

Mr Mark Dickens,  
Securities and Futures Commission.

24<sup>th</sup> January, 2002.

Dear Mark,

We have read with interest the consultation document published by the Securities and Futures Commission (SFC) on the proposed Securities Borrowing and Lending Rules, which will be part of Part XV (Disclosure of Interest) of the Securities and Futures Bill.

As an agent lender, we are concerned that the implementation of the proposed disclosure requirements for substantial shareholders may result in a further reduction of liquidity in the Hong Kong securities lending market. We appreciate that the disclosure requirements only effect those lenders holding 5% or greater of a security, however we are concerned that our clients, who are the beneficial owner and ultimate lender, may find the additional monitoring and reporting requirements to be too onerous, and determine that the risk of non-compliance, which carries criminal liability, is too great relative to the ever diminishing returns available in the Hong Kong market. As such, they may choose to cease to lend their Hong Kong securities.

For us, as a global custodian, criminal liability would have a significant effect in our ability to retain existing clients and to gain new clients throughout the world. We have not yet determined if continued participation in Hong Kong securities lending is worth the risk of the proposed rules.

Additionally, to the best of our knowledge, no other market in the world requires the reporting of securities lending transactions of substantial shareholders. Frankly, we do not view, nor does any other country view disclosure of securities lending transactions of substantial shareholders to be of any material value to investors. As securities lending is an activity that is widely accepted, in fact encouraged by The Group of 30, we would anticipate that in due time significant, if not a majority, of the securities float in Hong Kong and other markets will be made available to lend.

The simplified disclosure regime available to “institutional investors”, “approved lending agents” and “regulated persons” is not available to the full range of participants currently involved in securities lending in Hong Kong.

The definition of “institutional investor” does not include government organisations or supernationals. These types of lenders would need to apply to the SFC to be eligible for the simplified disclosure regime. It appears that this application process would be subject to public record, and as such these lenders may not wish to go through this application process, which may result in them ceasing to lend their Hong Kong securities. Government organisations, in particular, have historically been a significant source of Hong Kong securities, and as such their exit from lending would negatively impact liquidity in the Hong Kong market.

As part of our service as a custodian, we will always attempt to advise our clients of regulatory changes and help them understand the implications. Due to the complexity of the disclosure requirements, we would find it difficult to provide them with definitive advice as to what they need to do to ensure compliance.

It must also be noted that the SFC already has already introduced a number of other reforms as part of the "30 point short selling paper" introduced in 1998, which have had a negative impact on the liquidity of the Hong Kong securities lending market. One of the most notable is the requirement of lenders to issue hold and loan confirmations to borrowers before they can short sell in the market. This confirmation process not only slows down the whole process, but the criminal liability for non-compliance also makes Hong Kong an unattractive market to participate in. The removal of this confirmation requirement would be a significant step in reviving the index arbitrage strategies that were prevalent up until mid 1998.

As a corporation we feel that Hong Kong is a market of great opportunity. To encourage further investment in Hong Kong, especially from the increasing number of hedge funds that looking for places to invest, Hong Kong needs to look at relaxing some of their short selling and securities lending rules instead of increasing them. The hedge fund community needs to be supported by an efficient and liquid securities lending market. The disclosure requirements in Part XV of the Securities and Futures Bill, even with the simplified disclosure regime is only adding to the already onerous reporting requirements.

Please feel free to contact myself or David Timpany in our Hong Kong office if you would like to discuss our concerns further.

Yours faithfully,

Richard B. Bentsen

Senior Vice President,  
The Northern Trust Company,  
and Chairman, RMA Committee on  
Securities Lending.