



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

Consultation on increasing short position transparency

31 July 2009



Table of Contents

Foreword	1
Personal Information Collection Statement	2
Consultation on increasing short position transparency	4
Background	4
The objective of increased transparency on short positions	6
Increased transactional reporting – close out indicators	8
Short position reporting - issues	9
Scope of reporting – should derivatives be included?	9
How is the reporting requirement triggered?	12
How often will reporting be required?	16
Who should be required to report short positions?	17
What information should the report contain?	18
Private reporting or public disclosure?	19
Exemptions	20
Should the short position reporting requirements be homed in Part XV of the SFO?	21
Concluding remarks	22
Appendix A	24



Foreword

The Securities and Futures Commission (“**Commission**” or “**SFC**”) proposes to introduce short position reporting requirements under the Securities and Futures Ordinance, Cap. 571 (“**SFO**”). This consultation paper discusses the issues relevant to short position reporting requirements.

Market participants and interested parties are invited to submit written comments on the issues discussed in this consultation paper or to comment on related matters that may have a significant impact on the issues **by no later than 30 September 2009**. Any person wishing to comment on the consultation paper should provide details of any organisation whose views they represent.

All comments submitted will be carefully considered and consultation conclusions will be published after the end of the consultation period. Draft legislative amendments will be published for public consultation. We may publish the draft legislative amendments together with the consultation conclusions.

Please note that the names of the commentators and the contents of their submissions may be published on the SFC website and in other documents to be published by the SFC. In this connection, please read the Personal Information Collection Statement attached to this consultation paper.

You may not wish your name and/or submission to be published by the SFC. If this is the case, please state that you wish your name and/or submission to be withheld from publication when you make your submission.

Written comments may be sent

- | | |
|--------------------------|--|
| by mail to | Supervision of Markets Division
Securities and Futures Commission
8 th Floor, Chater House
8 Connaught Road Central
Hong Kong |
| by fax to | (852) 2521 7917 |
| by on-line submission to | http://www.sfc.hk/sfc/html/EN/speeches/consult/consult.html (or, enter into the subsection “Consultation Papers and Conclusions” under the section “Speeches, Publications & Consultations” on the Commission’s website at http://www.sfc.hk) |
| by email to | shortpositions@sfc.hk |

Supervision of Markets Division
Securities and Futures Commission
Hong Kong

31 July 2009



Personal Information Collection Statement

1. This Personal Information Collection Statement (“**PICS**”) is made in accordance with the guidelines issued by the Privacy Commissioner for Personal Data. The PICS sets out the purposes for which your Personal Data¹ will be used following collection, what you are agreeing to with respect to the SFC’s use of your Personal Data and your rights under the Personal Data (Privacy) Ordinance, Cap. 486 (“**PDPO**”).

Purpose of collection

2. The Personal Data provided in your submission to the SFC in response to this consultation paper may be used by the SFC for one or more of the following purposes :
 - (a) To administer the relevant provisions² and codes and guidelines published pursuant to the powers vested in the SFC;
 - (b) In performing the SFC’s statutory functions under the relevant provisions;
 - (c) For research and statistical purposes;
 - (d) For other purposes permitted by law.

Transfer of personal data

3. Personal Data may be disclosed by the SFC to members of the public in Hong Kong and elsewhere, as part of the public consultation on this consultation paper. The names of persons who submit comments on this consultation paper together with the whole or part of their submission may be disclosed to members of the public. This will be done by publishing this information on the SFC website and in documents to be published by the SFC during the consultation period or at its conclusion.

Access to data

4. You have the right to request access to and correction of your Personal Data in accordance with the provisions of the PDPO. Your right of access includes the right to obtain a copy of your Personal Data provided in your submissions on this consultation paper. The SFC has the right to charge a reasonable fee for processing any data access request.

Retention

5. Personal Data provided to the SFC in response to this consultation paper will be retained for such period as may be necessary for the proper discharge of the SFC’s functions.

¹ Personal Data means personal data as defined in the Personal Data (Privacy) Ordinance.

² Defined in Schedule 1 of the SFO to mean provisions of the SFO and subsidiary legislation made under it; and provisions of Parts II and XII of the Companies Ordinance (Cap. 32) so far as those Parts relate directly or indirectly, to the performance of functions relating to : prospectuses; the purchase by a corporation of its own shares; a corporation giving financial assistance for the acquisition of its own shares etc.



Enquiries

6. Any inquiries regarding the Personal Data provided in your submission on this consultation paper, or requests for access to Personal Data or correction of Personal Data, should be addressed in writing to

The Data Privacy Officer
Securities and Futures Commission
8/F Chater House
8 Connaught Road Central
Hong Kong

A copy of the Privacy Policy Statement adopted by the SFC is available upon request.



Consultation on increasing short position transparency

Background

1. Since September 2008, a number of overseas markets imposed emergency measures to regulate short selling. These measures included the banning of naked and/or covered short selling of all/certain stocks and requiring disclosure of short positions. Whilst some of these measures have since expired, a number of overseas regulators have implemented or are in the process of developing permanent regulations mostly to increase transparency in respect of short sales/positions. For example -
 - (a) The UK Financial Services Authority ("**UK FSA**") imposed a temporary short position disclosure requirement with a trigger of 0.25% of the issued share capital of a company in September 2008. The UK FSA has consulted on, amongst other things, proposals to make the requirement a permanent one with a 0.50% trigger.
 - (b) The Singapore Exchange ("**SGX**") issued a consultation paper in November 2008 to solicit comments on proposals to require marking of short sales and implementing short position reporting requirements with a 1% trigger.
 - (c) In February 2009, the Autorite Des Marches Financiers ("**AMF**") in France issued a consultation on, amongst other things, a requirement to publish net short positions exceeding a defined threshold (e.g., 0.25% of the capital of a listed company). A supplemental measure requiring investors to inform their intermediary when they place a short selling order is also being considered.
 - (d) In Australia, the Government passed the Corporations Amendment (Short Selling) Act 2008 in December 2008. Amongst other things, the Act prohibits naked short selling and establishes a framework for short selling disclosure. The Australian Treasury issued a consultation paper in March 2009 on concepts for the disclosure mechanism.
2. Hong Kong was one of the few markets that did not impose emergency short selling regulations during September 2008. This is because we have an existing short selling regulatory regime that features some of the emergency measures imposed overseas. Our short selling regulatory framework helps to minimize the potential risks whilst realising as much as possible the benefits of short selling.
3. That said, since September 2008 we have attempted to assess the implications of short selling activities for the Hong Kong market by looking at the aggregated short selling turnover published daily by the Hong Kong Exchanges and Clearing Limited ("**HKEx**"), stock loan estimates from the market as well as from requests to licensed corporations made from time to time. The information so collected has its limitations and may not always present a complete picture of the level of short interest in the market. Accordingly we believe there is a case to increase transparency of short positions.
4. This consultation paper discusses the objectives of increased transparency and the issues that will need to be considered and addressed in formulating relevant requirements. We seek public comments and input on the issues so that the regime we put in place is effective and proportionate in terms of achieving the intended objectives as well as efficient in terms of time and resources costs necessary for implementation and ongoing compliance. Based on the comments received, we will prepare the



legislative amendments to introduce the reporting regime and will consult the public on the draft legislative amendments when we publish the consultation conclusions.



The objective of increased transparency on short positions

5. We wish to stress at the outset that the SFC is not seeking to discourage legitimate short selling activity by increasing transparency on short positions. We recognise that legitimate short selling activity is beneficial to the operations of the market by increasing efficiency and liquidity.
6. Increased transparency to the SFC may have the following advantages –
 - (a) It provides an early warning sign of a build up of large short positions that may be potentially disruptive to the orderly functioning or stability of the market. This will enable regulators to assess whether any necessary action needs to be taken;
 - (b) It provides ready access to information on short selling to improve insight into market dynamics;
 - (c) It deters abusive short selling behaviour;
 - (d) It provides evidentiary proof that aids post event investigation and disciplinary action.
7. Increased transparency can take the form of transactional reporting requirements and/or positional reporting requirements. Both options are being considered overseas as measures that can be implemented permanently. It should be noted that transactional reporting and positional reporting can be complementary since each achieves different aspects of the objectives.
8. In Hong Kong, transactional reporting requirements for short selling orders have been implemented since 2000. Whilst the transactional reporting requirements provide some level of transparency, it may not help to achieve some important aspects of the objectives for increased transparency. For example, transactional reporting does not take into account positions that have subsequently been closed out because short sellers are not required to report their close-out orders for short positions previously established. It also does not include OTC transactions and derivatives. Hence it is not possible for us to gauge the outstanding short interest in the market which may inhibit our ability to properly monitor systemic risks.
9. Since September 2008 we have used short selling turnover data, estimates of stock loans and information collected from occasional requests to licensed corporations to obtain more information on short selling of certain stocks so as to assess whether there may be any systemic risks or irregularities in the market. However, there are limitations on the results based on those pieces of information. This is largely due to –
 - (a) The aggregate short selling turnover published daily by HKEx and the information from requests to licensed corporations share the same limitation - they include only short sale transactions executed on the Stock Exchange of Hong Kong Limited (“**SEHK**”). With increased financial innovation, short exposures can be created using derivatives or other instruments with no immediate short sale on an exchange. In addition, both sets of information do not reflect positions that have been closed. Consequently, the information may be incomplete.



- (b) Stock loan estimates are not a perfect proxy for short positions since stock loans can be for purposes other than short selling. Moreover the information we receive are estimates in themselves and are likely to be incomplete since they are provided by some stock lenders on a voluntary basis.
- (c) In addition, it may be more efficient to have an established mechanism under which complete information is collected regularly rather than to rely on occasional requests to licensed corporations.

10. For these reasons, there may be a need to introduce permanent regulations for increased transparency relating to short sales/positions. In the following sections, we seek comments on various issues associated with two approaches to enhance transparency of short selling/positions, namely increased transactional reporting and short position reporting.



Increased transactional reporting – close out indicators

11. Given that we already have transactional reporting requirements for short selling orders³ in Hong Kong, some take the view that the simplest method to add transparency is to require the use of close out indicators.
12. The operation of such indicators would be similar to the current transactional reporting requirements for short selling orders, i.e., a person placing a buy order will be required to inform his intermediary if the order is for closing out a short position and the exchange participant who inputs the order into the SEHK's trading system would be required to use a special input indicator for these transactions.
13. The drawbacks of using close out indicators include the fact that close out transactions may be executed off-exchange, as close out indicators may not be applicable to off-exchange transactions, these close out transactions may not be reported. In addition, since the indicators will only apply to cash market transactions executed on the exchange, the information collected will exclude derivatives transactions. Furthermore, the identities of short position holders will not be immediately available to the SFC.
14. Also, since there is currently no information on the initial outstanding short position, information about the close out transactions may not provide a clear picture of the overall outstanding short position. However, this is likely to be more of an issue during the initial stage of implementing close out indicators. Over time, the information should provide us with a more precise level of the pattern of outstanding short positions of stocks in the exchange traded cash market.
15. On the other hand, as the SEHK and market participants' systems already have the capability to comply with the existing transactional reporting requirements for short selling orders, substantial systems enhancement to introduce the use of close out indicators is unlikely to be required. The use of close out indicators is therefore likely to be the most straightforward way to give a more complete picture of the cash market short position which some may view as being more important.
16. If, however, it is considered that OTC trades are also important, one alternative is to impose both the use of close out indicators and a short position reporting regime. However, this is likely to increase compliance burden for market participants.
17. If close out indicators are required, it is likely that the daily aggregated close out transactions may be published by HKEx in the same manner as the daily aggregated short selling turnover.

Questions

- Q1** *Is the use of close out indicators an appropriate method to enhance transparency of short selling in the cash market to the SFC? Please provide reasons.*
- Q2** *If you believe the use of close out indicators can be adopted, how can we address the limitations that are set out in paragraphs 13 and 14?*

³ Section 171 of the Securities and Futures Ordinance.



Short position reporting - issues

Scope of reporting – should derivatives be included?

18. With increasing financial innovation, derivatives and other financial instruments can be used to create short exposures that have a similar effect to a short sale. It may be argued that short position reporting that does not include these instruments would provide an incomplete and misleading picture of the short interest in the market. Such an approach may also push activity to the derivatives or OTC market where these short positions are not caught by the reporting requirements.
19. On the other hand, if derivatives and other financial instruments are included, the information will be more complicated even though it may be more complete. This may have resources and costs implications for short position holders and the SFC as compliance may be more complicated and the information collected may also be more difficult and complex to interpret.
20. There does not appear to be a uniform practice internationally on the inclusion of derivatives and other financial instruments for the purpose of short position reporting.
 - (a) In the UK and some European countries, short positions that need to be disclosed include all instruments that give rise to an exposure directly or indirectly, to the issued share capital of a company (i.e., an economic interest approach).
 - (b) In the US, the Securities and Exchange Commission (“**SEC**”) reporting requirements on certain institutional investment managers only cover certain specified equity securities.
 - (c) In Japan, the short position reporting requirements cover only equity stock short positions.
 - (d) Currently, the Australian Securities Exchange (“**ASX**”) has short selling related disclosure requirements that are generally limited to positions relating to trades executed on the exchange. The Australian government has consulted on whether the new short position reporting regulations should, amongst other things, cover derivatives.
 - (e) SGX has also consulted its market on short position reporting requirements and its proposals appear to cover only securities traded on the SGX.
21. To strike a balance between simple but incomplete information on the short interest in the market and excessively complex information being reported, a number of alternatives may be considered –
 - (a) To include only single stock derivatives – this is a simpler approach but is likely to produce a less complete picture of the extent of short positions as basket and index derivatives are not uncommon. There is also a risk that basket derivatives will be structured to avoid reporting requirements. For example, a derivative with a basket of 2 underlying stocks where one underlyer is very lightly weighted will have a substantial exposure to the more heavily weighted underlyer. Such a derivative would not fall under a reporting regime which includes only single stock derivatives.



- (b) To include single stock, basket and index derivatives unless they have been exempted/excluded by the SFC – whilst this may be more complicated than to include only single stock derivatives, it should give a more complete picture of the short positions. In addition, it will be more difficult to circumvent the reporting requirements in the manner described in paragraph 21(a) above. This approach may be implemented in two ways –
- (i) To include a specific exemption for broad based basket and index derivatives in the law - this will be similar to the ‘basket exemption’⁴ in Part XV of the Securities and Futures Ordinance (“SFO”) where derivatives which are based on a basket consisting of at least 5 stocks and no one stock accounts for over 30% of the value of the entire basket are exempted from inclusion in calculations of a person’s position. If this approach is taken, we can consider adopting the same or different numbers of stocks and percentage levels as those in Part XV; or
- (ii) To empower the SFC to exempt specific baskets (and indices) on a case by case basis - the benefit of this approach to the one above in paragraph (i) is that it will be more flexible. However, as the SFC will need to review and exempt specific baskets, it may be more administratively burdensome for both market participants and the SFC. It may also create regulatory uncertainty for the market since it will have to wait for the SFC’s decision on whether the basket is exempted. To some extent this concern may be addressed by including the criteria in which the SFC will grant the exemptions. We envisage such criteria would be aimed to ensure that the baskets are sufficiently broad based and are not structured with the sole purpose of circumventing the reporting requirements.
- (c) It is also possible to use a phased approach. That is to say, in Phase 1, only single stock derivatives are included. After implementation for a certain period of time so that more experience is gained, Phase 2 (which will include basket and index derivatives which are not exempted) may be implemented.
22. To avoid overcomplicating the reporting requirements, under the above alternatives, financial products such as credit default swaps, which do not create a direct exposure to the stock of a listed company, will not be included in the reporting regime.
23. If derivatives are included, some believe that they should be included in the net exposure calculation based on a delta adjusted approach as this will produce a more realistic picture of the net exposure.
24. Separately, covered short selling in Hong Kong is only permitted in securities which are designated by the SEHK as eligible securities for short selling (“Designated Securities”). If short position reporting includes off-exchange transactions and derivatives, it may make sense for the short position reporting requirement to cover short positions in non-Designated Securities as well. This may be especially true if there is a concern on systemic impact - the fact that there is a large OTC short position on an illiquid stock is likely to be a concern because even though the stock may not be as significant as a Designated Security, a large OTC short position in such a stock may cause a

⁴ Section 308(5) of the SFO.



snowballing effect on other small cap stocks. On the other hand, some may take the view that substantial short positions in non-Designated Securities are unlikely to pose systemic risks. This is because the main criterion for eligibility as a Designated Security is liquidity and it is unlikely that there will be significant shorting of less liquid securities in OTC transactions⁵. Consequently, it may be argued that reporting of non-Designated Securities does not serve any meaningful purpose.

Questions

- Q3** *Should derivatives (both exchange traded and off-exchange transactions) be included in the short position reporting requirements? Please provide reasons.*
- Q4** *If derivatives are included, which (if any) of the alternatives in paragraph 21 above is the most appropriate? Are there any other practical alternatives? Please provide reasons.*
- Q5** *If any one of the approaches in paragraph 21 is adopted, should those derivatives be limited to ones that create direct exposures to the stock of the listed company? If so, what are the products that should be excluded (e.g., do you have any views on whether convertibles and other exchangeables should be included?) How should the definition of such derivative be crafted? Please provide reasons.*
- Q6** *If derivatives are included, should they be included on a delta adjusted basis? Please provide reasons.*
- Q7** *Should the reporting requirements cover short positions in Designated Securities only rather than in all listed corporations' securities? Please provide reasons.*

⁵ There should not be any short selling of illiquid securities on the SEHK since naked short selling is prohibited and covered short selling is not permitted for non-Designated stocks. Establishing short positions through exchange traded derivatives is also likely to be insignificant as usually only liquid stocks are accepted as underlying assets of exchange traded derivatives.



How is the reporting requirement triggered?

25. Internationally, there does not appear to be a uniform approach on how short position reporting requirements are triggered. For example –
- (a) The threshold approach - In the UK and some European countries reporting is triggered when a person holds a certain percentage threshold (“the initial threshold”) of a listed company’s issued share capital. Further reporting is required when the person’s short position crosses subsequent threshold levels (“subsequent thresholds”) or falls below the initial threshold. Others using or considering this approach include Japan⁶ and Singapore⁷.
 - (b) The periodic approach - The US reporting requirements imposed under its emergency measures apply only to institutional investment managers that exercise discretion with respect to accounts holding certain classes of equity securities having a fair market value of at least US\$100 million⁸. Such investment managers are required to file weekly reports to the SEC unless the short position is less than 0.25% of the issued securities and the fair market value of the short position is less than US\$1 million.
26. We have considered several different approaches –
- (a) Reporting of all short positions with no threshold – although this may arguably be a simple approach since there will be no need to monitor when thresholds have been reached, it is likely to be administratively burdensome for both the SFC and persons filing reports.
 - (b) The threshold approach - the imposition of a threshold may help to keep the burden and costs of the regime to an efficient and manageable level by excluding holders of small positions from the reporting obligation. However, this would result in some positions being excluded from reporting and reduce the overall completeness of the data. This may lead to an understatement of the total short positions.
 - (i) A threshold that is too low would be overly burdensome and may render the threshold meaningless. On the other hand, a threshold that is too high would fail to capture substantial positions. It is therefore critical that, if a threshold is adopted, an appropriate trigger level is identified so that small insignificant positions would be filtered out and all substantial positions will be captured.
 - (ii) The issue of an appropriate threshold is a green-field area in which there has been limited experience globally.
 - (iii) In our view, if a threshold is imposed, it must take into account the unique characteristics of the local market including the size of companies, market capitalisation, liquidity, the type of market participants and investors and their trading activities.

⁶ Japan is applying a 0.25% threshold on the exchange traded cash market short positions.

⁷ SGX is proposing a 1% threshold on the exchange traded cash market short positions.

⁸ This requirement is set to expire on 1 August 2009.



- (iv) Assuming that stock loan estimates are a reasonable proxy for the total short positions outstanding in the market, we analysed the stock loan estimates of about 320 Hong Kong stocks. In late February 2009, about half of the 320 stocks had a percentage of total size of stock loan to market capitalisation of less than 0.50%, i.e., no one held a short position in any of these stocks which was more than 0.50% of the issued share capital. This would suggest that a threshold of 0.50% is too high for the Hong Kong market. Even at a threshold of 0.25% about 36% of the 320 stocks had a percentage of total size of stock loan to market capitalisation of less than this threshold. Based on research of turnover in 2007⁹, the short selling/turnover ratio in Hong Kong is much lower than that in London and New York. The research also suggests that the short exposure/market capitalisation ratio in Hong Kong is also much lower than that in New York¹⁰. Hence, if we were to adopt a threshold approach to capture significant short positions, the threshold level should not be higher than 0.25% of the issued share capital which is the level adopted currently in London and New York. Alternatively, if we were to adopt 0.25% as the initial threshold, the law could be crafted in such a way that we would have sufficient flexibility to tighten the threshold during an emergency situation (this is discussed in detail in paragraph 26(d) below).
- (v) If a threshold approach is taken, we would also need to keep track of changes in the reported short positions (both increases above and decreases below the initial threshold). This could be done by either imposing subsequent thresholds or periodic reporting¹¹.
- (c) Periodic reporting – An alternative may be to adopt a periodic approach, either with or without a threshold level (that may be as a percentage of a listed corporation's issued share capital and/or a dollar value amount). The arguments in support of periodic reporting include the assertion that substantial short positions are not established within one trading day, hence reporting on a periodic basis, e.g., weekly, would be more appropriate. In addition, this may be a less onerous approach than reporting that is triggered solely by a percentage threshold.
- (i) For the same reasons as to why reporting of all short positions without any thresholds (see paragraph 26(a) above) may be less desirable, it may be more practical to require periodic reporting when a threshold has been reached. That is to say, reporting will be required on a weekly basis when a person holds a short position above a certain percentage of a listed corporation's issued share capital (and subsequently when the person's short position falls below the threshold) and/or a short position exceeding a certain value. If this

⁹ SFC Research Paper No. 42 – Short selling in the Hong Kong Stock Market, published 23 October 2008. The report states that short selling volume made up around 6% of market turnover in Hong Kong in 2007 and 7.6% in the first eight months of 2008. The corresponding ratios were 25% to 30% in New York and London in 2007.

¹⁰ The research report estimates aggregate short exposure in Hong Kong is at or below 1% of market capitalisation as at end-August 2008, whereas in New York it was about 4.7%.

¹¹ For example, in the UK when the disclosure obligation was first introduced in September 2008, disclosure was required on a daily basis, i.e., a person with a 0.25% or more short position was required to disclose this position by the following day irrespective of whether there had been a change in his reportable short position. In January 2009, the UK FSA substituted the daily reporting requirement (after the initial threshold was reached) with a 'banded approach', that is it introduced subsequent triggers of 0.10% increases under which further disclosures would only become necessary. This had the effect of reducing the reporting burden.



approach is adopted, similar to the threshold approach we will need to decide what is an appropriate initial threshold (either a percentage of a listed corporation's issued share capital and/or a dollar value amount) for the Hong Kong market.

- (ii) The periodic approach has its drawbacks - we are concerned that disclosure under this approach may not provide sufficiently timely information about the true level of short positions in crisis situations. If we adopt this approach, we will need to address the need for timely information in crisis situations. A possible solution to address this is to provide sufficient flexibility to increase reporting frequency in a crisis (see paragraph 26(d) below for a detailed discussion).
- (d) Flexibility approach – As mentioned above, one possibility is to adopt less onerous reporting requirements (either a threshold approach or a periodic reporting, both described above) with flexibility for the SFC to tighten the requirements in contingency situations.
 - (i) We envisage that if such an approach is adopted, in addition to either a threshold approach with a less onerous threshold or weekly periodic reporting, the SFC will be empowered to declare a contingency situation during which the reporting frequency will be increased (e.g., to daily reporting, at most) and threshold(s), if any are adopted, may be tightened. When normal market conditions resume, the usual reporting requirements will be reactivated. This may be a practical approach since it addresses our need for timely and detailed information in a crisis without incurring disproportionate compliance burden during normal circumstances.
 - (ii) If the above approach is taken, it is likely that the law will need to set out the circumstances in which there is a contingency situation as well as the manner in which the Commission's determination (that there is a contingency situation and when normal market conditions resume) are communicated to the public
 - (iii) In addition, during a crisis it is likely that we may not be able to give a substantial amount of time for market participants to adjust their reporting systems to comply with the crisis reporting requirements. Hence, it will be important for market participants' systems to be sufficiently flexible to switch over within a short time-frame. For example, the threshold levels should not be hard-coded and can be adjusted; the system should be designed to be able to run the reports on a daily basis; and changes can be made overnight, if required.

Questions

Q8 *Which of the approaches above (i.e., threshold approach (with initial and subsequent reporting), or periodic reporting (with or without a threshold level) or either the threshold approach or periodic approach with flexibility to tighten the requirements during a contingency situation) would be the most appropriate for short position reporting? Do you have any other suggestions? Please provide reasons.*



- Q9** *If a threshold approach is adopted, what is an appropriate threshold (and subsequent thresholds) for the Hong Kong market? If periodic reporting is adopted, should thresholds (either a percentage of a listed corporation's issued share capital and/or a dollar value amount) apply? If so, what are appropriate thresholds for periodic reporting? Please provide reasons. If you are a broker or custodian, it would be helpful if you could estimate how many of your clients would be required to file reports if the suggested threshold is adopted.*
- Q10** *If you agree that short position reporting can be more relaxed during normal market situations and more frequent reporting with tighter threshold(s) may be required in the event of a contingency, what are the circumstances that may amount to a contingency situation (as this may need to be included in the legislation)? Please provide reasons.*
- Q11** *Are there any reasons why systems for complying with reporting requirements cannot be adjusted in the manner described in paragraph 26(d) above? What are other operational issues that we should consider? Please provide reasons.*



How often will reporting be required?

27. The issue of how often reporting will be required depends largely on the approach adopted, i.e., a threshold approach or a periodic approach.
28. If a threshold approach is adopted, in order for reporting to be effective it should be done as soon as practicable after each threshold level has been crossed. However, we are mindful of the potential burden this may create for holders of short positions. Hence to balance the need for timely reporting with costs of compliance, if a threshold approach is adopted, reports should be done within the business day following the day on which the short position exceeding the threshold(s) is created. Reporting will also be required when the position falls below the initial threshold or each level of the subsequent triggers.
29. If periodic reporting is adopted, persons holding short positions may be required to disclose to the SFC their positions as at the close of the last business day of the week within the first business day of the following week.
 - (a) If no threshold is adopted with periodic reporting, any person who has a short position will be required to file such reports to the SFC on a weekly basis until the person does not hold any short positions. When the person no longer holds a short position, he will be expected to file a report that week informing the SFC that he no longer holds any position.
 - (b) If a threshold is adopted with periodic reporting, the person will need to report to the SFC on weekly basis when he has a short position exceeding the threshold as well as when his short position first falls below the stated threshold.
30. As mentioned in paragraph 26(d) above, we may consider providing certain flexibility in the law to require more frequent reporting and/or tighter thresholds during a contingency.

Questions

- Q12** *What are your views on the timing of reporting for the different approaches? Please provide reasons.*



Who should be required to report short positions?

31. There has been some discussion in overseas markets on who should be required to report short positions. Some believe that it may be more appropriate to require brokers to report their own and clients' positions since brokers are regulated. However, brokers may not have information on their clients' entire portfolios and information provided to them is only as good and accurate as given to them. In our view holders of positions are best placed to calculate their overall short position, hence the ultimate legal responsibility for reporting of short positions should rest with them. Whilst we are mindful of concerns that there may be risks of off-shore investors failing to comply with the reporting requirements we believe this is a long standing issue relating to difficulties in cross-border enforcement which does not affect short position reporting alone. To some extent, international regulatory cooperation may help to address cross-border enforcement issues.
32. Our preliminary view is that, if short position reporting requirements are introduced, we will impose the reporting obligation on holders of positions. Agents (e.g., brokers or custodians) may be permitted to report the information on behalf of holders. In such cases, the holder of the position would be responsible for managing this relationship and would be held accountable for any failure of this agent to comply with the reporting requirement and/or reporting of incorrect information.
- (a) In the case of funds, the reporting requirement should apply to each fund. The fund manager may report the positions on behalf of each of the funds it manages but will not be permitted to aggregate or net positions between different funds.
- (b) In the case of global financial institutions, the reporting obligation will be on individual legal entities within the group structure with no aggregation requirements. We understand that such an approach runs the risk of firms circumventing the reporting requirements by booking short positions falling just below thresholds (if any are adopted) into different legal entities. However, if we apply aggregation requirements to address this risk, the short position reporting regime will become very complex. In addition, it will be difficult for market participants to comply with more frequent reporting in contingency situations, if the flexibility approach is adopted. On balance, we prefer a simpler approach.

Questions

- Q13** *Should the obligation to report short positions be placed on holders of short positions? Please provide reasons.*
- Q14** *Should agents be permitted to report information on behalf of holders of short positions with the holders of the positions being held accountable? Please provide reasons.*
- Q15** *In the case of funds, should the reporting requirements apply to individual funds rather than to the fund manager? Please provide reasons.*
- Q16** *Do you agree that aggregation requirements should not be imposed on different entities within the same group? Please provide reasons.*



What information should the report contain?

33. Other than basic information relating to the person filing the report (e.g., entity name, dates etc.) short positions reports may be required to contain –
- (a) the net short position (i.e., the aggregated cash and derivative positions which result in the short position reaching the threshold trigger, if adopted); and
 - (b) the net position that is established on the SEHK (which may be a long position or a short position).
34. Whilst we appreciate that this is more than what is required in some overseas markets (which only require the disclosure of one net short position figure), the information is needed to enable us to better perform our market monitoring function (and to gauge the extent to which the short position is established on the exchange market). We believe market participants' concerns should, to a large extent, be alleviated by the fact that we do not intend to publish the broken-down information in detail. (Please see paragraphs 36 to 39 below for a detailed discussion on the proposal relating to public disclosure of the short position information).
35. In addition, the Commission intends to create a template to facilitate electronic reporting. The electronic reporting facility will enable any person, whether SFC licensed or otherwise, to submit their short position reports through the SFC's website.

Questions

- Q17** *What are your views on providing in the report to the SFC the net short position and the net position established on the SEHK? Please provide reasons.*
- Q18** *What are your views on the creation of a template to facilitate electronic reporting through the SFC's website? Please provide reasons.*



Private reporting or public disclosure?

36. One of the most contentious areas in short position reporting is whether the information should be reported privately to the regulator or disclosed publicly. Whilst there do not appear to be objections against reporting of short positions to regulators on a private basis in overseas markets, there appear to be grave concerns on public disclosure.
37. Arguments against public disclosure include –
- (a) Disclosure unfairly prejudices holders of short positions in the execution of their proprietary trading strategies. This may become a disincentive for traders/investors from engaging in legitimate short selling activities (which is generally beneficial to the market).
 - (b) Disclosure may subject short sellers to risks of being short squeezed when they cover their short positions.
 - (c) Disclosure may cause a herding effect where investors blindly follow a big-name short position holder.
38. Public disclosure of the information would serve the purpose of providing additional transparency to the public. In this context, some may argue that there is currently adequate transparency in the form of aggregated short selling turnover that the SEHK publishes daily without the need to further require public disclosure of short positions and identity of their holders.
39. A possible solution is to require reporting on a private basis to the SFC and for the information to be disclosed publicly by the SFC on a delayed (e.g., weekly or bi-weekly) and aggregated basis without the identities of the holders of the short positions.
- (a) We are mindful that such an approach would mean that there is a delay in the information being made publicly available. Some may argue that this will reduce the effectiveness of the disclosure to the public.
 - (b) There may also be criticism that the aggregated information may be partial and misleading. We believe that this cannot be avoided in any event if thresholds for reporting are imposed since only information on short positions which exceed the threshold will be reported.

Questions

- Q19** *Should the information reported to the SFC be disclosed publicly on an aggregated and delayed basis? Please provide reasons.*
- Q20** *If the information is published on a delayed basis, what would be the appropriate 'delay' (e.g., on a weekly basis for positions as at the end of the preceding week)?*



Exemptions

40. In some overseas markets, market makers are exempted from the public disclosure/reporting requirements. However, unless individual short positions are disclosed to the public, exemptions for market makers to the proposed short position reporting requirements may not be necessary.

Questions

- Q21** *Should the SFC consider any exemptions from the reporting requirements? Please provide reasons.*



Should the short position reporting requirements be homed in Part XV of the SFO?

41. We are mindful of the additional costs that a new short position reporting requirement will create for the industry.
42. In this regard, we have considered whether short position reporting requirements could be homed in the disclosure of interests regime in Part XV of the SFO or whether we could mirror the Part XV requirements for the short position reporting requirements. We had hoped that this would enable existing compliance programmes for Part XV to be used thus saving costs of building new systems for the short position reporting regime.
43. However, some may view Part XV as unsuitable for many reasons including –
 - (a) The definition of ‘short position’ in Part XV includes interests which we do not wish to include for the short position reporting regime, e.g., stock borrowings;
 - (b) The disclosure obligations under Part XV for short positions apply only when a person is a substantial shareholder (i.e., one who has a long position of 5% or more);
 - (c) We consider the time period for disclosures under Part XV (i.e., 3 business days) to be too long for the purposes of short position reporting;
 - (d) Derivatives are calculated by notional amount for Part XV, we would like to include derivatives for short position reporting on a delta adjusted basis;
 - (e) There will be more flexibility to create a simpler and more effective set of rules to address the need for the short position reporting if Part XV is not used.
44. Consequently it would appear that new subsidiary legislation under section 397(2) of the SFO to home the short position reporting requirements may be more appropriate.

Questions

- Q22** *Do you agree that the short position reporting requirements should not be homed in Part XV of the SFO or mirror the Part XV requirements? Please provide reasons.*



Concluding remarks

45. No decision has yet been made as to the approach we will adopt for increasing short position transparency. This section summarizes the gist of the models that have been discussed in this consultation paper.
46. Two approaches to increase short selling/position transparency have been considered -
- (a) The use of close out indicators (please see paragraphs 11-17); and/or
 - (b) Short position reporting requirements (please see paragraphs 18-35).
47. With respect to short position reporting requirements, this paper discusses the numerous elements to reporting, each with a number of possible alternatives. These are, in summary –
- (a) On the possible models for reporting –
 - (i) We may adopt a threshold approach where a holder of a short position will be required to report his short position within a specified period of time, e.g., within the next business day from when his short position exceeds a specified threshold that is measured by a percentage of the issued share capital of the listed corporation concerned. Subsequent reporting may be required by subsequent thresholds and when the position falls below the threshold(s); or
 - (ii) We may adopt periodic reporting where a holder of a short position will be required to report his short position on a periodic basis, e.g., weekly. We may not impose any threshold with periodic reporting in which case a person holding any short position will need to comply with the periodic reporting. Alternatively, a threshold (that is either a percentage of a listed corporation's issued share capital and/or a dollar value amount) may be imposed with periodic reporting in which case only a person with a short position exceeding the specified threshold will need to comply with the periodic reporting requirements as well as when the position falls below the threshold.
 - (iii) We may adopt either one of the above models and introduce flexibility in the law to increase the frequency of reporting (e.g., if reporting is done weekly, to increase reporting to at most daily) and/or to tighten the threshold(s) during a contingency situation. After the market situation resumes normal, the normal reporting requirements will be reactivated.
 - (b) On the inclusion of derivatives –
 - (i) We could include only single stock derivatives; or
 - (ii) We could include single stock derivatives as well as basket and index derivatives unless the baskets or indices are excluded under the law. Alternatively, we could provide the SFC with an exemptive power to exclude derivatives that fall within criteria set out in the law; or



- (iii) We could adopt a phased approach in which Phase 1 includes only single stock derivatives and in Phase 2 baskets and indices (which are not otherwise exempted) will be included.

- 48. There are numerous other issues which are not summarised in this section but are discussed in detail in the paper.
- 49. We seek comments on the questions raised in the paper (which are also listed in Appendix A) as well as comments on related matters that may have a significant impact on the issues. We will consider your comments and will publish the draft subsidiary legislation for public consultation when we publish the consultation conclusions for this paper.



Appendix A

List of Questions

- Q1 Is the use of close out indicators an appropriate method to enhance transparency of short selling in the cash market to the SFC? Please provide reasons.
- Q2 If you believe the use of close out indicators can be adopted, how can we address the limitations that are set out in paragraphs 13 and 14?
- Q3 Should derivatives (both exchange traded and off-exchange transactions) be included in the short position reporting requirements? Please provide reasons.
- Q4 If derivatives are included, which (if any) of the alternatives in paragraph 21 above is the most appropriate? Are there any other practical alternatives? Please provide reasons.
- Q5 If any one of the approaches in paragraph 21 is adopted, should those derivatives be limited to ones that create direct exposures to the stock of the listed company? If so, what are the products that should be excluded (e.g., do you have any views on whether convertibles and other exchangeables should be included?) How should the definition of such derivative be crafted? Please provide reasons.
- Q6 If derivatives are included, should they be included on a delta adjusted basis? Please provide reasons.
- Q7 Should the reporting requirements cover short positions in Designated Securities only rather than in all listed corporations' securities? Please provide reasons.
- Q8 Which of the approaches above (i.e., threshold approach (with initial and subsequent reporting), or periodic reporting (with or without a threshold level) or either the threshold approach or periodic approach with flexibility to tighten the requirements during a contingency situation) would be the most appropriate for short position reporting? Do you have any other suggestions? Please provide reasons.
- Q9 If a threshold approach is adopted, what is an appropriate threshold (and subsequent thresholds) for the Hong Kong market? If periodic reporting is adopted, should thresholds (either a percentage of a listed corporation's issued share capital and/or a dollar value amount) apply? If so, what are appropriate thresholds for periodic reporting? Please provide reasons. If you are a broker or custodian, it would be helpful if you could estimate how many of your clients would be required to file reports if the suggested threshold is adopted.
- Q10 If you agree that short position reporting can be more relaxed during normal market situations and more frequent reporting with tighter threshold(s) may be required in the event of a contingency, what are the circumstances that may amount to a contingency situation (as this may need to be included in the legislation)? Please provide reasons.
- Q11 Are there any reasons why systems for complying with reporting requirements cannot be adjusted in the manner described in paragraph 26(d) above? What are other operational issues that we should consider? Please provide reasons.



- Q12 What are your views on the timing of reporting for the different approaches? Please provide reasons.
- Q13 Should the obligation to report short positions be placed on holders of short positions? Please provide reasons.
- Q14 Should agents be permitted to report information on behalf of holders of short positions with the holders of the positions being held accountable? Please provide reasons.
- Q15 In the case of funds, should the reporting requirements apply to individual funds rather than to the fund manager? Please provide reasons.
- Q16 Do you agree that aggregation requirements should not be imposed on different entities within the same group? Please provide reasons.
- Q17 What are your views on providing in the report to the SFC the net short position and the net position established on the SEHK? Please provide reasons.
- Q18 What are your views on the creation of a template to facilitate electronic reporting through the SFC's website? Please provide reasons.
- Q19 Should the information reported to the SFC be disclosed publicly on an aggregated and delayed basis? Please provide reasons.
- Q20 If the information is published on a delayed basis, what would be the appropriate 'delay' (e.g., on a weekly basis for positions as at the end of the preceding week)?
- Q21 Should the SFC consider any exemptions from the reporting requirements? Please provide reasons.
- Q22 Do you agree that the short position reporting requirements should not be homed in Part XV of the SFO or mirror the Part XV requirements? Please provide reasons.