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Date: 25/01/2002 02:09 PM

Our Ref:

Subject: Comments on SBL Rules

On behalf of the financial institutions named below, I attach a submission on the draft Securities and Futures (Disclosure of Interests - Securities Borrowing and Lending) Rules.

List of Submitting Group Members
Credit Suisse First Boston (Hong Kong) Limited
Deutsche Securities Asia Limited
Goldman Sachs (Asia) L.L.C.
J.P. Morgan
Morgan Stanley Dean Witter Asia Limited
Salomon Smith Barney Hong Kong Limited
UBS Warburg
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Comments on SFC Consultation Paper on the Securities and Futures (Disclosure of Interests - Securities Borrowing and Lending) Rules

The financial institutions listed below welcome the opportunity to comment on the SBL Rules which are proposed to be made under Part XV of the Securities and Futures Bill (Disclosure of Interests) when it becomes law.

Scope of Part XV generally

We have previously made representations to the Government, the SFC and the Legislative Council on the broad scope of Part XV of the Securities and Futures Bill. Part XV of the Bill will substantially increase the existing disclosure requirements in the Securities (Disclosure of Interests) Ordinance, and will make the Hong Kong disclosure regime wider than that in other international markets. In considering whether a person has an "interest" reaching the 5% disclosure threshold, it will be necessary to take into account interests in unissued shares, and positions in cash-settled derivative instruments. It is also necessary to aggregate the "interests" of members of a group of companies at holding company level. Therefore, a financial services group may easily acquire an "interest" above the disclosure threshold simply as a result of its normal business activities (including stock borrowing) without being in a position to exercise control over any of the relevant listed company's shares, and where no stake-building activities are involved.

It will also be necessary for a person with an "interest" reaching the 5% disclosure threshold, to make disclosure of short positions of 1% or more, and changes in the nature of the person's interest. For the purposes of Part XV, a stock borrowing involves acquiring an "interest" in shares, and (unlike in other international markets) is also deemed to create a short position. Therefore, if a financial services group has an aggregate 5% interest, stock borrowing activities may trigger frequent disclosures, as the size of the aggregate long and short positions will fluctuate due to the stock borrowing.

The SFC also regards a lending of stock as a change in the nature of the lender's interest. Therefore (unlike in other international markets) stock lending activities may trigger disclosures by the lender (and its lending agent), even though the lender has a right to recall the stock and its economic interest in the stock remains unaffected.

There are various "de minimis" provisions in the Bill avoiding the need for disclosure in respect of small changes in the amount of a person's interest or short position, or a change in nature affecting only a small part of his interest. However, the de minimis exemptions are complex, and as a practical matter it will be extremely difficult to implement reporting and disclosure systems that take into account the potential availability of those exemptions. Therefore, it is unlikely that the de minimis exemptions will be relied upon in practice. Even if the exemption is relied on, monitoring the overall position to identify any disclosure obligation that may be triggered will add significantly to the compliance costs of dealing in Hong Kong listed shares for all parties concerned.

There is also a provision in the Bill by which the interests of a company, which acts as custodian, investment manager or trustee, do not need to be aggregated with the interests of other companies in the same group. In practice, however, this is unlikely to assist in many cases since custodial functions (including agency lending) are often carried out in a division of a bank or other highly-regulated entity which does not have a main business of conducting a custody business.

Overall, we believe that the new regime will create a negative perception of the Hong Kong market to lenders and investors, and pose a real threat of lenders pulling out of the stock loan market, which could clearly have a negative impact upon the cash and derivatives markets.

We believe that it would be far more satisfactory if, instead of reducing the impact of Part XV in the context of stock lending and borrowing through making the SBL Rules, Part XV was itself amended so as not to require disclosure of short positions, and disclosure of changes in the nature of a person's interests. Also, we believe that, if a custodial business is conducted as a separate division of a bank or other regulated entity, the "interests" held as custodian should be exempt from aggregation with the other interests of the entity and the group even if custody is not a main business.

Even with the benefit of the SBL Rules, the provisions of Part XV of the Bill will still be difficult and expensive to comply with. The volume of information disclosed is unlikely, in our view, to assist investors to make more informed investment decisions, but instead is likely to prove confusing and even misleading to investors, which will not be conducive to attracting new investors to Hong Kong or retaining those already active here.

However, if Part XV is not to be amended further, the SBL Rules are to be welcomed, insofar as they may reduce the number of notifications required to be made by financial institutions as a result of their stock lending and borrowing activities. We have previously had the opportunity to discuss with the SFC the principles underlying the SBL Rules, which we support. Our remaining comments on the draft SBL Rules are as follows:

Interpretation

Section 2 of the SBL Rules is incorrectly numbered as Section 2(1). In Section 2 of the SBL Rules (definition of "approved lending agent"), the cross-reference should be to Section 6 rather than Section 7 of the Rules.

Exemptions for Stock Lenders and their Agents

The exemptions in Section 3 of the Rules are only available to the end-lender (and, if relevant, to any approved lending agent through whom the securities are lent) if the end-lender is an "institutional investor" as defined in Section 2(1) of the Rules.

The definition covers, in summary, banks and insurance companies regulated in Hong Kong or other jurisdictions recognised for the purposes of the SBL Rules by the SFC, and certain types of widely-held and regulated pension schemes, provident schemes and mutual funds. (We are not clear as to the clause of the Bill under which the SFC would approve "approved pension schemes", as referred to in paragraph (b) of the definition of institutional investor, nor what type of schemes would be eligible for approval. We note that certain overseas pension schemes and provident fund schemes would constitute "qualified overseas schemes" within paragraph (e) of the definition in any event. It is not clear whether state pension funds/schemes would constitute "qualified overseas schemes", as generally they (as may be the case with other overseas pension funds/schemes) are not operated by way of business. Also many schemes are incorporated in Bermuda and the Cayman Islands, which may not necessarily be recognised by the SFC.)

We are concerned that banks and insurance companies would only be "institutional investors" if regulated in a jurisdiction recognised by the SFC. We assume that countries (such as Japan) that do not have an MOU with the SFC will not be recognised for this purpose. This may exclude some large stock lenders from the scope of the exemptions. Also, we see no reason why only overseas funds that fall within the definition of "qualified overseas scheme" in Clause 314(4) of the Bill

should be eligible to be treated as institutional investors for the purposes of the SBL Rules. Whilst Clause 314(1)(b) of the Bill creates a complete exemption from Part XV for holders of interests in, and trustees and custodians of, qualified overseas schemes, the SBL Rules do not create a blanket exemption from disclosure, but simply enable a fund to make a general disclosure of the amount of securities it has made available for lending, rather than making disclosure each time stock is lent and returned.

In our view, the definition of "institutional investor" is unduly narrow and excludes various categories of investors which regularly make securities available from their investment portfolio for lending, simply to enhance their investment returns. Stock lending activities are not conducted on behalf of retail investors, but the stock lending desk of a financial institution will have discretionary authority to lend out securities for various categories of clients, which may include the following:

- Clients of the Private Wealth Management division of the financial institution, who may be sophisticated high net worth individuals, or investment holding companies operated by such individuals.
- Governmental institutions and multilateral agencies.
- Institutions such as universities, charitable foundations and trust funds.
- Investment managers of pension schemes and mutual funds that would not fall within the definition of "institutional investor" in the SBL Rules.
- Banks and insurance companies in jurisdictions that may not obtain recognition from the SFC.

It might be argued that lenders such as trust funds which are not "institutional investors" are unlikely to have an "interest" of 5% or more of the issued share capital of a Hong Kong listed company, so Part XV is unlikely to be of concern to them. However, from the point of view of a financial institution acting as an approved lending agent, it may well have discretionary authority from a number of end-lenders to lend an amount of stock that, in aggregate (or, at least, when aggregated with other "interests" of the institution), exceeds the 5% threshold. Only if each end-lender is an "institutional investor" will the lending agent be able to rely on the SBL Rules in respect of the lending pool. It is not practicable to operate two separate lending pools for end-lenders depending on whether they are or are not "institutional investors". We also do not believe that the SFC's suggestion that lending agents should limit the pool of securities available for lending to under 5% is of any practical help, as this still involves complex monitoring and is not conducive to market development.

Therefore the result of the SBL Rules may be that lending agents will either cease to lend out Hong Kong shares at all, or will only be willing to do so for "institutional investors". This could have a significant impact on the volume of Hong Kong stock available for borrowing, with a negative effect on trading volumes and market liquidity, including in particular in the derivatives markets.

The definition of "institutional investor" as currently set out in the SBL Rules is narrower in scope than the definition of "professional investor" as set out in Schedule 1 to the Bill. That definition includes:

- A person carrying on a business of providing investment services, whether regulated in Hong Kong or elsewhere, and whether or not the place in which it is regulated has been "recognized" by the SFC.

- Banks or insurance companies, whether regulated in Hong Kong or elsewhere, and whether or not the place in which the bank or insurance company is regulated has been "recognized" by the SFC.
- Offshore funds (irrespective of whether they would fall within the definition of "qualified overseas scheme" in Clause 314(4) of the Bill).
- Pension schemes operated outside Hong Kong (irrespective of whether they would fall within the definition of "qualified overseas scheme" in Clause 314(4)).
- All companies in a group which includes a bank or investment services provider.
- Governments, central banks and multilateral agencies.
- Any person of a class prescribed by rules made by the SFC (and we understand that the SFC intends to make rules allowing companies, partnerships, trusts and individuals to be treated as "professional investors" as long as the relevant person has an investment portfolio of a certain minimum size).

In our view, consideration should be given to treating any "professional investor" as eligible for the stock lending exemptions in the SBL Rules. If this is thought by the SFC to go too far, then at least the definition of "institutional investor" should be expanded to include:

- all banks and insurance companies
- all offshore funds and pension schemes falling within the definition of "professional investor"
- governments, central banks and multilateral agencies.

As a drafting point, the word "and" at the end of Section 3(3)(b) of the Rules should be deleted.

Borrowing and lending by regulated persons

Rule 4 of the SBL Rules provides an exemption for borrowing and on-lending by a regulated person. For the exemption to apply, the interest in shares must be used, by the regulated person or by a related corporation of the regulated person, for a "prescribed purpose" within 5 business days after the interest was borrowed. A "prescribed purpose" is defined in Section 2 of the SBL Rules as on-lending the interest in shares or using the shares for a stock return.

Under Section 4(3) if an interest in shares is used for the purpose other than a prescribed purpose by a regulated person or by a related corporation of the regulated person, within the 5 business day period, the regulated person is deemed to acquire an interest/short position in the relevant shares.

It is very common for a regulated person to borrow stock and then on-lend it (within 5 business days) to a related corporation which uses the shares to settle a short sale. In these circumstances, the regulated person has used the shares for a prescribed purpose, and therefore the exemption in Section 4 should apply. We assume that Section 4(3) would not be interpreted as having the effect of disapplying the exemption because the securities are used for short selling (i.e. a purpose other than a "prescribed purpose") by the related corporation during the 5 day period. We would be happy to discuss this point further with the SFC.

For overseas corporations to be a "regulated person" they must be licensed or registered in a place recognised by the SFC. We are concerned that this may exclude certain institutions involved in the stock borrowing and lending market that are located in jurisdictions where the SFC does not have a MOU with the local regulator.

Notification by agents

Section 5 of the SBL Rules purports to relieve an institutional investor of the obligation under Clause 312 of the Bill to require the approved lending agent to notify the institutional investor of each lending and stock return effected for the institutional investor.

In our view, Section 5 of the SBL Rules is not strictly necessary, because Clause 312 only applies where a principal authorises an agent to acquire or dispose of "interests" in shares, or to have or cease to have "short positions" on behalf of the principal. When an agent lends shares on behalf of his principal, the principal retains an "interest" in the shares concerned (and, therefore, if any disclosure obligations are triggered this is only because of the change in the nature of the principal's interest). While we have no objection to Section 5 as drafted, in our view it should not be interpreted as meaning that Clause 312 of the Bill applies whenever an agent lends out stock in circumstances where the SBL Rules do not exempt such lending from disclosure. We would be grateful for the SFC's confirmation on this point.

Approvals and records

Section 6 of the Rules gives the SFC power to approve applications to become an "approved lending agent" and to withdraw any approval granted where the SFC "is satisfied that it is appropriate to do so". The SFC is not required to give reasons for any refusal or withdrawal of approval.

Clarification is sought on the criteria the SFC will take into account in considering applications for approval, or withdrawing its approval once given. We consider that reasons should be given for any refusal or withdrawal, and that such decisions by the SFC should be "specified decisions" for the purposes of Schedule 7 to the Bill, enabling an appeal to be made against any such decision to the Securities and Futures Appeal Tribunal.

Finally, whether or not the Bill is amended to enable "interests" held by a custody division of a bank or other financial institution to benefit from an exemption from aggregation, we propose that the SFC should, in the Rules, provide an exemption from aggregation in respect of the "interest" of an approved lending agent.

List of submitting financial institutions

Credit Suisse First Boston (Hong Kong) Limited
Deutsche Securities Asia Limited
Goldman Sachs (Asia) L.L.C.
J.P. Morgan
Morgan Stanley Dean Witter Asia Limited
Salomon Smith Barney Hong Kong Limited
UBS Warburg

If the SFC would like to discuss any of the issues raised in this paper with the above institutions collectively, please contact Pauline Ashall/Alison Fidler at Linklaters, 10/F Alexandra House, 10 Chater Road, Central, Hong Kong.

Tel: 2842 4819/2842 4811

LINKLATERS

年利達律師事務所

LINKLATERS
& ALLIANCE

Memorandum

Date: 22 February 2002

COMMENTS ON THE LATEST DRAFT (FEBRUARY 2002) OF THE SECURITIES AND FUTURES (DISCLOSURE OF INTERESTS - SECURITIES BORROWING AND LENDING) RULES

The change to the Rules so that approved lending agents ("ALAs"), and end-lenders who lend through ALAs, can rely on the simplified disclosure regime set out in the SBL Rules even though the end-lenders is not an "institutional investor", is welcomed. Our further comments are of a fairly technical nature.

Rule 2 - Interpretation

The definition of "qualifying shares" refers to shares which are "given to" an approved lending agent (and Rule 7(1)(b) refers to shares being "returned" to the approved lending agent). Can the SFC confirm that the Rules as drafted are intended to cover the situation where an ALA has responsibility for lending out client securities but the shares are held by a third party custodian (and the borrower would therefore return equivalent shares to the custodian)? For clarity, it may be preferable to amend (b) of the definition of "qualifying shares" to read:

> *... "in respect of which an approved lending agent has authority to lend the shares..."*

Rule 7(1)(b) could be amended to refer to "*shares to which Section 3(2)(ii) applies are returned in accordance with the terms of the relevant agreement.*"

Rule 3 - Prescribed circumstances

Under this Rule, when shares become, or cease to be, qualifying shares or designated shares, this is deemed to be a change in the nature of the relevant person's interest in those shares for the purposes of the Ordinance. (This is also reflected in Section 304(11)(c) of the Bill, although this Section does not require any particular event to be treated as a achange in the nature of an interest - this is only the case if the Rules say so.)

The effect is that a notification, complying with Section 317, requires to be made. Paragraph 3(8) of the Rules proposes to exempt ALAs from providing certain information that might otherwise be required to be included when completing the standard disclosure forms to be issued by the SFC.

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Although Section 304(7A) contains a "de minimis" provision in relation to disclosures of changes in nature of interest, there is still a concern that disclosures will need to be made by end-lenders and ALAs on a fairly frequent basis as the size of the lending pool fluctuates. Also, a difficulty with treating a fluctuation in the size of the lending pool as a change in nature of an interest is that the events resulting in a change in the size of the lending pool will normally also involve an increase or decrease in the size of the interest of the end-lender or approved lending agent (e.g. because shares which were subject to lending authority have been sold). It seems that separate disclosures may therefore need to be made to comply with:

- the provisions of the Ordinance relating to interests in shares and
- the SBL Rules.

From the point of view of the ALA, it would be more satisfactory if shares becoming or ceasing to be qualifying or designated shares was not treated as a change in the nature of the interest, but the Rules simply required that, whenever a disclosure is made in respect of fluctuations in the amount of an interest that includes an interest held as an ALA that disclosure should also indicate the amount currently available for lending.

An alternative approach would be to require the ALA to make a disclosure of a change in nature of interest when the amount of shares available for lending crosses, up or down, the 5% threshold (irrespective of whether this would also trigger a disclosure in respect of the amount of its interest) but not to require other fluctuations to be disclosed. In the case of an ALA, which would only lend out stock in response to market demand, there can be little or no justification for needing to disclose relatively small fluctuations in the size of its lending pool.

Failing the above changes, we consider that Rule 3(8) should also apply to a disclosure made by the ALA in respect of an increase or decrease in the amount of its interest, to facilitate the filing of a single disclosure form. The provisions of Section 317 disapplied by Rule 3(8) seem equally inapplicable to such a disclosure as to a disclosure of change in nature of interest.

From the point of view of an end-lender, we consider that it should also be able to rely on Rule 3(8) when it makes a disclosure as to a change in the nature of its interest pursuant to the Rules. Where, for example, a person with a 6% interest decides to make 3% available for lending, information on the 6% interest (e.g. consideration for which it was acquired) will already have been disclosed. It should not be necessary to have to provide this information again. Also, if the change in the amount available for lending is due to an acquisition or disposal, so that the end-lender will be disclosing a change in the amount of its interest, it should be possible to make a single disclosure in the standard way but simply adding to the disclosure form a note on the amount of the interest which is available for lending.

Finally, we consider that the provisions of Section 317 referred to in Rule 3(8) should include Section 317(6).

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Rule 5 - Notification by agents

We consider that, consistent with the changes made to Rule 3, Rule 5 should refer to "a person" and not only to an "institutional investor".

Rule 7 - Records to be kept by approved lending agents

See minor comment on Rule 7(1)(b) as set out above.

We would be happy to discuss these comments further with the SFC.