC considers that the law (both under sections 170 and section 171 of the SFO) does not differentiate between different trading units/books but recognizes only "a person". The SFC takes the view that as long as different trading units/books belong to the same legal entity, the positions of the proprietary trading units/books can be aggregated to determine whether the legal entity is net long or net short.
- 8.2 That is to say, for the purposes of determining whether a seller has a presently exercisable and unconditional right to vest the securities in the purchaser of them, the SFC will accept any of the following approaches -
- (a) the position of the seller's own trading book;
  - (b) the aggregated positions of a number of trading books which the seller controls or has knowledge of; or
  - (c) the aggregated position of the entire legal entity.

#### Example

*An organisation that operates different trading units within the same legal entity may monitor and conduct its trading activities on a "trading book" basis. It is possible that trader A is running a book that is "long" a particular security of a particular amount while trader B is running another book that is "short" (and has already been so reported) of the same security of the same amount. That is, the legal entity's overall position of that security may be square. In determining whether a sale order is a "short selling order", trader A should be able to sell that security through the SEHK without treating it as a "short selling order", even though, overall, the legal entity will be "short" of the security.*

*On the other hand, if a trader is running a book that does not have a "long" position in the security, and arranges to borrow the security and sell "short", this should be reported as a "short selling order"*

*even though, overall, the legal entity has a "long" position. This is so regardless of where the security is obtained from (for example, if the trader does not himself arrange the borrowing, but this is done through the stock lending/borrowing unit within the organisation, it is possible that the stocks will be sourced from within the organisation rather than borrowed from a third party lender).*

- 8.3 However, the SFC considers that this is limited to aggregating different trading units/books within the same legal entity and does not extend to the aggregation of position of trading books held under separate legal entities even if they are within the same group of companies.
- 8.4 Although the SFC accepts the adoption of any approaches described in paragraph 8.2, the SFC considers it desirable for an entity to apply an approach consistently.

#### **Client facilitation activities**

- 8.5 To fall outside section 170(1), the seller must have the shares or believe and have reasonable grounds to believe that he has a presently exercisable and unconditional right to vest the shares in the purchaser. This may include the situation where the seller has agreed to buy the shares before he sells them. For example, a seller may enter into an agreement with his client to buy shares from the client at the day's closing price of the shares or at a price computed based upon an agreed methodology. However, before the execution price is confirmed, the seller sells the shares on SEHK. The SFC considers that, in cases like the above example, the seller satisfies the test for believing and having reasonable grounds to believe that he has a presently exercisable and unconditional right to vest the shares after he has agreed to purchase them from his client. Therefore such sales are "long sales". However, if prior to placing the sell order, the seller has any reason to believe that there are circumstances that may frustrate the agreement, the SFC does not consider the seller to be able to satisfy the test for believing and having reasonable grounds to believe that he has a presently exercisable and unconditional right to vest the shares in the purchaser.

#### **Prime brokerage activities**

- 8.6 Questions were raised as to whether sections 171 and 172 of the SFO apply to prime brokers who provide settlement facilities for clients under the prime brokerage agreement. The SFC is of the view that regardless of what the arrangement is called, where there is a settlement facility or stock borrowing and lending facility that provides the seller with the right (without which the sale would have been a naked short) to vest the securities in the purchaser of them, then the sale under this arrangement is regarded as a "covered" short sale.

**Off-exchange short sales**

- 8.7 On the face of sections 171 and 172, the requirements would apply to short selling orders of any securities made at or through the SEHK. However, in practice, under the Rules of the SEHK, "covered" short sales are only permitted to be executed in Designated Securities. Therefore, in practice, the requirements in sections 171 and 172 would only apply to the Designated Securities unless the "covered" short sale is permitted under the SEHK Rules. By the same token, these requirements would also not apply to off-exchange sales of securities.

**9. Obligations of stock lenders to keep records**

- 9.1 The reporting obligations under sections 171 and 172 of the SFO fall upon intermediaries and other agents involved in covered short selling, but not upon lenders.
- 9.2 Section 5 of the Rules, made under section 397(1)(I) of the SFO, requires stock lenders to maintain certain records and to keep the records for one year from the date the relevant record is made. The purpose of section 5 is to retain information which will provide a proper audit trail for short selling transactions.
- 9.3 There is currently no criminal penalty for non-compliance although the power to make regulations imposing such penalty exists. The SFC does not currently intend to impose criminal penalties for breach of the Rules.
- 9.4 However, stock lenders who are regulated in Hong Kong are reminded that non-compliance may affect continued "fitness and

properness" as SFC licensed or registered intermediaries. In the case of overseas lenders, the SFC may take up any non-compliance with the regulators in their home country.

## **9.5 Definition of "Lender"**

A lender is defined in section 5(3) of the Rules as a lender of Hong Kong listed securities under a "securities borrowing and lending agreement". If the lender is lending as an agent for its clients, section 5(3) expressly provides that only the agent, and not the underlying clients, is required to comply with the Rules.

## **9.6 Application of the Section 5 of the Rules**

### **9.6.1 Section 5 applies when the lender:**

- (a) lends or agrees to lend securities to the borrower (a "borrow");
- (b) gives a "blanket assurance" to a borrower that the lender has a sufficient overall supply of a defined group of securities such that for a specific period of time as agreed on by the parties the securities concerned are available to lend to the borrower;
- (c) gives a "hold notice" to the borrower, i.e., a confirmation that for a specific period of time as agreed on by the parties specific securities in a specific quantity are available to lend to the borrower.

### **9.6.2 Section 5 requires that at the time of giving a "hold notice", "blanket assurance" or entering into a "borrow", a lender must make a documentary record of this, identifying-**

- (a) the name of borrower;
- (b) the type and quantity of securities borrowed or available for borrowing; and
- (c) whether a "hold notice" or "blanket assurance" or "borrow" was given or entered into, and the time it was given or entered into.

### **9.6.3 If the transaction is arranged by telephone, and the lender's line is recorded, the tape of the call will be a "documentary record". Otherwise, the lender will need to make an electronic or manual**

record of the transaction, and the record needs to be sufficient to identify the time of the "hold notice" or "blanket assurance" given or the actual "borrow". For example, a form which is filled out manually and time-stamped would meet this requirement.

- 9.6.4 The lender must keep the records for at least one year from the date the record is made and provide the records to the SFC on request.
- 9.6.5 Although it is not currently in the Rules, the SFC expects lenders to provide their potential borrowers or borrowers with a summary of the lending activities containing the required information (in relation to the "hold notices", "blanket assurances" and "borrows" conducted) at the end of the transaction day and by no later than 10:00 a.m. the following day (prior to the stock market opening).

