

Letterhead of The Pan Asian Securities Lending Association Ltd.

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The Secretary to the Bills Committee on the
Securities and Futures Bill,
Legislative Council,
8 Jackson Road,
Hong Kong.

May 18th, 2000

Dear Sirs,

The Pan Asian Securities Lending Association Ltd (PASLA) is an association of firms that are active in the business of borrowing and/or lending securities of Asian markets. At present, there are 33 member firms, 17 of which are represented by their company's Hong Kong offices, with the 16 other members domiciled across six other countries - Singapore, Japan, Australia, the U.K., and the U.S.

Over the last few months PASLA has been in discussions with the SFC and FSB, in conjunction with Linklaters, about the proposed legislation of Part XV of the Securities and Futures Bill (Disclosure of Interest). As a result of the discussions, we feel that the SFC and FSB have a much clearer understanding of our business and the potential impact that the proposed legislation, in its current form, would have.

As Part XV of the Bill is currently under review by the Bills Committee, PASLA would like to take this opportunity to represent our views and concerns about the proposed legislation.

Firstly, none of the other global financial markets that have a formal securities lending market treat securities lending as a discloseable event. The beneficial owner/lender of the security receives, and the borrower pays the economic equivalent of the security, including all dividends, corporate actions and market performance. Additionally, the lender of a security does not, in principle, lose the right to vote the shares as they can recall the shares at anytime. All share positions are fungible, and as such, it is our view that there is no change in the nature of interest.

From the point of view of an agent lender, we also believe that there is no change in the nature of an interest when stocks are loaned and recalled. Any "interest" of the agent lender simply arises from the authority to lend and recall stocks, and this authority remains in place throughout the securities lending transaction.

We would also like to point out that this view is in keeping with the provisions of the short selling regulations. A lender of shares who sells the loaned shares is not considered short due to the right to recall the shares at any time.

We also have concerns on the position of the borrower. We understand that the SFC considers that a borrower acquires, simultaneously, a long and a short position in the borrowed stock, with the long position being immediately disposed of when the stock is delivered out to settle a short sale. Assuming that disclosure thresholds are exceeded, every borrowing and recall would therefore trigger 6 disclosures by the borrower. This is very onerous, and potentially confusing to the listed corporation concerned and to the market. At most, we believe that a borrower should be treated as acquiring a short position, which is disposed of when equivalent stock is redelivered to the lender.

It might be useful to illustrate common transactions in the securities borrowing/lending (SBL) and related markets that would trigger disclosure, but not provide meaningful information. In the examples below we make the assumption that disclosure levels have been exceeded.

Fail Coverage requires borrowed stock to settle a sale where the shares to be delivered are not yet available. Typically, fail coverage occurs due to retail or institutional sellers, who are long the security not having input instructions to deliver because of time zone constraints and operational mistakes. The effect of fail coverage is to make for a much more efficient market, and was in fact the original reason for the development of an SBL market. These are normally very short term, and can be as short as one day.

Refinancing of existing stock borrows occurs without a new sell or buy-cover taking place in the market. The borrower of shares may return them to one lender and replace it with a borrow from another lender at a cheaper rate.

Recalls by a lender will force a borrower to either purchase back the shares or more often than not find another lender of the same shares. The borrower will return the shares to the lender that initiated the recall and borrow these shares from a different lender.

Equity Repo, reverse repo's, buy-sell backs are frequently used tools to finance long equity inventory. The principal reason for the transaction is to raise cash, utilising long stock that is pledged as collateral. Creditworthiness and liquidity determine the haircuts on the stocks. Please note that the driving reason to execute this transaction is to raise cash off long equity positions, and not to adjust one's exposure to the relevant equities.

Reallocations by Lender take place when shares loaned to a borrower from a specific underlying beneficial owner must be replaced by shares from a different beneficial owner, due to a sale by the original beneficial owner. In this instance both beneficial owners would need to report movements of their securities, but the borrower's position would remain the same, and is unaware that the shares originally borrowed have now been replaced.

Structured Financing. It is commonplace in the market to structure financing transactions where the underlying client retains exactly the same economic performance but in a derivative form. The purpose of the underlying transaction is to finance the long equity position and the client retains the interest, albeit in a different form. While the derivative may create disclosure obligations under the new law, it is unnecessary and confusing if the delivery of stock as collateral under the derivative itself triggers a disclosure obligation.

OTC Swaps, contract for differences are synthetic variants of a stock loan and therefore the lender or seller retains the right to recall the securities at any time and owner accrues all the economic benefits. Again, the transfer of stock under the swap should not of itself create a separate disclosure obligation.

Securities for Futures and Options margin collateral, while we understand this is currently being contemplated, it would be complicated if disclosures were required for the securities that were moved for margin purposes. Furthermore, in an index arbitrage situation, it is commonplace for the long securities to be repo'd in the market to raise cash to pledge as collateral. In all these instances the stock lending and borrowing is secondary to the economics driving the trade

It can be seen from the above examples that there is potential for a large amount of "irrelevant" reporting.

In summary, we have urged the SFC/FSB to accept the view that a securities lending transaction does not effect a 'change in the nature of interest' for the lender, in view of their right of recall. Our concern is that lenders may decide that the increased risk of non-compliance due to disclosure requirements out weigh the profitability of their Hong Kong lending activities, and decide to reduce or even cease to lend their Hong Kong securities.

Additionally, the broad number of transactions that trigger disclosure reporting for a borrower as well the complexity of the disclosure obligations, will create an administrative burden for the market which, from an economic viewpoint, could potentially make it difficult to continue the business, especially when criminal liability is involved.

In this light, we feel that the treatment of SBL in Hong Kong should be consistent with other global financial markets to ensure that liquidity and volume remain in the Hong Kong market.

PASLA welcomes the opportunity to continue working with the SFC/FSB to come up with legislation that provides broader exemptions from disclosure for securities borrowing and lending activities of both lenders and borrowers, whilst providing the market transparency the SFC/FSB is seeking. Furthermore, PASLA would be happy to discuss these issues further directly with the Bill Committee if you so wish.

For and on behalf of the Pan Asia Securities Lending Association.

Delyth Thomas, Chairman
Robert Cleasby
Ian Smith
David Timpany