

LEGISLATIVE COUNCIL BRIEF

Securities and Futures Ordinance (Cap. 571)

SECURITIES AND FUTURES (SHORT SELLING AND SECURITIES BORROWING AND LENDING (MISCELLANEOUS)) RULES

INTRODUCTION

Pursuant to section 397 of the Securities and Futures Ordinance (Cap. 571) (the SFO), the Securities and Futures Commission (the SFC), after consultation with the Financial Secretary, has made the Securities and Futures (Short Selling and Securities Borrowing and Lending (Miscellaneous)) Rules (the Rules) at the **Annex**.

BACKGROUND

The SFO

2. The SFO was enacted in March 2002. It consolidates and modernizes ten existing ordinances governing the securities and futures markets into a composite piece of legislation to keep the regulatory regime on a par with international standards and practices. For effective regulation, the SFO has already provided flexibility in addressing changing market practices and global conditions by empowering the Chief Executive in Council, the Financial Secretary, the Chief Justice and the SFC to prescribe detailed and technical requirements as necessary by way of subsidiary legislation, to supplement the regulatory framework laid down under the primary legislation.

3. On 22 February 2002, the House Committee of the Legislative Council established the Subcommittee on Draft Subsidiary Legislation to be made under the Securities and Futures Ordinance (the Subcommittee) to study the subsidiary legislation necessary for commencing the SFO. From March 2002 to October 2002, the Subcommittee held 12 meetings and considered a total of 37 sets of draft subsidiary legislation, including the *vires* to make them.

THE PROPOSALS

Major policy considerations

4. Earlier this year, the SFC engaged market participants in its efforts to identify possible areas of relaxation with a view to facilitating market development, enhancing liquidity and reducing compliance burden. In particular, some market participants have asked for extended and new exemptions in respect of the prohibition against naked short selling under section 170(1) of the SFO and the requirements to confirm short selling orders under section 171 of the SFO. The SFC, taking into account comments from market participants and in consultation with the Hong Kong Monetary Authority (HKMA), has put forward a number of proposals that will help achieve the aforesaid objectives without posing additional risks to the stability of the market or compromising the regulators' ability to monitor market volatility. Proposals covered in the Rules are set out in paragraphs 6 and 7 below.

The Securities (Miscellaneous) (Amendment) Rules 2002

5. The proposals outlined in paragraphs 6 and 7 below have also been effected through the recently made Securities (Miscellaneous)(Amendment) Rules 2002 which came into effect on 15 November 2002. The making of the Securities (Miscellaneous) (Amendment) Rules 2002 ahead of the Rules was to enable market participants to benefit from the relaxation measures as soon as possible.

Extended exemption from section 170

6. Section 170 of the SFO prohibits the selling of securities through a recognized stock market unless the seller (where selling as an agent, the principal) has, or believes and has reasonable grounds to believe that he (where selling as agent, his principal) has a presently exercisable and unconditional right to vest the securities in the purchaser of them. There were certain exemptions already granted under existing law. The SFC proposes to eliminate the inconsistencies which until recently existed under current law (prior to the making of the Securities (Miscellaneous) (Amendment) Rules 2002) and extends the exemption so that "on-exchange" market making and hedging transactions of all classes of market makers registered with the Stock Exchange of Hong Kong Limited (the SEHK) or the Futures Exchange Limited will be exempted.

Moreover, the exemptions for market makers registered with the SEHK will also be available to issuers of structured products like derivative warrants and equity linked notes/instruments.

New exemption from compliance with section 171

7. Section 171 of the SFO prescribes the reporting obligations for sellers (principals, exchange participants selling as principal, and agents) of a “short selling order”¹. Sellers (as principal, exchange participant selling as principal, or agent) are required to, at the time placing or receiving (as the case may be) a “short selling order”, confirm that it is a “short selling order” and that the sale is “covered”. An agent receiving a “short selling order” is required to obtain a documentary confirmation that the order is a “short selling order” and that it is “covered” from the seller prior to transmitting the order. The Rules provide that sellers, instead of complying with the requirements prescribed in section 171, can comply any of the three methods of reporting prescribed in section 4 of the Rules.

THE RULES

8. Section 2 contains interpretation provisions that apply throughout the Rules.

9. Section 3 prescribes classes of transactions to which the prohibition against naked short selling under section 170(1) of the SFO (paragraph 6 above) does not apply, namely –

- (i) sales of specified securities (exchange fund bills and notes and specified instruments) by HKMA appointed market makers and agents of these market makers; and

¹ A “short selling order” is an order to sell securities where the seller’s (if selling as an agent, the principal) presently exercisable and unconditional right to vest the securities in the purchaser of them is either by way of a borrowing under a securities borrowing and lending agreement or where the seller holds an option or other instrument which confers a right on him to acquire the securities to which the order relates.

- (ii) sales of securities in the course of “jobbing business”².

10. Section 4 provides that sellers (principals, exchange participants selling as principal, and agents) are not required to comply with the requirements to confirm short selling orders under section 171 of the SFO (paragraph 7 above), if, generally, they provide or receive (as the case may be) an oral assurance that the order is a “short selling order” and that it is “covered” at the time the order is placed or received (as the case may be); and -

- (a) a time-stamped document of the assurance with prescribed particulars is available;
- (b) a tape-recording of the assurance is available; or
- (c) a documentary confirmation of the assurance is available by the end of the day it was given.

Records (including documents and tape recordings) made or kept under section 4 are required to be retained for one year and produced to the SFC upon request.

² Section 3(2)(a) to (c) sets out the types of transactions which constitute ‘jobbing business’ for the purpose of the Rules. They are -

- (a) a sale of a security by a Stock Exchange of Hong Kong Limited (SEHK) market maker in the course of performing market making activities for that security (the market maker is required to acquire the right, within the next trading day, to vest the securities he has sold in the purchaser of them);
- (b) a sale of a security (“A”) for the purpose of hedging a market making position in another security (“B”) by a SEHK market maker as long as A and B are related (this would include where A is a component of B, or vice versa, or where A and B both have a third security as a common component); or
- (c) a sale of security (“C”) for the purpose of hedging a market making position in a futures contract by a Hong Kong Futures Exchange (HKFE) market maker as long as C and the futures contract position being hedged are related (this would include where the futures contract is in respect of C or an index of securities which includes C, or, where the futures contract is in respect of another security (“D”) and D has a common component with C).

11. Section 5 requires lenders of securities under a stock borrowing and lending agreement to record specified particulars relating to the lending transaction (including the giving of a blanket assurance, hold or a borrow) in a document. The document is required to be kept for one year and provided to the SFC upon request.

PUBLIC CONSULTATION

12. On 24 May 2002, the SFC released a consultation document and an exposure draft of the Rules for comments by the public. A total of five submissions were received. The SFC has considered all the comments received, including subsequent comments received as part of a continuing dialogue with certain respondents, and has revised the draft Rules as appropriate.

13. A draft of the Rules was considered by the Subcommittee at its meeting held on 15 July 2002. No major concerns were expressed by members of the Subcommittee at the meeting.

FINANCIAL AND STAFFING IMPLICATIONS

14. There are no financial or staffing implications for the Government.

COMMENCEMENT DATE

15. The Rules will come into operation on the day appointed for the commencement of the SFO, together with other subsidiary legislation necessary for the commencement. We expect this to take place shortly, after completion of the negative vetting procedure through the Legislative Council and allowing the industry a reasonable period of time for making necessary adjustments with reference to the subsidiary legislation. We aim to announce the target commencement date by the end of 2002.

PUBLICITY

16. The Rules will be published in the Gazette on 13 December 2002. The SFC will issue a press release on the same day.

ENQUIRIES

17. For any enquiries on this brief, please contact Ms. Alexandra Yeong of the Supervision of Markets Division of the SFC at 2840 9247 or Ms Mary Ahern of the Legal Services Division of the SFC at 2283 6809.

The Securities and Futures Commission
13 December 2002